May 10, 2024

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

**Re: Docket No. R-1818, RIN 7100-AG-67**
**Notice of Proposed Rulemaking: Debit Card Interchange Fees and Routing**

Dear Ms. Misback:

On behalf of the National Association of Convenience Stores (NACS), thank you for the opportunity to comment on the notice of proposed rulemaking ("Propose Rule") promulgated by the Board of Governors of the Federal Reserve System (the "Board" or "Fed") regarding debit card interchange fees and routing. We appreciate the work of the Board to analyze and write the Proposed Rule. In our view, the Proposed Rule should be revised as set forth in this letter in order to ensure it is consistent with the language and intent of the statute governing debit card transactions as set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

Background on the Convenience and Fuel Retailing Industry

NACS is an international trade association representing the convenience store industry with more than 1,500 retail and 1,600 supplier companies as members, the majority of whom are based in the United States.[1]

The convenience and retail fuels industry employed approximately 2.44 million workers and generated more than $906 billion in total sales in 2022, representing almost 4 percent of U.S. gross domestic product. Of those sales, approximately $607 billion came from fuel sales alone.

The industry, however, is truly an industry of small business. More than 60 percent of convenience stores are single-store operators. Less than 0.2% of convenience stores that sell gas are owned by a major oil company and about 4% are owned by a refining company. More than 95% of the industry, then, are independent businesses.

Members of the industry process more than 165 million transactions every single day. That means about half the U.S. population visits one of the industry's locations on a daily basis. In fact, 93% percent of Americans live within 10 minutes of one of our industry's locations. These businesses are particularly important in urban and rural areas of the country that might

[1] Data on the industry comes from the NACS, State of the Industry Annual Report of 2021 Data *available at* https://nacsannualreport.convenience.org.

not have as many large businesses. In these locations, the convenience store not only serves as the place to get fuel but is often the grocery store and center of a community.

Governing Law

The provisions of Dodd-Frank that grant the Fed authority to regulate debit card transactions are popularly known as the Durbin Amendment. The Durbin Amendment requires the Fed to limit the network-set interchange fees of debit card issuing banks with more than $10 billion in assets to amounts that are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[2] The Board promulgated Regulation II to carry out the purposes of the Durbin Amendment.

It has been and remains NACS' position that Regulation II as it exists today and has since it first went into effect in 2011 is not consistent with the language or intent of the Durbin Amendment. Specifically, it is NACS' view that the Board included costs in its determination of allowable debit interchange that Congress in passing the Durbin Amendment and Dodd-Frank intended to exclude from that analysis.

This letter, however, is not intended to rehash that question. Instead, this letter addresses other aspects of the Durbin Amendment, Regulation II as it stands, and the information in the Board's reports on issuer costs since the enactment of Dodd-Frank to evaluate the Proposed Rule.

Importantly, the language of the Durbin Amendment focuses on the cost of the debit transaction to the issuer. It does not say that all issuers must have the same fees on debit transactions. In fact, the language of the law indicates otherwise. Recognizing that a fee regulation from the Board does not need to be the same for all issuers is not revolutionary. In fact, the proposed rule originally promulgated by the Board in response to passage of the Durbin Amendment contemplated as one option a much lower fee than is currently in place under Regulation II, but also allowing individual issuers to charge higher amounts if their costs were higher.[3] That construct could avoid the legal infirmity of the Proposed Rule.

Similarly, the Board could set different fee limitations for high-volume issuers as opposed to mid- and low-volume issuers. That type of construct, as described below, could address the problem encountered by the Proposed Rule. The current problem is as follows – by proposing a debit fee that would cover the costs incurred for 98.5% of debit transactions, the Proposed Rule sets a fee amount that is not "reasonable and proportional" to the cost incurred in the vast majority of debit transactions. When the rate of return above cost for more than 90% of all debit transactions is on the magnitude of 400%, that is not "reasonable and proportional" under any straightforward reading of those terms. That rate dramatically exceeds rates of return in functioning markets.

[2] 15 U.S.C. §1693o-2(a)(2).
[3] Notice of proposed rulemaking, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81722, 81736-8 (Dec. 28, 2010).

Based on the language of the Durbin Amendment, the Board must find a way to address the wide discrepancies in costs among debit issuers in a way that does not provide windfall profits to issuers responsible for the vast majority of transactions. This letter will describe those problems and provide potential avenues to address those issues consistent with the statutory law.

<u>The Debit Landscape</u>

Debit card usage has grown throughout the past fifteen years from a total of 38.6 billion transactions in 2009 to 92.1 billion transactions in 2021.[4] During that time, issuers exempt from Regulation II, those with less than $10 billion in assets, have grown their share of the debit market.[5] These are strong indications of success in the reform of debit interchange fees. Healthy, growing card usage and improved competitiveness from smaller issuers has been paired with lower prices for Main Street businesses and, ultimately, their customers. More economically efficient transactions should be a goal of the financial system and was baked into the Durbin Amendment.

The language of the Durbin Amendment, for example, uses the check clearing system as a successful model for the Board to follow in Regulation II. The check system does not allow for the functional equivalent of interchange fees. Instead, it lets the parties on each side of the check transaction bear their own costs. That way, they are fully incentivized to find financial institutions that will be most efficient and keep their costs lowest. Without the centralized fees incurred in debit transactions, the check system has served Americans and the American economy well for a century. The electronic version of that system, debit cards, has lower inherent costs and greater efficiencies, but has come with a much larger price tag for merchants accepting debit payments.[6] The language of the Durbin Amendment was intended to address that unnecessary inefficiency by making the check system, and clearance at par value, a guiding principle for the Board in promulgating Regulation II. The Proposed Rule does not do that.

It is worth noting that debit cards and automated teller machine (ATM) cards are access mechanisms allowing people to get the funds they have in demand deposit accounts. Financial institutions must provide such access in some fashion. People would be unlikely to deposit their funds at a bank if they could never access them again. Debit and ATM cards were introduced as a way for financial institutions themselves to save costs when customers access their funds. Having branches and employing tellers to handle these transactions is expensive for financial institutions. And, at the time ATM and then debit cards were introduced, paper checks carried real costs of financial institutions as the original check needed to be physically transported to the

[4] 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" Table 3(October 2023) (available at Federal Reserve Board Publication) (the "October 2023 Federal Reserve Report").
[5] Exempt issuers' share of debit transaction volume was 37.1% in 2013 and grew to 39.0% in 2021. *Id*. Table 3 and analysis.
[6] Hearing before the Subcommittee on Financial Institutions and Consumer Credit of the U.S. House Committee on Financial Services, "Understanding The Federal Reserve's Proposed Rule On Interchange Fees: Implications And Consequences Of The Durbin Amendment" Testimony of David Seltzer, Vice President and Treasurer, 7-Eleven Inc. at 54 (Feb. 17, 2011) (available at K:\DOCS\64557.TXT (house.gov))

right clearing institution before the transaction could be settled. Making access to demand deposit accounts electronic with plastic cards carrying access numbers saved financial institutions on many of these costs. The cards were and remain a cost-saving measure for financial institutions and need not provide a source of revenue in order to be a financial benefit to financial institutions.

That history forms part of the backdrop for the Durbin Amendment language instructing the Board to consider the similarities between debit transactions and check transactions which clear at par. If higher cost check transactions can clear at par, then it stands to reason that debit transactions can clear at par (or very close to it). Both types of transaction are ways for financial institutions to provide their customers with access to the funds in the demand deposit accounts and debit is among the least expensive of those methods for the financial institution to accommodate.

Debit Issuer Costs

The prices of debit card transactions could be lower and more efficient than they are today. That would be beneficial for the economy and would bring regulation into compliance with the terms of the Durbin Amendment. The Fed's data, for example, shows that covered debit issuer costs have fallen dramatically since the promulgation of Regulation II. In 2011, The data used by the Fed to write the current Regulation II showed covered issuer costs at an average of 7.7 cents per transaction. The most recent data collection by the Fed shows those same costs averaging 3.9 cents per transaction. It is clear that Regulation II no longer comports with the language of the Durbin Amendment requiring interchange fees to be reasonable and proportional to issuer costs. The Proposed Rule is intended to address that.

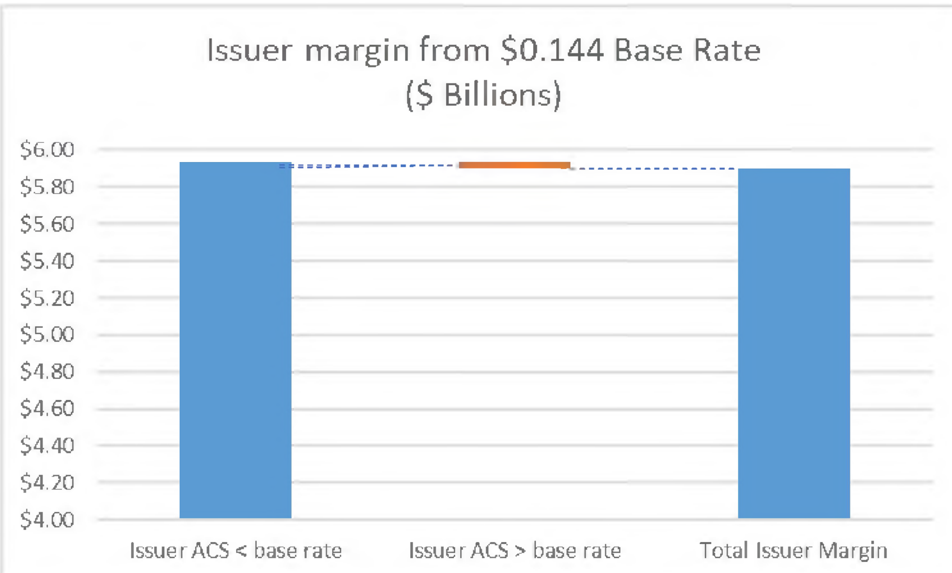
Proposed Base Interchange Rate

While the Proposed Rule moves in the right direction by reducing the amount of the fees, it would not bring Regulation II to a point that is consistent with the Durbin Amendment. A group of Main Street associations, including NACS, engaged Patrick Moran to analyze debit cost data and what it shows regarding Regulation II. The resulting white paper ("Moran paper") is attached as part of this comment letter and finds that the base interchange rate in the Proposed Rule does not meet the reasonable and proportional standard required by the Durbin Amendment.

The central shortcoming of the Proposed Rule in light of the statutory language of the Durbin Amendment is that the Proposed Rule attempts to ensure that a number of covered debit issuers that have very little debit volume recover all of their costs for their debit transactions. Those low-volume issuers are not significantly engaged in the debit business, do not engage in it efficiently based on their very high costs, and the revenue they would receive or not receive under different formulations of Regulation II are not material to their operations. By covering those high-cost, low-volume issuers at 100% of cost, the Proposed Rule ensures that debit interchange fees are far higher than the reasonable and proportional standard for [94%] of debit transactions.

