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-AG-67
Notice of Proposed Rulemaking: Debit Card Interchange Fees and Routing

Dear Ms. Misback:

On behalf of the National Association of Convenience Stores (NACS), thank you for the opportunity to comment on the notice of proposed rulemaking ("Propose Rule") promulgated by the Board of Governors of the Federal Reserve System (the "Board" or "Fed") regarding debit card interchange fees and routing. We appreciate the work of the Board to analyze and write the Proposed Rule. In our view, the Proposed Rule should be revised as set forth in this letter in order to ensure it is consistent with the language and intent of the statute governing debit card transactions as set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

Background on the Convenience and Fuel Retailing Industry

NACS is an international trade association representing the convenience store industry with more than 1,500 retail and 1,600 supplier companies as members, the majority of whom are based in the United States.[1]

The convenience and retail fuels industry employed approximately 2.44 million workers and generated more than $906 billion in total sales in 2022, representing almost 4 percent of U.S. gross domestic product. Of those sales, approximately $607 billion came from fuel sales alone.

The industry, however, is truly an industry of small business. More than 60 percent of convenience stores are single-store operators. Less than 0.2% of convenience stores that sell gas are owned by a major oil company and about 4% are owned by a refining company. More than 95% of the industry, then, are independent businesses.

Members of the industry process more than 165 million transactions every single day. That means about half the U.S. population visits one of the industry's locations on a daily basis. In fact, 93% percent of Americans live within 10 minutes of one of our industry's locations. These businesses are particularly important in urban and rural areas of the country that might

[1] Data on the industry comes from the NACS, State of the Industry Annual Report of 2021 Data *available at* https://nacsannualreport.convenience.org.

not have as many large businesses. In these locations, the convenience store not only serves as the place to get fuel but is often the grocery store and center of a community.

Governing Law

The provisions of Dodd-Frank that grant the Fed authority to regulate debit card transactions are popularly known as the Durbin Amendment. The Durbin Amendment requires the Fed to limit the network-set interchange fees of debit card issuing banks with more than $10 billion in assets to amounts that are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[2] The Board promulgated Regulation II to carry out the purposes of the Durbin Amendment.

It has been and remains NACS' position that Regulation II as it exists today and has since it first went into effect in 2011 is not consistent with the language or intent of the Durbin Amendment. Specifically, it is NACS' view that the Board included costs in its determination of allowable debit interchange that Congress in passing the Durbin Amendment and Dodd-Frank intended to exclude from that analysis.

This letter, however, is not intended to rehash that question. Instead, this letter addresses other aspects of the Durbin Amendment, Regulation II as it stands, and the information in the Board's reports on issuer costs since the enactment of Dodd-Frank to evaluate the Proposed Rule.

Importantly, the language of the Durbin Amendment focuses on the cost of the debit transaction to the issuer. It does not say that all issuers must have the same fees on debit transactions. In fact, the language of the law indicates otherwise. Recognizing that a fee regulation from the Board does not need to be the same for all issuers is not revolutionary. In fact, the proposed rule originally promulgated by the Board in response to passage of the Durbin Amendment contemplated as one option a much lower fee than is currently in place under Regulation II, but also allowing individual issuers to charge higher amounts if their costs were higher.[3] That construct could avoid the legal infirmity of the Proposed Rule.

Similarly, the Board could set different fee limitations for high-volume issuers as opposed to mid- and low-volume issuers. That type of construct, as described below, could address the problem encountered by the Proposed Rule. The current problem is as follows – by proposing a debit fee that would cover the costs incurred for 98.5% of debit transactions, the Proposed Rule sets a fee amount that is not "reasonable and proportional" to the cost incurred in the vast majority of debit transactions. When the rate of return above cost for more than 90% of all debit transactions is on the magnitude of 400%, that is not "reasonable and proportional" under any straightforward reading of those terms. That rate dramatically exceeds rates of return in functioning markets.

[2] 15 U.S.C. §1693o-2(a)(2).

[3] Notice of proposed rulemaking, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81722, 81736-8 (Dec. 28, 2010).

Based on the language of the Durbin Amendment, the Board must find a way to address the wide discrepancies in costs among debit issuers in a way that does not provide windfall profits to issuers responsible for the vast majority of transactions. This letter will describe those problems and provide potential avenues to address those issues consistent with the statutory law.

