August 11, 2021

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

Re: *Debit Card Interchange Fees and Routing (Docket No. R–1748, RIN 7100–AG15)*

Dear Ms. Misback:

The undersigned trade associations, which represent virtually all the Nation's regulated financial institutions, write to request that the Board of Governors of the Federal Reserve System ("Board") withdraw the recent Federal Reserve proposal ("Proposal") to amend Regulation II (12 C.F.R. Part 235),[1] unless it is revised materially in the manner recommended herein.

During this trying time, our members have proven critical to maintaining the health of an American economy under siege. Our members also have greatly stepped up their payments products to support American consumers and businesses, including by facilitating Congress' stimulus programs during the pandemic. We did not anticipate a new mandate that would require us to undertake distracting, expensive, time-consuming efforts to change our core network infrastructure. The Proposal is particularly surprising given that the primary beneficiaries of the Board's action would be large multinational retailers that have experienced double-digit profitability increases during the pandemic, not small businesses.

Moreover, we are concerned that the Board has taken an over-simplified approach to this rulemaking, failing properly to consider the Proposal's foreseeable harm to small businesses and consumers. We respectfully request that the Board withdraw the Proposal until it undertakes a proper analysis on the impact of any rulemaking on routing and exclusivity. In the event that the Board determines to proceed with its rulemaking, we respectfully request that the Board revise the Proposal in the manner set forth herein.

Our members remain committed to vigorously opposing any attempt to undermine the payments system at the expense of consumers. The Proposal presents a threat to consumers, issuers, and the U.S. payments system and should not be permitted to go into effect.

[1] 86 Fed. Reg. 26,189 (May 13, 2021).

Introduction

A decade ago, a broad coalition came together to oppose the Board's 2011 Regulation II proposal.[2] Our position then, as it is now, is that Regulation II represents flawed regulatory policy. However, the regulatory expansion represented by this Proposal stands on even weaker legal footing and would further the harmful consequences of the original regulation. Although it is presented as a "clarification," the Proposal represents a substantive shift in the routing and exclusivity provisions of Regulation II. Moreover, the analysis underlying the Proposal fails to take into account the practical and operational implications of the proposed change.

Furthermore, while this proceeding is undertaken pursuant to a law that has consumer protection *in its name*, the Dodd-Frank Wall Street Reform and Consumer Protection Act,[3] the Board concedes that the Proposal would not protect consumers and asserts that consumers are ignorant of the protections that they receive when they use payment cards issued by their financial institution. In reality, the Proposal represents a potential multi-billion-dollar transfer of money to the world's largest retailers from America's financial institutions, especially its small community financial institutions and their customers, who can ill afford to be subsidizing others.

Over the past decade, the Federal Reserve has collected data that demonstrates that the only winners from the Regulation II network exclusivity and routing restrictions have been the nation's largest retailers.[4] These retailers, unlike smaller merchants, have negotiated discount rates with specific networks that have benefitted the largest merchants that already dominate the e-commerce sales where card-not-present ("CNP") transactions will be most useful. As shown in Figures 1 and 2 below, more than two-thirds of all U.S. e-commerce sales were concentrated in just 10 large retailers.[5]

[2] Comments to the Federal Reserve of the American Bankers Association, Credit Union National Association, Consumer Bankers Association, The Financial Services Roundtable, Independent Community Bankers of America, Mid-Size Bank Coalition, National Association of Federally-Insured Credit Unions, National Bankers Association, and The Clearing House Association, Docket No. R–1404 (Feb. 22, 2011).

[3] Pub. L. No. 111–203, 124 Stat. 1376 (2010).

[4] *See, e.g.*, Wang, Z., Schwartz, S., and Mitchell, N., *The Impact of the Durbin Amendment on Merchants: A Survey Study*, Economic Quarterly, Vol. 100, No. 3, Third Quarter 2014, pp. 183–208, Federal Reserve Bank of Richmond ("FRB Richmond Study").

[5] *See also* Davis, Don, *The pandemic helps the biggest online retailers get bigger*, Digital Commerce 360, May 5, 2021, https://www.digitalcommerce360.com/article/top-1000-north-american-retailers/.

