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May 12, 2024

By Email to regs.comments@federalreserve.gov

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

Re: Docket No. R-1818, RIN 7100-AG67

To: Board of Governors of the Federal Reserve System

The Merchant Advisory Group ("MAG") appreciates the opportunity to comment on the notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System ("Board") regarding revised standards under Regulation II for assessing the maximum interchange fee that may be received by a debit card issuer with respect to a debit card transaction, published in the Federal Register on November 14, 2023. Debit Card Interchange Fees and Routing, 88 Fed. Reg. 78100 ("NPRM").

The MAG generally supports the Board's proposal to lower the cap on debit interchange fees imposed by Regulation II. The MAG's members pay billions of dollars of interchange fees annually to debit card issuers, and for many years the Board's maximum interchange fee has been set far higher than it should be under the Durbin Amendment, enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[1]

The MAG respectfully urges the Board to revise its proposal to stop the systematic overcompensation of issuers that the current regulated rate has provided, and that the Board's recent proposal, if not revised, will continue. This is especially important now, as debit card usage and debit interchange fees continue to grow at high levels, with the Board noting that 2021 saw nearly 20% growth, "the largest observed since Regulation II went into effect."[2] This trend has continued, as in 2023, debit volume as a whole was over $5 trillion.[3] The stakes of properly regulating the debit card industry have never been higher.

The MAG. Founded in 2008 by a visionary group of merchants dedicated to driving positive change in the payments industry through multi-stakeholder collaboration, the MAG represents more than 190 U.S. merchants in a variety of verticals such as mass merchant, e-commerce, travel and hospitality, quick service

[1] *See* Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111–203, 124 Stat. 1376 (2010)), which amended the EFTA (15 U.S.C. § 1693 et seq.) by adding a new Section 920 codified at 15 U.S.C. § 1693o–2.

[2] *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 (Oct. 2023), at 2.

[3] U.S. general purpose debit volume for the Visa and Mastercard networks was $3.78 trillion in 2020, $4.58 trillion in 2021, $4.85 trillion in 2022, and $5.10 trillion in 2023. Nilson Report Issues 1207 (Oct. 2021), 1230 (Nov. 2022), 1252 (Nov. 2023), 1257 (Feb. 2024), 1259 (Mar. 2024).

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restaurants, petroleum, and health care merchants among others, accounting for over $4.8 trillion in annual sales at over 580,000 locations across the United States and online. Roughly $3.5 trillion of those sales and over 100 billion card payments are electronic, which represents approximately 62% of total U.S. card volume.[4] MAG members employ over 14 million associates.

I. Introduction

Before addressing the substance of the proposed revisions to Regulation II, the MAG briefly highlights the history of the market failure in the payments industry that Congress sought to remedy by enacting the Durbin Amendment. That history should guide the Board's approach in this first and—if adopted as proposed—potentially last rulemaking concerning the regulated rate since the Board's initial rulemaking over a decade ago.

Following this introduction, the MAG offers two primary areas of comment for the Board's consideration.

First, the MAG urges the Board to set a single regulated rate at the level of the average cost of authorizing, settling, and clearing ("ACS") a debit transaction, with no multiplier. This cost-recovery level is most likely to encourage issuer efficiency, whereas a multiplier at any level above 1.0 systematically overcompensates issuers and actually rewards issuers for inefficiency and reporting higher costs. Financial institutions issue debit cards for a variety of reasons, including servicing the customer relationship and the cost-savings over other alternatives, such as paper checks. As a result, the MAG believes that inefficient issuers will continue to issue debit cards even if the rate is set below their individualized costs; debit cards provide their customers with easy access to their funds and are less expensive than processing paper checks, even for inefficient issuers. Market evidence supports this conclusion. Most, if not all, low-volume covered issuers have had higher ACS costs than the initial Durbin cap, yet low-volume issuers continue to issue debit cards.

Even if the MAG's assumption is not true, less than 3.5% of all debit transactions take place at covered issuers in the mid- and low-volume category. If these inefficient issuers end up leaving the market, it would have very little impact on the market. With some 9,838 covered and exempt institutions in the U.S. and only 110 in this category, it is irrational to protect them at the expense of setting cost which is not at a reasonable and proportional level as proscribed by Congress.[5] Because it encourages inefficiency and overcompensates the largest issuers, the MAG believes that the Board's current proposal is not supported by any economically defensible rationale.

