

Submitted via Electronic Mail

May 11, 2024

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

Re: Debit Card Interchange Fees and Routing - Docket No. R-1818, RIN 7100-AG67

Dear Ms. Misback:

McGovern Smith Advisors would like to share its analysis and concerns with respect to the data being used by the Federal Reserve to establish debit card interchange. The data and process employed to arrive at proposed debit interchange is flawed and the proposed base component of interchange does not reflect actual changes to covered issuer ACS costs or the Federal Reserve's stated position that interchange be set at levels that recover the 80th percentile of covered issuers ACS costs.

What has changed that necessitates dramatically lowering interchange?

We do not believe the Federal Reserve overlooked its requirement every two years to ensure debit card interchange is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. In its 2011 and 2013 study release, the Federal Reserve explicitly said it did not plan to propose revisions to interchange. However, by not stating anything to the contrary or stating unequivocally the original construct was no longer valid in these or subsequent studies, the Federal Reserve by default confirmed interchange has been reasonable and proportional to allowable costs.

Table 1 – Covered Issue ACS Costs by Survey Year¹

ACS Costs	2009	2011	2013	2015	2017	2019	2021
Trans. Weighted Average	\$0.0770	\$0.0510	\$0.0460	\$0.0420	\$0.0356	\$0.0389	\$0.0388
% Change Year over Year	-	-33.8%	-9.8%	-8.7%	-15.2%	9.2%	-0.2%
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% Change to 2009	-	-33.8%	-40.3%	-45.5%	-53.8%	-49.5%	-49.6%
% Change to 2011	-	-	-9.8%	-17.6%	-30.2%	-23.7%	-23.9%

Most of the ACS cost decline (please refer to Table 1) occurred in 2011 and since 2015 transaction weighted average ACS costs declined by only \$0.0032, a cumulative decline of 7.6%. What has changed that necessitates dramatically lowering interchange and why did the Federal Reserve not act earlier if it believed interchange was no longer reasonable and proportional?

2009 survey data is completely unreliable

We believe the Federal Reserve knows the 2009 data set is unreliable, softly disclosing the issue in its rulemaking proposal. Yet, the Federal Reserve stated in its proposed rules “costs on which the Board based the base component have nearly halved;” thus, requiring a dramatically lower

¹ 2017 results appear to be impacted low by respondent mix. See Appendix B.

interchange. One only gets there by including the results of 2009.

The 2009 survey was voluntary and the data used to establish interchange was from 43 financial institutions that provided relevant cost and transaction data – composition of the issuers, annual transactions, and mix of dual and single message transactions is unknown. The industry has no way of validating how the data in 2009 effectively compares to 2011 and all other studies.

Furthermore, the Federal Reserve reported the types of costs categorized as ACS were changed in 2011 to better match the categorization of costs used to determine the interchange fee standard. Again, the industry has no way of knowing how this change impacted the results. What we do know is that the 2009 data is driving 34% of the decline in transaction weighted ACS cost over time, cannot be verified, and certainly cannot be relied upon to set policy.

Other factors are likely influencing the data

The Federal Reserve has never disclosed in any study dual message, single message, and pre-paid debit transactions at the issuer (high-volume, mid-volume, low-volume) segment level. This is pertinent information to ascertain what is going on in the industry study to study and over time. Table 2 has our analysis of study data that highlights several correlations. Key areas of growth are in green, key areas of decline are in red, and neutral years in yellow.

Table 2 – Select Report Data

Item	2009	2011	2013	2015	2017	2019	2021
Trans. Weighted Avg. ACS	\$0.0770	\$0.0510	\$0.0460	\$0.0420	\$0.0356	\$0.0389	\$0.0388
% Change Year over Year	-	-33.8%	-9.8%	-8.7%	-15.2%	9.2%	-0.2%
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% Industry Debit Trans. Covered Issuers							
High Volume Issuers	?	94.04%	94.81%	95.12%	96.21%	93.54%	94.32%
Mid Volume Issuers	?	5.94%	5.17%	4.86%	3.78%	6.45%	5.68%
Low Volume Issuers	?	0.02%	0.02%	0.02%	0.01%	0.01%	0.01%
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% of Covered Issuers Transactions							
Dual Message Debit	?	66.62%	63.54%	63.81%	63.52%	64.66%	68.87%
Single Message Debit	?	33.11%	35.65%	35.51%	35.64%	34.80%	30.99%
Pre-Paid Debit	?	0.28%	0.80%	0.69%	0.83%	0.54%	0.14%
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% of Industry Debit Transactions							
Card Not Present Dual Message	9.1%	10.43%	12.62%	13.73%	17.41%	21.96%	30.13%
Card-Not Present Single Message	0.5%	0.47%	0.45%	0.74%	1.45%	1.36%	1.95%

Industry transaction weighted average ACS costs strongly correlate with high-volume issuer share. ACS costs declined 2013 to 2017 as high-volume issuers accounted for a larger share of covered issuer transactions and costs increased in 2019 when high-volume issuer share fell. A similar dynamic can be observed with single message debit (which has lower ACS costs than dual message debit).