The Debit Landscape

Debit card usage has grown throughout the past fifteen years from a total of 38.6 billion transactions in 2009 to 92.1 billion transactions in 2021.[4] During that time, issuers exempt from Regulation II, those with less than $10 billion in assets, have grown their share of the debit market.[5] These are strong indications of success in the reform of debit interchange fees. Healthy, growing card usage and improved competitiveness from smaller issuers has been paired with lower prices for Main Street businesses and, ultimately, their customers. More economically efficient transactions should be a goal of the financial system and was baked into the Durbin Amendment.

The language of the Durbin Amendment, for example, uses the check clearing system as a successful model for the Board to follow in Regulation II. The check system does not allow for the functional equivalent of interchange fees. Instead, it lets the parties on each side of the check transaction bear their own costs. That way, they are fully incentivized to find financial institutions that will be most efficient and keep their costs lowest. Without the centralized fees incurred in debit transactions, the check system has served Americans and the American economy well for a century. The electronic version of that system, debit cards, has lower inherent costs and greater efficiencies, but has come with a much larger price tag for merchants accepting debit payments.[6] The language of the Durbin Amendment was intended to address that unnecessary inefficiency by making the check system, and clearance at par value, a guiding principle for the Board in promulgating Regulation II. The Proposed Rule does not do that.

It is worth noting that debit cards and automated teller machine (ATM) cards are access mechanisms allowing people to get the funds they have in demand deposit accounts. Financial institutions must provide such access in some fashion. People would be unlikely to deposit their funds at a bank if they could never access them again. Debit and ATM cards were introduced as a way for financial institutions themselves to save costs when customers access their funds. Having branches and employing tellers to handle these transactions is expensive for financial institutions. And, at the time ATM and then debit cards were introduced, paper checks carried real costs of financial institutions as the original check needed to be physically transported to the

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[4] Board of Governors of the Federal Reserve System, "2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions" Table 3(October 2023) (available at Federal Reserve Board Publication) (the "October 2023 Federal Reserve Report").
[5] Exempt issuers' share of debit transaction volume was 37.1% in 2013 and grew to 39.0% in 2021. *Id*. Table 3 and analysis.
[6] Hearing before the Subcommittee on Financial Institutions and Consumer Credit of the U.S. House Committee on Financial Services, "Understanding The Federal Reserve's Proposed Rule On Interchange Fees: Implications And Consequences Of The Durbin Amendment" Testimony of David Seltzer, Vice President and Treasurer, 7-Eleven Inc. at 54 (Feb. 17, 2011) (available at K:\DOCS\64557.TXT (house.gov))

right clearing institution before the transaction could be settled. Making access to demand deposit accounts electronic with plastic cards carrying access numbers saved financial institutions on many of these costs. The cards were and remain a cost-saving measure for financial institutions and need not provide a source of revenue in order to be a financial benefit to financial institutions.

That history forms part of the backdrop for the Durbin Amendment language instructing the Board to consider the similarities between debit transactions and check transactions which clear at par. If higher cost check transactions can clear at par, then it stands to reason that debit transactions can clear at par (or very close to it). Both types of transaction are ways for financial institutions to provide their customers with access to the funds in the demand deposit accounts and debit is among the least expensive of those methods for the financial institution to accommodate.

Debit Issuer Costs

The prices of debit card transactions could be lower and more efficient than they are today. That would be beneficial for the economy and would bring regulation into compliance with the terms of the Durbin Amendment. The Fed's data, for example, shows that covered debit issuer costs have fallen dramatically since the promulgation of Regulation II. In 2011, The data used by the Fed to write the current Regulation II showed covered issuer costs at an average of 7.7 cents per transaction. The most recent data collection by the Fed shows those same costs averaging 3.9 cents per transaction. It is clear that Regulation II no longer comports with the language of the Durbin Amendment requiring interchange fees to be reasonable and proportional to issuer costs. The Proposed Rule is intended to address that.