Second, the MAG proposes that, given the Durbin Amendment's mandates—including the instruction to consider, among other things, "the extent to which interchange transaction fees have in the past reduced or increased incentives for parties involved in electronic debit transactions to reduce fraud," 15 U.S.C. § 1693o-2(a)(5)(B)(ii)(VI), the Board should not provide any amount to issuers for fraud losses, nor any adjustment for the costs to prevent fraud. The current rule—where merchants reimburse issuers for fraud losses—has not led to overall reductions in fraud. To the contrary, overall fraud has increased and issuers have succeeded only in shifting liability for fraud to merchants and consumers through changes in network rules such as the EMV

[4] Source of total U.S. card volumes: *Federal Reserve Payments Study*.

[5] Institutions exempt the standards & not exempt from the standards, https://www.federalreserve.gov/paymentsystems/regii-interchange-fee-standards.htm (data revised as of My 4, 2023).

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liability shift. The proposed rule continues the current regime of merchants and consumers makings issuers whole from fraud losses, even though it is issuers who are best positioned to prevent fraud in the first place.

II. Background

A. Congress Enacted the Durbin Amendment to Introduce Competition into a Broken Payments Market

The Durbin Amendment was just one of many legal and regulatory attempts to make the payment card markets in the U.S. competitive.[6] Congress enacted the Durbin Amendment in response to high interchange caused by the proliferation of exclusive issuance agreements between Visa and Mastercard and debit card issuing banks. These exclusive agreements eliminated routing competition, resulting in millions of debit cards enabled only for Visa and its affiliated network, Interlink, or Mastercard and its affiliated network, Maestro. The lack of routing competition, combined with the networks' honor-all-cards rules allowed for supracompetitive pricing, costing merchants billions of dollars. As a federal court examining claims against Visa in the debit market recently noted, "Prior to the Durbin Amendment . . . the interchange fees applicable to signature debit were similar to credit-card interchange fees."[7]

The Durbin Amendment was designed to fix the ongoing problem of Visa's and Mastercard's market power in the debit market. And where routing choice is fully available, routing provisions adopted in Regulation II have led to lower network fees and interchange—up to a point. For the most part, contrary to the Board's expectation in enacting an interchange fee "cap," large Visa and Mastercard issuers have successfully demanded interchange at no less than the cap established by the Board. The "cap" became a minimum, as the market does not function to drive interchange fees any lower than the cap. This immediately harmed merchants with small-ticket transactions, who saw an increase in their effective rates after Regulation II was implemented.[8] At the same time, Visa and Mastercard have introduced new network fees, leveraging their

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[6] While Visa and Mastercard lost several landmark antitrust cases in the last two decades, none of them materially impacted their dominance in the industry. *See In re Visa Check/MasterMoney Antitrust Litig.*, No. 96-cv-5238(JG), 2003 WL 1712568, *3, *4 (E.D.N.Y. Apr. 1, 2003) (granting partial summary judgment to merchant class against Visa, finding that it had market power and tied its debit cards to its dominant credit cards); *United States v. Visa U.S.A. Inc.*, 163 F. Supp. 2d 322, 329 (S.D.N.Y. 2001) (finding that Visa's and Mastercard's exclusionary rules harmed competition, including by barring entry into the debit card market), *aff'd*, 344 F.3d 229 (2d Cir. 2003). Visa and Mastercard are also currently defendants in a long-running antitrust case that a judge recently ruled may proceed to trial. *In re Payment Card Interchange Fee and Merchant Disc. Antitrust Litig.*, No. 05-md-1720(MKB), 2024 WL 1556931, at *21 (E.D.N.Y. Apr. 10, 2024) (resolving remaining summary judgment motions, holding that "a reasonable jury could find in favor of Plaintiffs on their Section 2 claims for a number of reasons, and taken together with the evidence discussed in [*In re Payment Card Interchange Fee and Merchant Disc. Antitrust Litig.*, --- F. Supp. 3d ---, 2024 WL 278565 (E.D.N.Y. Jan. 8, 2024)], a jury could reasonably find that Defendants' conduct has had an anticompetitive effect"). Globally, virtually every major economy regulates Visa and Mastercard in an effort to curb their market power. *See* Fumiko Hayashi, Aditi Routh, Sam Baird & Jalen Nichols, *Public Authority Involvement in Payment Card Markets: Various Countries*, Federal Reserve Bank of Kansas City (August 2023 Update).

[7] *Interchange Fee*, 2024 WL 1556931, at *3 (finding plaintiffs presented sufficient evidence for a reasonable jury to conclude Visa illegally monopolized the debit market pre- and post-Durbin).

