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By Email to regs.comments@federalreserve.gov

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

Re: Regulation II Amendment Regarding Interchange (Docket No. R-1818)

Ms. Misback:

We write on behalf of The Kroger Co. in response to the Board's request for comments on the proposed changes to Regulation II. We are, across our family of companies, nearly 500,000 associates who serve over 11 million customers daily through a seamless omnichannel shopping experience that also provides pharmacy and fuel services under a variety of banner names including, in addition to our namesake, Ralphs, Fred Meyer, Harris Teeter, Food 4 Less, Frys and King Soopers to name a few.

We genuinely appreciate the Board's actions and recommendations to amend the components of Regulation II as the debit card market and related economic factors have changed significantly in the 12 plus years since the Board set the original components and rates. With all the changes in payment technology and the findings stated in the 2021 Interchange Fee Revenue, Covered Issuers Cost, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions report published in October 2023, we strongly encourage the Board to adhere to the wording in the Durbin Amendment and Regulation II to limit costs specifically to those "reasonable and proportional" costs incurred for setting the amount charged for interchange

and not go beyond with additional components not provided for in the statute. Specifically, we encourage the board to consider their findings that, "the average per-transaction authorization, clearing and settlement (ACS) cost, excluding issuer fraud losses, which have significantly declined since 2011, among covered issuers were $0.039 in 2021, approximately half of the 2009 value". In addition, the Board's recommendation to implement an automatic mechanism to adjust the rate is indeed a welcome concept as it may reduce the need for future amendments. For an automatic mechanism to work properly though, the methodology supporting the mechanism must be correct and accurate; there must be checks and balances including a meaningful examination of the data from issuers for validity and anomalies before the new rate is set. Because of the enormous stakes involved, merchants paid covered issuers nearly $13 billion in debit interchange in 2021-greater transparency surrounding issuer costs is essential.

As a reminder of why Congress passed the Durbin Amendment, the debit card payments market that existed in the early 2000's leading up to Regulation II was characterized by high debit card interchange cost for debit transactions, concentration of debit card volume with a small number of issuers, exclusive card brand agreements with issuers for single network branding, issuers incentivizing customers to "skip the PIN and win" by charging fees to use more PIN debit transactions, limited or no routing for merchants and continuing increases of network costs set by card brands, all against the backdrop of ever increasing debit card use for purchases. Moreover, the rules of the card brands favored issuers in disputes resulting in an unfair balance with merchants incurring a disproportional share of the losses from fraudulent transactions via issuers.

Concerned about the lack of competition and excessive fees being charged on debit card transactions, Congress looked at the debit card market, dominated by two very large card brands, and recognized that the market was broken. Debit card transactions were fundamentally similar to check transactions that clear at PAR. While Congress did not intend for a debit card transaction to clear at PAR like a check, they did recognize that technology efficiencies with debit card transactions should lead to lower costs and lower fees charged to merchants and ultimately consumers. To correct a misfunctioning market, Congress conceived a structured approach to address the two main market concerns: excessive fees charged (and excessive profits for issuers) and lack of competition between debit networks. The Durbin Amendment, passed in 2010, established a format to bring about these changes by mandating that all debit interchange fees be "reasonable and proportional to the cost incurred by the issuer with respect to *the transaction*". Congress' intent was to enhance competition, transparency, choice, and eliminate inefficiencies by reducing rates that were providing excessive profits for issuers (and ultimately higher costs for consumers). Furthermore, Congress, through the Amendment, directed the Federal Reserve Bank to set an interchange fee

standard that allowed an issuing bank to recover only its transaction specific costs. The fact that the Board has had to intervene twice in recent years to remove actions by the issuers and card brands to prevent limited routing should not be overlooked as the Board proposes changes to the current rates and methodology.

Current State of Debit Card Market

Debit card volume continues to increase and in many businesses debit card is the preferred method of payment by the customer. When Regulation II was originally enacted debit cards were mainly used for in person transactions, but beginning in 2020, with the start of the pandemic, online shopping has grown and debit card volume has seen double digit increases. This is a significant transitional change in the payment space compared to the low single digit pre-pandemic increases.

