May 10, 2024

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

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

Dear Ms. Misback:

On behalf of our food retail, wholesale, and product supplier members, FMI – The Food Industry Association welcomes the opportunity to submit comments in response to the Notice of Proposed Rulemaking ("NPRM" or "Proposed Rule") published by the Board of Governors of the Federal Reserve System ("Board") on debit card interchange fees. We commend the Board for initiating this important rulemaking. The NPRM represents a meaningful opportunity for the Board to set the U.S. debit system on a path characterized by consistently reasonable interchange fees and effective incentives for reduced fraud.

I. Introduction

As the food industry association, FMI works with and on behalf of the entire food industry to advance a safer, healthier, and more efficient consumer food supply chain. FMI brings together a wide range of members across the value chain – from retailers that sell to consumers, to producers that supply food and other products, as well as a variety of companies providing critical services – to amplify the collective work of the industry.

Food retailing is a very diverse industry and brings a unique set of challenges when considering the numerous daily functions that a single store provides to its customers and communities. Grocery stores are the hub for everyday food and consumer goods, operating pharmacies that dispense life-depending medications, vaccines, and flu shots, and serving the community of Americans who rely on critical food assistance programs like the Supplemental Nutrition Assistance Program (SNAP) and the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC).

Our member companies, which range from independent operators to regional and large national and international businesses and brands, operate roughly 33,000 grocery stores and 12,000 supermarket pharmacies. FMI members produce and supply the more than 30,000 different food and consumer good products found on store shelves, and ultimately touch the lives of more than

100 million U.S. households per week. The food industry also provides a wide range of full-time, part-time, seasonal, and flexible workforce opportunities in a diverse variety of careers, employing more than six million individuals and serving as an essential employer in every community around the country. A single grocery store employs more than 100 individuals on average, and a larger format supermarket employs well over 300 individuals on average. The diversity of career opportunities offered through the food industry provides individuals with employment at any stage of life and at any education level.

The grocery industry is among the most competitive sectors in our economy. Grocers negotiate prices with vendors on every product they sell and every service they use and operate on very slim profit margins – about 1-2 percent annually on average. Grocers are doing everything possible to avoid passing inflationary costs onto shoppers. Competition in the grocery sector is fierce, and the battle for market share helps keep prices down for shoppers.

FMI commends the Board for initiating this rulemaking to lower the maximum regulated debit interchange rate and establish a process to adjust the regulated rate every other year. We appreciate the Board and Board staff for being responsive to the concerns raised by FMI and food retailers in recognizing that the current debit regulated interchange rate is inconsistent with applicable law that requires "reasonable and proportional" limits. The debit card serves as an access device to a customer's checking account, akin to the Federal Reserve-regulated paper check which clears at par. As noted above, the grocery industry operates on razor thin profit margins of between 1-2 percent annually. These slim margins have remained consistent for well over a decade since the implementation of the current debit regulated rate. As grocery customers have progressively increased their use of credit and debit cards over this time, due to customer preference and because of the COVID-19 pandemic, our industry's operations costs have been squeezed. Ensuring a "reasonable and proportional" debit regulated rate is critically important to keeping prices low for customers in the slim-margined grocery industry.

As noted in our December 22, 2022, petition[1] to the Board requesting this rulemaking, data collected by the Board clearly show that regulated issuers' cost of conducting debit transactions has decreased substantially since the 2011 promulgation of Regulation II and that the current regulated rate is not compliant with the governing law enacted in the Durbin Amendment and codified in Section 920 of the Electronic Fund Transfer Act ("EFTA"). While we commend the Board for proposing a reduction in the overall regulated rate, there are important changes that should be made to the Proposed Rule's methodology for each of the three components of the regulated rate. FMI also agrees with the Board that the debit regulated rate should be periodically updated. It has taken 13 years for the regulated rate under Regulation II to be revisited, which is simply unacceptable. However, we recommend that the Board make several changes to the NPRM's

---

[1]Petition letter from FMI and NACS to Federal Reserve Chairman Powell, Vice Chairs Brainard and Barr, and Governors Bowman, Waller, Cook and Jefferson, Dec. 22, 2022, *available at* https://www.federalreserve.gov/regreform/rr-commpublic/trade-association-letter-20221222.pdf.

proposed methodologies for the fee components before locking in any methodologies for future automatic updates to the regulated rate. Finally, it is critical that the Board lay out an oversight and audit plan for data collection from covered issuers going forward to ensure the integrity of reported data on which future automatic adjustments are based.

As detailed in the comments below, we strongly recommend the following:

> (A) the formula for calculating the base interchange fee component must not have a fixed multiplier of higher than 2.7, which is the multiplier that was applied in Regulation II, and which amply compensates covered issuers for the overwhelming majority, 95 percent, of debit transactions;
>
> (B) the *ad valorem* fraud loss fee component should be awarded on an issuer-by-issuer basis: with covered issuers that have demonstrated actual fraud reduction on their debit cards becoming eligible for the full *ad valorem* amount; while issuers that have not demonstrated fraud reduction only becoming eligible for a percentage of the full *ad valorem* rate that equals the percentage of fraud losses actually absorbed by the covered issuer on their debit cards;
>
> (C) the fraud prevention adjustment must be meaningfully evaluated on an issuer-by-issuer basis, with eligibility for both the fraud prevention adjustment and the fraud loss component depending on an issuer demonstrating it has taken specific fraud prevention steps that are actually effective; and
>
> (D) the Board's proposal for future rate adjustments should include these methodology changes and should also include a plan for careful oversight and auditing of reported data to ensure that issuer costs are not misrepresented or inflated.

Our letter also addresses several claims that the financial industry has repeatedly made in opposition to debit interchange regulation. We appreciate the Board's careful consideration of our policy recommendations and comments.

II. Comments on the Proposed Rule

FMI appreciates the Board's recognition that the current regulated rate must be reduced to comply with the statutory mandate in EFTA Section 920. As discussed below, we strongly urge that further changes be made to the NPRM's approach to each of the three fee components that comprise the regulated rate.

A. The base component fixed multiplier must be reduced to a level no higher than the fixed multiplier used in 2011 to reflect the subsequent decrease in issuer costs.

The Regulation II base component rate that the Board established in 2011 is too high and must be reduced. As noted in the NPRM, "several data points show that the allowable costs incurred by covered issuers have fallen significantly since the original Regulation II rulemaking."[2] The Board observed that the transaction-weighted average of per-transaction base component costs across covered issuers decreased from 7.7 cents in 2009 to 3.9 cents in 2021, which "represents a decline of nearly 50 percent."[3] The NPRM explicitly states that "the Board believes it is necessary to revise the interchange fee standards to reflect the decline since 2009 in base component costs."[4] However, the NPRM's proposed rate of 14.4 cents represents a decline in the base component fee of less than one-third from the current Regulation II rate of 21 cents, which does not reflect the nearly 50 percent actual decline in issuer costs.

The Board's methodological approach of choosing a 3.7 fixed multiplier based on a full cost recovery target over time of 98.5 percent fails to align with the statute, the data, or past practice, and would result in unreasonably high fees. In 2011, the Board selected a base component rate that matched "the site of a clear discontinuity in the distribution of per-transaction base component costs across covered issuers," which at that time was the 80th percentile of covered issuers.[5] The Board notes that subsequent data collected by issuer surveys did not similarly show such a clear level of discontinuity in the distribution of costs, and now deems its former methodology "not appropriate for determining the base component at this time."[6] Instead, the Board proposes "to determine the base component as the product of a fixed multiplier and the transaction-weighted average of per-transaction base component costs across covered issuers."[7] The Board plans to codify a "constant" fixed modifier that "would correspond to a target selected by the Board for a *reasonable* percentage of covered issuer transactions for which covered issuers should fully recover their base component costs over time, consistent with the Durbin Amendment."[8] The NPRM proposes a full cost-recovery target of 98.5 percent of covered issuer transactions, a seemingly random target which attempts to be rationalized by saying it equates to an efficiency gap of 5.2 with respect to transaction processing between covered issuers whose transactions are above and below that target. The NPRM does not explain why an efficiency gap of 5.2 is the appropriate figure. We are concerned that the NPRM is relying on an arbitrarily selected efficiency gap figure to justify an arbitrarily selected cost recovery target. As a consequence of the selection of this cost recovery target, the Board proposes to codify a fixed multiplier of 3.7 for the base component, which would nearly quadruple the average covered issuer cost, and which would be locked in in perpetuity for future rate adjustments.

---

[2] 88 Fed. Reg. 78105 (Nov. 14, 2023).
[3] *Id.*
[4] *Id.* (emphasis added).
[5] 88 Fed. Reg. 78106.
[6] *Id.*
[7] *Id.*
[8] *Id.* (italics in original).

We recommend a simpler and more reasonable solution which demonstrates greater consistency with the Board's 2011 methodology and reflects the actual decline in covered issuer costs shown in the data. This approach, detailed in our December 2022 petition to the Board, would implement a fixed multiplier of no higher than 2.7 times the average per-transaction cost – effectively the same multiplier that was applied by the Board in 2011.[9] Then, the Board set the base component rate at 21 cents, which was 2.7 times higher than the 2009 average allowable cost of 7.7 cents. A fixed multiplier of 2.7 corresponds to a cost-recovery target of 95 percent of covered issuer transactions – a small fractional difference from the NPRM's 98.5 percent target – but would produce a base component fee of 10.5 cents which reflects the fact that issuer costs have declined by approximately half since 2011. A base component rate of 10.5 cents would still be almost triple the average per-transaction cost. While there are some low-volume, high-cost issuers that may not be able to achieve 100 percent cost recovery with a 2.7 multiplier, the Board explicitly stated in 2011 that "[it] does not believe that it is consistent with the statutory purpose to permit networks to set interchange fees in order to accommodate 100 percent of the average per-transaction cost of the highest-cost issuers."[10] As we stated in our December 2022 petition, "[a] multiplier of 2.7 times the average per-transaction cost would accommodate the statutory 'reasonable and proportional' standard while allowing almost all issuers the flexibility to respond to changing costs and economic conditions."[11] Further, merchants and consumers would benefit from a reduced rate that actually reflects covered issuers' cost decreases.

