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May 11, 2024

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

RE: ICBA Comments in Response to Debit Card Interchange Fees and Routing Notice of Proposed Rulemaking Docket No. R-1818 or RIN 7100-AG67

Dear Madam:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the proposed rulemaking on Debit Card Interchange Fees and Routing, issued November 14, 2023.

ICBA strongly recommends the Board of Governors of the Federal Reserve System (Board) reconsider its proposed rulemaking on debit card interchange fees. The current proposal relies on incomplete and potentially flawed data that misrepresents the impact on both covered and exempt community banks. To ensure a more accurate analysis, the Board should refine its data collection methods for covered banks and consider studies that encompass exempt community issuers and the small business card acceptance landscape.

ICBA joined other financial trade associations (Joint Trades Letter)[2] opposing the proposed rule and is hereby reiterating and incorporating by reference the substance of that letter. We are further submitting this additional letter also in opposition to the proposed rule in order to highlight specific facets of the rule that will deleteriously impact community banks. This letter highlights the unique challenges that, while aligned with the broader industry concerns, require further attention by the Board.

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[1] The Independent Community Bankers of America® has one mission: to create and promote an environment where community banks flourish. We power the potential of the nation's community banks through effective advocacy, education, and innovation. As local and trusted sources of credit, America's community banks leverage their relationship-based business model and innovative offerings to channel deposits into the neighborhoods they serve, creating jobs, fostering economic prosperity, and fueling their customers' financial goals and dreams. For more information, visit ICBA's website at www.icba.org

[2] See Comment Letter submitted May 10, 2024 by Independent Community Bankers of America, Bank Policy Institute, American Bankers Association, America's Credit Unions, Consumer Bankers Association, Electronic Payments Coalition, Mid-Size Bank Coalition of America, National Bankers Association and The Clearing House Association.

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The rulemaking harms all debit issuers; however, it is especially harmful to the smaller covered issuers[3] because the Board's quantitative approach incorrectly categorizes deficiencies in the data collection and analysis as not statistically significant when considering transaction volume for all issuers.

The methodology and data the Board uses harms ALL community banks.

The Board is tasked with setting a 'reasonable and proportional' debit card interchange fee[4] that reflects the costs incurred by issuers during the transaction process. However, the proposed approach in this rulemaking effort of a single fee for all transactions ignores the complexities of the debit card payment system. The credit card system, which is analogous with debit cards at the point of acceptance, uses interchange rates based on merchant-controlled factors like data security methods (key-entered vs. chip vs. tokenized), business type, dispute volume (indicating customer complaints), and even merchant size. This creates a variable interchange rate that properly allocates costs based on the different risk profiles associated with the payment activity.

The Board's single debit card rate for all covered issuers simplifies risk assessment by averaging merchant fraud levels, data entry risks (card-present vs. card-not-present), and merchant risk profiles. This 'one-size-fits-all' approach fails to account for the varying risk profiles of different merchants and transactions. Failure to account for transaction risk improperly leads to underestimating costs of debit transactions to banks, which leads to debit interchange rate being set too low for cost recovery.

The current regulation's debit interchange rate, alongside the proposed rate—which amounts to a 30% reduction from the current rate—falls short of covering the variable costs for many smaller banks in providing debit card services to customers. Moreover, even exempt debit issuers are not immune to the repercussions of this regulation. Reduced costs result in diminished investment in debit infrastructure and hinder innovation, diverting resources towards mitigating transaction losses instead of fostering new features and innovations.

The collected data is incomplete for community banks.

The underlying survey data upon which the Board is relying for covered community banks is incomplete and potentially flawed. ICBA member banks reported significant difficulty completing the survey. Community banks rely on their core processors for data storage and reporting. In some cases the cost available did not align with the Board's survey directions, thereby resulting in 'not reporting' (NR) in key data fields. As discussed in the Joint Trades Letter[5], the survey's complexity disadvantages community banks, which generally lack dedicated data analysis teams, data metric support from technology providers, or the staff time required to manually calculate and produce an accurate cost breakdown.

