December 22, 2022

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

The Honorable Lael Brainard
Vice Chair
The Honorable Michelle Bowman
Governor
The Honorable Philip Jefferson
Governor

RE: Petition for Rulemaking Pursuant to Section 920 of the Electronic Fund Transfer Act

Dear Federal Reserve Chairman Powell, Vice Chairs Brainard and Barr, and Governors Bowman, Waller, Cook, and Jefferson:

On behalf of the merchant community, the undersigned petition the Federal Reserve Board to open a rulemaking proceeding under Section 920 of the Electronic Fund Transfer Act ("EFTA") in order to review the regulated debit interchange rate and amend the underlying rule so that it is lawful and consistent with the enabling statute. Put succinctly, the statute requires that the interchange fees received by covered debit card issuers are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[1] The results of the 2019 survey of issuer costs, as well as all of the previous surveys conducted by the Board, provide consistent data indicating that the cost of issuing debit has decreased substantially year after year since the original rule was promulgated.[2] Petitioners believe that the law now mandates that the Board revisit the debit interchange rate and accompanying regulations.

As the food industry association, FMI works with and on behalf of the entire industry to advance a safer, healthier, and more efficient consumer food supply chain. FMI brings together a wide range of members across the value chain — from retailers that sell to consumers, to producers that supply food and other products, as well as the wide variety of companies providing critical services — to amplify the collective work of the industry. More information about our organization is available at www.FMI.org.

Founded in 1961, the National Association of Convenience Stores ("NACS") is a non-profit trade association representing more than 1,300 retail and 1,600 supplier company members in the United States and abroad. NACS is the pre-eminent representative of the interests of convenience store operators. In 2021, the convenience and fuel retailing industry employed approximately 2.38 million

[1] Electronic Fund Transfer Act sec. 920; 15 U.S.C. sec. 1693o-2(a)(2) (2012).
[2] 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," May 2021 ("2019 Issuer Survey").

workers and generated $705.7 billion in total sales, representing approximately 3.1 percent of U.S. Gross Domestic Product. The industry paid or collected $159 billion in taxes in 2021, approximately 23 percent of all industry sales dollars. On a per-store basis, taxes collected averaged $1.1 million.

Below, we outline the key reasons why the current debit rate is in contravention of the EFTA, and ask that the Board begin a comment period on a rule that would: *first*, review the base component, which is currently set at more than 600% of issuers' allowable costs, to no more than 2.7 times average allowable costs, or $.097 instead of the current $0.21; and *second*, either eliminate or dramatically reduce the ad valorem component and the fraud prevention adjustment. Regardless of the way in which the Board approaches a rate reset, we believe that a new rulemaking is not only contemplated but *required* by the EFTA. We request that the Board initiate a rulemaking in response to this petition within 60 days of receipt of this letter.[3]

Legal Background

In 2010, as part of the Dodd-Frank Act, Congress passed Section 920 of the Electronic Funds Transfer Act, popularly referred to as the Durbin Amendment. Among other things, the amendment requires the Board "to prescribe regulations . . . to establish standards for assessing whether the amount of any" debit card "interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction." 15 U.S.C. § 1693o-2(a)(3)(A). The provision also sets out the considerations that are to inform the Board "[i]n prescribing regulations." *Id.* § 1693o-2(a)(4). As relevant here, when determining whether a fee is reasonable and proportional, Congress directed that the Board "shall . . . consider[]" "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction." *Id.* § 1693o-2(a)(4), (4)(B)(i). By contrast, the Board "shall *not* . . . consider[]" "other costs incurred by an issuer which are not specific to a particular electronic debit transaction." *Id.* § 1693o-2(a)(4)(B)(ii) (emphasis added).

