Kentucky's
Credit Unions

May 10, 2024

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

RE: Debit Card Interchange Fees and Routing
(Docket No. R-1818; RIN: 7100-AG67)

Dear Sir or Madam:

On behalf of Kentucky's Credit Unions, we are writing in response to the proposed amendments to Regulation II issued by the Board of Governors of the Federal Reserve System (Board). Kentucky's Credit Unions is the voice of consumers' best option for financial services: credit unions. We advocate for policies that allow the Credit Union movement to effectively meet the needs of their nearly 1 million members in the Commonwealth of Kentucky. We also greatly appreciate the Board's willingness to hold discussions with America's Credit Unions and other partner associations during the open comment period and we thank each of the individual Board Governors who listened to their concerns.

Kentucky's Credit Unions strongly opposes any reduction in the debit interchange fee cap. The proposed rule is based primarily on a flawed methodology that disregards the cost experience of most issuers, especially smaller credit unions. Moreover, the ultimate effect of reducing interchange revenue will be felt most by the member-owners of credit unions who will lose access to affordable banking products and services. The proposed rule will also hurt more than just covered credit union issuers. The Durbin Amendment's "exemption" of smaller financial institutions has proven to be largely illusory, as the Federal Reserve's own data shows that regulatory thresholds in the interchange market do not insulate smaller issuers from harm.[1] The Board must immediately halt this rulemaking so that a baseline of timely, accurate, and comprehensive data about the effect of current regulations can be developed and analyzed before further action is taken on new rules related to debit card interchange.

Executive Summary

As described in greater detail below, the Board's proposal also suffers from several critical flaws:

[1] The Board's data indicates that the average per transaction interchange fee for *exempt* single-message transactions has fallen by nearly 31% in inflation-adjusted dollars from 2011 to 2021.

- A skewed methodology for assessing base component costs that fails to give appropriate weight to the cost experience of a majority of covered issuers, especially credit unions;
- An arbitrary cost recovery target that would have prevented a third of covered issuers from fully recovering their base component costs had the amendments applied in 2021;
- A failure to properly consider and analyze the likelihood of negative consumer outcomes, as required by the Electronic Fund Transfer Act (EFTA);
- An unreasonable exclusion of certain allowable costs in the fraud prevention adjustment component; and,
- A failure to account for the full cost of fraud incurred by covered issuers.

Research examining the initial effects of the current fee cap introduced by the Board in 2011 shows that the resulting decline in debit interchange revenue translated into reduced access to free accounts, higher fees, and a rise in the number of unbanked consumers.[2] During this period, the loss of affordable banking services was compounded by a failure on the part of merchants to pass their savings on to consumers.[3]

A further reduction in the interchange fee cap, as proposed, would amplify Regulation II's known negative effects, yet the Board vastly understates the proposed rule's future impact and fails to offer meaningful analysis of likely consumer harm. Instead, the Board proposes a new rulemaking when none is required and adopts a methodology so skewed it practically invites future challenges. While it may seem expedient to quell the saber-rattling of the largest merchants by adopting their preferred (but severely flawed) mechanism for indexing costs automatically, this approach corresponds with numerous risks, not only to the Board's reputation as an apolitical entity, but also to the millions of credit union member-owners who are poised to bear the burden of a poorly calibrated fee cap.[4]

The Board's 2011 rule fulfilled the statutory requirement to adopt standards for reasonable interchange transaction fees.[5] Accordingly, there is no legal requirement to pursue a new rule now or in the future. Even assuming there was a need to reconsider whether interchange fees are

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[2] *See* Manuszak, Mark D. and Krzysztof Wozniak, "The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation," Finance and Economics Discussion Series 2017-074, Washington: Board of Governors of the Federal Reserve System, 5 (2017), *available at* https://www.federalreserve.gov/econres/feds/files/2017074pap.pdf (estimating that if the regulation had not been implemented, 65 percent of noninterest checking accounts offered by covered banks would have been free); *see also* Vladimir Mukharlyamov and Natasha Sarin, "The Impact of the Durbin Amendment on Banks, Merchants, and Consumers" Faculty Scholarship at Penn Law, 35-36 (2019), *available at* https://scholarship.law.upenn.edu/faculty_scholarship/2046/ (noting a rise in average fees on checking accounts and a corresponding rise in unbanked populations)

[3] *See* Sarin, Natasha, "Making Consumer Finance Work," Faculty Scholarship at Penn Carey Law, 1539 (2019) ("[A]nalysis suggests that around 75% of the $6.5 billion in annual Durbin savings went directly to retailers' bottom line."), *available at* https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3049&context=faculty_scholarship.

