May 13, 2024

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

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

Dear Ms. Misback:

On behalf of Best Buy Co., Inc. (Best Buy), I am pleased to submit these comments in response to the Federal Reserve's Notice of Proposed Rulemaking on Debit Card Interchange Fees and Routing (Regulation II: Docket No. R-1818). Best Buy joins the broader retail community in strongly supporting the Board for bringing forward this proposed rule to make an update to the regulated debit cap. We believe prompt finalization and implementation of this update will provide additional support to Congress' mandate that debit interchange fees be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[1]

BACKGROUND

As a merchant that accepts various payment tenders, we are deeply familiar with the costs of accepting credit and debit cards, namely interchange "swipe fees" and other related fees assessed by card networks. Best Buy is a North American retailer, based in the United States, which sells consumer electronics, home appliances, mobile phones, cameras, and a variety of other merchandise, and provides related services for installing, fixing, and maintaining these products. Best Buy operates approximately 980 stores in the United States, and sells products and services through physical stores, the Best Buy mobile app, BestBuy.com, business-to-business channels, and through partnerships with other retailers. Consumers choose to shop at Best Buy using multiple payment options, including cash, check, credit cards, debit cards, mobile payments, and through Best Buy's own credit and financing options.

BEST BUY SUPPORTS THE BOARD'S RULEMAKING

As noted, Best Buy, strongly supports the steps the Board has taken so far, and we encourage quick action to supplement those steps, to prevent issuers from continuing to be unfairly overcompensated through the collection of fees related to debit transactions. In order to preserve the intent of the statute, we recommend that your update (i) align the reduction in the regulated debit fee cap with a reduction in costs; (ii) encourage competition between issuers that can further drive down the excess profits that banks extract from merchants and their consumers through the debit interchange system; and (iii) limit excess fees on debit transactions based on fraud loss, increased network fees or otherwise.

[1] 15 USC 1693o-2(a)(2).

Because the current debit fee cap is insufficient to protect merchants and consumers, any delay in updating the regulated debit fee cap will prolong the inequity and result in further degradation of merchant business operations and consumer spending opportunities while allowing issuers to continue to be unfairly overcompensated.

INTERCHANGE BASE RATE PROPOSAL OVERCOMPENSATES ISSUERS

While we support the board's proposal as necessary, we do not believe it is sufficient. To be clear, the proposed cap is a substantial improvement over the status quo; however, it preserves a large, excess profit margin, particularly for the largest issuers. Therefore, the cap that the Board has proposed will continue to overcompensate issuers and is not accomplishing the mandate of the rule to make debit interchange fees "reasonable and proportional."

Costs have fallen by half since base component costs were established but the proposal does not reduce the cap proportionately to these cost changes. The Proposed Rule states "the Board believes it is necessary to revise the interchange fee standards to reflect the decline since 2009 in base component costs."[2] Those costs decreased by approximately half from 2009 to 2021 ($0.077 to $0.039). But the proposed base rate of $0.144 is a reduction of less than a third from the current rate. The Board must avoid not locking in a proposed multiplier that is not reasonable and proportional as called for by the Durbin Amendment. In Regulation II (Debit Card Interchange Fees and Routing), the Board effectively applied a multiplier of 2.7. Now the Board proposes to increase the multiplier to 3.7. The increase itself is concerning, but the methodology for arriving at 3.7 is even more so.

Using a 3.7 multiple of average authorizing, clearing, and settling (ACS) costs distorts incentives for issuers. If average ACS costs were to decline by $0.01, the proposed rate cap structure would result in a $0.037 reduction in interchange. So, if issuers increased efficiency, they would be worse off by $0.027 per transaction. Alternatively, if issuers were to become less efficient and their ACS costs increased by $0.01, the proposed rate cap structure would increase the base interchange by $0.037.

These incentives associated with a fixed multiplier are not consistent with efficient outcomes. For example, there were approximately 56 billion debit transactions covered by the Durbin regulation in 2021. Reducing efficiency by $0.01 per transaction (i.e., increasing costs by $0.01 per transaction) would result in issuers collecting approximately $2.1 billion in additional interchange ($0.037 multiplied by 56 billion). Of the $2.1 billion in additional interchange, approximately $1.5 billion would be profit for issuers ($0.027 multiplied by 56 billion). On the other hand, issuers would save approximately $560 million in costs if they reduced costs by $0.01 per transaction, but they would lose approximately $2.1 billion in interchange because the interchange standard would decrease. They would, therefore, be unwilling to invest in efficiency.

