February 1, 2022

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

Re: *Proposal to extend for three years, without revision, the Recordkeeping and Disclosure Requirements Associated with Regulation II (FR II; OMB No. 7100-0349)*

Dear Ms. Misback:

The undersigned trade associations appreciate the opportunity to provide comments on the proposal of the Board of Governors of the Federal Reserve System ("Board") to extend for three years, without revision, the Recordkeeping and Disclosure Requirements Associated with Regulation II (Debit Card Interchange Fees and Routing).[1]

We support the Board's proposal to maintain current recordkeeping procedures. In addition, we urge the Board to reconsider its recent proposal to reopen Regulation II and to resist requests from retailers for further changes that would increase the regulatory burden associated with the Durbin Amendment to the Dodd-Frank Act.[2]

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American leadership in the payments arena depends on the ability and willingness of all stakeholders to invest in continuous innovation. More so than anywhere else in the world, regulated financial institutions in the U.S. have led the way in continuously providing consumers and merchants with new, faster, and more secure payment options that support economic growth and inclusion and protect merchants and consumers alike from fraud.

Bank- and credit union-issued debit cards provide convenient access to deposits and serve as an alternative to cash, checks, expensive remittance transfers, and credit cards. Unfortunately, the Durbin Amendment has distorted the debit card and consumer checking markets, much to the detriment of consumers.

The law has made it more difficult for financial institutions to provide consumers with access to robust core banking services like free checking and feature-rich debit cards and hindered their ability to invest in needed payments infrastructure. Yet, there are ongoing efforts to compound this damage through gradual tightening of this misguided regulation.

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[1] 86 Fed. Reg. 68,667 (Dec. 3, 2021).

[2] See 86 Fed. Reg. 26,189 (May 13, 2021).

Debit Card Information Collection, Interpretation, and Burden on More Financial Institutions

The Paperwork Reduction Act process and the Board's request for information place importance on the "quality, utility, and clarity of the information to be collected." The way to appropriately measure and estimate key qualitative information in the debit card space is an area of controversy. Issuers use debit interchange revenue to fund electronic debit transactions, and this revenue is artificially capped through interchange regulation. On the other hand, merchants focus narrowly on authorization, clearance and settlement ("ACS") costs in their demand for a lower interchange fee cap while disregarding other issuer costs, along with the many merchant benefits of debit card acceptance.

The Durbin Amendment requires the Board to set an interchange cap that is reasonable and proportional to the costs incurred by issuers with respect to debit card transactions. Currently, the Board's ACS figure underestimates the true cost of issuing debit cards because it omits numerous fixed and variable cost components. Specifically, the Board uses a concept of incremental ACS costs that includes transaction-monitoring costs, in-house costs, third-party processing fees, network processing fees, and fraud losses. However, the Board's definition excludes many other essential issuer costs, including corporate overhead, account relationships, rewards programs, non-sufficient funds handling, non-sufficient funds losses, debit card compliance costs, cardholder inquiries, card production and delivery, fraud-prevention costs that are not incurred as part of authorization, costs associated with funds loads (or deposits), or costs of account set-up and maintenance. The Board's decision to exclude these costs is a policy choice that is not required by law, and it has led to an underestimate of the costs incurred by debit card issuers.

As a result of these methodological decisions, capped interchange does not cover the costs it is intended to cover for many issuers. According to the latest debit card cost report released last May, in 2019, the capped interchange fee did not cover the average per-transaction ACS costs (including issuer fraud losses) for 21 percent of covered issuers, and more than half of covered issuers had fraud-prevention costs that exceeded the one-cent fraud prevention adjustment.[3] Further, low- and mid-volume covered issuers face higher costs per transaction than high-volume issuers. In 2019, average ACS costs, excluding issuer fraud losses, for mid-volume issuers ($0.107) were more than three times as high as for high-volume issuers ($0.035). Similarly, average ACS costs, excluding issuer fraud losses, for low-volume issuers ($0.711) were nearly 20 times higher than for high-volume issuers ($0.035).[4] This trend is moving in the wrong direction: since 2015, the cost difference between low- and high-volume issuers has only increased. Lowering the interchange fee cap would drive small- and medium-volume card issuers out of the industry, which would have negative impacts on both competition and consumers in the long run.

