May 10, 2024

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

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

Dear Ms. Misback:

The Merchants Payments Coalition (MPC) is grateful for the opportunity to submit this comment on the Notice of Proposed Rulemaking ("NPRM" or "Proposed Rule") published by the Board of Governors of the Federal Reserve System ("Board") regarding debit interchange fees. The MPC is a group of retailers, supermarkets, restaurants, drug stores, convenience stores, gas stations, online merchants, hotels and other businesses focused on reforming the U.S. payments system to make it more transparent and competitive.[1] The MPC is dedicated to fighting unfair credit and debit card fees and advocates for a more competitive and transparent payments system. Many of the businesses and trade associations that make up the MPC are also submitting comments to the Board on the Proposed Rule, and the MPC supports and reaffirms its members' comments. We write today to reiterate several key points for the Board's consideration.

The MPC appreciates that the Board has proposed to update Regulation II and to reduce the maximum debit interchange rate that covered issuers are allowed to receive when card networks establish interchange rates on their behalf. For years, data collected by the Board has made a compelling case that the rate established by Regulation II in 2011 is not reasonable and proportional to the costs incurred by covered issuers as the governing statute requires. As we wrote to the Board in 2021, "[i]t is time for the Board to reduce the regulated debit rate to reflect issuer costs more accurately and to adhere to the intent of the law."[2] We appreciate the Board's recognition that the regulated rate must be reduced and that the Board's fees relating to fraud losses and fraud prevention costs must be revisited.

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[1] For more information, *see* https://merchantspaymentscoalition.com/.
[2] Comment by the Merchants Payments Coalition on Clarification of Regulation II, Docket No. R-1748, RIN 7100-AG15, August 10, 2021, *available at* https://www.federalreserve.gov/SECRS/2021/September/20210901/R-1748/R-1748_081021_140772_394947042778_1.pdf.

The MPC believes that several modifications are needed to the Proposed Rule in order to make it fully consistent with the governing statute. Those modifications relate to each of the three components that make up the regulated rate—the base component, the *ad valorem* fraud loss fee, and the fraud prevention adjustment—as well as the process the Board has proposed for regularly updating the rate going forward. We discuss each of these modifications below.

Base Component

While the MPC appreciates the Board's recognition that the base component must be reduced, the Proposed Rule's suggested methodology for calculating the base component falls short of compliance with the statutory reasonable and proportional standard. The NPRM explicitly states that "the Board believes it is necessary to revise the interchange fee standards to reflect the decline since 2009 in base component costs."[3] Those costs decreased by nearly 50 percent from 2009 to 2021 (7.7 cents to 3.9 cents). However, the methodology set forward in the Proposed Rule produces a base component rate that is reduced by less than a third from the current rate. The methodology does so by applying a fixed multiplier of 3.7, which is significantly larger than the 2.7 multiplier that the Board effectively adopted when Regulation II was published in 2011. It is neither reasonable nor proportional for the Board to adopt a larger multiplier than before and to propose a reduction that does not adequately reflect the decline since 2009 in base component costs.

The NPRM's proposed methodology for the base component rate is particularly problematic in that it establishes one uniform rate at a level that excessively overcompensates the high-volume covered issuers who handle the vast majority of debit transactions, while providing full cost recovery to many low-volume, high-cost covered issuers for whom debit transactions are a relatively insignificant part of their business. The Board previously applied a methodology in Regulation II that set the base component rate to target the 80th percentile of covered issuers, but the NPRM now proposes setting a full cost-recovery target of 98.5 percent of covered issuer transactions, with the justification that such a target equates to an efficiency gap of 5.2. There is no justification from the collected data why this particular efficiency gap and this cost recovery target should be locked into the methodology, especially since these metrics clearly skew revenue in the base component rate toward the highest-volume, lowest-cost issuers. If the Board is desirous of fully compensating low-volume, high-cost covered issuers, it can do so consistent with the statute by setting a separate base component rate tier for those low-volume issuers or, alternatively, by setting a safe harbor rate targeted to high-volume issuers while allowing other issuers able to receive a higher rate if they can justify it (similar to the Board's original proposal in December 2010). However, it is not reasonable for the Board to set a single base component rate that massively overcompensates high-volume, low-cost issuers because the Board is seeking to accommodate high-cost, low-volume issuers whose debit operations are a tiny part of their overall business.