Whereas the NPRM's proposed 3.7 fixed multiplier is based on both an untested methodology and on arbitrarily selected cost recovery and efficiency gap targets, a fixed multiplier that does not exceed 2.7 would be both consistent with the Board's prior Regulation II rulemaking and would be rationally linked to actual issuer cost data. We note that the Board would also be justified in adopting a fixed multiplier that modifies a more limited set of costs than currently included in the NPRM; the Board's inclusion of fixed costs and other "third category" costs in 2011 was a discretionary decision and, in our view, was inconsistent with the clear text and intent of EFTA 920. Limiting the universe of allowable costs in the base fee component to actual incremental authorization, clearance, and settlement (ACS) costs, like the plain language of the statute directs, would both help reduce the unjustifiably high regulated rate and also give covered issuers a competitive marketplace incentive to make their fixed costs more efficient. The Board should, at a minimum, address the potential loophole created by its inclusion of issuer-paid network processing fees in the universe of allowable costs for the base component fee. This inclusion, combined with

---

[9] *See* Dec. 22, 2022, petition from FMI and NACS *supra* note 1 ("When the base component was set at $0.21, it was 2.7 times higher than the average allowable costs of $0.077 reflected in the 2009 issuer survey."); *see also* Letter to Chairman Powell and Governors Brainard, Quarles, Bowman, and Clarida from FMI and other companies and trade associations, July 27, 2020, at p. 5, *available at* https://www.federalreserve.gov/regreform/rr-commpublic/merchants-and-merchant-trade-associations-meeting-20200923.pdf ("The Board should reset the base component of the interchange rate to be not more than the original multiple of 2.7 times average allowable costs.")
[10] 76 Fed. Reg. 43433 (July 20, 2011).
[11] Dec. 22, 2022, petition from FMI and NACS, *supra* note 1.

the Board's fixed multiplier proposal, would enable networks to unreasonably increase compensation to issuers by simply increasing network processing fees, since the issuers would receive multiple times the fee increase back in interchange through the multiplier. While the Board has indicated in the NPRM that it does not want to reopen debate on the universe of allowable costs in the base component, it should at a minimum fix the network processing fee loophole; furthermore, if the Board applies a new methodology based on a seemingly arbitrarily selected cost recovery target to multiply the universe of allowable costs by an excessively high fixed multiplier, it invites challenge to its exercise of discretion in determining the costs allowable under such a new approach.

B. The *ad valorem* fee component should be reduced and the methodology for the *ad valorem* fee must be revised.

FMI agrees that the *ad valorem* component must be reduced. As the NPRM notes, since 2011 "the issuer fraud losses on which the Board based the *ad valorem* component have fallen," as has the median ratio of issuer fraud losses to transaction value.[12] Those changes in the data alone warrant a reduction in the current *ad valorem* fee under the Board's existing methodology, as the current five basis point fee is not reasonable and proportional to covered issuer fraud losses.

However, shortcomings in the methodology for the *ad valorem* component must also be addressed. Fraud on covered issuer debit transactions has approximately doubled under Regulation II while the percentage of fraud losses absorbed by covered issuers has plummeted.[13] Years of collected data demonstrate that Regulation II's *ad valorem* fee for covered issuer fraud losses, which Congress neither called for nor intended in EFTA Section 920 and which the Board exercised its own discretion to create, does not establish sufficient incentives for fraud reduction in the debit system. Under the Board's current approach of uniformly compensating covered issuers in advance for potential fraud losses, fraud has not been reduced; rather, both fraud losses and fraud incidence for covered issuer transactions have soared, though issuers are getting more proficient at avoiding fraud losses and shifting them instead onto merchants and consumers (the same participants who also bear the cost of the *ad valorem* fee).[14] While the Board asserts that it "continues to believe that covered issuers have an incentive to protect cardholders and reduce fraud, despite a reduction in the proportion of fraud losses borne by covered issuers," the Board in 2012 described this as a "strong incentive" and now, in an apparent concession, no longer characterizes the incentive as

---

[12] 88 Fed. Reg. 78101.

[13] 88 Fed. Reg. 78118 ("With respect to covered issuer transactions, fraud losses to all parties as a share of transaction value increased from 9.0 basis points in 2009 to 17.5 basis points in 2021, and have displayed an upward trend since 2011…"Overall fraud incidence for covered issuer transactions approximately doubled from 2009 to 2021…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.").

[14] *Id.*

strong.[15] Further, as fraud increasingly shifts to card-not-present (CNP) channels, the Board's current methodology risks becoming even more ill-suited to incentivizing effective fraud reduction because, as the NPRM noted, "merchants absorb the majority of fraud losses for CNP transactions."[16]

We recommend that the Board revise its methodology of requiring merchants to compensate in advance all covered issuers for fraud losses through a uniform *ad valorem* fee, and instead provide the *ad valorem* fee component to covered issuers on an issuer-by-issuer basis in accordance with the following criteria.

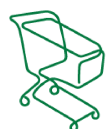
(1) To be eligible to receive any *ad valorem* fee component during an upcoming two-year rate period (*i.e.*, the two-year time periods proposed in the NPRM in which the most recently updated regulated rate applies), the issuer must be determined by the Board to be in compliance with more robust fraud prevention standards that the Board should establish and enforce (as discussed below in Part II. C of this comment letter);

(2) To be eligible for the maximum *ad valorem* fee component during an upcoming two-year rate period (*e.g.*, under the Board's NPRM, this maximum would equal four basis points for the next two years), an issuer must demonstrate that the per-transaction rate of fraud losses on transactions involving the issuer's debit cards <u>decreased</u> in the most recent two-year rate period compared to the two-year rate period prior to the most recent period, regardless of which participants in the system absorbed the losses. In other words, in order to receive the maximum fee rate, a covered issuer must work with other participants (merchants, acquirers, cardholders) to reduce <u>overall</u> fraud levels associated with the issuer's cards; this will prompt issuers to invest in effective fraud reduction steps such as encouraging the use of more secure authentication methods and technology (like single-message transactions, which have shown significant reductions in fraud according to the Board's data). If the issuer cannot demonstrate that the overall per-transaction rate of fraud losses decreased for the issuer's debit cards in the most recent two-year rate period, then for the next two-year rate period the issuer would receive <u>a percentage of the maximum *ad valorem* fee component that equals the percentage of fraud losses absorbed by the issuer in the most recent two-year rate period</u> (*e.g.*, if the issuer absorbed 33 percent of fraud losses in the most recent period and overall fraud losses on the issuer's debit cards did not decrease, then the issuer would be eligible for an *ad valorem* fee that is 33 percent of the maximum *ad valorem* fee during the next two-year rate period).

---

[15] 77 Fed. Reg. 46262 (Aug. 3, 2012); 88 Fed. Reg. 78119.

[16] Board of Governors of the Federal Reserve System, "2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions," Oct. 2023, at p. 24, *available at* https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2021.pdf.



Such reforms to the Board's methodology would not be challenging to implement, as they would be largely based on data the Board already collects from each covered issuer, and the reforms would realign incentives in a way that would once again give covered issuers "strong" motivation to reduce fraud. The reforms would also correct the current unreasonable situation in which the Board allows covered issuers to essentially have their cake (a network-established *ad valorem* fee that forces merchants to pre-pay all covered issuers for fraud losses regardless of how effective any particular issuer is at reducing fraud), and eat it too (by charging back merchants or cardholders for a majority of fraud losses when they occur), and then get another helping of cake (the fraud prevention adjustment, which covered issuers appear to be currently receiving under Regulation II without demonstrating that they are effectively preventing fraud).

There are several reasons why the Board can and should reopen its methodology for the *ad valorem* fraud loss fee component and revise the methodology as described above.

1. First, the Board's current methodology of providing a uniform *ad valorem* fee for covered issuer fraud losses is not mandated by statute and was not part of Congress's design for addressing fraud in the debit system. EFTA Section 920 was written and intended to limit centrally-fixed debit interchange rates to cover only issuers' incremental ACS costs plus an adjustment that would specifically compensate and reward those issuers who were demonstrating effectiveness at fraud prevention. Congress did not direct the Board to uniformly compensate all covered issuers in advance for potential fraud losses via interchange fees that merchants and their customers would ultimately bear, especially when issuers were already able to charge back most of the actual fraud losses on their debit cards to merchants and cardholders. Congress intended reform to incentivize issuers to reduce overall fraud losses, not subsidize issuers for fraud losses.

   Congress had good reason to be concerned about the negative effects of network-fixed interchange fees on fraud, because the way Visa, Mastercard and their member banks structured the debit card interchange system had long entrenched the wrong incentives when it comes to fraud prevention. When all card issuers in a network receive the same network-established interchange fee rates, it reduces the incentive for issuers to invest in minimizing fraud, since they will receive the same interchange fees regardless of whether they are better or worse than other issuers at combating fraud. Moreover, card networks have incentive to set interchange rates higher for authentication methods that bolster their network market share and stifle network competitors, even if those methods are more fraud prone. This prompts card issuers to steer their cardholders toward less-secure payment methods in order to collect more fees.

Nowhere were these misaligned incentives more evident than in the evolution of signature debit. It is well known that signature debit is significantly more fraud-prone than PIN debit.[17] However, in the 1990s Visa dramatically expanded the use of signature debit through an anti-competitive tying arrangement with Visa credit cards, and then Visa used signature debit to fundamentally change the structure and amount of debit interchange fees throughout the market.[18] By the time of the Durbin Amendment's enactment, signature debit was far more prevalent than PIN debit and issuing banks were urging customers to use signature, even though it carried significantly higher transaction fees and significantly higher fraud. The misaligned incentives behind signature debit's rise were a key consideration for Congress while the Durbin Amendment was under consideration. As Senator Dick Durbin (D-IL) explained on the Senate floor in June 2010 while the Durbin Amendment was being debated in conference committee:

> Visa, Mastercard, and the banks for years have been urging consumers to use payment methods that run higher fraud rates. On April 21, an article ran in the American Banker entitled ''Counterintuitive Pitch for Higher-Fee Debit Category.'' The article discusses how JPMorgan Chase, one of the Nation's largest debit card issuers, has urged all its customers to sign for its debit transactions rather than enter a PIN number. As the article points out, entering a PIN number greatly reduces the risk of fraud. The reason JPMorgan Chase urged its cardholders to use signature debit cards is the interchange fees for signature cards are higher. They make more money when you sign than when you use a PIN number. They are willing to absorb the possibility of fraud in a signature rather than in a PIN number, which is more secure. The banks do not appear to be nearly as concerned about lower fraud as they are about higher fees. Visa, MasterCard, and the banks have also been blocking the introduction of fraud-proof card technology in the United States, again because they want to keep interchange rates high. For example, many countries have chip and PIN cards where a card has a microchip that can only be activated by the use of a PIN number. The banks and card companies in this country have stifled that technology. When debit fraud does happen today, the big banks usually try to charge back the fraud loss to the merchants on the grounds that the merchants somehow violated Visa's and MasterCard's operating rules. As long as big banks are guaranteed the same interchange revenue no matter how much or how little fraud

---

[17] *See, e.g.*, 75 Fed. Reg. 81741 (Dec. 28, 2010) (stating that "Signature debit card transactions exhibit a higher fraud rate than that of PIN debit card transactions" and finding that, on a per-dollar basis, signature debit fraud losses were 3.75 times PIN-debit fraud losses).

[18] *See* Andrew Martin, "How Visa, Using Card Fees, Dominates a Market," *The New York Times*, Jan. 4, 2010, *available at* https://www.nytimes.com/2010/01/05/your-money/credit-and-debit-cards/05visa.html#:~:text=Visa%20and%20MasterCard%20set%20the,shift%20the%20cost%20to%20consumers.

> they have, the banks have no incentive to keep fraud costs low. My amendment will give big banks a real incentive to reduce fraud.[19]

The Durbin Amendment made no allowance for a uniform *ad valorem* interchange fee component to preemptively reimburse issuer fraud losses, but the Board exercised its discretion to create such a fee component structure in its final Regulation II. The Board has the discretion to revise its methodology. It would both be truer to Congress's design and beneficial to fraud reduction for the Board to exercise its discretion to revise the methodology as we have proposed.

