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May 9, 2024

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

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

Dear Sir or Madam:

I am writing in response to the proposed amendments to Regulation II issued by the Board of Governors of the Federal Reserve System (Board). The proposed amendments, if enacted, would have far reaching and detrimental effects on consumers, the availability of financial products and services, and progress towards financial inclusion.

As a member-owned credit union, Mountain America Credit Union invests in the development and accessibility of competitive, low, or no-cost products and services and work to empower our members financially. This commitment is evident in various ways, including reduced costs across our offerings, enhanced savings returns, and comprehensive financial education initiatives.

Achieving these goals requires careful management of revenue streams, including interest rates and fees such as debit interchange. Our member-owners, who are predominantly moderate to low-income consumers, from areas designated by the NCUA as low-income, rely on the affordability and accessibility of our offerings to effectively manage their finances and achieve their financial dreams.

After examination of the proposal, and careful consideration of its impact on our members, we strongly oppose any reduction to the debit interchange fee cap and urge the Federal Reserve to withdraw this proposal. Implementation of the proposed changes pose a significant threat to our members and will jeopardize our ability to provide products and services in their current form, including terms and prices. We have identified several critical flaws with the proposal:

1. Reducing interchange fee income will not only impose limitations on products and services, it will also increase costs to members while diminishing their returns. Additionally, it places credit unions at risk by denying the right to cover costs.
2. The proposed changes rely on a flawed methodology that utilizes outdated data, failing to accurately reflect the reality for most financial institutions. The proposed calculation method overlooks essential

costs of running a debit card program or intentionally excludes expenses that would discredit the underlying justification for these changes.

3. The automatic adjustment to the cap is arbitrary, and the hands-off approach eliminates any opportunity for debate or inclusion of new information. This lack of flexibility hinders fair application of interchange rates and prevents financial institutions from recovering costs associated with debit programs.

Negative Impact to Members and the Credit Union

Research and various economic analyses on the impact of the Durbin amendment reveal its detrimental effects on the affordability of financial products and services for low-income and minority households. Expecting a different outcome from the proposed change to Regulation II is unrealistic. Anticipated impacts of the rule implementation include tighter restrictions on free checking and savings accounts, heightened minimum balance requirements, elevated interest rates on loan products, and decreased savings rates. Moreover, the reduction in interchange income will likely lead to reduced funding available for community programs such as scholarships and grants.

Additionally, there is a tangible financial burden on our owner-members associated with the proposal. The reduction in fee income to credit union members would have exceeded $400 million if the rule had applied in 2023. While our members may not hold stock certificates, they are the credit union owners; hence, this income reduction directly impacts their resources, resulting in them bearing the brunt of higher costs for the products and services they use.

The proposal will also impede credit unions' ability to meet consumers' financial needs in secure and prudent ways. The continued lowering of caps forces credit unions to operate with reduced revenue, which is unsustainable. Debit program costs encompass various aspects such as call centers, branch servicing, dispute resolution, card production, ATM operation, vendor services, compliance testing, technology, and security. In 2010, when defining incremental costs referenced in the Dodd-Frank Act, the Board chose to exclude certain expenses due to a lack of data, signaling that they might be allowable costs but refrained from including them in the 2011 rule. In the years' since, this data has become more readily available and should be evaluated as part of any proposed changes.

Credit unions face greater challenges absorbing the reduction of interchange revenue due to their unique not-for-profit structure. Unlike banks, credit unions cannot raise capital by issuing shares to external investors. Instead, they primarily accumulate capital through retained earnings, a process that is slow and further constrained by a statutory interest rate ceiling for federal credit unions.

An important consideration that has not been discussed or factored into any conversation surrounding this proposal is how it coincides with other regulatory agencies proposed rules to limit the fees card issuers can levy, such as non-sufficient funds fees. The cumulative impact of multiple regulatory constraints on revenue sources cannot be overstated. When regulatory restrictions prevent financial institutions from charging fees for transaction-related activities, they are forced into an untenable situation by regulators. These actions

threaten the free market and limit financial institution's ability to generate revenue for the purpose of serving consumers.

