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National Association of Federally-Insured Credit Unions

Greg Mesack
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October 5, 2023

The Honorable Jerome Powell
Chair
The Honorable Philip Jefferson
Vice Chair
The Honorable Michael Barr
Vice Chair for Supervision
C/O
Anne E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

The Honorable Michelle Bowman
Governor
The Honorable Lisa DeNell Cook
Governor
The Honorable Adriana Kugler
Governor
The Honorable Christopher Waller
Governor

RE: Letter on Debit Interchange Fee Cap

Dear Ms. Misback:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to urge the Board of Governors of the Federal Reserve System (Board) to avoid an unwarranted review of the regulated debit interchange fee cap. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 138 million consumers with personal and small business financial service products. Debit interchange fees are crucial as they help offset the costs borne by debit issuers in providing these services, particularly in managing and mitigating debit card fraud, which has surged in recent years. These fees enable issuers to continuously reinvest in robust security measures and fraud prevention systems, safeguarding both their operations and their customers' financial assets. Suggestions that while debit interchange rates have remained steady, issuance costs have decreased, may not accurately reflect the experience for credit unions, particularly smaller entities. For many community-based financial institutions like credit unions, costs remain considerably high and comprehensive transaction costs remain elusive. The growing menace of fraud continually accelerates the operational costs for these institutions, making interchange income vital for maintaining a secure and viable debit issuance service for their members.

General Comments

Regulation II and the Durbin Amendment have presented significant challenges to credit unions, exemplifying regulatory overreach at the detriment of small financial institutions. Rather than fostering a competitive marketplace, these measures have favored one industry over another, leading to disastrous results and further consolidation of an already shrinking financial services industry. The proponents of reevaluating debit interchange rates under the guise of benefiting consumers are disingenuous, as historical evidence contradicts the narrative of savings passed on to consumers. The Federal Reserve Bank of Richmond, in 2014, illustrated that a majority of merchants retained their pricing structures post-Durbin Amendment and Regulation II enactment, with 21 percent actually increasing their prices.[1] A study by George Mason University in 2014 further corroborated these findings, establishing that the Durbin Amendment failed to pass savings onto consumers. The study highlighted that large banks recovered lost interchange fee revenue through the elimination or reduction of free checking, increased monthly fees, and raised minimum balance requirements.[2] A more recent study, published in 2019 by Vladimir Mukharlyamov (Georgetown University) and Natasha Sarin (University of Pennsylvania) concluded that consumers received no financial benefit from this regulation, and there is further evidence found in multiple research studies that both banks and consumers experienced negative financial impacts.[3] The ripple effects of these amendments have been especially detrimental to small and medium-sized financial institutions, rendering them unable to compete fairly in the market.

To provide a sense of the size and composition of the credit union industry, as of June 30, 2023, there were 4,686 federally insured credit unions with 137.7 million members. There are currently 22 credit unions with more than $10 Billion in assets and 4,664 with less than $10 Billion in assets and therefore exempt from the cap on fees implemented by the Durbin Amendment.[4] Although the vast majority of credit unions are exempt from interchange requirements, the provisions of Regulation II and the Durbin Amendment have had no less of an impact, as will be discussed further.

Higher Costs for Credit Unions

The crux of recent arguments in favor of lowering the debit interchange rate are premised on a misapprehension of data suggesting a decrease in the cost of issuing debit, therefore necessitating a reduction in the interchange rate. However, this data does not encapsulate the

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[1] Wang, Zhu, Schwartz, Scarlett and Mitchell, Neil, "The Impact of the Durbin Amendment on Merchants: A Survey Study." (2014) Federal Reserve Bank of Richmond Economic Quarterly, Volume 100, Number 3.
[2] Zywicki, Todd J. Manne, Geoffrey and Morris, Julian, "Price Controls on Payment Card Interchange Fees: The U.S. Experience" (2014). George Mason Law & Economics Research Paper No. 14-18, *available at* https://ssrn.com/abstract=2446080.
[3] Mukharlyamov, V., & Sarin, N. "The impact of the Durbin Amendment on banks, merchants, and Consumers" (2019) U of Penn, Inst for Law & Econ Research Paper.
[4] NCUA, "Call Report Quarterly Data" (2023).

financial realities of credit unions, which frequently face significantly higher per-transaction costs for issuing debit. Unlike large financial institutions, credit unions lack the economies of scale to mitigate these costs, which plays a critical role in the disparities seen in per-transaction expenses. Large financial institutions benefit from this fundamental economic principle as they have a substantial volume of transactions, coupled with expansive operational and technological infrastructures that allow for cost efficiencies and reductions.

