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: Regulation II Amendment Regarding Interchange (Docket No. R-1818)

Ms. Misback:

We write to you on behalf of the National Retail Federation (NRF) in response to the Board's request for comments on the above-referenced proposed amendment to Regulation II. NRF is the world's largest retail trade association, representing retailers ranging from the largest, most well-known brands, to hundreds of Main Street stores around the country. Its members include department stores, catalog, internet, specialty, discount, and independent retailers, grocery and drug stores, restaurants, multi-level marketing companies, and vendors. NRF represents the largest private-sector industry in the United States, containing over 3.8 million retail establishments, and supporting more than 52 million employees.

We appreciate the Board's attention to this matter, as the economic factors that were considered by the Board when it originally set the maximum allowable interchange rate for covered issuers in 2011, based on 2009 data, have changed considerably. The Board's proposal to adopt an automatic mechanism to adjust the rate is also a welcome addition, as an automatic adjustment that accurately reflects a "reasonable and proportional" recovery for covered banks' costs will appropriately account for future changes while recognizing that the substantive legal, policy, and economic factors encompassed within the rule remain unaltered. But, especially since these automatic adjustments will be predicated on the fixed methodology adopted here by the Board, it is critical that the methodology itself is sound.

NRF believes that the methodology set forth in the proposed amendment should be modified so that it is at least consistent with the Board's long-standing position as to what constitutes a "reasonable and proportional" rate. As it currently stands, when controlling for input costs, the

NATIONAL RETAIL FEDERATION
1101 New York Avenue, NW, Suite 1200
Washington, DC 20005
www.nrf.com

new methodology proposed in the NPRM allows issuers to collect significantly *higher* interchange rates as compared to the existing methodology, Specifically, while the ACS costs permitted by the Board have decreased by half since its data collection began, the newly proposed methodology only decreases the base rate cap by one third, resulting in a windfall for the issuers. If the existing methodology reflects a "reasonable and proportional" rate, as the Board has consistently asserted since Regulation II was first adopted, including before the District Court and Court of Appeals for the District of Columbia, the newly proposed rate does not.[1] There is an additional and critical reason that the Board should not finalize this NPRM using the proposed methodology: any new methodology should be constructed to maintain a reasonable and proportional rate today, while accommodating future developments that are inevitable in the rapidly changing payments industry. As set forth below, the new methodology is insufficient to accomplish this. Accordingly, we respectfully request that the Board modify the amendment in the manner discussed below to address these deficiencies.

NRF would further like to take this opportunity to urge the Board to reconsider its earlier decision to include non-incremental costs in the base rate and instead return to the position taken in its *original* NPRM. 75 Fed. Reg. at 81,755-56 (setting the base rate at 12 cents per transaction), then adjusting *that* amount downwards to account for the changed input costs acknowledged by the Board.[2] In *NACS*, the court upheld the *NACS v. Board of Governors of the Federal Reserve*, the court upheld the Board s' inclusion of multiple types of costs not listed in the statute as. Merchants' view then, as now, is that the statutory language distinguishes clearly between the "incremental cost" of "authorization, clearance, or settlement of a particular electronic debit transaction," which is recoverable, and "any other costs incurred by the issuer which are not specific to a particular electronic debit transaction," which are not. 15 U.S.C. §1693o-2(a)(4)(B)(i) & (ii). There is no in-between category of costs that the Board has discretion to consider as recoverable costs. NRF notes that *NACS v. Board of Governors of the Federal Reserve* upheld the final rule originally issued by the Federal Reserve over 10 years ago. As the Board is no doubt aware, all stakeholders in Regulation II face a changed legal landscape since *NACS*, and a court that feels unencumbered by the degree of deference afforded to the Board in that earlier action – which by most accounts is likely to be the case in a few months – may concur that these costs are not recoverable.[3] Although the Board notes in its current NPRM

[1] We urge the Board to note the implications of this for any judicial review of a newly-adopted methodology; the consistency of an agency's position is a factor in assessing the reasonableness of the agency's legislative interpretation. *See Good Samaritan Hosp. v. Shalala*, 508 U.S. 402, 417 (1993).

[2] Notably, the base rate calculated using the Boardne's wly proposed methodology is *higher* than the 12 cents proposed by the Board 14 years ago, even though the ACS costs considered by the Board have been *halved* during that same period.

[3] On January 17, 2024, the Supreme Court heard oral argument in *Loper Bright Enterprises v. Raimondo* on whether the Court should overrule *Chevron U.S.A., Inc v. Nat. Res. Def. Council, Inc.*, with a decision expected by the end of June. The D.C. Circuit's decision in *NACS* heavily relied on *Chevron* in affirming the Board's interpretation of the statute. *NACS*, 746 F.3d at 484-89. Were *Chevron* to be overturned, a future court reviewing the Board's interpretation of the statute would afford far less deference to the Board than the *NACS* court. Rather than acquiescing to the Board's interpretation merely because the court determined it to be reasonable, the future court would instead afford the level of deference justified by "the thoroughness evident in [the Board's] consideration, the

that it will decline to revisit its inclusion of these costs and does not wish to reopen the record on the issue, it may do well to reconsider its approach at this time.