While credit unions are member-owned financial cooperatives operating under a not-for-profit model, it remains imperative for us to generate reasonable profits. Profitability enables us to maintain financial stability, enhance member services, and invest in the technology and infrastructure necessary to compete effectively in the financial services industry. By earning profits, we can offer competitive interest rates on savings, loans, and other financial products, thereby directly benefiting our members. Furthermore, profits allow us to establish reserves, ensuring resilience against economic downturns and unforeseen challenges while continuing to provide essential services to our community. Additionally, profitability empowers us to serve more members, and support initiatives promoting financial literacy and community development. In essence, while our commitment lies in serving our members rather than maximizing shareholder returns, profitability remains crucial for us to fulfill our mission and maintain sustainability over the long term. The Federal Reserve, merchant lobbyists, or other federal agencies should not be in the game of fixing prices and should instead let the free market determine the price for providing services. The implementation of these new, flawed interchange caps not only undermines our ability to earn reasonable profits but also jeopardizes the stability of both the credit union and our members.

Flawed Methodology and Outdated Data

The three largest banks, which account for nearly 50% of overall debit volume, has driven their per-transaction costs significantly lower than those of other covered issuers due to economies of scale. The Board's proposed methodology fails to acknowledge disparity caused by scale, focusing instead on costs at the transaction level rather than the issuer level. By disproportionately weighting the transaction-weighted average per transaction costs towards the largest volume issuers, the Board effectively disregards the cost experience of approximately two-thirds of the total debit market.

Such an approach cannot lead to a reasonable and proportional base component cap. Moreover, nothing in the statutory text of EFTA compels the Board to adopt this new methodology; in fact, the plain text of section 920(a)(4) would, if anything, preclude the Board from adopting an interchange fee standard that minimizes the cost experience of a majority of covered issuers.[1].

The Board has overlooked how recent changes to Regulation II might increase exempt issuer sensitivity to compressed interchange margins. A fundamental flaw in the Board's approach is relying on 2021 DCI survey data that fails to reflect recent changes to Card Not Present (CNP) routing rules affecting all issuers. The Board's historical data shows a dramatic decline in single-message network fees for exempt issuers after Regulation II took effect. A similar decline could occur should the Board adopt the current proposal, yet, the Board appears

[1] *See* 12 U.S.C. 16930-2(a)(4) (requiring the Board to "establish standards for assessing whether the amount of any interchange transaction fee described in paragraph (2) is reasonable and proportional to the cost incurred by the *issuer with respect to the transaction*"). By comparison, the Board confuses the statutory text with its own surplusage, asserting that the Durbin Amendment requires that "the maximum interchange fee that a covered issuer may receive will be proportional to the base component costs incurred by covered issuers *with respect to the **average** covered issuer transaction*" (emphasis added). 88 Fed. Reg. 78106.

indifferent to this potential outcome, proceeding without the opportunity to review 2023 data revealing the fee impact of its routing amendments on issuers.

The 2021 data used as the basis for the proposal covers the COVID-19 pandemic and is not representative of the current landscape. This is especially true for fraud related costs, which have risen exponentially over the last three years as issuers have seen a significant shift from Card Present (CP) to CNP transactions. Despite CNP transactions representing 33% of debit transactions in 2022, they accounted for 84% of debit card fraud. CNP debit transaction volume has increased significantly, growing four times faster than CP volume, with online and mobile transactions experiencing over a 10% volume increase. To provide greater context, fraud rates on CNP transactions are about five times higher than CP transactions. A higher fraud adjustment is necessary to mitigate the impact of rising fraud and uphold the integrity of the financial system.

It is evident that the surge in fraud, especially within CNP transactions, demands an even higher adjustment to reflect these evolving trends. Interchange fees play a critical role in funding ongoing improvements in security measures. Despite credit unions' widespread implementation of advanced security protocols, fraud losses persist and are on the rise. Continued investment in fraud prevention strategies is imperative to guarantee a secure and seamless customer experience. Therefore, additional increases to the fraud adjustment are essential to counteract the effects of escalating fraud and safeguard the integrity of the financial system.

