May 24, 2024

Via Electronic Mail

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
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Re: Docket No. R-1818 – Debit Card Interchange Fees and Routing

Dear Secretary Misback:

As leading consumer advocacy organizations, Consumer Federation of America and Consumer Reports are deeply committed to promoting the financial well-being and inclusion of all consumers, particularly those with low and moderate incomes (LMI). We appreciate the Board's commitment to promoting competition in the debit card market and balancing the views of multiple stakeholders, including banks, merchants, and payment networks. As drafted, the rule will promote competition, reduce costs for merchants, potentially encourage innovation, increase transparency and reduce market inefficiency.

While these potential benefits are noteworthy, it is crucial to carefully weigh them against the possible impact on LMI consumers and the prospect that it may result in a bifurcated banking system. Policymakers should strive to find a balance that promotes competition, innovation, and efficiency in the debit card market while ensuring that all consumers, particularly those with low and moderate incomes, have access to affordable, high-quality financial services. This may require additional measures to mitigate the unintended consequences of the proposed changes and support the provision of inclusive financial services across the banking sector.

The economics of debit interchange rules have advantaged smaller banks and fintech companies over larger ones. The Durbin Amendment capped debit interchange for large banks at approximately 24 cents per transaction. The proposed amendments to those rules will drop the rate to 17 cents. By creating exemptions or tiered pricing structures based on institution size or mission, the current regulatory framework has unintentionally created a bifurcation of the banking system. The proposed changes may exacerbate the effect.

As a result, smaller banks and credit unions have different deposit service business models and cost structures compared to larger financial institutions. They may rely more heavily on interchange revenue to support their operations and offer competitive products and services to their customers. In fact, some industry consultants advise fintech partner banks to manipulate their balance sheets to stay below the threshold for the exemption.[1]

We fear that many large banks and credit unions have made strategic decisions to rely on overdraft fee revenue to cover the cost of provisioning these accounts, given their decreased ability to generate interchange revenue.

The rise of fintech has led to the proliferation of low-cost digital banking accounts, which have undoubtedly increased access to basic financial services for many consumers, and demonstrated that accounts can be offered without overdraft and other maintenance fees. However, these accounts often come with lower levels of customer service and fewer additional features compared to traditional bank accounts. For example, a recent Consumer Reports study found that digital-only banks often lack robust dispute resolution processes, in-person support, and the ability to deposit cash or checks, which can be particularly challenging for LMI consumers who may rely on these services more heavily.[2]

While we acknowledge the complex nature of interchange fee regulation and its potential effects on various stakeholders, our primary focus is on the welfare of LMI consumers who are the most vulnerable to changes in the financial services landscape. The proposed changes to Regulation II could potentially lead to a two tiered banking sector, which reinforces the idea that LMI consumers will have to rely on inferior options, while larger financial institutions with more diversified revenue streams may narrow or limit marketing of their more attractive products and services to affluent customers. Subsequently, fintech neobank companies are left to serve a disproportionately larger share of LMI consumers. By definition, fintechs offer fewer types of services, and notably, do not have branch networks. Due to their "unbundled" nature as stand-alone digital transaction accounts, do not offer relationship banking or opportunities for consumers to graduate to wealth-building financial services

This division is driven by the tiered approach to interchange caps embedded in current and proposed new interchange rules. While we understand some of the reasons for permitting smaller institutions to receive higher interchange rates, we are concerned that LMI consumers will now be disproportionately more likely to have accounts from fintech companies that partner with smaller banks whose asset sizes fall below the threshold and only offer basic transaction accounts without other products. As a result, LMI consumers may be increasingly relegated to a separate and potentially inferior tier of the banking system, characterized by lower-quality products, fewer choices, and reduced access to mainstream financial services and physical branches. Given the real access limitations to digital financial services in communities that are not sufficiently digitally connected, this bifurcation could have significant consequences for financial inclusion and equity.

[1] S&P Global Intelligence. "Compliance to Play Large Role in Banking-as-a-Service Sector in 2023," December 22, 2022.
[2] Consumer Reports. (March 2024). Banking Apps: The case study for a digital finance standard.

Moreover, the concentration of LMI consumers in digital-only accounts raises concerns about the long-term impact to financial inclusion and community development goals. Without access to physical branches and in-person support, LMI consumers may struggle to access credit, build wealth, and fully participate in the financial mainstream. This could exacerbate existing inequalities and hinder efforts to promote economic mobility in disadvantaged communities.

Additionally, while credit and wealth-building products can be accessed through digital channels, LMI consumers may face challenges in fully leveraging these products due to factors such as limited digital access, limited digital literacy, lack of trust in online platforms, and difficulty navigating complex product features.[3] Research suggests that LMI consumers may benefit from more direct engagement with financial representatives who can provide personalized guidance and support.[4] Without access to a full range of high-quality financial services and support, LMI consumers may struggle to fully participate in the financial mainstream and achieve their financial goals. This could exacerbate existing inequalities and hinder efforts to promote financial inclusion and economic mobility in disadvantaged communities."

As policymakers consider changes to Regulation II, it is essential to address these market distortions and ensure that the revised interchange fee structure promotes a more inclusive and equitable banking system. This may require targeted measures to support smaller community banks and CDFIs that serve LMI communities, as well as incentives for larger financial institutions to provide affordable, high-quality products and services to LMI consumers.

There are meaningful distinctions in how low- and moderate-income households use banking services. Whereas a high-wealth consumer may rely heavily on credit cards at the point of sale, creating substantial opportunities for a bank to generate interchange revenue, a low-wealth household is more likely to rely on debit.[5] Additionally, higher-wealth consumers are likely to deposit more funds in their deposit accounts, creating benefits for banks by lowering their cost of capital. Lastly, high-wealth consumers may provide non-interest income through use of additional services.