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[3] A covered issuers is a financial institution with at least $10 billion in deposits. See 88 Fed. Reg. 78100, 78101 (Nov. 14, 2023)

[4] 15 U.S.C. § 1693o-2(a)(3)(A).

[5] Joint Trades Letter May 10, page 9.

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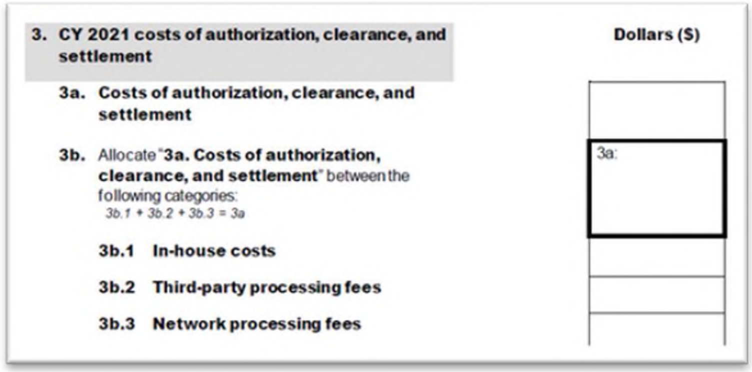
By way of example, please note survey question 3, of the 2021 survey - CY 2021 costs of authorization, clearance & settlement. Community banks have the ability to report third party processing costs(3b.2), and network processing fees (3b.3), if these costs are reported to the covered issuer by their debit processing technology partner. However, as noted above, most community banks reported difficulty in getting this data from their technology providers. The Board's specific instructions to measure costs does not align with how community banks measure and document their costs. Thus, many covered community institutions are forced to enter 'NR' in 3.b.1 – in house processing costs for authorized clearing and settling (ACS). Thus, the total found in 3a – ACS, a key metric underlying the Fed proposal, is missing data. These gaps may not be statistically significant when looking at the overall transaction volume for the entire debit card marketplace, but they are significant at the issuer level, especially at the mid-level and low-level issuer breakouts.



3. CY 2021 costs of authorization, clearance, and settlement	Dollars ($)
3a. Costs of authorization, clearance, and settlement	
3b. Allocate "3a. Costs of authorization, clearance, and settlement" between the following categories: 3b.1 + 3b.2 + 3b.3 = 3a	3a:
3b.1 In-house costs	
3b.2 Third-party processing fees	
3b.3 Network processing fees	

The presence of unanswered questions (blank ACS data) confirms the incompleteness of the data on covered community banks. This means the Board's proposed formula for debit transaction cost recovery relies on the median of an average calculated from flawed data.

We urge the Board to report the extent of missing data within the community bank survey. This should include breakdowns of all questions and sub-questions as well as any breakouts the Board creates. While the Board prioritizes covering the largest transaction volume, this focus often benefits only a few large institutions, leaving the community bank perspective unrepresented.

We support the Board developing a method to report data gaps that protects the confidentiality of reporting institutions while informing the public about these shortcomings. By providing a clear summary of missing data, the Board can ensure transparency and mitigate concerns about bias in its debit card research.

2021 Debit Report distorts community bank data.

The Board's 2021 Debit Report (October 2023), titled 'Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions,'[6] serves as the primary public source document justifying the proposed debit interchange fee rule. This report, frequently cited in discussions, raises concerns about the representation of community bank data.

[6] https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2021.pdf

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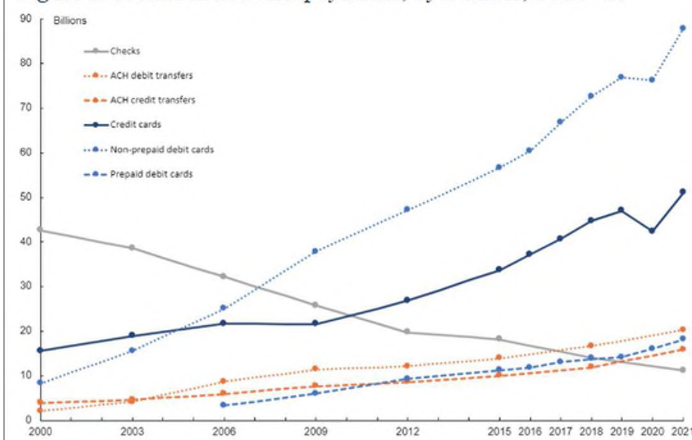
The Board misrepresents both covered and exempt community banks in the report and the proposed rulemaking. We focus on two specific areas:

- Segmentation Misrepresentation: The Board's categorization of issuers by high, mid, and low volume does not reflect the actual distribution of debit transaction volume within the covered debit market. This skews the data on covered community banks presented in subsequent reports.
- Exempt Community Bank Interchange Misrepresentation: The Board's portrayal of exempt community bank interchange is inaccurate.

These biases in the source data lead to unfair treatment of community banks in the final proposal.

The Board's segmentation of issuers by high-volume, mid-volume, and low-volume does not reflect the market distribution of debit transaction dollar value and volume.

Figure 2. Trends in noncash payments, by number, 2000–21



According to the Federal Reserve Payment Study there were 47 Billion transaction in 2012, and 87 Billion in 2021, a growth of 85%, The Board should adjust their groupings to better reflect the distribution of count of issuers and transaction.

The Board segments debit issuers into three categories: high-volume, mid-volume and low-volume. The Board then uses these categories to measure multiple substantive metrics, including ACS costs and fraud losses. The Board makes extensive use of these groupings. The grouping's metrics were established with 2011 data and, at the time, represented quartiles by issuer count. The Board, in the 2011 data set, established the threshold for high-volume debit issuers at 100 million transactions. Despite debit transaction volumes increasing by 84% [see Figure 2][7] since 2011, the threshold has not been adjusted.

In 2021, independent market data reported that eight issuers represent over 70% of debit transactions[8]. The largest three debit issuers alone represent over 50% of debit card purchases. Even with the addition of the next largest 5 debit issuers, only an additional 24% of debit volume is captured. Nine institutions account for nearly

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[7] Federal Reserve Payment Study https://www.federalreserve.gov/paymentsystems/fr-payments-study.htm (last checked 5/2/2024).

[8] Largest Debit Card Issuers https://wallethub.com/edu/ca/largest-debit-card-issuers/25539.

70% of the debit volume by sales nationwide. Thus, approximately 5% of covered issuers represent 70% of debit card volume nationwide.[9]

Table 12: Covered issuers by 2011 volume	Number of covered issuers		% of transactions ¹	% of transaction value ¹	Average transaction value ($) ²
All covered issuers	**131**				**39.21**
High-volume issuers (more than 100 million transactions)	31	*24%*	94.04%	93.60%	39.03
Mid-volume issuers (1-100 million transactions)	63	*48%*	5.94%	6.37%	42.04
Low -volume issuers (less than 1 million transactions)	37	*28%*	0.02%	0.03%	73.85

¹ The percentage of the total number or value of covered issuer transactions. Covered issuers represent about 65 percent of all debit card transactions.

² Average transaction values in this table are calculated from the Debit Card Issuer survey. Average transaction values reported in Tables 1-3 are calculated from the Payment Card Network survey.

Table 12: Covered issuers by 2021 volume	Number of covered issuers		% of transactions ¹	% of transaction value ¹	Average transaction value ($) ²
All covered issuers	**163**				**47.67**
High-volume issuers (more than 100 million transactions)	53	*33%*	94.32%	93.86%	47.44
Mid-volume issuers (1-100 million transactions)	86	*53%*	5.68%	6.13%	51.49
Low -volume issuers (less than 1 million transactions)	24	*15%*	0.01%	0.01%	78.47

¹ The percentage of the total number or value of covered issuer transactions. Covered issuers represent about 65 percent of all debit card transactions.

² Average transaction values in this table are calculated from the Debit Card Issuer survey. Average transaction values reported in tables 1-3 are calculated from the Payment Card Network survey.

The remaining 45 institutions in the high-volume group, including community banks under $50 billion in assets, are together contributing the additional 24%[10]. Those remaining 45 institutions, on average, represent one half percent of the total market.

