Meeting Between Governor Kugler and Staff of the Federal Reserve Board and Representatives of Various Trade Associations
April 10, 2024

Participants: Governor Adriana D. Kugler and Kelley O'Mara (Federal Reserve Board)

Rodney Abele (The Clearing House); Anne Balcer (Independent Community Bankers of America); Andrew Morris (America's Credit Unions); Paige Paridon Pidano (Bank Policy Institute); David Pommerehn (Consumer Bankers Association); Jess Sharp (American Bankers Association); Jeffery Tassey (Electronic Payments Coalition) (together, the trade associations)

Summary: Governor Kugler and staff of the Federal Reserve Board met with representatives of the trade associations to discuss their concerns regarding the Board's notice of proposed rulemaking on Regulation II (Regulation II proposal). Representatives of the trade associations also asked that the Board reconsider the rule in light of 2023 data, which they anticipate will reflect higher issuer costs due to 2022 amendments to Regulation II and increasing fraud costs. Representatives of the trade associations also questioned various aspects of the Board's methodology for calculating the fee cap in the Regulation II proposal, including the use of a transaction-weighted average to determine the base component; the use of median issuer fraud losses to determine the ad valorem component; the use of a Weibull distribution; and the setting of the base component to facilitate full cost recovery for only 98.5% of transactions.

Attachment

Background

- The proposed amendments to Regulation II would lower the aggregate interchange fees an issuer could collect by adjusting the three components of the cap as follows:
  - Authorization, clearing, and settlement (ACS) base component: decreases from 21 cents to 14.4 cents.
  - Ad valorem fraud loss component: decreases from 5.0 basis points to 4.0 basis points, multiplied by the value of the transaction.
  - The fraud-prevention adjustment: increases from 1 cent to 1.3 cents.
- The statute requires interchange fees to be "***reasonable and proportional***" to a covered issuer's costs—not merely "equal to" and certainly not "less than" those costs.
- Yet the Board acknowledges that the proposal would allow only some covered issuers to recover (only a subset of) their costs, but not a reasonable rate of return, for the payment services they provide.
- **In 2021, the current cap prevented 24% of covered issuers (approximately 40 of 162 covered issuers) from recovering their allowable costs, including 23% of mid-volume issuers and 84% of low-volume issuers.**
- **The Proposed Rule is projected to deny cost recovery to more than one third (34%) of covered issuers.**
- If Congress had meant for the cap to be "equal" to costs, it would have said "equal."
- In addition, the Board does not include in the calculation of the cap all relevant costs it may permissibly consider.

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The Board Is Not Required to Amend Reg. II Right Now

- There is no statutory or regulatory requirement that the Board revise the interchange fee cap either periodically or with reference to any particular data point (and certainly not by reference to a transaction-weighted average cost).

- In releasing the Regulation II final rule in 2011, the Board stated in the preamble to the rule that it would "periodically conduct surveys of covered issuers in order to reexamine and ***potentially reset*** the fee standard."

- Thus, the Board has all the time it needs to gather the relevant data, factor in a required rate of return, more fully consider the effect of the proposal on consumers, financial institutions, and reissue the proposal, if it determines that a proposal is appropriate.

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The Board Is Required to Consider the Effect of the Proposal on Consumers

- Section 904 of EFTA requires the Board to: (a) consider the "costs and benefits to financial institutions, consumers, and other users of electronic fund transfers" of the regulation prior to issuing the regulation; (b) consider the ways that the proposed regulation affects "competition in the provision of electronic banking services among non-exempt and exempt financial institutions and the availability of such services to different classes of consumers, particularly low-income consumers"; and (c) to the extent practicable, "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions."

