

May 10, 2024

Ann E. Misback, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue NW  
Washington, DC20551

Re: FRS Docket no. R-1818, RIN 7100-AG67

This letter is submitted by Ronald Bird in response to the Federal Reserve System's (hereafter, Fed) request for public comments pursuant to its publication at 88 Federal Register 218, Tuesday, November 14, 2023, p. 78100 of a proposed rulemaking entitled "Debit Card Interchange Fees and Routing." A notice published at 89 Federal Register 19 Monday, January 29, 2024, p. 5438, extended the deadline for public comment submissions to May 12, 2024. The proposed rulemaking will reduce the existing Fed Regulation II (hereafter, Regulation II) ceiling on transaction interchange fees received by covered debit card issuers.

**SUMMARY.** The proposed rulemaking is not justified by adequate data and analysis. The most egregious problem with the Fed's proposed regulation is its failure to address the critical issue of payment card transaction security and the need to protect consumers, merchants, and card-issuing banks from the mounting losses of debit card fraud. The Fed's own data<sup>1</sup> reveals fraud losses for debit cards covered by the existing Reg II interchange fee ceiling increased from 7.8 basis points relative to transaction value in 2011 (when Regulation II was first promulgated) to 17.5 basis points in 2021. The growth of debit card fraud losses in terms of basis points relative to transactions among the subset of payment

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<sup>1</sup> Board of Governors of the Federal Reserve System, "2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions," October 2023, p. 3. See also pp.19-24. Available at [Federal Reserve Board - Regulation II - Reports and Data Collections](#).

cards covered by Regulation II was more than twice the rate of growth of fraud losses across all U.S. consumer payment cards combined.<sup>2</sup>

The Fed's proposal addresses the costs incurred by debit card issuers for fraud-prevention activities, but it fails to recognize or analyze reasons for the disparity in fraud incidence and losses for debit cards covered by Regulation II compared to types of electronic payment instruments not covered by Regulation II. The Fed's proposal to increase the fraud prevention add-on to the interchange fee allowance from one cent to 1.3 cents per transaction fails to consider important analytical questions of (1) whether current expenditures by covered debit card issuers are sufficient to deter fraud and (2) whether the higher growth rate of fraud losses among covered debit card issuers compared to other payment card (exempt debit and credit) issuers was related to the existing interchange fee ceiling or might be exacerbated by the proposed reduction in the ceiling.

Other issues discussed in this letter include the Fed's failure to comply with the regulatory cost versus benefit analysis requirements of the Electronic Funds Transfer Act, the impropriety of the Fed's proposal to automatically adjust the fee ceiling parameters biennially, the need for the Fed to revise its survey data collections to facilitate comparisons of fraud prevention effectiveness between transaction processing networks, and the failure of the Fed to recognize the realities of competition among the card issuers and networks in the debit card and other segments of the payment cards market.

The Fed has not undertaken the difficult and complex work of empirically estimating the economic costs and benefits of its proposal. The Fed already does or readily could collect the requisite data and it has the staff resources to conduct the requisite econometric analyses of the data.

The EFTA, which governs the Fed's regulatory authority in this case, requires the Fed to show that the benefits of the proposed rulemaking exceed the costs in the aggregate, but the Fed has failed to present any credible data-driven

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<sup>2</sup> Author's calculations based on Euromonitor Passport Data at <http://www.portal.euromonitor.com> and total transactions estimates from the Federal Reserve Payment Study reports for 2011-2021 data ([Federal Reserve Board - Federal Reserve Payments Study \(FRPS\)](#)).

finding to a reasonable degree of economic scientific certainty that the benefits of the proposal will exceed its costs.

**STANDING AND INTEREST.** In addition to my personal interest in the rulemaking proposal as a debit cardholder, I am also interested in this proposed rulemaking from my professional perspective as an economist whose research focuses broadly on the federal regulatory process and on the economic benefits and costs to society of regulatory decisions. My perspective is that regulatory agencies should approach rulemaking decisions with cautious regard for both the intended and unintended consequences of their decisions. Good regulatory decisions should be informed by a clear understanding of the market structure directly impacted by the proposed action and of the inter-relationships of the affected market with other markets and with the economic decisions of consumers, businesses, and investors.

Timely and accurate data is foundational for every regulatory analysis and decision, and when data is found to be insufficient, it is the responsibility of the regulatory agency to seek and obtain better data before proceeding. Federal agencies have immense resources and authority at their disposal to obtain and analyze the data needed to inform regulatory decisions.

In the case of the proposal at hand, the regulatory agency has a special obligation to conduct a thorough retrospective evaluation of the economic and social impacts of the existing rule before proposing any revisions.