Reviewing Table 12, it becomes clear that the information gathered from a few market dominant issuers control the cost data analysis, leaving little room for consideration of the impact on covered community banks. Grouping community banks with under $50 billion in assets with institutions holding over a trillion dollars in assets raises significant concerns. These large institutions operate on a vastly different scale, pursuant to different business models and market segmentation than community banks.

To ensure statistically valuable data, the Board needs to adjust its issuer segmentation methodology. By accounting for market transformations and the unique characteristics of community banks, the adjusted segmented data will provide a more accurate reflection of community bank's debit card costs, fee revenue, and fraud losses.

ICBA objects to the Board's current segmentation of debit issuers into high-volume, mid-volume, and low-volume groups. This flawed methodology misrepresents the market and neglects other crucial factors. Shifting community bank data to the mid- and low-volume groups would likely yield a more statistically significant representation of the market distribution.

ICBA requests that the Board update Issuer Segmentation by issuer count. After each survey, the Board will have the ability to adjust the segmentation thresholds to maintain quartiles based on the number of covered issuers,

[9] 8 institutions, divide by 160 covered institutions.

[10] ICBA is aware that transaction count and transaction volume are different metric. However, at a high level they track together. As evident in Table 12 and the Board's reporting.

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ensuring a more balanced representation across all issuer sizes. Alternatively, the Board could adjust the transaction volume thresholds used for segmentation. These thresholds should be aligned with the growth in debit card transactions as measured by the Board's Payment Study. This approach would account for changes in market activity.

The Board is Misrepresenting Community Bank Interchange Fees

The Board is inaccurately portraying the interchange fees of exempt community debit issuers.[11] While covered issuers typically collect a flat fee per transaction, exempt financial institutions' debit interchange is primarily based on a percentage of the transaction value, set by routing networks and influenced by transaction risk. The Board's depiction in Figure 8 of the 2021 Debit Report, showcasing average per transaction interchange collected by institutions, however, suggests an increasing amount of interchange collected by exempt community banks, while failing to factor that these institutions earn interchange based on transaction value percentages.

Elsewhere in the same report, the Board notes increases in both online transactions and average purchase prices. Since community banks collect interchange as a percentage of transaction value, any rise in average transaction value naturally increases the per transaction amount, maintaining a consistent rate. Thus, the Board's focus on final amounts rather than rates misrepresents the situation.

Moreover, exempt issuer transactions incur higher rates for riskier transactions, such as non-tokenized card-not-present transactions compared to those conducted in-person. For instance, while a card-present transaction might have a 1% interchange rate, a non-tokenized online transaction could have a 1.25% rate. This higher rate accounts for increased processing and fraud risks associated with online transactions. However, the Board fails to communicate the underlying increase in online debit transactions, as it only presents final amounts, not rates.

The Board's creation of Figure 8 overlooks adjustments for transaction value size increases and the rise in online purchases. To accurately represent exempt institutions' interchange collected, a second scale should be included on the figure, displaying the blended rate these institutions collect. The Board possesses the necessary metrics from the Payment Card Network (PCN) Survey to achieve this. For transparency, the average rate that exempt institutions earn should also be included. Selective data representation compromises the Board's independence and complicates discussions on debit interchange.

RECOMMENDATIONS

ICBA, as stated in our Joint Trades Letter, urges the Board to withdraw its proposed rule. The proposed rule would further lower the existing deficient price cap on debit card interchange fees and thereby amplify the damage already done by Regulation II as promulgated in 2011. As stated in the Joints Trades Letter, the Board is

[11] 2021 Debit Report, page 14 https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2021.pdf

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not legally obligated to change the rate now[12]. If the Board moves forward ICBA urges the Board to (1) update the Debit Card Issuer Survey and reexamine the exempt market; and (2) study the impact of new developments in the debit card market.

The Board should update the Debit Card Issuer Survey.

The Payment Card Network (PCN) and Debit Card Issuer (DCI) Survey serve as the bedrock of data for the Board's policy formulation. While the DCI Survey furnishes the Board with data directly from covered banks, the PCN Survey holds particular significance for exempt community banks, providing metrics with both exempt and covered breakdowns.