Further—and especially relevant given 2021's high inflation readings, which most economists expect will persist into 2022 and potentially beyond—both the cap on interchange and the $10 billion asset requirement are not indexed to inflation. The longer the cap is in place, the

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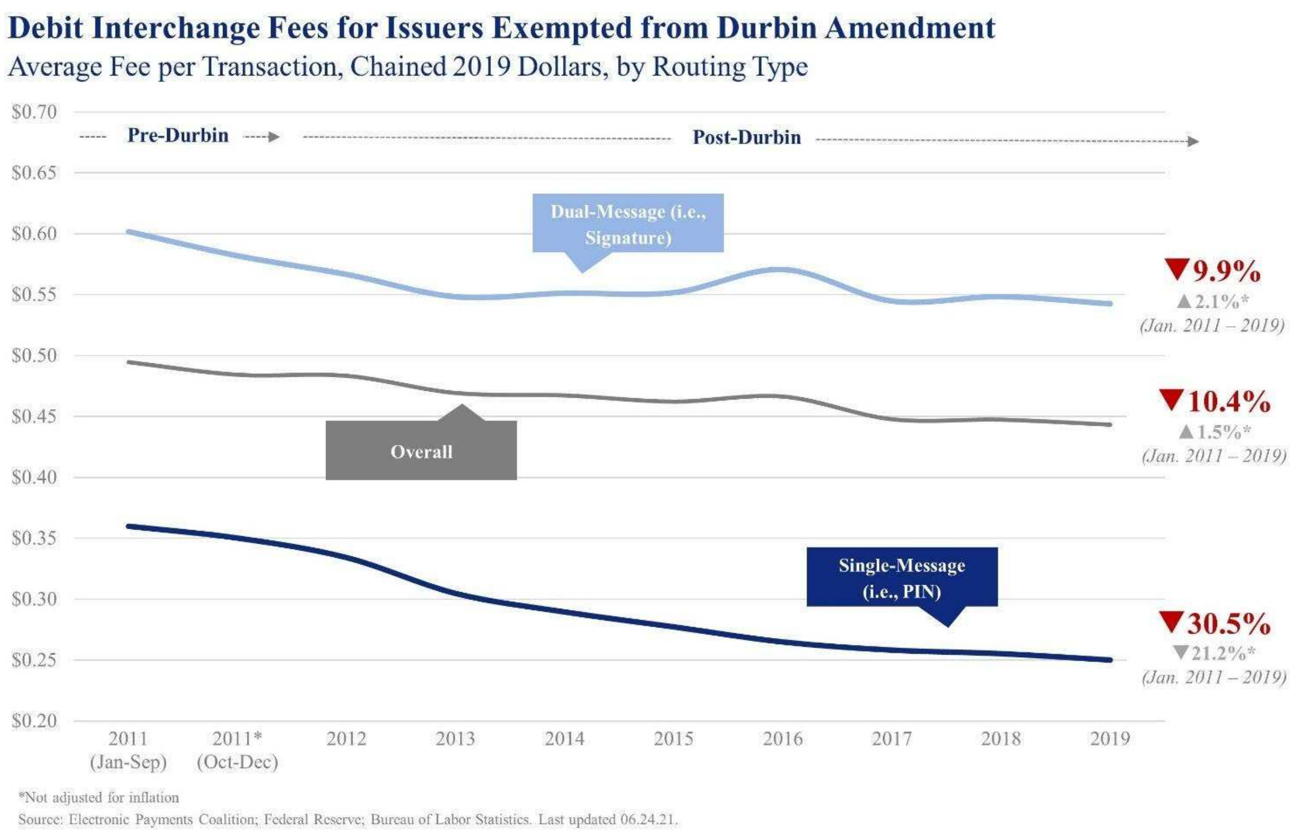
[3] Federal Reserve Board (2021). 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions. Published May 2021.

[4] *Id.*

more it adversely affects bank and credit revenue and the more institutions it captures through the $10 billion asset requirement, potentially increasing the recordkeeping and reporting burdens on these newly "covered institutions."

Durbin Amendment's Cost to Community Financial Institutions

The negative impacts of the Durbin Amendment are well documented, both by academic and Board staff researchers. Most recently, the Board's *Debit Card Issuer Cost Study*[5] found that community financial institutions (less than $10 billion in assets) experienced a 21% decrease in per-transaction debit card revenue (PIN) from 2011 to 2019. Adjusted for inflation, this is equivalent to a nearly 31% revenue decline. These smaller institutions were excluded from one prong of the law (i.e., the interchange transaction fee caps); however, this "exemption" has not shielded them from the distortive effects of the routing requirements.