2. Second, the current fraud landscape, and particularly the increase in card-not-present debit fraud, justifies a changed approach from the methodology the Board established in 2011. The Board designed its approach in 2011 with <u>issuer</u> fraud losses primarily in mind, crafting its approach based on 2009 data that showed that fraud losses on covered issuer transactions were borne 61.2 percent by issuers, 38.3 percent by merchants, and 0.5 percent by cardholders.[20] Those numbers have shifted dramatically; as the NPRM notes, "In 2021, covered issuers, merchants, and cardholders bore 33.5 percent, 47.0 percent, and 19.5 percent of fraud losses, respectively."[21] Covered issuers have <u>nearly halved</u> their absorbed losses, while overall fraud has doubled and the amount of fraud losses charged back to merchants and cardholders has soared. According to the Board's data, issuers do not now bear the majority of losses for <u>any</u> of the main types of debit fraud (CNP, lost-and-stolen, and counterfeit); rather, merchants and cardholders absorb a growing majority of losses in all three categories because of chargebacks.

   Further, while "merchants absorbed an increasing share of fraud losses across almost all transaction categories and fraud types in 2021, relative to 2009," the rise in card-not-present transactions has particularly exacerbated merchants' fraud burden.[22] As the Board noted, CNP transactions grew from 9.8 percent of covered issuer transactions in 2009 to 32.1 percent in 2021, and now half of overall fraud occurs on CNP transactions.[23] Merchants are severely limited in how they can prevent fraud in the digital space, and yet, as the Board's data show, merchants absorb a growing majority of fraud losses for CNP transactions ("almost two-thirds of card-not-present fraud in 2021)".[24] The increase of CNP transactions during the COVID-19 pandemic had a particularly acute impact on the food retail industry, as demand for e-commerce grocery ordering increased. According to FMI's most recent annual membership survey, 81 percent of FMI retail members now report having online sales, compared to 50

---

[19] 156 Cong. Rec. S4841 (daily ed. June 10, 2010) (statement of Sen. Durbin).
[20] 88 Fed. Reg. 78118.
[21] *Id.*
[22] 88 Fed. Reg. 78118-9.
[23] 88 Fed. Reg. 78118.
[24] *Id.*

percent pre-pandemic.[25] This is noteworthy from a fraud perspective, as orders placed through a grocery store's e-commerce site are deemed CNP transactions by the networks and merchants bear the majority of potential fraud liability, even when the orders are picked up at the curbside or inside the store.

Additionally, as the Board observed in its most recent data report, fraud losses on single-message (PIN) debit transactions have decreased significantly since 2017 while dual-message (signature) debit fraud transaction losses have soared to their highest-ever level and are nearly four times as high as PIN debit fraud losses as a share of transaction value.[26] Despite this, the Board noted that "in 2021, single-message networks were still used relatively rarely for CNP transactions," which is likely due in part to many issuers' efforts to circumvent Regulation II's requirement that two networks be available for each card-not-present transaction—issuer behavior that the Board had to issue a regulatory clarification in October 2022 to address.[27] Our recommended revisions to the Board's methodology would give issuers incentive to steer customers toward more fraud-proof methods of authentication, such as single-message transactions.

In short, there is a small and diminishing universe of fraud losses on covered issuer transactions that issuers do not charge back to merchants and cardholders, making it harder to justify forcing merchants (and ultimately their customers) to bear the cost of an *ad valorem* interchange fee component that uniformly compensates issuers in advance for potential fraud losses. As debit transactions increasingly move to online channels and are treated as CNP transactions where merchants bear almost two-thirds of fraud losses, and as those fraud losses increase due in large part to inadequate issuer encouragement of fraud-reducing authentication methods, the Board's current methodology will increasingly lead to unbalanced fraud burdens on debit system participants while forcing merchants, their customers, and cardholders to unreasonably and disproportionately bear the cost of rising fraud.

3. Third, the justifications the Board has put forward for its current methodology do not validate continuing the methodology without revision. In 2011, the Board rationalized its decision to create an *ad valorem* interchange fee component to uniformly compensate all covered issuers for fraud losses by making three main assertions: first, that "[a]n issuer may experience losses for fraud that it cannot prevent and cannot charge back to the acquirer or recoup from the cardholder;" second, that "[p]ermitting issuers to recover at least some fraud losses through interchange fees is reasonable given that the source of fraud could be any participant in an electronic debit transaction and that the exact source of fraud is often unknown;" and third, that "[a]llowing a portion of fraud losses to be recovered through interchange fees will not eliminate the incentive for issuers to monitor and prevent fraud. Issuers will continue to bear the cost of

[25] FMI, "The Food Retailing Industry Speaks," 2023, *available at* https://www.fmi.org/our-research/research-reports/food-retailing-industry-speaks.
[26] 2021 Interchange Fee Revenue, *supra* note 16, at p. 20.
[27] *Id.* at p. 21; 87 Fed. Reg. 61217 (Oct. 11, 2022).

some fraud losses and cardholders will continue to demand protection against fraud."[28] The Board made several additional assertions in the current NPRM to justify continuing its *ad valorem* methodology. As the debit fraud landscape and issuer behavior have evolved under Regulation II, these assertions can no longer reasonably justify the Board's current methodology.

The first assertion that the Board cited in 2011 to justify the fraud loss interchange fee component – that issuers may experience losses for fraud that they cannot prevent and cannot charge back – simply does not reflect issuers' role in shaping the debit card landscape. At the time of the publishing of Regulation II, issuers and their network allies were capable of doing far more to prevent fraud losses than they were actually doing. In fact, mere weeks after bank-supported legislation to delay Regulation II was defeated in the Senate in June 2011 and after Regulation II was then published, Visa announced a roadmap to promote U.S. adoption of EMV chip-card fraud prevention technology – a security technology that had already been in use in nearly all other developed countries but which Visa and its issuers did not feel incentivized to adopt in the U.S. until Regulation II implemented the Durbin Amendment's mandate that more than one network had to be available to handle debit card transactions and that merchants could choose how to route between those networks.[29] The Durbin Amendment's non-exclusivity and routing choice requirements created a competitive market dynamic between debit networks that prompted them to find a way to improve their offerings, including by enhancing protections against fraud through the transition to EMV chip cards as well as the introduction of full end-to-end encryption of data.[30] U.S. merchants welcomed this long-overdue move toward better fraud prevention in the debit system, even though merchants had to expend heavy costs installing EMV chip card terminals and invested an estimated $30 billion to do so.[31] The creation of an *ad valorem* fraud loss subsidy should not have been based on a claim that issuers experience losses for fraud "that they cannot prevent" when the Board had not meaningfully assessed the prevention steps issuers might take (and in fact did take shortly after Regulation II's pro-competitive mandates took effect). Issuers could still do far more to prevent fraud losses, including by encouraging the use of single-message transactions which result in dramatically less fraud than the dual-message transactions that issuers favor. Additionally, while the Board contended in 2011 that a universe of fraud losses that issuers "cannot charge back" justified creating an interchange component that compensated all issuers

---

[28] 76 Fed. Reg. 43431.

[29] *See* Visa presentation to Federal Reserve on U.S. Debit EMV, Jan. 8, 2014, at 2, *available at* http://www.federalreserve.gov/newsevents/rr-commpublic/visa-meeting-20140108.pdf ("In August 2011, Visa announced a U.S. EMV roadmap."). Mastercard announced their U.S. roadmap to adopt EMV chip cards in January 2012. *See* "Card Payments Roadmap in the U.S.: How Will EMV Impact the Future Payments Infrastructure?" EMV Connection, January 2013, *available at* https://www.emv-connection.com/card-payments-roadmap-in-the-u-s-how-will-emv-impact-the-future-payments-infrastructure/.

[30] *See, e.g.*, Tracy Kitten, "Visa's New End-to-End Encryption Service," *Bankinfo Security*, Sept. 12, 2012, *available at* https://www.bankinfosecurity.com/interviews/visas-new-end-to-end-encryption-service-i-1650.

[31] National Retail Federation, "EMV Chip Cards," *available at* https://nrf.com/emv-chip-cards.

in advance for fraud, this universe of issuer-absorbed fraud losses has dramatically shrunk since 2011 as issuer chargebacks have soared.

The Board's second assertion in 2011 – that it is reasonable to permit issuers to recover fraud losses through interchange because "the exact source of fraud is often unknown" – is undermined by the fact that the Board's "methodology for determining the *ad valorem* component is based on actual fraud losses absorbed by covered issuers."[32] This backward-looking calculation assesses losses after issuers have decided when to charge back losses to merchants or cardholders under card network rules for fraudulent transactions – meaning that, according to those network rules, the source of fraud and the participant responsible for it are not "unknown" and the responsible participant has already been assigned the burden of absorbing the loss. Given that issuers are not shy about charging back fraud on others when they deem the others to be the responsible participants, it is reasonable to assume that the fraud losses that issuers do absorb are losses for which a specific issuer is responsible. We do not believe it should be asserted that uncertainty about participant responsibility justifies subsidizing future fraud losses through a uniformly generous interchange fee component when the Board's methodology for that fee is based on known data and assignments of fraud loss responsibility. There are better ways to structure fee incentives to properly motivate issuers to reduce fraud than the approach of pre-paying all covered issuers for future fraud losses through interchange.

The Board's third assertion in 2011 – that allowing a portion of fraud losses to be pre-covered through interchange would not eliminate issuers' incentive to "monitor" and "prevent" fraud – overlooks the fact that covered issuers are already separately being compensated through interchange for transactions monitoring (as part of the base component allowable costs) and for fraud prevention (through the fraud prevention adjustment). Further compensating issuers for monitoring and prevention through the *ad valorem* fraud loss component provides no additional incentive or value in terms of reducing fraud. Furthermore, the assertion that cardholders will continue to demand protection against fraud does not necessarily mean that issuers will feel responsible to invest to provide it, so long as the issuers can point the finger at other participants (acquirers, merchants, even cardholders) for inadequate protection and charge back fraud to other participants when fraud occurs (including increasingly shifting fraud losses to those cardholders themselves).