[8] Renee Haltom & Zhu Wang, *Did the Durbin Amendment Reduce Merchant Costs? Evidence from Survey Results*, Federal Reserve Bank of Richmond, Economic Brief (Dec. 2015), at 2 ("[I]nterchange fees rose for small-ticket

power in the credit transactions market to then offer discounts off of these new fees only if merchants commit to route all of their debit transactions to them.[9]

As the Board's data has shown for many years, routing competition has worked to reduce interchange fees modestly, as exempt interchange rates for single-message (generally PIN-authenticated) transactions have fallen nearly to regulated rates, whereas exempt rates for dual-message (generally not PIN-authenticated) transactions have increased since 2011.[10] At the same time, despite the elimination of exclusive network agreements with issuers, Visa's share of debit volumes has steadily increased since the initial impact from Regulation II, and in 2023 rose to nearly 63%.[11] According to payments industry publication Nilson Report, networks other than Visa and Mastercard comprised just 14.73% of general purpose debit purchase volume in 2023, down to their lowest level of the last 20 years.[12] In ecommerce, Visa's debit share is roughly 70%, while Mastercard's share is 25%.[13] While the Board recently clarified that Regulation II's routing provisions apply to all types of transactions, Visa continues to use its market power to influence issuing banks to disable

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transactions, an unintended consequence of the Durbin Amendment. Prior to the regulation, most networks offered discounted debit interchange fees for small-ticket transactions as a way to encourage card acceptance by merchants for those transactions. For example, for transactions of $15 or less prior to the regulation, Visa and MasterCard set an interchange fee of 1.55 percent of the transaction value plus 4 cents for signature debit card purchases—or an 11 cent interchange fee on a $5 purchase. However, in response to the regulation, card networks eliminated the small-ticket discounts and assessed the maximum amount set by the regulation on all transactions. Since merchants have different compositions of transaction sizes, they would be affected differently by the changes of interchange fees. Merchants who specialize in small-ticket transactions would be most adversely affected."); *Applying the Durbin Maximum, Visa And MasterCard Could Squash Small Tickets*, Digital Transactions News (Sept. 27, 2011).

[9] "A critical aspect of the [post-Durbin Visa fee] FANF policy that Plaintiffs challenge is the use of FANF concessions or discounts in exchange for routing commitments from 'debit-intensive' merchants. Some of these agreements set targets for merchants that would trigger certain rebates on FANF if those targets were met. Other agreements used [Redacted] incentives to gain merchant commitments. For example, Visa entered into agreements with vendors such as [Redacted], pursuant to which the merchants would pay reduced [Redacted] in exchange for debit routing commitments. (See Hausman Rep. ¶¶ 555–73.)'" *Interchange Fee*, 2024 WL 1556931, at *4.

[10] *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 (Oct. 2023), at 3. As for network fees, the average per-transaction merchant-side network fee paid to dual-message networks "rose consistently from 2009 to 2021 and was the highest average per-transaction network fee across all categories after 2011"—double the merchant-side fees paid to single-message networks. *Id.* at 16-17.

[11] *Nilson Report* Issues 1005 (Oct. 2012), 1028 (Oct. 2013), 1051 (Oct. 2014), 1074 (Oct. 2015), 1097 (Oct. 2016), 1119 (Oct. 2017), 1141 (Oct. 2018), 1163 (Oct. 2019), 1185 (Oct. 2020), 1191 (Feb. 2021), 1200 (June 2021), 1257 (Feb. 2024), 1259 (Mar. 2024).

[12] *Nilson Report* Issues 1257 (Feb. 2024), 1259 (Mar. 2024).

[13] *See* Complaint, *United States v. Visa Inc. & Plaid Inc.* (N.D. Cal. filed Nov. 5, 2020) ("DOJ Complaint") ¶¶ 1, 5. Visa and Mastercard dual-message networks accounted for more than 95% of online (card-not-present) transaction value in 2021. *See Interchange Fee Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions, Data Tables: revised as of April 3, 2023*, Board of Governors of the Federal Reserve System, at Table 2.

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PINless specifications from competing networks, with the goal and effect of ensuring merchants must send any non-PIN-authenticated transactions to Visa.[14]

Against the backdrop of this highly concentrated industry dominated by two incumbent networks with nearly identical issuer-centric business models, the Board's determination of the maximum interchange fee an issuer may receive is of paramount importance.