**FRAUD.** Payment card fraud (both debit and credit) is a major and growing problem worldwide. Table 1. shows that combined stolen/lost card, counterfeit card, or card not present types of card fraud, which includes both debit and credit cards, was a \$16.4 billion dollar dead-weight loss to the global economy in 2021. The \$10.9 billion share borne by U.S. consumers, merchants, banks, and processing networks in 2021 was 68 percent of the world total (Table 2), and at 12.9 percent per year, payment card fraud annual growth in the U.S.

exceeds the world average. Payment card fraud amounted to 99.3 percent of all consumer-related financial fraud in the U.S. in 2021.

**Table 1. Worldwide Consumer Financial Fraud 2012-2021  
(millions U.S. dollars)**

<b>Data category:</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>
<b>World Total All Types</b>	7,845.5	8,325.7	8,995.4	9,170.0	9,672.1	10,438.7	11,492.4	12,005.4	13,493.4	16,431.0
<b>World Total Payment Card Fraud</b>	7,522.0	8,003.8	8,663.0	8,861.7	9,365.3	10,090.0	11,123.5	11,626.8	13,079.5	15,980.6
<b>Card fraud % All consumer fraud</b>	95.9%	96.1%	96.3%	96.6%	96.8%	96.7%	96.8%	96.8%	96.9%	97.3%
<b>US Payment Card Fraud</b>	3,641.8	3,878.2	4,266.6	4,694.7	5,139.6	5,770.3	6,375.2	7,010.7	8,428.4	10,861
<b>US card fraud % world card fraud</b>	48.4%	48.5%	49.3%	53.0%	54.9%	57.2%	57.3%	60.3%	64.4%	68.0%
<b>US card fraud % of all US consumer fraud</b>	98.8%	98.9%	98.9%	99.0%	99.0%	99.1%	99.2%	99.2%	99.2%	99.3%

Note: Payment cards include both debit and credit types. Fraud losses are losses to consumers by country of residence. Types of payment card fraud are 1. Lost or stolen, 2. Counterfeit card, 3. Card Not Present. Identity theft and all other types of consumer fraud are included in the World Total All Types Row and in the percentage calculation of “US card fraud % of all US consumer fraud.”

Source: Euromonitor Passport Data at <http://www.portal.euromonitor.com>. Available documentation does not reveal whether or not business-owned payment cards issued to employees are included in the definition of consumer fraud data. Clarification on this point is being sought.

Credit card fraud is a significant cost to merchants and card-issuing banks worldwide. According to the Nilson report, card-issuing banks or processing networks absorb the largest share of credit fraud losses. Having issuing banks and their affiliated networks absorb card fraud losses is a sound practice from both business marketing and economic efficiency perspectives: It reduces

merchant and cardholder anxiety, which encourages merchant acceptance and consumer use of payment cards, and it places the incentive to develop and deploy effective card security technology and protocols on the market participant best positioned to do so.

<b>Table 2. International Comparisons of Payment Card Fraud Losses 2012 and 2021</b>				
Million US Dollars			Annual growth rate	Percent of world total 2021
	2012	2021		
USA	\$ 3,641.8	\$ 10,861.1	12.9%	68.0%
Mexico	\$ 442.4	\$ 784.3	6.6%	4.9%
Canada	\$ 474.9	\$ 776.7	5.6%	4.9%
United Kingdom	\$ 564.4	\$ 732.9	2.9%	4.6%
Australia	\$ 244.9	\$ 524.4	8.8%	3.3%
France	\$ 418.0	\$ 488.7	1.8%	3.1%
China	\$ 299.5	\$ 327.8	1.0%	2.1%
Peru	\$ 102.1	\$ 218.1	8.8%	1.4%
Germany	\$ 140.4	\$ 135.5	-0.4%	0.8%
India	\$ 88.8	\$ 118.8	3.3%	0.7%
Other 37 Countries	\$ 1,104.8	\$ 1,012.3	-1.0%	6.3%
World Total	\$ 7,522.0	\$ 15,980.6	8.7%	100.0%
US Percent World Total	48.4%	68.0%	3.8%	
<b>Note:</b> Available documentation does not reveal whether business-owned payment cards issued to employees are included in the definition of consumer fraud data. Clarification on this point is being sought.				
<b>Source:</b> Euromonitor Passport Data at <a href="http://www.portal.euromonitor.com">http://www.portal.euromonitor.com</a> .				

On the negative side, however, this distribution of fraud loss burdens may curtail cardholder's and merchants' own precautionary sense of responsibility. As with any two-sided market, the distributions of both costs and benefits

among the participants may affect the economic efficiency of the overall system. Fraud, like other types of theft, is a deadweight loss on the economic system, and the extent of fraud may be affected by the distribution of its burdens.

Based on the Euromonitor data regarding card-related fraud losses (credit and debit cards combined) and total transaction estimates from the Federal Reserve Payment Study reports, the proportion of U.S. payment card consumer finance fraud in 2021 was 10.9 basis points.<sup>3</sup> This estimated value for combined credit and debit card losses was a 47.1 percent increase in basis points relative to total transactions value from the 2011 amount of 7.8 basis points.