In any event, the bottom line remains: If the "reasonable and proportional" requirement imposed by EFTA is to serve as any logical limit on what banks can charge merchants for swiping debit cards, it has to mean that the rate cannot allow the vast majority of transactions to earn rent-seeking profits for issuers. Reconsidering allowable costs would be one way to lower the rate appropriately. But to the extent the Board remains unwilling to do so, the other proposals suggested below (and by other merchant commentors) provide alternative avenues to at least partially accomplish that goal.

In the pages that follow, NRF has endeavored to respond to the questions posed by the Board[4] to the extent that they apply to NRF or its members.

The Proposed Amendment to Regulation II is Inconsistent with the Board's Long-Held Views, and the Electronic Funds Transfer Act

Since it is the Electronic Funds Transfer Act (EFTA) that grants the Board's authority to promulgate Regulation II, any discussion must start with the language of the Act itself. EFTA prohibits covered issuers from charging an interchange fee that is not "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[5] It further requires the Board to prescribe regulations for assessing whether an amount charged as interchange complies with this mandate.

Pursuant to EFTA's requirements, the Board in July 2011 adopted Regulation II,[6] setting forth three permissible components of interchange:

- A 21-cent *base component*, which was 2.7 times the transaction-weighted average of per-transaction costs incurred by issuers;
- An *ad valorem component* of 5 basis points, calculated by reference to the median ratio of issuer fraud losses to transaction value among covered issuers; and
- A 1-cent *fraud-prevention adjustment*, calculated by reference to the median total data-security cost incurred by issuers per transaction.

Based on their view that the above components permitted issuers to charge in excess of the "reasonable and proportional" costs incurred, merchants were largely displeased with Regulation

validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors give it the power to persuade." *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

[4] See NPRM, 88 Fed. Reg. 78113-14.

[5] 15 U.S.C. §.1693o-2(a)(2), colloquially referred to as the "Durbin Amendment."

[6] 12 CFR Part 235.

II as promulgated in 2011.[7] However, in the face of multiple legal challenges, the Board vociferously and successfully defended its methodology before the U.S. Court of Appeals for the D.C. Circuit.

When Regulation II was first enacted, the most recent data available to the Board was from 2009. As such, the overall permissible interchange fee adopted by the Board as referenced above was calculated in reliance on that data. While the amount of allowable interchange has remained static since then, the input costs for these components have changed significantly. For example, per-transaction costs incurred by issuers have fallen by nearly 50%, and issuer losses due to fraud have also decreased. Accordingly, the time is well overdue for each of the components above to be adjusted by incorporating these updated inputs into the methodology. But the proposed amendment takes a different course. Instead, it significantly changes the methodology itself in a manner that is detrimental to merchants and, ultimately, consumers.

As we note above, if the Board is to alter its current methodology, it should do so in the manner that merchants proposed in the original Regulation II rulemaking. But if the Board is steadfast that it will not revisit those questions, then the Board should not act in contravention of the methodology it has followed for the past 13 years, and instead simply update the inputs based on more current data [8] Any departure from the Board's prior methodology must be based on a reasoned explanation of the change and take into account the serious reliance interests engendered by the Board's prior actions. *See Encino Motorcars, LLC v. Navarro*, 579 U.S. 211, 221-22 (2016).

The Board has consistently argued that its methodology is the appropriate way to calculate an interchange rate that is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction,"[9] as mandated by EFTA. When the updated inputs are applied to the Board's newly proposed methodology, it results in interchange rates significantly higher than that resulting from the application of these same inputs into the existing methodology. If an interchange rate calculated using the existing methodology is reasonable and proportional – as the Board has consistently argued it is – a higher rate calculated by reference to the new methodology while using these same input costs is not reasonable. The proposed amendment should also take account of other developments that have occurred over the past thirteen years in relation to the respective burden of fraud suffered by issuers and merchants, as detailed below.

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[7] Most (if not all) merchants believe, as do we, that even under the existing methodology, issuers are permitted to collect interchange that is in excess of the "reasonable and proportional" amounts dictated by EFTA. For the reasons expressed in comments to prior rulemakings, litigation, and official correspondence and petitions to the Board, we continue to believe the existing methodology is legally flawed. However, here, we focus primarily on ensuring that the Board act in a manner consistent with its own prior actions and the position it has long advocated.