B. The Board's Delay in Adjusting the Rate Has Cost Merchants Billions

Action to adjust the regulated rate is long overdue. Compared to the average cost of a debit transaction, the base interchange fee of $0.21 has overcompensated issuers for their recoverable cost by approximately $73 billion from the time Regulation II was implemented through 2021, the latest year of available data. In 2021 alone, issuers were overcompensated by approximately $10 billion as compared to the average cost of a debit transaction.

As discussed in more detail below, the Board's proposed 3.7 multiplier will continue to result in issuers collecting base interchange far in excess of their costs. Yet the MAG notes that even this modest proposed reduction has been delayed for far too long. For context, if the 3.7 multiplier had been implemented at the inception of Regulation II, issuers would have "only" collected approximately $48 billion more than their ACS costs in base interchange. In other words, the Board's delay in adjusting the regulated rate has cost merchants some $25 billion in additional interchange, relative to if the Board had implemented the 3.7 multiplier rule from the time Regulation II was implemented through 2021. Of that $25 billion, merchants would have paid nearly $4 billion in additional debit interchange in 2021 alone.

The stakes are therefore extraordinarily high for merchants, consumers, and the economy.

C. Unlike Debit Card Network Services, Retail Is Highly Competitive

The market for debit card network services is highly concentrated—Visa and Mastercard are two dominant players, able to exercise market power as evidenced by the ability to price far above cost and their extraordinarily high profit margins.[15] Likewise, profits among debit issuers are far above that of retailers. Most retailers operate in highly competitive segments with low profit margins.[16] Therefore, merchants can be expected to pass lower acceptance costs to their customers.[17]

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[14] Visa published a "Visa Business News" or VBN to issuers on March 23, 2023, stating that "issuers are not required to enable CP PINless." (AI12875; Regulation II Clarification: Card-Present PINless Enablement Not Required).

[15] Visa's most recent net profit margin is 54%; Mastercard's is 45% (https://www.macrotrends.net/stocks/charts/V/visa/net-profit-margin; https://www.macrotrends.net/stocks/charts/MA/mastercard/net-profit-margin).

[16] General retail has a net profit margin of approximately 3%; grocery, 3.0% (https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html).

[17] *See, e.g.*, Marie-Hélène Felt, Fumiko Hayashi, Joanna Stavins & Angelika Welte, *Distributional Effects of Payment Card Pricing & Merchant Cost Pass-through in the United States & Canada*, Federal Reserve Bank of Boston, Working Papers (Dec. 2020), at 9 n.13 (assuming 90% pass-through rate of costs to consumers and citing research for same).

Lower costs will have the effect of increasing acceptance overall, and consumer welfare will therefore increase. Visa and Mastercard have acknowledged that lower acceptance costs lead to greater merchant acceptance: Former Mastercard CEO Ajaypal Banga stated as much, explaining that when European regulators imposed much lower prices for debit and credit cards "actually, we are beginning to see an expansion and acceptance, for sure, across the EU, probably facilitated by the lower interchange rates that merchants who earlier were reluctant to accept electronic payments are now willing to do so. That's for sure. That's a good thing."[18]

III. Ensuring the Price of Regulated Transactions Are Proportional to Issuer Costs

In the NPRM, the Board notes that it has concluded that "proportional" does not imply any mathematical formula, only that the regulated rate bears a "relationship" to cost. NPRM at 78106 & n.40. This cannot be correct—under this interpretation, ten times or 100 times cost would bear "a relationship" to cost—a disproportionate relationship.

The MAG believes that the Boards' position is not supported by the text of the statute or Congressional intent, which calls for the Board to ensure that interchange fees are "reasonable and proportional" to cost. Congress specifically directed the Board to consider the similarities between debit cards and checks—which clear at par—in setting the fee cap. 15 U.S.C. §1693o-2(a)(4)(A). This is additionally instructive because debit cards are far less expensive for banks to process than checks and are therefore a cost-savings device for banks. To comply with the statute, and to properly incentivize efficiency, the MAG believes the Board should set the base component at no more than the level of the average cost of a covered debit card transaction.

A. The Interchange Rate Proposal Systematically Overcompensates Issuers, Contrary to the Text of the Statute, and Rewards Inefficiency

The Board's proposal aims to set the base interchange fee such that 98.5% of transactions would provide an interchange fee to issuers that would at least cover their ACS costs. However, this approach ignores that the average covered debit transaction has costs significantly below the 98.5 percentile transaction. In fact, over 80% of the base interchange collected by issuers over the period since 2011 has been profit in excess of their actual ACS costs. During that time, issuers collected over $90 billion in base interchange while their ACS costs were less than $18 billion.

