



Old-fashioned Innovation

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February 17, 2021

*VIA EMAIL*

Matthew J. Eichner

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Director – Division of Reserve Bank Operations and Payment Systems  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue NW  
Washington D.C. 20551

**Re: Clearing House Association Proposals Regarding Regulation II**

Dear Mr. Eichner:

This letter is being sent in response to the letter dated October 23, 2020 regarding debit interchange fee restrictions that the Clearing House Association, L.L.C. (the “Clearing House”) submitted to the Board of Governors of the Federal Reserve System (the “Board”) on October 23, 2020 (the “TCH Letter”). As one of the small issuers named in the TCH Letter as purportedly engaged in prepaid card activities designed to “inappropriately utilize the small issuer exemption to avoid the interchange fee limitations under EFTA and Regulation II,” Sutton Bank has a compelling interest in setting straight the many factual inaccuracies recited in the TCH Letter under the guise of “observations.” While we cannot speak to how other small issuers operate their prepaid card programs, we can assure the Board that the Clearing House’s assumptions about how we do business are unfounded. Moreover, when the true facts are considered, we are confident the Board will dismiss any notion of an “uneven regulatory playing field” between the nation’s largest banks and Sutton Bank.<sup>1</sup>

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<sup>1</sup> As was reported on the Board’s website, representatives of the Clearing House, together with representatives of JPMorgan Chase Bank, N.A. and Capital One, met with the Board to discuss the TCH Letter on December 10, 2020. According to published Board statistics on large commercial banks, Chase (\$2.87 trillion in total assets) and Capital One (\$360 billion in total assets) are first and ninth largest banks in the U.S, respectively. The asset size of Sutton Bank was stated in the TCH Letter as \$780 million. We have grown since then to approximately \$1 billion in total assets, but remain miniscule in comparison to Chase or Capital One.  
<https://www.federalreserve.gov/releases/lbr/current/default.htm>

## I. Introduction

Sutton Bank was founded in 1878. The history of Sutton Bank is fundamentally linked to the development of southeastern Seneca and western Huron Counties. We have long served as a community pillar, staying strong through the Great Depression, times of war, and fluctuating economies. A progressive, privately held, and independent community bank, Sutton Bank has consistently been named one of the top small business and agricultural lenders in the State of Ohio. We are supervised by the FDIC and the Division of Financial Institutions – Ohio Department of Commerce and take pride in conducting our activities in compliance with both the letter and the spirit of the law.

Although our roots are deeply tied to the people, commerce and values of north central Ohio, we offer prepaid card products on a nationwide basis. The latter activities are largely made possible by the small issuer exemption to Regulation II and generate revenue that allows Sutton Bank to continue to provide jobs and banking services in the heart of ‘flyover country’ despite ever increasing competition from larger institutions and non-bank fintech companies, and the ongoing economic challenges posed by the COVID-19 pandemic.

As *American Banker* reporter Kevin Wack noted in his January 8, 2020 article entitled, *Banking 2025: The struggle to avoid becoming the ‘dumb utility,’* the continued deep inroads by non-bank fintech companies into what had historically been ‘bread and butter’ banking services places “thousands of smaller, locally oriented banks . . . in a particularly tough spot.” In that same article, Wack elaborated on “important distinctions between large banks — relatively well positioned to weather rapid changes in the business climate — and smaller, more vulnerable institutions.”<sup>2</sup> Briefly, for smaller institutions, such as Sutton Bank, the need to embrace innovation, including by partnering with fintechs, is a matter of their very survival. The fact that Regulation II facilitates such relationships is a positive result which in no way reflects abuses or evasions of the law. In this regard we remind the Board that a key goal of Senator Richard Durbin in crafting the amendment to the Electronic Funds Transfers Act that would eventually bear his name was to further the ability of small banks to compete effectively against large banks:

This duopoly, this power in the market, this ability to terrorize credit unions and small banks [of large banks] is an indication of too much power and too little competition. If we truly believe in a free market and an entrepreneurial society, we have to support competition. In this case, merchants, businessmen, small banks, and small credit unions are being terrorized by these powerful interests.<sup>3</sup>

In seeking to address what it perceives as unfair competitive advantages for large fintechs over large banks, and exempt small banks over large banks with up trillions of dollars in assets, the Clearing House has asked the Board to adopt new regulatory interpretations that risks erasing smaller banks from the competitive equation and would increase costs for those consumers least

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<sup>2</sup> <https://www.americanbanker.com/news/the-struggle-to-avoid-becoming-the-dumb-utility>

<sup>3</sup> 156 CONG. REC. S4977 (daily ed. June 16, 2010) (statement of Sen. Durbin).

able to pay more.<sup>4</sup> We ask the Board to consider the Clearing House's arguments in light of the true facts, which we believe support keeping the interpretative guidance to Regulation II exactly as is.

