May 10, 2024

Via Email (regs.comments@federalreserve.gov)

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

RE: Notice of Proposed Rulemaking on Regulation II; Docket No. R-1818, RIN-7100-AG67

Dear Ms. Misback:

Mastercard International Incorporated ("Mastercard") submits this comment letter to the Board of Governors of the Federal Reserve System ("Board") in response to the notice of proposed rulemaking to amend Regulation II ("NPRM").[1] Mastercard appreciates the opportunity to provide comments on the NPRM.

Background on Mastercard

Mastercard is a technology company in the global payments industry. Mastercard operates a multi-rail payments network that provides choice and flexibility for consumers, merchants and our customers. Mastercard does not issue payment cards of any type nor does it contract with merchants to accept those cards. In the Mastercard network, those functions are performed in the United States by banks and credit unions. Mastercard refers to the financial institutions that issue payment cards bearing the Mastercard brands to cardholders as "issuers." Mastercard refers to the financial institutions that enter into contracts with merchants to accept Mastercard-branded payment cards as "acquirers."

When a cardholder presents a Mastercard-branded payment card to a merchant to purchase goods or services, the merchant sends an authorization request to its acquirer, the acquirer routes the request to Mastercard, and Mastercard routes the request to the issuer. The issuer either approves or declines the authorization request and routes its decision back to the merchant through the same channels. Mastercard's role in the transaction is to facilitate the payment instructions among the parties to the transaction and to facilitate the clearing and settlement of the payment transaction between the issuer and acquirer.

[1] 88 *Fed. Reg*. 78,100 (Nov. 14, 2023).

Executive Summary

The Board should not proceed with finalizing the NPRM at this time. When the Board adopted Regulation II in 2011, it made policy choices that were not required by Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") in setting the base and *ad valorem* components of the interchange fee cap and the fraud prevention adjustment. In Regulation II, the Board interpreted the key phrase in Dodd-Frank Act Section 1075 ("Section 1075"), "reasonable and proportional," in a manner that was inconsistent with the stated intent of the sponsor of Section 1075 and with the Board's own interpretation of identical statutory language in the Credit Card Accountability Responsibility and Disclosure Act of 2009 ("CARD Act"). As predicted at the time Regulation II was issued, and as shown by ample independent research since, the effect of choices the Board made has been to drive down revenue from debit card programs for issuers, in particular smaller issuers that are not exempt from the interchange fee cap, which has resulted in consumers incurring more expenses for basic banking services without any evidence of offsetting price reductions by merchants.

The best way for the Board to avoid doing further harm to smaller issuers and consumers is to suspend the NPRM process and fully reevaluate the policy choices it made in the 2011 Regulation II final rule. If the Board determines to proceed with the NPRM, we strongly encourage the Board to refocus its amendments to Regulation II in the following manner and also to reevaluate its methodology for the *ad valorem* component and fraud prevention adjustment.

<u>Allowable Costs</u>. The Board erred in defining "allowable costs" when it issued Regulation II. The Board adopted a definition that limited issuer costs in a manner that was not required by statute and ignored relevant precedent from other regulated industries. This contributed significantly to the harm experienced by issuers, particularly smaller non-exempt issuers (*i.e.*, covered issuers), and consumers. Yet, in a rulemaking in which the Board proposes to significantly overhaul the regulation, the Board evidences no interest in revisiting this crucial definition. If the Board is going to issue a final rule, it should reconsider the elements of allowable costs. In addition, it should revise the defined terms in the Debit Card Issuer Survey to ensure that issuers are not underreporting their allowable costs.

<u>Cost Recovery</u>. Further compounding the harm to issuers and consumers, in the NPRM the Board has arbitrarily selected a cost recovery target that would result in one-third of issuers not recovering the full amount of their allowable costs. Without providing a justification in the NPRM, the Board's proposal on the cost-recovery target would mean that more issuers are unable to recover allowable costs under the NPRM than under the existing rule. This would occur against a backdrop of higher overall issuer costs per debit card transaction, taking into consideration increases in the many costs that the Board does not include in "allowable costs." The Board's proposed cost-recovery target will do the most harm to smaller issuers that are subject to the interchange fee cap. But it will also harm the smallest issuers – those that are exempt from the interchange fee cap. This is because, as regulated interchange falls, many of the nation's largest merchants will demand more favorable interchange on unregulated transactions from networks. This will result in lower interchange received by the smallest exempt issuers for transactions at these dominant merchants. The Board should not set a cost-recovery target that

inflicts harm on smaller covered issuers and the smallest exempt issuers and, as a result, indirectly on the consumers who rely on those issuers for banking services.

Interchange Fee Cap Adjustments. The Board's proposal to routinely and automatically adjust the interchange fee cap will violate the Administrative Procedure Act ("APA"). The Board should revise this proposal to provide for regulatory review and a notice and comment period prior to each adjustment if it moves forward with a final rule. Also, the mechanics of the Board's proposed fee cap adjustments will unreasonably burden issuers and other participants in the payment card industry. To mitigate these burdens, at a minimum the Board should: (i) postpone any final rule at least until the 2023 Debit Card Issuer Survey is available and can be analyzed; (ii) use a cadence of at least four years instead of a two-year cadence to make any changes to the interchange fee cap; (iii) not amend the interchange fee cap if issuer allowable cost changes are de minimis; (iv) announce any changes to the interchange fee cap in October with the changes to go into effect in April rather than on the proposed March-July timeline; and (v) clarify that interchange is determined at clearing, not at settlement.

The NPRM has many flaws that would merit full reconsideration at any time. But now is a particularly bad time for the Board to consider lowering the interchange fee cap, as issuers are suffering from the effects of inflation on their cost structures. Section 1075 does not require the Board to amend the interchange fee cap, and the Board should not finalize the amendments to the interchange fee cap based on the NPRM.

Comments

I. *General*

Section 1075 directs the Board to establish standards for assessing whether the amount of any interchange fee for an electronic debit transaction is reasonable and proportional to the cost incurred by the debit card issuer with respect to the transaction.[2] To fulfill this statutory mandate, the Board issued Regulation II.

In developing the regulation, the Board first determined the categories of cost that would be in scope. Based on its reading of Section 1075, it concluded that these would be incremental costs of authorization, clearing and settlement of a particular debit card transaction as well as any other issuer costs that are specific to a particular debit card transaction. Next, the Board defined the individual types of costs incurred by debit card issuers within these categories that the Board considered relevant to the statutory purpose of Section 1075 ("allowable costs"). The Board explained in the supplementary information to the 2011 final rule that allowable costs consist of (i) transaction-processing costs, including fixed and variable authorization, clearance, and settlement costs, network processing fees (*e.g.*, switch fees), and the costs of processing chargebacks and other non-routine transactions; (ii) transaction-monitoring costs; and (iii) issuer fraud losses.[3] The Board elected to exclude other costs incurred by debit card issuers in

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[2] 15 U.S.C. § 1693o-2.