NYU Stern reports that average bank profit margins are approximately 29.67%—far greater than the market average of 8.54%, but vastly different from the 270% profit margin that banks will earn on the average debit transaction under the proposed cap. Similarly, reported efficiency ratios for the banking industry (which compare total revenues net of interest expenses against non-interest costs) range from 1.6 to 1.8, a multiplier far below the one that the Board's current proposal produces. Meanwhile, the industries that pay

[2] 12 CFR Part 235 RIN7100-AG67.

these inflated debit interchange fees have profit margins far below market-wide averages, including 3.09% for general retail, and 1.18% for grocery and food. The Durbin Amendment does not imply that debit issuers should have per-transaction profit margins that would make not only their paying customers envious but also surpass those of any business, including other lines of business within the same bank.

We suggest the Board provide a base component rate of $0.05-$0.06 which provides covered issuers with a 35% (or more) debit interchange profit margin – significantly more than covered bank overall profit margins. That would meet the definition of a reasonable and proportional rate as it is an industry standard margin for banking services. Anything exceeding this threshold might raise questions about reasonableness and proportionality.

THE BOARD MUST ACTIVELY ENSURE DATA INTEGRITY

If the Board adopts an automatic process to adjust future rates based on issuer-reported costs, the Board must conduct oversight of the data collection process to ensure that costs are not misstated or inflated. The data currently collected and used to determine ACS is all self-reported by the financial institutions (FIs) with no audit process on its integrity or validity. To date, reporting the data has not had much impact on the FIs as the rate has not moved over the life of the reporting period. That will change if this proposal is adopted.

Without clear definitions and audit processes in place, the likelihood of a mischaracterization of fees or liberal interpretations of cost may have a negative effect on the outcomes. One way to ensure this does not happen is to subject the data to periodic audits and to conduct statistical analyses between like FIs to identify inconsistencies.

An audit plan, how the integrity of the data will be ensured, and enforcement mechanisms must be made part of the Proposed Rule. Additionally, the Board should consider retaining the flexibility for adjusting or excluding costs from specific issuers that do not appear legitimate or representative.

ISSUERS SHOULD NOT RECOVER FRAUD LOSSES FROM MERCHANTS

The Board should eliminate the *ad valorem* fee entirely and allow fraud losses when they occur to be absorbed by the responsible parties. This would incentivize each party to do their best to reduce fraud, rather than have merchants subsidize issuers in advance for their potential, not actual, losses.

The Board's methodology for the *ad valorem* component does not meet the data that the Board has collected. It was a discretionary decision by the Board to establish a uniform *ad valorem* fee component to compensate all covered issuers in advance for predicted fraud losses. The Board designed this approach in 2011 with issuer fraud losses primarily in mind, when the data showed that issuers bore 61% of fraud losses. This structure is no longer justifiable when issuers now bear only 33% of fraud losses and when losses are increasingly charged back to merchants or covered by cardholders. Also, the structure simply has not worked to incentivize reductions in fraud. Using this methodology going forward will lock in the wrong incentives for fraud reduction. Issuers will be able to continue pushing actual fraud losses to merchants and cardholders. There is no reasonable justification for continuing to require merchants to pre-pay potential fraud losses through interchange when merchants absorb a higher percentage of fraud losses than issuers – which only cover a small and dwindling percentage of actual losses. Also, as fraud increasingly shifts to card-not-present channels where merchants already absorb the vast majority of fraud losses, locking in the Board's current methodology risks becoming even more inconsistent with the statute as merchants would cover fraud multiple times (*ad valorem* fee, absorbing actual fraud losses via chargebacks, and paying the fraud prevention adjustment) with no evidence that fraud would actually be lessened.

ISSUERS SHOULD NOT RECOVER FRAUD PREVENTION COSTS FROM MERCHANTS

The statute mandates that the Board establishes fraud prevention standards requiring issuers to effectively mitigate fraud occurrence and associated costs. To qualify for a fraud prevention adjustment, issuers must comply with these standards. However, the Board's current approach lacks efficacy assessment, as it looks to grant adjustments without evaluating the effectiveness of issuer measures and solely focuses on adjusting for increase in issuer fraud prevention costs. The Board's survey merely solicits checkbox responses from issuers regarding their engagement in broad fraud prevention categories, without setting measurable effectiveness metrics or verifying compliance.