Additionally, the NPRM cites several further justifications for continuing with the current methodology. Those justifications are flawed. First, the NPRM asserts that despite a steep decline in the proportion of fraud losses absorbed by covered issuers, the Board still believes that covered issuers have an incentive to reduce fraud (though no longer a "strong" incentive, as the Board said in 2012) because "[c]overed issuers continue to bear more than a quarter of all fraud losses, which means that their efforts to reduce fraud rates translate directly into lower

[32] 88 Fed. Reg. 78108 at Fn. 50.

fraud losses."[33] However, since the Board is awarding covered issuers a pre-paid *ad valorem* fee component directly based on issuer fraud losses, issuer efforts to reduce fraud rates actually translate directly into lower *ad valorem* fee revenue for themselves. That is a disincentive for issuer efforts to invest in reducing fraud, one which our recommended reforms would correct. Second, the NPRM asserts that "competition with other debit card issuers continues to provide downward pressure on the proportion of fraud losses that an issuer passes on to its cardholders."[34] The Board's own data show that this downward pressure is simply not working – as the most recent data show, the percentage of losses shifted from issuers to cardholders not only increased from 1.8 percent in 2011 to 8.2 percent in 2019, but "it more than doubled from 2019 to 2021, reaching 19.5 percent."[35] Cardholders will benefit when issuers are incentivized to invest in fraud reduction rather than further escalating the already-soaring rate of losses shifted onto cardholders. Finally, the NPRM asserts that equivalent interchange fees for different authentication methods "suggests that covered issuers have no incentives to promote the use of networks or authentication mechanisms that have higher rates of fraud."[36] This assertion is belied by the Board's own experience last year when it found, while clarifying Regulation II to ensure network non-exclusivity in card-not-present transactions, that "almost a quarter of issuers with consolidated assets over $10 billion, representing slightly more than 50 percent of the total number and value of all debit card transactions subject to Regulation II's interchange fee standards in 2019, did not process any card-not-present debit card transactions over single-message networks."[37] Single-message transactions have declining fraud rates and yet the Board found that covered issuers handling half of covered debit transactions were going out their way to avoid using them, thereby promoting dual-message authentication which has fraud losses four times as high.

In conclusion, the Board's fraud data collection compellingly demonstrates that the Board should exercise discretion to revise the methodology for the *ad valorem* fee component to better incentivize each covered issuer to reduce fraud. We recommend reasonable and measured reforms that would better align the Board's methodology with Congress's design for EFTA Section 920 and allocate burdens among debit system participants for fraud reduction. Combating payment system fraud is a core value for FMI. For years, our members have taken seriously their responsibility and investments to reduce fraud in the debit card system. Prior to the enactment of the Durbin Amendment, food retailers strongly encouraged the use of PIN debit over signature debit, recognizing that signature debit is significantly more fraud-prone.[38] Food retailers invest heavily in

---

[33] 88 Fed. Reg. 78119.
[34] *Id.*
[35] 2021 Interchange Fee Revenue, *supra* note 16, at 3.
[36] 88 Fed. Reg. 78119.
[37] 87 Fed. Reg. 61218 at Fn. 12 (emphasis added).
[38] *See* 75 Fed. Reg. 81741 (finding that, on a per-dollar basis, signature debit fraud losses were 3.75 times PIN-debit fraud losses.). In 2010, food retailers conducted three times more debit transaction volume over PIN debit than signature debit, and food retailers' PIN debit usage accounted for one-quarter of the entire

data security and compliance with Payment Card Industry Data Security Standards (PCI DSS), which costs include "technology upgrades, hardware and software maintenance, maintaining new segment firewalls, point-of-sale card reader replacements, personnel training, and external assessors."[39] Our members are combating fraud by investing in secure debit technology. The methodology the Board has implemented has penalized grocery stores not only by subjecting them to an excessive *ad valorem* fee but also by assessing that fee uniformly on all debit transactions regardless of the method of authentication used. The reforms we propose would realign incentives and reallocate burdens in a way to increase issuers' use of fraud-proof authentication methods. This change will benefit all the participants in the debit system and the system as a whole.

C. The fraud prevention adjustment must not be awarded to a covered issuer without actual confirmation that the issuer is taking effective fraud prevention steps.

The NPRM proposes to modify the methodology established in 2012 to determine the fraud prevention adjustment. We believe it is time for the Board to finally use the adjustment as Congress intended: to reward only those covered issuers that are actually and demonstrably taking effective steps to reduce debit fraud. Congress created the fraud prevention adjustment in EFTA Section 920 in response to the urgent need to enhance security in the U.S. payment card system and to protect American consumers and businesses from fraud. Prior to the Durbin Amendment, 1970s-era magnetic stripe technology for debit cards was still widely in use in the U.S., and the U.S. accounted for nearly half of global fraud losses even though it represented less than one-quarter of worldwide payment card volume.[40] In the Durbin Amendment, Congress directly instructed the Board to make any fraud prevention adjustment it allowed to debit interchange fees contingent upon card issuers' taking effective steps to reduce debit card fraud.[41] This was a potentially transformative tool that Congress directed the Board to use to meaningfully address debit card fraud, but that tool has not been used as intended. Regrettably, the Board's methodology for implementing, overseeing, and enforcing the fraud prevention adjustment has fallen far short, and in the meantime, debit fraud has approximately doubled.[42]

PIN debit transaction volume in the country. *See* FMI, "Debit Card Fraud: The Impact of Proposed Regulations on the Food Retailing Industry," Feb. 2012, at p. 9, *available at* https://www.fmi.org/docs/interchange/fmi-report-on-debit-card-fraud.pdf.

[39] FMI, Comments to the Board of Governors of the Federal Reserve System, Debit Card Interchange Fees and Routing, Feb. 21, 2011, at p. 7, *available at* https://www.federalreserve.gov/SECRS/2011/February/20110228/R-1404/R-1404_022111_67730_570739703686_1.pdf.

[40] Pete Rizzo, "Global Card Fraud Rises 14% In 2012," PYMTS.com, Aug. 21, 2013, *available at* https://www.pymnts.com/news/2013/global-card-fraud-rises-14-in-2012/. ("The U.S. accounted for 47.3 percent of global fraud losses, despite generating just 23.5 percent of the total transactions for goods and services.").

[41] 15 U.S.C. 1693o-2(a)(5)(A)(ii)(II).

[42] 88 Fed. Reg. 78118 ("With respect to covered issuer transactions, fraud losses to all parties as a share of transaction value increased from 9.0 basis points in 2009 to 17.5 basis points in 2021.").

In EFTA Section 920, Congress mandated that the Board establish fraud prevention standards that "require issuers to take effective steps to reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions," and under the statute an issuer can only receive a fraud prevention adjustment if the issuer "complies" with the Board's standards.[43] In its final fraud prevention adjustment rule published in August 2012, however, the Board permitted every covered issuer to receive one cent per transaction if the issuer merely "develop[s] and implement[s] policies and procedures reasonably designed to take effective steps to reduce the occurrence of, and costs to all parties from, fraudulent electronic debit transactions."[44] Under the Board's 2012 final rule, issuers are directed to review their fraud prevention policies and procedures at least annually and to update them "as necessary," but the Board's rule allows issuers to evaluate their own compliance. The 2012 regulation does not ensure that issuers actually follow their own polices, nor does it ensure that issuers' policies include steps that issuers actually "take" and that are "effective" in reducing fraud. Instead, the 2012 final rule said that issuers are eligible to receive a fraud prevention adjustment if the issuer simply notifies its payment card network that the issuer complies with the minimal standards the Board set out (*i.e.*, that it has policies and procedures in place and that it reviews them at least annually).

We do not believe any issuer has been deemed ineligible for the fraud prevention adjustment, and we are not aware of the Board collecting any data from issuers that would demonstrate whether any fraud prevention step taken by an issuer was or was not effective in reducing fraud. The Board's Debit Card Issuer Survey (FR 3064a) simply asks issuers to check a box whether or not they engage in certain broad categories of fraud prevention activities (*e.g.*, "Data-security" and "PIN customization") with no further information requested or provided on the specific steps the issuer takes and how often those steps are used on the issuer's debit transactions.[45] While the Board collects data on issuers' total costs of fraud prevention, this reveals little about the effectiveness of any particular fraud prevention step without further detail about how much the issuer uses or invests in specific measures. The Board also has never established a target metric for fraud prevention effectiveness, nor has it laid out any clear mechanism for it or other regulators to verify or evaluate issuer compliance with the issuer's own policies and procedures. It is not clear if the Board collects copies of the annual notification that its standards require issuers to provide to their card networks.

Despite the serious shortcomings of the administration of the fraud prevention adjustment, the Board has set a fraud adjustment fee amount that encompasses the costs of a broad range of activities that issuers may (or may not) be engaging in, including "[c]osts associated with research and development of new fraud-prevention technologies, card reissuance due to fraudulent activity, data security, card activation, and merchant blocking" and the costs of "denying a transaction or

---

[43] 15 U.S.C. 1693o-2(a)(5)(A)(ii)(II) and 15 U.S.C. 1693o-2(a)(5)(A)(ii) (emphasis added).
[44] 77 Fed. Reg. 46262.
[45] *See* Debit Card Issuer Survey, FR3064a, Survey Period: Calendar Year 2021, at p. 11, *available at* https://www.federalreserve.gov/paymentsystems/files/2021DebitCardIssuersurvey.pdf.

contacting the cardholder to verify the legitimacy of a previously authorized transaction."[46] The NPRM would increase that adjustment amount from 1 cent to 1.3 cents per transaction based on a reopened and revised methodology for measuring those issuer costs,[47] but the Board seeks to do so without proposing any change in its methodology to ensure that this interchange revenue is being used effectively to actually reduce fraud.

The Board's current fraud prevention methodology is inconsistent with the text and intent of EFTA Section 920, and the inadequacy of the current methodology is reflected in the fact that fraud has significantly grown while it has been in effect. This rulemaking provides the Board with the opportunity to fulfill the Congressionally-assigned responsibility to ensure the effectiveness of debit fraud prevention steps, particularly in light of the sobering debit fraud data revealed by the Board's most recent report. Accordingly, we recommend the Board modify its methodology for the fraud prevention adjustment so that a covered issuer is not deemed eligible to receive the adjustment unless:

(1) the issuer has first provided to the Board, either as part of the Board's data collection efforts or in a supplemental submission:

- a copy of the issuer's current fraud prevention policies and procedures and each annual notification the issuer has provided of its compliance;
- a list and narrative description of specific steps the issuer has taken in the most recent data collection period to carry out the issuer's policies and procedures, including the costs invested for each step and the percentage of the issuer's debit transactions that apply to that step; and
- evidence demonstrating whether each specific step has been effective in reducing fraud associated with that issuer's debit cards.

(2) The Board, either by itself or in consultation with the appropriate regulatory enforcement agency overseeing the issuer, has verified that the information provided by the issuer shows that the issuer has met the statutory requirement that the issuer <u>take effective steps</u> to reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions.

---

[46] 77 Fed. Reg. 46264.

[47] The Board proposes to modify the original methodology used to determine the fraud-prevention adjustment; whereas Regulation II in 2012 calculated the difference between the median per-transaction fraud-prevention costs aggregated with transaction-monitoring costs among covered issuers and the median per-transaction transaction monitoring costs among covered issuers, rounded to the nearest cent, the Board now proposes to determine the fraud-prevention adjustment as the median per-transaction fraud-prevention costs among covered issuers rounded to the nearest tenth of one cent.

(3) If an issuer has reported increased per-transaction fraud losses on its debit cards for two two-year rate periods in a row and has not provided evidence demonstrating that it has changed its fraud prevention steps to more effectively reduce fraud, the issuer should be deemed ineligible for the fraud prevention adjustment for subsequent rate periods unless and until it can demonstrate that it is taking effective fraud prevention steps. Further, as discussed above in Part II.B of this letter, a covered issuer should not be deemed eligible for the *ad valorem* fraud loss fee component unless and until the issuer has established eligibility for the fraud prevention adjustment according to the criteria discussed in this section.