[4] *See* Petition for Rulemaking, https://www.federalreserve.gov/regreform/rr-commpublic/trade-association-letter-20221222.pdf (calling for the use of a fixed cost multiplier and automated indexing to avoid future notice and comment rulemaking).

[5] *See* 12 U.S.C. § 1693o—2(a)

"reasonable and proportional," it would be premature to do so before interested parties have had time to consider the impact of the Board's 2022 amendments to Regulation II.[6] Those amendments only took effect in July 2023 and are not reflected in the 2021 Debit Card Issuer survey data relied upon by the Board in the current proposal. Furthermore, the dual routing amendments are likely to correspond with a decline in future interchange revenue generated from card not present (CNP) transactions, which represent the fastest growing transaction type by volume and fraud source.[7]

The Federal Reserve has also improperly excluded certain categories of allowable costs when calculating the fee cap and maintains this exclusion in the proposal without reasonable justification.[8] Denying credit unions recovery of these costs increases the likelihood that credit unions may need to operate their debit programs at a loss, which is both unsustainable and ultimately harmful to members in the long term.

Credit unions are less able to absorb reductions in interchange revenue due to their unique, not-for-profit structure. Unlike banks, credit unions are unable to issue shares to outside investors as a means of raising capital. Instead, credit unions must build capital primarily through retained earnings, a process which is slow and, in the case of federal credit unions, further constrained by a statutory interest rate ceiling. The introduction of the Durbin Amendment, coupled with new laws and regulations targeting sources of non-interest income in the Dodd-Frank era, has had a profound effect on the credit union industry's ability to maintain competitive viability. Further reduction in interchange revenue could also threaten credit unions' ability to return savings and benefits to their members. Based on analysis of credit union data by America's Credit Unions, over 3,500 credit unions offer free checking accounts. Those credit unions serve 130 million members, or 93 percent of total credit union members.

The Proposed Methodology for Determining the Base Component is Flawed

The Board has proposed calculating the allowable base component by taking the product of a fixed multiplier and the transaction-weighted average of per-transaction base component costs.[9] The fixed multiplier would correspond to a target percentage of transactions for which covered issuers *should* (but might not in any particular year) fully recover their base component costs over time.[10] This departs from the Board's current methodology, adopted in the 2011 final rule,

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

[7] *See* CMSPI, "Card Not Present Routing: The $3 Billion Opportunity for Merchants" (October 3, 2022) (estimating that single-message routing enablement could save merchants $3 billion annually), *available at* https://cmspi.com/card-not-present-routing-the-3-billion-opportunity-for-merchants/; *see also* Federal Reserve, 2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions.

[8] *See* 88 Fed. Reg. 78100, 78104 (stating briefly, and without further explanation, that the Board's prior analysis of allowable costs in the 2011 rule "remains sound")

[9] *See* 88 Fed. Reg. 78100, 78106.

[10] *Id* at 78107.

for determining the allowable base component cost by identifying a point of discontinuity in the distribution of per-transaction base component costs across covered issuers, arranged from lowest- to highest-cost covered issuer. At that time, the Board's analysis of 2009 survey data revealed such a discontinuity, but a more significant consideration for the Board was a desire to account for the "overall cost experience of the substantial majority of covered *issuers*."[11]

A transaction-weighted methodology departs from the Board's current approach by disregarding the cost experience of most covered issuers. Instead, it skews the transaction-weighted average of per transaction base component costs to reflect the cost experience of the highest volume issuers. This bias results from the way the Board estimates average per-transaction costs: "the Board first determines the per-transaction base component costs of the covered issuer by (1) summing the base component costs reported by the covered issuer and (2) dividing this sum by the total number of debit card transactions reported by the covered issuer."[12] The Board then assigns this result to each of the covered issuer's transactions.[13]

The three largest banks account for a substantial share of overall debit volume, and their economies of scale have driven their per-transaction costs far lower than those of other covered issuers. Yet the Board's proposed methodology obscures this relationship by focusing on costs at the transaction level rather than at the issuer level. By skewing the transaction-weighted average per transaction costs for all covered issuers towards the cost experience of the largest by volume, the Board effectively disregards the cost experience of approximately two-thirds of the total debit market.