- *This requirement is fully consistent with the statute, as properly read, given that (as noted above) allowing a rate of return as part of a "reasonable and proportional" price would allow for consumer interests to be factored into the cap, whereas the proposal's focus solely on cost has not.*

- **The Board can further give effect to this provision through its choice of metrics to analyze industry costs and methodology to establish an interchange fee cap.**

- The stakes are significant. Prior to the Board's imposition of the Interchange Fee Cap in 2011, nearly 60 percent of large financial institutions offered free checking account options to consumers.
  - In first few years after the cap was imposed, that number fell to below 20 percent.
  - The availability of free, non-interest-bearing checking accounts offered by ***exempt financial institutions*** declined by 15.5 percent following imposition of the Interchange Fee Cap.
  - Consumers also experienced substantial increases in the amounts of fees on fee-based checking accounts. Within the first few years after 2011, average checking account fees for consumers nearly doubled, from roughly $4 per month to more than $7 per month.
  - Reduced interchange fee revenue also likely reduces innovation and investment in the payments system by covered issuers.

- **If finalized as proposed, it is estimated consumers are will pay an extra $1.3-$2 billion annually in higher account fees.** (Nick Bourke, "How Proposed Interchange Fee Caps Will Affect Consumer Costs", Jan. 24, 2024, at https://ssrn.com/abstract=4705853, building on the work of Mukharlyamov, Vladimir and Sarin, Natasha, "Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards", Nov. 24, 2022).

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Access to Low-Cost Banking Accounts will be Reduced

- Financial institutions’ decreased ability to offer free and low-cost deposit accounts and other financial products to consumers includes, for example, “Bank On” and similar financial-inclusion products targeted at unbanked and underbanked consumers.

- The goal of Bank On is to ensure that everyone has access to a safe and affordable bank or credit union account.
  - The Bank On National Account Standards allow for limited monthly fees and opening deposit amounts in recognition of the costs of account maintenance but prohibit overdraft or insufficient fund fees.
  - Bank On Certified products provide a safe, affordable substitute to higher priced alternative financial options like money orders and check cashing services.

- The long-term sustainability of Bank On Certified products relies on banks’ ability to continue to invest in these products.
  - By the very nature of the customers they serve, products designed for unbanked/underbanked generate significantly less revenue per account than mass market products. Debit interchange is critical to keep costs low for customers due to higher costs to serve them
  - Bank On accounts have been carefully crafted by participating financial institutions to succeed, notwithstanding the current Interchange Fee Cap.
  - However, the viability of Bank On certified accounts, and mainstream financial services accessed by financially vulnerable consumers, will be threatened should merchants pay even less than they currently do in interchange revenue.

- Please see the comment letter submitted by the Cities for Financial Empowerment Fund to the Board.

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The Vagueness of the Board's Survey and Reliance on Core Providers for Data May Lead to Underreporting of Issuer Costs

- It is important that the Board base its rulemaking on accurate data.

- The banking industry requested that the Board more precisely define the types of costs that would be responsive to the Debit Card Issuer Survey questions in 2011, 2013, and 2016, but the Survey has not been updated to reflect additional precision or detail.
  - The current generality, vagueness, and imprecision of the issuer survey likely leads to inconsistent data reporting among issuers, and to many covered issuers understating the costs they report.

- All but the very largest banks struggle with gathering the required Survey data from their core providers, resulting in many blank and "N/R" data field responses from these medium and small issuers.
  - Only the Board knows how pervasive these incomplete Survey responses are.
  - Incomplete reporting by medium and small issuers skews the Survey cost data, over representing large issuers in the data.

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Issuer Costs Do Not Justify Lowering the Fee Cap

- Even based on the limited universe of costs that the Board currently includes in the calculation, as demonstrated above, issuer costs as measured by transaction weighted average do not support a 30% reduction in the base component of the interchange fee cap.

- The transaction weighted average of per-transaction base component costs across covered issuers has fallen only 1.2 cents since 2011. (That metric was 3.9 cents in 2021, and 5.1 cents in 2011.)

- This is well within the range of uncertainty for this type of data collection exercise and the lack of consensus and clarity about what costs are appropriate to include.

- We use 2011 survey as the base case because, the original 2009 voluntary produced inaccurate data.
    - Based on the 2009 data, it was estimated that 80 percent of issuers would recover their allowable costs with a 21 cent cap, but **this has never occurred**.
    - The mandatory 2011 survey showed that only **61 percent of issuers** recovered their costs with a 21 cent cap.
    - In 2021, still only **77 percent of issuers** recovered their allowable ACS costs.
    - Using the rule's current metric, the costs of the 80th percentile issuer, the base component should increase.

