May 12, 2024

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

Re: Debit Card Interchange and Routing
(Docket No. R–1818, RIN 7100–AG67)

Dear Ms. Misback:

On behalf of Virginia's credit unions, we are writing in response to the proposed amendments to Regulation II issued by the Board of Governors of the Federal Reserve System (the Board). The Virginia Credit Union League represents and advocates for the 100 not-for-profit, member-owned credit unions throughout the Commonwealth of Virginia. We advocate for policies which allow Virginia's credit unions to best serve their members, and we appreciate the opportunity to provide input on these proposed amendments.

Credit unions use revenue from debit card interchange to prevent and mitigate fraud, to provide provident credit to their members and communities, and to offer valuable products and services such as free checking accounts. This proposal threatens credit unions' ability to offer these services and serve the communities in which they operate. It will harm consumers while only helping large merchants. For these reasons and those described below, we strongly oppose the proposed rule and urge the Board to withdraw it.

Research has shown merchants did not pass savings through to consumers after the 2011 debit interchange cap was implemented

In its proposed rule, the Board notes that the primary impact of the rule on merchants would be to lower their costs of accepting debit card transactions. The Board then acknowledges the difficulty of concluding that merchants would pass on these cost savings to consumers. The Board writes that "measuring the extent to which merchants pass on cost savings to consumers, including any decrease in the costs of accepting certain forms of payment, is generally difficult. Efforts to measure the extent to which merchants passed on to consumers any savings associated with the decrease in the costs of accepting debit card transactions in the period following the adoption of the current interchange fee cap in 2011 have yielded a wide range of results."

To illustrate this "wide range of results," the Board cites research that it describes as showing contrasting results. They accurately cite research supporting the argument that merchants *did not* pass savings from reduced debit card processing costs on to consumers following the adoption of the current interchange fee cap in 2011. In a 2014 survey study by the Richmond Fed, the authors found that only 1.2% of merchants reduced prices post-regulation, while 21.6% increased prices and 77.2% of merchants did not change prices.[1] This research clearly showed there was no widespread pass-through of savings from merchants to consumers in the form of lower prices.

The proposed rule states that "by contrast, later research efforts analyzing data from longer time periods found evidence that merchants passed on to consumers a portion of their debit card acceptance costs (*e.g.,* by adjusting their prices) and that the degree of pass-through depended on merchant size." To support this claim, the proposed rule cites two papers.

The first citation is a manuscript titled *Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards.*[2] In their research, the authors write:

> "Merchants do experience a reduction in interchange fees on payments with debit cards. However, since these savings appear negligible relative to combined sales including credit-card and cash transactions, **estimating with statistical significance the extent of merchant's pass-through is virtually impossible. As such, ascertaining the accomplishment of the regulation's stated objective, which was to enhance consumers' welfare through lower retail prices, is unworkable."** (emphasis added)[3]

The paper analyzes gasoline prices in 2016, using price, ZIP code and merchant category code (MCC) data to see if they could quantify how much of their debit card processing costs savings merchants passed through to consumers. The authors concluded:

> "Our results suggest that the Durbin Amendment has had, as far as retail prices are concerned, at best a modest effect on a non-negligible—yet still small—segment of the payments market**. This renders statistically accurate pass-through quantification impossible. On the other hand, the evidence strongly suggests that the regulation made checking accounts less affordable."** (emphasis added)[4]

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[1] *See* Wang, Zhu, Scarlett Schwartz, & Neil Mitchell, *The Impact of the Durbin Amendment on Merchants: A Survey Study,* 100 Federal Reserve Bank of Richmond Economic Quarterly 183 (2014), *https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2014/q3/pdf/wang.pdf*.
[2] Vladmir Mukharlyamov & Natasha Sarin, *Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards* (last rev. Nov. 28, 2022) (unpublished manuscript), *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3328579;*
[3] *Id. at 2.*
[4] *Id. at 27.*

The second citation is titled *Rewarding the Rich: Cross Subsidies from Interchange Fees*.[5] In this study, the authors examine "a proprietary dataset of retail stores in a particular industry which contains annual revenue, profit, and interchange costs for the years 2012 to 2021."[6] In their analysis, they assess "the relationship between interchange fees and store profit in order to examine whether retailers pass through interchange fees to consumers."[7]

The authors conclude that "although larger stores, on average, are able to pass through interchange costs to consumers, smaller stores appear to have reduced profit from interchange increases."[8] The study's dataset included no data from before the 2011 interchange caps went into effect, and therefore makes no assessment of whether merchants passed on savings from reduced debit processing costs brought on by the 2011 cap. Rather, the study showed that large retailers can more easily pass on interchange costs to their customers than smaller retailers can.

