May 10, 2024

Via Electronic Delivery

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

Re: Docket No. R-1818, RIN 7100-AG67; Debit Card Interchange Fees and Routing

Dear Ms. Misback:

The Clearing House Association L.L.C.,[1] the Bank Policy Institute,[2] and the Consumer Bankers Association[3] (collectively, the "Associations") respectfully submit this comment letter to the Board of Governors of the Federal Reserve System in response to the notice of proposed rulemaking regarding modifications to Regulation II[4] and the Official Board Commentary on Regulation II related to debit card interchange fees.[5]

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[1] The Clearing House Association L.L.C., the country's oldest banking trade association, is a nonpartisan organization that provides informed advocacy and thought leadership on critical payments-related issues. Its sister company, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the U.S., clearing and settling more than $2 trillion each day. *See*, The Clearing House's web page at www.theclearinghouse.org.

[2] The Bank Policy Institute is a nonpartisan public policy, research and advocacy group that represents universal banks, regional banks, and the major foreign banks doing business in the United States. The Institute produces academic research and analysis on regulatory and monetary policy topics, analyzes and comments on proposed regulations, and represents the financial services industry with respect to cybersecurity, fraud, and other information security issues.

[3] The Consumer Bankers Association is the only national trade association focused exclusively on retail banking. Established in 1919, the association is a leading voice in the banking industry and Washington, representing members who employ nearly two million Americans, extend roughly $3 trillion in consumer loans, and provide $270 billion in small business loans. See the Consumer Bankers Association's web page at consumerbankers.com.

[4] Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203, 124 Stat. 1376 (2010)) amends the Electronic Fund Transfer Act (15 U.S.C. 1693 et seq.) (the "EFTA") to add Section 920 to the EFTA. Section 920(a)(2) of EFTA, codified at 15 U.S.C. 1693o-2 (the "Durbin Amendment") requires debit interchange transaction fees to be an amount that is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." The Durbin Amendment is implemented through Regulation II (12 C.F.R. Part 235).

[5] *See* Debit Card Interchange Fees and Routing, 88 Fed. Reg. 78100 (Nov. 14, 2023).

I. Introduction

The Board proposes to amend Regulation II and the Commentary to reduce the interchange fee cap, to adopt a new methodology for determining the base component of the interchange fee cap, to provide for automatic adjustments to the interchange fee cap on a biennial basis in the future, and to make certain other conforming and clarifying changes to Regulation II. The Board does not, however, propose to meaningfully amend Regulation II's prohibitions on circumvention, evasion, and net compensation.

Much has changed since the Board first issued Regulation II in 2011.[6] Debit card transactions have continued to grow at a rapid pace,[7] and large participants in the financial technology ("fintech") industry have continued to grow and partner with small exempt financial institutions, frequently leveraging those small financial institutions to issue debit and prepaid cards in connection with the fintech companies' financial services programs.[8] The legal agreements may be complex between the fintech and the exempt partner bank and nominally provide the bank with certain authorities or responsibilities related to the card program, but ultimately, in practice, the fintech has effective control over all material aspects of the debit or prepaid card program.[9] As the U.S. Department of the Treasury has noted in detail,[10] certain fintech companies are engaging in regulatory arbitrage by selecting small, exempt financial institutions as card issuers and structuring their card issuing programs to take advantage of the small issuer exemption to avoid the interchange fee limitations under EFTA and

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[6] *See* Debit Cards Interchange Fees and Routing, 76 Fed. Reg. 43478 (July 20, 2011).

[7] The value of core noncash payments in the United States (including debit card payments) grew faster between 2018 and 2021 than in any previous Federal Reserve Payment Study measurement period since 2000, with the number of non-prepaid debit card payments increasing the most of all card types. (The Federal Reserve Payments Study: 2022 Triennial Initial Data Release, p. 1, https://www.federalreserve.gov/paymentsystems/fr-payments-study.htm.)