[8] As explained *infra*, NRF believes that a tiered approach to rate-setting, in which the Board distinguishes among the high, medium, and low volume issuers, is the methodology that is most consistent with the statute. The Board would also be required to explain this new approach, of course, but we believe a tiered approach is easily supported by the record and the law.

[9] 15 U.S.C. § 1693o-2(a)(2).

The Proposed Base Component is Neither Reasonable Nor Proportional

As discussed above, the Board's consistent position to date, which it defended before the D.C. Circuit, is that a base component set so that 80 percent of covered issuers fully recover their allowed costs is "reasonable and proportional."[10] Under this methodology, the 20 percent of issuers that are the least cost-efficient do not obtain full recovery of their allowed costs. The Board determined that this methodology reflected the reasonable and proportional cost incurred by "a representative issuer," and that "[t]he Board therefore does not believe that setting interchange fee standards to accommodate these higher-cost issuers would be reasonable or proportional to the overall cost experience of the substantial majority of covered issuers."[11] However, the proposed methodology risks precisely that problem.

The Board's amendment es that the base component be set so that *all* issuers receive full recovery for 98.5% of *all* debit transactions.[12] Notably, the costs incurred by the least efficient issuers are included in these calculations, effectively penalizing merchants (and their customers) and rewarding issuers for these issuers' inefficiency.

There is no legal nor regulatory basis for this change. The Board has not sufficiently explained why the new methodology is a reasonable interpretation of its statutory mandate, especially when it departs so much from the old methodology. In fact, the Board notes that "the shape of the distribution of per-transaction costs across covered issuer transactions has not changed markedly between the data collections."[13] The Board uses this observation to conclude that use of *a* multiplier to determine base rates going forward is an appropriate tool for adjusting the rate. But this point does not support *changing* the multiplier from 2.7 times fixed costs to 3.7 times fixed costs – an increase of 37 percent. Nor does the efficiency gap analysis that the Board puts forth to support its raising the multiplier to 3.7 support its conclusion. Section VII of the NPRM indicates that at the 95th percentile of covered issuer transactions, the efficiency gap between covered issuers whose transactions are below and above that percentile is 3.8; at the 98.5th percentile, it is 5.2. It's unclear why 5.2 was chosen as the important data point here, other than that it is the median number between the 95th percentile and the 99.5th percentile—which itself is a range that the Board proffers without explanation. If the Board left the methodology at a 2.7 multiplier, 95 percent of covered issuer transactions would be fully compensated by the base rate. Higher than that, and the efficiency gap grows by leaps and bounds. At the very least, the Board has not presented reasoning sufficient to conclude that creating a new methodology that compensates transactions at a much higher ratio is "reasonable and proportional" under the statute.

[10] *See* 76 Fed. Reg. 43,394, 43,434 (July 20, 2011) ("[T]he final rule establishes a standard that caps the base component of any interchange fee at 21 cents per transaction, which corresponds to the 80th percentile issuer's average per-transaction included costs.").
[11] 76 Fed. Reg. 43,394, at 43,433.
[12] 88 Fed. Reg. 78,100, 78,101 (Nov. 14, 2023).
[13] 88 Fed Reg. at 78,107.

Explained another way, the new methodology results in a significantly higher base component than that calculated when *the same updated allowable costs* are input into the existing "reasonable and proportional" methodology. Specifically, in calculating the base component, the proposed methodology multiplies the transaction-weighted average of per-transaction allowable costs across covered issuers (3.9 cents) by a fixed multiplier of 3.7, and then rounds the result to the nearest tenth of one cent.[14] This results in the 14.4 cents base component proposed by the Board.

By contrast, when the current base was set at 21 cents, *these same allowable costs* were 7.7 cents, meaning that the base component under the existing methodology is 2.7 times higher than the allowable costs on which that figure is based. Were this same multiplier applied to the costs reflected in the 2021 issuer survey, the base component would be 10.5 cents—not the 14.4 cents proposed by the Board. In other words, the new methodology allows issuers to collect a base component that is 37% higher than that which the Board has long advocated as being "reasonable and proportional."

Looking at it yet another way, as the Board notes in its NPRM, issuers' allowable costs have been reduced 49%—from 7.7 cents to 3.9 cents—between 2009 and 2021.[15] Since issuers' allowable costs have been reduced by 49%, one would expect the base component to fall by a commensurate amount if base component is to remain reasonable and proportional to the expenses incurred by issuers (under the Board's own decade-long position). But the Board's new methodology reflects only a 31% reduction in the base component (from 21 cents to 14.4 cents). Setting aside reasonability, by definition, a reduction in 49% in one of these figures but not in the other is not "proportional."