[3] 76 *Fed. Reg.* 43,394, 43,429–31 (July 20, 2011).

connection with their debit card programs, such as corporate overhead and account relationship costs; general debit card program costs (*e.g.*, card production and delivery costs, marketing costs, and research and development costs); and costs of non-sufficient funds handling, cardholder rewards, and cardholder inquiries (including call center costs and in-branch costs).[4] The Board made this determination despite the obvious financial benefits that inure directly to merchants as a result of such excluded costs being incurred by debit card issuers.

Merchants filed a lawsuit to challenge the Board's allowable costs formulation, asserting that the Board had been overly broad in its interpretation of Section 1075. In 2014, the D.C. Circuit held that the Board did not err when it determined the categories of costs that issuers were permitted to recover. Importantly, the court did not decide the issue of which individual types of costs should be included in allowable costs.[5] Therefore, the court holding does not foreclose the Board from revisiting its analysis of the individual types of costs included in allowable costs.

The Board's formulation of allowable costs left out many issuer costs that relate exclusively to an issuer's role in debit card transactions and consequently should be regarded as specific to a particular debit card transaction. (*See* Section II.A.) The Board then amplified the adverse effect of establishing an over-narrow set of allowable costs in its development of Regulation II by setting the interchange fee cap in Regulation II at a level that prevented smaller covered issuers from full recovery of even this subset of their total debit card issuance costs.

The Board's approach to setting the interchange fee cap was suspect. The Board contradicted its own precedent by interpreting "reasonable and proportional" in Section 1075 differently than it interpreted the same standard in the CARD Act, which was enacted just a year before the Dodd-Frank Act.[6] In that case, the Board adopted a safe harbor for late payment fees charged by issuers of credit cards that the Board believed would be generally sufficient to cover all costs incurred by issuers that are associated with late payments and other violations of cardholder agreements, including costs incurred by "most small issuers."[7] The Board also contradicted the express legislative intent of Section 1075, as straightforwardly communicated by its author, Senator Durbin. In a press release issued the day after the Senate approved his amendment, which added Section 1075 to the Dodd-Frank Act, the Senator explained that the "reasonable and proportional" standard in Section 1075 "is the same 'reasonable and proportional' standard that Congress directed the Fed to use to oversee consumer credit fees in

[4] *Id*. at 43,427–29.

[5] *NACS v. Board of Governors of the Fed. Res. Sys.*, 746 F.3d 474 (D.C. Cir. 2014).

[6] *See* 15 U.S.C. § 1665d(a) (requiring that the amount of any penalty fee that a card issuer may impose for a late payment fee for a violation of the cardholder agreement "shall be reasonable and proportional to such omission or violation.").

[7] 75 *Fed. Reg*. 37,526, 37,542 (June 29, 2010) ("the Board believes that . . . the safe harbor amounts . . . are generally sufficient to cover issuers' costs and to deter future violations. Based on the comments, the $25 safe harbor . . . is sufficient to cover the costs incurred by most small issuers as a result of violations.")

the 2009 Credit CARD Act."[8] The Senator's press release mirrored his floor statements from the debate over the amendment.[9] The Board's approach to setting the interchange fee cap also fully disregarded decades of precedent regarding the manner in which other federal agencies have implemented similar rate setting statutes.

The predictable and observable effect of the Board's narrow scoping of allowable costs and uncommon limitations on recovery of those costs was that the overall cost of operating a debit card program exceeded issuer revenues for many banks—especially smaller banks that were still large enough to be subject to the interchange fee cap—and many banks eliminated free checking, increased checking account fees and raised checking account minimum balances to address the governmentally-imposed cost-revenue imbalance. The clear winner of the Board's scoping of allowable costs has been U.S. merchants, and the clear loser has been low- and moderate-income Americans who most need free and low-cost checking accounts. Research, including from the Board's own staff, has shown this to be the case. In a 2017 study, two Board economists who are actively involved in the NPRM summarize the conclusion of their research on this topic as follows:

> Our results show that banks subject to the cap raised checking account prices by decreasing the availability of free accounts, raising monthly fees, and increasing minimum balance requirements, with different adjustment across account types. We also find that banks exempt from the cap adjusted prices as a competitive response to price changes made by regulated banks. Not accounting for such competitive responses underestimates the policy's impact on the market, for both banks subject to the cap and those exempt from it.[10]

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[8] Office of Sen. Richard Durbin, *Durbin Statement on His Debit Card Swipe Fee Amendment* (May 13, 2010), available at: https://www.durbin.senate.gov/newsroom/press-releases/durbin-statement-on-his-debit-card-swipe-fee-amendment.

[9] *See* 156 Cong. Rec. S3588-90 (daily ed. May 12, 2010) (statement of Sen. Richard Durbin) (remarking that Section 1075 would "use the same mechanism we used in credit card reform . . . which called on the Federal Reserve to establish the appropriate fees and charges to business establishments for the use of credit cards—and that [the Section 1075] fees and charges [would] be reasonable and proportional when it comes to debit cards. . . . It is the same standard which the Banking Committee and Senator Dodd offered when it came to credit card reform. It is not a radical notion. It is in the law already.").

[10] *See, e.g.*, Mark Manuszak and Krysztof Wozniak, *The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series, 2017-074 (2017). *See also* Vladimir Mukharlyamov and Natasha Sarin, *Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards* (Sept. 2022), at 3 (finding "significant evidence that banks offset the resulting loss of interchange revenue [from caps imposed under Regulation II] by raising checking account fees" and noting that "[t]hese higher fees are disproportionately borne by low-income consumers whose account balances do not meet the monthly minimum required for fee waiver").