After notice and comment, the Board issued a final rule, commonly known as Regulation II. *See* Debit Card Interchange Fees and Routing, Final Rule, 76 Fed. Reg. 43394 (July 20, 2011); *Corner Post, Inc. v. Bd. of Governors of Fed. Rsrv. Sys.*, No. 1:21-cv-00095, 2022 WL 909317, at *3 (D.N.D. Mar. 11, 2022). The rule permitted issuers to recover a base interchange fee of up to "21 cents plus an ad valorem component of 5 basis points . . . to compensate issuers for fraud losses," as well as a 1 cent fraud adjustment, discussed in more detail below. *See NACS v. Bd. of Governors of Fed. Rsrv. Sys.*, 746 F.3d 474, 480 (D.C. Cir. 2014) (citing 76 Fed. Reg. 43404); *see* 12 C.F.R. § 235.3(b). The 21-cent figure corresponded to the average per-transaction cost of an issuer at the 80th percentile in a 2009 survey of issuers. *See* 76 Fed. Reg. at 43422. But that figure included costs beyond "the incremental cost incurred by an issuer" for its role in "a particular electronic transaction." 15 U.S.C. § 1693o-2(a)(4)(B)(i); *see* 76 Fed. Reg. at 43427.

Notably, in promulgating Regulation II, the Board stated that it anticipated that it would "periodically conduct surveys of covered issuers in order to reexamine and potentially reset the fee standard," and that, in the future, "[l]ower [issuer] costs should result in a lower interchange fee cap." 76 Fed. Reg. at 43422, 43433. Surveys conducted by the Board showed that allowable costs have in fact

[3] The undersigned hereby adopt and incorporate the points and arguments made in the 2020 Merchants' Letter, *infra*, and request that they be made part of the administrative record.

rapidly and substantially decreased over time, but the Board nonetheless has not reexamined the fee cap. *See* Letter from Members of the Merchant Community to the Board 4 (July 27, 2020) ("2020 Merchants' Letter"). Under these circumstances, the Board must review and adjust the fee cap in order for the cap to remain in compliance with the law.[4]

In this vein, two years ago, thousands of members of the merchant community wrote to the Board, including current petitioners, seeking amendments to the interchange rate. *See* 2020 Merchants' Letter at 1. Merchants argued that the interchange rate should be adjusted regularly, *see id.*; that the base fee was no longer reasonable and proportional, *see id.* at 2; that the *ad valorem* component was too high and had failed to incentivize fraud-mitigation measures, *see id.* at 6, 8; and 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, *see id.* at 9. Representatives of the letter's signatories met with Board staff in September 2020 to discuss their concerns, *see* https://bit.ly/3g9oxDv, the Board has taken no action and has not indicated that it has begun a new rulemaking.

The continued silence in response to the 2020 Merchants' Letter is disappointing and inconsistent with the Board's obligations, both under the Durbin Amendment itself and the Administrative Procedures Act ("APA"). The APA directs "[e]ach agency" to "give an interested person the right to petition for the issuance, amendment, or repeal of a rule." 5 U.S.C. § 553(e).[5] The APA does not "specif[y] any formalities for a rulemaking petition," *see Am. Horse Prot. Ass'n, Inc. v. Lyng*, 812 F.2d 1, 5 (D.C. Cir. 1987), and the Board has not prescribed the use of a particular form for rulemaking petitions. The Board has promulgated regulations governing applications to the Board, stating simply that a petition "should be signed by the person making the application or by his duly authorized agent, should state the facts involved, the action requested, and the applicant's interest in the matter, and should indicate the reasons why the application should be granted." 12 C.F.R. § 262.3(a). The petitioned agency must respond "within a reasonable time." 5 U.S.C. § 555(b).

The Board, like other agencies, has previously engaged in rulemaking in response to rulemaking petitions. *See, e.g.*, 86 Fed. Reg. at 18173–74 (Board adoption of a rule requested in a petition); 85 Fed. Reg. 78224-01, 78224–25 (Dec. 4, 2020) (Securities & Exchange Commission adoption of rule requested in a petition). Indeed, the Board recently argued with respect to this very issue in *Corner Post* that, to avoid a statute of limitation, the plaintiffs should have petitioned for rulemaking *rather* than filed suit. *See* Board Reply Brief in Support of Motion to Dismiss at 5–7, *Corner Post* (No. 1:21-cv-00095), 2021 WL 6880956. The Board should hold itself to that representation. We believe that the 2020 Merchants'

