Kentucky Bankers Association
600 West Main Street, Suite 400, Louisville, KY 40202
502.582.2453 fax 502.584.6390 | kybanks.com

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SENT VIA FIRST CLASS MAIL AND E-MAIL

Board of Governors of the Federal Reserve
Ann E. Misback, Secretary, Board of
Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Email: regs.comments@federalreserve.gov

Re: Notice of Proposed Rulemaking: Notice of Proposed Rulemaking Regarding Debit Card Interchange Fees and Routing, Docket No. R-1818 or RIN 7100-AG67.[1]

Dear Board of Governors of the Federal Reserve System,

The Kentucky Bankers Association (KBA) is pleased to submit this response to the Notice of Proposed Rulemaking (the "Proposal") from the Board of Governors of the Federal Reserve System (Fed), which seeks comments on its proposal to reduce interchange fees under Regulation II.[2]

"Under the current rule, for a debit card transaction that does not qualify for a statutory exemption, the interchange fee can be no more than the sum of a base component of 21 cents, an ad valorem component of 5 basis points multiplied by the value of the transaction, and a fraud-prevention adjustment of 1 cent if the issuer meets certain fraud-prevention standards." Under the Proposal, "the base component would be 14.4 cents, the ad valorem component would be 4.0 basis points (multiplied by the value of the transaction), and the fraud-prevention adjustment would be 1.3 cents for debit card transactions performed from the effective date of the final rule to June 30, 2025.[3]

"The data collected by the Board from large debit card issuers since the original Regulation II rulemaking show that the costs incurred by large debit card issuers in connection with debit card transactions have changed significantly over time. In particular, the costs on which the Board based the base component have nearly halved, the issuer fraud losses on which the Board based the ad valorem component have fallen, and the fraud-prevention costs on which the Board based the fraud-prevention adjustment have risen, according to key metrics of those costs. As a result, the Board believes that the current interchange fee standards may no longer be effective for assessing whether, for a debit card transaction subject to the standards, 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. Further, the Board believes that the current fraud-prevention

[1] Board of Governors of the Federal Reserve System, Notice of Proposal Rulemaking: Notice of Proposed Rulemaking Regarding Debit Card Interchange Fees and Routing, 88 Federal Register, Page 78100, November 4, 2023.
[2] Proposal, page 78100.
[3] Proposal, page 78100.

adjustment may not reflect an amount that is reasonably necessary to make allowance for costs incurred by the debit card issuer in preventing fraud in relation to debit card transactions involving that issuer," (the "Purpose").[4]

After consulting with representatives from the Kentucky Bankers Association's one hundred and fifty-four (154) member institutions ranging in asset size from twenty-one million dollars ($21,000,000) to over three hundred and seventy billion dollars ($370,000,000.00), the Kentucky Bankers Association submits its comments to the Proposal as set forth below.

1. The Proposal is Misguided

A. The Proposal is Based on Merchants' Support and Not Data

The Proposal is based on nothing more than mere guesses as to the effects of the proposed rule. Simply put, nothing should be changed when the Proposal has no substantive data to support its adoption. For that reason alone, this Proposal must not be adopted.

In the Proposal, the Fed states, "The Board believes that the primary way in which the proposal would impact merchants is by lowering their costs of accepting debit card transactions. The proposal would generally decrease the interchange fee paid by an acquirer (i.e., a merchant's depository institution) on an average transaction performed using a debit card issued by a covered issuer, which would in turn decrease a merchant's costs by decreasing the merchant discount that the merchant pays to its acquirer for a debit card transaction. ***Although the precise extent to which acquirers would pass on savings from lower debit card interchange fees to merchants may vary, competition between acquirers in the industry should generally result in acquirers passing on savings from lower interchange fees to their merchant customers***."[5]

"Merchants that experience a decrease in the costs of accepting debit card transactions ***may*** pass on some or all these savings to consumers in the form of lower prices, foregone future price increases, or improved products or services. The extent to which merchants would pass on such savings to consumers ***may*** depend on many factors. For example, merchants in more competitive markets would be likely to pass on more of their cost savings to consumers compared with merchants facing less competition."[6]