Moreover, merchants have long asserted that consumers pay higher prices as a result of interchange fees,[11] with the implication being that consumer prices would decrease if interchange fees decrease. However, shortly after Regulation II went into effect, research from the Federal Reserve Bank of Richmond found that merchants did not in fact lower their prices as a result of the interchange fee cap on electronic debit transactions.[12] Another more recent study of retail gasoline merchants found that it is "virtually impossible" to quantify with statistical significance any pass-through to consumers by merchants of merchant savings from lower interchange fees.[13]

For these reasons, Governor Bowman rightly cautioned during the meeting at which the Board adopted the NPRM that "it is incumbent upon policymakers to understand the intended and unintended consequences of our revisions [to Regulation II]."[14] Despite Regulation II having been in effect for over a decade with no evidence that merchants pass interchange savings to consumers, merchants continue to trot out this justification in their advocacy for a lower interchange fee cap. When Governor Bowman posed a question to the Board's staff at the meeting about whether merchants would pass through lower prices to consumers and if there is evidence to suggest that Regulation II would benefit consumers,[15] the staff could not identify support for the claim of consumer benefits: "the question of merchant cost pass through is . . . recognized to be very difficult. Partly because prices are well known to be sticky, especially when the underlying cost changes are relatively small."[16] Not only have merchants not passed reduced debit interchange savings to consumers, but merchants often impose a surcharge on debit card transactions. Even though surcharging is contrary to payment card network rules and violates the laws of some states, merchants use surcharging to pass through interchange fees

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[11] *See, e.g.*, Letter from Merchants and Merchant Trade Associations to Board Chairman Powell and other Governors of the Board, dated July 27, 2020 (indicating a direct correlation between merchant prices paid by consumers and the level of the debit card interchange fee cap).

[12] *See, e.g.*, Zhu Wang, *Debit Card Interchange Fee Regulation: Some Assessments and Considerations*, Federal Reserve Bank of Richmond, Economic Quarterly, Vol. 98, Number 3 (3d Qtr. 2012) ("At this point, little empirical evidence has been reported on the change of merchant prices due to the debit interchange regulation.").

[13] Mukharlyamov and Sarin, *supra*, n. 10, at 4-5; *see also* Howard Chang, David S. Evans, and Daniel Garcia-Swartz, Federal Reserve Bank of New York, *The Economic Effects of Australia's Regulation of Interchange Fee Setting after Two Years*, Antitrust Activity in Card-Based Payment Systems: Causes and Consequences Conference (Sept. 15, 2005) (concluding that Reserve Bank of Australia intervention had "[n]o change in relevant prices at point of sale to consumer" after credit card interchange fee caps were introduced in Australia).

[14] Michelle W. Bowman, *Statement on Proposed Revisions to Regulation II's Interchange Fee Cap by Governor Michelle W. Bowman*, Board of Governors of the Federal Reserve System (Oct. 25, 2023).

[15] Governor Bowman stated: "the materials suggest that the benefits of this proposal will come from merchants passing on reduced fees to consumers in the form of lower prices, fewer price increases over time, or improved service quality. Is there any evidence to base that assertion on, that the effects of the final rule, whether they will benefit or harm consumers?" Board of Governors of the Federal Reserve System, Open Board Meeting Transcript, Governor Bowman at 12 (Oct. 25, 2023).

[16] Board of Governors of the Federal Reserve System, Open Board Meeting Transcript, Krysztof Wozniak at 12-13 (Oct. 25, 2023).

directly to consumers, which further calls into question the need for any reduction in the interchange fee cap.

The Board made interpretive choices in the drafting of the interchange fee cap provisions of Regulation II that were neither compelled by the text of Section 1075 nor an inevitable outcome of the statutory language. Smaller banks and consumers, particularly low-and moderate-income consumers, were harmed by those choices. As suggested by the Board's economists, the failure of the Board to account for competitive responses to Regulation II underestimated the harm caused by the Board's policy choices. Now the Board is revisiting Regulation II with the intent of lowering the interchange fee cap.

The Electronic Fund Transfer Act ("EFTA") requires that, in prescribing regulations for Section 1075, the Board must consider "the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers" and "the effects upon competition in the provision of electronic banking services among large and small financial institutions and the availability of such services to different classes of consumers, particularly low income consumers."[17] The staff memo to the Board discussing the NPRM asserts that the net effect of the NPRM on consumers is difficult to predict.[18] We disagree. The evidence from the Board's promulgation of Regulation II in 2011 is crystal clear. Consumers and smaller banks were harmed by the imposition of an interchange fee cap that the Board developed, and the magnitude of the harm will increase if the Board lowers the interchange fee cap. In this regard, we refer the Board to the comment letter submitted by 38 Members of Congress and the comment letter submitted by the Cities for Financial Empowerment Fund.[19] Both letters caution the Board about reducing the interchange fee cap, because accounts offered to unbanked and underbanked consumers through the Bank On initiative rely on interchange to make the accounts economically sustainable for the financial institutions that offer them. These comment letters address only one such program, but the NPRM would broadly harm low- and middle-income consumers and other comparable programs.

We encourage the Board to withdraw the NPRM not only because it would result in harmful policy, but also because the Board has not met the standard to issue the amendments to Regulation II required by the EFTA. For these reasons, the Board should not make any changes to Regulation II at this time.

If the Board chooses to finalize the amendments to Regulation II, this rule making process is an opportunity for the Board to reconsider elements of its Regulation II policy and possibly reverse some of that harm. At a minimum, though, the Board should do no further harm. Mastercard has identified elements of the NPRM, Regulation II and the Board's data

[17] 15 U.S.C. § 1693b(a)(2).

[18] Memorandum from Board Staff to Board, Subject: Proposed Revisions to Regulation II's Interchange Fee Cap, at 10 (Oct. 18, 2023).

[19] Letter from Members of Congress Nikema Williams, Blaine Luetkemeyer, et al., to Jerome Powell, Chair of the Board, dated March 5, 2024, and Letter from Jonathan Mintz, President and Chief Executive Officer, Cities for Financial Empowerment Fund, to the Board, undated.

collection activities for which the Board should reconsider its approach (or, in one instance, maintain the Board's approach) to better serve smaller banks and consumers without contravening the letter or spirit of Section 1075.

II. *Allowable Costs*

A. Determination of Allowable Costs

The Board erred in defining "allowable costs" when it issued Regulation II in 2011 and by not revisiting the definition when it issued the NPRM. Allowable costs are used to determine the base component and *ad valorem* component of the interchange fee cap. Thus, the definition of "allowable costs" is a critical element of the Board's implementation of Section 1075. In the NPRM, the Board gives light treatment to this important topic. Without elaboration, the Board notes only that it does not propose any changes to allowable costs because its prior analysis remains sound.[20] This is a surprisingly casual treatment of a central, and highly controversial, feature of the Board's original Regulation II rulemaking.

In 2011, we and other commenters identified in comment letters several ways in which the Board failed to properly define allowable costs.[21] Specifically, the Board's reading of the statutory phrase "specific to a particular electronic debit transaction" and other key language in Section 1075 unnecessarily limited allowable costs to average variable costs based on the number of transactions sent to the issuer, limited the costs it included within authorization, clearing and settlement costs and misinterpreted the reference to "reasonable and proportional" in the statute. The Board also disregarded decades of precedent that applies to government rate regulation in other industries. As a result, the Board's definition of "allowable costs" excludes corporate overhead and account relationship costs; general debit card program costs (*e.g.*, card production and delivery costs, marketing costs, and research and development costs); and costs of non-sufficient funds handling, cardholder rewards, and cardholder inquiries (including call center costs and in-branch costs). In short, Section 1075 should have resulted in a definition of "allowable costs" that equates to the full range of costs incurred by issuers with respect to each debit card transaction.