The Board's proposed 3.7 multiplier would continue to allow issuers to collect base interchange far in excess of their costs. As noted above, if the 3.7 multiplier had been implemented at the outset of Regulation II, issuers would have collected approximately $48 billion more than their ACS costs in base interchange through 2021. In all, 73% of base interchange collected over the period would have been profit in excess of issuers' actual ACS costs. This approach—setting the base interchange rate at 270% more than cost—is akin to setting a regulated net profit rate of 73% for the industry. Consider how absurd this methodology would be if deployed in setting milk or gasoline prices, which are sometimes subject to government regulation. Assuming the average wholesale price of gasoline at $3, a 3.7 multiplier sets pricing at $11.10 per gallon, without taking into consideration the actual cost to distribute fuel and maintain gas stations, which are of course far lower than $8.10 per gallon.

[18] *Mastercard (MA) Q4 2016 Results – Earnings Call Transcript*, Seeking Alpha (Jan. 31, 2017), at 11.

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Similarly, a 2.7 multiplier—the level adopted by the Board in 2011—would have also resulted in issuers collecting more base interchange than their ACS costs. Issuers would have collected approximately $30 billion more than their ACS costs from base interchange. In all, 63% of base interchange collected over the period would have been profit in excess of issuers' actual ACS costs. Even with a 2.7 multiplier, the approach of setting the base interchange rate at 170% above cost is akin to setting a regulated net profit rate of 63% for the industry.

The fundamental problem with the Board's proposal is that a 3.7 multiplier of average ACS costs distorts incentives for issuers. If average ACS costs were to decline by $0.01, the proposed rate cap structure would result in a $0.037 reduction in interchange. Thus, increasing efficiency would make issuers worse off by $0.027 cents per transaction.

Similarly, if issuers were to become less efficient and their ACS costs increased by $0.01, the proposed rate cap structure would increase the base interchange by $0.037. Thus, issuers would be made better off by $0.027 per transaction, and issuers would make greater profits by decreasing efficiency. These incentives are not consistent with the statute nor with efficient outcomes.

For example, there were approximately 56 billion debit transactions covered by the Durbin regulation in 2021. Reducing efficiency by $0.01 per transaction (i.e., increasing costs by 1 cent per transaction) would result in issuers collecting approximately $2.1 billion in additional interchange (3.7 cents multiplied by 56 billion). Of the $2.1 billion in additional interchange, approximately $1.5 billion would be profit for issuers (2.7 cents multiplied by 56 billion). On the other hand, issuers would save approximately $560 million in costs if they reduced costs by $0.01 per transaction, but they would lose approximately $2.1 billion in interchange because the interchange standard would decrease, resulting in a net loss of $1.5 billion. Under this scenario, it would be irrational to invest in efficiency.

The "efficiency gap" does not provide a sound economic basis for setting the multiplier to 3.7.
The proposal calculates the "efficiency gap" as the ratio of the transaction-weighted ACS costs above the target percentile to the transaction weighted ACS cost below the target percentile. NPRM at 78107. The efficiency gap of 5.2 when targeting cost recovery for 98.5% of covered issuer transactions means the average cost for the 1.5% most expensive transactions is 5.2 times as large as the average cost of the remaining 98.5% of transactions.

The table found at NPRM at 78113 shows the efficiency gap for several other cost recovery targets. While the Board's calculation shows that the relatively few transactions in the outer tail of the distribution are relatively most costly, this result is not a justification for setting the base interchange level to 3.7—or any other multiplier—times the transaction-weighted average ACS cost. As explained above, using a multiplier, such as 3.7, results in large profits for the industry and an incentive for the industry as whole to become less efficient.

At the same time, the MAG sees little risk to competition on the issuer side of the market. Only a small percentage (3.5%) of debit transactions occur at covered high-cost issuers. And there are only 534 covered

financial institutions, compared to over 9,300 exempt institutions.[19] Exempt interchange has increased by 17% since the inception of Regulation II, proving predictions of harm to small issuers to be unfounded.[20]

Predicted harm to consumers also did not materialize: the rate of the unbanked and underbanked decreased, and free checking remains widely available. The FDIC reports that since Regulation II was implemented, the rate of unbanked consumers dropped almost in half from 8.2% to 4.5%. And underbanked consumers declined from 18.1% in 2017 to 12.7% in 2021. According to Bankrate/MoneyRates surveys, free checking has increased from 34.7% in 2010 to 45% in 2023 and the average monthly cost of having a checking account remains unchanged.[21] The huge recent reduction in overdraft fees also has not led to a reduction in free checking, and there is no evidence that banks are increasing other fees in response to the decline in overdraft revenue.[22] These are signs of healthy competition to the benefit of consumers.