"***Measuring the extent to which merchants pass on cost savings to consumers, including any decrease in the costs of accepting certain forms of payment, is generally difficult***. Efforts to measure the extent to which merchants passed on to consumers any savings associated with the decrease in the costs of accepting debit card transactions in the period following the adoption of the current interchange fee cap in 2011 have yielded a wide range of results. For example, in response to a survey conducted soon after the introduction of the interchange fee cap, merchants did not consistently report making adjustments to their prices in response to the interchange fee cap. By contrast, later research efforts analyzing data from longer time periods found evidence that merchants passed on to consumers a portion of their debit card acceptance costs (e.g., by adjusting their prices) and that the degree of pass-through depended on merchant size."[7]

"Finally, the decrease in costs of accepting debit card transactions ***may*** incentivize some merchants that until now have not accepted debit cards as a form of payment to begin

[4] Proposal, pages 78100-78101.
[5] Proposal, pages 78114-78115 (emphasis added).
[6] Proposal, page 78115 (emphasis added).
[7] Proposal, page 78115 (emphasis added).

doing so. In particular, while debit card acceptance is already high for most in-person transactions, the proposal ***may*** encourage greater adoption of debit cards in market segments where acceptance may be lower, such as card not-present (e.g., ecommerce) transactions. Another market segment for which merchants ***may*** increase debit card acceptance are small-dollar purchases because, for this market segment, the proposed decrease in the base component would substantially reduce debit card acceptance costs as a proportion of the transaction value. Faced with lower debit card acceptance costs, some merchants ***may*** also look to provide incentives to their customers, or otherwise steer them, to pay with debit cards over alternative payment methods."[8]

In short, the only thing the Fed knows will happen if the Proposal is adopted is that debit card interchange fees will decrease. Everything else hinges on the word "may." Consumers may save money. Retailers may keep the money for themselves (most likely). It is hard to contemplate why the Fed would issue a proposed rule based on nothing more than mere guesses; however, when you look at the background of the Proposal it shows that the Fed has simply been lobbied to issue this Proposal.

Footnote 35 discusses these lobbying efforts of merchants stating, "In December 2022, two trade associations representing merchants submitted a rulemaking petition to the Board regarding the interchange fee standards in Regulation II. Specifically, the petitioners requested that the Board initiate a rulemaking to lower the base component from 21 cents to 9.7 cents, and eliminate or substantially reduce the ad valorem component and the fraud-prevention adjustment. The Board views the rulemaking petition as an additional consideration related to the proposal; however, the Board's rationale for the proposal is discussed in this section III.B."[9]

The bottom line is that this rulemaking begins and ends with merchants. It is concerning that the Fed payments team met with convenience stores[10] to review their petition[11] for this rulemaking, while simultaneously declining, deferring, or failing to respond to several similar meeting requests from financial sector groups[12] to address the petition's misleading content before a rulemaking was undertaken. Instead, the Fed continued with the Proposal without hearing from the financial sector.

Before issuing the Proposal, the Staff Memo to the Board of Governors of the Fed 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."[13] Again, the Fed, at the bequest of the merchants, operated on the premise that there may be some savings to the consumer; nothing based on empirical data or actual evidence.

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[8] Proposal, page 78115 (emphasis added).

[9] Proposal, page 78105.

[10] 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

[11] 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

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

[13] 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

What we do know is that this Proposal will harm the financial sector. Stifel Nicolaus analyst Chris Brendler told *TheStreet* that, "TCF Financial is one of the highest exposed as 10% of their revenue comes from interchange, adding that it would be difficult for them to compete and they don't have the synergy and scale."[14]

Richard Bove with Rochdale Securities described this form of Proposal as, "A bunch of hysterical politicians that are trying to help consumers in the wrong way. I doubt if you went into a Walmart you will see a 30-cent reduction on debit card transactions as merchants are just going to profit at consumers' expense."[15]

While the financial sector is vehemently opposed to the Proposal as seen in *TheStreet*, the concern lies not only with the financial sector but also Governors of the Board of the Federal Reserve.