This issuer-specific evaluation will not only realign issuer incentives to encourage and achieve actual reductions in debit fraud but will also give the Board greater insight into the fraud prevention activities that are working effectively. The Board can then share aggregated information about the effectiveness of certain fraud prevention measures. This will benefit the overall debit system and help create a competitive dynamic between covered issuers by enabling issuers to demonstrate to consumers that they are taking actions to prevent fraud that the Board has found to be effective. Congress intended for the fraud prevention adjustment to provide this type of issuer-specific oversight and accountability. We strongly urge the Board to fix the methodology, particularly before locking in its proposed plan and formula for future rate adjustments.

In summary, Congress tasked the Board with the important responsibility to administer the fraud prevention adjustment in a way that would demonstrate and achieve effective fraud reduction. Our recommendations provide an immediate opportunity for the Board to strengthen fraud prevention and reduction efforts in the debit system.

D. Future rate adjustments made every other year should be based on revised methodologies for the fee components and the Board should implement oversight and auditing of reported data to ensure that issuer costs are not misrepresented or inflated.

FMI supports the Board's proposal to regularly update fee rates in Regulation II every other year, as the 13-year delay in updating these rates has exacerbated the degree to which the current rate is neither reasonable nor proportional to covered issuer costs. Regular and predictable updates to the regulated rate to reflect changes in costs would be beneficial to the overall debit system and its participants. However, it is imperative that the Board not lock flawed methodologies into place for future rate adjustments. We oppose codifying an unjustified and excessive fixed multiplier of 3.7 into regulation and locking it into a formula going forward, or codifying a methodology that fails to close the issuer-paid network processing fee loophole. Similarly, locking in an *ad valorem* component methodology that rewards all covered issuers regardless of their record on fraud, or a 1.3 cent fraud prevention adjustment that similarly is untethered to any assessment of whether specific issuers are taking steps that are effective in reducing fraud, would entrench the wrong incentives for fraud prevention in perpetuity. Our recommendations discussed above would

improve the methodologies for these fee components such that they could be credibly used for future rate adjustments.

In addition, we strongly support oversight and enforcement by the Board. Neither the NPRM nor its proposed Appendix B to Part 235 indicate that the Board will audit or otherwise verify data provided by issuers using FR 3064a. Without oversight and periodic audits, issuers may inflate or misrepresent costs that they report to the Board or may attempt to include costs that the Board has not deemed allowable in their reported costs. Issuers and networks have attempted to circumvent the requirements of EFTA Section 920 and Regulation II before, which led to the Board's clarification of the CNP routing rule in 2022 and has prompted investigations by the Federal Trade Commission and the Department of Justice.[48] We strongly urge that the final rule lay out a plan in Appendix B for verifying and periodically auditing data provided by issuers to ensure that the data is valid and accurate.

III. Competition, consumers, and the overall debit system will benefit from rate reductions and methodology reforms to Regulation II.

Reducing the regulated debit interchange rate and revising the Board's fee component methodologies as recommended in this comment letter will improve the efficiency, security, and overall functioning of the debit system. The following are responses to five primary claims that have been repeatedly made by financial industry (card network and issuer) advocates in opposition to debit interchange regulation. In this section, we provide important factual, historical, and empirical context to refute these claims.

Financial Industry Claim #1: "The Durbin Amendment has distorted the market to the detriment of small businesses, consumers and financial institutions of all sizes, and further expanding government price controls will only exacerbate those damaging consequences."[49]

Response: The Durbin Amendment was a much-needed intervention to help limit the harmful effects of Visa and Mastercard's price-fixing of interchange fees, and the only distortions that have arisen from it were the result of changes that banks aggressively sought to the Board's December 2010 draft rule.

---

[48] *See, e.g.,* FTC closing letter to Visa, Nov. 22, 2016, *available at* https://www.ftc.gov/system/files/documents/closing_letters/nid/closing_letter_from_james_frost_to_visa_-_11-22-16.pdf; Reuters, "Visa, Mastercard draw FTC inquiry over debit card transactions," Nov. 13, 2019, *available at* https://www.reuters.com/article/us-ftc-visa-mastercard-probe/visa-mastercard-draw-ftc-inquiry-over-debit-card-transactions-bloomberg-law-idUSKBN1XN291; Reuters, "DOJ probing Visa on U.S. debit card practices, competition," Jan. 27, 2023, *available at* https://www.reuters.com/business/finance/doj-probing-visa-us-debit-card-practices-competition-2023-01-27/.

[49] American Bankers Association press release, "ABA Statement on Federal Reserve's Proposed Regulation II Changes," Oct. 25, 2023, *available at* https://www.aba.com/about-us/press-room/press-releases/federal-reserve-proposed-regulation-ii-changes.

The Durbin Amendment was the culmination of years of analyses by Congress,[50] Federal Reserve experts,[51] and other stakeholders[52] that determined that interchange fees had been structured to avoid normal marketplace competition and that excessively high fees were imposing significant burdens on merchants and their customers. Whereas nearly every other type of fee charged by banks is set in a competitive market environment in which each bank sets the fee rate that it receives, interchange fees within the Visa and Mastercard credit and debit card systems are set by the card network companies on behalf of the thousands of financial institutions that issue their cards. As Senator Durbin put it, "[t]he banks get the fees, but they do not set the fees."[53] Centralized fee-fixing reduces the incentive for card-issuing banks to manage their operational and fraud costs efficiently because the banks are guaranteed to receive network-fixed interchange fee rates no matter how efficient or inefficient they are. Also, Visa and Mastercard each have network rules that require merchants to accept all cards issued with their network logo, even though the interchange fee rates for some of their cards are significantly higher than others. The combination of centrally-fixed rates and "honor all cards" rules gives Visa and Mastercard incentive to increase interchange fee rates in order to encourage banks to issue more cards. Because Visa and

---

[50] *See, e.g.,* Hearing on Oversight of Federal Payment of Interchange Fees: How to Save Taxpayer Dollars Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations, 111th Cong. (2010); Hearing on H.R. 2695, the Credit Card Fair Fee Act of 2009 Before the H. Comm. on the Judiciary, 111th Cong. (2010); Hearing on H.R. 2382, The Credit Card Interchange Fees Act of 2009 Before the H. Comm. on Financial Services, 111th Cong. (2009); Hearing on H.R. 5546, The Credit Card Fair Fee Act of 2008 Before the Antitrust Task Force, H. Comm. on the Judiciary, 110th Cong. (2008); Hearing on Credit Card Interchange Fees Before the Antitrust Task Force, H. Comm. on the Judiciary, 110th Cong. (2007);.Hearing on Credit Card Interchange Fees: Antitrust Concerns? Before the S. Comm. on the Judiciary, 109th Cong. (2006).
[51] *See, e.g.*, Terri Bradford & Fumiko Hayashi, "Developments in Interchange Fees in the United States and Abroad," Federal Reserve Bank of Kansas City, Apr. 2008, at 2, *available at* https://www.kansascityfed.org/Payments%20Systems%20Research%20Briefings/documents/695/briefings-psr-briefingapr08.pdf ("While regulation of interchange fees is still just a point of discussion in the United States, regulation abroad is a reality. In about 20 countries, public authorities have taken actions that limit the level of interchange fees or merchant discount fees. Many of these actions require interchange fees to be set according to cost-based benchmarks, although the cost categories that are eligible for the benchmarks vary by country. In several countries, interchange fees are set at zero."); James McAndrews & Zhu Wang, "The Economics of Two-Sided Payment Card Markets: Pricing, Adoption and Usage," Federal Reserve Bank of Kansas City, Dec. 2008, *available at* The Economics of Two-Sided Payment Card Markets: Pricing, Adoption and Usage (ssrn.com) ("We show that privately determined card pricing, adoption and usage tend to deviate from the social optimum, and imposing a ceiling on interchange fees may improve consumer welfare.").
[52] *See, e.g.*, Fumiko Hayashi, "Payment Card Interchange Fees and Merchant Service Charges – An International Comparison," Lydian Payments Journal, Jan. 2010, at 6, 11-12 ("In general, the United States has the highest debit card interchange fees…the United States has the highest interchange fees for both credit and debit cards among the 13 countries where adoption and usage of payment cards are well advanced."); Alan S. Frankel & Allan L. Shampine, "The Economic Effects of Interchange Fees," 73 Antitrust Law Journal 627, 671 (2006) (finding that the interchange fee "acts much like a sales tax, but it is privately imposed and collected by banks, not the government. It significantly and arbitrarily raises prices based not on technologically and competitively determined costs, but through a collective process.").
[53] 157 Cong. Rec. S2021 (daily ed. March 31, 2011) (statement of Sen. Durbin).

Mastercard for decades have controlled more than 80 percent of the payment card network market, there is little that merchants can do to temper those fee increases. As a result, prior to 2010 merchants were forced to pay ever-rising debit interchange fees that were not tethered to any issuing bank's actual costs, that subsidized bank inefficiencies, and that were ultimately borne by consumers in the form of higher prices.

Additionally, the passage of the Durbin Amendment in 2010 was preceded by growing awareness of three facts about the debit card system. First, Congress recognized that debit cards effectively function as electronic versions of checking accounts, and since the Federal Reserve Act of 1913, Congress has prohibited any transaction fees from being deducted as checks pass between banks in the Federal Reserve system.[54] Second, Congress knew that numerous other countries enjoyed robust debit systems in which interchange fees were firmly regulated or even prohibited altogether, whereas unregulated debit interchange rates in the U.S. kept rising.[55] Third, in the U.S., debit interchange rates were minimal before Visa entered the debit market in the 1990s through an anti-competitive tying arrangement with Visa credit cards and then dramatically increased debit fees.

Interchange fees were initially established in 1971 for credit cards by the card network companies that later became known as Visa and Mastercard.[56] However, interchange fees were not initially charged for debit card usage. When debit cards started becoming common in the 1980s, the cards were linked to networks that operated ATM machines; these networks required debit transactions to be authenticated with a PIN and "[m]erchants were not charged a fee for accepting PIN debit

---

[54] *See* 156 Cong. Rec. S3696 (daily ed. May 13, 2010) (statement of Sen. Durbin) ("Right now in the United States, there are zero transaction fees deducted when you use a check. The Federal Reserve does not allow transaction fees to be charged for checks. But when it comes to debit cards, Visa and MasterCard charge high interchange fees just as they do for credit. Why? Because they can get away with it.").

[55] *See, e.g.*, Dennis W. Carlton, "Externalities in Payment Card Networks: Theories and Evidence, Commentary, The Changing Retail Payments Landscape: What Role for Central Banks," proceedings of a conference held at the Federal Reserve Bank of Kansas City, Nov. 9-10, 2009 at 125, 129, *available at* https://www.kansascityfed.org/Payments%20Conferences/documents/7461/PSCP2009_CarltonCommentary.pdf ("It turns out that in seven of the eight countries with the highest debit card usage per capita there is no interchange fee, casting empirical doubt on the proposition that interchange fees are necessary to stimulate usage through promotional activity and cross subsidy from the merchant side of the market to the consumer side."); *see also* 156 Cong. Rec. S3696 (daily ed. May 13, 2010) (statement of Sen. Durbin) ("Here is the most unbelievable part. Businesses in every other country in the world get a better interchange deal from Visa and Mastercard than businesses in the United States of America….They charge American businesses higher interchange fees than they charge businesses around the world.").