The chart below from the Moran paper demonstrates the issuer margins under the Proposed Rule for those issuers with costs that fall below the base rate in the Proposed Rule and for those with costs above that base rate.

Estimated Issuer Margin from Current Proposal[7]




The chart demonstrates the dramatic way in which the Proposed Rule has set the base debit interchange rate too high. The tiny number of transactions with costs above the base rate are almost undetectable compared to the huge margins earned from the vast majority of transactions for issuers with costs far below the base rate.

The issuers defined as high-volume by the Board generate 94% of all debit transactions. Their average costs as calculated by the Board are 3.5 cents per transaction on average.[8] There is no justification consistent with the language and intent of the Durbin Amendment for providing those high-volume issuers with a base rate of interchange at 14.4 cents per transaction.

The Proposed Rule employs a 3.7 multiplier to the average issuer cost for a debit transaction to reach the 14.4 cents per transaction figure. As noted, that multiplier results in covering the full costs for 98.5% of covered transactions. That is dramatically higher than the 2.7

[7] This and the other graphics in this paper were taken from Patrick Moran, "Considerations for the Federal Reserve Board's Proposed Rule for Debit Interchange," (May 10, 2024) ("Moran paper"). October 2023 Federal Reserve Report Table 12 was used for volumes within each Issuer grouping. Nilson data was used to estimate volume within each quartile. ACS margins were estimated using October 2023 Federal Reserve Report Table 14.
[8] October 2023 Federal Reserve Report Table 13.

multiplier which is the ratio employed by the original Regulation II, illustrating the difference between the average issuer cost and the allowable base interchange rate under Regulation II.

While a 2.7 multiplier (resulting in a base interchange rate of about 10.5 cents) would have the benefit of consistency with the current Regulation II, neither 2.7 nor 3.7 represent rates of return that are reasonable and proportional to cost. Businesses in competitive markets simply do not earn profit margins of 270% or 370% of their costs. While there are many sources reporting profit margins of individuals businesses, we find the data tracking profit margins by U.S. industry which is published by the Stern School at New York University to be helpful because it tracks average margins by industry sector. That data reports that, in fact, the U.S. industry with the highest net profit margins is the U.S. banking industry.[9] The data shows that U.S. money center banks earn average net profit margins of 30.89% and regional banks earn net profit margins of 29.67%.[10] A multiple of 3.7 then, provides these banks with margins approximately twelve times higher than the margins that they earn throughout the rest of their business lines. That makes the 3.7 multiple in the Proposed Rule or the 2.7 multiple in the current Regulation II neither reasonable nor proportional. Those multiples are simply far out of step with what the same regulated financial institutions earn compared to their costs.

It is important to recognize that the debit business simply is not financially material to most mid- and low-volume covered issuers. They provide debit cards to accountholders to save their own costs on how those customers access funds and as a service to those accountholders, but they don't have much incentive to control their costs on debit transactions because it isn't much of their business anyway. In addition to the large differences in overall costs, this is demonstrated by the relative lack of concern these issuers have in controlling debit card fraud. Issuers with debit portfolios that are important to their bottom lines try to control their costs including fraud, but that does not seem to be happening for mid-volume issuers as shown in Figure 11 of the Moran paper and reproduced below. The base interchange rate in Regulation II simply should not be skewed so heavily toward a small number of high-cost transactions when the issuers conducting those transactions do not rely on those small volumes or control those costs in the way that would be expected for companies for whom that debit business is material.

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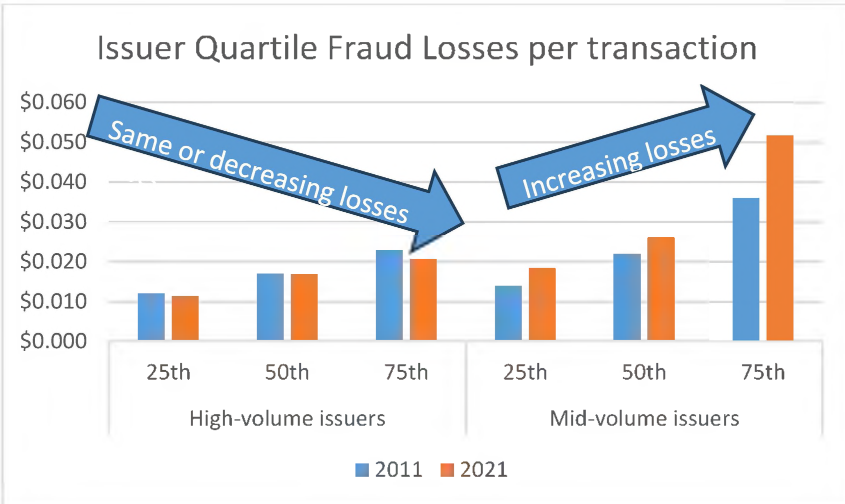
9 "Margins by Sector (US)," New York University Stern School (data as of January 2024) (available at [Operating and Net Margins (nyu.edu)](#))

10 *Id.*

High-volume and Mid-volume Covered Issuer Fraud Losses in 2011 and 2021[11]




The Proposed Rule, then, rather than focusing on which issuers and transactions will receive full cost recovery, ought to grapple with the intent of the law – that is, what is reasonable and proportional to the cost incurred by the issuers generating 94% of the transaction volume. Once that decision is made, then the Board could separately provide for treatment of the low-volume, high-cost issuers that comprise the tiny minority of debit transactions.

Engaging in that analysis provides a very different outcome than the Proposed Rule. It would provide high-volume issuers with a rate of return that is common for financial institutions (about 30%). The result would be a regulation which limits debit interchange to about 6 cents for 94% of transactions.[12] That analysis and result would provide a debit interchange rate that is "reasonable and proportional" to the cost – noting that it is still based upon the regulation including more types of costs in the calculation than we believe are allowable according to the statutory language. The returns would be healthy and overly fair to those high-volume issuers.

From there, the Board could make any of a number of choices for mid- and low-volume issuers. The Board could set one different limit to cover those issuers. The Board could set one rate for mid-volume issuers and a separate one for low-volume issuers. Or, the Board could return to its originally-proposed formulation of having those individual issuers justify a higher rate up to a limit based upon their actual costs. Frankly, those different options are not as material to the determination of the proposal as is the decision regarding the rate for 94% of transactions. Yet, by setting the rate to provide full cost recovery for 98.5% of transactions, the Proposed Rule makes the tail of a small number of inefficient, high-cost transactions wag the dog of the vast majority of debit transactions. That choice conflicts with the choices made by the

[11] Moran Paper; October 2023 Federal Reserve Report Table 14.
[12] See Moran Paper at 14-15.

Congress in the Durbin Amendment and therefore should be changed in the final rule promulgated by the Board.

Regular Updates to the Interchange Rate

The Proposed Rule would provide for updates to Regulation II every two years based upon the survey data that the Fed collects from the industry. This would happen automatically by taking the average issuer costs collected by the Fed and multiplying it by 3.7 to reach the new base interchange rate for the following two years. This formula results in higher interchange rates than can be said to be reasonable and proportional. It would, on average, provide debit issuers with 370% profit margins. Margins of that size are far higher than profit margins for financial institutions which average about 30%.[13] So, the Proposed Rule would be more than 12 times a margin amount that would be considered reasonable for a financial institution.

And, it is worth noting that financial institution profit margins themselves are already higher than profit margins for businesses in other sectors of the U.S. economy. In fact, financial institution margins, at 30%, are higher than for any other industry. So, it is questionable that allowing profit margins commensurate with the highest margins of any industry would be reasonable and proportional.

The multiplier also introduces a problematic incentive for financial institutions to become less cost-efficient. If they have confidence that in two years the Fed will automatically provide them a 3.7 multiple on every additional dollar they spend conducting debit card transactions, they may see it as beneficial to increase those costs and reap a delayed return. One of the most likely ways this could occur is through Regulation II's inclusion of issuer-paid network fees in the base rate cost calculation. The two major networks, Visa and Mastercard, could argue that they should increase the fees they charge financial institutions for the networks' role in handling debit transactions in order to inflate the allowable debit costs for those financial institutions and ensure higher interchange later through the Fed's automatic updates of Regulation II. That would lead to more inefficiency and cause costs to be competed up, where competitive markets should compete costs down (or slow their increases). It would also exacerbate the problem noted in the attached Moran paper of merchants absorbing all network fees for debit transactions.[14]

We agree that the Board should make automatic updates to interchange levels under Regulation II, but it is imperative that the Board correct deficiencies in its methodologies before automatically applying those methodologies in the future. Adopting a rule that is consistent with the "reasonable and proportional" legal standard would allow that to happen without creating incentives for issuers to pad their costs. Providing a return on cost of 30%, consistent with the rest of issuers' business lines, would mitigate the incentive to increase costs for a return later because the returns would not be out of step with the returns the financial institutions could expect to receive on those dollars today. And, as noted, higher-cost issuers could have a separate

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[13] "Margins by Sector (US)," New York University Stern School (data as of January 2024) (available at Operating and Net Margins (nyu.edu))

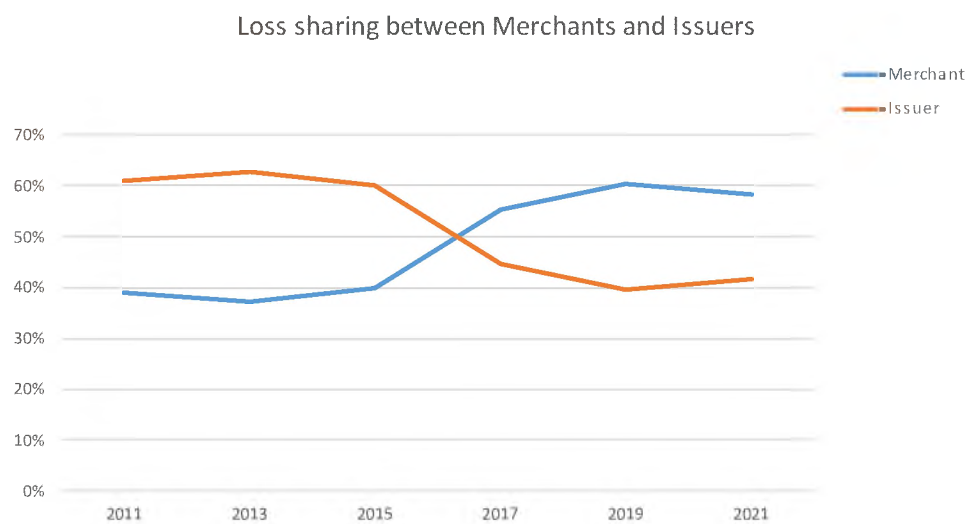
[14] See Moran paper at 9.

rate that is also pegged at around a 30% rate of return such that those issuers would avoid the negative incentive to increase costs.