Figure 1: Share of E-Commerce Revenue

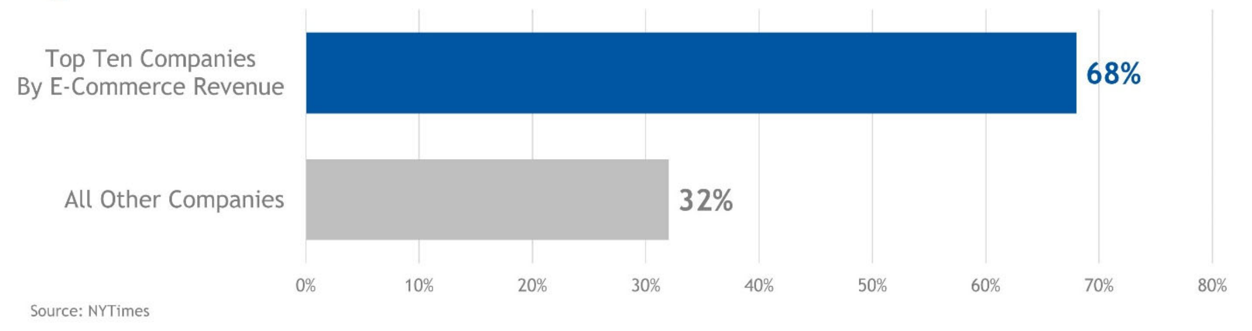
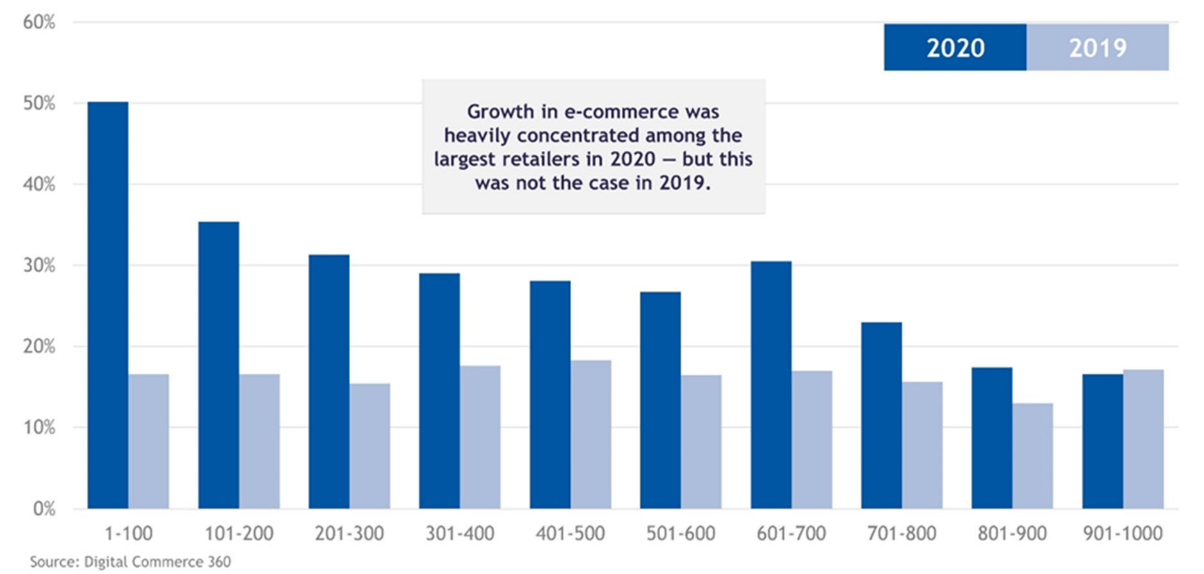


Figure 2: E-Commerce Revenue Growth
Among Top 1000 Retailers (Y/Y)



Cardholders, on the other hand, have seen little benefit from the routing and exclusivity provisions of Regulation II. There is no evidence that merchants have passed interchange savings on to their customers.[6] Instead, consumers have seen free checking and rewards programs withdrawn and new fees introduced by community financial institutions seeking to make up revenue lost in complying with the current Regulation II requirements.

Yet the Board proposes to extend further these benefits to large retailers, and amplify these harms to issuers and their customers, by taking the Regulation II routing and exclusivity restrictions into new, dangerous territory. The Proposal, as discussed below, would force issuers to accept services from networks that have not proven their ability to handle fraud security in the

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[6] *See* FRB Richmond Study at 185.

category of CNP transactions, which is more prone to fraud. Although certainly not intended, the Proposal risks reducing hurdles faced by criminals who wish to steal consumers' identities or payment credentials to commit fraud. And it would reward unfair treatment of community financial institutions by the companies that lobbied for, and eagerly await, an unprecedented windfall from the Proposal.

As discussed further herein, the Proposal is inconsistent with the Durbin Amendment's basic purpose and contains numerous fatal infirmities. The truncated regulatory analysis the Board offers to support the Proposal is fundamentally and irretrievably flawed in its premises, analysis, and conclusions. The Board overlooks these infirmities by calling its proposed change a clarification, but the Board's own rulemaking release recognizes that the Proposal is a "notice of proposed rulemaking," as opposed to a "clarification."[7] We believe the proper course is to withdraw the Proposal until the Board can complete an impact analysis and then, if the analysis supports it, begin again. If the Board determines to proceed with its rulemaking, notwithstanding these infirmities, the Board should revise the Proposal in the specific ways detailed herein.

The Proposal is Functionally Impracticable, Rendering it Arbitrary and Capricious.

The first fatal legal flaw with the Proposal is that it would impose requirements that cannot be carried out by issuers or networks on any timeline the Board may impose, because of both the vagueness and the nature of the requirements.

The Proposal Would Impose a Vague Requirement that Issuers "Enable" Multiple Networks.

A fundamental problem with the Proposal is the vagueness of the new obligations that the proposed regulation would impose on issuers for *all* electronic debit transactions—whether the card is present or not. The Proposal would require that issuers do more than merely "*allow* an electronic debit transaction to be processed on at least two unaffiliated networks," as Section 235.7 of Regulation II currently provides. It would require issuers to ensure that those networks are "*enabled*" on their cards, "to emphasize the issuer's role" in ensuring that multiple networks are available for any particular electronic debit transaction.[8] The Board is clear that this "enabling" responsibility goes beyond merely contracting with network providers capable of meeting the Regulation II routing and exclusivity requirements. It would require that issuers take affirmative steps to *ensure* the networks they have contracted with are actually capable of working with their debit cards, and make issuers responsible for actions that are outside of the issuer's control. The Proposal does not, however, specify the steps issuers must take to ensure enablement. The Proposal is void for vagueness because issuers would have no basis to determine whether they have done enough to ensure they are in compliance.

Moreover, this new "enablement" mandate would impose burdensome responsibilities that issuers are unable to undertake without significant restructuring of the contractual framework underlying debit card transactions. Issuers do not have information regarding whether a

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[7] *Compare* 80 Fed. Reg. 48,684 (August 14, 2015) *with* 86 Fed. Reg. 26,189 (May 13, 2021).