The Board should not finalize the NPRM without reconsidering the definition of allowable costs. This is particularly important as the Board proposes to lower the portion of allowable costs that issuers may recover and as the many costs of effecting a debit card transaction that the Board has disallowed have increased substantially since promulgation of Regulation II in 2011.

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[20] 88 *Fed. Reg.* at 78,104.

[21] *See* Letter from Shawn Miles, Senior Vice President, Group Head, Global Public Policy & Regulatory Strategy Counsel, Mastercard, to Jennifer J. Johnson, Secretary, Board, dated February 22, 2011, available at: https://www.federalreserve.gov/SECRS/2011/March/20110303/R-1404/R-1404_022211_67641_571589563753_1.pdf; *see also* 76 *Fed. Reg.* at 43,420.

B. Ensuring That Allowable Costs are Accurately Measured

Under the NPRM, the Board would determine the base component, *ad valorem* component and fraud-prevention adjustment for applicable periods based on the data reported in the Debit Card Issuer Survey, FR 3064a, as set forth in paragraphs (c) and (e) of Appendix B of the NPRM. In Item 7(a) of the Request for Comment in the NPRM, the Board asked about reporting challenges or data quality issues with each of the applicable line items from FR 3064a.[22] The Board also proposed in the NPRM to extend the use of FR 3064a without revision for three years.[23]

We are concerned that issuers may not be fully reporting their allowable costs in response to the biennial Debit Card Issuer Survey because the defined terms in FR 3064a do not make clear all the elements included in key line items. The relevant defined terms were adopted in 2011 and have not been updated since then.[24] However, more than a decade removed from 2011, debit card transactions have become substantially more complicated. At the time Regulation II was adopted, debit card transactions primarily occurred through swiping cards at merchant terminals or providing information to an agent or via a user interface checkout screen on a merchant website. In the present day, merchant terminals boast swipe, dip and tap capabilities, while card-not-present ("CNP") transactions have evolved to encompass card-on-file and tokenized transactions. These advances introduce additional costs for issuers. In light of these developments, the definitions relevant to considering the allowable cost of a transaction must adapt to reflect the current landscape.

We believe that the ambiguity in the defined terms results in issuers making judgment calls on what is reportable and invariably underreporting in order to be conservative. To address this concern, we request that the Board take this opportunity to revise form FR 3064a to update the examples of allowable costs to reflect innovative technologies. We propose changes in the FR 3064a glossary to the following terms, as indicated, with proposed new language underlined:

(i) "Third-party processing fees," which is a component of the amount reported in line item 3a:

> "**Third-party processing fees:** Fees paid to unaffiliated service providers for services related to the authorization, clearance, and settlement of debit card transactions that are performed by those service providers on behalf of the debit card issuer. Fees paid to unaffiliated service providers that are digital wallet operators that participate in the data flow between merchants and issuers as necessary for the authorization, clearance, and settlement of debit card transactions. Service providers may also include payment card networks or affiliates of payment card networks to the extent that such parties provide optional services related to transaction processing. They do not include other fees charged

[22] 88 *Fed. Reg.* at 78,114.

[23] *Id.* at 78,120.

[24] *See* 76 *Fed. Reg.* 79,184 (Dec. 21, 2011).

by a payment card network for services that are required for the network processing of transactions or fees charged by an affiliated processor (i.e., a processor in the same holding company).

(ii) “Total fraud-prevention and data-security costs” which is line item 5a:

“**Total fraud-prevention and data-security costs:** Costs related to activities aimed at identifying and preventing debit card fraud, costs related to the monitoring of the incidence of, reimbursements received for, and losses incurred from debit card fraud, costs related to responding to suspected and realized debit card fraud in order to prevent or limit losses, costs incurred in securing the data processing and communications infrastructure of debit card operations, and costs incurred in the development or improvement of fraud-prevention technologies. Examples include costs incurred to implement the following technologies and actions: EMV chip technology and contactless card technology; tokenization technology; machine learning and artificial intelligence used to detect patterns and anomalies in transaction data, thereby enhancing the precision of fraud detection; technologies that allow cardholders to easily enable or disable their cards, allowing cardholders to proactively prevent unauthorized transactions; technologies that allow cardholders to restrict transactions from specific geographies; technologies that identify merchants or industries known for high fraud risk; automated cardholder travel alerts and fraud alerts through text, email, or phone call; technologies for cardholder authentication, such as biometric authentication of in-person transactions and two-factor authentication for online and mobile transactions; card blocking and replacement upon detecting fraud, when a cardholder reports a lost or stolen card or as a result of a merchant breach; technologies to secure online banking platforms that can be used to access debit card information; technologies that improve the accuracy of debit card transaction information to allow cardholders to more readily identify fraud; technologies that secure communication channels used for debit card transactions; technologies that enable cardholders to easily stop recurring payments that may be the result of fraud; proactive issuer communications to educate cardholders on safe debit card practices; and reactive cardholder customer service to identify, prevent, respond and limit losses related to fraud.”

(iii) “Transaction monitoring costs,” which is line item 5a.1:

“**Transaction monitoring costs:** Costs related to programs that monitor transactions in order to assist in the authorization process by providing information to the issuer before the issuer decides to approve or decline the transaction. These costs include the costs of neural networks and fraud-risk scoring systems, and other technologies deployed for transaction monitoring, evaluation and alerts that inform issuer responses to transaction authorization requests.”

III. *Cost-Recovery Target*

The NPRM proposes a cost-recovery target of 98.5% of covered issuer transactions, and Item 2 in the Request for Comment in the NPRM asks whether the Board should select an alternative cost-recovery target.[25] Mastercard believes that the Board should use a 99.5% cost-recovery target to prevent the harm that would result from a reduction in the interchange fee cap.