Fraud Losses

The Proposed Rule would require U.S. merchants to pay 0.4% of the amount of debit transactions in order to cover debit card issuers' fraud losses on debit transactions. The data collected by the Fed, however, shows that the share of fraud losses borne by merchants has increased since Regulation II was first promulgated. According to the latest data collection, merchants shoulder a significantly higher proportion of fraud losses than debit issuers. Figure 8 from the Moran paper, reproduced below, illustrates this trend. When combined with the share of fraud that merchants are forced to pay after-the-fact, including fraud losses within the calculation of debit interchange that merchants must pay does not make sense or comport with the Durbin Amendment.

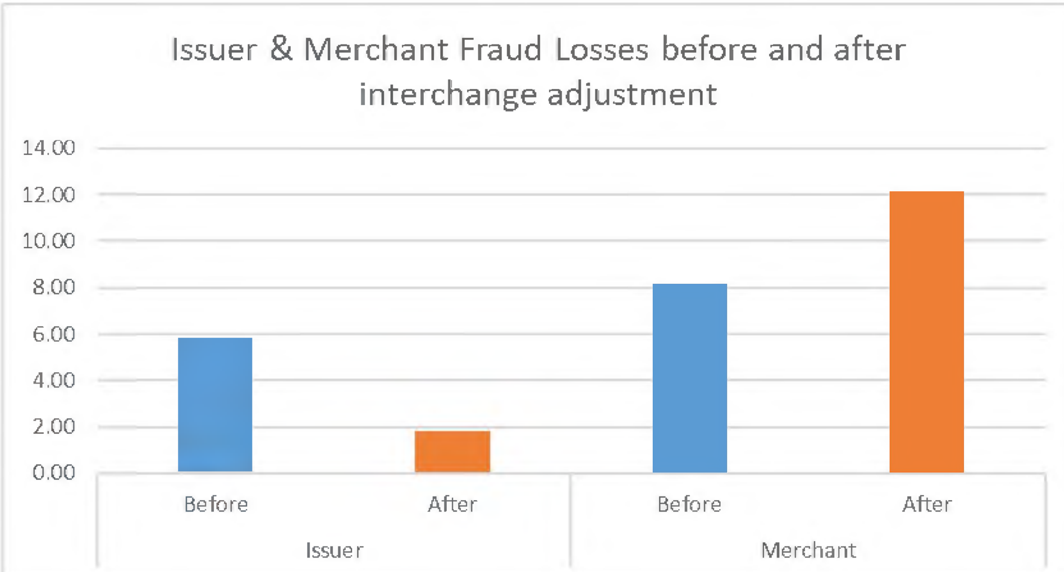
% of Fraud Losses Absorbed between Merchants and Issuers[15]




Not only that, but the Proposed Rule would result in merchants shouldering nearly all of the fraud losses that fall on either issuers or merchants today as shown in Figure 9 of the Moran paper included below. In doing that, the Board would be removing much of the economic incentive for debit issuers to work to reduce fraud losses. With issuers not feeling any real financial pain from fraud, they may well choose not to make investments in prevention of that fraud.

[15] Moran Paper; October 2023 Federal Reserve Report Table 11 and analysis (excludes losses absorbed by cardholders).

Issuer and Merchant Fraud Losses after 4bps Interchange Component[16]




Removing all of the financial incentives for debit issuers to combat fraud would risk fraud increases and increasing costs on merchants and consumers. In fact, one of the most striking data points in the most recent Fed report on debit costs is the increase in the share of fraud that is being shouldered by consumers. The Fed's data shows that consumers now shoulder 19.5% of fraud losses compared to the 8.2% they absorbed just two years prior.[17] That is a concerning trend. One way to help mitigate the risk of consumers absorbing increasing amounts of fraud losses is to ensure that issuers, not just merchants, have a financial incentive to combat fraud. Given the numbers and clear trends, the only way to do that is to eliminate the fraud loss adjustment so that issuers continue to bear some of the costs of fraud.

Fraud Prevention Adjustment

The fraud prevention adjustment compensates issuers for funds they spend to help prevent fraud. Those costs, however, have fallen since Regulation II was written. In light of that, the fraud prevention adjustment should be reduced commensurate with the reduction in fraud prevention spending by issuers.

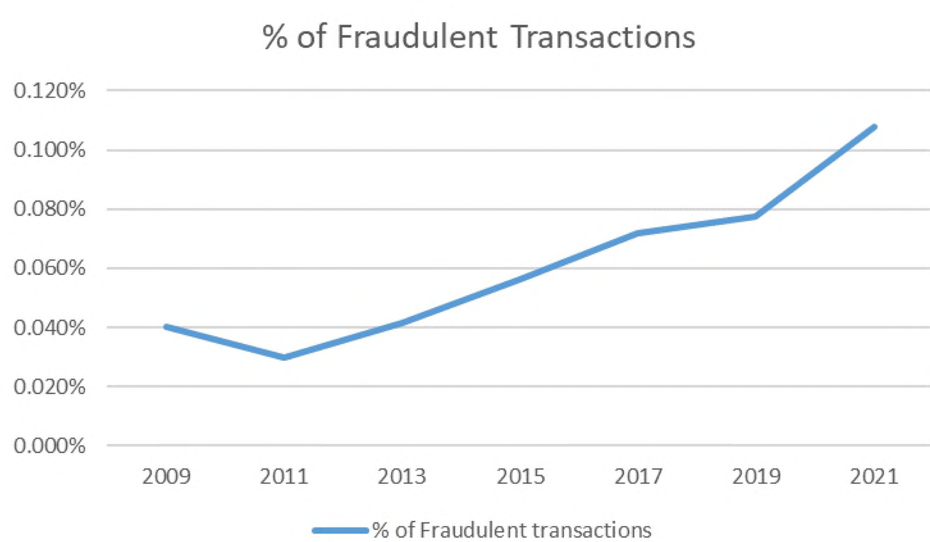
In addition to that, the administration of the fraud prevention adjustment should be reformed. There is nothing in Regulation II requiring any issuer to spend funds on things that are actually effective in reducing fraud. Covered issuers all receive the full amount of the fraud

[16] October 2023 Federal Reserve Report Table 14 and analysis.
[17] "2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions" Board of Governors of the Federal Reserve System at 3 (Oct. 2021) (available at Federal Reserve Board Publication).

prevention adjustment regardless of their effectiveness or spending. That is because the Board has left the administration of the adjustment to a self-certification system.

Every debit issuer that we are aware of certifies that it qualifies for the fraud prevention adjustment – and has for the past dozen years that Regulation II has been in effect. This strains credulity. Not every issuer is doing an effective job preventing fraud. In fact, fraud losses have climbed steadily over the years as shown in Figure 10 of the Moran paper and reproduced below. Some of that is likely reflective of an overall increase in fraud generally across all payment card systems in the United States (including credit cards). But, at the least, it does not provide any strong evidence that the current self-certification system in Regulation II is working to incentivize effective fraud prevention.

Percentage of Fraudulent Transactions over Time[18]




The bottom line is that the Proposed Rule should be modified to require that issuers actually show that their spending is consistent with and/or results in reduced fraud in order for them to receive the fraud prevention adjustment.

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[18] October 2023 Federal Reserve Report Table 10.

We appreciate the Board's work on the Proposed Rule and the fact that it moves the regulations in this area in the right direction. But, as noted, the Proposed Rule still does not comport with the requirements of the Durbin Amendment. We hope that the Board will revise the Proposed Rule consistent with our recommendations and those in the accompanying Moran paper in order to ensure that the regulation does comport with the language of the law.

Sincerely,

Doug Kantor
General Counsel
NACS

# CONSIDERATIONS FOR THE FEDERAL RESERVE BOARD'S PROPOSED RULE FOR DEBIT INTERCHANGE

## Suggested modifications to help the FRB adhere to the reasonable and proportional standard


### Abstract

Since debit regulation took effect in 2011, Merchant costs have continued to increase while Issuer costs have declined. While the FRB's proposal would lower regulated interchange, it does not adhere to the reasonable and proportional standard that the FRB is compelled to follow. Specific modifications are suggested to aid the FRB in complying with the standard. In addition, suggestions are made to enhance the statistical information the FRB presents.



Pat Moran

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# Contents

# Executive Summary

Regulation II applies to debit card-issuing financial institutions with over $10 billion in assets, and as such it includes the largest, high-volume US debit Issuers as well as many institutions whose debit operations are a rather insignificant portion of their business. The statute requires that the Federal Reserve Board (FRB or Board) establish a rule whereby the regulated debit interchange rate is reasonable and proportional to certain Covered Issuer costs. As one would expect, the largest and highest-volume Covered Issuers have costs that are significantly lower than other Covered Issuers with small debit operations. Since 2011 the FRB has classified Covered Issuers into three separate volume tiers: High-Volume > 100 million annual transactions; Mid-Volume between 1 million and 100 million transactions; and Low-Volume under 1 million annual transactions.

For the first time since 2011, the FRB has proposed modifying the regulated rate that would apply to debit transactions from Covered Issuers from the existing rate of $0.21 per transaction + 0.05% of transaction dollar value with a $0.01 per transaction fraud prevention adjustment to a rate of $0.144 + 0.04% with a $0.013 fraud prevention adjustment. Going forward, the FRB proposes updating the regulated rate every two years using a prescribed formula designed so that 98.5% of Covered Issuer transactions would receive full cost recovery.

When initially established, the base rate of $0.21 was set equal to 2.7 times Covered Issuer costs, which at that time were $0.077 per transaction. Under the new proposal, the base rate of $0.144 per transaction would be set equal to 3.7 times Covered Issuer costs of $0.039 per transaction, and future base rates would also be set equal to 3.7 times actual ACS[1] costs every two years.

## The Proposal Fails to Meet the Reasonable and Proportional Standard

The Board's proposal does not meet the reasonable and proportional standard required by the governing statute. The proposal's 98.5% full cost recovery target is unjustifiably high, and using such a high full cost recovery target means that the FRB proposal increases the multiplier that it used in 2011 even though Issuer costs decreased. In using such a high 3.7 multiplier, the proposal fully compensates many relatively inefficient Mid-Volume debit Issuers and generates an enormous Issuer margin for most transactions, while the impact on the small percentage of transactions not receiving full cost recovery is essentially immaterial to those Issuers' operations. The High-Volume Issuers have average ACS costs of $0.035 per transaction, and thus would receive over 4 times their costs under the FRB's proposal, while the Mid-Volume Issuers on average would receive 32% more than their costs. Since the High-Volume

[1] In this paper "ACS" is used as a proxy for the allowable costs that the Board considered and included in the Base Rate. While ACS is used here for convenience to discuss Regulation II, the rule and the proposed rule include costs in the calculation of ACS that are not necessary to include. In fact, there remains legal controversy regarding the appropriateness of including some costs. The use of ACS should not be read to agree with the Board's decision to include costs in the calculation that are not specific to the authorization, clearance, and settlement of the debit transaction at issue.