[8] 86 Fed. Reg. at 26,192.

particular network does anything to "restrict the operation of the network to a limited geographic area, specific merchant or particular type of merchant or transaction." Nor are issuers aware of the steps a network or processor must undertake to be compatible with their cards. Issuers can only accept what the networks, merchants, and acquirer processors tell them about their capabilities and what it will take to enable them. Issuers lack the information necessary to understand, and it is impracticable to implement, the proposed enablement requirement, which would cast doubt on whether issuers are in compliance with Regulation II on *any* debit transaction.

The proposed enablement requirement would force issuers to redirect funds and personnel from critical projects, and this would have a disproportionate impact on small issuers and community banks. Smaller financial institutions do not have adequate personnel to put the necessary systems in place and must rely on vendors. There are a limited number of vendors who are capable of putting these systems into place and thousands of issuers who would need to come into compliance in the same timeframe. The additional funds and effort that would be directed to coming into compliance would take away funds and limit staff resources that issuers, and, in particular, smaller institutions, use to provide services, rewards, and low-cost products to their customers, as well as to undertake charitable and community-focused projects.

If the Board determines to proceed with this enablement requirement, to attempt to avoid the vagueness flaw, the Board should specify, and consider the burden related to, the steps necessary to enable multiple unaffiliated networks on debit cards to be in compliance, if such steps are determinable.

Additionally, the Board should clarify which transaction types are at issue, rather than leaving it vague and open-ended, particularly in an ever-changing payments landscape. It is currently impracticable for issuers to comply with this vague requirement, as issuers do not have a clear idea of what problem they are attempting to solve. Given the serious fraud concerns, issuers will need to test and approve any new systems they build, and those systems will be tailored to specific transaction types. A new transaction type could require entirely different fraud controls.

The Proposal Fails to Consider the Incremental Fraud Risks on CNP Transactions.

The Board's Proposal would introduce risk to the payments system by requiring that issuers enable multiple unaffiliated networks for CNP transactions. The Board acknowledges that most issuers will have to make arrangements with at least one "single-message" PIN debit network to meet these network availability requirements for CNP transactions, because that is the solution that the "vast majority of issuers choose" to meet Regulation II's similar requirements for "card-present" transactions."[9]

The Board acknowledges that PIN debit networks would not have been an option for CNP transactions "[a]t the time the Board promulgated Regulation II," because at that time, single-

[9] *Id*. at 26,191.

message PIN debit networks could not handle CNP transactions.[10] But the Board, believes "technology has evolved," and "nearly all single-message debit card networks conducted card-not-present transactions in 2019."[11] The Board assumes that because some initial technological barriers have been overcome, issuers should have no trouble utilizing PIN debit networks for CNP transactions.

But it is not solely technological barriers; there are more practical barriers that have prevented "PINless" adoption in CNP scenarios. Our members generally do not enable CNP electronic debit transactions across single-message, PIN debit networks because fraud is most rampant in CNP transactions. Issuers may determine to decline authorization messages that come over single-message networks because of fraud concerns. Instead, for CNP transactions, our members utilize dual-message networks, which are robust enough to support sophisticated security systems, incorporating tools such as tokenization, geolocation, and better audit trails to identify and prevent fraud in CNP transactions.

By contrast, due to the history of single-message networks, which were originally developed to communicate with ATM machines, there is wide variation in the ability of such networks to adequately support robust security systems. Instead, the security of single-message networks is necessarily tied to use of a PIN, which is why, until recently, PIN debit networks refused to dispense with PINs. Indeed, retailers and their trade associations previously insisted that even the most modern "chip" debit cards cannot "provide sufficient security" "without [PIN]s," because "the absence of a PIN leaves no protection against the fraudulent use of lost or stolen cards."[12] Retailers only switched to their current demand for PINless CNP transactions over single-message networks after certain merchants negotiated heavy discounts with these networks. Senator Durbin himself stated that when card issuers fail to require a PIN at the point of sale, it presents a grave mistake motivated solely by *issuer* economic interest, but then demanded that issuers allow transactions without PINs.[13] Thus, the views of retailers and PIN debit networks regarding security and fraud protection have varied with their economic interest; issuers' position, on the other hand, has to do with what is needed to fight fraud in the payments system and protect consumers.

If finalized, the Proposal would require an expansion of PIN debit networks, some of which lack adequate anti-fraud security for this new scale, into an operating environment they fundamentally cannot handle and in which fraud is most rampant. Some of the PIN debit networks implicitly recognize this shortcoming as well since they only allow PINless transactions under a certain transaction threshold. The CNP environment is also where the main security feature of PIN debit networks, the debit PIN, becomes a no-win liability. That is because, if merchants dispense with the PIN in a CNP transaction, as many do, then the PIN

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[10] *Id.* at 26,190.

[11] *Id*. at 26,191.

[12] EMV Chip Cards, National Retail Federation, https://nrf.com/emv-chip-cards.

[13] *See* Letter from Senator Durbin to Brian Byrne, Director of Operations, EMVCo, LLC, May 11, 2016; Letter from Senator Durbin to Federal Reserve Board Chairman Powell, July 24, 2020.

debit network's main security feature is disabled. If, on the other hand, a merchant is taking a PIN in an environment not created to support the transmission of a PIN, the PIN numbers could be compromised, leading to more damaging fraud. Forcing issuers to use PIN networks for CNP transactions would put the task of fraud prevention in the hands of networks, which have not dealt with fraud at this scale.

The Proposal would Result in Significant Increased Costs on Community Financial Institutions.