One way the Board could revise its methodology to ensure that the base component fee is reasonable and proportional to cost is to establish one or more tiers of fee rates that are consistent with rates of return that are reasonable for businesses in a competitive market. The methodology

[3] 88 Fed. Reg. 78105.

in the Proposed Rule, which provides high-volume issuers with huge net profit margins, falls short of meeting the reasonable and proportional standard.

***Ad Valorem* Fraud Loss Component**

The MPC also appreciates the Board's recognition that the *ad valorem* fee for fraud losses must be reduced. However, we are concerned that the Board's methodology for this component neither meets the data the Board has collected nor fits with Congress's statutory design. It was a discretionary decision by the Board in 2011 to establish an *ad valorem* fee to uniformly compensate all covered issuers in advance for predicted fraud losses. The Board crafted this approach back when the data showed that issuers bore approximately 61 percent of fraud losses. But this structure is no longer justifiable when issuers now bear only 33 percent of fraud losses and when losses are increasingly being charged back to merchants or covered by cardholders. And the Board's current structure simply has not worked to incentivize reductions in fraud, as both overall fraud incidence and fraud losses on covered transactions have approximately doubled under Regulation II. The Board's current *ad valorem* fee structure simply does not appear to be making issuers more effective at reducing the incidence or cost of fraud, though it does appear to be incentivizing issuers to be more effective at shifting fraud losses onto other parties.

There is no reasonable justification for continuing to require merchants to pre-pay for potential fraud losses through interchange when merchants now absorb a higher percentage of actual fraud losses than issuers. And as post-pandemic debit transactions and fraud increasingly shift to card-not-present channels where merchants already absorb the vast majority of fraud losses, locking in the Proposed Rule's methodology risks becoming even more inconsistent with the statute. Merchants are now paying for fraud multiple times—through the *ad valorem* fee, by absorbing actual fraud losses, and by paying the fraud prevention adjustment—with no evidence that fraud will actually decrease. This must change.

The *ad valorem* fee was not part of Congress's design for reducing fraud in the debit system, and it has not worked to reduce fraud. Additionally, the data that prompted the Board to create the fee—namely, data showing that 61 percent of fraud losses in 2009 were borne by issuers—has shifted dramatically. In light of these changed circumstances, the Board should exercise its discretion to eliminate the *ad valorem* fee and allow fraud losses to be apportioned after the fact as already happens today. This would incentivize issuers to do their best to reduce fraud, similar to the way that merchants are incentivized to reduce fraud due to the large losses they take on them, rather than have merchants effectively subsidize issuers for their losses.

Fraud Prevention Adjustment

Congress's plan for addressing fraud in the debit system was centered around authorizing the Board to adjust the amount of interchange a covered issuer can receive to account for certain fraud prevention costs. The statute specifically provides that the Board must establish fraud prevention standards that "require issuers to take effective steps to reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions" and that an issuer can only receive a

fraud prevention adjustment if the issuer "complies" with the Board's standards.[4] In other words, the statute requires that an issuer must take effective fraud prevention steps in order to receive an adjustment. However, neither the current regulation nor the Proposed Rule appropriately administer this requirement. The standards established by the Board simply direct issuers to have policies in place and instruct issuers to self-certify to networks that they follow the policies. And the Board appears to have awarded the fraud prevention adjustment to every covered issuer on every transaction, without collecting any data from issuers that would demonstrate whether any fraud prevention step taken by the issuer was or was not effective. The Board's data collection through its Debit Card Issuer Survey simply asks issuers to check a box whether or not they engage in certain broad activities like "data security" and "PIN customization."[5] The Board has not established a target metric for effectiveness, nor does it appear to evaluate whether issuers comply with their own policies or how often issuers use particular fraud prevention measures on their transactions. It is not clear if the Board even collects copies of the annual certifications that issuers are required to provide to networks.