Issuers generate over 94% of the transaction volume, most transactions would generate revenue far out of proportion to their underlying costs if the proposal were adopted. Using 2021 actual covered transactions, the Board's proposal generates an unreasonably high annual excess margin for Covered Issuers of around $5.9 billion. That measure is inconsistent with the statutory language calling for fees to be "reasonable and proportional" to costs. And, when one considers that the Board has included costs that go beyond what is actually called for by the statute, the gap between the proposal and any measure of "reasonable and proportional" is even further out of balance. It is worth noting that the Issuers for the 1.5% of transactions that would not receive full cost recovery for their transactions would on average have a negative ACS margin of about $700,000 per Issuer, clearly an immaterial amount for a financial institution with assets exceeding $10 billion. Reducing the proposal to ensure that the 94% of transactions generated by High-Volume Issuers becomes "reasonable and proportional" would not increase the negative margin of Issuers at the other end of the spectrum in a way that would be material to their operations.

## The Process of Regularly Adjusting Rates Requires Change

The FRB's proposal to update the regulated rate every two years is an improvement over the existing approach where the FRB has not made changes since the initial rule was implemented, which allowed Covered Issuers to collect interchange revenue that far exceeded costs for over a decade. However, the FRB's proposal to derive the future base rate by applying a fixed 3.7 multiplier to actual costs promotes inefficiency and may encourage abuse. It is likely that having a fixed multiplier will change the behavior of Covered Issuers, networks, and third-party processors thus undermining the logic under which the fixed multiplier concept was developed. Covered Issuers will not be encouraged to control costs under the FRB proposal, as each dollar in additional cost will be rewarded by $3.70 in additional base component revenue. This incentivizes manipulation between Covered Issuers and their vendors such as third-party processors and networks to shift costs around and use the multiplier to circumvent the statute's reasonable and proportional standard. It is important to note that networks and third-party processors provide and bill for services to Covered Issuers for both debit and credit transactions. It would be relatively straight-forward for these entities to increase fees on debit transactions while decreasing fees on credit transactions, leaving total Issuer costs unchanged, but nonetheless benefitting Covered Issuers due to the multiplier applied to Covered debit costs. Even without abuse, it is highly likely that networks will quickly realize that they can increase the network fees Issuers pay and Issuers will benefit through the fixed multiplier from any increase in Issuer-borne network fees. To prevent these unintended consequences, the fixed multiplier approach should be avoided.

## Fraud Loss Component

It was a discretionary decision by the Board to establish a uniform *ad valorem* fee component to compensate all Covered Issuers in advance for predicted fraud losses. When the FRB implemented the *ad valorem* fraud loss component in 2011, total fraud losses were less than 8 basis points (bps) of transaction dollar volume and Issuers bore 61% of fraud losses. By 2021, fraud losses more than doubled to over 17bps and Issuers only picked up about a third of fraud losses while Merchants bore a larger share of fraud losses than did Issuers.[2] Accordingly, including an *ad valorem* component for fraud losses is no longer reasonable as Merchants already cover more fraud losses than do Issuers.

### Fraud Prevention Adjustment

The percentage of fraudulent transactions has increased steadily from 4bps in 2009 to 10.8bps in 2021.[3] Meanwhile, median fraud prevention costs have decreased from $0.017 per transaction in 2009[4] to $0.013 per transaction in 2021.[5] Under the FRB's current rule as well as its proposal, Covered Issuers are merely required to have fraud prevention policies in place and to self-certify to networks that they follow their policies to receive the current $0.01 fraud prevention adjustment. All Covered Issuers receive the adjustment on their entire transaction volume despite differing effectiveness in fraud prevention. As an example, High-Volume Issuers at each quartile incurred the same or lower fraud losses in 2021 vs. 2011 while comparatively each Mid-Volume Issuer quartile incurred higher fraud losses.[6] The current rule and the proposal do not require fraud prevention to be effective for the fraud prevention adjustment to be awarded and should be modified to condition the adjustment on effectiveness. Covered Issuers should have to show either reduced fraud on their transactions or slower fraud growth on average to receive fees to cover their fraud prevention spending. An Issuer that has not demonstrated overall reduced per-transaction fraud losses (or slower increases than average) over a measurement period should lose eligibility for the adjustment until they demonstrate that they are effective in reducing fraud. Also, rather than increase the fraud prevention adjustment from $0.01 to $0.013, the adjustment should be lowered proportionately with the decrease in median costs that took place between 2009 and 2021.

## Changes Since Interchange Regulation Was Implemented in 2011

### Overall Debit Landscape

Since the FRB put Regulation II in place, significant changes have taken place in the debit marketplace. Total debit transactions have increased from 38.6 billion in 2009 to 92.1 billion in 2021.[7] Card-not-present (CNP) transactions have experienced explosive growth from 3.6 billion in 2009 to 29.5 billion in 2021.[8] CNP transaction growth has contributed to a shift that has taken place between Issuers and Merchants with respect to fraud losses. Network rules primarily assign responsibility to Merchants for

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[2] Table 11 and analysis.
[3] Table 10.
[4] Table 13 in 2009.
[5] Table 14.
[6] Table 14.
[7] Table 3.
[8] Table 2.

fraud conducted on CNP transactions, and now Merchants shoulder significantly more fraud losses than do Issuers.

With the growth of CNP transactions, the Dual-Message networks (Visa and MasterCard) have had their share of transactions grow from 62% of transactions in 2009 to 68% of transactions in 2021.[9] Since both Visa and MasterCard also own single message networks, these leading debit networks have maintained their market dominance since 2011. While the number of Issuers subject to the regulation has increased from 131 in the early years of regulation to 163 in 2021, Covered Issuers' share of the total debit market remained fairly constant.[10]

Chip cards and terminals have been widely deployed since Regulation II was published and networks encouraged Merchant adoption of EMV terminals by changing rules to make Merchants liable for counterfeit fraud on card-present transactions when EMV terminals were not used. Despite an estimated $30 billion investment by Merchants in EMV technology,[11] counterfeit fraud increased, and the portion of counterfeit fraud absorbed by Merchants has increased.[12]

## Issuer Cost Changes

Covered Issuer transaction costs have fallen nearly 50%, from $0.077 per transaction in 2009 to $0.039 per transaction in 2021.[13] This decrease appears to be from a combination of declining transaction processing expenses and declining network fees charged to Issuers.

[9] Table 3 and analysis.

[10] Covered Issuer debit transaction dollar share changed from 63.7% in 2013 to 63.3% in 2021 while Covered Issuer share of debit transactions measured by count dipped from 62.9% to 61.0% between 2013 and 2021. Table 3 and analysis.

[11] From NRF "EMV Chip Cards" available at https://nrf.com/emv-chip-cards.

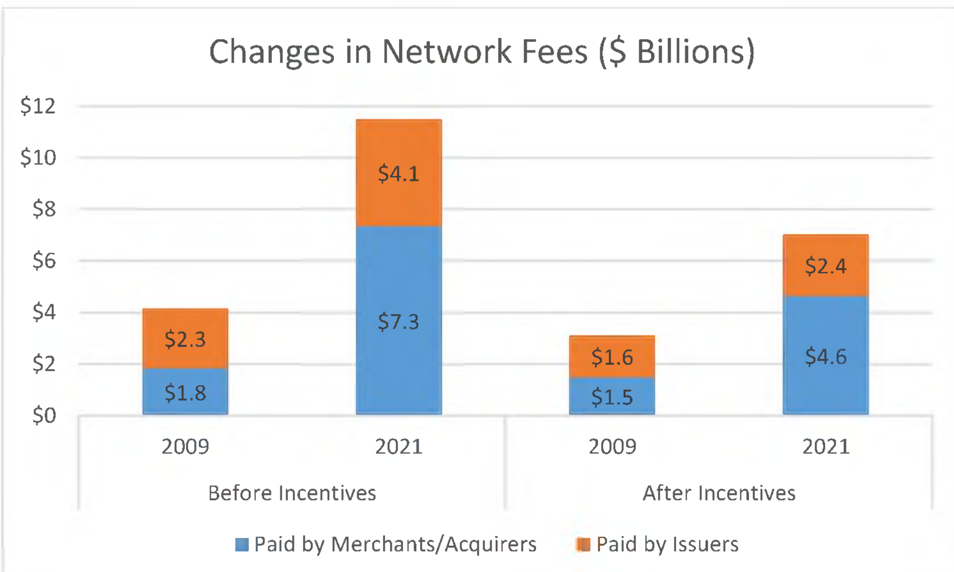
[12] Note these are aggregate statistics. Impacts on individual Merchants varies, and not all Merchants have deployed EMV terminals.

[13] Table 13.

## Network Fee and Rule Changes

As Figure 1 below indicates, overall network fees charged to Merchants have increased substantially since Regulation II, as have the incentives that networks pay.[14] While networks earned most of their revenue from Issuers before Regulation II was published, now most of their revenue is derived from Merchants. After factoring in incentives, network fees have tripled for Merchants between 2009 and 2021 from $1.5 billion to $4.6 billion, while Issuer fees have increased about 50%, from $1.6 billion to $2.4 billion. Network fees after incentives have increased at a higher rate than has the growth in debit transaction volumes.

Figure 1. Changes in Network Fees[15]




[14] Networks pay incentives to some Issuers to secure brand decisions and to some Merchants in order to ensure that Merchants route debit transactions to the network providing the incentive.
[15] Tables 6, 8 and analysis.

## New Merchant Fees Introduced

Since regulation took place, many networks introduced new Merchant fees not specifically tied to transactions. As examples, Visa introduced its Fixed Acquirer Network Fee and MasterCard introduced its Merchant Location Fee. PIN networks have implemented similar fees. By introducing fees not linked to individual transactions, networks can lower the cost of a marginal transaction for Merchants, thus helping networks compete for routing, while still increasing overall revenue from Merchants.

Prior to regulation, Visa and MasterCard applied the lowest interchange rates to transactions meeting each of their respective highest qualification standards. Higher interchange rates applied to transactions not meeting those standards. Subsequently, both Visa and MasterCard implemented new "Transaction Integrity" fees that apply to debit transactions not meeting specific standards. Now the fee flows to the networks instead of Issuers. It is unclear whether the network fees included in [the previous chart] [Figure 1] include these integrity fees, as the network survey allows networks to exclude "optional" fees, and it is not clear which fees the networks classify as optional.[16]

## Elimination of Interchange Refunds

Prior to regulation, it was common for Issuers to refund interchange to Merchants on cardholder returns and chargeback transactions. Since regulation, many networks have eliminated this practice, thereby improving economics for Issuers and increasing effective interchange rates.