The Board downplays the distortions introduced by its new methodology by pointing to a general decline in covered issuer costs since 2009.[14] However, by using survey data from 2009, the Board overstates the actual decline in base component costs. At that time, the DCI survey was not mandatory and many smaller issuers did not respond to the Board's 2009 voluntary survey or did not know how to respond accurately.[15] A more reasonable starting point for measuring changes in base component costs would be 2011, when the first DCI survey data was collected. More importantly, the nominal decline observed by the Board ignores the fact that even under the current cap not all issuers are recovering their base component costs. In 2011, the Board determined that the current 21 cent cap was reasonable and proportional even though only 80 percent of covered debit card issuers would see cost recovery for their authorization, clearance, and settlement (ACS) costs—at that time, a group comprised of the largest banks. As of the Board's last data collection, only 77.4% of debit card issuers are experiencing full recovery of ACS

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[11] 76 Fed. Reg. 43394, 43433 (July 20, 2011).
[12] Board of Governors of the Federal Reserve System, "Additional Data Concerning the Proposed Methodology for Determining the Base Component of the Interchange Fee Cap," FN 4 (January 22, 2024), *available at* https://www.federalreserve.gov/paymentsystems/RegII_Additional_information_proposed_methodology.htm.
[13] *Id.*
[14] *See* 88 Fed. Reg. 78100, 78104
[15] *See id.* at FN. 27 ("The survey respondents included 66 covered issuers, representing about 57 percent of total debit card transactions by volume and 60 percent of total debit card transactions by value in 2009")

costs—again leaving high-cost, low-volume issuers, including many credit unions, operating at a deficit.

The Board rationalizes its approach by claiming that other methodologies would have been too sensitive to the average costs of low-volume, high-cost covered issuers. Approached from a different perspective, there appears to be concern that a higher cost recovery target would grant a windfall to a small group of very high-volume issuers. Yet the Board's solution is to deny at least a third of issuers recovery of their actual base component costs and masks this unjust outcome by promising that the market—as an abstract of pure transactions—should mostly achieve full cost recovery over time.[16] But for credit union issuers, forcing the share of recoverable costs downwards will lead to reduced capability to offer affordable services and pressure to consolidate.

The fixed multiplier that underpins the automatic indexing process is derived from an arbitrarily formulated cost-recovery target that is, in turn, established from a distribution model that cannot guarantee full cost recovery in any particular year.[17] While the proposed methodology may be convenient from an administrative standpoint, the Board cannot rule out the possibility that issuers' actual cost recovery may be less than expected, both in the short term and long term. The alleged stability of the Weibull distribution cited by the Board as justification for a mostly hands-off approach is questionable at best. Accordingly, denying issuers the ability to comment on future updates to the cap, especially when data regarding the 2022 routing amendments is not fully reflected in the Board's analysis, would be unfair and inconsistent with well-established Administrative Procedure Act (APA) jurisprudence.

The Proposal Will Negatively Impact Consumers

A Government Accountability Office (GAO) study ranked the Durbin Amendment among the top five laws and regulations most cited as having significantly affected the cost and availability of basic banking services.[18] The study further concluded that the regulation was associated with increases in the costs of checking accounts and a decrease in the availability of noninterest checking accounts without monthly fees.[19]

Section 904(a)(2) of the EFTA requires the Board, in prescribing regulations to carry out the purposes of EFTA section 920, to prepare an economic analysis that considers the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers. The proposed reduction in the fee cap is likely to harm consumers by reducing the availability of free or low-cost banking products and services.

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[16] *See id.* at 78113 (data table showing that only 66 percent of covered issuers would have fully recovered their base component costs had the proposed changes applied in 2021)
[17] *See id.* at at 78107 ("[T]he proposed approach would not guarantee this precise level of cost recovery in any particular year.")
[18] GAO-22-104468 (February 2022), *available at* https://www.gao.gov/assets/gao-22-104468.pdf.
[19] Id.