Durbin Amendment's Effect on the Cost and Availability of Core Financial Services

Twelve years after the passage of the Durbin Amendment, the evidence is clear: the large merchants who advocated for the law's passage have reaped the vast majority of its benefits in the marketplace at the expense of consumers and small businesses.

[5] Federal Reserve Board (2019). Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions.

Contrary to merchant promises to Congress that average Americans would benefit from the Durbin Amendment, there exists no evidence that consumers and small businesses have benefitted from the law. Instead, issuers have lost an estimated $106 billion in interchange revenue since 2011, and much of that revenue was absorbed by large merchants.[6] Small businesses have also been disserved by the Durbin Amendment, as interchange fees have actually increased for small-ticket transactions: According to research from the Federal Reserve Bank of Richmond, interchange fees increased for almost one-third of all merchants after the Durbin Amendment was implemented, and merchants who specialize in small-ticket items are nine times more likely to have encountered an increase in interchange cost than a decline.[7] The basic economic principle still holds that price ceilings become price floors.

Banks and credit unions have made affordability and access an industry focus, with low- or no-fee deposit account options increasingly being offered by financial institutions through initiatives like #GetBanked and Bank On, which has been endorsed by regulators and consumer groups. Yet, as with any price control, and in line with widely accepted market theory, the Durbin Amendment has restricted the supply of the service being regulated—the provision of core banking services. This has created an unusual bifurcation where a statute constrains access to banking services while broader public policy is increasingly focused on overcoming such gaps. A Board study found that as a result of capping debit interchange fees, financial institutions are 35% less likely to offer consumers free checking. Based on this finding, researchers estimated that if the Durbin Amendment had not been enacted, twice as many consumers would enjoy free checking, translating to tens of millions of consumers who now face checking account fees as a direct result of the Durbin Amendment.[8] While these fees are often perceived by consumers as originating entirely from a decision by their bank or credit union, the reality is that this damage has been done by an inefficient regulation that concentrates its costs on one sector's lowest-margin products.

According to the Board's research, consumers have also experienced increased costs of maintaining a checking account, including higher minimum balance requirements and fees.[9] A more recent study from University of Pennsylvania researchers, including Deputy Assistant Treasury Secretary for Economic Policy Natasha Sarin, found that consumers lose about $2 billion each year due to the Durbin Amendment.[10]

The real-world financial experience for consumers has been negative when standing at the checkout as well. Debit card rewards, which were more frequently offered prior to the

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[6] Electronic Payments Coalition (2021), The Cost of the Durbin Amendment. https://electronicpaymentscoalition.org/resources/the-cost-of-the-durbin-amendment/. Also see: Electronic Payments Coalition (2018). Out of Balance: How the Durbin Amendment has Failed to Meet Its Promise. http://www.electronicpaymentscoalition.org/wp-content/uploads/2018/12/EPC.DurbinStudiesPaper.pdf

[7] Wang, Z., Schwartz, S., and Mitchell, N. (2014). The Impact of the Durbin Amendment on Merchants: A Survey Study. Federal Reserve Bank of Richmond and Javelin Strategy & Research, 194.

[8] Manuszak, M. and Wozniak, K. (2017). The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation. Federal Reserve Board, 5-6.

[9] *Id.*

[10] Mukharlyamov and Sarin (2019), The Impact of the Durbin Amendment on Banks, Merchants, and Consumers. University of Pennsylvania Law School Institute for Law and Economics: Research Paper No. 19-06.

enactment of the law, have also now largely disappeared. These changes have occurred without the promised offsetting reduction in prices at merchants' point of sale. According to the Federal Reserve Bank of Richmond, only 1% of merchants reduced prices in the wake of lower debit fee acceptance costs. Most (77%) did not adjust prices at all, and 22% actually *raised* them.[11] The contribution of broken retailer promises to the impact of these fees is a consumer protection issue that should inform the Board's views on the sufficiency of data that is regularly reported to the public on the net costs of Regulation II.