Available data does not facilitate the separation of fraud loss values by credit card versus debit card distinction (this is a problem the Fed could correct by improving its data collection program), but the Fed's recent biennial debit interchange report provides an important clue of the relative distribution.

*"In 2021, across all debit and general use prepaid card transactions by covered issuers, fraud losses to all parties as a share of the transaction value were 17.5 basis points, or \$17.45 per \$10,000 in transaction value. This value is a product of a steady increase in fraud losses of 7.8 basis points in 2011."*<sup>4</sup>

The Fed's report relates only to fraud losses by banks, consumers, and merchants for debit cards issued by the 134 banks with assets above the \$10 billion threshold of the 2011 Federal Reserve Regulation II that was mandated by the 2009 "Durbin Amendment" to the Dodd-Frank Act. The 17.5 basis points of fraud losses in 2021, compared to 7.8 basis points in 2011, constitutes a 124 percent increase.

The Fed's survey data did not report or estimate data regarding fraud losses associated with debit/credit cards issued by any of the remaining 2,095 U.S. banks which were not covered by Regulation II. The Fed should expand its biennial survey to collect such data from all or a sample of the exempt debit card issuers.

Fraud loss rates for both the subset of banks covered by Regulation II mandates and the fraud loss rates for all debit and credit cards combined were

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<sup>3</sup> Author's calculation based on combining transactions volume data reported by Fed with card-related fraud values reported by EuroMonitor.

<sup>4</sup> [Federal Reserve Board Publication](#), p. 2.

similar (7.8 basis points) at the beginning of the period in 2011. However, the fraud loss rate for the subset of debit cards issued by banks subject to the Fed's Regulation II mandates was 58 percent higher in 2021 than the fraud loss rate combined for all debit and credit cards (17.5 bps versus 11.1 bps). The growth rate of transaction fraud was **2.6 times greater** for the subset of debit cards covered by the Fed's regulation compared to the growth rate in fraud per transaction dollar for all cards.

Why has debit card fraud for the subset of debit card issuers covered by Regulation II grown significantly faster than overall payment card fraud? Two related causes may have been at work together: The ceiling on interchange fees, including the limited allowance of one cent per transaction, has constrained the ability and incentive for covered card issuers themselves to invest in fraud prevention systems to keep pace with the evolving methods of fraud perpetrators.

What's more, since 2011 debit card issuers have been required to provide for at least two non-affiliated network processors for processing payments with their cards. The rule also prohibited card issuers from imposing on merchants any requirements to implement effective fraud prevention technologies on their end of the process or to incentivize them to choose a transaction processor based on fraud prevention effectiveness.

Have the additional unaffiliated network processors that added to debit cards because of Regulation II been more prone to fraud than the previously exclusive network processors? Have these new processors offered lower costs to merchants and have merchants chosen lower cost processors? Is there a correlation between some processor's costs or experience to the incidence of fraud when their services are chosen? These questions constitute testable hypotheses that the Fed can empirically examine and potentially find to be false. Until the Fed does so, there is no credible basis for going forward with the proposed rule, and the viability of the existing Regulation II rule is questionable. The Fed's periodic surveys of debit card issuers and networks serving the debit card market can readily be adapted to provide data to empirically test these hypotheses. On the debit card issuer survey, respondents should be required to separately report transactions, interchange fees received, and fraud cases reported for each available network available to their card.

The Fed could have collected this data for the past 12 years, and if it had done so we would already have had the data and the opportunity to test these critical hypotheses. The Fed has neglected its duty to collect and analyze readily available data necessary to evaluate the effects of the existing parameters of Regulation II. The lack of such data and analysis today means that the Fed cannot demonstrate that the proposed reduction in the interchange fee ceiling is appropriate.

To understand how these factors may have accelerated fraud growth, it is useful to consider the economic preferences influencing the fraud prevention equilibrium in an unregulated competitive market.<sup>5</sup> This involves consideration of the possible differences in fraud risk aversion between cardholding consumers and merchants and how each side's preferences are transmitted to the other participants in the transactions system (acquirers, networks, and card issuers).

Typical cardholders may place a relatively high value on fraud risk avoidance because they perceive their potential loss to be somewhat large relative to their income and assets. This causes a degree of hesitancy to use payment card systems unless the perceived risk is somehow mitigated. The card-issuing financial institution may assume some of the fraud risk because the card issuer values the cardholder's account and desires to encourage increased card use (cash-back or other rewards programs serve a similar purpose).

To obtain and retain profitable cardholder accounts and encourage widespread card use, payment-card-issuing financial institutions compete across numerous dimensions of service attributes, including shielding cardholders from the perceived risk of losses from fraudulent uses of their card credentials.