Governor Michelle W. Bowman of the Federal Reserve stated, "In my view, before engaging in a significant regulatory proposal, it is critical to reflect on the broader context, and understand the potential consequences of the revisions. While the proposal suggests that it could result in benefits to consumers, I am 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— may not be realized."[16]

"The debit card payments ecosystem is a vitally important part of the overall payment infrastructure in the United States, and as staff has noted according to the most recent industry data collection from 2021, debit cards remain the most popular form of noncash payment. When we are considering proposed changes to the fees that support this important form of payment, we 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."[17]

"While today's rule acknowledges the varied size, business models, and product offerings of banks subject to the interchange fee cap, the fee cap aims to achieve "rough justice" by establishing a single cap that applies to all covered issuers. This fee cap is the product of aggregated data reported by issuers."[18]

"Both setting a single cap for all issuers and basing that cap on data reported by a wide range of issuers is regressive in several ways. Larger issuers—those with the highest transaction volumes, greater negotiating power, and the most efficiencies that come from scale—will continue to have a significant competitive advantage under this rule. Even the lower interchange fee may allow them to continue profitably operating their debit card programs."[19]

"By contrast, smaller issuers subject to the cap—those with smaller transaction volumes, less negotiating power, and fewer efficiencies in scale—may be at a significant competitive disadvantage. Because retail banking is such a core function for many smaller issuers, this pricing dynamic may not ultimately force smaller issuers to abandon their debit card programs. But it is possible that banks will be forced to either pass costs through to customers or operate their debit card programs as a loss leader, which many banks do today. Under the proposed rule, nearly one-third of bank issuers would not be able to

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[14] Maria Woehr, *10 Banks with the Biggest Fee Worries*, THESTREET, April 7, 2011.
[15] *Id*.
[16] Governor Michelle Bowman, *Statement on Proposed Regulation II's Interchange Fee Cap by Michelle W. Bowman*, October 25, 2023.
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recover even the subset of costs that factor into the interchange fee cap, let alone those debit card program costs that are disregarded in the cap. Because debit card programs are important to the functioning of the payments system, any increase in price or reduction in availability of debit cards could be harmful for bank customers, particularly low-income customers who may not qualify for credit card products or other alternatives."[20]

"The proposal also acknowledges that a lower interchange fee cap will result in an ongoing, permanent decrease in gross revenue from interchange fees. This consequence will be felt at banks of all sizes. While the banking system remains strong and resilient, I am concerned that the cumulative effect of regulatory changes—including a lower interchange fee cap, higher capital requirements, new debt-funding requirements, increasing data collection requirements, and many others—could pose ongoing risks to the health of certain financial institutions and the overall U.S. banking system."[21]

"While banks charging fees for services has been criticized by some regulators, in many instances, these fees support a bank's ability to offer low-cost or no-cost banking products or services to customers. It is difficult to predict the impact of this rule on bank product offerings, but one consequence may be that banks discontinue their lowest-margin products, including options designed to increase financial inclusion and access for low- and moderate-income individuals and families. I sincerely hope that this is not the case, but this is a real and important risk. While the newly revised CRA rules create incentives for banks to offer responsive deposit products, other rules should not impede ongoing progress to improve broader financial product access and availability."[22]

"Before finalizing any rule, it is incumbent upon policymakers to understand the intended and unintended consequences of our revisions. This is particularly important when we are talking about vital payment tools like debit cards."[23]

The Proposal admits that, "The primary way in which the proposal would affect covered issuers would be by lowering their revenue from debit card transactions. In particular, covered issuers' interchange fee revenue would decline as the proposal would decrease the average interchange fee they collect on debit card transactions subject to the interchange fee standards."[24]

What we know is that the Proposal will harm those in the financial services industry. Will those savings be passed on to consumers? That is highly doubtful as set forth *supra*. Nonetheless, definitively damaging the financial industry at the surmise of potentially benefitting consumers is not enough to justify adopting the Proposal.