On the other hand, credit unions, due to their smaller size and community-focused operations, do not have the high volume of transactions or the broad infrastructural base to spread out the fixed costs associated with issuing debit. Credit unions often incur higher per-transaction costs for issuing debit, which can be largely attributed to their limited scale of operations. This is in stark contrast to the situation for large banks, highlighting that cost dynamics for credit unions remain unchanged or have escalated over the years. Furthermore, credit unions often prioritize providing personalized, community-based services, which can incur additional costs. These higher per-transaction costs make the proposed reduction in the interchange rate particularly burdensome for these smaller, community-centric institutions. In the Board’s 2019, Debit Card Issuer Cost Study, the Board found that financial institutions with less than $10 billion in assets experienced a 21 percent decrease in per-transaction debit card revenue from 2011 to 2019. With the ever-increasing onslaught of fraud costs, it seems likely that this trend has continued since 2019 and potentially worsened. This not only threatens the financial viability of credit unions but also hampers their ability to provide essential financial services to local communities, especially underserved populations. Most importantly, the impact to these “exempt” institutions has been significant, and has not been considered by the Board in setting the interchange fee cap.

Finally, the introduction of routing mandates has reduced the fees for a merchant to route a debit transaction. Regulation II's routing requirements have established a dual pathway for the authorization of debit payments by an issuer. The routing mandates have reduced revenue from debit card transactions for all issuers regardless of asset size. However, these pathways are not identical in their capabilities or their costs. Furthermore, the revenue can be quite different based on the networks the issuer has contracted with for transmitting the payment authorization to its card processing system. Significant differences exist between single-message and dual-message networks that impact operation and fraud costs for issuers. While merchants have the liberty to select which networks to use, they frequently opt for the most cost-effective solution without considering other factors, such as fraud.

While depository institutions have had a national standard on data protection since the passage of the Gramm-Leach-Bliley Act (GLBA) over two decades ago, other entities that handle consumer financial data are not held to the same standards. Our members have serious and justifiable concerns with merchant data security practices, which directly impact the prevalence of payments fraud. In order to combat the increased likelihood of fraud in transactions with entities that are not subject to the same rigorous oversight and supervision as credit unions and other

federally examined institutions, the Board should support stronger data security standards for merchants and non-depository financial institutions that handle consumer payments.

Impact on Small Institutions

The enactment of the Durbin Amendment has clearly left a lasting impact on financial institutions of all sizes, a scenario extensively documented over the past decade. A comprehensive report from the Government Accountability Office (GAO) revealed that the Durbin Amendment triggered a 25 percent reduction in annual interchange revenue for covered issuers.[5] Although exempt institutions were not bound by price caps, the financial impacts from routing mandates significantly diminished the revenue streams crucial for supporting the delivery and servicing of checking accounts. A notable outcome for numerous banks and credit unions has been the pressing need to consolidate in a bid to augment their customer base, particularly debit card account holders, driven by the financial shortfall induced by Regulation II's enactment.

To illustrate the magnitude of consolidation, in the third quarter of 2011, the banking sector boasted 14,204 banks and credit unions each with assets below $10 billion. This stands in stark contrast to the end of 2022, where this figure plummeted to a mere 9,043 institutions.[6] The Board's detailed reports on debit interchange depict a concerning trajectory: post-Regulation II until 2019, covered institutions witnessed a per-transaction revenue decline from $0.31 to $0.25.[7] The Board additionally found a distressing 19.3 percent revenue loss on debit card interchange transactions processed on single-message networks between 2011 and 2019 for credit unions and community banks falling below the $10 billion asset threshold—categorized as exempt institutions.[8]

The data on consolidation for financial institutions beneath the $10 billion threshold is glaring. Over an eleven-year span, the industry witnessed the closure or merger of over 5,100 institutions, including 2,516 credit unions. Today, nearly a third fewer credit unions are operational compared to 2011, hence a diminished capacity to serve members and communities. An array of factors precipitated these closures, however a predominant driver was mergers into larger organizations as both credit unions and banks endeavored to improve operations and widen their geographical footprint to counterbalance the reduced revenue, a direct upshot of the Durbin Amendment.

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[5] GAO, "Regulators Have Taken Actions to Increase Access, but Measurement of Actions' Effectiveness Could Be Improved" (2022) *available at* https://www.gao.gov/assets/gao-22-104468.pdf.
[6] Cornerstone Advisors, "The True Impact of Interchange Regulation: How Government Price Controls Increase Consumer Costs and Reduce Security" (2023) *available at* https://www.cuna.org/content/dam/cuna/advocacy/priorities/documents/True-Impact-of-Interchange-Regulation-CornerstoneAdvisors-June-2023.pdf.
[7] Board of Governors of the Federal Reserve, "2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions" (2021).
[8] *Id*.

These data points clearly emphasize the detrimental repercussions the Durbin Amendment and Regulation II have unleashed on small and medium-sized financial institutions. Furthermore, they underscore the critical necessity to staunchly oppose any proposals that seek to exacerbate this already precarious financial situation by reducing the interchange rate.