In order to comply with the statute, the Board's final rule must condition an issuer's eligibility for the fraud prevent adjustment on the issuer demonstrating that the adjustment is supporting fraud prevention steps that are effective in minimizing fraud. Issuers that cannot demonstrate reduced per-transaction fraud losses over a period of time (or, alternatively, slower growth in fraud than the mean for covered issuers) should lose eligibility for the fraud prevention adjustment until the issuer can demonstrate to the Board that it is taking effective fraud prevention steps. It is particularly important that the Board hold issuers accountable for taking effective fraud prevention steps given that the Proposed Rule seeks to increase the fraud prevention adjustment from one cent to 1.3 cents based on a revised methodology for measuring issuer fraud prevention costs, even though median issuer fraud prevention costs have decreased on a per-transaction basis since the Board's initial rule in 2012. It would be clearly unreasonable for the Board to award covered issuers a larger fraud prevention adjustment when the issuers have not demonstrated that they have taken effective fraud prevention steps.

Regular Updates to the Regulated Rate

The MPC appreciates the Board's proposal to establish a process to adjust the regulated debit rate every two years. However, it is critically important that the Board not lock in methodologies for future rate adjustments that permit issuers to circumvent the statutory requirements. For example, the NPRM proposes to adopt a fixed multiplier for the base component while continuing to treat issuer-paid network fees as an allowable cost; this would give networks and issuers incentive to increase issuer-paid network fees in order for issuers to receive multiple times that amount back from merchants as interchange. It is critical that this network fee loophole be addressed in the final rule. Additionally, the Board should establish a process by which disputes over issuer costs can be brought to the Board's attention, evaluated, and resolved during the periodic rate adjustment process. The Board should also conduct oversight of the data collection process to ensure that issuer costs are not misstated or inflated, including by establishing an audit plan and enforcement mechanisms. This is important because the adoption

[4] 15 U.S.C. 1963o-2(a)(5)(A)(ii)(II) and 15 U.S.C. 1963o-2(a)(5)(A)(ii) (emphasis added).
[5] *See* Debit Card Issuer Survey, FR3064a, Survey Period: Calendar Year 2021, at p. 11, *available at* https://www.federalreserve.gov/paymentsystems/files/2021DebitCardIssuersurvey.pdf.

of a fixed multiplier would give issuers incentive to inflate costs, to adjust the timing of costs during data reporting periods, and to shift costs from credit to debit operations in order to benefit from the multiplier's effect. The Board should further consider retaining the flexibility for adjusting or excluding costs from specific issuers if audits or other data indicate that those costs are not legitimate or representative. And, of course, the Board should not make additional costs a profit center that is out of line with normal net profits in issuers' other lines of business. Doing so inevitably creates negative incentives for issuers to game the system by inflating costs in order to later gain windfall returns.

Conclusion

The MPC sincerely appreciates that work that the Board and staff have put into the NPRM. Congress assigned the Board the critical role of ensuring reasonableness, proportionality, and competition in a debit card industry that lacked them, and Main Street businesses and our customers rely on the Board to fulfill that role effectively.

When interchange fees are centrally fixed by networks on behalf of issuers, competitive market forces do not serve to keep those fees in check. Instead, each issuer receives the same network-established schedule of fees as any other issuer regardless of the efficiency or security of the issuer's debit operations, and networks are motivated to increase fees in order to incentivize issuers to issue more of their cards. Centrally-fixed interchange rates thus subsidize inefficiency and end up inflating the retail prices paid by all consumers, including those who do not pay with plastic.

Because normal marketplace competition does not serve to keep these centrally-fixed interchange fees in check, Congress directed the Board to ensure that such fees are limited to levels that are reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Reducing the fees that are deducted from debit transactions provides cost savings to merchants that ultimately accrue to the benefit of consumers, because merchants operate in an intensely competitive market environment with tight profit margins. When merchants save on costs, those merchants' customers save on prices. Since Regulation II took effect, merchants have faced inflation and production cost increases but have shielded consumers from their full effects in part because of debit interchange savings, resulting in prices that are lower than they otherwise would have been. And our recommendations for improvements to the Proposed Rule would also benefit consumers by incentivizing more effective fraud reduction in the debit system—fraud that is increasingly being shifted to consumers as well as to merchants.

For the reasons discussed above, we urge the Board to act quickly to finalize the Proposed Rule with the recommendations of the MPC and its members incorporated. Thank you for your consideration of this comment.

Sincerely,

Merchants Payments Coalition