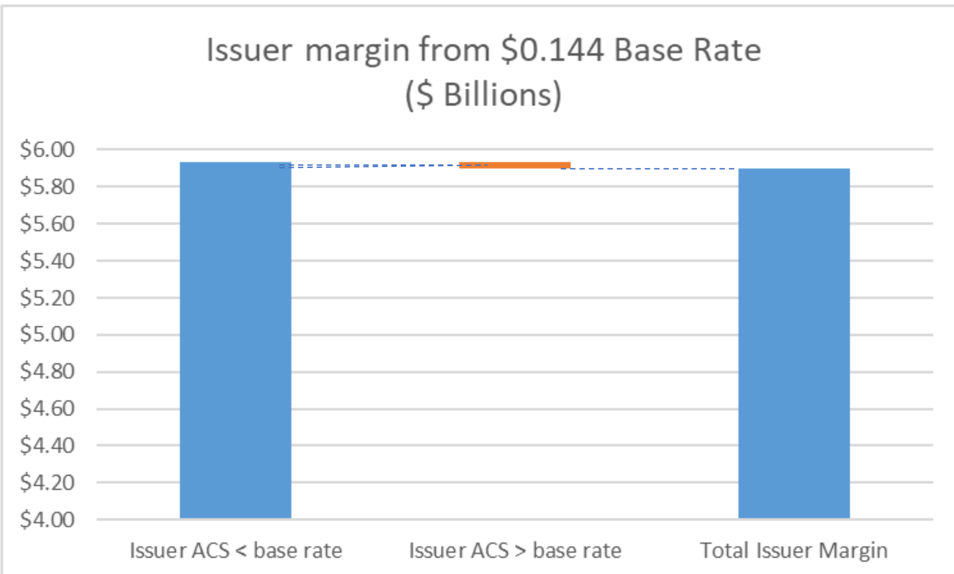
Proposed Base Interchange Rate

While the Proposed Rule moves in the right direction by reducing the amount of the fees, it would not bring Regulation II to a point that is consistent with the Durbin Amendment. A group of Main Street associations, including NACS, engaged Patrick Moran to analyze debit cost data and what it shows regarding Regulation II. The resulting white paper ("Moran paper") is attached as part of this comment letter and finds that the base interchange rate in the Proposed Rule does not meet the reasonable and proportional standard required by the Durbin Amendment.

The central shortcoming of the Proposed Rule in light of the statutory language of the Durbin Amendment is that the Proposed Rule attempts to ensure that a number of covered debit issuers that have very little debit volume recover all of their costs for their debit transactions. Those low-volume issuers are not significantly engaged in the debit business, do not engage in it efficiently based on their very high costs, and the revenue they would receive or not receive under different formulations of Regulation II are not material to their operations. By covering those high-cost, low-volume issuers at 100% of cost, the Proposed Rule ensures that debit interchange fees are far higher than the reasonable and proportional standard for [94%] of debit transactions.

The chart below from the Moran paper demonstrates the issuer margins under the Proposed Rule for those issuers with costs that fall below the base rate in the Proposed Rule and for those with costs above that base rate.

Estimated Issuer Margin from Current Proposal[7]



The chart demonstrates the dramatic way in which the Proposed Rule has set the base debit interchange rate too high. The tiny number of transactions with costs above the base rate are almost undetectable compared to the huge margins earned from the vast majority of transactions for issuers with costs far below the base rate.

The issuers defined as high-volume by the Board generate 94% of all debit transactions. Their average costs as calculated by the Board are 3.5 cents per transaction on average.[8] There is no justification consistent with the language and intent of the Durbin Amendment for providing those high-volume issuers with a base rate of interchange at 14.4 cents per transaction.

The Proposed Rule employs a 3.7 multiplier to the average issuer cost for a debit transaction to reach the 14.4 cents per transaction figure. As noted, that multiplier results in covering the full costs for 98.5% of covered transactions. That is dramatically higher than the 2.7

[7] This and the other graphics in this paper were taken from Patrick Moran, "Considerations for the Federal Reserve Board's Proposed Rule for Debit Interchange," (May 10, 2024) ("Moran paper"). October 2023 Federal Reserve Report Table 12 was used for volumes within each Issuer grouping. Nilson data was used to estimate volume within each quartile. ACS margins were estimated using October 2023 Federal Reserve Report Table 14.
[8] October 2023 Federal Reserve Report Table 13.

multiplier which is the ratio employed by the original Regulation II, illustrating the difference between the average issuer cost and the allowable base interchange rate under Regulation II.