Considering that issuers' allowable costs have been reduced 49% since 2009, while the interchange they will be permitted to collect is reduced only 31% under the Board's newly-proposed methodology, the largest issuers in the country are further guaranteed a higher profit margin under the proposed rule than that which the Board deemed "reasonable and proportional" when Regulation II was first enacted.[16] *If the existing methodology reflects a "reasonable and proportional" interchange fee, as the Board has advocated for years, the new methodology does not.*

Based on its NPRM, we understand that the reason the Board is looking to change the existing methodology is that the data no longer reflects a clear "breaking point" at the 80th percentile, or

[14] 88 Fed. Reg. at 78,108.
[15] 88 Fed. Reg. at 78,105.
[16] Further, by raising the multiplier from 2.7 to 3.7, the newly proposed methodology incentivizes issuers to become even more *inefficient*. For every 1 cent in increased costs issuers incur due to inefficiency in future years, they will be permitted to collect an additional 3.7 cents from merchants, yielding a net *profit* of 2.7 cents. Conversely, for every 1 cent in decreased costs issuers would save due to efficiency in future years, the amount of interchange they will be permitted to collect will fall by 3.7 cents, yielding a net *loss* to their bottom line of 2.7 cents. Even more so than the existing methodology, issuers are awarded for inefficiency and punished for efficiency.

perhaps, any percentile (and as we explain above, the Board seems focused on the efficiency gap). But any new methodology intended to address this challenge must result in a reasonable and proportional interchange rate. The proposed methodology, while it does lower the overall base rate, results in *higher*profits for the vast majority of transactions.

There is, however, an equally simple mechanism that is consistent with the Board's earlier methodology. As described above, when it was set, the existing 21 cent base component was 2.7 times the transaction-weighted average of per-transaction allowable costs reported by covered issuers. The Board need only apply this same 2.7 multiplier to the allowable costs reported by these issuers on a periodic basis to arrive at a base component that is equally "reasonable and proportional" to that which has been in place for the past 13 years.

Using this mechanism, if issuers' allowable costs fall by 20%, so does the base component they are permitted to collect. Conversely, were these costs to rise by 20%, so would the base component. This is as simple as, more consistent with, and as proportional as the existing methodology. In fact, the Board has already performed this calculation, as shown in the NPRM, where the Board reports that using a 2.7 multiplier as it has for years results in a 10.5 cent base component when 2021 data is used.[17] As described above, this 49% reduction in the base component set back in 2011 (based on 2009 data)—from 21 cents to 10.5 cents—exactly reflects the reduction in issuers' costs during that period. If the Board's methodology in 2011 resulted in a fair and proportional base component, this is the only methodology that is equally so. And it provides for simple periodic updates of the base component as issuers' allowable costs vary in future years, whether up or down.[18]

NRF also proposes an alternative methodology that our members believe is even more consistent with a reading of EFTA than either the 3.7 multiplier or the original 2.7 multiplier of the covered issuers' reported costs. Subsection 1693o-2(a)(2) requires that "the amount of any interchange transaction fee that *an* issuer may receive or charge with respect to *an* electronic debit transaction shall be reasonable and proportional to the cost incurred by *the* issuer with respect to *the* transaction." 15 U.S.C. §§ 1693o-2(a)(2) (emphasis added). Reading this specific language to mean that a "reasonable and proportional" rate can be assessed with regard to the overall weighted average transactions costs among *all* covered issuers is arguably inconsistent with the statute. Rather, this language directs the Board to figure out how to determine an interchange fee that is *no more than what is reasonable and proportional to the cost of that transaction.*[19]

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[17] *See* the bottom column of the chart at 88 Fed. Reg. at 78,113, which shows a fixed multiplier of 2.7 (the same as used in the current methodology), and a resulting base component of 10.5%. This is exactly proportional to the existing methodology, which likewise uses a multiplier of 2.7.

[18] Notably, the fact that issuers' costs have decreased since Regulation II was implemented means that they have been increasingly profiting each year from the base component, as it has remained constant and was calculated by reference to the higher costs that existed in 2009.

[19] *See, e.g.*, *American Bus Ass'n v. Slater*, 231 F.3d 1 (D.C. Cir. 2000) ("'it is a rule of law well established that the definite article 'the' particularizes the subject which it precedes. It is a word of limitation as opposed to the definite or generalizing force of 'a' or 'an.''(*citing Brooks v. Zabka*, 168 Colo. 265, 450 P.2d 653, 655 (1969 (en banc)).

Accordingly, the Board should move to a tiered approach to setting the base interchange rate consistent with the categories on which it currently gathers data in the biannual survey. This approach would guarantee the greatest practicable degree of consistency with the statutory mandate. Furthermore, this approach is both practical and achievable. The Board already collects data on the ACS costs of high-volume issuers (more than 100 million debit card transactions annually), mid-volume issuers (those between 1 million and 100 million annually) and low-volume issuers (those with fewer than 1 million annually).[20] This data yields two key observations, both of which lead to the conclusion that a tiered approach to rate-setting would be most consistent with the statute's mandate to set a rate that is "reasonable and proportional" the cost of a transaction.