The result of all these changes is a significant increase in Merchant costs and a significant decrease in Issuer costs.

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[16] Address Verification Service provides an interesting example of the difficulty in determining whether a fee should be considered optional. To receive the best CNP interchange rates a Merchant must perform an AVS, for which the networks receive a fee. While AVS is not mandatory, on every CNP transaction a network will either receive an AVS fee or a Transaction Integrity Fee (which would apply if the AVS is not performed). Accordingly, it seems reasonable that AVS fees should not be considered optional.

# Overview of FRB Proposal

The table below summarizes the Board's proposal for regulated debit interchange.

Figure 2. Summary of FRB Proposal

| Component | Value | Rationale |
|---|---|---|
| Base rate | $0.144 | Transaction weighted ACS cost of $0.039 times fixed multiplier of 3.7 set to provide full cost recovery for 98.5% of transactions. |
| Ad valorem | 4bps of transaction value | Set at overall Issuer median for fraud losses. |
| Fraud prevention | $0.013 per transaction | Set at overall Issuer median cost and available to Issuers that have fraud prevention policies in place. |

In addition, the Board's proposal contemplates updating the values for the components (except for the 3.7 multiplier) every two years.

We will analyze the three components separately in later sections but first we will explore how the FRB proposal compares to actual costs for Covered Issuers. Based on an average transaction value of around $48, combining these three components results in a per transaction interchange fee of $0.176. The base rate is the most significant component, comprising about 82% of the sum of the three components.

Since 2011 the FRB has grouped Covered Issuers into three separate groupings based on their annual covered debit transaction volume. Figure 3 below shows selected statistics across Covered Issuers, using the FRB's proposal and 2021 transaction volumes.[17] Under the FRB'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 about $6.6 million. These institutions likely average over $45 billion in assets and 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.[18]

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.[19]

[17] The Board should consider changing its Issuer groupings. Please see the section "Suggestions for Changing Issuer Groupings and Reporting Statistics" on pages 19-20 regarding the advantages of making changes.

[18] According to the FDIC Quarterly Banking profile, there were 142 FDIC Insured institutions with between $10 billion and $250 billion in assets, with average assets of $45 billion and trailing 4 quarter return-on-assets of 1.63% in Q3 2023.

[19] Tables 3, 12, Nilson data and analysis. Maximum for High-Volume Issuers is approximated by referencing Nilson Report #1218 from April 2022. Wells Fargo had over 9.63 billion debit transactions in 2021. Bank of America and Chase each generated over 8.7 billion.

Figure 3. Covered Issuer Interchange with Current FRB Proposal using 2021 Transaction Data[20]

| In millions except # of Issuers | | | | Interchange per Issuer (Millions) | | |
|---|---|---|---|---|---|---|
| Volume Tier (annual trans) | # of Issuers | Transactions | Total Interchange | Average | Maximum | Minimum |
| High (over 100) | 53 | 52,996 | $ 9,333.4 | $ 176.1 | $ 1,695.4 | $ 17.6 |
| Medium (1-100) | 86 | 3,189 | $ 566.9 | $ 6.6 | $ 17.6 | $ 0.176 |
| Low (under 1) | 24 | 4 | $ 0.8 | $ 0.034 | $ 0.176 | n/a |
| *Total* | *163* | *56,190* | *$ 9,901.1* | $ 60.7 | | |

# Base Rate Discussion

## Fixed Multiplier & Including Issuer Network Fees in Allowable Costs

The FRB's proposal to derive the future base rate by applying a fixed 3.7 multiplier to costs promotes inefficiency and may encourage abuse. Issuers will not be incentivized to control costs under the FRB proposal, as each $1 in additional cost will be rewarded by $3.70 in additional revenue. This will encourage manipulation between Covered Issuers and their vendors such as third-party processors and networks.

The existing FRB rule allows Issuers to include network-imposed fees when calculating their allowable costs of debit transaction processing. All networks charge transaction-related fees to both Issuers and Merchants. By allowing Issuers to include network fees when determining regulated debit interchange, ***the FRB has implicitly determined that Merchants should incur all transaction related network fees***. This approach is contrary to the approach to interchange and client fees that every network has adopted. If networks had wanted to only charge Merchants for transaction related fees, they could have achieved the same economic result by lowering interchange by the amount of implicit Issuer network fees and increasing Merchant fees by the same amount. This approach would seem to be less costly for the networks since they would only have to collect from Merchants and not Issuers. Despite the cost advantage of this approach, no network implemented their fee structure this way, suggesting that the networks always considered interchange separate and distinct from Issuer network fees.

**Even more problematic, it is highly likely that networks will quickly realize that Issuer fee increases can be easily implemented since Issuers will benefit by any increase in Issuer fees, as any $0.01 increase in network fees upon Issuers will result in the Issuers receiving $0.037 in additional interchange.** A perverse competitive dynamic could easily transpire where networks leapfrog one another with higher and higher Issuer fees (which ironically would benefit Issuers), just the way that Visa and MasterCard leap-frogged one another in 1998 and 1999 with a series of interchange increases in attempt to win Issuer issuance decisions. To prevent these unintended consequences, the fixed multiplier approach should be avoided, or at a minimum, network fees must be removed from allowable ACS costs and the FRB should retain the flexibility to adjust or exclude consideration of costs that facilitate circumvention

[20] Tables 3, 12, Nilson data and analysis. Maximum for High-Volume Issuers is approximated by referencing Nilson Report #1218 from April 2022. Wells Fargo had over 9.63 billion debit transactions in 2021. Bank of America and Chase each generated over 8.7 billion.

of the regulation or that do not appear representative or legitimate. In 2021 Mid-Volume Issuers incurred per transaction network Fees 7.6 times higher than High-Volume Issuers ($0.046 vs. $0.006).[21] Clearly, High-Volume Issuers have been successful negotiating lower fees with networks. The approach adopted by the FRB should continue to encourage Issuers to reduce their costs.

## ACS Costs and the FRB's 98.5% Full Cost Recovery Target

Covered Issuer allowable costs vary widely, but average $0.039 across all transactions.[22] The Board derives its base rate recommendation of $0.144 per transaction by multiplying the actual $0.039 transaction weighted average of per-transaction allowable costs by 3.7 as that generates a result where 98.5% of transactions would receive full cost recovery. This target is unreasonable in that it is very high. The proposed multiplier is like a profit margin for a business, and a business that can generate revenue equal to 3.7 times costs would be completely out of character for any business in a functioning competitive market. Further, the FRB points out that at the 98.5% transaction threshold the average allowable cost for transactions above the threshold is 5.2 times that for transactions below the threshold, and claims that suggests that the threshold is reasonable.[23] While we agree that having a cost difference of five times is large, we also note that having a much smaller cost difference would also generally be perceived as large. For example, we suspect that most consumers would perceive the 25% price difference between a $40,000 car and a similar $50,000 car to be large.

In sum, the transaction threshold is not consistent with the statute. The profit margin implied by a 3.7 multiplier is excessive and 5.2 "efficiency ratio" is not reasonable and cannot be justified.

In 2011, the Board noted that the term "reasonable" implies that, above some amount, an interchange fee is not reasonable, and noted that common definitions of the term "reasonable" include "fair, proper, or moderate" and "not excessive." [24] Since the current Board proposal increases the multiplier from the one applied in 2011 and derives a result that generates a whopping $5.9 billion in overcompensation to Issuers with ACS costs below the $0.144 threshold (and an immaterial under-compensation to the Low-Volume Issuers with ACS costs above the threshold), it is evident that the Board's current base component proposal is unreasonably high.

[21] Table 13.

[22] To ease review by making the statistics referenced agree with those included in the FRB data set, we did not adjust allowable costs by removing network fees. Doing so would reduce actual per transaction allowable costs somewhere between $0.008 per transaction and $0.0011 per transaction, thus reducing actual per transaction costs to somewhere between $0.028 and $0.031 per transaction. The impact from removing fees is expressed as a range because only a subset of Issuers separated network fees from other allowable costs. See Table 13.

[23] "For the proposed cost-recovery target of 98.5 percent of overed Issuer transactions, the average value of this ratio across these data collections is approximately 5.2, meaning that covered Issuers whose transactions are above the 98.5 percentile are, on average, more than five times less efficient than covered Issuers whose transactions are below the 98.5 percentile. Accordingly, the Board believes that targeting full cost recovery over time for 98.5 percent of covered transactions is reasonable." Federal Register/ Vol.88 No. 218 pages 78107 and 78108.

[24] Federal Register/ Vol.88 No. 218 page 78107 footnote 45.

Figure 4 below displays the enormous margin derived from Issuers with costs below the proposed base component rate compared to the small negative margin from Issuers with costs above the proposed rate.

Figure 4. Estimated Issuer Margin from Current Proposal[25]

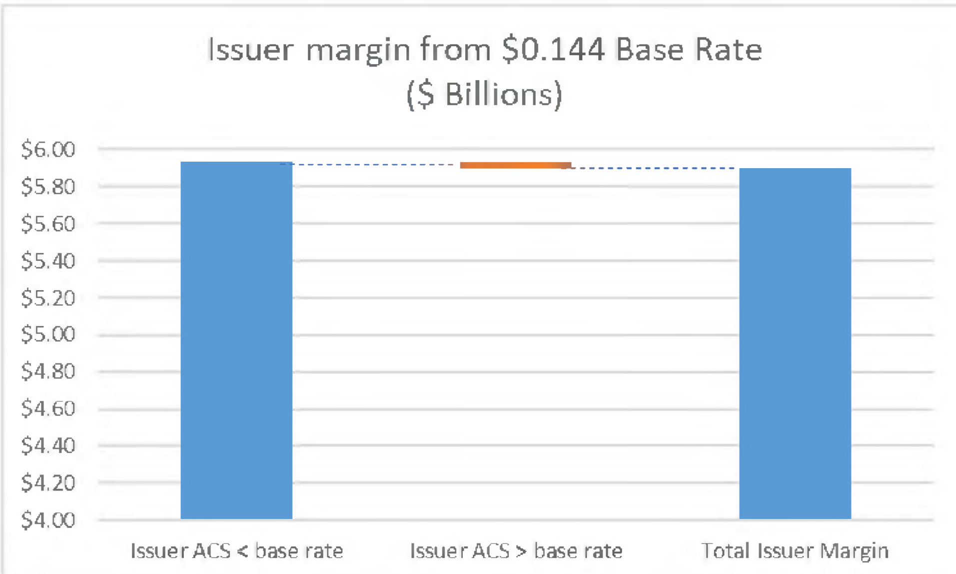



Figure 4 highlights how unreasonable the Fed proposal is with respect to the base rate, as well as its lack of proportionality. The proposal overcompensates 98.5% of transactions by $5.9 billion dollars, while it undercompensates 1.5% of transactions by $40 million.