While a 2.7 multiplier (resulting in a base interchange rate of about 10.5 cents) would have the benefit of consistency with the current Regulation II, neither 2.7 nor 3.7 represent rates of return that are reasonable and proportional to cost. Businesses in competitive markets simply do not earn profit margins of 270% or 370% of their costs. While there are many sources reporting profit margins of individuals businesses, we find the data tracking profit margins by U.S. industry which is published by the Stern School at New York University to be helpful because it tracks average margins by industry sector. That data reports that, in fact, the U.S. industry with the highest net profit margins is the U.S. banking industry.[9] The data shows that U.S. money center banks earn average net profit margins of 30.89% and regional banks earn net profit margins of 29.67%.[10] A multiple of 3.7 then, provides these banks with margins approximately twelve times higher than the margins that they earn throughout the rest of their business lines. That makes the 3.7 multiple in the Proposed Rule or the 2.7 multiple in the current Regulation II neither reasonable nor proportional. Those multiples are simply far out of step with what the same regulated financial institutions earn compared to their costs.

It is important to recognize that the debit business simply is not financially material to most mid- and low-volume covered issuers. They provide debit cards to accountholders to save their own costs on how those customers access funds and as a service to those accountholders, but they don't have much incentive to control their costs on debit transactions because it isn't much of their business anyway. In addition to the large differences in overall costs, this is demonstrated by the relative lack of concern these issuers have in controlling debit card fraud. Issuers with debit portfolios that are important to their bottom lines try to control their costs including fraud, but that does not seem to be happening for mid-volume issuers as shown in Figure 11 of the Moran paper and reproduced below. The base interchange rate in Regulation II simply should not be skewed so heavily toward a small number of high-cost transactions when the issuers conducting those transactions do not rely on those small volumes or control those costs in the way that would be expected for companies for whom that debit business is material.

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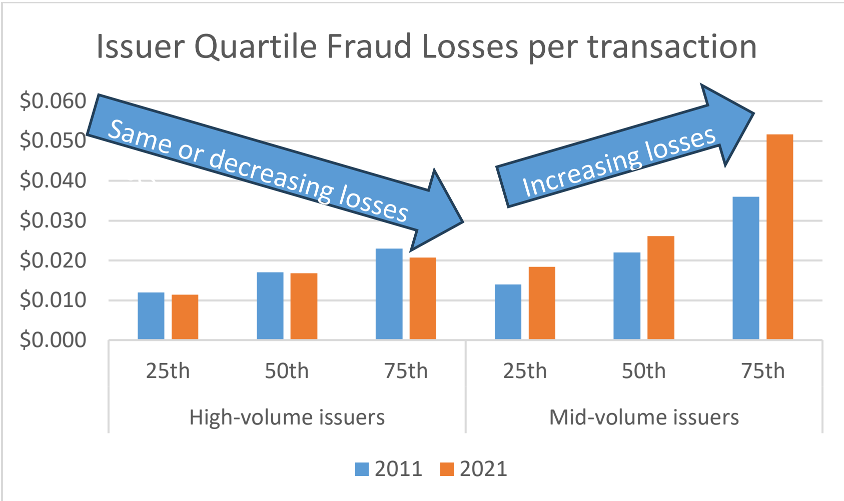
[9] "Margins by Sector (US)," New York University Stern School (data as of January 2024) (available at Operating and Net Margins (nyu.edu))
[10] *Id*.

High-volume and Mid-volume Covered Issuer Fraud Losses in 2011 and 2021[11]



The Proposed Rule, then, rather than focusing on which issuers and transactions will receive full cost recovery, ought to grapple with the intent of the law – that is, what is reasonable and proportional to the cost incurred by the issuers generating 94% of the transaction volume. Once that decision is made, then the Board could separately provide for treatment of the low-volume, high-cost issuers that comprise the tiny minority of debit transactions.

Engaging in that analysis provides a very different outcome than the Proposed Rule. It would provide high-volume issuers with a rate of return that is common for financial institutions (about 30%). The result would be a regulation which limits debit interchange to about 6 cents for 94% of transactions.[12] That analysis and result would provide a debit interchange rate that is "reasonable and proportional" to the cost – noting that it is still based upon the regulation including more types of costs in the calculation than we believe are allowable according to the statutory language. The returns would be healthy and overly fair to those high-volume issuers.