B. The Board Should Require Annual Cost Reporting

As discussed, the cap-setting structure proposed by the Board creates incentives for issuers to report higher costs, whether correct or not. If issuers increase their reported ACS cost but do not actually incur additional costs, all $2.1 billion in the above example would be profit. The MAG notes that data submitted by issuers and payment card networks to the Board is not verified.

In addition to the dictates of the statute, economic efficiency would be enhanced if price was set as close as possible to cost. For this reason, while the statute requires the Board to disclose summary information "on at least a bi-annual basis," 15 U.S.C. § 1693o-2(a)(3)(B), the MAG suggests that the Board should perform an annual rather than biennial data collection on costs. The statute provides the Board the authority to "require any issuer (or agent of an issuer) or payment card network to provide the Board with such information as may be necessary" to carry out the regulation. Id. If the formulaic rate reset is adopted, issuers would be incentivized to shift costs to reporting years. At worst, biennial reporting encourages issuers to shift costs to certain years, inviting abuse. At best, biennial reporting cuts the number of data points in half without any rationale and contrary to best practices.

The Board should make use of its broad authority to require verified data annually "as necessary" to best inform its implementation of the Durbin Amendment. This should include auditing the data and a comparison of costs across similar institutions.

IV. Issuers Should Not Recover Fraud Losses or the Cost of Fraud Prevention from Merchants

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[19] *Interchange Fee Standards: Small Issuer Exemption*, Board of Governors of the Federal Reserve System (Data revised as of May 4, 2023).

[20] *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 (Oct. 2023), at 14.

[21] Karen Bennett & Matthew Goldberg, *Survey: ATM fees hit record high while overdraft and NSF fees fell sharply*, Bankrate (Aug. 30, 2023) (also noting free checking available despite lower overdraft fees); Richard Barrington, *Bank Fee Survey Mid-2011 – Free Checking Options Fewer, But Not Gone*, MoneyRates (Mar. 18, 2024).

[22] *Overdraft/NSF Revenue in 2023 down more than 50% versus pre-pandemic levels, saving consumers over $6 billion annually*, Consumer Financial Protection Bureau (Apr. 24, 2024).

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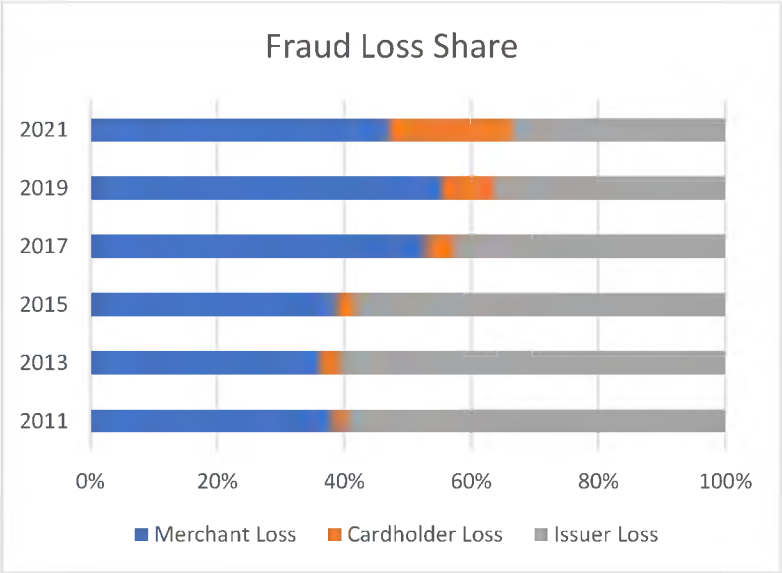
The MAG believes that the Board should not permit issuers to recover fraud losses from merchants via the ad valorem component of the maximum interchange fee. After all, the fraud reimbursement is not specific to "a particular debit transaction" as contemplated by the statute. 15 U.S.C. § 1693o-2(a)(4)(B)(i).