[8] *See* "Banking as a service: The role of banks in powering the fintech industry," https://www.spglobal.com/marketintelligence/en/news-insights/research/banking-as-a-service-the-role-of-banks-in-powering-the-fintech-industry (accessed Feb. 1, 2024)) (noting that "there are more than 50 financial institutions that support fintechs on an as-a-service basis . . . [which banks] often have less than $10 billion in assets.")

[9] For example, these arrangements often give a significant share of all interchange to the fintech, require the fintech to incur losses for customer fraud, transaction errors, and chargebacks, and assign control of the customer relationship to the fintech, from customer acquisition to customer service. (*See, for example*, Marqeta, Inc. Form 10-K (2023), https://investors.marqeta.com/static-files/4068a8e7-2689-4462-b802-9f6acb512e74. "Under this agreement we are entitled to receive 100% of the Interchange Fees for processing our customers' card transactions.")

[10] U.S Department of the Treasury Report to the White House Competition Council, *Assessing the Impact of New Entrant Non-bank Firms on Competition in Consumer Finance Markets*, November 2022, page 82, https://home.treasury.gov/system/files/136/Assessing-the-Impact-of-New-Entrant-Nonbank-Firms.pdf (noting that non-banks are able to commit regulatory arbitrage by taking advantage of Regulation II's small issuer exemption to "scale up their operations to be larger than the $10 billion threshold.")

Regulation II.[11] Indeed, the Treasury concluded that "[s]uch use of the Durbin Amendment exemption warrants further examination."[12]

The Board proposes to continue Regulation II's current exemption from the interchange fee limitations implemented through Sections 235.3, 235.4, and 235.6 of Regulation II.[13] Under the Board's proposal, an issuer would continue to be exempt from the rule if the issuer (i) holds the account that is debited; and (ii) together with its affiliates, has assets of less than $10 billion as of the end of the preceding calendar year)).[14] Large fintech companies, including those with well over $10 billion in assets, are engaging issuers whose assets qualify them for the small issuer exemption to: (a) serve as BIN sponsors[15] for the fintech companies' debit and prepaid cards in reliance on the small issuer exemption to avoid applicability of the interchange fee limitation to the fintech companies' card services offerings, and (b) hold only a small portion of funds that are accessible through the debit and prepaid cards issued by the exempt issuers.

Such arrangements are designed to maintain a small but positive balance in the small BIN sponsor bank's accounts, while keeping the sponsor bank's assets below the $10 billion threshold for the interchange fee cap exemption. For example, the fintech company may exercise substantial control over the amount of funds held by the BIN sponsor bank and regularly move funds between accounts owned by the fintech company held at large financial institutions and accounts held at the exempt issuer of the fintech's debit and prepaid cards. Such positive balance, however, is far less than the total amount of funds accessible by the debit and prepaid cards the BIN sponsor bank issues for the fintech company. In exchange, the exempt BIN sponsor issuer generally shares – or passes through entirely, in some cases – its unregulated interchange revenue with the fintech company. These arrangements unfairly and inappropriately evade the interchange fee limitations of EFTA and Regulation II and create

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[11] Section 920(a)(2) of EFTA requires the amount of any interchange fee that an issuer of debit cards receives or charges to be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. As proposed by the Board in the proposed rule, Sections 235.3 and 235.4 of Regulation II would give effect to section 920(a)(2) of EFTA. *See* Debit Card Interchange Fees and Routing, *supra* note 5.

[12] *Supra* note 10.

[13] The Board proposes technical revisions to Regulation II, including adding "covered issuer" as a defined term, and certain conforming revisions to the regulation to reflect the addition of "covered issuer" as a defined term. The Board proposes to amend Section 235.2(f) so that "covered issuer" would be defined to mean "for a particular calendar year, an issuer that, together with its affiliates, has assets of $10 billion or more as of the end of the preceding calendar year." For example, the Board proposes to incorporate the defined term "covered issuer" where relevant in other sections of Regulation II, particularly in § 235.5(a) (the small issuer exemption) and § 235.8(a) (reporting requirements) and the commentary thereto. The Board does not intend the addition and incorporation of the defined term "covered issuer'" to be a substantive change. Thus, the Board proposes to amend Section 235.5 to exempt from Sections 235.3, 235.4, and 235.6 of Regulation II any issuer that "(i) [h]olds the account that is debited; and (ii) [i]s not a covered issuer when the electronic debit transaction is performed." Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78123, 78121.