Increased fraud resulting from the Proposal would result in higher costs for fraud and identity theft losses for our members' customers, and would require issuers to undertake numerous steps to combat that fraud. As a practical matter, the Proposal would create a quagmire as 8,000 debit issuers, all at the same time, try to vet and bring online one of the few available PIN debit networks capable of handling their CNP transactions. This technology mandate would impose significant costs on all issuers, including small issuers and community financial institutions. Issuers would have to help PIN networks build or provide compensating controls and systems for PIN debit networks that will actually work in the CNP environment; help their new networks develop fraud-scoring and monitoring systems to assist in identifying potential fraud; help set up new methods to decline transactions at the merchant ID/DBA level in the case of a fraud attack; develop systems to ensure that networks have the ability to decline bad card verification values if the issuer is unavailable; and help the PIN networks they are compelled to enable build an entirely automated chargeback process for CNP transactions. Without these baseline protections, the networks will have to handle those claims manually, harming consumers and creating liability for consumers and issuers under Regulation E.

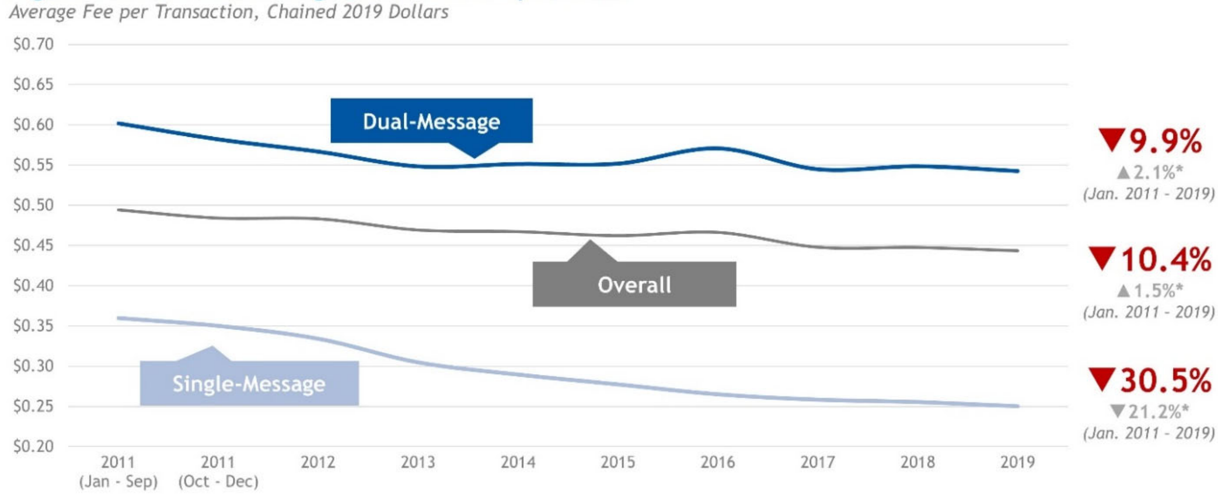
Issuers would have to do this on top of the other, ill-defined oversight responsibilities that would be mandated by the Proposal, and on top of the other major modifications that issuers would need to make to their own systems to enable PIN networks for CNP transactions. This would involve technology changes to modify authorization, settlement, and back-office support, as well as modification of issuer practices to accept network fraud scores and comply with new network rules. All of this would significantly burden the resources of issuers and networks to find network options that will work for CNP transactions. And it would take a significant amount of time; our members estimate that these changes would take three to four years to implement.

These changes would fall most heavily on smaller issuers and community financial institutions. Smaller issuers would have difficulty getting the attention of the national PIN networks and would be stuck cobbling together a patchwork of more regional, potentially less reliable or scalable networks. This would burden the resources of institutions that are already threatened by extraordinarily thin margins. The high cost of bringing card programs into compliance with the proposed changes could also necessitate new budget priorities, undermining the availability of affordable, core deposit products like free checking, and undermining the ability of community financial institutions to compete in an era where payments system costs are rising. As a practical matter, the work needed to enable additional networks cannot happen all at the same time, and it is likely that smaller financial institutions would be at the back of a long line of banks needing to contract with various additional networks for PINless capability. All this suggests that the Proposal is more than a clarification of existing routing and exclusivity requirements. It would require significant and extensive reordering of the payments system, creating a regulatory quandary that could threaten the economic viability of many community financial institutions.

Further, as the Board memo for the Proposal shows, single-message transaction fees for so-called "exempt" institutions (i.e., a small debit card issuer, together with its affiliates, with assets of less than $10 billion) have fallen substantially since the implementation of Regulation II. In nominal terms, the average per-transaction interchange fee for single-message transactions fell from 31 cents in December 2011 to 25 cents in the most recent Federal Reserve survey. However, these figures are not adjusted for inflation and understate the scale of the decline. In real terms, the average fee fell by 31 percent, from 35 cents in December 2011 to 25 cents in the most recent survey.[14] The same trend can be seen for dual-message transactions, for which the average per-transaction interchange fee has fallen 10 percent from 58 cents to 54 cents in real terms over the last decade (see Figure 3).

Figure 3: Debit Interchange Fees for Exempt Issuers

Average Fee per Transaction, Chained 2019 Dollars



*Percentages in red are have been adjusted for inflation using the CPI; percentages in gray are in nominal dollars and are not adjusted for inflation.
Source: Federal Reserve; Bureau of Labor Statistics; Electronic Payments Coalition calculations.