A. Significant Decrease in Coverage is an Unreasonable Departure from Current Regulation

In the supplementary information to the NPRM, the Board includes a table that shows the percentage of covered issuers that fully recovered their base component costs (77%) in 2021 and the percentage of covered issuers that would have fully recovered their base component costs in 2021 under various sample cost-recovery targets using the Board's proposed allowable cost calculation methodology: 99.5%, 99.0%, 98.5%, 98.0% and 95.0%. As provided in the table, the proposed 98.5% cost-recovery target would have resulted in 66% of covered issuers fully recovering their base component costs in 2021 had the relevant base component calculation been in effect in 2021. Stated differently, approximately one-third of covered issuers would not have fully recovered their base component costs. The table also provides that a 99.5% cost-recovery target would have resulted in 76% of covered issuers fully recovering their base component costs in 2021 if the proposed calculation methodology had been in place in 2021.[26] Of the sample cost-recovery targets set forth in the table, the 99.5% cost-recovery target would result in the closest percentage of covered issuers that would have fully recovered their base component costs to the actual percentage (77%) of covered issuers that fully recovered their base component costs in 2021.[27]

There is no policy justification for the Board proposing a rule change that would result in a lower percentage of covered issuers recovering allowable costs. Section 1075 does not require it, and the Board has advanced no rationale for this proposed change other than not wanting to support supposed issuer inefficiencies. Moreover, a decline in the allowable costs of processing electronic debit transactions since 2011 does not justify a decline in the percentage of covered issuers that should fully recover their base component costs.[28] These two data points must operate independently if the interchange fee cap is to be set at a level that is reasonable and proportional to smaller covered issuer allowable costs.

Such a rule change would only compound the pressure that issuers already experience as a result of not being able to fully recover their costs of providing debit card transactions through interchange. In recent remarks, Governor Bowman labeled this approach in the NPRM as

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[25] 88 *Fed. Reg.* at 78,113.

[26] *Id.*

[27] *Id.*

[28] *See also infra* part III.D (discussing that overall debit program costs have increased).

"rough justice," implying that smaller covered issuers are the ones being treated roughly.[29] Frankly, a change to Regulation II that results in fewer covered issuers fully recovering their allowable costs, with the strain felt most acutely among smaller covered issuers, is exactly the type of consequence that the Board should avoid and that Governor Bowman cautioned needs to be understood.

B. Material Harm to Smaller Covered Issuers

The proposed cost-recovery target would materially harm smaller covered issuers. These issuers have assets above the $10 billion threshold for exemption from the interchange fee cap but are nowhere near the size of the nation's largest banks. These issuers also are those most likely to have the highest base component costs.

The implication in the NPRM and the Board's discussion in the supplementary information adopting Regulation II in 2011 is that covered issuers with the highest costs are not efficient and thus experience high costs as a result of their own poor operations. For example, the Board states in the NPRM that "the full cost recovery for the highest-cost covered issuer transactions would not be reasonable" and refers to the difference between covered issuer transactions above the proposed percentile and covered issuer transactions below the proposed threshold as the "efficiency gap."[30] The position of the Board that issuer allowable costs above a certain threshold are unreasonable and therefore should be unrecoverable does not derive from Section 1075. It was developed by the Board based on the proposition that cost inefficiency (in purely economic terms) should not be rewarded and seemingly without any policy consideration of the important role of smaller covered issuers in the banking system. It stands in contrast with nearly all other Board regulations that have an explicit cost component (*e.g.*, capital and liquidity regulations), which scale with the size of the depository institution.

Because of the Board's position, Regulation II imposes a larger relative cost on smaller covered issuers than large covered issuers, and the NPRM would exacerbate this harm. We do not accept the Board's inefficiency premise. Higher costs for smaller covered issuers are frequently not due to inefficiencies or poor management of operations, but rather result from the relationship between the size of their debit card portfolios and the common method of pricing of support services in the debit card industry. Many processing-related fees are determined based on transaction volume, and smaller covered issuers with lower transaction volume pay higher per-transaction fees. Additionally, some companies that provide services to issuers offer a suite of services (*e.g.*, issuer processing, debit network and anti-fraud software) that are needed by issuers and offer price discounts based on the totality of an issuer's spend. This dynamic magnifies the disproportionality in buying power between large covered issuers and smaller covered issuers. This is the nature of the prevalent volume-based pricing, and we see no policy

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[29] Michelle W. Bowman, *Reflections on the Economy and Bank Regulation*, remarks to the Florida Bankers Association Leadership Luncheon Events (Feb. 27, 2024).

[30] 88 *Fed. Reg.* at 78,107. The NPRM also cites to the Board's determination when it issued the final rule that it "did not believe that it was consistent with the statutory purpose to permit networks to set interchange fees in order to accommodate 100 percent of the average per-transaction costs of the highest-cost issuers." *Id.* at n. 45 (citing 76 *Fed. Reg.* at 43,433).

reason to regard the costs smaller covered issuers incur as unreasonable and thus outside the scope of reasonable recovery.

The Board's most recent report on covered issuer costs supports the fact that smaller covered issuers experience higher authorization, clearing and settlement ("ACS") costs. Specifically, the average per-transaction ACS cost for low-volume issuers was more than 17 times higher than the cost for high-volume issuers, and third-party processing fees for low-volume issuers comprise a higher percentage of overall ACS costs compared to high- or medium-volume issuers.[31]

We are also concerned that the NPRM could harm the long-term viability of smaller covered issuers to the detriment of consumers. As discussed above, the Board's 2011 Regulation II interchange fee cap formulation caused issuers to make changes to their checking account availability and pricing to the detriment of low- and moderate-income consumers. The exacerbation of consumer harm as a result of the Board now proposing to lower the interchange fee cap is reason for concern. Indeed, Governor Bowman has remarked that banks "may need to make some tough decisions about the path forward"[32] for their debit card programs and specifically that "one consequence [of adopting the NPRM] may be that banks discontinue their lowest-margin products, including options designed to increase financial inclusion and access for low- and moderate-income individuals and families."[33] It is possible that smaller covered issuers react to the lower interchange fee cap in the same way as they did in 2011. It is also possible that they decrease future investments in debit card services that are favorable for consumers.

There may also be limits to the actions that smaller covered issuers can take to address a Board-mandated imbalance in the revenues and costs of debit card issuance, and their utility may now or in the near future be exhausted. If the Board further tilts the revenue-cost imbalance of smaller covered issuers, it is possible that the Board's action will be a catalyst for some smaller covered issuers concluding that they lack the scale to operate profitably. After all, many smaller covered issuers do not have diversified products and services that could otherwise compensate for losses in revenue from decreased debit interchange fees. The result would be fewer smaller covered issuers and more large covered issuers. Again, low- and moderate-income consumers will be harmed, as they are most likely to depend on smaller community banks to serve their needs.

C. Exempt Issuers Will Be Affected Too

Even though issuers that, together with their affiliates, have under $10 billion in assets are exempt from the interchange fee cap in Regulation II, lowering the interchange fee cap through a lower cost-recovery target will still harm these issuers. The Board's historical data

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[31] Board, *2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*, at 25, 26 and 38 (Oct. 2023).