From there, the Board could make any of a number of choices for mid- and low-volume issuers. The Board could set one different limit to cover those issuers. The Board could set one rate for mid-volume issuers and a separate one for low-volume issuers. Or, the Board could return to its originally-proposed formulation of having those individual issuers justify a higher rate up to a limit based upon their actual costs. Frankly, those different options are not as material to the determination of the proposal as is the decision regarding the rate for 94% of transactions. Yet, by setting the rate to provide full cost recovery for 98.5% of transactions, the Proposed Rule makes the tail of a small number of inefficient, high-cost transactions wag the dog of the vast majority of debit transactions. That choice conflicts with the choices made by the

[11] Moran Paper; October 2023 Federal Reserve Report Table 14.
[12] See Moran Paper at 14-15.

Congress in the Durbin Amendment and therefore should be changed in the final rule promulgated by the Board.

Regular Updates to the Interchange Rate

The Proposed Rule would provide for updates to Regulation II every two years based upon the survey data that the Fed collects from the industry. This would happen automatically by taking the average issuer costs collected by the Fed and multiplying it by 3.7 to reach the new base interchange rate for the following two years. This formula results in higher interchange rates than can be said to be reasonable and proportional. It would, on average, provide debit issuers with 370% profit margins. Margins of that size are far higher than profit margins for financial institutions which average about 30%.[13] So, the Proposed Rule would be more than 12 times a margin amount that would be considered reasonable for a financial institution.

And, it is worth noting that financial institution profit margins themselves are already higher than profit margins for businesses in other sectors of the U.S. economy. In fact, financial institution margins, at 30%, are higher than for any other industry. So, it is questionable that allowing profit margins commensurate with the highest margins of any industry would be reasonable and proportional.

The multiplier also introduces a problematic incentive for financial institutions to become less cost-efficient. If they have confidence that in two years the Fed will automatically provide them a 3.7 multiple on every additional dollar they spend conducting debit card transactions, they may see it as beneficial to increase those costs and reap a delayed return. One of the most likely ways this could occur is through Regulation II's inclusion of issuer-paid network fees in the base rate cost calculation. The two major networks, Visa and Mastercard, could argue that they should increase the fees they charge financial institutions for the networks' role in handling debit transactions in order to inflate the allowable debit costs for those financial institutions and ensure higher interchange later through the Fed's automatic updates of Regulation II. That would lead to more inefficiency and cause costs to be competed up, where competitive markets should compete costs down (or slow their increases). It would also exacerbate the problem noted in the attached Moran paper of merchants absorbing all network fees for debit transactions.[14]

We agree that the Board should make automatic updates to interchange levels under Regulation II, but it is imperative that the Board correct deficiencies in its methodologies before automatically applying those methodologies in the future. Adopting a rule that is consistent with the "reasonable and proportional" legal standard would allow that to happen without creating incentives for issuers to pad their costs. Providing a return on cost of 30%, consistent with the rest of issuers' business lines, would mitigate the incentive to increase costs for a return later because the returns would not be out of step with the returns the financial institutions could expect to receive on those dollars today. And, as noted, higher-cost issuers could have a separate

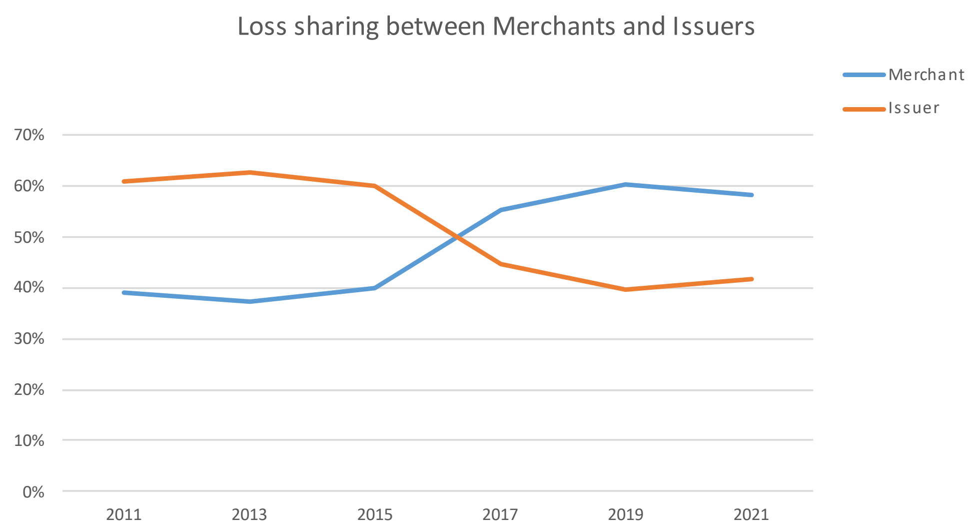
[13] "Margins by Sector (US)," New York University Stern School (data as of January 2024) (available at Operating and Net Margins (nyu.edu))
[14] See Moran paper at 9.