A. The Statute Requires the Board to Consider All the Parties That Bear the Cost of Fraud, Not Simply to Fully Reimburse Issuers for Fraud Losses

Merchants must invest in many different types of fraud prevention, but their costs are not quantified nor considered by the Board. Consideration of merchant fraud costs is required by the statute with respect to the fraud adjustment: 15 U.S.C. § 1693o-2(a)(5)(B)(ii)(IV) requires the consideration of "fraud prevention and data security costs expended by each party involved" in debit transactions. Merchants bear many costs of fraud in addition to just the cost of chargebacks. At the same time, large issuers have faced increasing criticism for failing to cover fraud losses incurred by their customers.[23]

Even keeping within the narrow lens of actual fraud loss, merchant losses have grown faster than overall losses. In 2011, merchant losses were 2.98 bps out of a total 7.77 bps of fraud losses to all parties (~38%). In 2021, merchants' losses were 8.17 bps out of a total 17.45 bps (~47%).[24] The below graphs show the increasing merchant share of fraud loss.



[23] *See, e.g.*, Stacy Cowley & Lananh Nguyen, *Fraud Is Flourishing on Zelle. The Banks Say It's Not Their Problem.*, N.Y. Times (Mar. 6, 2022); James Pothen, *Warren probes Zelle scam policy*, Payments Dive (Feb. 21, 2024).

[24] *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 (Oct. 2023), Appendix: Tables, Table 11 (2021 fraud losses reported by covered issuers).

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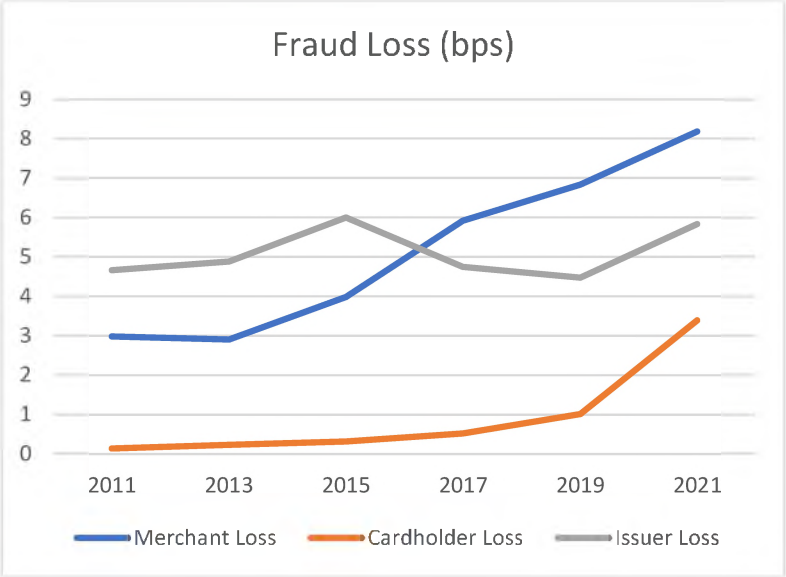

The Board has noted this trend: "Altogether, from 2011 to 2021, the percentage of losses from fraudulent transactions reported by covered issuers absorbed by merchants steadily increased from 38.3 to 47.0 percent, while the percentage of losses absorbed by issuers steadily decreased from 59.8 to 33.5 percent."[25] In light of this trend, it is especially inappropriate for the Board to permit issuers to recover 100% of their fraud loss via the ad valorem component of the maximum interchange fee.

B. Issuers Should Not Recover Fraud-Prevention Costs from Merchants

Finally, the MAG believes that the Board should revisit its decision to allow issuers, with minimal certification of their efforts, to collect any per-transaction amount for the fraud-prevention adjustment. Merchants have spent billions in infrastructure investments since 2012 to enable EMV-compliant terminals, and many incurred millions in EMV chargebacks through no fault of their own because Visa and Mastercard caused delays in the development of EMV-chip debit-routing specifications.[26] In fact, merchants incurred the vast majority of the expenditure required to migrate the U.S. payment system to the more secure EMV technology. Merchants also continue to invest heavily in the security of their customers' ecommerce purchases. As the Board's data shows that merchants (and customers) bear an increasing majority share of all fraud losses, this fraud-prevention adjustment is no longer necessary or appropriate and should be eliminated.

In setting any fraud adjustment, the Durbin Amendment expressly requires that the Board consider "the extent to which the occurrence of fraud depends on whether authorization in an electronic debit transaction is based on signature, PIN, or other means" and "the extent to which interchange transaction fees have in the past

[25] *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 (Oct. 2023), at 3.