The card issuer may have a legitimate interest in designating a single network for processing the cards it issues because doing so may enable the card issuer to monitor the fraud prevention performance of the network more efficiently and at less cost than if there were multiple designated networks available. The existence of exclusivity agreements between card issuers and transaction processing networks may not be a reliable indicator of competitive

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<sup>5</sup> The question of whether or not the market in question departs from competitive ideals and how such departures should be addressed by social intervention is a separate issue that will be addressed in a subsequent section of this letter.



market failure: In fact, it appears to be a Coasian outcome in a competitive market.<sup>6</sup>

The rewards of reducing fraud are balanced by consideration of the marginal costs of attempting to do so. Organizations involved in the payments facilitation process may assume a significant portion of the risk of fraud losses and the costs of fraud detection and prevention to benefit from the expanded volume of transactions that flow through their systems. The adoption of standardized procedures and technologies by networks and card issuers contributes to both fraud loss reduction and to greater overall transaction processing cost efficiency than if the cost burden for fraud loss prevention and liability were distributed more heavily upon merchants or cardholders.

The competitive interplay of the various incentives and preferences among the participants in the multi-sided payments system market ideally results in a Pareto-optimal distribution of costs and benefits among the several participants, including the distribution of fees to cover the costs of operating the system between merchants and consumers. The cost of operating an electronic (payment card) system is small relative to these benefits, but it is not zero. When public policy makers are tempted to intervene and change the distribution of cost burdens or the operating norms of a payment system, there will be consequences that must be considered. The proposed changes to Regulation II do not reflect adequate consideration of these consequences.

Currently, U.S. credit card issuers may be able to limit transaction processing alternatives to networks (i.e., card affiliation brands like Visa and Mastercard) that offer fraud protection attributes aligned with cardholders and card issuer's preferences for reduction of fraud loss risk along with other attributes such as transaction reliability, speed and accuracy, and the extent of merchant acceptance of cards bearing the network brand.<sup>7</sup> The result may be a

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<sup>6</sup> Similarly, the transition of merchants to customer self service in grocery and dry-goods stores in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries led to increases in shop-lifting theft losses, but merchants calculated that the reduced labor costs, increased customer traffic and increased profitable revenue offset the expected theft and accidental damage losses. In the 20<sup>th</sup> century merchants adopted acceptance of customer checks drawn on individual bank deposit accounts in a similar way: check fraud and insufficient balance losses occurred despite merchants' precautions and expected losses were incorporated into the cost of doing business and into pricing.

<sup>7</sup> This may have been changed by the terms of the recent court-approved settlement of a civil lawsuit between merchants and two transactions processing networks which may prevent contractual exclusivity agreement, but card issuers who were not parties to the lawsuit may continue to have the right to choose

market equilibrium with respect to fraud loss distribution and fraud detection and prevention efforts that efficiently balance costs and benefits among the various participants.

Prior to 2011, the debit card issuers' rights were similar, and available data suggests that both segments (credit and debit) of the payment card market experienced a similar level of fraud losses relative to transaction values (about 7.8 basis points). The imposition of Regulation II in 2011 disrupted the competitive balance of fraud prevention efforts by mandating the expansion of the number of networks available to process transactions on every debit card.

The introduction of the Fed's Regulation II in 2011 marks a significant break between the two payment card market segments in terms of fraud loss experience. The Fed has not demonstrated any credible empirical data or theoretical analysis to refute the hypothesis that the regulatory restraints on debit card issuers in combination with the interchange fee ceiling imposed on covered debit card issuers are the cause of the disparity in the growth of debit card fraud in comparison to credit card fraud. The data needed is readily obtainable by the Fed through its periodic surveys of payment processing networks and debit card issuers to test the hypothesis that Regulation II has created conditions conducive to the growth of fraud in the debit card market segment covered by Regulation II.

The current proposal to reduce the interchange fee ceiling may further discourage debit card fraud detection and prevention and, it may lead to an acceleration of fraud loss growth in the covered debit card segment.

The Fed may be on course to exacerbate the fraud problem by promoting ill-considered constraints on interchange fee revenues of card-issuing banks. These constraints risk curtailing private investment and action for fraud prevention. Such short-sighted policy may have saddled consumers, banks, and merchants with an exponentially growing dead-weight burden of fraud losses, ultimately resulting in reduced economic activity, higher prices, and reduced employment as fear of fraud impedes the confidence of buyers and sellers to trade. The Fed has the duty and the ability to collect and analyze the data necessary to test the hypothesis of a causative link between Regulation II and the

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the single processing network option. The Credit Card Competition Act currently being considered by Congress would remove that right to choose for many credit card issuers.

disparate growth of fraud losses in the debit card market segment covered by Regulation II. Until that is done, there is no justification for proceeding with the proposed rulemaking.