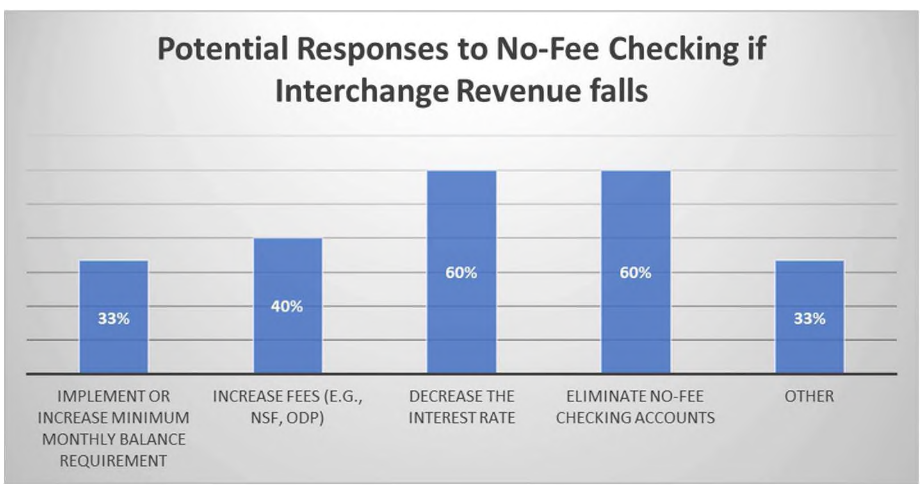
A study conducted by the Richmond Federal Reserve in conjunction with Javelin Strategy and Research concluded that current Regulation II has had limited positive effects for consumers. According to the study's authors:

- 77 percent of merchants did not change prices following the implementation of debit card price caps;
- 22 percent of merchants chose to increase prices; and,
- 1 percent passed on savings to customers.[20]

From 2012 to 2022, issuers collectively lost nearly $106 billion in interchange revenue, a figure that largely represents what merchants kept in their own pockets.[21] Despite this evidence, the Board concludes that merchants are likely to pass on a larger portion of their costs savings—a finding that is completely unsupported by any kind of empirical analysis.[22]

The Board's approach to the question of potential consumer harm does not fulfill the statutory obligation to conduct an actual economic analysis or consider how the weight of historical evidence predicts no consumer upside. Covered credit union issuers surveyed by America's Credit Unions have indicated which actions are likely to follow from the proposed reduction in the fee cap (Figure 1).

Figure 1



None of these outcomes are positive for credit union members, and none have been considered by the Board.

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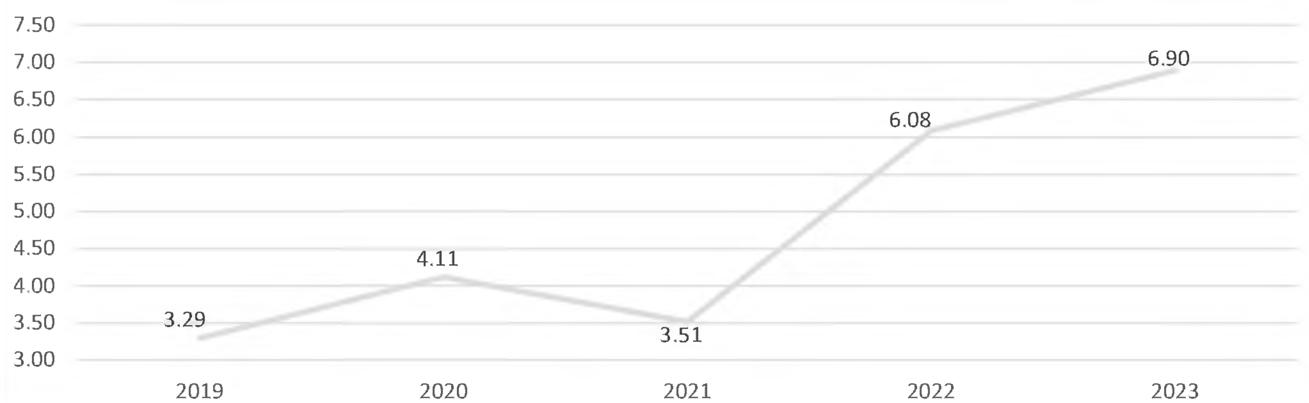
[20] Wang, Zhu, Schwartz, Scarlett and Mitchell, Neil, "The Impact of the Durbin Amendment on Merchants: A Survey
Study." (2014) Federal Reserve Bank of Richmond Economic Quarterly, Volume 100, Number 3.
[21] *See* Cornerstone Advisors, The True Impact of Interchange Regulation, 20 (June 2023)
[22] See 88 Fed. Reg. 78116.