First, there is a massive delta between the reported costs of high-volume issuers and those of low-volume issuers. By 2021, high-volume issuers' ACS costs per transaction were $0.035. Mid-volume issuers costs were nearly three times as high, at $0.109, and low-volume issuers' costs were *17 times more* at $0.595 per transaction.21 The Board could easily use a methodology that compensates issuers in each category for their cost, without resulting in rent-seeking profits for any issuer. This would ensure that the margin on each transaction is priced reasonably and proportionally, while at the same time, keeping incentives in place for smaller issuers (which are also lower volume) to maintain their debit-issuing business. This, in turn, will provide customers throughout the US with the greatest access to, and choice among, debit services.

Second, the stark differences between the costs of high-, medium-, and low-volume issuers means that the vast majority of debit transactions, under both the Fed's current and proposed methodologies, garner windfall profits for issuers. This is not what Congress intended under EFTA. Specifically,

> Under the [Board's] proposal, the 24 Covered Issuers with the smallest debit programs on average will generate around $34,000 annually from regulated debit interchange and issuers that fall in the middle on average will generate annual pre-tax profits of more than $730 million, suggesting that the debit card business is a rather insignificant business line for them, yet they are impacting the Board's recommendation.
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> In contrast, the largest volume issuers will on average receive interchange revenue of approximately $176 million, with the very largest generating nearly $1.7 billion.[22]

This data indicates that tiering would result in a rate that is less skewed towards compensating the lower-volume issuers, for whom debit is a small part of their business. By contrast, the

[20] 88 Fed. Reg. at fn 20.
[21] *See ibid*., Fig. 19.
[22] "Considerations for the Federal Reserve Board's Proposed Rule for Debit Interchange," Pat Moran (May 2024), at 8, attached to this letter as Exhibit A. This paper sets forth several alternative ways to set a reasonable and

current and proposed methodologies allow for recovery of costs that are many multiples of the actual costs incurred by each transaction, and many *more* multiples of the actual costs of almost all transactions. Tiering the issuers based on data that the Board already collects would eliminate the windfall profits that the largest, most efficient issuers receive under the proposed methodology, which as it stands, has the perverse effect of encouraging inefficiency and discouraging further reductions in cost. By contrast, tiered rates that hew more closely to the actual ACS costs of issuers in each tier would encourage issuers in *all* tiers to lower costs and maximize efficiency.[23]

NRF notes, in conclusion, that even a tiered system would need to reflect a multiplier or rate of recovery for issuers that is still "reasonable and proportional." We emphasize, again, that a 3.7 multiplier is inconsistent with the Board's previous interpretation of its statutory responsibility.

The *Ad Valorem* Component of Interchange Should be Based on Net Fraud Losses

The existing *ad valorem* component of interchange was set by the Board at 5 basis points for the purpose of allowing issuers to recover their losses suffered due to fraud. In its NPRM, the Board explains that covered issuers have benefited from a reduction in fraud losses, and that the *ad valorem* component should be reduced.[24] We agree.[25]

But the Board further notes that there has been an increase in the amount of fraud losses suffered by the industry overall, disproportionately suffered by merchants.[26] This not only means that merchants have suffered increased fraud losses as issuers' losses have decreased, but that the increase in merchant fraud losses has surpassed the significant fraud reductions from which issuers have benefitted.[27] In other words, while merchants have continued to subsidize issuers by

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proportional base rate. NRF uses its comments primarily to express its views regarding the Board's statutory obligations, and the methodologies that would be most consistent with these. The paper sets forth other alternatives which we urge the Board to consider as well.

[23] NRF recognizes that the smaller the group of issuers from which data is gathered, the easier it may be, in theory, for issuers to drive up the mean or median ACS cost in each category by supporting data that purports to reflect higher ACS costs. NRF discusses *infra* why it is important to monitor the data from the issuer survey, and to provide enhanced opportunities for comment should the data show a cost increase. Even if, however, self-reported ACS costs were to drive the base rate upwards in low- and medium-issuer categories, the significantly lower base rate that would be achieved by, for example, setting a reasonable and proportional rate for the vast majority of (high-volume issuer) transactions would represent a substantially more reasonable base rate by weighted average.

[24] As with the base component, issuers have been increasingly profiting each year from the *ad valorem* component, as it too has remained constant and was calculated by reference to the higher level of fraud losses existing in 2009.

[25] In fact, we believe the ad valorem component should be eliminated in its entirety. Allowing issuers to shift the burden of their fraud losses to merchants affirmatively eliminates all incentives that would otherwise exist for issuers to detect and eliminate fraud, to the detriment of the payments system, the economy, and consumers.