However, the DCI Survey falls short in capturing the full spectrum of costs incurred by covered community banks. Notably, crucial data such as ACS lacks comprehensive information at the community bank level. These data gaps, coupled with the Board's classification of financial institutions based on transaction volumes from decades past, result in an incomplete representation of covered community banks in the final report. Therefore, it's imperative for the Board to reassess its survey methodology, particularly for institutions with under $100 billion in assets. Should the Board opt to continue with the current survey, it must provide clearer guidance to banks, enabling them to report data thoroughly.

Furthermore, the Board's last inquiry into exempt issuer debit cards occurred in 2012. There is a pressing need for the Board to undertake a comprehensive study of the exempt debit card market. However, conducting this study through the flawed DCI Survey for exempt financial institutions is not advisable. Instead, we urge the Board to conduct multiple in-depth case studies with community institutions. This approach will enable the Board to delve into the metrics currently accessible to banks for measuring debit card costs, as well as explore the information available from the banks' technology partners. Obtaining an updated perspective on community institutions is crucial for understanding the impacts of Regulation II.

The Board should study the impact of new developments in the debit card market, including the evolving role of debit card transactions, the role of Reg II in financial institution consolidation, and the roles of payment facilitators in merchant card acceptance.

The Board's proposed solution focuses solely on data collected from one side of the equation: the issuers. However, we contend that the Board's underlying structure for the debit card market overlooks crucial participants. While the Board determines what banks collect in debit interchange, it lacks jurisdiction over what small and medium-sized businesses (SMBs) pay for card acceptance. Notably, the Board does not set merchant acceptance costs and fails to acknowledge the presence of Payment Facilitators (PayFacs) in the card acceptance market.

The Board's analysis indicates that banks directly provide card acceptance services to merchants, without addressing the role of Payment Facilitators or Payment Processors. PayFacs, which are predominantly technology

[12] See page 11, item 7 Joint Trades Letter.

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companies, have significantly increased their market dominance since the passage of Regulation II. However, the Board fails to measure or discuss the costs borne by SMBs using PayFacs for accepting cards. Many PayFacs charge a flat fee to merchants, without passing on any cost savings accrued from Reg II (See table below). Therefore, it is imperative for the Board to conduct thorough research on SMBs' card acceptance options and follow the financial trail, which often leads to PayFacs rather than banks.

Provider	Formula	$50 debit purchase
	What the Financial Instituion receives (covered interchange)	
Federal Reserve (proposed)	($0.144 + .04%(Purchase) + $.013)	$0.18
Federal Reserve (current)	($0.21 + .05%(Purchase) + $.01)	$0.25
	What the Small Merchant Pays (swipe fees)	
Square https://squareup.com/us/en/pricing	2.6% + .10	$1.40
Stripe https://stripe.com/pricing	2.9% + .30	$1.75
PayPal https://www.paypal.com/us/webapps/mpp/merchant-fees	2.99% + .49	$1.98
Toast https://pos.toasttab.com/payments/payment-processing-fees	Interactive chart hidden	$1.42
Clover Clover POS System Pricing and Cost https://www.clover.com/pricing	2.3% + .10	$1.25

The Board study should also investigate the role of community banks as merchant partners in acceptance. Since the passage of Regulation II, the number of community banks offering card acceptance programs has changed dramatically as most community banks have exited the merchant processing business.

CONCLUSION

We recommend the Board reevaluate its data collection and industry outreach practices. The current lack of engagement with community banks is reflected throughout this rulemaking process. We previously offered to assist with survey outreach and bank staff training to ensure data accuracy and would like to offer our assistance again. Collaboration with the community bank industry will help ensure that the Board does not prioritize a purely quantitative approach, potentially neglecting valuable industry insights and data.

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For the reasons set forth above, and as incorporated by reference to the Joint Trades Letter submitted, ICBA opposes the Board's advancement of the debit card interchange proposal, restates that the Board is not required to promulgate a new rule at this time, but urges that, if the Board does determine that it will proceed with rulemaking, it relies upon complete data that does not disregard or diminish the proposed rule's impact on community banks. For further information regarding the impact on community banks, please contact Kari Mitchum at kari.mitchum@icba.org.

Sincerely,

/s/

Kari Mitchum
Vice President, Payments Policy

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