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[4] Regulation II did not accurately implement the Durbin Amendment's direction that the rule should distinguish between the "incremental cost" of "authorization, clearance, or settlement of a particular electronic debit transaction," which the statute authorizes to be included in the interchange fee, and all "other costs incurred by the issuer which are not specific to a particular transaction," which are *not* allowed as part of the interchange fee. 15 U.S.C. section 1693o-2(a)(4)(B). Merchants also request that the Board re-evaluate its interpretation of allowable costs, as set forth below, and promulgate a rule that is in compliance with the statutory mandate.

[5] The term "agency" means any "authority of the Government of the United States," *id.* § 551(1), a definition broad enough to include the Board. *See 9 to 5 Org. for Women Office Workers v. Bd. of Governors*, 721 F.2d 1, 2 (1st Cir. 1983); *cf. also Lee Const. Co. v. Fed. Rsrv. Bank of Richmond*, 558 F. Supp. 165, 179 (D. Md. 1982) (concluding that an individual Federal Reserve Bank was an "agency" under the APA).

Letter meets this standard, and that the Board has had before it for two years a petition for rulemaking under Regulation II. In the alternative, however, and in an abundance of caution, the undersigned formally submit this letter as an additional petition for rulemaking.

I. The Base Component Is No Longer "Reasonable and Proportional" as Required by Statute and the Board is Now Required by Law to Undertake a Rulemaking

As merchant groups and retailers noted in the 2020 Merchants' Letter, the base component of the debit interchange fee that limits the fee that banks with more than $10 billion in assets can charge is long out of date. We begin by unpacking the Board's rationale for the 21-cent figure, and we explain why data subsequent to 2009 is not open to any interpretation other than that covered banks' "authorization, clearance, [and] settlement" ("ACS") costs have steadily decreased since the original cap was set, to the point that the rate is no longer "reasonable and proportional" to those costs.

Put in the starkest terms, the Board's biannual issuer survey for calendar year 2019 now places the 21-cent figure – which at the time of promulgation was in the 80th percentile of covered issuers who responded to the 2009 calendar year survey – in the 99.3 percentile of covered transactions. This fact should be dispositive of the question whether the Board must engage in a new rulemaking to bring the fee in line with the statutory mandate.

At the time of promulgation, the Board provided a lengthy rationale for why it decided that the 80th percentile best represented a "reasonable and proportional" relationship to issuers' ACS costs. In summary, the Board found that the 80th percentile was the point at which the volatility of the responses in the 2009 issuer survey leveled out. Below that point, there was little difference among similar issuers; above that point, per-transaction costs varied widely.[6] While rejecting merchants' arguments that the base component should be set even lower, the Board did conclude that the higher-cost issuers who comprised the top fifth of the survey respondents need not receive total compensation for their costs under a "reasonable and proportional" standard. The Board explicitly stated that it "[did] not believe that setting interchange fee standards to accommodate these higher-cost issuers would be reasonable or proportional to the overall cost experience of the substantial majority of covered issuers," and furthermore, "that it [did] not believe that it is consistent with the statutory purpose to permit networks to set interchange fees in order to accommodate 100 percent of the average per-transaction cost of the highest-cost issuers."[7]

This rationale mandates lowering the base component now. For the past two issuer surveys over the last four years, the base component alone has accommodated more than 99 percent of the average per transaction cost of the highest cost issuers. As the Board noted then, "[l]ower costs should result in lower interchange fee caps as issuers become more efficient."[8] And lower costs are exactly what have come to pass, as shown once again by the 2019 issuer survey. Excluding issuer fraud losses, the average per-transaction cost for covered issuers is now *half* the 2009 value at just $.039. Even the lowest-cost category of debit transactions – single-message transactions – which saw the lowest level of reduction, declined just over 40 percent since the 2009 survey.[9]

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[6] 76 Fed. Reg. 43433.
[7] *Ibid.*
[8] *Id*. at 43432.
[9] 2019 Issuer Survey at 20-21.