Credit unions, as not-for-profit entities based on communal ties with limited fields of membership, reinvest in the communities they serve. The revenue generated from interchange fees often supports community-oriented projects, grants and programs.

The Proposal Fails to Adequately Consider the Full Costs of Fraud

Under the Board's current interchange fee standard, fraud costs are partially recovered through an *ad valorem* component, which is the median ratio of issuer fraud losses to transaction value among covered issuers. While the Board proposes no changes to the way this component is calculated, it does propose a downward adjustment, observing that the median ratio of issuer fraud losses to transaction value among covered issuers has declined from 2011 to 2021, despite an overall increase in fraud losses to all parties.[23] In this regard, the Board downplays the *ad valorem* component's most obvious shortcoming; namely, that it forces half of covered issuers to settle for less than full recovery of their actual fraud costs.

Figure 3
Ratio Total Fraud Losses to Total Transactions



The size of financial institutions plays a significant role in terms of preventing fraud and mitigating losses. For smaller covered credit union issuers, lack of scale makes it harder to absorb fraud losses while maintaining net margin within debit card programs. While the median ratio of issuer fraud losses to transaction *value* has declined, data collected by America's Credit Unions (Figure 3) shows that the ratio of fraud losses to total transactions is actually increasing for covered credit unions. When the magnitude of fraud is greater on a per-transaction basis, issuers with lower debit transaction volume are likely to experience greater volatility on a year to year basis in terms of their ability to fully recover fraud costs. Such volatility is compounded by the Board's decision to target full recovery for only half of the covered issuer market.

[23] *Id.* at 78108

Despite accelerating fraud, credit unions are investing more money than ever into fraud prevention activities.[24] Yet the fraud prevention costs that that the Board deems are allowable and therefore recoverable are narrow. For example, the Board has not properly considered fraud losses that result from foreign transactions involving stolen U.S. debit cards.[25] Regardless of whether an issuer intends to serve an international market, the fact remains that domestic data breaches can result in stolen debit credential being used in foreign countries.

The Board should also consider that its 2022 amendments requiring dual routing for CNP transactions is likely to reduce available interchange revenue to cover for fraud losses. Merchants are expected to prefer routing CNP transactions over single-message networks to take advantage of the 2022 enablement rules, and the income previously derived by issuers from dual-message CNP transactions is expected to decrease. Given that CNP transactions are the fastest growing by volume, loss of revenue is likely to accelerate as higher-fee, dual-message networks are deprioritized by merchants.

The Board Has Improperly Excluded Additional, Allowable Costs

The Board has unreasonably excluded certain costs that it should properly consider when calculating the fee cap. These costs include the costs of non-fraud-related cardholder inquiries, NSF losses and handling costs, card production costs, and (as mentioned previously) fraud losses resulting from certain international transactions.[26] As affirmed by the courts, the Board may consider any costs—not just incremental ACS costs—that are not expressly prohibited by the Durbin Amendment and specific to a particular electronic debit transaction.[27]

More generally, the Board should not proffer a lack of historical data as a basis for excluding costs that are specific to debit transactions. Excluding these costs understates the true operational expense of maintaining debit card programs and overstates issuer cost recovery targeted under both the current and proposed fee cap. Accordingly, we recommend the Board consider these costs in a separate study before proceeding with any future rulemaking activity.