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Fraud Growth Does Not Justify Lowering the Fee Cap

- Fraud incidence (the share of all covered issuer transactions that are fraudulent) has more than tripled from 2011 to 2021, increasing from 3 bps in 2011 to 10.8 bps in 2021.
- According to studies conducted biannually by Visa, the presence of fraud, including through ransomware attacks, enumeration attacks that impact merchants and consumers alike, and general fraud committed at card-not-present merchants, has reached all-time highs.
- Transaction-weighted average issuer fraud losses **increased** from 1.8 cents to 2.8 cents between 2011 and 2021; while issuer-weighted average issuer fraud losses also **increased** from 4.4 cents to 5.3 cents during the same period.
- **Yet the Proposal would reduce the ad valorem multiplier based on the *median* issuer fraud losses.**
- Issuer fraud costs and losses are expected to rise with recent material changes in the debit card market, including:
  - Changes to card network rules designed to shift fraud losses from merchants to card issuers;
  - Initial effects of the card-not-present routing amendments to Regulation II; and
  - Rapid growth in contactless and mobile wallet usage, and PIN-less card-not-present transactions.
- As 2021 Fed data shows, **card-not-present fraud** accounted for 64% of overall fraud incidents in 2021.
- As fraud schemes continue to grow in frequency and sophistication, covered issuers should be encouraged to innovate, increase investment, and devote substantial resources in fraud detection and prevention.

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Regulation II's Current Interchange Fee Cap has Harmed Even Exempt Issuers

- Regulation II's current interchange fee cap has harmed even exempt issuers due to the downward drag of competition from regulated interchange and spillover regulatory effects, and lowering the cap will increase the harm.

- Between 2011 and 2021, exempt institution debit card interchange revenue fell 16% for single-message network transactions.

- Additionally, the availability of free, non-interest-bearing checking accounts offered by exempt financial institutions declined by 15.5 percent following imposition of the Interchange Fee Cap according to Board economists.

- The proportion of all debit card transactions processed over single message networks is likely to increase substantially as a result of the Board's 2022 Regulation II routing amendments, which effects are not reflected in current data.

- In 2014, 73.3% of surveyed exempt banks indicated that "debit card interchange fees policy" had a negative impact of some kind (either "significant" (29.1%) or "slight" (44.2%)) on their earnings.

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Further Reducing the Interchange Fee Cap is Unlikely to Result in Merchants Passing on Resulting Savings to Consumers

- Congress's stated goals in enacting the Durbin Amendment included consumers benefiting through lower retail prices and helping small, struggling businesses. Merchants indicated that any resulting increase in consumer fees for banking services would be offset by merchants passing through to consumers, in the form of lower pricing, their interchange fee savings.

- There is little evidence to indicate that merchants have passed on to consumers the merchants' savings from Regulation II's current interchange fee cap.
    - **According to a merchant survey conducted by the Federal Reserve Bank of Richmond and Javelin Strategy & Research in 2014, 75% of merchants reported that they did not change prices due to Regulation II, 23% reported that they increased prices and 2% reported that they decreased prices.**

- The Board acknowledges in the NPR that a direct and certain impact of the proposal would be to reduce merchants' costs of accepting debit cards whereas it is uncertain whether merchants will pass any of these savings on to consumers.

- In addition, the Interchange Fee Cap has primarily benefited larger retailers without helping smaller merchants.
    - Larger merchants tend to pay for payments acceptance on a "cost-pass-through" basis, which means reductions in interchange fees correlate to a direct reduction in those merchants' costs incurred to reap the significant benefits provided by the payment card system.
    - Smaller merchants, by contrast, tend to pay a flat-rate blended fee for payments acceptance services, which does not vary with cost inputs, such as interchange fees.