[56] *See* Adam J. Levitin, "Priceless? The Economic Costs of Credit Card Merchant Restraints," 55 UCLA Law Review 1321, 1368 (2008).

cards."[57] However, "[t]hat changed after Visa entered the debit market."[58] As recounted by *New York Times* reporter Andrew Martin in an influential 2010 article often cited by Senator Durbin:

> In the 1990s, Visa promoted a debit card that let consumers access their checking account on the same network that processed its credit cards, which required a signature. To persuade the banks to issue more of its debit cards, Visa charged merchants for these transactions and passed the money to the issuing banks. By 1999, Visa was setting fees of $1.35 on a $100 purchase, while Maestro and other regional PIN networks charged less than a dime, Federal Reserve data shows….Merchants said they had no choice but to continue taking the debit cards, despite the higher fees, because Visa's rules required them to honor its debit cards if they chose to accept Visa's credit cards.[59]

While Visa and Mastercard later settled antitrust litigation and agreed to end their network rules that tied merchant acceptance of their debit cards with merchant acceptance of their credit cards, the market had already been changed by Visa's maneuvers. According to Martin's 2010 article:

> Competition, of course, usually forces prices lower. But for payment networks like Visa and MasterCard, competition in the card business is more about winning over banks that actually issue the cards than consumers who use them. Visa and MasterCard set the fees that merchants must pay the cardholder's bank. And higher fees mean higher profits for banks, even if it means that merchants shift the cost to consumers. Seizing on this odd twist, Visa enticed banks to embrace signature debit – the higher-priced method of handling debit cards – and turned over the fees to banks as an incentive to issue more Visa cards. At least initially, MasterCard and other rivals promoted PIN debit instead. As debit cards became the preferred plastic in American wallets, Visa has turned its attention to PIN debit too and increased its market share even more. And it has succeeded – not by lowering the fees that merchants pay, but often by pushing them up, making its bank customers happier. In an effort to catch up, MasterCard and other rivals eventually raised fees on debit cards too, sometimes higher than Visa, to try to woo bank customers back. "What we witnessed was truly a perverse form of competition," said Ronald Congemi, the former chief executive of Star Systems, one of the regional PIN-based networks that has struggled to

---

[57] Andrew Martin, "How Visa, Using Card Fees, Dominates a Market," *The New York Times*, Jan. 4, 2010, *supra* note 18 (noting that sometimes merchants "even got a small payment because it saved banks the cost of processing a paper check"). *See also* 157 Cong. Rec. S1569 (daily ed. March 10, 2011) (statement of Sen. Durbin); 157 Cong. Rec. S3042 (daily ed. May 17, 2011) (statement of Sen. Durbin).
[58] Martin, *supra* note 18.
[59] *Id.*

> compete with Visa. "They competed on the basis of raising prices. What other industry do you know that gets away with that?"[60]

Concerns that the debit interchange fee system had been structured to avoid competition and to produce excessively high fees led to a bipartisan consensus in Congress that debit reform was needed. On May 13, 2010, the Durbin Amendment passed on the Senate floor by a bipartisan 64-33 vote, and it was signed into law as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010.

Congress mandated several reforms in the Durbin Amendment. First, Congress required that if a card network sets debit interchange fee rates on behalf of card-issuing banks with assets of over $10 billion, the fees set by the network must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[61] Congress then instructed the Board to issue regulations implementing this requirement, and provided the Board with several considerations to apply in the regulations.[62] Specifically, Congress directed the Board to consider the functional similarity between electronic debit transactions and checking transactions that are required within the Federal Reserve bank system to clear at par,[63] and also directed the Board, when determining the costs permissible to be covered by network-fixed interchange fees, to "distinguish between (i) the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered…and (ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered….[64] The rationale behind these considerations was to reduce network-fixed interchange fees to cover only the core costs of what any large issuer must do to conduct a debit transaction (namely, complete the transaction's authorization, clearance, and settlement), thereby compelling these large issuers to compete against each other to manage their other costs more efficiently. The amendment also directed the Board to allow for an interchange fee adjustment to cover an issuer's fraud prevention costs if the issuer met Board-established standards demonstrating that the specific issuer is taking effective steps to reduce the occurrence and cost of debit fraud.[65]

Additionally, Congress in the Durbin Amendment prohibited several anti-competitive restrictions that card networks had imposed on other participants in the debit system. Most notably, the Amendment directed the Board to issue regulations ensuring that networks and issuers could no longer form exclusivity agreements restricting debit cards to one exclusive network (or to two

---

[60] *Id.*
[61] 15 U.S.C. 1693o-2(a)(2). Note that under the Durbin Amendment, any card issuer is free to set its own fee rates; only fee rates that are fixed by card networks on large issuers' behalf are subject to regulation.
[62] 15 U.S.C. 1693o-2(a)(3)(A).
[63] 15 U.S.C. 1693o-2(a)(4)(A).
[64] 15 U.S.C. 1693o-2(a)(4)(B).
[65] 15 U.S.C. 1693o-2(a)(5).

networks affiliated with each other) and could not inhibit the ability of merchants to choose between networks that are enabled on a card.[66]

After the Durbin Amendment was enacted in July 2010, the Board issued a draft regulation in December 2010 that established standards for reasonable and proportional fees that card networks could set on behalf of issuers with over $10 billion in assets.[67] The Board's proposed rulemaking set forth two potential options for reasonable and proportional fees, one that allowed networks to create a safe harbor rate of seven cents per transaction with a maximum rate of 12 cents, and another option that set a 12 cent per-transaction maximum. At the time, the Board found that the average debit interchange fee was 44 cents per transaction, an amount far in excess of issuer costs; the Board stated in its notice of proposed rulemaking that "[t]he Board believes that setting the cap at 12 cents per transaction will be sufficient to allow all but the highest-cost issuers…to recover through interchange transaction fees the costs incurred for authorizing, clearing, and settling electronic debit transactions."[68] FMI filed comments on February 21, 2011, expressing appreciation for the thoughtful work that was taken into account in the proposed rule.[69]

After the Board published its proposed rule in December 2010, the financial industry simultaneously pushed for legislation in the Senate to delay and rewrite the Board's rulemaking, brought litigation against the Board seeking to enjoin the rulemaking in a case spearheaded by TCF National Bank, and lobbied the Board aggressively to water down the proposed rule and preserve more of the existing debit interchange revenue stream.[70] The industry's desired legislation, which

---

[66] 15 U.S.C. 1693o-2(b)(1). In the 1990s and early 2000s, debit cards typically bore the logos of multiple debit networks and each of the networks could be used for transactions. However, in the years leading up to 2010, "the largest national PIN debit networks ha[d] increasingly required issuers to sign exclusive agreements under which they become the sole PIN network whose logo appears on an issuer's cards." *See* Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, Ron Borzekowski, "Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., May 16, 2009, at p. 27, *available at* https://www.federalreserve.gov/pubs/feds/2009/200923/index.html. These exclusivity agreements limited merchant and consumer choice, diminished competition by threatening to drive smaller debit networks out of business, and created significant barriers to entry for new debit networks.
[67] 75 Fed. Reg. 81722.
[68] 75 Fed. Reg. 81737.
[69] FMI Comment Letter, Feb. 21, 2011, *supra* note 39.
[70] *See* Marian Wang, "At Behest of Banks, Fed Relaxes Debit Card Regs in Final Rule," *Pro Publica*, June 30, 2011, *available at* https://www.propublica.org/article/at-behest-of-banks-fed-relaxes-debit-card-regs-in-final-rule ("Banks, fearing a loss of billions in fee revenue, pulled out the stops—launching ad campaigns and a Twitter campaign, writing letters to the Fed, threatening to sue, in one case actually suing, and donating to lawmakers who supported delaying the rules."); *see also* Ylan Q. Mui, "Banks convince Fed to raise swipe fee limit," *The Washington Post*, June 29, 2011, *available at* https://www.washingtonpost.com/business/economy/banks-convince-fed-to-raise-swipe-fee-limit/2011/06/29/AGBD8PrH_story.html ("The financial industry waged an aggressive campaign to stop the law—plastering Metro cars with ads and funneling donations to key politicians—but the effort came up short this month when banks failed to win enough votes in the Senate to secure a delay.").

would have delayed the Board's final rule and required the Board "to consider all fixed and incremental costs associated with debit card transactions and program operations" in issuing final rules, was rejected in a vote on the Senate floor on June 8, 2011.[71] The TCF National Bank litigation, which sought to enjoin the Board's final rule, also proved unavailing to the financial industry.[72]

Unfortunately, the industry's lobbying effort succeeded in persuading the Board to announce a final rulemaking on June 29, 2011, that was far more favorable to issuers than the December 2010 proposed rulemaking. The final Regulation II nearly doubled the cap proposed in December 2010, allowing networks to fix fee rates for regulated issuers of up to 21 cents plus five basis points plus a one cent fraud prevention adjustment on each debit transaction.[73] The 2011 final rule construed the Durbin Amendment to allow the Board discretion to incorporate numerous issuer costs that were not mentioned in the statute Congress passed, including fixed (as opposed to incremental) ACS costs, network processing fees, costs of processing chargebacks, transaction monitoring costs, and issuer fraud losses.[74] Even though the Senate only weeks earlier had rejected legislation that would have required the Board to set a regulated rate that would cover "all fixed and incremental costs associated with debit card transactions and program operations," many such costs were allowed into Regulation II as a result of the Board's construction of the statute. Commentators observed that the Board's 22-cent final regulated rate "looks like they split the baby in half" between the previous 44 cent average and the instruction for the Board to consider the functional similarity of debit cards to checks where zero fees are deducted.[75] The financial industry was not shy in claiming that their lobbying effort influenced the Board in producing a far more bank-friendly final rule.[76]

---

[71] Senate Amendment 392, 157 Cong. Rec. S3558-9 (daily ed. June 7, 2011); *see also* 157 Cong. Rec. S3594 (daily ed. June 8, 2011) (roll call vote rejecting Amendment 392).

[72] *TCF Nat. Bank v. Bernanke*, 643 F.3d 1158 (8th Cir. 2011) (affirming district court's denial of TCF's motion for a preliminary injunction enjoining the Board's regulations).

[73] 76 Fed. Reg. 43394, 43404.

[74] 76 Fed. Reg. 43429-31.

[75] Robert Schmidt and Timothy R. Homan, "Fed's 21-Cent Swipe-Fee Cap Leaves Banks, Merchants Unsatisfied," *Bloomberg*, June 30, 2011, *available at* https://www.bloomberg.com/news/articles/2011-06-30/fed-s-21-cent-swipe-fee-cap-leaves-banks-merchants-unsatisfied.