## II. Sutton Bank holds substantial prepaid Card program funds

All of arguments made in the TCH Letter hinge on the core assumption that small issuers hold only nominal funds underlying their prepaid card programs. In the case of Sutton Bank, this assumption is false, including for programs in which the prepaid card account has a zero balance until it is funded by deposits triggered by card transactions. To this end, consistent with the requirements of Regulation II that (i) the issuing bank must hold the account that is being debited and (ii) the card device must constitute the "only means of access to the underlying funds," Sutton Bank requires all of its third-party program partners to maintain more than adequate deposits to cover the aggregate card transactions that might occur at any moment in time. For our largest such 'zero balance' prepaid card program, the total funds held or managed by Sutton Bank on any given day may exceed \$500 million, which is an unquestionably large sum for a rural community bank with approximately \$1 billion in total assets.<sup>5</sup>

The TCH Letter additionally asserts that "[a] small financial institution may be unable to honor its settlement obligations to payment card networks if the actual card spend exceeds the funds held in the cardholder account and the institution is unable to recover the excess amount from its fintech partner." This is not a genuine risk for Sutton Bank for several reasons. First, none of our prepaid card programs permit the cardholder to overdraw their account. If a deposit cannot be made to the cardholder's prepaid account in the amount necessary to fund a given card transaction, that transaction will be denied with no exceptions made. Second, the amount of funds our program partners are contractually required to maintain at Sutton Bank should always be more than enough to cover any card settlements. To this end, we note that the adequacy of our card program reserves is examined for safety and soundness purposes by the FDIC and the Division of Financial Institutions – Ohio Department of Commerce. Lastly, as a member of the card associations (Visa, MasterCard, Discover, etc.) Sutton Bank is obligated to comply with all network requirements, including for collateral to secure settlement.

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<sup>4</sup> As Ryan McCarthy noted in his 2017 article entitled, *The Durbin Amendment: Summary, Impact, and Reform*, which was published in the *Review of Banking and Financial Law*, one effect of the amendment was that exempt banks, unlike non-exempt banks, responded to the amendment by increasing their offerings of free accounts to consumers. Specifically, "from 2011 to 2012, exempt banks offering free current accounts increased by 7 percent." *Id.* at p. 81 (citing *The Impact of Debit Card Regulation on Checking Account Fees*, 98 Fed. Res. Bank Kan. City Econ. Rev. 59, 65–66 (2013)) To this end, all prepaid card products issued by Sutton Bank charge either no fees or very low fees.

<sup>5</sup> Contrary to what is implied in the TCH Letter, the Frequently Asked Question About Regulation II stating that some funds-loading arrangements may warrant additional supervisory scrutiny to determine whether circumvention or evasion is occurring," including 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" is not targeted at exempt small issuers. The FAQ cites paragraph 6(a)-2.ii of the commentary to Regulation II, which addresses the risk that a *non-exempt issuer* might try and game the system by "replac[ing] its debit cards with prepaid cards that are exempt from the interchange limits."

### **III. Requiring issuers to all hold funds “associated with” debit or prepaid cards is an unworkable concept and at odds with Regulation II**

The proposed interpretation requiring funds “associated with” a prepaid card to be held at the issuing bank is both patently vague and premised on faulty legal reasoning. The fact that deposits to a prepaid account may be made with funds held elsewhere besides at the issuing bank should not cause those external funds to be deemed associated with the subject prepaid card program. For certain of Sutton Bank’s programs, card balances are loaded by funds drawn from an account held elsewhere by the cardholder. But that does not mean that such external funds are therefore prepaid card funds. In all such programs, the terms and conditions of the externally-held account allow the customer to deploy their funds in a host of other ways besides making deposits to their Sutton Bank prepaid account; e.g., in peer-to-peer transactions or making permitted investments. In point of fact, a given Sutton Bank prepaid card customer may choose to use *none* of their purportedly “associated” funds to deposit funds to their card balance. Furthermore, as a legal matter, the Regulation II small issuer exemption would not permit Sutton Bank to hold such external funds for the simple reason that they are accessible in multiple ways unrelated to the prepaid card.<sup>6</sup>

The proposed “associated with” addition to existing Regulation II guidance would capture any account that could conceivably be used to fund a consumer’s prepaid card account. Hence, all customer funds held in any external asset account would have to be transferred to the card issuer. The implausibility of such transfers would have practical effect of making prepaid card issuance impossible, which we suspect may be the unstated goal behind this ill-conceived proposal.