- **Other studies purporting to assess lower prices for consumers looked to merchant profitability as a proxy, but did not directly study consumer prices.**

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The Rule Excludes Relevant Costs It Is Legally Permitted To Include

- In calculating the cap, the Board includes only the following components: ACS costs, ad valorem fraud loss costs, and fraud-prevention costs.

- The Board is legally permitted to include additional costs specific to a particular transaction when calculating the cap. *NACS v. Board of Governors of the Federal Reserve System*, 746 F.3d 474 (D.C. Cir. 2014)

- **The Board has in fact collected data via the Survey on components of additional costs since 2011 that the Board has acknowledged would be legally permissible to consider** (76 Fed. Reg. 43394, 43429 (July 20, 2011; 76 Fed. Reg. 79184, 79189 (Dec. 21, 2011)).

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Additional Costs Included in the Survey which the Board May Include In the Cap Are Material

- In particular, the Board's biennial survey collects cost information on two components it clearly may, but does not currently, include in the cap:
  - **Cardholder Inquiry Costs** and
  - **NSF Handling Costs.**

- Based on 2021 Survey data, the transaction weighted average cost of:
  - non-fraud-related, transaction-specific cardholder inquiries was **3 cents** and
  - NSF handling cost was **0.5 cents**.

- Using the Board's proposed new methodology, adding these components to the existing pre-multiplier base component of 3.9 cents would yield a pre-multiplier base of 7.4 cents.

- Applying the Board's chosen 3.7x multiplier to ACS costs would yield a base component of 27.4 cents per transaction.

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Other Additional Costs which the Board May Include In the Cap

- In addition to the two components referenced in the prior slide, the following cost components are examples of costs specific to debit transactions, which also may be considered by the Board for inclusion:

  - **Non-sufficient funds losses** and
  - **Debit card transaction compliance costs**(e.g., laws, such as Reg E error resolution program costs, and network rules)

- BPI/TCH/ABA have collected data through a supplemental issuer cost survey and estimated the amount of the costs from NSF Losses and Debit Transaction Compliance Cost in 2022.

- Based on the Supplemental survey data, the transaction weighted average costs of:
  - **NSF Losses** is estimated to have been **1.05 cents** and
  - **Debit Transaction Compliance** is estimated to have been **1.15 cents**.

- Including these components of transaction specific costs would result in a further increase of the 27.4 cent cap referenced in the prior slide.

- The following slide provides an illustration of the increase in the transaction weighted average cost were these four categories of permissible costs included in the calculation of the cap.