[76] *See* Frank Keating, President and CEO of the American Bankers Association, "Who won and who lost with the Federal Reserve's final debit interchange rule?" American Bankers Association Washington Perspective (July 1, 2011) (stating "I am pleased that the Fed took what action it could to ease the rule's impact on banks. . . . It's clear to me that the aggressive six-month campaign that ABA, state bankers associations and bankers waged on this issue had a real bottom-line impact."); *see also* Ylan Q. Mui, "Banks convince Fed to raise swipe fee limit," *supra* note 70 ("[T]he industry looked to the Fed for relief. Last week, the American Bankers Association sent a letter to Bernanke asking him to consider the cost of maintaining the network to process debit card transactions, customer service expenses and fraud losses, among other things. Each of those categories was included in the Fed's revised calculations that boosted the limit on swipe fees. 'It is clear that the board benefitted from the input of bankers, policymakers and other commentators,' Frank Keating, ABA president and chief executive, said in a statement Wednesday.").

Regarding the 2011 final rule, FMI expressed disappointment and noted that the final rule "will not provide sufficient reform for businesses that are currently fighting high debit swipe fees."[77] Given that the perverse structure of the interchange system meant that networks competed with each other to raise interchange fees to incentivize banks to issue more of their network's cards, FMI had warned in our 2011 comment letter that it "is unlikely that networks will set interchange fees below the maximum allowable level."[78] That is indeed what happened; after the financial industry lobbied aggressively to increase the maximum regulated rate, within a matter of weeks after Regulation II was finalized first Mastercard and then Visa turned the Board's fee limitation into a fee floor.[79] This predictable, and predicted, outcome caused a significant market distortion arising from Regulation II – merchants had warned the Board that if the fee limit was set too high, it would cause serious problems for merchants who specialized in small dollar (*i.e.*, small ticket) transactions, and once Regulation II set a fee limit higher than that intended by Congress (*i.e.*, limiting fees to ACS costs plus a fraud prevention adjustment), merchants were suddenly faced with small ticket interchange rates that had nearly tripled even though the cost to issuers of conducting small ticket debit transactions had not increased.[80] The dramatic increase in interchange fees on small ticket transactions imposed a substantial burden on merchants and on consumers who ultimately bore the cost of the increases; however, this distortion was exactly what the financial industry lobbied the Board for, and when FMI and other merchant groups brought litigation seeking to reduce the Regulation II rate and correct these small ticket fee increases, the financial industry staunchly opposed the relief requested in the litigation.[81] A federal district court judge ruled in favor of merchants in this litigation, but ultimately the D.C. Circuit Court of Appeals ruled that the Board was not prohibited from using its discretion to increase Regulation II's fee limit by including an unmentioned "third category" of issuer costs. FMI understands and acknowledges the D.C. Circuit's decision, but we want to make clear that it is the height of hypocrisy for financial industry lobbying

---

[77] FMI Press Release, "FMI Expresses Extreme Disappointment in the Federal Reserve Ruling," June 29, 2011, *available at* https://www.fmi.org/newsroom/news-archive/view/2011/06/29/fmi-expresses-extreme-disappointment-in-the-federal-reserve-ruling.

[78] FMI Comment Letter, Feb. 21, 2011, *supra* note 39, at p. 2.

[79] *See, e.g.,* Digital Transactions News, *Applying the Durbin Maximum, Visa and MasterCard Could Squash Small Tickets,* Sept. 27, 2011, *available at* https://www.digitaltransactions.net/applying-the-durbin-maximum-visa-and-mastercard-could-squash-small-tickets/.

[80] *See, e.g.*, 76 Fed. Reg. 43435 ("Merchants suggested that the Board establish different standards for small-ticket sales (under $5) because the proposed cap likely would result in higher interchange fees than merchants currently are paying on those transactions.") Note that while the financial industry claimed that small ticket transactions received an alleged interchange "discount" rate prior to Regulation II, this characterization was inapt. In the 1990s, Visa and Mastercard had imported the debit interchange fee structure of an *ad valorem* rate plus a flat fee rate from the credit card interchange fee structure, even though the cost of authorizing, clearing, and settling a debit transaction does not depend on the dollar amount involved in the transaction. This debit fee structure was applied to all transactions and it was lucrative for debit card issuers, because the networks established the flat fee component at a level to safely cover the fixed costs of conducting a debit transaction while the *ad valorem* component served as an escalating profit generator for issuers.

[81] *See NACS v. Board of Governors of the Federal Reserve System*, 746 F.3d 474 (D.C. Cir. 2014).

groups to claim that the market distortions caused by Visa's and Mastercard's jacking up of fees on small ticket debit transactions is the fault of the Durbin Amendment. The legislation was intended and designed to reduce all debit interchange fee rates, and it would almost certainly have done so had the Board stayed true to Congress's design and the Board's December 2010 proposed draft rulemaking.[82]

We cite this history about the Durbin Amendment not to re-litigate it, but because we are worried about history repeating itself. As the Board considers comments to its current NRPM, we are already seeing aggressive lobbying efforts by the financial industry to delay the Board's process, to seek increases in the regulated rate, and to try to squeeze more types of costs into consideration for the regulated rate calculation. Merchants and consumers were harmed by the 2011 changes that were made to accommodate issuers, as costs were included that Congress did not intend to be covered by network-fixed interchange fees and the fees were set at higher level than they should have been.

Financial Industry Claim #2: "The last time the Federal Reserve placed a cap on debit transaction costs, two things happened: the availability of free checking accounts declined, and merchants pocketed the difference in cost, defaulting on their promise to the American consumer to lower costs at the counter."[83]

Response: The financial industry's own data undermines their claim about free checking, and studies and economic logic undermine their claim that merchants pocketed cost savings from debit reform.

The financial industry has frequently argued that the Durbin Amendment forced covered issuers to increase checking account fees on consumers to make up for lost interchange fee revenue. This claim – that any diminution of bank revenue in one area necessarily forces banks to raise consumer checking fees in other areas – has been made frequently by the financial industry, and not just about interchange reform. For example, before the Durbin Amendment was enacted, the financial industry cited the 2008 financial crisis, high unemployment, limits on overdraft fees, and loan losses as reasons why banks were being compelled to boost checking account fees on consumers.[84] While

---

[82] As Senator Durbin stated on the Senate floor, the Durbin Amendment was intended and designed to "help every single Main Street business that accepts debit cards keep more of their money, which is a savings they can pass on to their consumers." 156 Cong. Rec. S4839 (daily ed. June 10, 2010) (statement of Sen. Durbin). Senator Durbin filed amicus briefs in support of the merchant position in this litigation at the district court, circuit court, and petition for certiorari stages.

[83] Statement of the Consumer Bankers Association, The Bank Policy Institute, and the Clearing House in response to the Federal Reserve's proposed changes to Regulation II, Oct. 28, 2023, *available at* https://www.consumerbankers.com/cba-media-center/media-releases/cba-bpi-and-tch-respond-fed-announcement-reg-ii.

[84] *See, e.g.*, Jane J. Kim, "Banks Boost Customer Fees to Record Highs," *The Wall Street Journal*, Nov. 12, 2008, *available at* https://www.wsj.com/articles/SB122645109077719219 ("Banks are responding to the troubled

the financial industry has shifted its rationale for the basis for banks to raise consumer checking fees and now blame interchange fee reform, the reality is that banks have consistently increased consumer fees as far as market conditions and the regulatory environment will allow them to do so. Because there is a competitive market dynamic between banks pertaining to winning consumer business (in contrast to centrally-fixed interchange fees where all banks receive the same fee rates), banks have incentive not to impose excessive consumer fees that will cause consumers to leave for other banks. Interestingly, while banks argue to the Board that free checking has decreased since the Durbin Amendment, statistics published by the American Bankers Association (ABA) say otherwise. In 2015, the ABA reported that "the majority of Americans – 61 percent – pay nothing at all for bank services" – an increase from the 53 percent the ABA reported had free checking when the Durbin Amendment was enacted in 2010.[85] Also, it is notable that free checking is still easy to find today, both from exempt issuers as well as from numerous covered issuers.[86]

Additionally, the financial industry frequently claims that merchants hoarded cost savings from interchange reform and did not pass savings along to consumers, but this claim is contrary to both evidence and logic. As the Board noted in the NPRM, "[m]easuring the extent to which merchants pass on cost savings to consumers, including any decrease in the cost of accepting certain forms of payment, is generally difficult" because of challenges that include "contemporaneous changes in other costs for merchants" and "the small magnitude of cost variation due to changes in interchange fees relative to total price."[87] However, the retail sector is highly price-competitive and multiple studies show that savings from debit interchange reform have been passed along to

---

economy by jacking up fees on their checking accounts to record amounts."); *ABC News*, "Banks find ways to boost fees; checking accounts latest target," May 28, 2009, *available at* https://abcnews.go.com/Business/story?id=7694339 ("[B]anks seized upon another way to squeeze profits out of struggling consumers: higher checking account fees….Banks defend their policies, saying that as unemployment rises, consumers have become riskier, and the higher fees reflect that risk."); *CBS News*, "Why Are Banks Raising Fees?", July 17, 2009, *available at* https://www.cbsnews.com/news/why-are-banks-raising-fees/ ("With mortgage defaults and unemployment still on the rise, the big banks are still taking a beating on bad consumer loans…To offset those losses banks are hiking fees even on good customers…[Bank of America] raised the fee on its basic monthly checking account from $5.95 to $8.95"); Kathy Chu, "Banks return to charging credit card, checking account fees," *USA TODAY*, May 18, 2010, *available at* https://usatoday30.usatoday.com/money/industries/banking/2010-05-18-bankfees12_st_n.htm ("[B]anks are turning back to familiar money-making strategies: annual credit card fees, monthly checking account fees and product bundling…[a]s measure take effect this year to overhaul credit card and overdraft practices.").

[85] *See* American Bankers Association, "Survey: Most Americans Pay Nothing for Bank Services," Aug. 18, 2015, *available at* http://www.aba.com/Press/Pages/081815SurveyonBankCosts.aspx; *see also* American Bankers Association, "ABA Survey Shows Majority of Bank Customers Pay Nothing for Monthly Bank Services," Oct. 7, 2010, *available at* http://www.prnewswire.com/news-releases/aba-survey-shows-majority-of-bank-customers-pay-nothing-for-monthly-bank-services-104516904.html.

[86] *See, e.g.*, Matthew Goldbert and Karen Bennett, "Best free checking accounts for May 2024," *Bankrate.com*, viewed on May 7, 2024, *available at* https://www.bankrate.com/banking/checking/best-free-checking-accounts/#top-free-checking-accounts; also, a Google search for "credit union free checking account" shows extensive offerings for free checking accounts at credit unions.