[32] Bowman, *supra* n. 29.

[33] Bowman, *supra* n. 15.

shows that interchange fees for exempt issuers have fallen since the adoption of Regulation II,[34] and lowering the interchange fee cap will further drive down exempt issuer interchange fees. This will result from the Regulation II two-network provision, which gives large merchants pricing power over networks. These merchants currently use this governmental grant of power to demand below-market interchange fees on all debit card transactions. By lowering the interchange fee that applies to issuers that are subject to the interchange fee cap, the Board will incentivize these merchants to demand lower interchange on the debit card transactions of exempt issuers. Governor Bowman touched on this very concern in a speech earlier this year: "the proposed revisions to Regulation II have generated concern from banks directly subject to the rules, but also from exempt banks concerned that the practical effect will be to push lower interchange fees down to all debit card issuers."[35]

D. Increases in Overall Debit Program Costs

As discussed above, when the Board originally issued Regulation II, the Board designated allowable costs as well as other costs that were not allowable for cost recovery. The fact that the Board has observed a decrease in allowable costs in Debit Card Issuer Survey data does not mean that total costs for covered issuers of offering a debit card program have decreased. To the contrary, we understand that the non-allowable costs of operating a debit card program have increased since 2011. Accordingly, if the Board sets the cost-recovery target at a level lower than the current level of covered issuer cost recovery, the dimension of covered issuer harm will not merely be the reduction in allowable cost recovery but also interchange-derived cost recovery relative to *an increasing overall cost* to provide electronic debit transactions to cardholders. Thus, the Board should ensure the greatest recovery of allowable costs possible for covered issuers given that lower interchange cost recovery will put pressure on the overall economics of debit card programs that will generate the type of unintended consequences that the Board's economists observed in hindsight after they developed the 2011 interchange fee cap.

E. Shift in Economics Hurts Consumers

Regulation II provided a multi-billion dollar economic windfall to merchants at the expense of issuers, and the NPRM would further tilt the debit card economics in favor of merchants. Merchants did not pass along the Regulation II cost savings to consumers and will not do so if the Board lowers the interchange fee cap as proposed in the NPRM. On the contrary, before Regulation II transferred economics from issuers to merchants, issuers provided more no-fee and low-fee deposit products and other pro-consumer services. Perhaps issuers used the pre-Regulation II interchange revenue to benefit consumers because of the Community Reinvestment Act or because they must answer to federal government regulators that prefer a financially inclusive banking environment. Perhaps merchants dropped the post-Regulation II savings to their bottom line because they are unregulated. Whatever the reason, it is clear that consumers,

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[34] Board, *Average Debit Card Interchange Fee by Payment Card Network*, Data for Previous Years, available at: https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm (comparing average interchange fees for the 2011 period before the Regulation II effective date to the average interchange fees for 2022).

[35] Michelle W. Bowman, *New Year's Resolutions for Bank Regulatory Policymakers* (Jan. 8, 2024).

particularly low- and moderate-income consumers, suffer when the Board shifts debit transaction economics in favor of merchants. It also is clear that doing so is the expression of policy choices by the Board that Section 1075 does not compel. We urge the Board to take this effect on consumers into consideration in its determination of what cost-recovery target will result in "reasonable and proportional" issuer cost recovery.

IV. *Interchange Fee Cap Adjustments*

If the Board finalizes the NPRM, it should revisit its proposed approach to periodically adjusting the interchange fee cap. There are several ways in which the Board could address this topic to minimize unnecessary adverse consequences.

A. The Board Must Review Methodology Results and Allow for Notice and Comment at Each Reset Point

As described below, the Board's methodology for updating the interchange fee cap on a two-year basis is likely to be influenced by anomalous events and diverge from actual cost trends. Because Section 1075 mandates that the Board's standards be "reasonable and proportional" to the cost of debit transactions, it would be arbitrary and capricious under the APA for the Board to adopt a new interchange fee cap without ensuring that a particular cap is reasonable and not a result of statistical aberration or data impacted by intervening events. The Board should adopt procedures to require reasonableness review and provide for notice and comment before each adoption of a new cap. The Board should also conduct a periodic review of its formula to determine whether it in fact results in a cap that is "reasonable and proportional" to costs across effective periods. Accordingly, the Board should decline to adopt its current proposal, pursuant to which it "would not be exercising any discretion in connection with such [reset] determinations," and does not provide for regular evaluation of its methodology.[36]

Even where the Board has adopted a formula through final rulemaking, it maintains an obligation pursuant to Section 1075 to ensure that the resulting cap for a given period is reasonable.[37] While a formula can be helpful, "the ultimate responsibility for the policy decision remains with the agency rather than the computer."[38] For that reason, the Board may not permissibly refuse to consider the output of the formula. Instead, it must review the results of its

[36] 88 *Fed. Reg.* at 78,109 n. 59.

[37] "It goes without saying that the agency cannot sidestep a reexamination of particular regulations when abnormal circumstances make that course imperative." *Geller v. FCC*, 610 F.2d 973, 979 (D.C. Cir. 1979) (cleaned up); *see also id.* at 980 (noting that agency maintains a continuous obligation to ensure its rules meet its statutory mandates as conditions change).

[38] *Sierra Club v. Costle*, 657 F.2d 298, 334 (D.C. Cir. 1981) (approving of EPA's use of notice and comment rulemaking when relying on complex modeling).

methodology to determine whether the formula's output is a reasonable fee cap for each effective period.[39]

The Board must then provide for notice and comment before finalizing the new cap. "Public notice and comment regarding relied-upon technical analysis are 'the safety valves in the use of sophisticated methodology.'"[40] Consistent with that rule, federal agencies applying complex formulas based on market data commonly provide for notice and comment each time they update their rates.[41] The Board should follow suit. Such a practice is essential to allow for regulated parties and the general public to ensure agency regulations are sufficiently tested.[42]

The NPRM suggests that the Board proposed to forego review of the formula's output so that it could invoke the "good cause" exception to an agency's general obligation to engage in notice and comment rulemaking.[43] If so, that consideration is misplaced. This is not one of the narrow circumstances in which notice and comment is "unnecessary" because the agency action is "insignificant in nature and impact, and inconsequential to the industry and the public."[44] On the contrary, the Board's formula for setting the interchange rate cap involves the complex consideration of industry data and will have far-reaching effects, both intended and unintended.[45] Particularly where the Board's chosen effective period is just two years, each new fee cap risks significant volatility that would impact, and create uncertainty for, the industry and consumers alike. The Board cannot evade its obligation to go through notice and comment by refusing to consider whether the fee cap is substantively reasonable.