Figure 5 below compares key differences if the FRB were to reduce the full cost recovery target to 95%, which was another scenario the FRB considered. The table highlights how striking it is that the FRB did not propose a lower base rate. Reducing the base rate to $0.105 would bring excess revenue closer to actual Issuer costs by about $2.2 billion annually, thus moving in the right direction to achieve the reasonable and proportional standard.

In doing so, twenty-three fewer Issuers would receive "full cost recovery," and on average these Issuers no longer receiving full cost recovery would generate about $3.3 million less annually in interchange revenue. Still, over half of the 163 covered Issuers– those responsible for 95% of transactions - would receive full cost recovery.[26] It is also interesting to note that at a 95% full cost recovery target the base rate of $0.105 would be 2.7 times average Issuer costs of $0.039 per transaction, the same ratio of base rate to cost that the FRB used when implementing the initial regulated rate.

[25] Table 12 was used for volumes withing each Issuer grouping. Nilson data was used to estimate volume within each quartile. ACS margins were estimated using Table 14.

[26] Likely over 60% of High and Mid Volume Issuers would receive full cost recovery at the $0.105 base rate.

While we believe the scenarios cited below considered by the FRB each have a base rate that is too high, the fact that the FRB proposed a 98.5% target recovery threshold when the 95% scenario clearly better matches the reasonable and proportional standard is alarming. On that point, it is interesting to note that a base rate of $0.105 is exactly half of the current base rate of $0.21, which is proportional to the approximately one-half decrease in Covered Issuer allowable costs since the issuance of Regulation II.

Figure 5. FRB Proposal & the 95% Recovery Target Considered by the FRB[27]

| | Fed Proposal | 95% Target |
|---|---|---|
| Transaction Full Cost Recovery Target | 98.5% | 95% |
| Base Rate | $0.144 | $0.105 |
| Multiplier | 3.7 | 2.7 |
| Difference in Base Rate Revenue from $0.144 | n/a | $0.039 per tran<br>$2.2 billion overall |
| Issuers with Full Cost Recovery | 108 (66%) | 85 (52%) |
| Change in Issuers with Full Cost Recovery | | 23 (14%) |
| Average annual transactions per changed Issuer without Full Cost recovery (millions) | n/a | 85.5 |
| Average change in Base Rate Revenue per changed Issuer without Full Cost recovery | | $0.039 * 85.5 = $3.3 MM |

## Suggestion for Ensuring that the Base Rate Adheres to the Reasonable and Proportional Standard

In a way, interchange revenue from a debit card transaction is unique to financial institutions in that it provides a revenue source when demand deposit account (DDA) holders choose to access their funds when other access methods usually only provide costs to Issuers. If a DDA holder enters a financial institution (FI) to make a withdrawal to access funds, the FI typically receives no revenue. Similarly, when DDA holders write checks or withdraw funds from a FI-owned ATM, usually the FI receives no revenue and only incurs costs. This reality also highlights the incongruity associated with the FRB's desire to seek ***full*** cost recovery for a very high percentage of debit transactions, including from FIs that have relatively small debit programs.

We recommend that the FRB adopt an approach to establishing the base rate for debit interchange that sets the base rate as close to actual transaction weighted Issuer cost as possible, while providing full cost recovery for most transactions and balancing the materiality of the impact of the base rate on Covered

[27] First three rows derived from Federal Register/ Vol 88. No. 218 page 78113. Information in remaining rows derived from analysis using data from various FRB Tables.

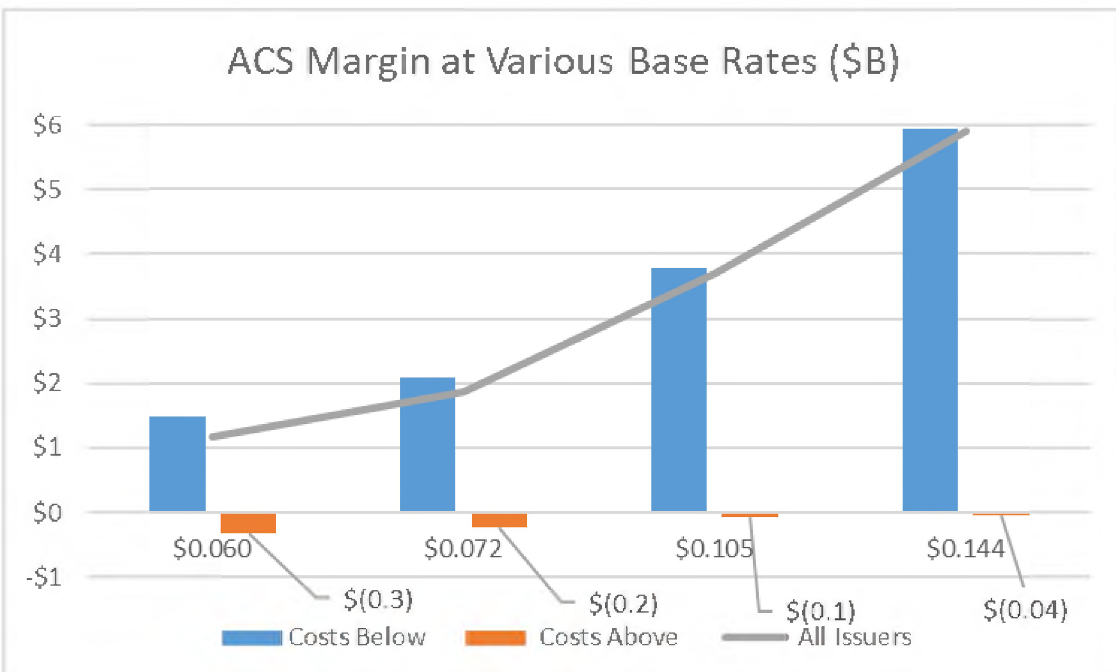
Issuers not receiving full cost recovery. To the extent that total Issuer base rate revenue exceeds Issuer cost, the overall margin should approximate financial institution margins.[28]

Additionally, if the Board adopts an automatic process to adjust future rates based on Issuer-reported costs, the Board must conduct oversight of the data collection process to ensure that costs are not misstated or inflated. An audit plan and enforcement mechanisms must be made part of the Proposed Rule.

## ACS Margin at Varying Base Rates

The chart below displays the total margin (grey line), margin from Issuers receiving full cost recovery (blue bar) and negative margin from Issuers not receiving full cost recovery (orange bar). Importantly, note how much smaller the orange bar is than the blue bar, even at base rates significantly lower than the Fed proposal of $0.144. A $0.06 Base Rate still generates over a $1 billion margin for covered Issuers.

Figure 6. ACS Margin at Various Base Rates[29]

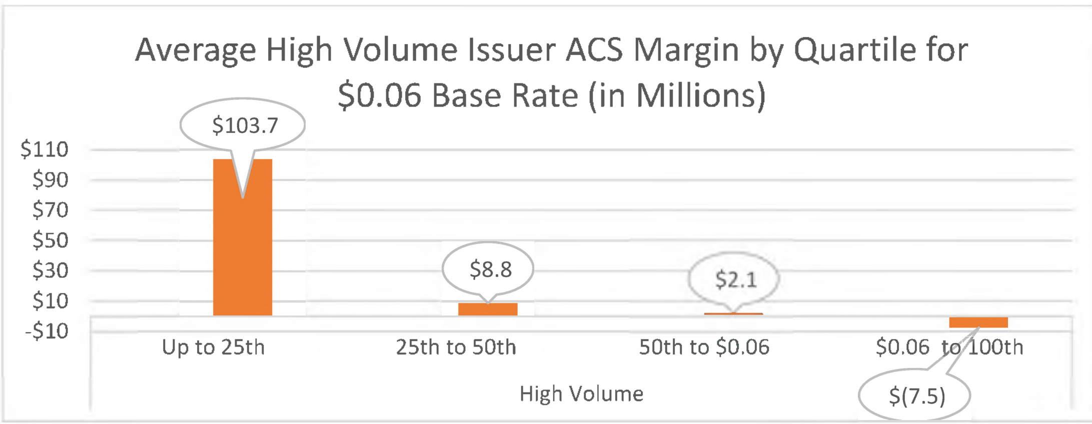


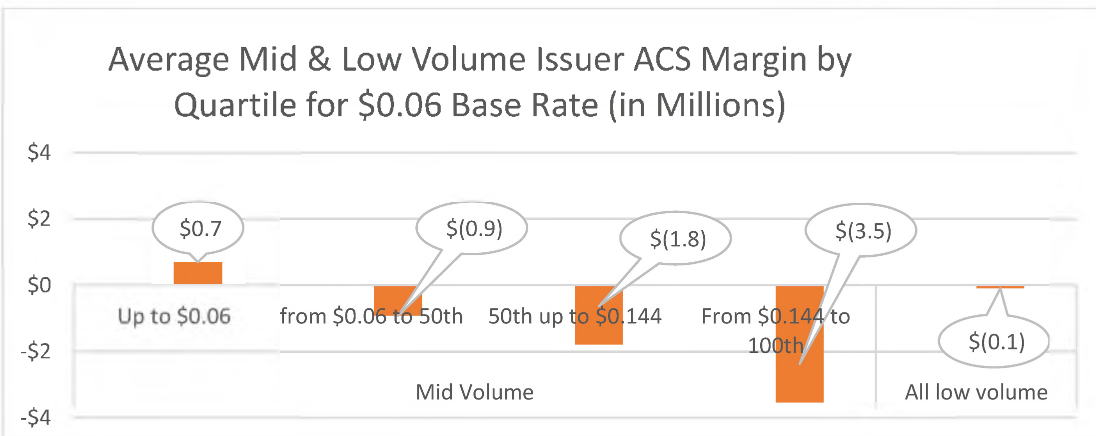

[28] In his January 5, 2024, summary of various industry profit margins, Professor Aswath Damodaran of NYU's Stern School of Business indicates Money Center Bank net profit margin of 30.89% and Regional Bank profit margin of 29.67%.
[29] Table 12 was used for volume within each Issuer grouping. Nilson data was used to estimate volumes within each quartile. ACS quartile margins were estimated using Table 14.

## $0.06 Base Rate / 35% Margin Scenario

One scenario that would represent a significant improvement over the current proposal would be to implement a $0.06 base rate. In aggregate, this would result in a 35% overall margin which is reasonable in comparison to financial institution margins.[30] Over half of High-Volume Issuers would receive full cost reimbursement and some of the first quartile Mid-Volume Issuers would likely receive full cost reimbursement. The average impacts on Issuers not receiving full cost reimbursement appear immaterial.