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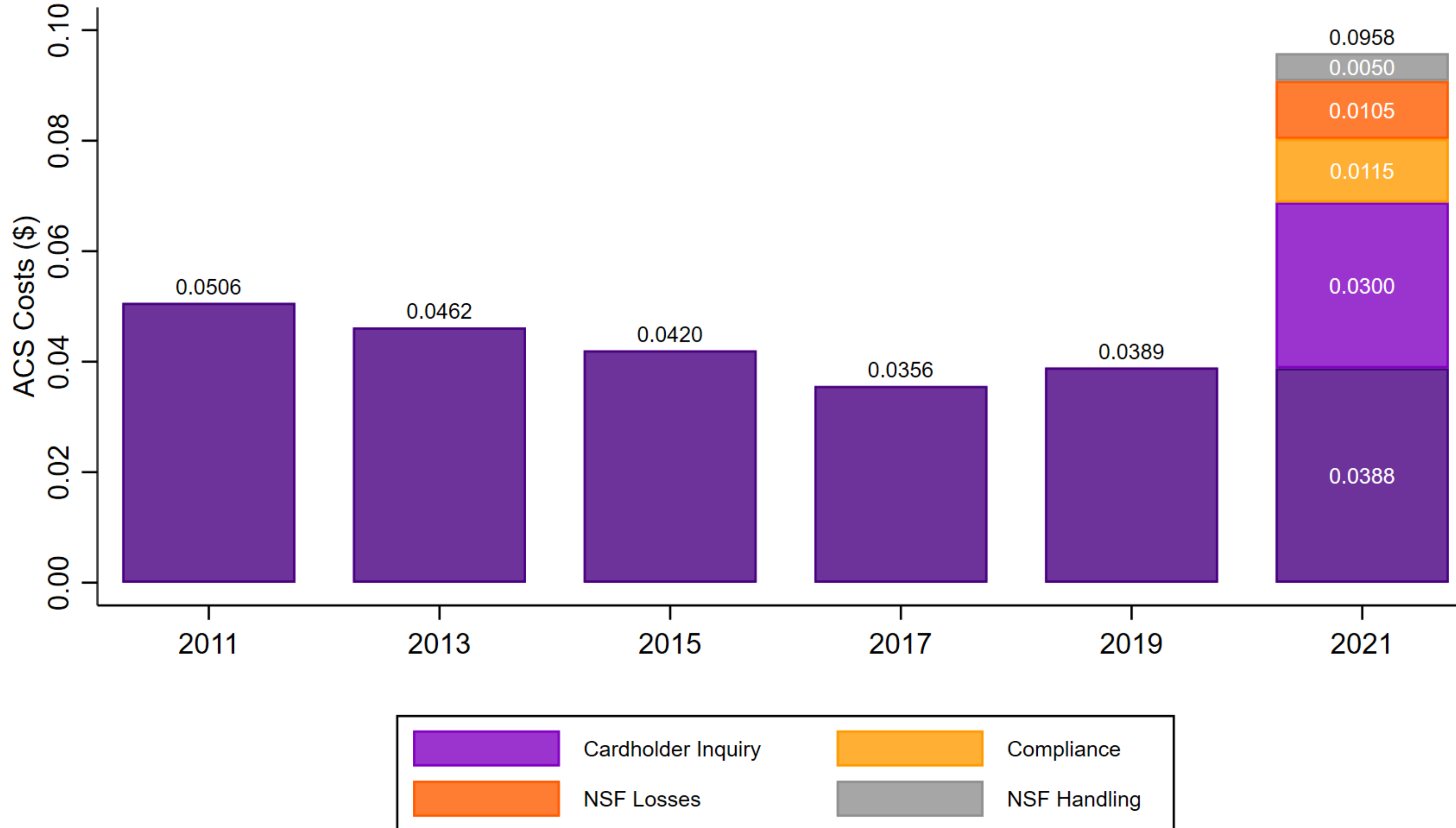
The Current Cap Excludes Relevant Costs



Sources: Federal Reserve Board, BPI & Trade Groups Survey.

The Proposal's Shift in Methodology is Unexplained and Unwise

- **The largest change in the cap from the proposal comes from a change in methodology, not from changing industry costs**.
- The methodology would change from using an issuer-weighted cost to transaction-weighted cost.
- Transaction weighting skews the allowable base component toward high-volume issuers, weighting the average transactions of 33% of issuers at 94.3 percent while weighting 67% of issuers at less than 6 percent – effectively disregarding their cost experience.
- Because of scale, the very largest issuers have always reported the lowest costs, so the move to transaction weighting significantly lowers the cap.
- If the proposal had retained the original methodology for setting the base component of the cap – even based on the limited set of costs the Board considers – the cap would have increased from its current 21 cents.
  - Based on the 2009 data, it was estimated that 80 percent of issuers would recover their allowable costs with a 21 cent cap.
  - In 2021, still only 77 percent of issuers recovered their allowable ACS costs.
  - The proposal provides no justification for this change or explanation why covering 80 percent of issuers is no longer appropriate.