For these reasons, the KBA disagrees with the Proposal and urges the Fed to not adopt the Proposal.

B. Consumers Disagree That They Will Benefit from the Proposal

The Proposal is based on the premise that consumers "may" and consumers "could" benefit from the Proposal. However, consumers disagree that the Proposal will have that effect.

"As discussed above in the context of effects on merchants and debit card issuers, the proposal could affect consumers in two main ways. On the one hand, consumers could benefit if merchants pass on savings associated with the decrease in costs of accepting debit card transactions in the form of lower prices, forgone future price increases, or

[20] *Id*.
[21] *Id*.
[22] *Id*.
[23] *Id*.
[24] Proposal, page 78115.

improvements in product or service quality. On the other hand, consumers could be negatively affected if covered issuers increase fees on debit cards or checking accounts, or make other adjustments that make these products less attractive to consumers."[25]

"The net effect on consumers, both individually and in the aggregate, will depend on which of these two effects predominates, which would in turn depend on many factors and is thus difficult to predict. As noted above, merchants in more competitive markets would likely pass on a larger portion of their cost savings to consumers. In a similar way, in response to declines in interchange fee revenue, covered issuers in more competitive markets would be less likely to increase fees or make other changes that negatively affect consumers. Covered issuers that face strong competition from exempt issuers may be less likely to raise fees, as doing so could increase the probability that customers switch to these competing institutions."[26]

"In addition, the effect of the proposal could differ between particular classes of consumers in several ways. First, if the proposal results in merchants further increasing debit card acceptance (e.g., for card-not-present transactions), consumers' ability to make such payments could increase, generating benefits to consumers without access to alternative non-cash payment methods, such as credit cards. Second, if the proposal results in covered issuers increasing fees, banking services could become less accessible to lower-income consumers who may be more sensitive to such fees."[27]

In short, the Proposal admits that it may ***harm*** consumers. Merchants may not pass on savings to consumers, and consumers may pay more and have less services while those in the financial sector are also harmed. Even more concerning is that those with low to moderate income may be harmed; a key demographic that regulatory agencies have sought to protect in other rulemaking.

This begs the question of how consumers really feel about the Proposal. Consumer response has not been positive.

According to Independent Consumer Banking Association polling conducted by *Morning Consult*:

- Two-third of adults (66%) — including 72% of Democrats and 67% of Republicans — say big-box stores would likely choose cheaper, less secure networks to process credit card transactions;
- Nearly 7 in 10 adults (69%) say merchants would likely keep their cost savings for themselves;
- A majority of adults — including 54% of Democrats and 60% of Republicans — say consumers are likely to bear the costs of the technology changes; and
- Most adults say these changes would have a negative effect on inflation (56%) and the economy (55%).[28]

Based on this study, the majority of consumers believe that they will not benefit from amendments made to the interchange system. The only clear beneficiary of the Proposal is merchants. A unilateral benefit to merchants is not a reason to adopt the Proposal.

For these reasons, the KBA disagrees with the Proposal and urges the Fed to not adopt the Proposal.

C. The Solution of Higher Fees is Not Tenable

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[25] Proposal, page 78116.
[26] Proposal, page 78116.
[27] Proposal, page 78116.
[28] Nicole Swan, *Polling Shows Americans Oppose Durbin-Marshall Credit Card Routing Mandates*, April 7, 2024, Polling Shows Americans Oppose Durbin-Marshall Credit Card Routing Mandates (icba.org).

The Proposal is clear that those in the financial services industry will be harmed by the Proposal. What is more curious is the Fed's suggestion to remedy this harm by increasing fees.