As with the years leading up to the passage of Regulation II, issuers with significantly higher debit card transaction volume continued to dominate. According to the Board's data from the 2021 Interchange Fee Revenue, Covered Issuers Cost, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions report, there are 53 high volume covered issuers (more than 100 million transactions) and these issuers have 94.32% of the transactions. Part of the increase in debit card volume is attributed to the increased issuance of commercial debit cards by exempt issuers which are excluded from the regulated rate and are priced at markedly high percentage rates. These commercial debit cards nevertheless use the same payment technology rails as consumer debit cards but generate higher revenue and profits for the issuer. With consumer and commercial debit cards, the card brands charge through the acquirers to the merchants a significant number of individual network fees. Some are a per-transaction fee, and some are a percentage of the spend and are unavoidable for the merchant. This represents instances of merchants paying multiple times for fraud services on multiple debit card transactions.

While we are grateful that the Board is reexamining debit fees, we have concerns over the methodology the Board is now proposing and the implications of that methodology, if maintained, in setting future costs related to the acceptance of debit card transactions from regulated issuers. Our concern is that the proposed methodology does not address certain current market conditions such as the concentration of volume among a very small group of issuers, fraud losses by merchants and the rapid pace of change within the payments industry. In addition, the methodology is seemingly contradictory to the arguments of the Board before the District Court and the Court of Appeals for the District of Columbia.
Therefore, we respectfully request the Board modify their proposed amendment as outlined below.

Base Component

Regulation II expressly "Prohibits covered issuers from charging interchange that is not reasonable and proportional to cost incurred by the issuer with respect to the transaction". In 2011 the Board set the methodology for determining the base rate of authorized costs. The original base rate was set at $0.21, which was 2.7 times the ACS cost reported by the issuers. Under the methodology, 80% of transactions were covered. The Board stated, "they didn't believe setting a rate to cover high-cost issuers would be *reasonable or proportional* to the overall cost experience of the substantial majority of covered issuers." The Board used this methodology as the basis of its winning argument to the District Court and the Circuit Court of Appeals.

Now, more than twelve years later, the Board is proposing a new methodology that would cover 98.5% of covered transactions. By changing the percentage of transactions covered from 80% to 98.5%, the Board in effect is saying that issuers that run inefficient operations and do not control their costs should be compensated outside the bounds of a reasonable and proportional cost. There is no regulatory justification for this change, and it is contrary to what Congress intended. The statute is clear in its wording that cost must be reasonable and proportional to the allowable costs. From our perspective, including and indeed rewarding inefficient issuers does not meet a generally accepted view of reasonable and proportional, as it systematically over-compensates all other issuers, including high volume issuers who account for the vast majority of transactions.

In addition to its decision to cover the costs of almost 100% of the covered transactions, the Board proposes a new *arbitrary* multiplier of 3.7. This number would then be multiplied by the ACS costs of $0.039 and rounded to the nearest tenth of a cent for an ACS cost of $0.144. This new multiplier combined with the increase of 98.5% of covered transactions rewards issuers with efficient low-cost operations with billions of additional dollars in revenue. The highest volume issuers under this scenario would receive over $6 Billion in excess profits over their costs. If the Board used the existing multiplier of 2.7 it adopted 12 years ago, the new cost would be $0.105 which would be much closer to the reasonable and proportional cost mandate.

The new methodology increases the rate 269% above issuer reported costs and the Board calculated allowable cost. We suggest that this amount is neither reasonable nor proportional as required by the statute. In this regard, consider that issuer ACS costs have declined 49% from 2009 to 2021, $0.077 to $0.039, but the Board is only reducing the rate by 31% from $0.21 to $0.144.

To have a standard comparison of "reasonable and proportional", the Board only has to look internationally at the interchange rate set for debit card transactions: Australia – benchmark $0.053, cap $0.099; European Union – 0.20% of the transaction value...USD = $0.05 ($25 transaction) and $0.086 ($43 transaction); Israel – 0.25% of the transaction value... USD = $0.0625 ($25 transaction) and $0.1075 ($43 transaction); New Zealand – POS Contact $0.03 and POS Contactless 0.20%...USD = $0.05 ($25 transaction). There is no data or reason to believe the United States issuers are less efficient than the issuers in these countries that are receiving these rates. By comparison, the Board is proposing a base interchange rate that is almost 3 times higher than the average of four international industrialized jurisdictions.

Given existing market conditions we urge the Board to set the ACS rate at $0.039 as reported by the issuers.