[26] 88 Fed. Reg. 78100, at 78108 ("Since the Board adopted the interchange fee standards in 2011, the Board has observed an overall increase in fraud losses to all parties related to covered issuer transactions, but the share of such fraud losses absorbed by covered issuers (i.e., issuer fraud losses) has declined during that time."

[27] This is not surprising, as the allocation of fraud losses between issuers and merchants is set unilaterally through network rules, and the networks—previously owned by the issuers—are unabashedly pro-issuer in their conduct.

covering the entirety of their fraud losses, they have at the same time had to cover all of their own increasing fraud losses. Based on these changes in circumstance, the methodology presently used for calculation of the *ad valorem* component is no longer reasonable *nor proportional* to the losses suffered by each of these participants in the payments system, as is mandated by EFTA. Unlike the methodology used to calculate the base component, which is predicated solely on expenses incurred by the issuer and can be adjusted by reference to those costs, here there has been a substantiated shift in burden of fraud-related costs *from* issuers *to* merchants justifying a change in the methodology used to calculate the *ad valorem* component.

If the Board wishes to continue to allow issuers to recover for their fraud losses through an *ad valorem* component, it should do so not solely by reference to the steadily decreasing fraud losses incurred by issuers. Rather, it should also take account of the steadily increasing fraud losses suffered and borne by merchants. To effectuate this, we propose that the fraud component of interchange be set by reference to the *net* fraud losses suffered by issuers as compared to merchants.[28] As this figure is adjusted periodically, this calculation may work to the benefit of merchants sometimes and issuers other times. But, either way, it is fair and proportional, and it incentivizes *all* participants in the ecosystem to reduce fraud.[29]

The Fraud Mitigation Component of Interchange Should be Eliminated

EFTA Section 920 provides that the Board *may* allow for an adjustment to the permissible interchange fee if it is "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer."[30] In adopting Regulation II, the Board chose to do so, allowing an additional 1 cent per transaction to be recovered by issuers that assert they have taken steps toward fraud mitigation.[31]

By contrast, EFTA Section 920 provides that, in choosing whether to create make such an adjustment, the Board *shall* (i.e., is required to) take into account a number of factors, including "the fraud prevention and data security costs *expended by … retailers*," and "the costs of fraudulent transactions absorbed by *each party* involved in such transactions … *including … retailers*."[32] In other words, there is a mandate that the Board take into consideration the fraud mitigation costs and fraud losses incurred by merchants, weighing these against those claimed by issuers.

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[28] In the event it is necessary to gather additional information for this purpose, the Board should proceed to finalize the amendments relating to the base rate at this time and leave this element open for future rulemaking.
[29] To the extent merchant fraud losses exceed those of issuers, a truly proportional *ad valorem* component would result in a flow of funds *from* issuers *to* the merchant, resulting in a *reduction* in the overall interchange paid by merchants. If the Board does not wish to allow the *ad valorem* component to become negative, however, it should instead be based on net fraud losses as discussed above and simply cease to be charged whenever merchant losses are equal to or exceed those of issuers.
[30] 15 U.S.C. § 1693o-2(a)(5)(A)(i).
[31] 12 CFR Part 235.4.
[32] 15 U.S.C. § 1693o-2(a)(5)(B)(iv) and (v) (emphasis added).

Since Regulation II was enacted, the debit networks have enacted issuer-friendly rules that require merchants to expend significant amounts of time and money to install EMV terminals at each and every one of their physical points of sale. The costs of doing so are tremendous, estimated at 30 billion. In deciding whether to permit issuers to continue to collect a fraud mitigation component and, if so, the amount of that component, the Board is *required* by EFTA to take this into account as it is among "the fraud prevention and data security costs expended by … retailers."[33] This would be true even were these costs not incurred as a result of network mandates.

Further, as the Board recognizes in its NPRM, while fraud losses for issuers have decreased since Regulation II was enacted, those suffered by merchants have increased. This again is a result of issuer-friendly rules enacted by the debit networks that shift the burden for fraudulent transactions from issuers to merchants. But in any event, the Board is required to take this into account at is reflects "the costs of fraudulent transactions absorbed by each party involved in such transactions … including … financial institutions [and] retailers."[34]

If a fraud mitigation adjustment had been warranted in 2011 (we contend it was not), that is certainly no longer the case in light of developments since then. EFTA mandates that the Board take these developments into account, and the existing fraud mitigation component should be eliminated.[35]