Now, the Board proposes to increase fraud prevention adjustments based on a revised methodology, despite median issuer fraud prevention costs decreasing per transaction. Meanwhile, merchant investments in fraud prevention remain unquantified and disregarded. Eligibility for adjustments should hinge on demonstrable fraud reduction or slower growth compared to the mean, indicating effective spending. Issuers failing to demonstrate reduced fraud losses over time should temporarily forfeit adjustment eligibility until efficacy is proven. Overall, a case-by-case evaluation of issuer fraud prevention effectiveness is deemed the most pragmatic approach.

POTENTIAL FOR CIRCUMVENTION OF THE PROPOSED RULE

A decade of experience for merchants and the Board under the Durbin Amendment and its implementing regulations has demonstrated the extreme ingenuity of the banks and card networks when it comes to fighting against the statutory vision of the Durbin Amendment in order to hold on to their excess profits. We have seen the issuers and networks together take actions to evade the letter and spirit of Regulation II. The Board addressed this on card-not-present routing and the Federal Trade Commission (FTC) addressed it on the manipulation of point-of-sale screens. But we have also seen it to varying degrees on shifting network fees, shifting fraud chargebacks, and other actions to interfere with routing. It should be easier to raise, investigate and address these kinds of issues. The Board needs to be aware of potential loopholes in the proposal and address and future proof any potential circumvention.

One potential area of abuse that could be consequential is the inclusion of network fees in issuer costs with a fixed multiplier. The Board considers issuer-paid network fees to be an allowable cost for calculating the base component rate. With a fixed multiplier, networks and issuers could easily increase issuer-paid network fees and then the issuers would receive multiple times that amount back as interchange. That loophole must be addressed in the final rule. Of the issuers providing detailed cost data, it is interesting to note that in 2021 mid-volume issuers incurred network fees 7.6 times higher than the high-volume issuers ($0.046 vs. $0.006). It is clear that high-volume issuers have been successful in negotiating lower fees with networks, and the Board should adopt a policy that continues to encourage issuers to reduce their costs. A competitive dynamic between networks could easily develop that would result in an escalation of network fees on issuers to push interchange higher. The result could be similar to the series of interchange fee increases that took place in 1998 and 1999 when Visa and Mastercard leap-frogged each other multiple times with higher interchange fees in an attempt to win issuer business.

We have already seen significant increases of network fees imposed on merchants under Regulation II, often to try to influence routing, and it is clear that networks are on alert for ways to use network fees creatively to benefit themselves and issuers in their networks.

Given that we have seen this activity since the start of the rule, we would recommend the Board creates a formal process to provide feedback for when potential rule violations present themselves. We should all understand by now that they will occur again and would like to work together to make that process easier through a more formal process for collaboration.

CONCLUSION

Best Buy commends the Board for issuing this Notice of Proposed Rulemaking and wishes to thank it for taking this important step to propose updates to the regulated debit interchange cap. Overall we think the Board is moving in the right direction, and we need to ensure the proposed rule is reasonable and proportional to what the Board set out to accomplish in the initial rule making process.

Specifically, we propose the Board consider (i) adjusting the base component to $0.05 - $0.06 to align to the profit margins; (ii) removing the *ad valorem* and fraud prevention costs; and (iii) restricting the increase in network fees, which would accomplish the goal of making the rule reasonable and proportional.

As a result of comments received during the comment period in 2010, the proposed rule significantly changed in the banking industry's favor. Merchants are nervous about that history repeating itself. We have put forward good faith proposals, herein, for revised methodologies that are critically important to implement in order to ensure the final rule is consistent with the intent of the statute, resulting in a benefit for the entire debit system.

Additionally, we wish to express our support for the detailed comments submitted by our industry associations: Retail Industry Leaders Association (RILA), National Retail Federation (NRF) and Merchant Advisory Group (MAG).

Thank you for the opportunity to comment and for your consideration of Best Buy's concerns. We are happy to discuss any of the content included herein, or to provide other assistance, as the Board finalizes and implements these changes. I can be reached directly at (612) 308-2005 or Matt.Carter@bestbuy.com.

Sincerely,

DocuSigned by:

Matt Carter

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Matt Carter
Senior Vice President, Finance