**RELIABILITY.** Closely related to security concerns is uncertainty about the reliability of the payment processing system. Existing networks have heavily invested resources to ensure the reliability and efficiency of the payments processing system. If an issuing bank is required to make its card available to an unsecured or unreliable alternative network processor, the result could be serious losses to merchants and consumers from processing delays or errors, loss of interchange revenue, or added costs to acquiring or issuing banks. A further consideration is the potential for significant damage to the issuer's valuable reputation on which it depends to attract and retain cardholders. Each covered issuer will be forced to expend valuable time and unknown sums of money to examine and verify the reliability of new network service providers seeking to process transactions with the issuer's card brand. The proposed reduction in interchange fee revenue for debit card issuers covered by Regulation II will further hinder the issuing banks from performing the necessary due diligence for admitting new competitors to process their cards.

**A SINGLE INTERCHANGE FEE CEILING DOES NOT FIT ALL ISSUERS.** A fundamental flaw in the Fed's approach in 2011 (which is also inherent in the new proposal) was to rely only on the distribution of card costs of *each issuer* in relation to *one another* as the analytical process to set the base component benchmark. The Fed instead should analyze the actual ratio of interchange fee revenue in comparison to costs incurred at the *individual issuer level*. The current fee cap formula, based on the median of issuers reported per transaction costs, has the result that 23 percent of debit card issuers (nearly one in four issuers) recover less than their full costs per transaction, but lower-cost issuers (those whose reported costs are less than the 21 cent base amount) may continue to receive fees in excess of costs.<sup>8</sup>

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<sup>8</sup> See table on page 78113 at 88 Federal Register No. 218, Tuesday, November 14, 2024: the text of the subject Notice of Proposed Rulemaking.

Under the proposed reduced ceiling the proportion of covered card issuers who will be denied full cost recovery will rise to one in three. The selection of a benchmark that increases the proportion of covered card issuers who will be unable to recover allowed debit card processing costs will contribute to further increases in fraud losses to merchants, networks, card issuers, and consumers.

The Fed claims the proposed 14.4 cent benchmark would have resulted in 98.5 percent of transactions having covered costs if it were in effect in 2021, but that result is an artifact of the dominance of a few very large low-cost issuers. The important fact is the proposed lower ceiling will, according to the Fed's own calculations, increase the proportion of debit card issuers who fail to recover their full costs on some issuers and deepen the losses of debit card issuers who are "underwater" with respect to the existing fee ceiling.

While a reduction in the per-transaction base amount in the proposed regulation will reduce the profits of some of the card issuers at the lower end of the distribution, it will continue to allow some of the lowest average cost issuers (generally those who enjoy the largest shares of total transactions and aggregate transaction value) to collect fees in excess of costs, and simultaneously increase the proportion of card issuers at the higher average cost end of the spectrum who are not allowed to recover their full costs. The Fed's approach to setting the current cap seems contrary to the explicit intent of the Durbin Amendment that fees be reasonably related to actual costs. The disparities the method creates among covered card issuers may have an unintended consequence of promoting greater market concentration within the banking industry. It encourages the growth of debit card programs of the large low-cost issuers, and it discourages the existence and growth of the debit card programs of the relatively smaller covered issuers (e.g., smaller/higher cost issuers are less able to match the generous cash back rewards that their large low-cost competitors offer). This contributes to the continuing concentration of the debit card transactions market among a small number of very large banks. The Fed should abandon its current approach and instead specify a uniform fee as a percentage of revenue in excess of allowed costs that each covered card issuer may recover.

**INDIRECT EFFECTS ON CARDHOLDERS.** The Fed's analysis of the effects of the existing fee ceiling and its forecast of the effects of the proposed

reduction in the fee ceiling celebrates the idea that merchants will benefit from reduced interchange fee expenses and that the reduction in revenue to debit card issuers will have no significant effect. This erroneous conclusion by the Fed is based on a presumption that all covered debit card issuers are effectively monopolists who set a price (the interchange fee) at a level above marginal cost. College students in Economics 101 learn that a government regulator can improve social welfare in a monopolized market by mandating a price ceiling equivalent to marginal cost and thereby transfer excess profits from the monopolist to consumers (and this will also incentive increased production). However, college students who receive a passing grade in that introductory class also learn the market model presented by the Fed's assumption is unrealistic. There is not a single monopoly bank issuing debit cards: There are thousands. There are over 130 covered by the Fed's Regulation II fee ceiling. Imposing a binding price ceiling on a competitive market may reduce the revenue of suppliers on whom the ceiling is binding, but that reduction of revenue will have consequences in terms of the quantity of services supplied.