[14] *See* Section 235.5(a)(1)(i) of Regulation II, (Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78123, 78121.

[15] A "BIN sponsor" in the card issuing context is a bank that provides card issuing services and related access to a payment network through licensure of its Bank Identification Number, or "BIN" to non-bank third parties.

an uneven regulatory playing field that both has implications for financial stability[16] and unfairly disadvantages large financial institution debit and prepaid card issuers that are ineligible for the small issuer exemption (both directly and through relationships with small financial institutions) relative to similarly-sized non-bank competitors. As the CEO of one fintech exploiting the exemption put it, "small banks lend out their charters to powerful fintech players."[17]

If the Board moves forward with amending other provisions of Regulation II (which we do not believe it should, as detailed in a separate comment letter),[18] it should also amend Regulation II and the Commentary to eliminate the ability of fintech companies to abuse the small issuer exemption. If the Board does not move forward with amending Regulation II, it should adopt revisions to its Regulation II frequently asked questions, as reflected in Exhibit A to this letter, to implement the key clarifications requested in this letter.

II. The Board should clarify that: (i) a card issuer does not "hold" the account to be debited by a debit or prepaid card it issues unless the issuer holds in its own deposit accounts all of the funds accessible by the debit or prepaid card; and (ii) when a card issuer does not hold in its own deposit accounts all of the funds accessible by the debit and prepaid cards it issues for a program, such debit and prepaid card program constitutes decoupled debit for which the small issuer exemption is unavailable.

In the proposal, the Board proposes to amend the Commentary to Section 5(a) of Regulation II to provide that, "[a]n issuer that is not a covered issuer is exempt under § 235.5(a) [the small issuer exemption] only if the issuer holds the account that is debited," which is consistent with the concepts set forth in the existing Commentary to Section 2(k) of Regulation II.[19] Although critical to the availability of the small issuer exemption, the Board continues to provide little guidance in the proposed rule or otherwise clarify what qualifies as "holding" the account that is debited. Large fintech companies partnering with small financial institutions as debit and prepaid card issuers regularly take advantage of this ambiguity, placing only a small fraction of the funds accessible through the issued cards on deposit with the exempt issuer. The Board already recognizes in the frequently asked questions it has issued regarding the small issuer exemption to Regulation II that "some funds-loading arrangements may warrant additional supervisory scrutiny," and the Associations do not believe the Board intended that a debit or prepaid card issuer that holds as deposits only a fraction of the funds that may be accessed through the cards it issues under a program would be eligible for the small issuer exemption with

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[16] *See*, *e.g.*, Acting Comptroller of the Currency Michael J. Hsu "Preventing the Next Great Blurring," Vanderbilt University, February, 21, 2024, https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-17.pdf ("From a financial stability perspective, the deposit-taking-like activity warrants the most scrutiny because of the vulnerability it creates to runs. Any entity managing money on behalf of customers can face a run if those customers have doubts about the safety of their money. […]Significant data gaps exist, however. The lack of standardized data makes it challenging to aggregate and compare the amount of money nonbank companies manage on behalf of their customers.")

[17] "How the Durbin Amendment sparked fintech innovation," by Eric Glyman, Logan Bartlett, and Emily Man, July 13, 2022, https://ramp.com/blog/how-the-durbin-amendment-sparked-fintech-innovation.

[18] *See* Letter from the Bank Policy Institute, The Clearing House Assn., the Consumer Bankers Assn., et al. to Board of Governors of the Federal Reserve System (May 10, 2024).