Changing Interchange Environment

The rise of card fraud and its associated costs for financial transactions, especially in relation to interchange caps, has created a two-fold issue for financial institutions. The fraud itself, increasingly perpetrated through Card Not Present (CNP) transactions, and subject to interchange caps, results in losses to financial institutions. The 2021 Nilson Report statistics showing an 18 percent increase in fraud volume in the U.S. from the previous year with fraud losses close to $12 billion, highlight the growing challenge.[9] The shift of fraud from Card Present (CP) to CNP transactions illustrates how fraudsters adapt to technological advancements, which were initially aimed at reducing fraud. The significant increase in CNP fraud, following the COVID-19 induced surge in online transactions, unveils a changed fraud landscape from what was initially envisioned during the enactment of the Durbin Amendment, which mainly dealt with interchange fee regulation.

Beyond the fraud losses themselves are the costs associated with fraud prevention and management. Interchange caps, as a regulatory measure, have a direct impact on the ability to combat fraud. While they were instituted to reduce transaction costs, they also affect the revenue streams of financial institutions, including credit unions. The financial health of these institutions is crucial for effective fraud prevention measures. In NAFCU's 2023 Federal Reserve Meeting Survey, nearly 75 percent of respondents reported that they would be investing in fraud prevention projects over the next three years. This was corroborated in a study by CUNA, conducted between 2020 and 2021, which emphasized the dilemma faced by credit unions whose fraud program expenses surged amidst declining interchange revenue.[10] Credit unions face the one-two punch of fraud losses and significant operational costs involved in managing disputes arising from such transactions. This scenario is particularly challenging for smaller financial institutions like credit unions that, unlike their larger counterparts, lack the substantial resources to manage the weight of increased fraud costs. A reduction in the interchange rate cap would also mean a reduction in the ability of credit unions to invest in fraud prevention and mitigation. This would lead to a rise in fraud losses and further undermine the ability of smaller financial institutions to remain viable and offer financial services to the communities that most need them.

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[9] Nilson Report, "Card Fraud Losses Worldwide" (2022) *available at* https://nilsonreport.com/articles/card-fraud-losses-worldwide.
[10] Cornerstone Advisors, "The True Impact of Interchange Regulation: How Government Price Controls Increase Consumer Costs and Reduce Security" (2023).

The ability to combat fraud effectively requires the investment of massive resources on the part of financial institutions. A 2020 letter from the merchant community noted that an additional $0.01-per-transaction fee established by the Board to help fund issuers' fraud-prevention measures had been ineffective and was unfair to merchants. This argument is illogical. Fraud is clearly a significant issue for both issuers and merchants. That a fee assessed to fight fraud was ineffective in stopping fraud should not lead to an assumption that nothing should be done to fight fraud. Instead, it seems clear that limited resources may be insufficient to implement effective fraud controls. This is exemplified by big banks where the scale of operations at these institutions enables the leveraging of advanced technologies like AI and extensive cybersecurity expertise, which are fundamental in today's fraud prevention environment, especially concerning CNP transactions that have become the new target for fraudsters. The disparity in resource allocation between large card issuers and smaller credit unions is clear. While the former can significantly invest in sophisticated fraud detection and prevention systems, the latter finds themselves in a financial bind exacerbated by reduced interchange revenue.

The strong linkage between adequate resources, facilitated by healthy revenue streams like interchange rates, and the capacity to mitigate fraud, especially the growing CNP fraud, is clear. Thus, any discussion on interchange rate adjustments must be carefully balanced with the needs of fraud prevention, especially in a transaction landscape that's vastly becoming complex and susceptible to fraud.

The proposition of reducing the interchange rate is a short-sighted one, potentially exacerbating financial disparities in our communities. The reality is that any such reduction would undermine the financial stability of small credit unions, likely propelling a wave of consolidations within the financial sector. This would, in turn, diminish the accessibility of financial services, particularly in underserved communities, thereby undermining the primary mission of credit unions. The distressing trend of declining per-transaction rates not only shifts a significant financial burden onto exempt institutions but largely favors large multinational retailers at the expense of small businesses and community-based financial institutions. Any proposed rule aimed at a further reduction in per-transaction rates would redirect billions from exempt institutions to these large retailers.

NAFCU staunchly opposes any efforts to reduce the debit interchange rate. We urge the Federal Reserve Board to consider the disparaging effects such a move would have on credit unions and, by extension, the communities they serve. NAFCU is in the process of collecting additional data from our credit union members to create a more comprehensive picture of the impacts of debit interchange fee caps and we look forward to additional engagement with you and your staff on this issue.

Conclusion

NAFCU appreciates the Board's attention to the impact of the debit interchange rate on credit unions. If we can answer any questions or provide you with additional information, please do not hesitate to contact Senior Regulatory Affairs Counsel James Akin at 703-615-5109 or jakin@nafcu.org.

Sincerely,

Greg Mesack