Figure 7. ACS Quartile Margins per Issuer for Covered Issuers with $0.06 Base Rate[31]

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[30] ($0.06 - $.039 = $0.021; $0.021 / $0.06 = 35%) A 35% margin is generous for financial institutions. In his January 5, 2024 summary of various industry profit margins, Professor Aswath Damodaran of NYU's Stern School of Business indicates Money Center Bank net profit margin of 30.89% and Regional Bank profit margin of 29.67%. Macrotrend's Financial Institution Pre-Tax Margin averaged 28.7% from 12/09 – 9/23. Keep in mind that allowable costs have not been adjusted to exclude Issuer network Fees. Issuer network fees are likely about $0.01 per transaction, so similar quartile $ margins would result in a Base Rate Scenario of $0.05 and allowable costs of $0.029. However, the overall % margin would increase to about 42% ($0.05- $0.029 = $0.021; $0.021/ $0.05 = 42%).

[31] Fed Table 12 was used for volume data within each Issuer grouping. Nilson data was used to estimate volumes within each quartile. ACS margins were estimated using Table 14.

## Implementing Multiple Regulated Rates Could Cost Effectively Increase the Percentage of Issuers Receiving Full Cost Recovery

Perhaps the most straightforward way for the Board to ensure full cost recovery for a large portion of Issuers while also applying a more reasonable base rate would be to implement multiple regulated rates. While doing so marginally increases complexity,[32] it has the advantage of more closely ensuring that regulated debit interchange is reasonable and proportional to Issuer costs. One scenario for the FRB to consider would be to set the base rate equal to the 50% percentile of Mid-Volume Issuer cost ($0.113) for Low and Mid-Volume Issuers and similarly set the base rate for High-Volume issuers equal to the 50% percentile of Issuer costs ($0.042) for High-Volume Issuers. This solution would not create any significant competitive advantage for any Covered Issuer. The smallest Covered Issuer would have assets near $10 billion, and FDIC insured institutions in this size range average 1.63% pre-tax return on assets, or $163 million for a covered Issuer with exactly $10 billion in assets.[33] The revenue difference that occurs for a Covered Issuer crossing into the High-Volume Tier would be an immaterial $7.1 million (100 million transactions * ($0.113-$0.042) or roughly 4% of pre-tax profits for the smallest possible Covered Issuer.[34] The Board could update the qualification criteria for the High-Volume tier every two years, along with the planned update to the regulated rate to manage the impacts on specific Issuers crossing tiers.

This approach would provide full cost recovery to the majority of High and Mid-Volume Issuers and over 88% of transactions and would provide an overall margin of 15% (network fees included) - 37% (if network fees are excluded). A summary of various scenarios where multiple base rates are implemented is included on page 22.

## Total Fraud

Under the current regulation, Merchants cover the costs of fraud multiple times. As fraud increasingly shifts to card-not-present channels where Merchants already absorb most fraud losses, locking in the Board's current methodology for addressing fraud risks becoming even more inconsistent with the statute as Merchants would cover anticipated fraud losses in advance via the *ad valorem* fee, absorb actual fraud losses via network rules and chargebacks, and pay the fraud prevention adjustment with no evidence that fraud would actually be reduced.

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[32] However, we note that the market already exists with complex network interchange structures. The current market includes dozens of tiers of regulated and unregulated rates. Introducing an additional regulated rate would appear to be trivial.

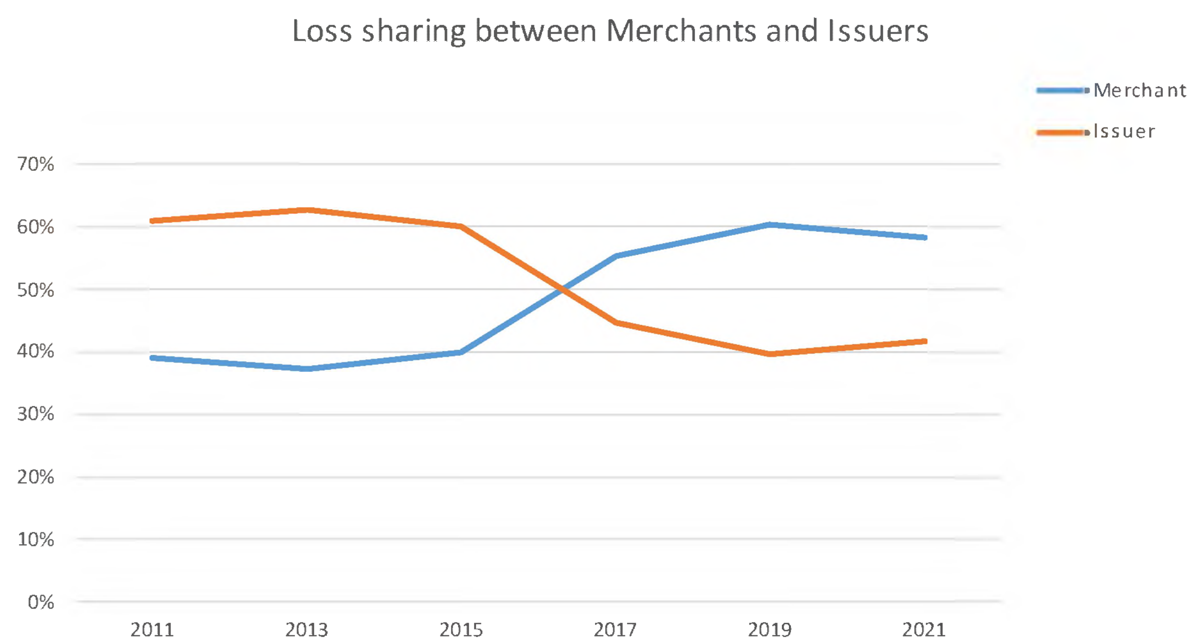
[33] FDIC Quarterly Banking Profile; ratios-by-asset-size; 4 quarters ended Q3 2023

[34] The New Importance of Materiality, by James Brady Vorhies in The Journal of Accountancy, May 1, 2005. "Working materiality levels or quantitative estimates of materiality generally are based on the 5% rule, which holds that reasonable investors would not be influenced in their investment decisions by a fluctuation in net income of 5% or less."

## Issuer Fraud Losses

In the debit card market each stakeholder plays a role in combatting fraud. Fraud can occur from lapses by Issuers as well as Merchants. Recognizing this interdependency, the networks have established a set of rules that allocate fraud losses between Issuers and Merchants. For example, a Merchant may be on the hook for a fraudulent transaction if the Merchant did not properly obtain cardholder authorization. Additionally, networks have devised reimbursement schemes under which Merchants pay Issuers for card reissuance costs when it is determined that a breach has taken place for which the Merchant is culpable. As depicted in the graphic below, Merchants have shouldered more of the fraud losses than have Issuers since 2017.

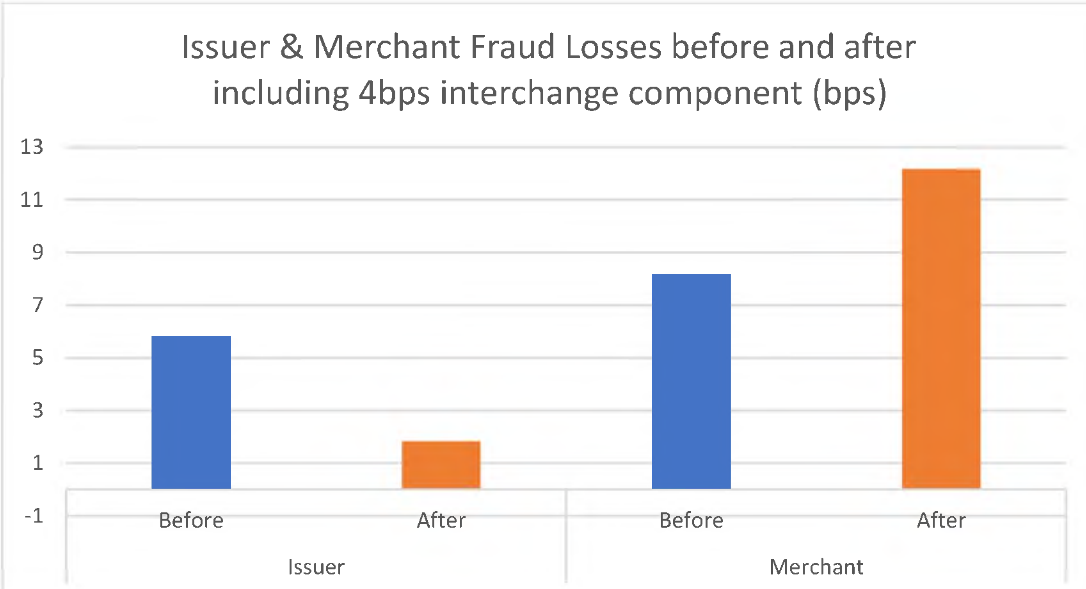
Figure 8. % of Fraud Losses Absorbed between Merchants and Issuers[35]




Even though **Merchants are already incurring more fraud losses than Issuers**, the *ad valorem* component of the Board's proposed interchange fee pushes yet another 4bps of losses onto Merchants. The result is that fraud losses are minimal and shrinking for Issuers and exceed 12bps for Merchants.

[35] From Table 11 and analysis; excludes losses absorbed by cardholders.

Figure 9. Issuer and Merchant Fraud Losses after 4bps Interchange Component[36]



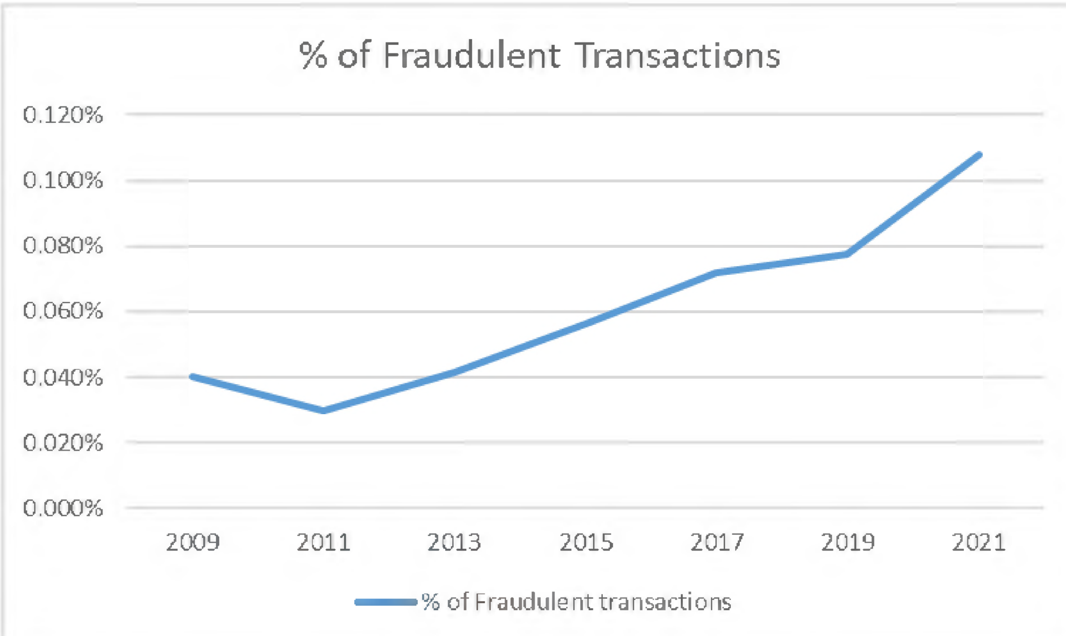

The reality that all stakeholders must play a role to effectively combat fraud would seem to suggest that a combination of network rules and regulated interchange that results in Merchants absorbing significantly more fraud losses thank Issuers is not reasonable and may reduce the incentive for Issuers to diligently combat fraud.