[19] Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78129.

respect to that program.[20]

The Associations further believe that this type of card program is a decoupled debit arrangement for which the small issuer exemption is unavailable. In the proposed rule, the Board proposes to amend the Commentary to Section 5(a) of Regulation II to reflect a concept that was previously included in the Commentary to Section 2(f) of Regulation II – that debit cards issued by exempt issuers as part of a decoupled debit card program are categorically ineligible for the small issuer exemption.[21] Consistent with the existing definition under Regulation II, the proposal would define a "decoupled debit card" as a debit card "issued by an entity other than the financial institution holding the cardholder's account. In a decoupled debit arrangement, transactions that are authorized by the card issuer settle against the cardholder's account held by an entity other than the issuer, generally via a subsequent ACH debit to that account."[22] Similarly, the Board proposes to amend the Commentary to Section 5(a) of Regulation II to provide that "the issuer of a decoupled debit card is not exempt under § 235.5(a) [the small issuer exemption] regardless of asset size, because it is not the entity holding the account to be debited," a concept that was previously included in the Commentary to Section 2(f) of Regulation II.[23]

Although the description of "decoupled debit cards" and their programs under Regulation II as currently in effect and as proposed to be revised by the Board only expressly limits availability of the small issuer exemption where the exempt issuer does not hold the cardholder's account, the Associations believe the Board should clarify that the same reasoning applies where the issuer does hold a cardholder account but where that account holds less than all of the funds accessible through use of the applicable debit and prepaid cards. This clarification would address the types of circumvention efforts that exist in the marketplace today, such as where (i) the exempt issuer holds a cardholder account that has a zero deposit balance at the time electronic debit transactions are conducted, (ii) the exempt issuer holds a cardholder account that has a nominal deposit balance at the time electronic debit transactions are conducted and such balance is far less than the total balance accessible through the card, or (iii) the exempt issuer otherwise holds as deposits less than all of the cardholder funds accessible through the card such that use of the card may regularly overdraw funds in the small issuer's cardholder account in a manner inconsistent with incidental overdraft coverage that may be offered by the issuer.

Accordingly, the Associations encourage the Board to abandon the current proposal and instead issue the frequently asked questions attached as Exhibit A to this letter, to clarify that an issuer does not "hold the account being debited" by a debit or prepaid card unless it holds as deposits all of the funds associated with and accessible by use of the debit or prepaid card. The Board should clarify further that arrangements where an issuer does not hold all of the funds accessible by the cards issued in connection

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[20] *See* Board of Governors of the Federal Reserve System, Frequently Asked Questions About Regulation II, at Section 235.5(c) (noting that an example of a funds-loading arrangement that warrants additional scrutiny is where prepaid cards are linked to an issuer's customers' transaction accounts such that funds may be swept from the transaction accounts to the prepaid accounts as needed to cover transactions).

[21] Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78129.

[22] Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78125.

[23] Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78125.

with a program is a decoupled debit card program and, therefore, is ineligible for the small issuer exemption. Should the Board proceed with amending Regulation II, the Board should amend the Regulation and the Commentary to make these clarifications.

III. Even if a financial institution holds all of the funds accessible by the debit or prepaid cards it issues, the Board should prohibit a financial institution from qualifying as an exempt issuer with respect to any debit or prepaid card program for which: (i) the financial institution issues debit or prepaid cards as the BIN sponsor for a third party, (ii) the third party has the principal relationship with the cardholder and has the authority to direct the issuer to move funds into or out of the issuer's cardholder account associated with the cards, and (iii) the combined assets of the issuer and the third party are equal to or greater than $10 billion.

In the proposed rule, the Board proposes to amend the Commentary to Sections 5(a) and 2(f) of Regulation II to provide that, "[a]n issuer that is not a covered issuer [(a covered issuer being an issuer whose "total worldwide banking and nonbanking assets, including assets of affiliates, other than trust assets under management, are at least $10 billion, as of December 31 of the preceding calendar year")] is exempt under § 235.5(a) [the small issuer exemption] . . . ."[24] This asset size test applies only to the card issuer and does not encompass the assets of a non-bank third party on whose behalf the issuer may issue debit or prepaid cards. The Board proposes to maintain the definition of "affiliate" to mean "any company that controls, is controlled by, or is under common control with another company."[25] As such, a small bank issuer would typically not be an affiliate of a large fintech partner on whose behalf it issues debit or prepaid cards even though the fintech entity exercises substantial control with respect to those debit and prepaid cards and the underlying funds.