The Proposal states, "Faced with lower interchange revenue from debit card transactions, covered issuers ***may offset some or all lost interchange fee revenue through a combination of customer fee increases*** and issuer cost reductions (e.g., improvements to transaction-processing efficiency)."[29]

The mere suggestion that adopting this Proposal may require those in the financial services sector to increase fees to consumers is hard to fathom. Fees of all forms have been attacked by the Consumer Financial Protection Bureau and others have been heavily scrutinized. It is difficult to fathom that prudential regulators would approve increased fees to offset these losses to the financial sector given its current position on fees such as overdraft. Simply put, the mere suggestion that increasing fees as a solution to this Proposal seems disingenuous at best in the current regulatory environment.

For these reasons, the KBA disagrees with the Proposal and urges the Fed to not adopt the Proposal.

2. The Proposal is Based on a Flawed Premise

The Proposal states, "To ensure that, for a debit card transaction subject to the interchange fee standards, the amount of any interchange fee received or charged by a debit card issuer is reasonable, the Board proposes a cost-recovery target of 98.5 percent of covered issuer transactions, which corresponds to a fixed multiplier of 3.7 based on the cumulative data collected from covered issuers since 2009. The Board believes that this cost-recovery target, and the base component that would result from multiplying this fixed multiplier and the transaction-weighted average of per transaction base component costs, is reasonable because it would allow covered issuers to fully recover their base component costs over time for a significant majority of covered issuer transactions. At the same time, this target acknowledges that full cost recovery for the highest-cost covered issuer transactions would not be reasonable."[30]

In short, the Fed is proposing a below break-even analysis for interchange or, otherwise stated, a product losing money.

It is hard to believe that the Fed truly believes that the financial sector will continue to offer debit card services if they are losing money on the product. According to basic economics, if something loses money; you stop doing it.

In terms of general bank regulation, how is it a safe and sound practice to remain in a product with essentially a guaranteed best return of breaking even? The answer to that would be up to the prudential regulators, but it would not be consistent with their positions on other products.

Furthermore, as seen *infra*, there are already concerns that this Proposal will have negative impacts on low- to-moderate income families. When aggregated with the Consumer Financial Protection Bureau's proposed rule on overdraft and late fees, this could cut off debit card usage in its entirety for large sectors of consumers.

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[29] Proposal, page 78115 (emphasis added).
[30] Proposal, page 78107.

With the guaranty that banks will not make money on interchange and without the assurance that merchants will pass savings on to consumers, this Proposal cannot proceed.

For these reasons, the KBA disagrees with the Proposal and urges the Fed to not adopt the Proposal.

3. The Fed Should Follow the Small Business Regulatory Enforcement Act (SBREFA)

In the rulemaking process, the Fed did not follow additional procedures set forth by SBREFA in issuing this rulemaking because only banks with less than $850 million in assets are considered small entities.

SBREFA mandates that: "(1) federal agencies establish a policy or program that reduces and waives civil penalties for violations of a statutory or regulatory requirement by a small entity; (2) the SBA Administrator designate a Small Business and Agriculture Regulatory Enforcement Ombudsman to receive, investigate, and report on regulatory compliance and enforcement comments and complaints from small business owners; and (3) the SBA Administrator appoint and designate SBA Regional Small Business Regulatory Fairness Boards to:

- review regulatory compliance and enforcement comments and complaints made by small business owners, and
- recommend regulatory improvements to the SBA Administrator and the head of affected agencies;

(4) Federal regulatory compliance rules and guidelines to be written in plain English and readily available to small business owners.[31]

The Fed has essentially stated that since this rulemaking only effects issuers $10 billion or greater, SBREFA does not apply. However, as Governor Bowman notes, this Proposal will affect those much smaller than $10 billion.