Even the small community banks and credit unions—who are supposedly exempt from the rule—are receiving far less revenue. Further, because the $10 billion threshold for covered issuers, along with the 21-cent interchange cap for covered issuers, are also not indexed to inflation, more medium-sized banks are being affected than Regulation II originally intended. When adjusted from June 2021 to 2011 dollars using the BLS Consumer Price Index, the $10 billion cap in 2011 dollars is effectively a cap of less than $8 billion in today's dollars, and the interchange restriction of 21 cents is actually only 17 cents in today's dollars.

The Proposal would compound the revenue losses for small banks and credit unions, transferring billions of dollars from community financial institutions to large retailers. This could foreseeably cause these community financial institutions to introduce or increase fees for

[14] Data are in December 2019 dollars and are adjusted for inflation using the Consumer Price Index published by the Bureau of Labor Statistics.

consumers, increase minimum balance requirements, and reduce debit card rewards, thereby deepening the loss of access to financial services that has become the well-proven, documented legacy of the Durbin Amendment.

The Proposal Ignores the Role of Processors.

Making matters worse, all the efforts that issuers undertake to enable multiple networks for their electronic debit transactions does not translate to multiple unaffiliated networks for any transaction type, because some debit card transaction processors do not have capabilities in place to route CNP transactions to different networks. In these processors' systems, PIN transactions may go to different networks, but CNP transactions always go to the network brand on the card due to the processors' capabilities. Additionally, some processors own their own PIN networks and do not have incentives to enable other networks.

Accordingly, issuers would need processors to participate in order to attempt to comply with the Proposal's vague requirements. Merchants generally have agreements with acquiring banks and processors. To further complicate matters, many merchants work with merchant aggregators, who would also need to be considered in this process. Smaller financial institutions are further disadvantaged by the failure of the Proposal to consider this market structure entirely, and the Proposal would do nothing to require processors or other merchant-facing providers to enable multiple networks for merchants. So even if issuers made the investment to enable multiple networks, they would not be able to ensure that many small business merchants would be able to take advantage of them.

Any rule that would impose impracticable requirements that cannot be fulfilled and would be rendered nugatory in practical application by factors the Board has failed to consider is arbitrary and capricious in violation of the Administrative Procedure Act.[15]

The Proposal Fails to Address Key Differences in Transaction Types.

Crucial to implementation of the Proposal, we understand from our members that PINless transactions are often enabled by their core processors, which now also own PIN debit networks. In some cases, enablement occurs through clauses added to consolidated terms of service during contract renewal, making it a challenge to opt out of PINless transactions—at that time or in the future—regardless of the issuer's operational or fraud concerns. Community financial institutions report that, as a direct consequence of these vendor clauses, their right to charge back fraud is either watered down or nonexistent when compared to transaction types they have traditionally been presented with by the processor.

The remaining (independent) PIN debit networks do not have the same enmeshed relationship with financial institutions as the merged vendors with whom they compete, yet the Proposal treats them as is they were the same. The Proposal fails to address whether the recent

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[15] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

phenomenon of processor-owned debit networks affects either the issuers' choice of competitive options or issuers' rights under EFTA, both of which are material to the operation of the Proposal's new requirements.

For a bank or credit union customer, the PINless experience is not interchangeable with or equal to traditional processing in key ways. One major retailer states that customer refunds for purchases originally made on PINless transactions take up to 10 days to post versus a third to half of that time for traditional card purchases. Whatever the market's judgements about their relative value, they are not equivalent experiences for the consumer, and mandating that banks facilitate such significantly different service levels for their customers is harmful to customers and is not consistent with a mere regulatory clarification.

The Durbin Amendment did not entitle merchants to obtain all payments technologies that have been invented or may be invented at any point in the future regardless of their freely made choices in the market. The statute circumscribed their expectations to a limited set of scenarios and services. Yet the Proposal, consistent with the merchants' "everything for nothing" approach to payments, would take an expansive view of the entitlements to be created for merchants and extend such entitlements beyond mere debit routing protocols.

The Proposal Fails to Undertake the Analyses Required by Federal Law.

The regulatory analysis that the Board has offered in the Proposal is deficient. As described above, the Proposal does far more than simply "clarify" matters already covered under Regulation II.[16] It is a wholesale reworking of the network exclusivity and routing requirements. It imposes new, vague responsibilities on issuers for all transaction types that do not exist under Regulation II. That cannot be called a mere "clarification." The Board's analyses under the Electronic Fund Transfer Act ("EFTA"), the Paperwork Reduction Act of 1995 ("PRA"), and the Regulatory Flexibility Act ("RFA") are also fatally flawed.

The Board's Analysis Does Not Satisfy its Obligations under the EFTA.

The Board acknowledges that it must conduct an analysis under EFTA Section 904(a)(2), which requires the Board to "prepare an analysis of economic impact which considers the costs and benefits to financial institutions, consumers, and other users of electronic transfers…." That analysis must include "the effects upon competition in the provision of electronic banking services among large and small financial institutions."[17] However, the Board makes no attempt to consider that the Proposal would benefit primarily large retailers, certain PIN network providers, and fraudsters, while harming virtually everyone else in the electronic debit payment ecosystem. The Board's analysis likewise does not discuss why large retailers, who have flourished during a worldwide pandemic, need this subsidy to succeed. For that matter, the

[16] 86 Fed. Reg. at 26,189.

[17] 15 U.S.C. § 1693b(a)(2).

Board does not offer any defense of the Proposal's apparent economic theory, which paradoxically proceeds by requiring *more* networks instead of *better* networks.

The Board's Analysis Fails to Consider the Impact on Consumers.