Fraud Ad Valorem Fee

The fraud ad valorem fee set by the Board is not provided for within the language of the statute. It was created without specific statutory authorization. In addition, since the original fee, 5 basis points, was set by the Board, payment card technology has changed substantially. In 2011, the card brands announced the move to chip card payment technology and set an implementation date for almost all businesses of October of 2015. This chip card technology was designed and did in fact reduce or eliminate fraud and provide all parties, including consumers, with more security except in the case of card-not-present debit transactions where fraud is significantly high. The cost to the merchant community to purchase new chip terminals and develop the programming to support the technology ranged in the tens of billions of dollars. In other countries, such as United Kingdom, Australia, and Canada, the card brands and issuers reduced interchange rates to assist the merchants in implementing this costly technology. That did not occur here. Merchants in the United States did not get any interchange reductions and continued to fully incur unfair fraud losses by virtue of this process, because the timeline provided to US merchants was far shorter than any other country. Furthermore, beginning around 2015 the card brands began introducing tokens that replace the primary account number in the processing stream. In 2023, several issuers had adopted this token process and merchants were told that they could either use these specific tokens, which can only be detokenized by the card brand, or pay a higher interchange rate for eCommerce transactions.

There is no regulatory justification for the current ad valorem fee. This fee is charged on every debit card transaction, but plainly there is *not fraud on every debit card transaction*--in other words, fraud losses bear no relationship to particular debit transactions. Continuing allowing the ad valorem fee to be charged on every transaction is providing covered issuers excess revenue well above their fraud losses. There is no sound reason for merchants to act as the

insurers for issuers losses. That was never the intent of the statute, and it makes no sense from a policy perspective. Based on these noted advances in payment card technology and the Board's findings that covered issuer fraud losses have declined, while merchant losses have increased, we encourage the Board to eliminate the fraud ad valorem fee entirely, or at least reduce it substantially.

Fraud Mitigation Component

Unlike fraud losses, the statute does provide for a fraud prevention component. The Board has chosen under this provision to provide the covered issuers with a fraud mitigation fee of $0.01. Our issue with this practice is that the fee is charged on almost every debit card transaction without any verification that the issuer has implemented a fraud prevention process. The Board allows self-reporting from the covered issuers without any verification or validation that the requirement of implementing a meaningful fraud prevention process has been undertaken. According to the Board's reported data, fraud loss has declined for issuers and increased for merchants. How the Board can continue to award a fee for fraud prevention when merchant losses are greater than issuer losses defies logic. As noted above, the changes in payment card technology have greatly reduced the way fraud can occur. We encourage the Board to eliminate the fraud prevention component entirely, or at least reduce it significantly. Merchants are given no credit for their expenses in fraud technology they adopt; we see no reason to do so for issuers.

The Board also asked for comments on setting an automatic 2-year adjustment and timing based on the survey responses from covered issuers. We support the Board initiative creating a more efficient process and a regular mechanism to adjust the base interchange rate, so long as the Board uses a methodology that is faithful to the language of Regulation II and provides a process to validate the data supplied by the covered issuers. Self-reporting by issuers can, and often does, lead to inaccurate or incorrect calculations affecting billions of dollars of misplaced costs to the merchants. It goes without saying that this translates into billions of dollars of unentitled profits above ACS cost to the issuers. This suggested verification could easily be provided by the same external auditors that the issuers use to review and validate their financials. If the information received by the Board from issuers shows anomalies, the Board should have an established process of transparency with the permissible input by all stakeholders to address the identified issues.

Moreover, we urge the Board to set the timing of the implementation of the new base interchange rate under the biannual adjustment procedure to thirty days to maximize the impact of the adjustment. Card brands frequently make adjustments that issuers and merchants must absorb within thirty days; this should be no different and should reflect current market operations.

Summary

To reiterate, we sincerely appreciate the Board proposing changes in light of twelve years of survey data showing ACS costs continuing to decline substantially, coupled with a decline of issuer fraud. We compete every day with thousands of food retailers and restaurants for customers to shop our stores and online. Part of that competition includes working to get the lowest price from our suppliers so we can pass those savings on to our customers. We have a twenty plus years of history of passing savings onto our customers when we realize lower costs on a service or item.

By using the data received from the covered issuers, we encourage the Board to take the right action and implement only the ACS per-transaction cost of $0.039, that would align costs with other industrialized countries as "reasonable and proportional". Providing a rate higher than the reported rate only increases the profits of the high-volume issuers. The extraordinary changes in payment card technology and merchant software have addressed the fraud issues that plagued the issuers and the merchants before Regulation II. In addition, we pay network fees and third-party fees to support payment fraud detection and prevention. Therefore, we respectfully request the Board not just change the interchange fee, but to eliminate in their entirety the fraud ad valorem fee and the fraud prevention fee.

We thank the Board for its consideration of the concepts and the rule changes discussed in this letter.

Respectfully,

TODD A. FOLEY