To be clear, while the proposed two-year reset interval increases the likelihood that the methodology will not accurately reflect the true state of costs in the industry, the obligation to

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[39] *See City of Idaho Falls v. FERC*, 629 F.3d 222, 230 (D.C. Cir. 2011) ("[W]e may not defer to an agency interpretation that would cause a regulation to violate the very statute the agency administers."); *id.* at 229 (emphasizing that statutory obligation to set "reasonable" rate was mandatory).

[40] *Am. Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 236 (D.C. Cir. 2008) (quoting *Sierra Club*, 657 F.2d at 334) (cleaned up).

[41] *See e.g.*, 88 *Fed. Reg.* at 55,629-55,660 (Coast Guard proposed rule regarding 2024 Great Lakes Pilotage Rates); *Se. Alabama Med. Ctr. v. Sebelius*, 572 F.3d 912, 914 (D.C. Cir. 2009) (noting that HHS updates annual cost-related rate through notice-and-comment rulemaking.).

[42] *See Chamber of Com. of U.S. v. S.E.C.*, 443 F.3d 890, 900 (D.C. Cir. 2006) ("[T]he APA provides a procedural device to ensure that agency regulations are tested through exposure to public comment, to afford affected parties an opportunity to present comment and evidence to support their positions, and thereby to enhance the quality of judicial review.").

[43] *See* 88 *Fed. Reg.* at 78,109 n. 59. Under 5 U.S.C. § 553, good cause to forego required notice and comment may exist where it is "impracticable, unnecessary, or contrary to the public interest." However, "the good cause exception is to be 'narrowly construed and only reluctantly countenanced.'" *Tennessee Gas Pipeline Co. v. FERC*, 969 F.2d 1141, 1144 (D.C. Cir. 1992).

[44] *Mack Trucks, Inc. v. EPA*, 682 F.3d 87, 94 (D.C. Cir. 2012) (quoting *Util. Solid Waste Activities Grp. v. EPA*, 236 F.3d 749, 755 (D.C. Cir. 2001) (announcing the standard for the "unnecessary" prong of the good cause exception).

[45] *See supra* part III.B-D (discussing consequences of rate cap change).

review the results exists at longer intervals as well, given the inherent risk that within any one period, events (*e.g.*, a global pandemic) or changed circumstances (*e.g.*, technological evolutions) might transpire and undermine the Board's expectations regarding the utility of the methodology to accurately measure costs. At least in such circumstances, automatic adoption without review of a fee cap based solely on that methodology would be unreasonable, arbitrary and capricious.[46] And regardless of the chosen effective period, the Board must provide for notice and comment before adopting a new interchange fee cap.

In addition to reviewing each new interchange fee cap, the Board should commit to conducting a periodic review of its underlying formula to ensure its efficacy—and thus reasonableness.[47] The Board's discretion to make rules "based upon predictive judgments deriving from its general expertise [] implies a correlative duty to evaluate its policies over time to ascertain whether they work—that is, whether they actually produce the benefits the [Board] originally predicted they would."[48] Data not captured in the Debit Card Issuer Survey could reveal shortcomings in the present calculation methodology that would otherwise result in a mismeasure of costs for debit transactions. For example, we noted technological changes—*e.g.*, tap technology quickly adopted by end-consumers—that transformed the nature of debit transactions in ways not reflected in the methodology adopted by the Board in 2011. The Board should proactively evaluate the accuracy of its formula rather than "be forced to reexamine its approach" in light of industry changes.[49] These advances in technology have already highlighted the weaknesses in the Board's methodology. As this development continues, the Board's formula will need to be updated. Without periodic review and revision, the Board's formula is very likely to produce unreliable results that lead to the adoption of unreasonable interchange fee caps.

We recommend the Board incorporate into the final rule a provision to review the results of its formula, provide for notice and comment before adopting a fee cap change, and commit to regularly evaluating the efficacy of its methodology.

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[46] *See City of Idaho Falls*, 629 F.3d at 226-30 (vacating agency action where automatic, "ministerial" update to annual rates was based on formula in which variable of underlying data changed dramatically from previous year); *see also W. Coal Traffic League v. United States*, 677 F.2d 915, 927 (D.C. Cir. 1982) (approving rate reset approach where Interstate Commerce Commission "stated its intention to periodically check the results of its current methodology against other data sources. . ." and "expressed its willingness to consider altering its methodology . . . at some later date.").

[47] In determining the reasonableness of agency action, courts have considered whether the agency will monitor the efficacy of its chosen formula. *See, e.g.*, *W. Coal*, 677 F.2d at 930 (highlighting court's expectation that the agency would periodically review its methodology, as promised); *Ass'n of Oil Pipe Lines v. FERC*, 876 F.3d 336, 340 (D.C. Cir. 2017) (noting court's previous denial of challenges to agency formula where, *inter alia*, agency "determined that consistent monitoring of the formula would be *necessary* to measure [its] continued [accuracy]" and "committed to revisit the formula every five years." (emphasis added)).

[48] *Bechtel v. FCC.*, 957 F.2d 873, 881 (D.C. Cir. 1992).

[49] *Id.* (quoting *WWHT, Inc. v. FCC*, 656 F.2d 807, 819 (D.C. Cir. 1981)).

B. Postpone Issuing a Final Rule Until 2023 Survey Data is Available

The Board should not determine whether to update the interchange fee cap in Regulation II at least until issuer data becomes available for 2023. While the Board reports that certain issuer costs have been decreasing since 2009,[50] we believe that this trend may have changed since mid-2023 with respect to issuer fraud costs. Recently, CNP fraud has accounted for almost half of overall fraud,[51] and it is possible that the 2023 issuer survey will show that the cost of CNP fraud (and thus overall fraud) is trending upward because of the amendment to Regulation II that became effective in 2023. These amendments effectively require issuers to enable a so-called "PINless" service of a single-message network for CNP transactions.[52] When a merchant routes a debit transaction using a regional debit network PINless service, transactions will travel over a network without the protection of PIN authentication with potentially fewer security controls. We regard these regional debit network PINless services as significantly less secure than Mastercard and expect issuer fraud losses to trend upward as merchants increasingly route transactions to regional debit network PIN-less services.

C. The Board Should Adopt a Cadence of at Least Four Years

The Board proposes to recalculate the interchange fee cap every two years based on the most recent Debit Card Issuer Survey results, beginning with the period from July 1, 2025, to June 30, 2027. In Item 1 of the Request for Comment in the NPRM, the Board asks whether the proposed two-year cadence of determining the interchange fee cap is appropriate.[53] We are concerned that a two-year period for resetting the interchange fee cap is too short and will result in aberrations. We recommend that the Board adopt a period of at least four years if the Board determines to finalize the periodic recalculation proposal.