What little analysis the Board does provide is incorrect. Particularly troublesome is the Board's analysis of the Proposal's likely effect on consumers, especially "low-income consumers," as required by EFTA. The Board goes so far as to suggest that the Proposal does not even "relate to consumer protections," and that consumers are ignorant of debit transaction routing.[18] Indeed, as industry analysists have noted, the Proposal seems to have overlooked consumers completely: "What is missing from this announcement is any consideration for cardholders and how they may be impacted by clarifications of the law."[19]

The Board believes the interests of cardholders are irrelevant because they are usually "unaware of the networks used to process many debit card transactions today."[20] However, the Proposal would harm consumers even if they are unaware of its existence, so the Board cannot justify the Proposal by relying on consumer ignorance; the Board must analyze whether the Proposal would benefit consumers. The Board failed to analyze whether cardholders would enjoy any benefit, or suffer any harm, from the Proposal, claiming "the effect of the proposed rule on the availability of services to consumers" is too "uncertain" to anticipate.[21]

That analysis is inadequate, especially because the Proposal would likely harm consumers. That is the foreseeable effect if the Proposal is finalized as proposed, because that is what has happened to consumers under the current Regulation II requirements for card-*present* transactions: consumers have been squeezed. They have not experienced any benefit from the savings that merchants have experienced under Regulation II because merchants have not passed those savings on to consumers. And consumers have seen their relationships with their issuing financial institution harmed. To manage the cost of the present regime of network exclusivity rules, issuers have been forced to limit rewards programs, and impose new checking and debit account fees. There is every reason to believe that the Proposal would accelerate these ill effects for consumers.

[18] 86 Fed. Reg. at 26,193.

[19] Grotta, Sarah, *Will the Fed Clarify Regulation II to Enforce Utilization of Two Unaffiliated Networks?* at 1, Mercator Advisory Group (June 2021).

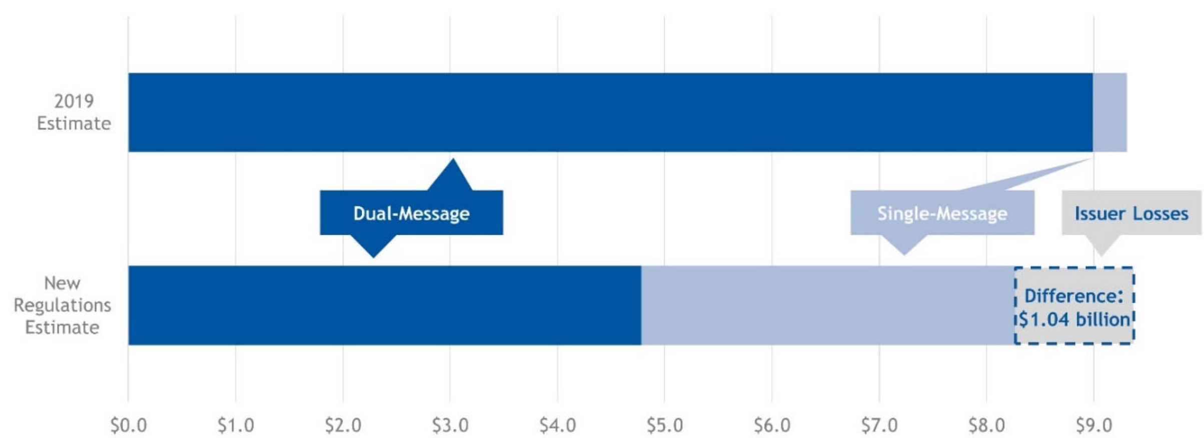
[20] 86 Fed. Reg. at 26,193.

[21] *Id.*

According to the Federal Reserve's latest debit interchange report, dual-message transactions made up roughly 51 percent of card-present transaction value and 95 percent of CNP transaction value in 2019. If the Proposal were to take effect, the e-commerce sector could begin to resemble the roughly even split found in the card-present space in terms of dual- and single-message transactions. As shown in Figures 4 and 5, **such a shift would result in a windfall of $1.04 billion for major retailers in 2020 alone (or $27 billion over the next 10 years), with gains concentrated among the largest multinational retailers.**[22] These gains would come at