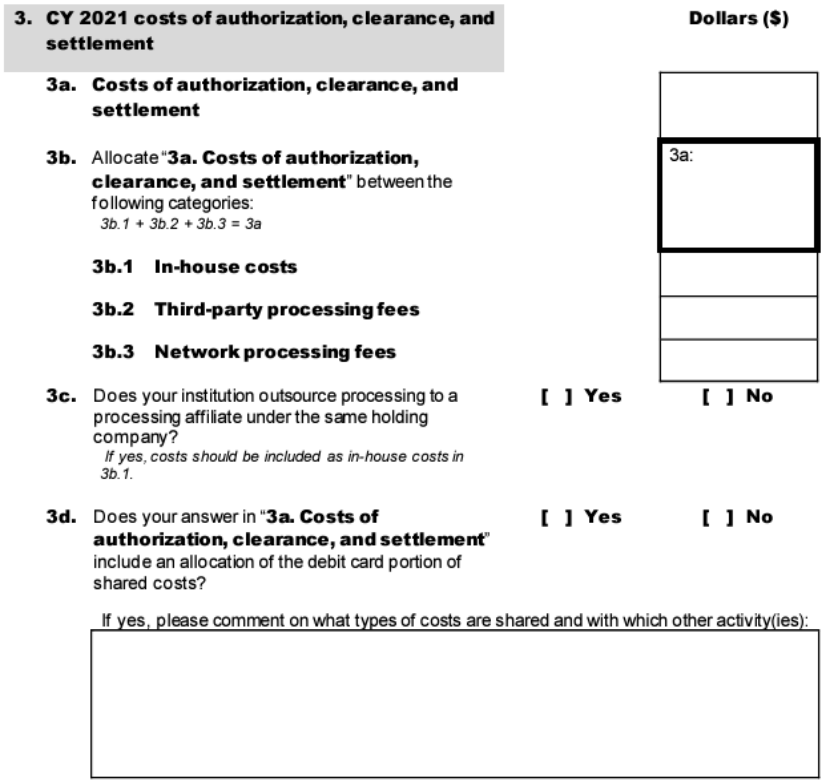
Issuers Should be Required to Substantiate their Claimed Costs and Efforts

In its present form, the amount of interchange that covered issuers may collect under Regulation II is calculated wholly by reference to those same issuers' self-reported expenses as communicated to the Board through the completion of a "Payment Card Issuer Survey."[36] The amounts that issuers attribute to fraud losses, and those spent by issuers for purposes of fraud mitigation, are likewise self-reported through this same survey. The amendments proposed by the Board would continue this practice and use those same self-reported expenses to automatically adjust the permissible interchange rate in the years to come.

But the information elicited is devoid of any detail, and not subject to substantiation. For example, the issuer's costs of authorization, clearance, and settlement—which form the very

[33] Although the Board's Debit Card Issuer Survey elicits information from issuers regarding their costs spent in relation to fraud mitigation, we are unaware of any effort to collect such information from merchants, even though the Board is required to consider merchant's expenses.
[34] Again, the Board's Debit Card Issuer Survey elicits this information from issuers, but no such information has to our knowledge been gathered from merchants, even though the Board must consider each group's losses.
[35] As with the *ad valorum* component above, in the event it is necessary to gather additional information for this purpose, the Board should proceed to finalize the amendments relating to the base rate at this time and leave this element open for future rulemaking.
[36] "Debit Card Issuer Survey," Board of Governors of the Federal Reserve, Form 2064a. *See* the most recent version available to the public at https://www.federalreserve.gov/paymentsystems/files/2021DebitCardIssuersurvey.pdf.

heart of the base component—is gathered simply by asking the issuer to input the following barebones information into an online form:[37]



3. CY 2021 costs of authorization, clearance, and settlement		Dollars ($)
3a. **Costs of authorization, clearance, and settlement**		
3b. Allocate "**3a. Costs of authorization, clearance, and settlement**" between the following categories: *3b.1 + 3b.2 + 3b.3 = 3a*		3a:
3b.1 **In-house costs**		
3b.2 **Third-party processing fees**		
3b.3 **Network processing fees**		
3c. Does your institution outsource processing to a processing affiliate under the same holding company? *If yes, costs should be included as in-house costs in 3b.1.*	**[ ] Yes**	**[ ] No**
3d. Does your answer in "**3a. Costs of authorization, clearance, and settlement**" include an allocation of the debit card portion of shared costs?	**[ ] Yes**	**[ ] No**

If yes, please comment on what types of costs are shared and with which other activity(ies):

Issuer's purported fraud losses and fraud mitigation expenses are collected in a similar manner.[38] Likewise, issuers are allowed to determine themselves whether they have undertaken the necessary efforts to qualify for the fraud mitigation component and are merely asked to tick boxes identifying which of several efforts they have allegedly undertaken.[39]

Even setting aside the prospect of intentional misrepresentation, predicating calculation of the base, *ad valorem*, and fraud mitigation components on self-reported figures that issuers calculate utilizing their own discretion as to which of their annual expenses are recoverable invites a result that does not reflect the true sums that the Board is required to consider for purposes of calculating permissible interchange under EFTA. Since these reported figures are then input directly into the Board's calculation of permissible interchange under the existing and proposed methodology, the figures, if faulty for whatever reason, could result in billions of dollars (or

[37] *Id.*, p. 8.
[38] *Id.*, pp. 11, 14-16.
[39] *Id.*, p. 11.

more) of excess interchange paid by merchants in violation of EFTA.[40] *per transaction* for its purported fraud mitigation efforts, without any substantiation that it undertook such efforts, invites abuse.