rate that is also pegged at around a 30% rate of return such that those issuers would avoid the negative incentive to increase costs.

Fraud Losses

The Proposed Rule would require U.S. merchants to pay 0.4% of the amount of debit transactions in order to cover debit card issuers' fraud losses on debit transactions. The data collected by the Fed, however, shows that the share of fraud losses borne by merchants has increased since Regulation II was first promulgated. According to the latest data collection, merchants shoulder a significantly higher proportion of fraud losses than debit issuers. Figure 8 from the Moran paper, reproduced below, illustrates this trend. When combined with the share of fraud that merchants are forced to pay after-the-fact, including fraud losses within the calculation of debit interchange that merchants must pay does not make sense or comport with the Durbin Amendment.

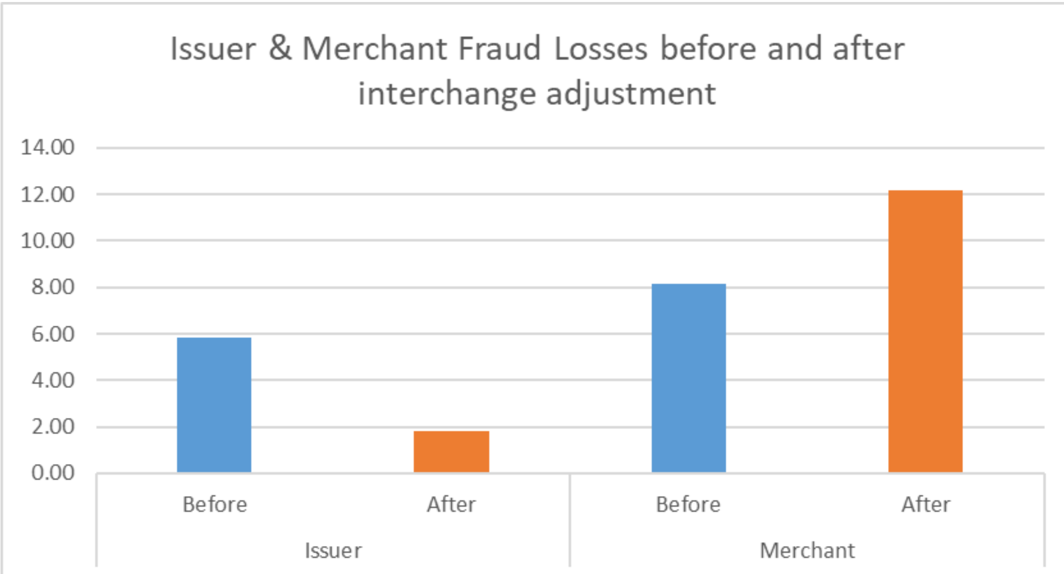
% of Fraud Losses Absorbed between Merchants and Issuers[15]



Not only that, but the Proposed Rule would result in merchants shouldering nearly all of the fraud losses that fall on either issuers or merchants today as shown in Figure 9 of the Moran paper included below. In doing that, the Board would be removing much of the economic incentive for debit issuers to work to reduce fraud losses. With issuers not feeling any real financial pain from fraud, they may well choose not to make investments in prevention of that fraud.

[15] Moran Paper; October 2023 Federal Reserve Report Table 11 and analysis (excludes losses absorbed by cardholders).