While the largest issuers may leverage their scale advantages to absorb fraud losses with relatively less impact on short-term liquidity or long-term profitability, smaller issuers could face significant challenges in managing their card programs if fraud-related adjustments fail to keep pace with the comprehensive cost of fraud. This encompasses not only direct losses but also the expenses associated with honoring consumer rights to reimbursement for unauthorized transfers under the Electronic Fund Transfer Act.

To provide context, the average cost of card replacement in 2023 stands at $7.26 per card. Over a two-year period, 36% of adults replaced their cards due to fraud. These hard costs are intentionally excluded by the Board in both the current and proposed ACS calculations. Rather than continuing to ignore and exclude these costs, the Board should take proactive steps to gather data and conduct a comprehensive analysis that encompasses all incremental costs associated with debit card programs. This inclusive approach would facilitate the development of a more accurate calculation for cost recovery, unlike the current proposal that unduly restricts issuers' ability to recover costs associated with their debit programs.

The Regulation II rule of 2010 was structured in a way that resulted in only 80% of card issuers recovering all of their allowable costs. Despite the new proposed rule suggesting a decline in costs for debit card programs since 2010, recent data from the Board reveals a decrease in the number of issuers achieving full ACS cost recovery to just 77.4%. The Board is now proposing a cap of 14.4 cents per debit transaction. Considering low-volume issuers' average ACS cost is $0.595 per transaction, costs would need to be reduced by more than 75% just to break even, which is clearly unreasonable.

Regulation II will disproportionately impact credit unions, given that most are small to mid-size issuers. The proposed recovery rate of 98.5% of transaction costs will force 33% of card issuers to operate their debit card programs at a loss. This calculation is based on only a fraction of the costs included in the current interchange fee calculation, which by no means represents the comprehensive costs of these programs. If full cost recovery were to be considered, this percentage would significantly escalate.

The original rule assessed cost recovery across covered issuers, whereas the new approach disregards data acknowledging differences in economies of scale. Although the proposal suggests decreasing costs for debit card programs post the Durbin amendment, the data supporting this assertion relies heavily on the experience of a few high-volume issuers, making it non-representative of the broader market.

As was detailed above, the challenges posed by a rule that obstructs cost recovery and focuses on average transaction costs rather than statutory requirements mandating interchange caps based on issuer-incurred costs, the data employed in the proposal is both unreliable and incomplete.

<u>Automatic Adjustment to the Cap is Arbitrary – Eliminates the Inclusion of New Information</u>

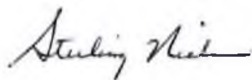
Costs associated with debit card programs are continuously evolving. Formulating and cementing a cost recovery formula today, only to apply it indefinitely, fails to acknowledge the dynamic nature of payment systems, as evidenced by the data on CNP transactions. The ramifications of future technologies, regulatory frameworks, and economic uncertainties on the costs associated with debit card transactions remain uncertain and inherently unpredictable. The proposed "set it and forget it" formula would inhibit the board from fulfilling its responsibility to establish standards for assessing interchange fees that are both reasonable and proportionate to the costs borne by issuers concerning the transaction.

We strongly oppose any provision within the proposal that would preclude future discussion on the methods and approaches for calculating interchange. Additionally, we adamantly oppose a process that revises debit interchange fees every two years in July. Such an approach would inflict significant and adverse effects on the stability of financial institutions, impeding their ability to develop and manage operational budgets effectively.

The combined effect of these regulatory adjustments will disproportionately affect small to mid-volume issuers, typically known for their adaptable programs and focus on serving underserved communities. This will represent a significant step backward for low to moderate-income individuals and families, who will bear the brunt of increased costs and diminished access to financial services.

We urge the Board to acknowledge its detrimental impact on consumers by rescinding the proposal. It will not only curtail access and escalate costs for accessing financial products and services but also create anti-competitive consequences for low to mid-volume issuers. We urge the board to enhance its data collection practices and acquire genuinely representative insights into the costs of debit card programs before moving forward with any efforts to revise the debit interchange fee cap.

Respectfully,



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