The Associations recommend that, if the Board insists on amending Regulation II, the Board also amend Regulation II and the Commentary to establish that such exemption will not be available to an otherwise qualifying financial institution with respect to any program for which (i) the financial institution issues debit or prepaid cards as the BIN sponsor for a third party, (ii) the third party has the principal relationship with the cardholder and has the authority to direct the movement of funds into or out of the issuer's cardholder account associated with the cards, and (iii) the combined assets of the issuer and the third party, together with assets of their affiliates, are equal to or greater than $10 billion. The Associations believe such an approach would be consistent with the fact finding and surveying performed by the Board in contemplation of the rule that was published in 2011 in so much as the Board appears to have sought to understand the relationships between entities that establish issuing arrangements through that process.[26]

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[24] Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78129, 78125.

[25] Debit Card Interchange Fees and Routing, *supra* note 5, at p. 78121.

[26] *See* Debit Cards Interchange Fees and Routing, *supra* note 6, at p. 43479 (noting that the Board has surveyed bank holding companies and other financial institutions that, together with their affiliates, offered debit products); *see also* 77 FR 43394 (Aug. 3, 2012)(One commenter specifically expressed concern about a covered issuer being able to contract with a small issuer for issuance of the card and having the small issuer receive and pass back the higher interchange fees. The Board noted that, "as a matter of law, agents are held to the same restrictions with respect to the agency relationships as their principals . . . [f]or example, if an issuer uses a third-party processor to authorize, clear, or settle transactions on its behalf, the third-party processor may not receive interchange fees in excess of the issuer's permissible amount.")

IV. The Board should clarify that financial institutions may be deemed to engage in circumvention or evasion of the interchange fee limitations where they knowingly assist a third party in establishing a debit or prepaid card issuing program that engages multiple exempt issuers to avoid applicability of Regulation II's interchange fee limitations.

In the proposed rule, the Board proposes to maintain the existing exemption to the general prohibition in Section 235.6 of Regulation II against circumvention, evasion, and net compensation for issuers that both are not covered issuers and hold the account that is debited.[27] However, the Associations do not believe the Board intended this blanket exclusion to apply to schemes between fintech companies and exempt issuers, such as described in this letter, designed to evade applicability of Regulation II's interchange fee limitations to a larger debit or prepaid card program.

If the Board moves forward with amending Regulation II, the Associations recommend that the Board amend the regulation and the Commentary to establish that an exempt issuer that knowingly participates in a scheme that is designed to circumvent or evade the applicability of the interchange fee limitation, including by participating as one of several exempt issuers in a third party's financial services program that was structured to avoid the interchange fee limitations, may be found liable for circumvention or evasion.

V. Clarifying that a debit card issuer does not "hold" the account to be debited unless the issuer holds all of the funds accessible by the debit card would encourage these funds to be held by depository institutions that are subject to bank regulation, oversight, and examination.

Clarifying that a debit card issuer does not "hold" the account to be debited unless the issuer holds all of the funds accessible by the debit card is not only consistent with the intent of section 920(a)(2) of EFTA, it also would provide greater protections to consumers. Such a clarification would remove an incentive for large fintech companies to hold customer funds accessible through use of bank-issued debit and prepaid cards in a manner that lacks full bank regulation and supervision and that may deny cardholders the protections they receive when their funds are held by the depository institution that issues their debit or prepaid cards. This clarification also would mitigate the risk frequently cited by the Federal Deposit Insurance Corporation of fintechs promising but failing to structure programs that qualify for pass-through deposit insurance.[28] Additionally, the holding of funds by non-depository institutions for which a depository institution is liable to payment card networks poses a risk to the safety and soundness of debit- and prepaid-card-based payment systems, particularly for a card issuer that is a small financial institution. A small financial institution may be unable to honor its settlement obligations to payment card networks if the actual card spend exceeds the limited funds held in the

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[27] The Board proposes to generally maintain the language of Section 235.5(a)(1), which states that "Sections 235.3, 235.4, and 235.6 do not apply to an interchange transaction fee received or charged by an issuer that (i) [h]olds the account that is debited; and (ii) [i]s not a covered issuer when the electronic debit transaction is performed." Debit Cards Interchange Fees and Routing, *supra* note 5, at p. 78123.