In contrast to the proposed interpretation, the small issuer exemption in Regulation II itself is clear and unambiguous and, as noted above, does not result in prepaid card issuers’ only holding nominal funds or any of the other adverse consequences the TCH letter speculates about. In an obvious effort to quash increasing competition from fintech companies, and perceived unfair competition from small banks,<sup>7</sup> the TCH Letter seeks to have the Board introduce significant ambiguity into Regulation II in the form of vague references to “underlying funds” and funds that are “associated with” the subject prepaid or debit account that would be impossible to apply in actual operation.

### **IV. Irrespective of the fintech party’s size, a well-managed relationship between an insured bank and a fintech is never controlled by the fintech**

Throughout the TCH Letter the Clearing House assumes that large fintechs engaged in prepaid card relationships with small issuers automatically dominate the parties’ relationship,

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<sup>6</sup> 12 C.F.R. § 235.5(c)(1)(iii).

<sup>7</sup> The TCH letter notes in footnote 5 that “certain small issuers rank among the top ten debit card issuers (by transaction volume). . .” Although Sutton Bank is proud to be a part of that success, we clearly pose no serious competitive threat to banks with assets many hundreds or thousands of times greater.

including with respect to control over the card program's underlying funds. In the case of Sutton Bank, this assumption is false. All of our prepaid card programs are contracted for under bank program agreements that treat the fintech partner as a third-party service provider to the bank. Those agreements assign to bank management the sole discretion to make all key decisions affecting the program, including, but not limited to, regarding changes recommended by any regulatory authority. In addition, all programs are maintained and managed in strict accordance with the safety and soundness expectations stated in FDIC FIL 44-2008 (Guidance for Managing Third-Party Risk), including through ongoing oversight provided by the bank's Third Party Risk Management Group. Lastly, the possibility of a non-bank fintech party's freely moving card program in and out of Sutton Bank is completely precluded by our contractual requirements governing transaction funding and reserves.

Because any prepaid card program relationship between a small bank issuer and a large fintech company is required by FDIC guidance to be structured in a manner that gives the bank appropriate control over its card product, the Board should reject the suggestion made in the TCH Letter that the assets of the small issuer should be combined with the assets of the fintech company in determining whether the issuer qualifies for the \$10 billion exemption threshold of Regulation II. As with other proposals set forth in the TCH Letter, this suggestion is premised on the misplaced assumption that a large fintech company will necessarily dominate any relationship with a small issuer.

**V. Any proposed revisions to the existing Board interpretations of Regulation II should be published for notice and comment**

For all of the above-stated reasons, we urge the Board to reject the proposals stated in the TCH Letter. The alleged regulatory "gaps" and purported industry abuses the Clearing House urges the Board to address in the form of a new FAQ or revisions to official commentary are rooted in unsupported assumptions about how small issuers operate. Moreover, in attempting to address competitive disadvantages between large banks and large fintech companies, the Clearing House and its large bank constituency seem to have no qualms about calling for the adoption of actions that could threaten the future viability of small banks.

Before seriously entertaining any regulatory revisions, the Board should hear directly from small issuers by publishing any proposed interpretative changes for notice and comment, which would allow the small banks most affected by the potential changes to weigh in. Small issuers, however, are not the only key stakeholders that the Board should hear from. If the Board were to accept the proposals described in the TCH letter as written, the result would be to severely curtail the existing ability of small issuers to charge interchange fees. The resulting loss of revenue to such issuers would almost certainly result in higher fees being charged to consumers. To this end, because prepaid card customers disproportionately consist of persons who have limited economic means, a likely result of the Board's action would be to increase costs for persons who can ill afford to pay more, especially in light of the still raging COVID-19 pandemic.

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Thank you for your careful consideration of this letter. If you have any questions regarding the above, please do not hesitate to contact me at (419) 426-6262 or [mdabertin@suttonbank.com](mailto:mdabertin@suttonbank.com).

Sincerely yours,

A handwritten signature in cursive script that reads "Mark T. Dabertin".

Mark T. Dabertin  
General Counsel and Chief Compliance Officer

Cc: J. Anthony Gorrell, Chief Executive Officer, Sutton Bank