"While today's rule only applies directly to a subset of issuers, those with more than $10 billion in assets, I am concerned that the impact of the fee cap and will likely continue to affect a broader range of issuers, including community banks. Virtually all retail banks offer checking accounts and debit cards to their customers, and many of these retail banks are community banks, banks that are intended to be exempt from the interchange fee cap."[32]

"These smaller debit card issuers do not exist in a vacuum. Issuers of all sizes 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 collected since the introduction of the interchange fee cap may have remained largely stable, it is difficult to determine how this compares to the aggregate costs of processing, fraud and fraud prevention, and the many other inputs for running a debit card program. It is not clear that interchange fees have kept up for many smaller issuers, and I am concerned that even if the interchange fee cap does not directly apply, smaller issuers will continue to face ongoing fee pressure in operating debit card programs."[33]

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[31] Small Business Regulatory Enforcement Act (SBREFA) - United States Department of State.

[32] Governor Michelle Bowman, *Statement on Proposed Regulation II's Interchange Fee Cap by Michelle W. Bowman*, October 25, 2023.

[33] Governor Michelle Bowman, *Statement on Proposed Regulation II's Interchange Fee Cap by Michelle W. Bowman*, October 25, 2023.

The reality is that this Proposal impacts all card issuers. As Governor Bowman noted, there needs to be more impactful study of these effects on community banks before the adoption of the Proposal. Otherwise, large groups of consumers may be placed at risk of losing their debit cards, or even worse, their banking entity, due to lack of due diligence.

For these reasons, the KBA believes that the Fed's conclusions and presumptions of the Proposal are highly misguided and that the Proposal should not be adopted.

4. The KBA Supports the Fed's Efforts to Address Fraud

Fraud continues to be a challenge for everyone in the financial services industry.

As noted in the Proposal, "Most fraud losses associated with covered issuer transactions in 2021 were borne by covered issuers and merchants. In 2009, covered issuers, merchants, and cardholders bore 61.2 percent, 38.3 percent, and 0.5 percent of these fraud losses, respectively. In 2021, covered issuers, merchants, and cardholders bore 33.5 percent, 47.0 percent, and 19.5 percent of fraud losses, respectively. This shift reflects a number of factors. First, card-not-present transactions grew from 9.8 percent of covered issuer transactions in 2009 to 32.1 percent of covered issuer transactions in 2021. Second, card-not-present fraud accounted for almost half of overall fraud in 2021, and merchants bear a greater share of fraud losses for this type of transactions (almost two-thirds of card-not-present fraud in 2021). Third, merchants absorbed an increasing share of fraud losses across almost all transaction categories and fraud types in 2021, relative to 2009. For example, merchants' share of fraud losses has also increased over time for single-message transactions, from around 4 percent in 2009 to 31.9 percent in 2021."[34]

While the Fed goes to great lengths to show the increase in fraud sustained by merchants, the reality is that it is still roughly half of the losses sustained by financial institutions. Pursuant to Regulation E, banks are the bearer of most losses in fraud transactions in protecting consumers.

There are hundreds, if not thousands, of studies of various sizes and forms measuring the increase in fraud. While they may differ in numbers, their conclusions are the same; fraud is increasing.

The KBA supports the Fed's recognition of all parties seeking to fight fraud for the embitterment of all stakeholders. The KBA and its members take fraud seriously and have their own Fraud Academy to help fight fraud.

While all industries work to combat fraud, the KBA supports the Fed's efforts to increase fraud provisions in the Proposal.

For these reasons, the KBA appreciates the Fraud Provisions of the Proposal to the extent such amounts account for all fraud losses suffered by the financial sector.

5. The KBA does not Support the Proposal

The KBA opposes the changes set forth in the Proposal. As set forth *supra*, the KBA does not believe that the Purpose actually aligns with consumer interests and is not protecting consumers. Furthermore, based on empirical evidence, the KBA believes that these changes are likely to cause more harm to the majority, if not all, consumers. The KBA believes that these changes to interchange fees will ultimately benefit solely the merchants without creating any savings for consumers while potentially placing consumers' current debit card products and services at risk.

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[34] Proposal, page 78119.

Thank you for considering our suggestions. If there are any questions, please do not hesitate to contact the undersigned.

Sincerely,

Timothy A. Schenk

Timothy A. Schenk
General Counsel
Kentucky Bankers Association
tschenk@kybanks.com