The Proposal Fails to Adequately Consider the Impact on Exempt Issuers

Regulation II's current interchange fee cap has harmed even exempt issuers due to the competitive dynamic that exists between large covered issuers representing the vast majority of

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[24] *See* Cornerstone Advisors, The True Impact of Interchange Regulation, 26 (June 2023).
[25] See 76. Fed. Reg. 43420.
[26] *See* 88 Fed. Reg. 78104.
[27] See NACS v. Bd. of Governors of the Fed. Reserve Sys., 746 F.3d 474 (D.C. Cir. 2014) ("[H]ad Congress wanted to allow issuers to recover only incremental ACS costs, it could have done so directly."); *see also* 88 Fed. Reg. 78104 FN 23.

transactions and smaller issuers who account for a small share of total debit market volume and lack equivalent bargaining power.[28]

Exempt credit unions, due to their smaller size and community-focused operations, do not have the high volume of transactions or broad infrastructural base to spread out the fixed costs associated with issuing debit. Credit unions often incur higher per-transaction costs, which can be largely attributed to their limited scale of operations. Furthermore, credit unions with comparable debit transaction volume to banks tend to have fewer total assets. For small, low volume credit union issuers, a reduction in debit interchange revenue is likely to impact other areas of operations, as most cannot afford to simply abandon debit card programs if they hope to offer a minimum viable banking experience.[29] Consequently, credit union debit card programs that are already loss leaders today may be even more expensive to maintain should the Board adopt the proposal.

The Board has also failed to consider how recent changes to Regulation II might increase exempt issuer sensitivity to compressed interchange margin. As noted previously, a fundamental flaw in the Board's approach is relying on 2021 DCI survey data that does not reflect recent changes to CNP routing rules which affect all issuers. The Board's historical data shows that after Regulation II took effect, single-message network fees for exempt issuers declined dramatically by nearly 31 percent in inflation-adjusted dollars from 2011 to 2021. A similar decline could occur should the Board adopt the current proposal. Yet the Board appears indifferent to this potential outcome, instead forging ahead before even having the opportunity to review 2023 data that would reveal the fee impact of its routing amendments on issuers.

Among members of America's Credit Unions, exempt credit unions reported that a proposed reduction in the debit interchange cap, although not directly applicable, would prompt their credit union to consider various mechanisms for replacing lost revenue. The most likely courses of action would translate to increased fees on share draft/checking accounts (42 percent), higher debit card fees (39 percent), and increasing other fees (31 percent).[30] Nearly all actions intended to compensate for lost interchange revenue involved passing costs onto members.

Exempt credit unions rely on interchange revenue to support community-focused programs and services. Interchange revenue supports credit builder programs offered by 46 percent of credit unions; free checking offered to 93 percent of total credit union members; and financial education programs offered by 88 percent of credit unions.[31]

Exempt credit unions cannot afford to see interchange revenue decline by even a small margin. In 2023 alone, total fraud losses grew by 28 percent for exempt respondents. Like covered credit

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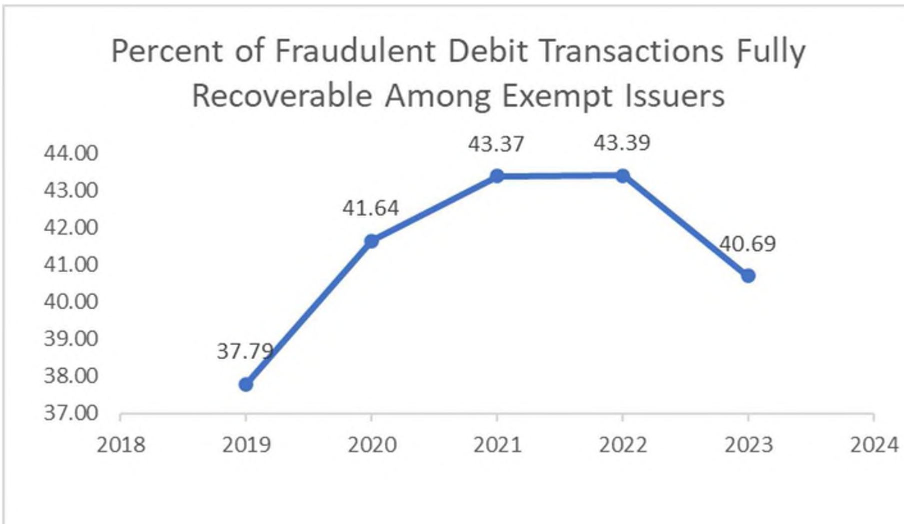
[28] *See* Board of Governors of the Federal Reserve System, "Statement on Proposed Revisions to Regulation II's Interchange Fee Cap by Michelle W. Bowman" (Oct. 6, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231025.htm
[29] *See id.*
[30] 2024 America's Credit Unions Survey of Exempt Issuers
[31] America's Credit Unions, National Credit Union Administration Financial Performance Report data.

unions, exempt credit unions are simultaneously making larger investments to prevent fraud. Fraud prevention costs have increased across the board in just the last five years. These costs include things like data security (41 percent increase), transaction monitoring (34 percent increase), R&D (20 percent increase), and tokenization (70 percent increases).