Conversely, low-wealth consumers typically maintain lower account balances and are less likely to use additional fee-based services, limiting the revenue banks can generate from these accounts through traditional means. As a result, interchange revenue from debit transactions and overdraft fees often constitute a larger proportion of the total revenue generated by their accounts. This reliance on interchange and penalty fees to cover the costs of servicing low-wealth accounts may create incentives for banks to prioritize these revenue streams over the development of more affordable and inclusive banking products and services. We fear that some banks may have made strategic decisions to rely on overdraft fee revenue to cover the cost of provisioning these accounts, rather than exploring alternative business models that better serve the needs of low-wealth consumers.

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[3] Brainard, L. (2022). The Role of Financial Inclusion in Building a More Equitable Economy. Speech at the Financial Health Network Summit, Washington, D.C., June 15, 2022. https://www.federalreserve.gov/newsevents/speech/brainard20220615a.htm

[4] Servon, L. (2017). The Unbanking of America: How the New Middle Class Survives. Mariner Books.

[5] Levinger, Benjamin, and Michael Zabek. "Credit or Debit:How Do Lower-Income Consumers Pay?" In *Communities and Banking*. 2011 Series. Federal Reserve Bank of Boston, 2011. https://www.bostonfed.org/home/publications/communities-and-banking/2011/winter-2011.aspx.

Indeed, the bifurcation may have the effect of moving lower-wealth households into accounts that are a mismatch for their needs. The FDIC's National Survey of Unbanked and Underbanked Households revealed that consumers with less than $15,000 and between $15,000 and $30,000 in income are 3.0 and 2.98 times more likely, respectively, to use a bank teller as their primary point of access for managing their finances.[6] This suggests that lower-income consumers often prefer or require in-person banking services, which may not be readily available through digital-only accounts. Empirical evidence also indicates that the presence of bank branches in low and moderate-income communities is associated with lower default rates and greater access to credit for borrowers in those areas.[7]

The mismatch between the needs of lower-wealth households and the services provided by digital-only accounts is further highlighted by the fact that some neo-bank fintech companies derive a significant portion of their revenue from out-of-network ATM fees. For example, one of the primary neo-bank fintech companies reported that out-of-network ATM fees are its second-largest source of revenue, contributing 21 percent of its total revenue in 2022.[8] This suggests that many lower-wealth consumers using these accounts still require access to physical cash and ATM services, which can be costly when using out-of-network ATMs. This additional cost burden underscores the potential disconnect between the services provided by digital-only accounts and the actual needs of lower-wealth households.

The Durbin exemption has led to a disconnect between the banks that partner with fintech companies to offer digital-only accounts and their obligations under the Community Reinvestment Act (CRA). Many fintech "neobank" partnerships involve a bank with only one or a handful of branches in a single metropolitan area, but through their digital-only products, these banks can serve households across the country. This structure allows banks to benefit from the Durbin exemption while having minimal physical presence in the communities they serve, effectively bypassing their CRA obligations. The Federal Reserve should consider how an unintentional outcome of the Durbin exemption has been to drive this disconnect. The recently-updated rules implementing the Community Reinvestment Act through Regulation BB did not address this disconnect, leaving open the possibility that institutions serving these consumers would have little or no accountability for community reinvestment responsibilities.

To mitigate the risks of a bifurcated banking system, policymakers should consider the potential impact of interchange fee regulation on different segments of the banking sector and take steps to ensure that LMI consumers are not inadvertently harmed or excluded. While smaller banks, CDFIs, and fintech companies may benefit from the higher interchange fee cap, it is important to ensure that these institutions are using this advantage to provide high-quality, affordable, and inclusive financial services to LMI communities. Policymakers could consider implementing targeted measures to encourage these institutions to invest in more comprehensive services, such as in-person support, financial education, and access to physical branches or ATMs in underserved areas. Additionally, policymakers could explore ways to promote

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[6] Federal Deposit Insurance Corporation. "2021 FDIC National Survey of Unbanked and Underbanked Households." Federal Deposit Insurance Corporation, July 24, 2023. https://www.fdic.gov/analysis/household-survey/index.html.
[7] Ergungor, O. Emre, and Stephanie Moulton. "Do Bank Branches Matter Anymore?" *Federal Reserve Bank of Cleveland Economic Commentary*, no. 2011–13 (August 4, 2011). https://doi.org/10.26509/frbc-ec-201113.
[8] Larson, Stefan. "Chime Revenue, Users & Valuation 2024." *Priori Data* (blog), January 19, 2024. https://prioridata.com/data/chime-statistics/.

greater collaboration and partnerships between larger financial institutions and community-focused providers to create a more integrated and inclusive banking system that serves the needs of all consumers. This could involve incentives for larger institutions to invest in and support the growth of smaller, community-focused providers, as well as the development of shared infrastructure and resources to enhance access to financial services in LMI communities.

Ultimately, the goal should be to create a regulatory framework that promotes competition, innovation, and access to affordable financial services for all, while avoiding the unintended consequence of a bifurcated banking system that leaves LMI consumers behind. This will require a careful balancing of competing priorities and a willingness to adapt and adjust policies based on empirical evidence and stakeholder feedback.

We appreciate the opportunity to provide our perspective on this critical issue and urge the Board to carefully consider the potential impact of the proposed changes to Regulation II on LMI consumers and the broader goal of financial inclusion.

Sincerely,

Adam Rust
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Consumer Federation of America

Delicia Hand
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