We recognize there are multiple interdependent factors influencing results, including the rapid rise of card not present transactions. By not having transparency in the data necessary to determine granular trending, it is impossible to determine if other factors are contributing to the results and, if so, by how much. While cardholders will continue to make purchases using the debit payment product of their choosing, merchants can influence underlying volumes and industry ACS costs (whether by dynamic

routing, prompting for PIN, agreements made with networks, or other actions). It is important to understand what is mathematics driven (i.e. mix related) and what portion is driven from true decline in ACS costs. The latter of which should be used to determine any required changes in interchange.

The complexity of the market and the various interdependencies at play are key reasons why the automatic calculation approach proposed by the Federal Reserve (using a factor multiplied by average industry ACS costs) is fundamentally flawed.

Why is the 80th percentile no longer valid?

The Federal Reserve’s current position is that “the Board did not indicate that the Board was adopting any particular cost-recovery target across covered issuers (i.e., that 80 percent of covered issuers should fully recover their base component costs) or across covered issuer transactions.”

We find this statement to be incongruous at best. This position is counter to what the Federal Reserve said in December 2010²: “The Board proposes a cap of 12 cents per transaction because... it allows for the recovery of per-transaction variable costs for a large majority of covered issuers (approximately 80 percent).” There was no apparent qualifier in that notice to the industry.

We do recognize that the Federal Reserve attempted to provide clarity about the 80th percentile and the data set in July 2011³. However, its final word on the matter stated: “Based on a review of the survey data and public comments, and for the reasons explained above, the final rule establishes a standard that caps the base component of any interchange fee at 21 cents per transaction, which corresponds to the 80th percentile issuer’s average per-transaction included costs.”

And the Federal Reserve made no commentary in March 2013 and subsequent survey releases that the 80th percentile was no longer valid or that a new methodology was used to arrive at keeping the base component of interchange at \$0.21.

We believe the Federal Reserve’s position that the 80th percentile is no longer valid is because it could not justify materially lowering debit card interchange otherwise. According to Federal Reserve data (please refer to Table 3), the 75th percentile of ACS costs were \$0.180 in 2009 and \$0.176 in 2021. That data does not support a dramatic lowering of interchange and most likely the 80th percentile, if published, would not as well.

Table 3 - ACS Costs, excluding fraud losses

	<i>Issuer percentiles</i>			
	<i>25th</i>	<i>50th</i>	<i>75th</i>	<i>80th</i>
<i>All Transactions</i>				
2021	0.0534	0.1024	0.1760	<i>not avail.</i>
2019	0.0441	0.1008	0.1623	<i>not avail.</i>
2017	0.0423	0.0947	0.1847	<i>not avail.</i>
2015	0.0580	0.1230	0.3050	<i>not avail.</i>
2013	0.0690	0.1490	0.4220	<i>not avail.</i>
2011	0.0740	0.1100	0.3610	<i>not avail.</i>
2009	0.0900	0.1100	0.1800	0.2100

The data also begs the question as to why no action was taken when the 75th percentile ACS costs increased dramatically in 2011, 2013, and 2015. There was a rational argument to be made to increase interchange. We would have expected the Federal Reserve to clearly state that a different methodology was being used to mitigate the raising of interchange rather than tacitly using a different standard to determine whether interchange was reasonable and proportional.

Community financial institutions will be disproportionately harmed

The Federal Reserve’s proposal to reduce the base component of interchange by \$0.066 will be

² Notice of Proposed Rulemaking December 10, 2010

³ Final Rule July 20, 2011

detrimental to covered community financial institutions and, if history is any guide, will also trickle down to exempt / small financial institutions. In 2013, only 62.0% of mid-volume issuers and 7.1% of low-volume issuers had ACS costs that were below the level permitted by the interchange fee standard. However, by 2021, 78.3% of mid-volume issuers and 21.1% of low-volume issuers had costs below \$0.21.

The Federal Reserve expects its base component interchange proposal will lower the share of issuer costs covered by the interchange fee standard to 66%. Much lower than the 77.4% share that occurred for all issuers in 2021. The Federal Reserve's data (please refer to Appendix A) shows that the proposed \$0.144 rate would cover ACS costs for the 50th percentile of mid-volume issuers and maybe a 60th percentile but likely no low-volume issuers. More mid-volume and low-volume issuers would not be able to cover their ACS costs going forward. And when one factors in other debit program costs (e.g., card production, cardholder inquiry support, overhead, etc.), but not allowed in setting interchange, many of these and other financial institutions will be greatly harmed.