These are entirely predictable effects[12] of a law premised on arbitrarily and simplistically setting static prices for services in a highly complex and dynamic two-sided market. Flexible interchange rates make it possible for networks to deliver maximum value for both merchants and consumers. By accepting debit payments, merchants enjoy higher average sales and can better meet consumer demand by quickly processing transactions and reducing checkout times, all while reducing the risks of theft and fraud. For consumers, debit payments are a convenient, secure, and easy way to pay for items, whether in-store or online. These benefits have grown more valuable during the pandemic as debit cards have provided contactless and online payment functionality that support social distancing.

However, due to the two-sided nature of this market, restraint of one side of the market results not in lower overall costs, but in shifting costs onto another group, in this case checking account customers. The rigidity of the Durbin Amendment's approach has created the artificial shortages referenced above and placed the Board in the peculiar role of enforcing one sector's financial interests at the expense of all other stakeholders, including consumers. Unfortunately, the current data collection does not quantify these consumer harms on an ongoing and systemic basis.

We are especially dismayed that the law's impacts have been most pronounced for those consumers in need of feature-rich, low-cost basic banking services and that these social costs are not captured in the relevant statistics. When access to a bank or credit union service like checking is hindered, a consumer faces a cascade of impacts, including loss of access to other basic financial tools such as direct deposit and ACH bill pay. Following the enactment of the Durbin Amendment, the share of banks providing free checking accounts fell steeply.[13] Industry is working aggressively to overcome these challenges and restore access, but it is doing so while swimming against a strong economic undertow created by the Durbin Amendment.

Pushed out of the banking system but still needing access to financial services, many consumers turn to check cashers, bill pay stores, and under-regulated nonbank and "big tech" payments platforms. Not only are these services often more expensive than those offered by a traditional bank, they also make it difficult to build a credit history needed to access lower-cost payment methods and loans.[14] In summary, by depriving financial institutions of needed revenue to serve

[11] Wang, Z., Schwartz, S., and Mitchell, N. (2014).

[12] Katz, D. (2011). Blame Dick Durbin for Bank Fees. The Heritage Foundation, Washington, DC.

[13] Mukharlyamov and Sarin (2019), "The Impact of the Durbin Amendment on Banks, Merchants, and Consumers." University of Pennsylvania Law School Institute for Law and Economics: Research Paper No. 19-06.

[14] Hayashi, F. and Cuddy, E. (2014). General Purpose Reloadable Prepaid Cards: Penetration, Use, Fees, and Fraud Risks. The Federal Reserve Bank of Kansas City, 32-36; Hayashi, F. (2014). General Purpose Reloadable Prepaid

underbanked populations, the Durbin Amendment is at odds with public policy that values increasing inclusion in mainstream banking services.

Community Financial Institutions and Investment in Evolving, Faster Payments

For smaller financial institutions that lack the economies of scale of larger competitors, the Durbin Amendment's adverse impact on debit card revenue is especially important and compounds the challenges they face in the marketplace.

Compared to large issuers, smaller institutions have fewer customers across which to spread payments system costs and are often debit-only card issuers. They frequently pay third-party "core" providers for service upgrades that allow them to remain competitive, but must finance these investments with existing revenue. By reducing the revenue available to make these investments, the Durbin Amendment impairs the ability of smaller institutions to modernize their payments infrastructure and offer new options that may come to market. This is particularly damaging because the ability to adopt new real-time payment options has become even more important during the COVID-19 pandemic.[15] Even pre-pandemic, the Federal Reserve demonstrated awareness of this need through the *Faster Payments Task Force*.

Regulation II's Divisive History

The Durbin Amendment was premised on the flawed logic that debit cards, which act as a method of transmitting funds from underlying accounts, could be isolated from the rest of the customer's interactions with a bank or credit union. In reality, a debit card is the revenue-contributing component of a deposit relationship *bundle* that includes a checking account, technology, and customer service.

In implementing the Durbin Amendment, the Board faced the unenviable task of interpreting a flawed and hastily enacted law. The provision was drafted at the last possible moment as a peripheral inclusion in the Dodd-Frank Act and did not face the rigorous scrutiny of legislative hearings or regular legislative order. Nor was there opportunity for assessment, amendment, or improvement. Its mandates, particularly the use of price controls, represented a departure from norms of modern commercial regulation and a return to discredited central planning of business relationships. Given these circumstances, it was not surprising that protracted litigation ensued in connection with Regulation II. We expect that currently proposed and potential future expansions of the regulation will provoke a revisiting of those basic questions about the ultimate legality of the Durbin Amendment.