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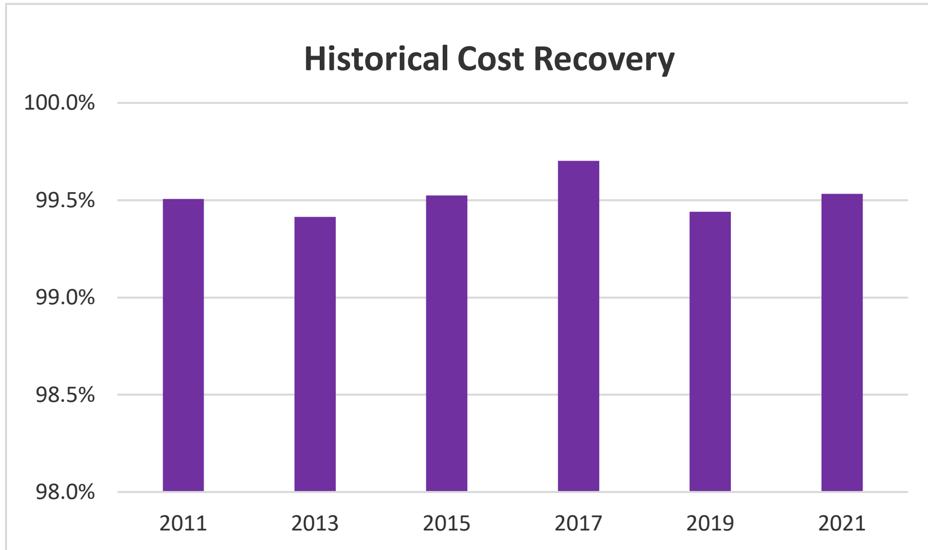
The Proposal's Shift in Methodology is Unexplained and Unwise, cont.



21.0 → 17.6 cents
= 16% reduction

17.6 → 14.4 cents
= a further 18% reduction

- In addition to relying on a transaction-weighted average, which effectively disregards the cost experience of 67 percent of issuers, the proposal chooses a cost recovery target well below the historical performance of the interchange cap.
- According to Board survey data, a 21 cent cap has meant that on average 99.5% of transactions met the "cost recovery" of the 2011 rule.
- If the proposal had used the TWA ACS base costs, but used a multiplier that corresponds to a historical average "cost-recovery" of 99.5%, **the base component would drop from 21 cents to 17.6 cents.**
- Instead, the proposal arbitrarily chooses to lower the "cost-recovery target" from 99.5% to 98.5%, **further lowering the base component from 17.6 cents to 14.4 cents.**
- The decision to use a 98.5% "cost-recovery target" is supported by no facts or evidence, the proposal merely observes that a 98.5% corresponds to an "efficiency gap" of 5.2.
- The proposal provides no evidence or justification for its conclusion that an efficiency gap of 5.2 is reasonable, or that an efficiency gap of 7.7 (at 99.5%) would be unreasonable.

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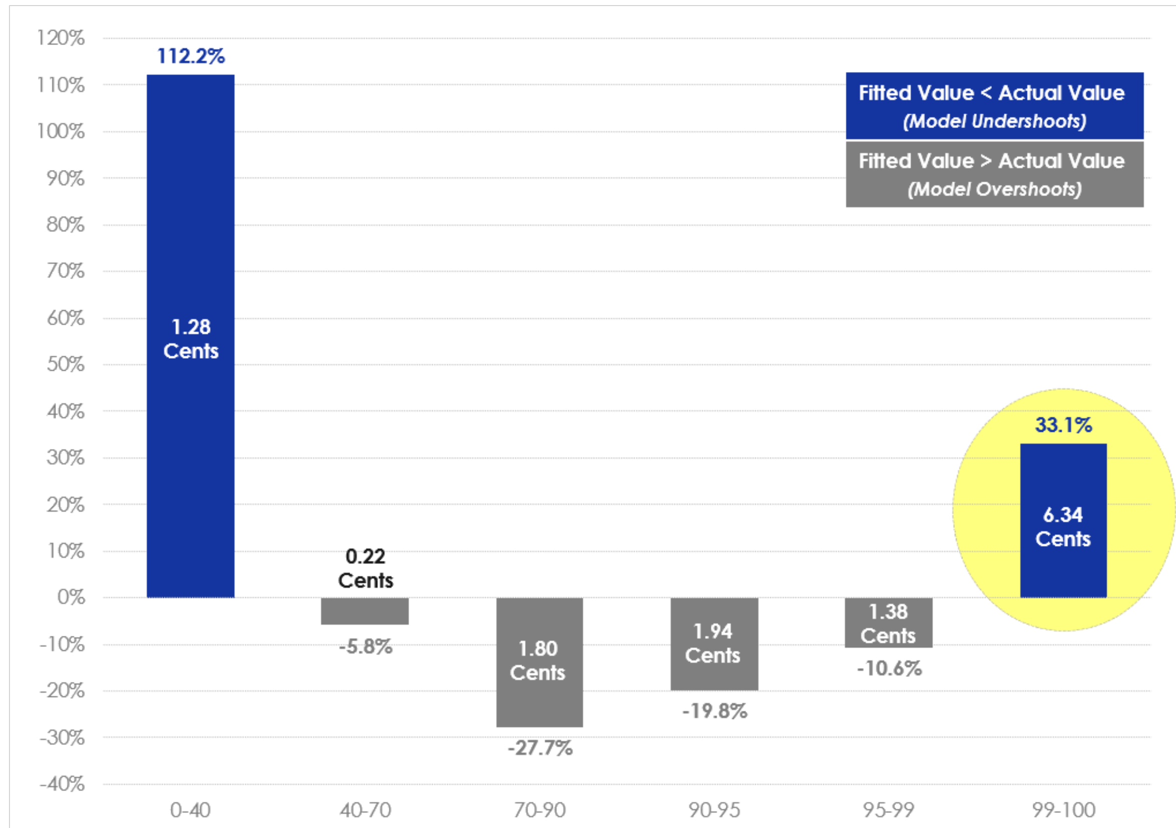
The Proposal's Shift in Methodology is Unexplained and Unwise, cont.