The proposed rule describes the research of whether merchants passed on decreased debit card processing costs to consumers after the 2011 interchange caps as having "yielded a wide range of results." The rule cites the 2014 Richmond Fed research which found only 1.2% of merchants lowered their prices after the interchange cap, while 21.6% increased their prices. However, the rule cites no study supporting the opposite viewpoint – that merchants *did* pass through their cost savings to consumers in the form of lower prices after 2011. Their citation of the "contrasting" data from the Richmond Fed research is 1) research that analyzed 2016 gas prices and found no statistical significance of merchants passing through savings, and 2) research that analyzed post-2011 data and concluded large retailers can more easily pass-through increased interchange costs to consumers than small retailers.

Neither of these cited studies found that after the 2011 interchange cap merchants passed through their cost savings to consumers. There is no "wide range of results." The idea that this proposed reduction to debit card interchange will benefit consumers because merchants will see reduced debit card processing costs and pass those savings to consumers by reducing prices is a myth. It did not happen in 2011, and it will not happen in 2024 if this rule is finalized.

Consolidation in the credit union industry will be accelerated and consumers will bear the burden

The credit union industry is consolidating due to increased regulatory burden and compliance costs. When the current interchange fee cap was adopted in 2011, there were 7,386 credit unions, Today, there are 4,593 active credit unions, dozens of which have proposed merger agreements

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[5] Efraim Berkovich & Zheli He, *Rewarding the Rich: Cross Subsidies from Interchange Fees* (Hispanic Leadership Fund, May 3, 2022)
[6] *Id. at 27.*
[7] *Id. at 27.*
[8] *Id. at 40.*

and may soon cease operations.[9] Regulatory changes like this proposed rule will accelerate the pace of consolidation by reducing a critical source of income credit unions rely on to operate.

Over half of today's credit unions – 2,479, to be exact – are low-income designated credit unions, meaning the majority of their membership earns less than 80% of the median household income for the area in which they live.[10] Credit unions who serve these communities cannot simply flip a switch and offset lost debit interchange revenue by taking actions like eliminating free checking or raising loan interest rates. These actions will have a material impact on credit union members who cannot afford these changes. And yet, credit unions who cannot operate debit card programs as loss leaders may have no other option than to raise other fees, reduce grants and scholarships to the community, or cut back on other services. Every one of these actions will harm consumers and the community, yet credit unions may have no other choice if this rule is finalized.

Consolidation hurts consumers by reducing competition and access to local financial services. The potential closure of credit unions in low-income communities will reduce financial inclusion and leave these communities with fewer options – and likely higher fees and costs – for basic financial services. A reduction in debit interchange revenue will lead to more credit unions merging or reducing services – an outcome which harms consumers and communities.

The Board underestimates the impact the proposed rule will have on exempt financial institutions

The proposed rule states that "the proposal would not directly or, the Board believes, indirectly affect exempt issuers (*i.e.*, those with consolidated assets under $10 billion)." However, data shows that the 2011 interchange cap impacted both covered and exempt issuers. Research from the Federal Reserve in 2017 found that free noninterest checking accounts from exempt issuers fell by 15.5% after the 2011 debit interchange cap.[11] Additionally, the Board's historical data shows that after Regulation II took effect, single-message network fees for exempt issuers declined dramatically by nearly 31 percent in inflation-adjusted dollars from 2011 to 2021.

Despite research and data showing the impact of the debit interchange cap on exempt issuers, the Board still believes these proposed changes will have no direct or indirect impact on exempt institutions. As such, they are basing their new calculations in the proposed rule on data from covered issuers, disregarding valuable data and insights from smaller financial institutions. Proposed changes to the interchange cap in 2024 would impact both large and small debit card

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[9] *See* National Credit Union Administration, Research a Credit Union, https://mapping.ncua.gov/ResearchCreditUnion; Comments on Proposed Credit Union Mergers, https://ncua.gov/support-services/credit-union-resources-expansion/credit-union-merger-resources/comments-proposed-credit-union-mergers

[10] *Id.*

[11] Manuszak, Mark D. and Krzysztof Wozniak, "The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation" 5-6 (2017), available at https://doi.org/10.17016/FEDS.2017.074.

issuers just as they did when the cap was implemented in 2011, and the Board should fully consider and analyze data from exempt issuers before moving forward with this proposed rule.

Even if the Board holds firm in this belief, their dataset is still incomplete. In 2022, the Board amended Regulation II to require dual routing for card not present (CNP) transactions.[12] This amendment went into effect in July of 2023. The 2021 Debit Card Issuer survey data the Board is relying on in its proposed rule does not reflect this change. These new dual-routing amendments will have an impact on interchange revenue, and to change the calculation of the interchange fee cap without considering data that accurately reflects the current regulatory structure is premature. The Board should not finalize this rulemaking until the effects of the 2022 routing requirements and their effect on interchange can be analyzed.

Conclusion

For the reasons detailed above, we urge the Board to withdraw the proposed rule. Thank you for the opportunity to provide comments. If you have any questions, please do not hesitate to contact me at 434-237-9608 or at jblau@vacul.org.

Sincerely,

JT Blau
Chief Advocacy Officer

[12] See Board of Governors of the Federal Reserve System, Debit Interchange Fees and Routing, 87 Fed. Reg. 61217 (October 11, 2022).