Cards. Federal Reserve Bank of Boston; Bennet, J. (2015). From Coins to Big Bucks: The Evolution of General-Purpose Reloadable Prepaid Cards. Page One Economics, The Federal Reserve Bank of St. Louis.

[15] Ramsey, Craig (2021). U.S. Payments Players Must Build on Real-Time's Breakthrough Year. https://fasterpaymentscouncil.org/blog/6206/U-S-Payments-Players-Must-Build-on-Real-Time-s-Breakthrough-Year

Secure Payments Require Constant Investment

Lobbying groups for the nation's largest merchants have advocated for the Board to repeat the rule writing process,[16] but this is neither justified by the facts nor good public policy. These groups assert that the reduction in fraud resulting from highly effective security systems such as chip cards constitutes a reduction in the cost burden borne by banks and credit unions, and insist that these reduced costs should be reflected by a corresponding reduction in interchange.

This is an intentionally narrow misreading of the current state of fraud. If pursued, these calls would punish card issuers for their anti-fraud investments and prematurely presume a long-term step change in overall fraud levels. While banks and credit unions are actively battling against payments fraud and have achieved notable progress against specific threats over certain time periods, the payments threat landscape is constantly evolving, and a posture of unrelenting adaptation is essential. Although some merchant groups may believe that now is the time for a victory lap (and a reduction in interchange),[17] our members recognize the need to continue developing and investing in advanced fraud detection, prevention, and mitigation technologies.

As the Board knows from the *Secure Payments Task Force,* highly sophisticated criminal organizations attacking the U.S. payment infrastructure will continue to incessantly seek opportunities to defraud, shifting to new tactics which only become apparent with time. The observed reductions in counterfeit card fraud thanks to the widespread adoption of chip cards is an industry-led success story, but combatting other emerging forms of fraud requires constant innovation of new technologies to keep merchants and consumers safe.

For example, while counterfeit fraud has fallen as a result of increased chip card use, card issuers are facing new kinds of direct and indirect fraud costs related to social engineering and collusive merchants. According to one estimate, card-not-present fraud increased more than 250 percent from 2015 to 2020.[18] This type of fraud is likely to increase further in the coming years as e-commerce continues to grow—a trend that was not recognized in detail in the Board's most recent debit interchange report.[19] Recognizing this trend, the financial services sector is providing tools for merchants to reduce the entry of these card-not- present losses in the payments system.

Meanwhile, issuers and their customers continue to endure the fallout of frequent data breaches at merchants who fail to comply with industry security standards or any national data safeguarding rules. Regulation II was drafted at the dawn of what has become the age of routine merchant megabreaches. According to the Identity Theft Resource Center, the number of major

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[16] Kantor, Doug (2021). Retail groups urge credit swipe routing changes. Payments Dive; RILA (2021). Retail Seeks to Protect Merchants in Interchange Legislation. Retail Industry Leaders Assn. Washington, DC.

[17] Merchant Payments Coalition (2021). Merchants Call on Fed to Cut Debit Card Swipe Fee Rate as Banks' Costs Fall, Applaud Routing Announcement. https://merchantspaymentscoalition.com/merchants-call-on-fed-to-cut-debit-card-swipe-fee-rate-as-banks-costs-fall-applaud-routing-announcement/

[18] Euromonitor (2021).

[19] Federal Reserve Board (2021). 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions. https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2019.pdf

data compromise events more than doubled from 2015 to 2021 and rose 68 percent from 2020 to 2021. In the retail sector alone, more than seven million consumers were victims of data breaches.[20] These breaches trigger increasingly costly chip card replacements. In a single well-known incident, more than 50 million cards were compromised at Home Depot in 2014.[21] More recently, Neiman Marcus Group announced that names and credit card numbers for more than three million credit cards and gift cards may have been compromised in 2020.[22] To claim that financial institutions are materially less impacted by fraud or need be operationally less focused on it in today's world of multiplying threats is not credible.

Simply put, the effectiveness of the chip card transition in combating counterfeit fraud is a welcome success story, but is not a sufficient or reliable signal to predict future fraud trends. Indeed, we know that fraudsters will not simply throw in the towel in the face of stronger industry fraud protections, but instead will shift their strategies and tactics—necessitating additional fraud prevention investments. A reduction in traditional counterfeit fraud following the chip card conversion is not compelling reason to reevaluate fraud assumptions made in Regulation II.