- Actual issuer cost data poorly fit the proposed Weibull distribution.
- If the Board chooses to use a Weibull distribution, it should incorporate an adjustment factor to offset the model's consistent underestimation of costs at the historical cost-recovery target of 99.5 percent.



Survey year	Distribution	Transaction percentile range					
		0–40	40–70	70–90	90–95	95–99	99–100
2013	actual	2.8	3.6	5.8	8.6	12.5	31.7
	fitted	1.3	4.1	7.5	11.1	14.7	21.4
	% variance actual and fitted, 2013	115.4%	-12.2%	-22.7%	-22.5%	-15.0%	48.1%
2015	actual	2.6	3.5	5	7.8	11.9	26.4
	fitted	1.2	3.7	6.9	10.1	13.3	19.2
	% variance actual and fitted, 2015	116.7%	-5.4%	-27.5%	-22.8%	-10.5%	37.5%
2017	actual	2.2	3.1	4	6.6	9.8	21.6
	fitted	1	3.1	5.8	8.6	11.5	16.8
	% variance actual and fitted, 2017	120.0%	0.0%	-31.0%	-23.3%	-14.8%	28.6%
2019	actual	2.2	3.3	4.6	8	11.2	24.2
	fitted	1.1	3.5	6.3	9.3	12.3	18.6
	% variance actual and fitted, 2019	100.0%	-5.7%	-27.0%	-14.0%	-8.9%	30.1%
2021	actual	2.3	3.2	4.4	8	12.1	21.6
	fitted	1.1	3.4	6.3	9.6	12.6	17.8
	% variance actual and fitted, 2021	109.1%	-5.9%	-30.2%	-16.7%	-4.0%	21.3%
Average % variance actual and fitted across surveys		112.2%	-5.8%	-27.7%	-19.8%	-10.6%	33.1%

Legend
Fitted Value < Actual Value (model undershoots) = (+) Positive Number
Fitted Weibull Value > Actual Value (model overshoots) = (-) Negative Number

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Conclusion

- Nothing requires the Board to amend the rule.

- Data deficiencies and policy implications for consumers and financial institutions weigh against amending the rule to lower the cap.

- If, however, the Board proceeds with considering amendments to the current rule, the Board should, at a minimum, wait to consider proposing changes to the Interchange Fee Cap until:
    - The full impact of the Board’s recent amendments to the regulation’s network routing provisions can be discerned from the 2023 survey data,
    - The Board includes in the calculation of the cap allowable costs that the Board has wrongly excluded, and
    - The Board can ensure that the survey instrument elicits data that provides a realistic full view of the ecosystem.

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