[26] Fumiko Hayashi, Zach Markiewicz & Sabrina Minhas, *The Initial Effects of EMV Migration on Chargebacks in the United States*, Federal Reserve Bank of Kansas City (Dec. 2018), at 7 (Federal Reserve working paper noting that "variation in the liability shift across networks made EMV adoption more complex").

reduced or increased incentives for parties involved in electronic debit transactions to reduce fraud on such transactions." 15 U.S.C. § 1693o–2a(5)(B)(ii)(II), (VI).

Visa's and Mastercard's actions "in the past" to promote the use of higher-fraud signature debit rather than cheaper, more secure PIN debit is instructive. Before the Durbin Amendment, Visa and Mastercard used their power in credit to advance their fraud-prone signature debit products and diminish rival debit networks who offered more secure PIN transactions. In fact, Visa and Mastercard delayed bringing chip technology to the U.S. despite rising domestic fraud and fraud migration to the U.S. for many years to protect their lucrative, but fraud-prone signature debit products, leaving the U.S. as the last major economy in the world to migrate to chip.[27] After Regulation II reduced signature debit interchange to the same level as PIN debit for covered issuers, Visa and Mastercard introduced EMV chip technology only because signature debit's high fraud rates were unsustainable. Moreover, Visa and Mastercard controlled the technology and could use it to limit routing required by Regulation II. These networks then adopted rules to prohibit routing from their proprietary chip technology widely used across the globe. Visa and Mastercard required bifurcated access to widely used chip technology—with one "global" AID and one "common" AID, requiring merchants to install custom logic in order to preserve the ability to route to unaffiliated networks. The routing impediments introduced through the EMV-related network rules in the U.S. were contrary to the payments experience globally, where routing from chip cards is no different than routing from magnetic stripe cards—that is, accomplished by BIN tables. This strategy resulted in a complex dual-AID implementation in the U.S. unlike any other in the world, including countries where there also is more than one debit network enabled on cards.

The impact of this conduct was seen in the market as "US Debit/Visa Debit" point-of-sale screens proliferated, which reflect the dual-AID infrastructure in the U.S. developed in response to Visa's rules about securing "cardholder choice." Those screens confused customers into making Visa Debit transactions rather than PIN transactions on unaffiliated networks, reinforcing Visa's monopoly power, and required action by the FTC and the Board.[28]

The Board should consider this history when determining whether to set any amount for a fraud adjustment. Issuer fraud-prevention costs are determined by decisions made by issuers without input from merchants. However, merchants currently pay for the fraud-prevention efforts made by issuers. Situations where one party makes decisions on expenditures but does not bear the cost of those decisions generally do not lead to economically efficient outcomes. Issuers might overspend on fraud prevention or may not chose the most efficient fraud-prevention methods because only certain fraud-prevention efforts would be included in the determination of the interchange fee cap. Because issuers and networks control key fraud-prevention decisions, they should not be reimbursed for avoidable fraud.

This is especially true because issuers and networks decided to implement EMV in the U.S. using a "chip and choice" model instead of a "chip and PIN" model as used in most of the world. Chip and PIN eliminates lost/stolen fraud. Not requiring a PIN enables increased fraud. Whereas 0.0016% of single-message debit

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[27] *See, e.g.*, Richard J. Sullivan, *Can Smart Cards Reduce Payments Fraud and Identity Theft?*, Federal Reserve Bank of Kansas City, Economic Review (3d Quarter 2008), at 51 (citing one "challenge" impeding the U.S. market's migration to EMV that "[B]anks make more revenue from signature debit compared to PIN debit. *Because the EMV and [other chip card] standards would essentially eliminate signature debit, bank revenue for payment services could be reduced.*") (emphasis added).

[28] Jim Daly, *Visa Modifies Its Controversial EMV Debit Card Transaction-Routing Policies*, Digital Transactions News (Nov. 22, 2016).

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transactions, which often require a PIN, were fraudulent in 2021, 0.130% of dual-message transactions, which usually do not require a PIN, were fraudulent in 2021. Thus, the percentage of fraudulent transactions when a PIN is not typically required is more than 80 times larger than when a PIN is typically required.

At the same time, merchants cannot elect to require a PIN, as Visa requires merchants to allow "PIN bypass" so that customers can exit out of PIN prompts. These are decisions made by issuers (who configure their cards not to require a PIN) and networks.
Issuers should not be reimbursed for fraud losses they and the networks cause by electing not to use effective fraud-prevention methods.

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The MAG appreciates the opportunity to comment on the proposed amendments to Regulation II and the Board's continued attention to the debit transactions market.

Respectfully,

John Drechny
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