[36] Table 14 and analysis.

## Issuer Fraud Prevention

The percentage of fraudulent transactions has increased steadily from 4bps in 2009 to 10.8bps in 2021.[37]

Figure 10. Percentage of Fraudulent Transactions Over Time[38]




Meanwhile, median fraud prevention costs have decreased from $0.017 per transaction in 2009[39] to $0.013 per transaction in 2021.[40] Issuers are directed under Regulation II to have fraud prevention policies in place and to self-certify to networks that they follow their policies to receive the current $0.01 fraud prevention adjustment. All Issuers receive the adjustment despite differing effectiveness in fraud prevention. As an example, High-Volume Issuers at each quartile incurred the same or lower fraud losses in 2021 vs. 2011 while comparatively each Mid-Volume Issuer quartile incurred higher fraud losses.[41]

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[37] Table 10

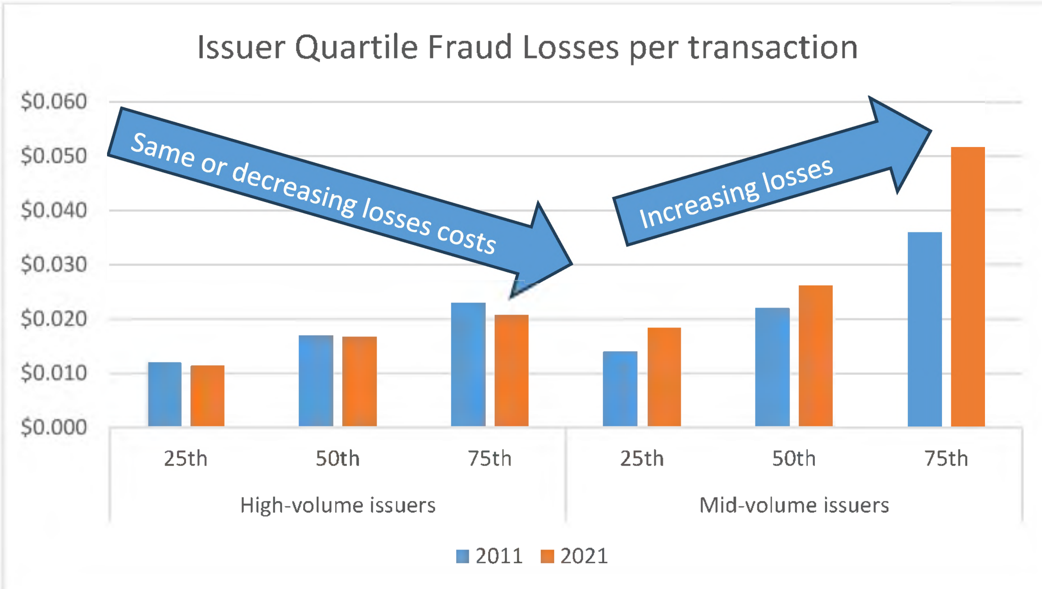
[38] Table 10.

[39] Table 13 in 2009

[40] Table 14.

[41] Table 14.

Figure 11. High-Volume and Mid-Volume Fraud Losses in 2011 and 2021[42]




The current rules and the proposal do not require fraud prevention steps to be effective and should be modified to condition the awarding of the adjustment upon demonstrated effectiveness. Individual Issuers that are effective in reducing fraud should be eligible to receive the fraud prevention adjustment, but ineffective Issuers should not receive the adjustment. There are various ways this could be implemented. Perhaps the fraud prevention adjustment is only made available to Issuers that achieve lower fraud rates than their previous measurement period or have slower growth in fraud than the mean. Those Issuers could then be eligible to receive the adjustment in the future once their fraud prevention efforts are shown to be successful. Since median fraud prevention costs have declined between 2009 and 2021, the amount of the Fraud Prevention Adjustment should be reduced proportionate to the reduction in per transaction spending, to $0.008 per transaction.[43]

## Suggestions for Changing Issuer Groupings and Reporting Statistics

Since it first started publishing statistics for covered Issuers, the Board has chosen to group Issuers into the following categories that have stayed consistent over time.

Figure 12. Existing Issuer Transaction Volume Groupings

| Issuer Grouping | Annual Transactions |
|---|---|
| High-Volume | Over 100 million |
| Mid-Volume | 1 to 100 million |
| Low-Volume | Under 1 million |

[42] Table 14.

[43] $0.017 median in 2009 vs, $0.013 in 2021 and a $0.01 existing fraud prevention adjustment ($0.013 / $0.017 = .76; $0.01 *.76~ $0.008)

Grouping Issuers in this manner creates several difficulties. Specifically, the High-Volume Issuer group always overwhelms the other groups. In every year for which data was collected the High-Volume grouping has never generated less than 93.5% of transactions. The low end of the Mid-Volume grouping potentially includes too many Issuers that have small debit programs that are immaterial to those financial institutions' overall operations. (As currently constructed an Issuer with over $10 bill in assets but with under $200k in total interchange revenue could be classified as a Mid-Volume Issuer).

Given the high concentration in the debit card market and the widely varying cost structures across Issuers, we suggest establishing target percentages of transactions when grouping Issuers, while ensuring each group contains no less than 8-12 Issuers. Groups such as those suggested below would allow for better understanding of varying cost structures across Covered Issuers that are having an impact on the overall market and thus would result in more meaningful statistical data.

Figure 13. Suggested Modified Issuer Groupings

| Issuer Grouping | Transaction Threshold | Target % of Transactions | Likely number of Issuers |
|---|---|---|---|
| High-Volume | Over 1.0 billion | 85% | <15 |
| Mid-Volume | 10 million to 1.0 billion | 14-15% | 105-120 |
| Low-Volume | Under 10 million | ~ 1 percent | 30-40 |

In addition, it would be helpful for the FRB to report additional statistics for each quartile (e.g. % of transactions, average ACS for quartile and range within each quartile), as well as include statistics for the 75$^{th}$-100$^{th}$ quartile, as this would greatly aid in understanding the changes across Issuers.

# Summary of Recommendations

## Core Proposal

Figure 14. Recommendations to Modify the Board's Proposal

| Component | Fed Proposal | Recommendation | Rationale |
|---|---|---|---|
| Allowable costs | Includes Issuer-borne network fees | Exclude Issuer-borne network fees | Allowing Issuer-borne network fees will almost certainly result in increasing Issuer fees (and as a result, interchange) and circumvention of the reasonable and proportional standard |
| Base rate & multiplier | Implement a formulaic approach targeting full cost recovery for 98.5% of transactions. Set base rate equal to transaction weighted ACS of $0.039 and multiply by 3.7 to derive a $0.144 base rate | Set the base rate consistent with a reasonable FI margin (20-35% above cost) | Adheres to reasonable and proportional standard |
| Ad valorem component for fraud losses | 4bps | Eliminate ad valorem component | Proposed approach ignores fraud losses already being paid by Merchant community which exceed the losses borne by Issuers. Elimination would ensure Issuers still have incentives to reduce fraud while the proposal risks undermining Issuer financial incentives for fraud reduction |
| Fraud prevention | $0.013; continue to allow self-certification | $0.008; limit to Issuers demonstrating effectiveness in mitigating fraud | Reduce existing $0.01 fraud prevention component by the approximate relative change in median fraud prevention costs between 2009 and 2021 |
| Updates | Every 2 years with a 3.7 multiplier | The final rule must include an oversight and audit plan to ensure allowable costs are not misrepresented or inflated. Make multiplier consistent with reasonable FI profit margins of 20-35% | Essential to ensure the integrity of the update process and keep the regulation reasonable and proportional considering normal market rates of return |

## Other Alternatives for Consideration

The Board should also consider implementing multiple interchange rates to better match rates with industry costs. Rates that varied by up to $0.08 or $0.09 per transaction between High-Volume and other Issuers would not have a material impact on bank financial results or the competitive landscape.

## Single Base Rate Scenario Summary

| | | Include Network Fees in Allowable Costs | | Exclude assumed $0.01 of Network Fees from Allowable Costs | | | |
|---|---|---|---|---|---|---|---|
| Scenario | Base Rate per transaction | Margin $ Billions | Margin % | Margin $ Billions | Margin % | % Transactions FC Recovery | Est # Issuers FC Recovery |
| FRB Proposal | $0.144 | $5.9 | 73% | $6.5 | 80% | 98.5% | 108 |
| 95% Target | $0.105 | $3.7 | 63% | $4.3 | 72% | 95% | 85 |
| $0.06 Base Rate | $0.06 | $1.2 | 35% | $1.7 | 52% | ~89% | ~41 |
| $0.05 Base Rate | $0.05 | $0.6 | 22% | $1.2 | 42% | ~86% | ~35 |

## Multiple Base Rate Scenario Summary

| | | | Include Network Fees in Allowable Costs | | Exclude assumed $0.01 of Network Fees from Allowable Costs | | | |
|---|---|---|---|---|---|---|---|---|
| Scenario | High Volume Base Rate | Other Base Rate | Margin $ Billions | Margin % | Margin $ Billions | Margin % | % Transactions FC Recovery | Est # Issuers FC Recovery |
| Base Rate equal to 50th ACS percentile | $0.042 | $0.113 | $0.4 | 15% | $1.0 | 37% | ~88% | 70 |
| Proposal adopted with $0.05 for HV | $0.05 | $0.144 | $0.9 | 30% | $1.5 | 48% | ~89% | ~84 |
| Proposal adopted with $0.06 for HV | $0.06 | $0.144 | $1.4 | 40% | $2.0 | 55% | ~90% | ~88 |

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