Figure 4: Estimated CNP Interchange, Status Quo vs. New Reg II

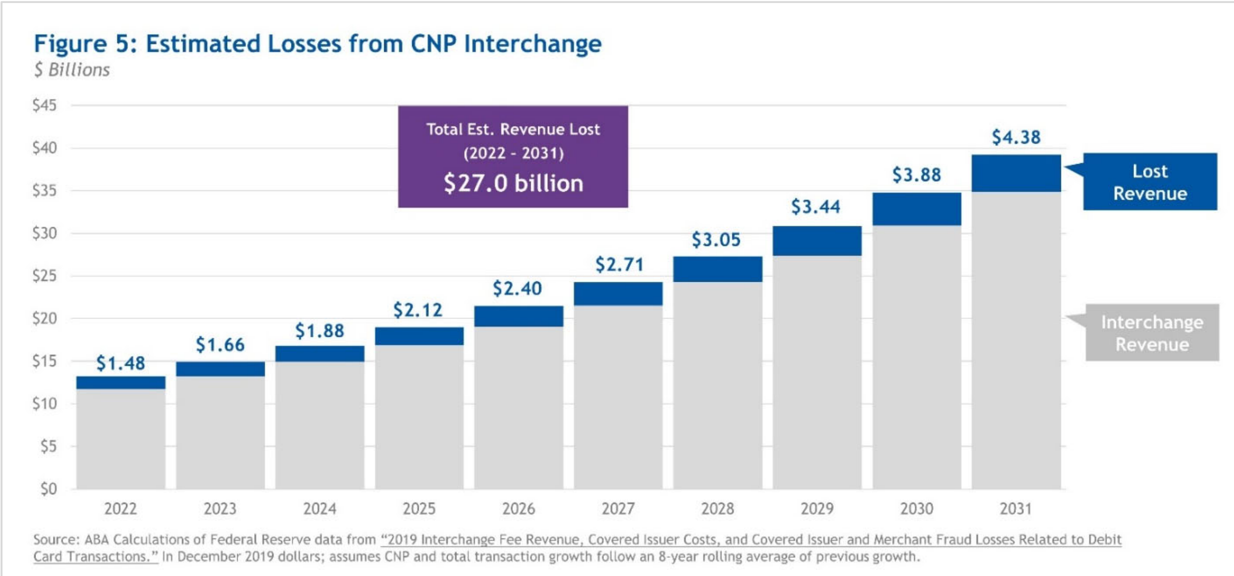
2019, $ Billions



Source: ABA calculations of data from Federal Reserve Board (2021), "2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions.", Table 2.

the expense of debit card issuers, who would likely respond by reducing benefits and increasing costs on consumers to offset the lost revenue imposed by the price control.

[22] These figures assume an average interchange rate of 0.85% of transaction value for dual-message and 0.64% for single-message transactions, based on the Federal Reserve's Average Interchange Fee by Payment Card Network for 2019. Card-present and CNP transaction data by network type comes from the Federal Reserve's report on 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions. Data are in December 2019 dollars and are adjusted for inflation using the Consumer Price Index published by the Bureau of Labor Statistics. Transaction growth is forecast using an 8-year rolling average to approximate CNP and total transactions.



It is not surprising that small businesses are unlikely to benefit much, if at all, from the proposed change given the real-world experience that occurred following the enactment of the Durbin Amendment more than a decade ago. As the Electronic Payments Coalition reported in 2018, prior to Regulation II there was more variability in interchange fees depending on the type of merchant and size of purchases. Networks tailored fees in a manner that optimized income, risk exposure, and adoption rates, as one would expect in a well-functioning two-sided market. As a result, networks routinely offered merchants significant discounts for small-ticket purchases, resulting in interchange fees that were often below the allowable level set by the Federal Reserve under the Durbin Amendment as a means of encouraging debit card acceptance. However, after Regulation II was implemented, networks eliminated these discounts and moved to a flatter rate structure which, for some merchants—particularly Main Street stores who are more likely to specialize in smaller-ticket items—caused their debit costs to increase rather than decrease.[23] While big box retailers benefitted to the tune of billions of dollars in lower interchange fees, many smaller firms now face higher fees as a direct consequence of the Durbin Amendment.

Research conducted by economists at the Federal Reserve Bank of Richmond supports this conclusion: among merchants with small-ticket transactions, nine times as many respondents (27 percent over 3 percent) reported a cost increase as those who reported a cost decrease.[24] The Durbin Amendment has primarily benefitted large retailers at the expense of consumers and smaller merchants, and the Proposal would exacerbate this outcome.

[23] *See* Electronic Payments Coalition, "Out of Balance: How the Durbin Amendment has Failed to Meet Its Promise" (Dec. 2018).

[24] *See* FRB Richmond Study at 189.

Despite claims made by some trade associations that represent large retailers, policy measures designed to ratchet down interchange fees are not designed to help small businesses and may, in fact, have the opposite effect. A 2017 study conducted by Javelin Strategy & Research illustrates this fact. In a survey of small businesses, Javelin found that small merchants who understand the interchange component of electronic payments are overwhelmingly satisfied with the rates they pay—in fact, these merchants were willing to pay more for greater benefits. Javelin also found that an insufficient understanding of interchange, not price, seems to generate any merchant dissatisfaction, and that merchants who said they do not understand what benefits they are paying for tended to be the least satisfied with the rates they pay. Based on these survey results, Javelin concluded that "when it comes to the complex process related to interchange, education, communication, and transparency are crucial" and that "[w]hile unintended, price controls often result in fewer consumer choices…. Policymakers should carefully consider potential unintended consequences of regulations on interchange."[25]

This is particularly unfortunate, given that the benefits associated with issuer-provided debit card programs provide a rewards-earning opportunity for people who do not have access to credit cards or want to spend what they have and not borrow additional funds. Many customers view these rewards as a form of savings. In an era where interest rates have made traditional savings accounts less remunerative, it is, therefore, unfortunate that the Board would take action to discourage issuers from providing these benefits.

The Board Failed to Analyze the Impact on Small Issuers.

The Board's waving away of concern about the Proposal's potential effects on smaller issuers is another problem. The Board claims that small issuers will experience no ill-effects "[b]ecause the proposed amendments apply to all issuers regardless of their size" and because of uncertainty about the "market response."[26] However, the fact that all issuers would be impacted by the Proposal cannot be the end of an analysis regarding the *scope* of that impact, and the Proposal fails to conduct the necessary analysis regarding the scope of the impact.

The Proposal would impose incremental costs on issuers, in the form of compliance costs, technology build costs, increased fraud-related losses, and increased costs of necessary fraud-mitigation measures. Increased fraud, in turn, would entail additional issuer costs, such as the cost of issuing new cards for impacted cardholders. For example, the cost of issuing new EMV-chip cards is significantly higher than the cost of issuing traditional magnetic stripe cards, and so increases in fraud are very costly for issuers. Indeed, it is foreseeable that small issuers would suffer as a result of the Proposal because small issuers experience special difficulties that larger issuers do not in overseeing networks, ensuring network compatibility, and dealing with the greater fraud losses and fraud claims that would result from inserting antiquated technology into the higher fraud area of CNP transactions. Aside from fraud events, small issuers, in particular,

[25] Javelin Strategy & Research, "Small Merchants on Interchange: Value More Important than Cost" at 4, 5 (2017) (sponsored by the Electronic Payments Coalition and independently produced by Javelin).