For this reason, a system should be put in place to substantiate the figures reported and the purported fraud mitigation efforts undertaken by each covered issuer. For example, a requirement that each issuer's claimed expenses must be independently verified by an external firm as a qualifying expense, and that each issuer be subject to an audit by the Board in the event its claimed expenses appear excessive or inconsistent with others. Similarly, issuers should be required to substantiate that, at a minimum, they are incurring *bona fide* fraud mitigation expenses that are equal to or greater than the fraud mitigation expenses they are collecting from merchants. Issuers should further be required to retain the records substantiating their calculations for no fewer than seven years.[41] Considering that each regulated issuer holds assets greater than $10 billion and given that tens of billions of interchange revenue is dependent on the accuracy of these figures, these are not unreasonably burdensome requests.

Although the Board's proposal calls for the interchange calculations to be updated biannually, issuer data should be collected and audited annually, to avoid any cost-shifting between reportable and non-reportable years.

Finally, to ensure merchants' and other stakeholders' interests (including those of consumers) are protected, in the event that the data reported would result in an increase in any of the components of interchange, it should trigger a public comments period regarding whether the formula used continues to be viable.[42]

Timing of Implementation

Under the current proposal, the changes to the base and *ad valorem* components are scheduled to be implemented on July 1, 2025. Notably, the fraud-prevention adjustment—reflecting the one component that would be increased were the Board to adopt its amendment as proposed—is instead scheduled to be implemented as soon as the amendment becomes effective.

Based on our experiences during the original enactment of Regulation II and its recent amendment, we anticipate that issuers and networks will assert that they require more time to implement any changes. This is false. The networks implement new interchange fee rates twice a year, and issuers happily accept the increased fees without incident. If issuers and networks can

[40] In 2021 alone, issuers collected $31.59 billion in interchange on debit and prepaid card transactions, an increase of 19.1 percent over that collected in 2020. https://www.federalreserve.gov/paymentsystems/2021-Interchange-Fee.htm
[41] To the extent issuers assert that this requirement is duplicative of other record keeping obligations, then there is no additional burden imposed on issuers by imposing this requirement.
[42] As discussed above, issuer expenses have steadily decreased since Regulation II was enacted. As such, this may never trigger a comment period. However, to the extent these claimed expenses begin instead to rise, such a process is warranted.

increase rates in such a short period, they can decrease them just as quickly. Additionally, to the extent the fraud-adjustment component is ultimately increased as a result of the amendment, that modification should not in fairness be implemented until the other components are adjusted.

Conclusion

As we stated at the outset of this letter, we are very appreciative that the Board has undertaken to update the interchange rate so that it will no longer depend on data that is now fifteen years old. We further wholeheartedly support a mechanism to update interchange in future years, so that it may accurately reflect the permissible amount as costs inevitably change. But particularly because those automatic adjustments will be based on the methodology adopted by the Board through this amendment, this methodology must be sound and compliant with EFTA.

The methodology proposed in the amendment is inconsistent with that used for the past 13 years, which the Board has repeatedly asserted reflects the "reasonable and proportional" interchange rate mandated by EFTA. The proposed methodology would result in a base component that is 37% higher than one calculated using the existing methodology and the same input figures. If the existing methodology results in a reasonable and proportional base component according to the Board, one that instead results in a base component that is 37% higher is not reasonable by the Board's own standard. Further, the amendment should account for significant shifts of the burden of fraudulent transactions from issuers to merchants that have occurred since Regulation II was first enacted. Finally, the Board should ensure the figures input into the adopted methodology are accurate and substantiated, as are issuers purported fraud mitigation efforts.

The National Retail Federation is of the firm view that these proposals will make significant progress toward ensuring that the Board's actions comply with EFTA. We urge the Board to resist any entreaties from the issuers and networks seeking to weaken the Board's proposed amendment, and instead to adopt revisions to strengthen it as set forth above.

Sincerely,

Stephanie Martz
Chief Administrative Officer and General Counsel
National Retail Federation

NATIONAL RETAIL FEDERATION
1101 New York Avenue, NW, Suite 1200
Washington, DC 20005
www.nrf.com