One of the risks associated with the Board's recent proposal[23] on the Durbin Amendment's routing requirement is that many issuers would need to reissue chip cards as part of their transition to supporting new networks and transaction types. The payments industry is already facing a global semiconductor shortage that will strain the ability of U.S. card issuers to fulfill new account opening, replace lost cards, and keep up with card expiration schedules. Unlike the rest of the world, the chip in U.S. cards must support a complex routing process, potentially further limiting the supply of cards available. As the Administration takes a whole-of-government approach to mitigating the economic harm of this semiconductor shortage, the Board may be the only agency with the ability to provide immediate relief by withdrawing or postponing regulatory changes that could trigger *en masse* card reissuance by some issuers at the worst time.

Conclusion

During these trying times, our members remain committed to serving the American economy—consumers and merchants alike. Merchants value the benefits of accepting cards, as proven by their increasingly demonstrated preference for electronic payments. Only a handful of the largest merchants view electronic payments as a battleground and many are grateful to have access to the latest technology.

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[20] Identity Theft Resource Center (2022). 2021 Data Breach Annual Report. https://notified.idtheftcenter.org/s/2021-data-breach-report

[21] Fortune (2017). Home Depot to Pay Banks $25 Million in Data Breach Settlement. https://fortune.com/2017/03/09/home-depot-data-breach-banks/

[22] Dallas Morning News (2021). Neiman Marcus tells 4.6 million customers about credit card and gift card data breach. https://www.dallasnews.com/business/retail/2021/10/01/neiman-marcus-tells-46-million-customers-that-credit-card-and-gift-card-data-breached/

[23] https://www.federalregister.gov/documents/2021/05/13/2021-10013/debit-card-interchange-fees-and-routing

We continue to believe that the Durbin Amendment was a transparent attempt to reallocate wealth to a small tranche of the largest merchants. In doing so, much harm has been done to the once-vibrant debit card ecosystem and its actors, including consumers, small businesses, and community banks and credit unions.[24] Almost a decade later, the Durbin Amendment remains controversial and as evidence mounts, legislative attempts to repeal it emerge periodically.

It had never been the role of the central bank to attempt to replace, through regulation, the price discovery mechanisms of a complex two-sided marketplace. Products such as the latest debit interchange report provide useful information about the electronic payments market, but focus too narrowly on merchant costs while ignoring the myriad benefits they receive in return, including increased sales, faster transactions, reduced cost of handling cash,[25] and prompt guaranteed payments.[26] Further adjustments, ostensibly to refine the implementation of the Durbin Amendment's mandates, would be likely to have additional and unpredictable distortionary market effects and exacerbate the damage done by the existing rules.

We urge you to recognize that demands to reopen Regulation II are premature and motivated by short-term and parochial economic interests, and to exercise appropriate restraint by declining to entertain those demands. Further, we reiterate the request[27] made during the 2016 Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA") process that the Board report to Congress a conclusion that the Durbin Amendment has failed to achieve its stated goals, and that the Board recommend its speedy repeal.

Sincerely,

AMERICAN BANKERS ASSOCIATION

CONSUMER BANKERS ASSOCIATION

CREDIT UNION NATIONAL ASSOCIATION

INDEPENDENT COMMUNITY BANKERS OF AMERICA

NATIONAL ASSOCIATION OF FEDERALLY-INSURED CREDIT UNIONS

NATIONAL BANKERS ASSOCIATION

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[24] Electronic Payments Coalition (2018). Out of Balance: How the Durbin Amendment has Failed to Meet Its Promise. http://www.electronicpaymentscoalition.org/wp-content/uploads/2018/12/EPC.DurbinStudiesPaper.pdf

[25] Card acceptance reduces costs associated with counting, storing, safeguarding, and transporting cash, and limits losses from mislaid or stolen cash — all of which are significant expenses that retailers often overlook. A recent study conducted by a retail industry research firm found that the average retailer spends more than 9% of the value of their cash transactions counting, auditing, and depositing cash. See IHL Group (2018), "Cash Multipliers: How Reducing the Costs of Cash Handling Can Enable Retail Sales and Profit Growth."

[26] Federal Reserve Board (2021). 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions. https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2019.pdf

[27] Kern, S. (2016). Re: Fourth Published Request for Comments Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Amer. Bankers Assn., https://www.aba.com/Advocacy/commentletters/Documents/ABACommentLettertoJointAgenciesonFourthEGRPRAReview.pdf