Although consumers are subsidized in the sense that interchange and other fees necessary to cover the operating costs of the payment system are directly paid by merchants, it is not a simple transfer issue to redistribute interchange fee costs from merchants to consumers. If the share of costs borne by merchants is reduced and the share of payments for system operating costs ultimately borne by consumers must rise, then there will be network effect repercussions.<sup>9</sup>

Raising the share of costs borne by consumers will have a multiplicative adverse effect on the transactions that flow through the merchant's till: Instead of switching from debit cards to cash or checks, consumers may reduce purchases in the aggregate, resulting in a gross sales loss to merchants that may more than offset any savings merchants enjoy from a reduced interchange fee. Instead of simply transferring a portion of the interchange costs to consumers, the redistribution of the fee burden from merchants to consumers may negatively affect total transactions and spending. This effect is possible even if merchants

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<sup>9</sup> Unless the transaction processing services providers in the middle (acquirers, networks and debit card issuers) actually do comprise a self-serving monopoly entity or unless the various participants collude in a conspiracy to restrain trade with the equivalent effect. There has been no evidence presented to justify such a presumption.

pass 100 percent of their transaction fee share savings to consumers in terms of lower prices, which empirical evidence finds did not occur after the 2011 price cap imposition.<sup>10</sup>

The Fed's regulatory analysis acknowledges that burden-increasing effects on consumers as described above may occur, but the discussion is in vague qualitative terms and it presents no credible empirical data or econometric analysis. Estimating the relative elasticities of behavior responses is critical. The Fed considers two avenues by which consumers may be affected by the existing and the proposed reduced interchange fee requirements: (1) To the extent that merchants' competition results in price reductions that mirror merchant's cost savings because of interchange fee reductions, consumers would directly benefit, but (2) to the extent that covered debit card issuers increase direct or indirect fees charged to customers who use debit cards, the benefits from lower prices would be offset. However, no definitive data-derived analytical conclusion is shown.

The net effect may be influenced by the amount of reduction in the interchange fee implemented: A reduction of the ceiling by X percent could result in a net gain for consumers, while a reduction by 2X percent could result in a net loss. Making the right regulatory decision depends on knowing the facts about the relationship between the interchange fee ceiling amount to the relative sizes of each of the potentially off-setting effects. The only conclusion drawn in the regulatory analysis included in the notice of proposed rulemaking is the following:

*"The net effect on consumers, both individually and in the aggregate, will depend on which of these two effects predominates, which would in turn depend on many factors and is thus difficult to predict. As noted above, merchants in more competitive markets would likely pass on a larger proportion of their cost savings to consumers. In a similar way, in response to declines in interchange fee revenue, covered issuers in more competitive markets would be less likely to increase [cardholder] fees or make other changes that negatively affect consumers. Covered issuers that face strong competition from exempt issuers may be less likely to raise fees, as doing so*

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<sup>10</sup> Cite Richmond FRB survey study: [https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic\\_brief/2015/pdf/eb\\_15-12.pdf](https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_brief/2015/pdf/eb_15-12.pdf)

*could increase the probability that customers switch to these competing institutions.”<sup>11</sup>*

In addition to increases in direct consumer fees for transactions processed by debit cards, indirect reductions in card issuer’s interchange revenue may be offset. For instance, it could reduce cash-back rewards programs, increase in general fees charged by banks to all depositors, or increase in minimum deposit balance requirements or overdraft fees.

In a footnote to its regulatory economic impact analysis, the Fed cites a working paper by members of staff of its Divisions of Research & Statistics and Monetary Affairs.<sup>12</sup> This study used the econometric techniques of difference-in-differences analysis to compare the possible effects in 2011-2013 of the implementation of Regulation II on debit card interchange fee revenue, general deposit fees revenue (of which debit card transaction specific fees might be a component), and bank operating income (net of interest income). These aggregate performance measures for the 134 banks with \$10 billion in assets covered by the Regulation II fee ceiling were compared to the trend over time in corresponding aggregate measures for the more than 2,000 smaller banks exempt from the Regulation II interchange fee ceiling. The study found that about 30 percent of revenue losses by covered debit card issuers attributable to the Regulation II ceiling had been recouped from customers by increases in deposit service fees. The study also found that net operating income had also decreased, which implies some of the negative impact on revenue may have been passed on to shareholders in the form of reduced stock value or foregone stock value appreciation.

The study did not investigate whether other indirect adverse impacts on cardholders (such as increased deposit minimums or other restrictions on debit card eligibility) may have occurred. Two other shortcomings of the study are

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<sup>11</sup> 88 Federal Register No. 218, November 14, 2023, p. 78116.

<sup>12</sup> Benjamin Kay, Mark Manuszak and Cindy Vojtech, “Bank Profitability and Debit Card Interchange Regulation: Bank Responses to the Durbin Amendment,” Board of Governors of the Federal Reserve System, Finance and Economic discussion Series no. 2014-77.

notable: (1) the study relied on data only from the first two years of Regulation II implementation (changes in depositor fees and other policies take time to decide and implement); and (2) the necessary requirement of exogeneity for the difference-in-differences control group was violated (while the exempt banks were not covered by the fee ceiling, they were subject to the Regulation II non-exclusivity requirements regarding available networks). This study represents a useful beginning of work that the Fed should have continued to pursue, but standing alone, it does not provide a basis for concluding that the proposed regulation amendment will have a positive net economic impact.