[28] *See, e.g.,* FDIC Press Release – FDIC: FDIC Demands Three Companies Cease Making False or Misleading Representations about Deposit Insurance, March 19, 2024; and FDIC and Board, Joint Letter Regarding Potential Violations of Section 18(a)(4) of the Federal Deposit Insurance Act, issued July 28, 2022 to Voyager Digital, LLC.

cardholder account and the institution is unable to recover the excess amount from its fintech partner.

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Partnerships between large fintech companies and small banks that evade the interchange fee limitations of EFTA and Regulation II create an uneven regulatory playing field that unfairly disadvantages banks with assets of equivalent size as large fintech companies that offer debit and prepaid cards directly to the public through exempt issuers. An exempt issuer holding only a portion of cardholder funds accessible by the cards it issues under a fintech program is a form of decoupled debit that allows outsized fintech companies to control funds that should be held by the exempt issuer and that, if held by the exempt issuer, would properly be considered when determining that issuer's asset size under Regulation II. Moreover, consumers would be better protected if such clarification were implemented. Finally, competition among small banks for fintech partner business, and concentrations of fintech business at a handful of small, card-issuing banks can generate risks that regulators must consider and closely monitor. For these reasons, the Board should amend its proposal or, preferably, abandon the proposed rule and issue the frequently asked questions attached as Exhibit A, to close gaps in the availability of the small issuer exemption for partnerships between fintech companies and financial institutions.

Thank you for your consideration and review of these observations. If you have any questions or wish to discuss this letter, please do not hesitate to contact Paige Pidano Paridon at (703) 887-5229 or paige.paridon@bpi.com or Rodney Abele at (347) 703-1839 or rodney.abele@theclearinghouse.org.

Respectfully submitted,

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Exhibit A

Proposed FAQs

§ 235.5 Exemptions

235.5(a) Small Issuer Exemption

Q1. Section 235.5(a) provides that an issuer is exempt from the interchange fee standards if, among other things, the issuer "holds the account that is debited." Does an issuer hold the account that is debited if the total amount of funds accessible exceeds the amount of funds held as deposits in the account at the issuer associated with the debit card?

A1. No. An issuer "holds the account that is debited" only if the issuer holds, as deposit liabilities in an account at the issuer associated with the debit card, all of the cardholder funds accessible through electronic debit transactions that may be initiated using the card pursuant to the terms of the cardholder agreement. An issuer only holds cardholder funds accessible through electronic debit transactions if those funds are held in an account at the issuer, reflected on the books of the issuer as a deposit liability to the cardholder, at the time the transactions are authorized. An issuer may still hold the account that is debited where the issuer authorizes electronic debit transactions in excess of the available balance in an account pursuant to a discretionary overdraft service involving an incidental extension of credit by the issuer.

Q2. Can an issuer that does not qualify for the small issuer exemption with respect to one card program still qualify for the exemption with respect to a different card program?

A1. Yes. An issuer that does not qualify for the small issuer exemption with respect to one card program may still qualify for the exemption under a different card program. The small issuer exemption is available if the issuer holds the account that is debited and the issuer, together with its affiliates, has assets of less than $10 billion as of the end of the calendar year preceding the date of the electronic debit transaction. If an issuer that satisfies the asset size requirement of the small issuer exemption operates two debit card programs, one in which the issuer holds the account debited for electronic debit transactions and one in which the issuer does not hold the account debited, the issuer is eligible for the small issuer exemption with respect to the first program but not for the second.