[26] 86 Fed. Reg. at 26,193.

may need to issue new EMV-chip cards to comply with the regulation at a time when public reporting suggests that a global chip shortage (expected to last through mid-decade) is driving up the per-unit costs of these payment credentials. These demands would be imposed on community financial institutions that already experience paper-thin margins, in which they might not break even on a checking account, given today's low-interest environment. Ultimately, the economic reality of the Proposal would prompt reconsideration of account and product pricing to the detriment of consumers, and could even drive community financial institutions into a wave of consolidation—given that many mergers today are intended to provide efficiencies that bring margins up to a sustainable level.

The Board Failed to Comply with the RFA.

The RFA requires the Board to consider a proposed regulation's effect on "small entities," and the Board identifies some "2,925 bank holding companies 132 savings and loan holding companies, and 16 Edge and agreement corporations" that qualify.[27] But the Board states that the proposed regulation would not have any impact on these small entities because it does not involve any expansion of coverage" to any new "small entities" that were not already covered under Regulation II.[28] This analytical shortcut allows the Board to evade considering the substantial—and disproportionate—impact that the regulation would have on these already-regulated small entities.

The Proposal Contravenes Established Board Policy.

The Proposal also contravenes established Board policy. The Board has long maintained that it should not mandate specific technology. In 2015, for example, after receiving an inquiry from Senator Mark Warner (D-Va.), former Board Chair Janet Yellen issued the following statement:

> *In our role as supervisor, the Federal Reserve does not mandate use of a specific technological approach to payment card security in recognition of the evolving nature of payment card fraud threats and of the variety of tools that can be employed to address these threats. This approach is intended to allow financial institutions and other industry participants sufficient flexibility to design policies and procedures that most effectively reduce fraud losses to all parties involved in payment card transactions.*
>
> *The Federal Reserve supports a layered approach to payment card security that does not mandate a particular security technology.*[29]

The expansion of Regulation II contemplated by this Proposal would essentially reverse the Federal Reserve's stated policy position, which aligns with that of other federal regulators,

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[27] 86 Fed. Reg. at 26,194.

[28] *Id.*

[29] Letter from Federal Reserve Chair Janet Yellen to Sen. Warner (D-Va.), Mar. 5, 2015.

greatly reducing the flexibility that financial institutions could employ in being discerning selectors of payments rails for their customers. In effect, the Proposal would create the conditions for a de facto mandate that would drive the majority of transactions across rails and with authentication methods that regulated, insured financial institutions may judge to be inferior and not best-in-class. That issuers would have the full force of federal enforcement upon them to accept these transactions, despite well-reasoned reservations, is counterintuitive.

The Board Should Withdraw the Proposal and Conduct Further Analysis.

The Proposal would impose many harms not expressly addressed by the Board in its analysis, which greatly outweigh its limited benefits. Publishing the Proposal, without analyzing these issues, is a neglect of responsibility, and, accordingly, the Board should withdraw the Proposal. However, even if the effects on the payments ecosystem were merely uncertain, rather than certainly harmful, withdrawal would still be in order. Rather than press forward into the unknown, with consumer welfare and community financial institution survival at stake, we urge the Board to start the process over, conduct the analysis that the law and good policymaking demands, and balance any further regulatory action demanded by merchants against other vital considerations important to consumers, small businesses, and community financial institutions.

At a Minimum, the Board Should Revise the Proposal.

As discussed above, the Proposal is overbroad and vague, rendering it unworkable and difficult to comply with. While the best course of action would be to withdraw the Proposal, at a minimum, we urge the Board to take the following steps to improve the rule. *First*, the Board should remove the impracticable requirement that issuers "enable" multiple networks on their cards and return to the original language requesting that issuers "allow" multiple networks on their cards. *Second*, the Board should specify the exact transaction types that must be capable of being routed on multiple networks. Given the ever-changing nature of payment technology, an open-ended definition is unworkable, and particularly burdensome on smaller financial institutions and community banks. *Finally*, the Board should permit four years to come into compliance with the Proposal. Given the thousands of issuers and millions of merchants, it would take a significant amount of time for issuers to comply. Allowing for this amount of time would avoid issuers being forced to create makeshift solutions that are not properly vetted and tested to prevent fraud. Smaller financial institutions need time to come into compliance, particularly since it is impossible for all the issuers to work with the debit networks and vendors at the same time.

* * *

In conclusion, the associations contend that the Board is not obligated to conduct this discretionary rulemaking, and respectfully contend that the Board has not conducted the required analysis of the impact of the Proposal; therefore, we urge the Board to withdraw the Proposal, which would increase costs on consumers and small issuers during an already challenging time. If the Board determines to proceed with its rulemaking, notwithstanding these infirmities, the Board should revise the Proposal in the specific ways detailed herein.

Thank you for your attention to this request and we would appreciate the opportunity to answer any questions you may have.

Sincerely,

AMERICAN BANKERS ASSOCIATION

CONSUMER BANKERS ASSOCIATION

CREDIT UNION NATIONAL ASSOCIATION

MID-SIZE BANK COALITION OF AMERICA

NATIONAL ASSOCIATION OF FEDERALLY-INSURED CREDIT UNIONS

NATIONAL BANKERS ASSOCIATION

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