The result of network effects could be a net social welfare cost shared by both merchants and consumers. Only under very particular empirical conditions of relative elasticities of merchant and consumer behavior might the outcome be otherwise, and the Fed has not conducted an empirical analysis to prove such a special case. The Durbin Amendment and the Fed's implementation of it are based on an economic analysis that ignores the complexities of markets and network economics.

**BIENNIAL ADJUSTMENT OF THE FEE CEILING.** The Fed's proposal to adjust the fee ceiling biennially will be costly and may be illegal. The proposed rule would automatically revise the basic fee ceiling based on its survey of allowable costs relative to transactions processed, without a public notice and comment rulemaking. In effect, the proposed rule would violate long-standing principles of the Administrative Procedure Act. The act requires that no regulatory action be undertaken by any federal administrative agency, including the Fed, without some form of public input opportunity to respond to the proposed action before a final decision is promulgated. This may entail either a formal quasi-judicial hearing or the published notice and public written comment process.

The requirement for public input is intended to ensure that substantive knowledge of the facts involved in the decision held by the affected public is revealed and considered by the regulatory agency. Implicit in the Administrative Procedure Act is congressional recognition that administrative agencies are



fallible, sometimes not in possession of all the facts needed for a reasoned decision, and, perhaps, capriciously, or intentionally blind to reason. In granting the administrative agencies regulatory power, Congress enshrined public comment as a preliminary check on agency regulatory discretion. When agencies wantonly ignore the public's right to participate in the rule-making process, the act provides the Federal courts with a basis for review and the rescinding of arbitrary agency decisions. The Congressional Review Act provides an ultimate check on an agency's abuse of regulatory power. The Fed's proposal for automatic adjustment of the fee cap without public notice and comment is a blatant attempt to circumvent this clear intent of the Administrative Procedure Act and to avoid oversight of the Congressional Review Act.

#### **FAILURE TO COMPLY WITH ECONOMIC ANALYSIS**

**REQUIREMENTS.** Section 904(a)(2) of the Electronic Funds Transfers Act (EFTA) requires the Fed to prepare an economic analysis that considers and compares the costs and benefits of any proposed regulations with respect to affected financial institutions, consumers, and other affected parties (e.g., merchants). The economic analysis section of the notice of proposed rulemaking fails to credibly and definitively answer the key question that EFTA requires the Fed to answer: Will the proposed rulemaking result in positive net benefits relative to costs considered across the spectrum of affected financial institutions, consumers, and others (e.g., merchants). The answer to the question offered by the Fed in each case is "we do not know:"

1. **Merchants.** With respect to merchant effects the Fed states, "Although the precise extent to which acquirers would pass on savings from lower debit card interchange fees may vary, competition between acquirers in the industry should generally result in acquirers passing on savings from lower interchange fees to their merchant customers."<sup>13</sup> If transaction-acquiring banks fail to pass on to their merchant customers the full benefits of revenue flow reduction from the interchange fee

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<sup>13</sup> Ibid, p. 78114.

ceiling the potential for any Regulation II social benefit to merchants or consumers is lost. The effect would be merely to transfer revenue from one “middleman” to another. That outcome is especially likely for the large proportion of transactions in which the acquiring bank and the card issuing bank are the same: The bank is the custodian of both the cardholder’s deposit account and the merchant’s deposit account. This is a question for which the Fed has had the opportunity and the ability to answer by collecting data and analyzing it over the past 12 years through its periodic surveys of financial institutions. The debit card issuers survey could have readily been expanded to collect data from banks regarding their involvement in transactions in the acquirer role as well as their card issuer role. If their authority to do so was believed to be limited by the legislation that enabled Regulation II, then the Fed should have reported to Congress the need and sought amended authority. There is no evidence that the Fed ever considered this need.

2. Financial Institutions. The Fed’s conclusion is another example of uncertainty: “...covered issuers’ total debit card revenue would decline...[but]... this reduction ... could be offset to some extent by the likely continued growth in total debit card volume.”<sup>14</sup> This indecisive statement identifies another critical issue that the Fed could have addressed through data collection and analysis but has failed to do so. The question begs for an estimation of the elasticity of merchants’ acceptance of debit cards with respect to the merchant discount level. If the Regulation II interchange fee ceiling set in 2011 had reduced merchant discount expenses (i.e., savings were passed through to merchants by acquirers and other “middlemen”) sufficiently to expand the number of merchants accepting debit cards (and encouraging customers to use debit cards rather than credit cards) and to increase transactions by a proportion greater than the reduction in the fee, then debit card issuing banks would have experienced a net increase in total

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<sup>14</sup> Ibid. p. 78115.

interchange revenue despite the reduction in revenue per transaction. This would imply an unambiguous increase in social welfare resulting from Regulation II. Some evidence, including the Kay, Manuszak, & Vojtech study cited by the Fed and discussed previously in this letter, suggests that issuers experienced a revenue decline initially, but it remains possible the initial decline found by that study could have reversed subsequently. The Fed needs to conduct the necessary data collection and analysis to resolve this question before proceeding with the proposed regulatory action