Community financial institutions do not have the ability to raise banking fees or charge debit program fees to offset the shortfall. And they certainly do not have the ability to rationalize ACS costs by \$0.066 as most of authorization, clearing, and settlement are performed by third party providers. The Federal Reserve study data shows that transaction weighted average ACS costs only fell by \$0.0037 for mid-volume issuers from 2011 to 2021. High volume issuer ACS costs only fell by \$0.0122 over the same period. Yet, the Federal Reserve is proposing a \$0.066 decline in the base component of interchange.

Debit is an integral part of a cardholder's deposit relationship with its financial institution. The Federal Reserve's proposal has the chance to be quite devastating to many covered issuers and, in particular, mid-volume and smaller financial institutions. We believe the proposed decline in interchange will accelerate banking consolidation and force many to consider exiting the market prior to exceeding the \$10 billion asset threshold to be a covered issuer.

In our view, the Federal Reserve's proposal is based on flawed data, lacks the transparency in terms of relevant data to determine what is truly happening with respect to ACS costs, and is bad policy.

Respectfully,

Scott Reaser
Partner
McGovern Smith Advisors

Appendix A - ACS costs, excluding fraud losses¹

	<i>All covered issuers</i>				<i>High-volume issuers</i>				<i>Mid-volume issuers</i>				<i>Low-volume issuers</i>				
	<i>Transaction-weighted average</i>	<i>Issuer percentiles</i>			<i>Transaction-weighted average</i>	<i>Issuer percentiles</i>			<i>Transaction-weighted average</i>	<i>Issuer percentiles</i>			<i>Transaction-weighted average</i>	<i>Issuer percentiles</i>			
		<i>25th</i>	<i>50th</i>	<i>75th</i>		<i>25th</i>	<i>50th</i>	<i>75th</i>		<i>25th</i>	<i>50th</i>	<i>75th</i>		<i>25th</i>	<i>50th</i>	<i>75th</i>	
2021	All Transactions	0.0388	0.0534	0.1024	0.1760	0.0348	0.0287	0.0423	0.0782	0.1093	0.0723	0.1130	0.1688	0.5951	0.5189	1.3501	2.0288
	Dual-Message Debit	0.0391	0.0367	0.0764	0.1659	0.0372	0.0287	0.0424	0.0790	0.0934	0.0578	0.1055	0.1871	0.3626	0.2048	0.7934	1.7960
	Single Message Debit	0.0253	0.0254	0.0590	0.1525	0.0233	0.0219	0.0283	0.0626	0.0894	0.0533	0.0861	0.1847	<0.001	0.4542	0.9879	1.8225
	Prepaid Debit	0.0818	0.0306	0.0978	0.2683	0.0815	0.0306	0.0785	0.1405	0.3530	0.1037	0.2639	3.2145				
2019	All Transactions	0.0389	0.0441	0.1008	0.1623	0.0346	0.0261	0.0379	0.0810	0.1063	0.0637	0.1071	0.1502	0.7110	0.8367	1.1432	3.5762
	Dual-Message Debit	0.0419	0.0397	0.0896	0.1606	0.0392	0.0253	0.0381	0.0844	0.1080	0.0727	0.1171	0.1650	0.9052	0.9934	1.3339	3.5831
	Single Message Debit	0.0274	0.0238	0.0703	0.1592	0.0253	0.0160	0.0316	0.0681	0.0917	0.0474	0.0992	0.1623	<0.001	0.9159	1.2151	3.5072
	Prepaid Debit	0.0764	0.0454	0.0915	0.1850	0.0682	0.0355	0.0637	0.1196	0.4308	0.0981	0.2605	0.8238				
2017	All Transactions	0.0356	0.0423	0.0947	0.1847	0.0327	0.0258	0.0368	0.0750	0.1216	0.0828	0.1216	0.1839	0.4770	0.3712	0.9225	1.6929
	Dual-Message Debit	0.0398	0.0343	0.0819	0.1579	0.0376	0.0292	0.0345	0.0821	0.1214	0.0699	0.1411	0.2085	0.1356	0.1779	0.2237	0.2695
	Single Message Debit	0.0206	0.0247	0.0498	0.1328	0.0196	0.0155	0.0302	0.0535	0.0779	0.0448	0.1016	0.1766	<0.001	0.4985	1.1985	2.0107
	Prepaid Debit	0.0790	0.0359	0.0769	0.1159	0.0783	0.0340	0.0715	0.1153	0.2827	0.0407	0.1005	0.6361				
2015	All Transactions	0.0420	0.0580	0.1230	0.3050	0.0380	0.0350	0.0490	0.0770	0.1180	0.0810	0.1310	0.1990	0.5160	0.4130	1.3450	3.6070
	Dual-Message Debit	0.0480	0.0530	0.1010	0.1810	0.0450	0.0390	0.0560	0.0840	0.1280	0.0890	0.1510	0.2090	0.5370	0.2100	0.8110	7.8460
	Single Message Debit	0.0230	0.0320	0.0720	0.1550	0.0220	0.0180	0.0330	0.0510	0.0820	0.0470	0.0950	0.1590	1.4840	0.7140	4.6140	29.4060
	Prepaid Debit	0.1140	0.0690	0.1100	0.3030	0.1130	0.0650	0.1010	0.1610	0.2000	0.0880	0.4950	1.5560				
2013	All Transactions	0.0460	0.0690	0.1490	0.4220	0.0410	0.0390	0.0520	0.0760	0.1380	0.0790	0.1490	0.2390	0.6610	0.4430	1.2530	3.4690
	Dual-Message Debit	0.0520	0.0610	0.1060	0.1950	0.0490	0.0420	0.0700	0.0930	0.1300	0.0800	0.1570	0.2010	0.9190	0.5770	1.7640	13.3880
	Single Message Debit	0.0250	0.0340	0.0620	0.1530	0.0230	0.0170	0.0360	0.0560	0.0680	0.0400	0.0750	0.1490	2.1710	1.8480	2.4950	17.3730
	Prepaid Debit	0.1080	0.0920	0.1680	0.3100	0.0980	0.0930	0.1660	0.2780	0.5440	0.0520	0.2460	0.4120				
2011	All Transactions	0.0510	0.0740	0.1100	0.3610	0.0470	0.0440	0.0710	0.0910	0.1130	0.0810	0.1240	0.1830	0.5920	0.5200	0.9790	3.7460
	Dual-Message Debit	0.0550	0.0820	0.1200	0.2300	0.0510	0.0540	0.0870	0.1000	0.1250	0.0920	0.1390	0.1830	0.9810	0.7130	1.1770	5.7890
	Single Message Debit	0.0310	0.0380	0.0720	0.1830	0.0290	0.0320	0.0450	0.0640	0.0690	0.0500	0.0830	0.1410	0.7450	0.3740	1.0500	3.7560
	Prepaid Debit	0.1250	0.0840	0.1860	0.4980	0.1200	0.0680	0.1740	0.3500	0.7010	0.0890	0.7490	0.9510				