Congress has not compelled the Board to make updates to the interchange fee cap or to make any such updates on a particular timeline. If the Board does so, the Board should exercise care to set a cadence that will be minimally disruptive within the statutory parameters of "reasonable and proportional." Interchange rate caps calculated on a two-year cadence are susceptible to significant deviations in allowable costs that results from external factors. For example, in the proposed initial measurement period of 2020-2021, the COVID-19 pandemic and the CARES Act resulted in overall debit card usage and online debit card usage that deviated significantly from historical patterns, which affected issuer allowable costs in an uncommon, nonrecurring manner. Moreover, we have some concern about the accuracy of the issuer survey results from this period of significant disruption.

Also, using a two-year cadence may result in frequent changes to the interchange fee cap that do not reflect trends in the data. In addition, changing the interchange fee cap every two

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[50] *See, e.g.*, 88 *Fed. Reg.* at 78,105.

[51] *Id.* at 78,118.

[52] 87 *Fed. Reg.* 61,217 (Oct. 11, 2022).

[53] 88 *Fed. Reg.* at 78,113.

years would be unnecessarily disruptive to the financial and technology planning of issuers. Banks commonly plan investments in their debit card business on a multi-year basis taking into consideration not only costs but also projected revenues. Moreover, bank technology investments in the debit card business often are for the purpose of lower fraud risks, increasing cardholder safety and security, or improving the card features and utility. We are concerned that the potential for issuer interchange revenues to fluctuate on a biennial basis will discourage appropriate issuer investments in these types of technologies that improve the cardholder experience and benefit the debit card ecosystem.

Accordingly, we believe that there is little benefit to adjustment periods that are too short to reflect meaningful trends in the data.

D. Minimum Threshold for Changes

Furthermore, we recommend that the Board incorporate into the final rule a minimum threshold of change in allowable costs below which the Board will not reset the interchange fee cap. In particular, the Board should not reset the interchange fee cap unless there is at least a 10% change in the transaction-weighted average of per transaction base component costs and the determination calculation provides a change of at least one cent from the then-current interchange fee cap. The Board issued the NPRM in part because it believes that the interchange fee cap "should be updated regularly and predictably to reflect changes in the allowable costs incurred by covered issuers as those changes occur."[54] If the changes reported on a periodic basis to the Board do not change in any significant way, then there would be no need to update the cap. Surely, interchange fee cap adjustments below some minimum percentage threshold would be unnecessary to maintain an interchange rate that is reasonable and proportional to issuer costs as directed by Section 1075.

E. Timing of Announcements and Effect of Changes

The Board does not identify a policy reason for its proposal to publish updates to the interchange fee cap by March 31 and for the interchange fee cap to become effective by July 1, and we are not aware of one. In Item 9 of the Request for Comment in the NPRM, the Board seeks public comment on whether this timeline would provide sufficient notice to covered issuers, payment card networks, and other industry stakeholders to prepare for changes to these amounts.[55]

These dates would not provide sufficient notice and should be revised to align with industry planning cycles. The payment card industry typically releases technology and operational changes in October and April. Any change to the interchange fee cap, whether up or down, should conform to the October/April cadence of related efforts.

If the Board finalized the NPRM proposal to periodically recalculate the interchange fee cap, we urge the Board to revise the proposed timing so that it announces changes to the

[54] *Id.* at 78,119.

[55] *Id.* at 78,114.

interchange fee cap on October 1 (or earlier) with an effective date of those changes on April 1 of the following year. This revision would result in the Board providing sufficient notice of an interchange fee cap change, will align with other payment card industry periodic change notices and will allow banks to plan for the financial effects of changes to the interchange fee cap.

F. Interchange Should Be Determined at Clearing

The Board should make a modification to the proposed commentary to facilitate payment network implementation of the final rule. Proposed comment 235.3(b)-4 would clarify that an electronic debit transaction is considered to be performed on the date on which such transaction is settled on an interbank basis. The example given in the proposed comment is that an electronic debit transaction that is authorized and cleared on June 30, 2023, but is settled on an interbank basis on July 1, 2023, is considered to be performed on July 1, 2023.

Mastercard determines the interchange rate to be paid to an issuer for a debit card transaction based on the date of the clearing message. If the Board determines to reset the interchange fee cap periodically and it adopts this comment as proposed, the first day on which a new interchange fee cap becomes effective, Mastercard will collect and transmit to issuers incorrect interchange. However, this problem can easily be avoided by the Board revising the proposed comment to indicate that the date of a debit card transaction for purposes of determining the appropriate interchange fee payment is the date on which the transaction clears the payment network.

V. *Ad Valorem and Fraud Prevention Adjustment Methodologies*

The Board proposed to use the same methodology going forward as it used in 2011 to determine the *ad valorem* component of the interchange fee cap and the same methodology as used previously to determine the fraud prevent adjustment, except that the Board would now directly calculate this metric rather than approximating it. In Items 4 and 5 of the Request for Comment in the NPRM, the Board asked if it should use alternative methodologies to determine these components.[56]

We encourage the Board to pause and rethink its approach to the *ad valorem* and fraud prevention adjustment methodologies. The decision in 2011 to establish an *ad valorem* component and fraud prevention adjustment that results in only half of covered issuers recouping their costs is yet another Board policy choice that was not required by Section 1075. Like the Board's concept of allowable cost recovery, the *ad valorem* component of the interchange fee cap falls short of the "reasonable and proportional" standard by depriving half of all covered issuers from recovering fraud losses. For the same reason, the fraud prevention adjustment methodology fails to provide the statutorily mandated "reasonably necessary" level of fraud prevention cost recovery. In the years that have passed since the issuance of Regulation II, the adverse effects of the Board's policy choices on smaller covered banks and consumers have become clear. The Board is not compelled by the letter or spirit of Section 1075 to continue down a path with Regulation II that narrowly scopes permitted interchange. Rather, the Board

[56] *Id.* at 78,114.

has the authority to reconsider the choices it made in 2011 with respect to the *ad valorem* and fraud prevention adjustment methodologies with the benefit of a decade of data and we urge it to do so.

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Mastercard appreciates the opportunity to provide comments to the NPRM. If there are any questions regarding our comments, please do not hesitate to contact the undersigned at (914) 249-1582 or Tina.Woo@mastercard.com or our counsel at Sidley Austin LLP in this matter, Joel Feinberg, at (202) 736-8473, and Stan Boris, at (202) 736-8227.

Sincerely,

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Senior Managing Counsel
Regulatory Affairs

cc: Randi Adelstein, Mastercard International Incorporated
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