3. Consumers. Here, again, the Fed fails to present a definitive answer to the question on which the balance of benefits versus costs depends. “The net effect on consumers, both individually and in the aggregate, will depend on which of these two effects predominates, which would in turn depend on many factors and is thus difficult to predict.” The Fed was created to assemble data and expertise to make difficult but necessary predictions about complex public policy decisions. The Fed could answer this question. It has or can obtain the requisite data and it has or can obtain the expertise to conduct the requisite analyses. Until the Fed does so and is able to predict to a reasonable degree of economic certainty that the proposed reduction in the interchange fee ceiling will increase consumer welfare, then the current rulemaking proposal is unjustified.

**STRUCTURE OF THE PAYMENT CARDS MARKET.** The Fed’s analysis in support of its proposed rulemaking reveals an inadequate understanding of the intense competitive context that characterizes the U.S. and global payments market and the trends that are likely to alter the market in the future. The Fed also seems unaware of the various ways in which its own regulatory decisions may alter the speed and direction of changes in the market. The Fed’s approach in Regulation II is based on an inadequate perspective regarding the structure of the debit card market. The Fed’s approach depicts the debit card market based on financial institutions’ issued cards linked to cardholders’ deposit accounts as

distinct from other elements of the electronic funds transfer payment market. It depicts the market as dominated by two network service providers who in combination with a few major card-issuing banks exercising monopolistic power colluded to set fees prior to the introduction of Regulation II. This is a distorted picture that ignores the competitive interactions across a diverse and evolving electronic funds transaction market. Within the debit card sector, there are 137 major debit card issuing banks covered by the Regulation II fee ceiling (issuers with assets of \$10 billion or more) and over 2,000 smaller asset-level debit card issuers exempt from the fee ceilings.

Rather than colluding to divide the market as a duopoly, the Visa and Mastercard networks compete intensely head-on-head with each other in both the debit and credit sectors of the payments arena, and they also face countervailing competition from American Express and Discover. Many financial institutions offer credit and debit cards affiliated with each of the two major U.S. network brands, which gives consumers expanded choice and further dilutes the putative market power of the networks.

At the global level, the competition includes other regional or nation-specific competition, some of which are poised to enter the U.S. market. American Express and Discover operate under the three-party transactions processing model which gives them competitive advantages not available to the payment card networks like Visa and Mastercard, which operate under the four-party model. American Express offers both credit cards and (through its banking affiliate) checking and debit cards, its debit cards are not subject to Regulation II, which only applies to debit cards issued under the four-party transaction processing model.<sup>15</sup>

The pending merger of Discover with Capital One Bank, if successfully completed, will add more competition on both the debit and credit sides of the market, especially if Capital One issues cards with only its own brand by using

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<sup>15</sup> The Credit Card Competition Act (S 1838) currently under consideration in Congress would extend regulatory prescriptions similar to Regulation II to the four-party model segment of the credit card market, but it would also exempt American Express, Discover and other competitors who operate under the three-party model.

the Discover facilities to operate in the unregulated three-party transactions clearance model space. The Fed should postpone immediate regulatory action regarding the interchange fee ceiling and await developments pursuant to the Discover/Capital One merger before deciding whether or not to proceed. A similar wait-and-see caveat applies with respect to the recently announced settlement of a civil lawsuit brought against Visa and Mastercard by a coalition of merchants. This settlement will have significant impacts on fees and operating procedures that may alter the Fed's assessment of justification for the proposed Regulation II revision.

Other market structure considerations that the Fed has overlooked in its regulation proposal are the growing trends of the use of reloadable general-use debit cards and decoupled quasi-debit cards associated with a particular merchant that rely on ACH transfers from the cardholder's bank deposit account rather than using traditional transaction debit procedures. Both trends involve exemptions from Regulation II fee constraints and other requirements. Before proceeding with its proposal to reduce the interchange fee ceiling for debit cards covered by Regulation II, the Fed should consider the implications of a fee ceiling reduction for driving transactions away from covered cards and into these alternatives.

**CONCLUSION.** The Fed has not undertaken the difficult and complex work of empirically estimating the economic costs and benefits of its proposal. In every case, it has been shown that the task is not impossible. The Fed already does or readily could collect the requisite data. The Fed has the staff resources to conduct the requisite econometric analyses of the data.

The EFTA, which governs the Fed's regulatory authority in this case, requires the Fed to show the benefits of the proposed rulemaking exceed the costs in the aggregate. There is no data-driven credible finding to a reasonable degree of economic scientific certainty that the benefits of the proposal will exceed its costs. Lacking that finding, the Fed must withdraw the proposal.

Instead, the Fed should undertake a comprehensive regulatory program evaluation review of Regulation II as it currently exists.