The fact that the 21-cent figure is high enough to cover virtually *all* of the covered transactions in 2019, even those of issuers with the most expensive portfolios, necessitates the conclusion that a lower rate is dictated by statute.

Further, the undersigned submit (as explained in further length in the 2020 Merchants' Letter) that a lower rate should be calculated based on a multiplier of the *average* per-transaction ACS cost of *all* covered issuers, rather than a calculation based on the 80th percentile (or any other percentile) of covered issuers' costs. As the survey data demonstrates, the allowable costs of either a representative issuer or an issuer percentile are inherently volatile over time. The average allowable cost per transaction for all covered issuers is the most stable measure, reflecting the overall cost experience of covered issuers without the variability that results from individual issuer economics and industry changes (including issuer growth or consolidation).

This standard would accomplish two goals that are consistent with the Board's stated policy when Regulation II was originally adopted. First, at that time, the Board concluded that the large degree of volatility that has consistently been evident in higher-cost transactions need not be accommodated through a "reasonable and proportional" standard. A comparison of surveys in 2011 and onward, when survey responses became mandatory, shows the pull that expensive debit portfolios have had on the issuer percentiles. While allowable *average* costs have decreased, the costs of issuers at the 75th percentile have doubled. And, low-volume issuers, whose costs are consistently the highest, represented 14 percent of covered issuers in 2019 but only .01 percent of covered transactions.[10] Thus a multiplier of *average* per-transaction costs would better capture the statutory "reasonable and proportional" standard set forth by Congress as interpreted by the Board.

Second, a multiplier of 2.7 times the average per-transaction cost would reflect the Board's own interpretation of proportionality. This would result in a base component rate of $0.097. When the base component was set at $0.21, it was 2.7 times higher than the average allowable costs of $0.077 reflected in the 2009 issuer survey. This multiplier builds in the flexibility that the Board sought when it rejected the wishes of commenters who advocated against a blended, singular base component in favor of different components based on the risk of each transaction type, or even an average cost across debit portfolios. The Board noted the availability of the *ad valorem* component and the fraud-prevention adjustment, and concluded that "[n]etworks are not prohibited from varying the amount of either interchange fee component by transaction type, transaction value, or merchant type, provided the interchange fee for any transaction not exceed the maximum permissible amounts… The flexibility to vary the amounts of interchange fee components below the cap enables networks to establish interchange fees that reflect variation in transaction risk and to account for other factors that affect a network's ability to increase its transaction volume."[11] A multiplier of 2.7 times the average per-transaction cost would accommodate the statutory "reasonable and proportional" standard while allowing almost all issuers the flexibility to respond to changing costs and economic conditions.

In addition, adopting a multiplier as the Regulation II standard would greatly ease administration of the rule. The Board could set a base component rate that uses a multiplier and is triggered by the biannual survey data. This process would allow issuers and merchants to respond to changing

[10] Regulation II Reports Data, Table 12.
[11] 76 Fed. Reg. 43435.

circumstances, such as inflation and competition, on equal footing and with some degree of predictability, and may obviate the need for the Board to undertake full notice-and-comment rulemaking to adjust the rate unless or until the multiplier proves to be inconsistent with the statute's reasonable-and-proportional standard.

The impact that the excessive maximum fee has had on merchants is dramatic and can be accurately described as inflationary. As merchants noted in their 2020 letter, the additional cost of excessive debit fees to merchants and consumers was expected to exceed $5 billion in that year alone. Since then, actual calculations have shown that the pandemic dramatically escalated the dollar amount in debit fees that merchants have paid. When Regulation II initially went into effect, the dollar amount of debit fees paid by merchants initially decreased, and then began to increase – despite issuers' costs plummeting during the same time period. Then, due to changes in shopping patterns during the pandemic, 2020 and 2021 brought fee increases of 13 percent and 28 percent as customers preferred using cards to cash (and card-not-present transactions, which are generally more expensive dual-message transactions, to card-present transactions).[12] Debit fees paid by merchants topped a record-setting $23 billion in 2021.