[87] 88 Fed. Reg. 78115; *Id.* at Fn. 89.

consumers. Economist Robert Shapiro conducted a study showing that in 2012, the first year when Regulation II was in effect, consumers saved nearly $6 billion from reform.[88] Moody's Investor Service similarly reported in 2012 that merchants would use debit reform savings to help shield consumers from higher prices that would otherwise result from other cost increases.[89]

The evidence that merchants have not hoarded savings under Regulation II is consistent with economic logic. Retail net profit margins are extremely narrow, with general retailers having a net profit margin of 3.09 percent as of January 2024 and as we noted earlier, the grocery sector having an even narrower margin of 1.18 percent.[90] Retail profit margins did not grow after Regulation II took effect; rather, retailers faced inflation and production cost increases but shielded consumers from their effects in large part because of debit reform savings. From October 2011 when Regulation II took effect through the end of 2016, the Producer Price Index for retail trade industries rose 9.4 percent while the Consumer Price Index increased only 4.3 percent; the difference between the higher costs that merchants paid for goods and the prices they charged consumers after Regulation II indicates that debit reform helped keep consumer costs lower than they otherwise would have been.[91] Retail is intensely price-competitive while the interchange fee system is structurally anti-competitive – as a result, it is not surprising that the profit margins of the money center banks and regional banks that issue most debit cards remain robust at 30.89 percent and 29.67 percent respectively, far higher than those of the retail sector.[92]

Further, it is hypocritical for the financial industry to claim that consumers have not saved enough from Regulation II when the industry aggressively lobbied the Board during the 2011 comment period to double the fee limits the Board had proposed in December 2010, thereby significantly reducing the amount of savings consumers could achieve and leading to an increase in interchange fees on many small ticket debit transactions.

Financial Industry Claim #3: "The Durbin Amendment's 'exemption' of smaller financial institutions has proven to be largely illusory, as the Federal Reserve's own data shows that

---

[88] *See* Robert J. Shapiro, "The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees," Oct. 1, 2013, *available at* http://www.sonecon.com/docs/studies/Report_on_Interchange_Fees-RShapiro-October_2013.pdf.

[89] Moody's Investor Service, "New Debit Rules Hurt Banks and Reshape the Payment Processor Market," June 20, 2012, at 10 ("As merchant acquirers pass on debit fee savings to retailers, we believe retailers will use them to help shield customers from the impact of these other rising costs.").

[90] New York University, "Margins by Sector (US)," Data as of January 2024, *available at* https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html.

[91] Producer Price Index figures are available at https://fred.stlouisfed.org/series/PCUARETTRARETTR and Consumer Price Index figures are available at https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.html.

[92] New York University, "Margins by Sector (US)," *supra* note 90.

regulatory thresholds in the interchange market do not insulate smaller issuers from harm."[93]

Response: The Board's data consistently shows that exempt issuers have not seen decreased interchange fees, and the Durbin Amendment also gave small issuers a competitive advantage against covered issuers in the debit issuance market.

Under the Durbin Amendment, small banks and credit unions with assets of under $10 billion are permitted to continue allowing Visa, Mastercard and other networks to fix debit interchange fee rates on their behalf without regulatory limits. Competition between networks in the interchange system incentivizes networks to increase rates to win more issuer business, and so it was not surprising that all networks established separate rate schedules for non-covered issuers under Regulation II and that those issuers have not seen decreased interchange fees. As noted in the NPRM, "data collected by the Board demonstrate that average per-transaction interchange fees for exempt issuers across all payment card networks did not decline after the current interchange fee cap was introduced in 2011 and have not declined since then."[94] Further, exempt small issuers have obtained a significant competitive advantage in the debit issuance market from the Durbin Amendment because the interchange fees they receive "have remained at a level substantially higher than average per-transaction interchange fees for covered issuers, with the latest data collected by the board documenting that average per-transaction interchange fees for exempt issuers increased in 2020 and 2021."[95] As the NPRM noted, if covered issuers decide to increase customer fees (as they have often tried to do both before and after Regulation II), "consumers may switch to checking account or debit card programs offered by exempt issuers."[96] The Philadelphia Federal Reserve published a study in February 2016 on the effect of Regulation II on exempt issuers which found that after Regulation II, "the volume of transactions conducted with cards issued by exempt banks grew faster than it did for large banks."[97]

Financial Industry Claim #4: "[T]he Durbin Amendment has severely diminished consumer access to debit rewards."[98]

---

[93] Letter from the American Bankers Association and eight other trade associations to Chair Powell, Oct. 20, 2023, at p. 2, *available at* https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/joint-trades-letter-on-reg-ii-board-meeting.pdf?sfvrsn=3caeee17_0.

[94] 88 Fed. Reg. 78116.

[95] *Id.*

[96] 88 Fed. Reg. 78115.

[97] James Disalvo and Ryan Johnston, "How Dodd-Frank Affects Small Bank Costs," Economic Insights: Federal Reserve Bank of Philadelphia, Feb. 2016, p. 17, *available at* https://www.philadelphiafed.org/-/media/frbp/assets/economy/articles/economic-insights/2016/q1/eiq116.pdf.

[98] Independent Community Bankers of America Statement on Federal Reserve Proposal on Debit Card Interchange, Oct. 25, 2023, *available at* https://www.icba.org/newsroom/news-and-articles/2023/10/25/icba-statement-on-federal-reserve-proposal-on-debit-card-interchange.

Response: Debit reward programs are alive and well, according to the financial industry's own reporting.

While the NPRM states that data collected by the Board showed that covered issuers limited debit rewards programs under Regulation II, financial industry trade publications have indicated otherwise. In March 2016, *CU Today* reported that "[d]ebit card reward programs, once considered a dying breed as the Durbin rules took hold, are still going strong at many of the nation's largest financial institutions, a new study shows."[99] The article noted that "[a]ccording to a new report from the Mercator Advisory Group, a majority of the country's top banks and credit unions offer debit card reward programs: 14 of the 25 largest banks and 13 of the 25 largest credit unions."[100] In 2016, the *Credit Union Times* also reported that "53% of credit unions say they're likely to add a debit rewards program in the next 12 months, according to a survey conducted by CUNA Strategic Services and Buzz Points."[101] Currently, there remain a broad range of checking/debit rewards options available to consumers.[102] This is not surprising, since merchants – which have far smaller profit margins than card-issuing financial institutions – often use rewards programs as a competitive tool to win consumer business. The discrepancy between what covered issuers are reporting to the Board about a dearth of such rewards programs and reports coming from financial industry publications indicating that the programs are still alive and well may be attributable to covered issuers preferring to use rewards programs to steer consumers toward higher-interchange credit card transactions rather than continuing to prioritize rewards to incentivize consumers to use debit cards where interchange is regulated.

It should be noted that cardholder rewards programs can create problematic regressive cross-subsidies in which low-income and cash-paying consumers pay higher prices to subsidize rewards that largely benefit wealthier cardholders.[103] Notwithstanding this concern, it is evident that such programs remain widely available today, particularly among exempt debit issuers such as credit unions.[104] Because these exempt issuers receive unregulated interchange rates that far exceed their covered issuer competitors, exempt issuers can choose to use this revenue to fund rewards

---

[99] "Despite Durbin, Debit Card Reward Programs Remain Vibrant," *CU Today*, March 29, 2016, *available at* http://www.cutoday.info/Fresh-Today/Despite-Durbin-Debit-Card-Reward-Programs-Remain-Vibrant.

[100] *Id.*

[101] Tina Orem, "Credit Unions Pile into Debit Rewards," *Credit Union Times*, Jan. 20, 2016, *available at* http://www.cutimes.com/2016/01/20/credit-unions-pile-into-debit-rewards?page=2&slreturn=1486526918.

[102] *See, e.g.,* Brian Martucci, "20 Best Rewards Checking Accounts of May 2024," *Money Crashers.com*, May 2, 2024, *available at* https://www.moneycrashers.com/best-rewards-checking-accounts/; Chanelle Bessette, "11 Best Rewards Checking Accounts of 2024," *Nerdwallet.com*, May 6, 2024, *available at* https://www.nerdwallet.com/best/banking/rewards-checking-accounts.

[103] *See, e.g.*, Efrain Berkovich & Zheli He, "Rewarding the Rich: Cross Subsidies from Interchange Fees," Hispanic Leadership Fund, May 3, 2022, *available at* https://hispanicleadershipfund.org/wp-content/uploads/2022/05/HLF_Report_RewardingTheRich-InterchangeFees_03May22.pdf.

[104] A Google search for credit union debit rewards reveals an extensive list of credit union websites offering rewards programs.

programs and thus gain yet another competitive advantage under the Durbin Amendment to try to win debit issuance market share away from the giant issuers.

Financial Industry Claim #5: The American Bankers Association (ABA) issued a statement from its President and CEO stating that the current NPRM was the result of "flawed data" and an "incomplete process."[105]

Response: The data used by the Board was provided by covered issuers, and the fact that the ABA labels it flawed reinforces the importance of auditing the data provided by covered issuers to ensure its integrity. Also, the process is always incomplete at the comment stage of notice-and-comment rulemaking, but the Board should be aware that covered issuers have incentive to delay rate reductions as long as possible and to seek to do so by making process complaints and claiming data limitations.

Just as the financial industry mounted an effort in 2011 to combat and weaken the Board's December 2010 proposed rulemaking, it is doing so with respect to the Board's current NPRM and is citing flawed data and process complaints as part of its initial strategy. The Board should not be swayed by arguments that it cannot act because of the October 2022 card-not-present routing clarification to Regulation II, as this clarification was made necessary by covered issuers' circumvention of the Durbin Amendment's text and intent. These covered issuers should not be rewarded for that misbehavior by being allowed to continue receiving interchange fees that the data clearly show are unreasonable and not proportional to cost. Further, covered issuers have every incentive to delay the Board's process of considering and finalizing its current NPRM, as each month of delay enables covered issuers to continue to receive unreasonably high levels of interchange.

IV. Conclusion

FMI commends the Board for initiating this public rulemaking, as requested in our December 22, 2022, petition[106], and from the numerous conversations that we and the merchant community have had with the Board and Board staff since the implementation of the current debit interchange rate. Our food retailer members, grocery customers, other main street merchants serving every community in the country, and the debit system on the whole need thoughtful and measured reforms. As previously noted, a "reasonable and proportional" debit regulated interchange rate is of the utmost importance to the grocery industry, which operates on razor thin annual profit margins of 1-2 percent.

---

[105] American Bar Association press release, "ABA Statement on Federal Reserve's Proposed Regulation II Changes," Oct. 25, 2023, *available at* https://www.aba.com/about-us/press-room/press-releases/federal-reserve-proposed-regulation-ii-changes.

[106] Dec. 22, 2022, petition from FMI and NACS, *supra* note 1.

We appreciate the Board taking into consideration our recommended modifications to the proposed methodologies to better align those methodologies with EFTA Section 920 and the data collected by the Board and to enhance the efficiency and security of our nation's debit system. It is critical to make these recommended changes to the Board's methodologies prior to locking in any methodologies for future rate adjustments. With several reasonable and measured changes to its methodologies as we have recommended above, the Board can set our nation's debit system on a path toward a robust, efficient, secure, and sustainable future.

Again, thank you for your consideration of our comments. We welcome the opportunity to discuss our recommendations in further detail.

Sincerely,

Leslie G. Sarasin
President and Chief Executive Officer