Issuer and Merchant Fraud Losses after 4bps Interchange Component[16]



Removing all of the financial incentives for debit issuers to combat fraud would risk fraud increases and increasing costs on merchants and consumers. In fact, one of the most striking data points in the most recent Fed report on debit costs is the increase in the share of fraud that is being shouldered by consumers. The Fed's data shows that consumers now shoulder 19.5% of fraud losses compared to the 8.2% they absorbed just two years prior.[17] That is a concerning trend. One way to help mitigate the risk of consumers absorbing increasing amounts of fraud losses is to ensure that issuers, not just merchants, have a financial incentive to combat fraud. Given the numbers and clear trends, the only way to do that is to eliminate the fraud loss adjustment so that issuers continue to bear some of the costs of fraud.

Fraud Prevention Adjustment

The fraud prevention adjustment compensates issuers for funds they spend to help prevent fraud. Those costs, however, have fallen since Regulation II was written. In light of that, the fraud prevention adjustment should be reduced commensurate with the reduction in fraud prevention spending by issuers.

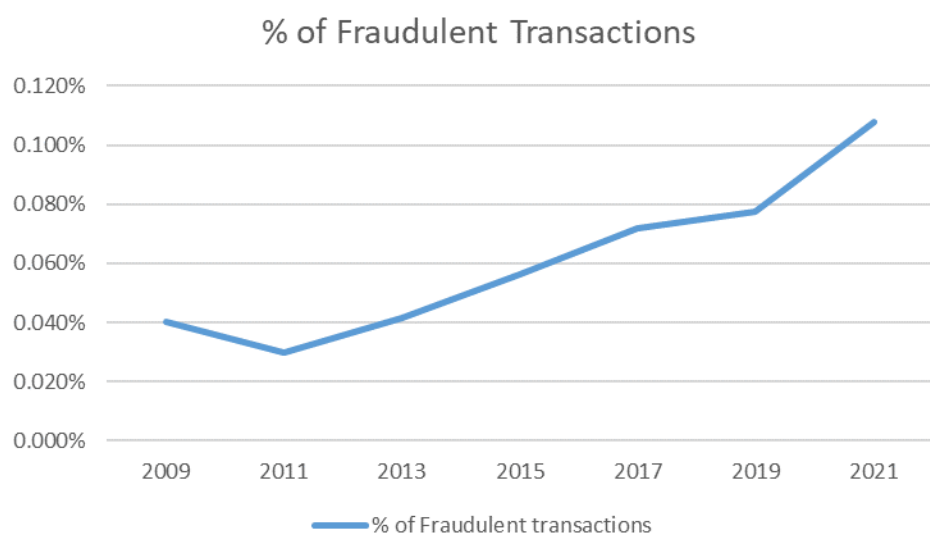
In addition to that, the administration of the fraud prevention adjustment should be reformed. There is nothing in Regulation II requiring any issuer to spend funds on things that are actually effective in reducing fraud. Covered issuers all receive the full amount of the fraud

[16] October 2023 Federal Reserve Report Table 14 and analysis.
[17] "2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions" Board of Governors of the Federal Reserve System at 3 (Oct. 2021) (available at Federal Reserve Board Publication).

prevention adjustment regardless of their effectiveness or spending. That is because the Board has left the administration of the adjustment to a self-certification system.

Every debit issuer that we are aware of certifies that it qualifies for the fraud prevention adjustment – and has for the past dozen years that Regulation II has been in effect. This strains credulity. Not every issuer is doing an effective job preventing fraud. In fact, fraud losses have climbed steadily over the years as shown in Figure 10 of the Moran paper and reproduced below. Some of that is likely reflective of an overall increase in fraud generally across all payment card systems in the United States (including credit cards). But, at the least, it does not provide any strong evidence that the current self-certification system in Regulation II is working to incentivize effective fraud prevention.

Percentage of Fraudulent Transactions over Time[18]



The bottom line is that the Proposed Rule should be modified to require that issuers actually show that their spending is consistent with and/or results in reduced fraud in order for them to receive the fraud prevention adjustment.

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[18] October 2023 Federal Reserve Report Table 10.

We appreciate the Board's work on the Proposed Rule and the fact that it moves the regulations in this area in the right direction. But, as noted, the Proposed Rule still does not comport with the requirements of the Durbin Amendment. We hope that the Board will revise the Proposed Rule consistent with our recommendations and those in the accompanying Moran paper in order to ensure that the regulation does comport with the language of the law.

Sincerely,

Doug Kantor
General Counsel
NACS

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