¹ Authorization, clearing, and settlement costs include transactions monitoring costs and exclude issuer fraud losses, which are reported separately. The transaction-weighted average for ACS costs excludes covered issuers that could not allocate among in-house, third-party, and network costs. The issuer-weighted average (not shown) and issuer percentiles include all responses.

Appendix B - Covered Issuers by Volume

		<i>Number of covered issuers</i>		<i>% of transactions</i>
	All covered issuers	163		
2021	High-volume issuers (more than 100 million transactions)	53	33%	94.32%
	Mid-volume issuers (1-100 million transactions)	86	53%	5.68%
	Low-volume issuers (less than 1 million transactions)	24	15%	0.01%
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	All covered issuers	152		
2019	High-volume issuers (more than 100 million transactions)	45	30%	93.54%
	Mid-volume issuers (1-100 million transactions)	85	56%	6.45%
	Low-volume issuers (less than 1 million transactions)	22	14%	0.01%
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	All covered issuers	115		
2017	High-volume issuers (more than 100 million transactions)	38	33%	96.21%
	Mid-volume issuers (1-100 million transactions)	59	51%	3.78%
	Low-volume issuers (less than 1 million transactions)	18	16%	0.01%
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	All covered issuers	129		
2015	High-volume issuers (more than 100 million transactions)	35	27%	95.12%
	Mid-volume issuers (1-100 million transactions)	65	50%	4.86%
	Low-volume issuers (less than 1 million transactions)	29	22%	0.02%
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	All covered issuers	131		
2013	High-volume issuers (more than 100 million transactions)	33	25%	94.81%
	Mid-volume issuers (1-100 million transactions)	63	48%	5.17%
	Low-volume issuers (less than 1 million transactions)	35	27%	0.02%
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	All covered issuers	131		
2011	High-volume issuers (more than 100 million transactions)	31	24%	94.04%
	Mid-volume issuers (1-100 million transactions)	63	48%	5.94%
	Low-volume issuers (less than 1 million transactions)	37	28%	0.02%