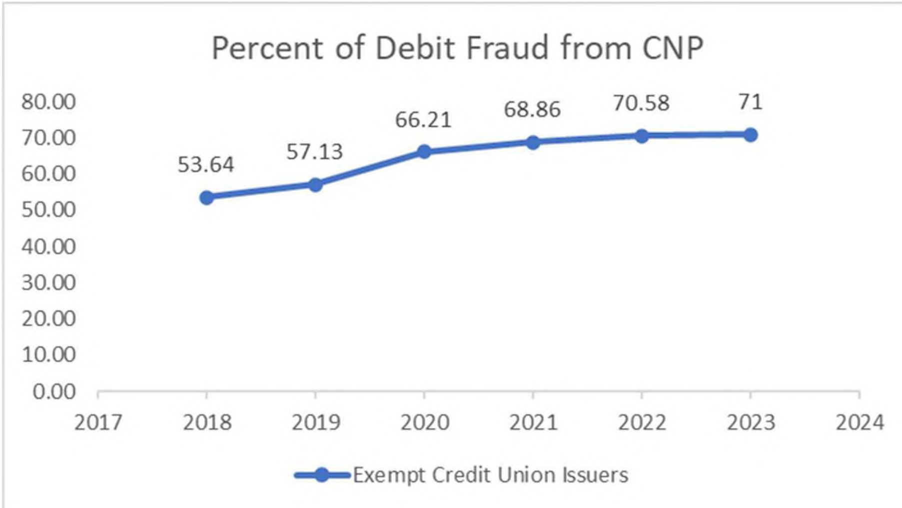
Figure 6



While these investments are necessary to slow the growth of fraud, the share of fraudulent debit transactions that are fully recoverable by exempt credit unions has never been favorable and has even started to decline (Figure 6). Furthermore, CNP transactions represent a growing source of overall debit fraud (see Figure 7). As merchants exercise new routing privileges and steer CNP transactions to single message networks, issuers will have to contend with the long-term impact of lowest-cost routing. As conveyed to the Board in 2021 when CNP routing changes were proposed, differences in the relative experience of dual-message versus single-message networks with respect to managing CNP fraud could amplify the risks of accepting a growing share of PINless debit transactions.[32]

[32] *See* Joint Trades Letter, Debit Card Interchange Fees and Routing (Docket No. R–1748, RIN 7100–AG15) (August 11, 2021), *available at* https://www.nafcu.org/system/files/files/Financial%20Sector%20Comments%20to%20FRB%20on%20Reg%20II%20Debit%20Card%20Proposal%20%282021%29.pdf

Figure 7



Sensitivity to fraud losses is particularly acute for exempt credit union issuers who often lack the scale to absorb fraud during bad years. In cases where fraud losses vastly exceed the income generated from debit card programs, small credit union issuers may face pressure to merge. Consolidation of smaller credit unions would have a detrimental effect not only on the availability of financial services generally, but especially for low- and middle-income communities given that 54 percent of all federally-insured credit unions are designated as low-income institutions by the NCUA.[33]

Conclusion

Merchants have enjoyed an absence of government price controls as consumer goods and services have grown more expensive. By contrast, credit union issuers have had to manage the costs of debit card programs under the burden of price controls and potentially a future proposal that will ratchet down interchange fees even further.

Not only is the Board's decision to issue the proposal unnecessary, but it is also premature. The Board lacks relevant data concerning 2022 changes to CNP routing rules while relying upon a flawed methodology that is poised to deny a third of issuers full cost recovery. The Board has also improperly excluded relevant costs from its calculation of the fee cap and severely underestimated the impact the proposal will likely have on exempt issuers, which include many small credit unions serving low income and rural populations. Accordingly, we urge withdrawal of the proposed rule.

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33 NCUA 5300 Call Report Data, https://ncua.gov/files/publications/analysis/quarterly-data-summary-2023-Q4.pdf

Thank you for the opportunity to provide comments in response to the proposed rule.

Sincerely,

Jim Kasch
President & CEO