For the foregoing reasons, we submit that the statutory language of the Durbin Amendment requires the Board to undertake a new rulemaking to adjust downward the base component of the debit rate for covered issuers.

II. The Ad Valorem and Fraud Prevention Adjustments Are No Longer Appropriate Under the Statute

Put simply, the ad valorem component of the debit fee, which was intended to reimburse a portion of the issuer's fraud losses, no longer serves its intended purpose. In originally establishing this component, the Board noted the most common types of card fraud – counterfeit card fraud, lost and stolen card fraud, and card-not-present fraud. The Board further observed that "certain fraud and the related losses can be reduced through actions by the merchants. Even if the merchant takes all necessary steps to verify the card user, however, the transaction may nonetheless be fraudulent… *Allowing a portion of fraud losses to be recovered through interchange fees will not eliminate the incentive for issuers to monitor and prevent fraud. Issuers will continue to bear the cost of some fraud losses and cardholders will continue to demand protection against fraud*" (emphasis added).[13] The debit card fraud environment that has evolved since the rule was promulgated indicates that the $0.05 ad valorem to compensate issuers for fraud is no longer reasonable and proportional to the issuers' fraud losses. Moreover, neither the ad valorem component nor the fraud adjustment fee has worked to incentivize issuers to adopt fraud-prevention mechanisms.

After the adoption of Regulation II, merchants paid an estimated $30 billion to install EMV chip card terminals.[14] As an incentive to adopt the new technology, network rules provided that if a merchant was EMV compliant, the issuer would bear the liability for fraudulent transactions that occurred at the physical point of sale. These changes to chip cards made the in-person use of cards less

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[12] CMSPI, "How Have U.S. Card Fees Grown Since 2006?" Fig. 1 (May 3rd 2022), available at https://cmspi.com/nam/en/resources/content/how-have-us-card-fees-grown-since-2006/.
[13] 76 Fed. Reg. 43431.
[14] NRF, "EMV Chip Cards," available at https://nrf.com/emv-chip-cards.

prone to fraud; therefore, the problems of counterfeit cards and lost or stolen cards – and the fraud that resulted from insufficiently authenticated customers at the point of sale – somewhat dissipated, and with it, the proportion of fraud costs borne by issuers. At the same time, fraud costs borne by merchants spiked to the point that merchants now bear the majority of debit fraud losses, according to the Board's surveys. According to the 2019 survey, merchants "absorbed 56.3 percent of losses from fraudulent transactions reported by covered issuers, up from 52.8 percent in 2017, while issuers absorbed 35.4 percent, down from 42.5 percent in 2017."

As the Board observed in the 2019 issuer survey, "The adoption of chip-based payment technology had the potential to increase the overall security of in-person card payments and therefore decrease overall fraud. However, fraud is ever-evolving and shifted toward new areas of vulnerability. For example, with the introduction of increased security for in-person card payments, card fraud shifted from in-person fraud toward CNP, or remote, fraud."[15] Figures 13 and 14 in the 2019 issuer survey show the unfortunate trend: fraud losses as basis points per transaction rose from 11.2 to 12.4 just between 2017 and 2019, and the steady rise in fraud losses from 2009[16] was driven by the *quadrupling* in the incidence of fraudulent dual-message card-not-present transactions as a percentage of total transactions.

Merchants are severely limited in how they themselves can prevent fraud in the digital space, and yet they bear most of the liability for such fraud under the networks' rules. This is why the percentage of overall fraud loss borne by merchants increased from 38.3 percent in 2011 to 56.3 percent in 2019, and why it is inappropriate and unfair that merchants must also continue to reimburse the issuers' theoretical fraud losses.[17] The ad valorum component has actually become a windfall: *issuers receive 0.05 percent per transaction in ad valorem fees, despite the fact that issuer fraud losses average 0.0439 percent per transaction in 2019, down from 0.0475 percent in 2017*.

In addition to base and ad valorum interchange fees, the Board established a fraud prevention adjustment of $0.01 per transaction to reimburse issuers for the expense of implementing fraud prevention measures. To qualify for the adjustment, issuers were required to evaluate and update their fraud prevention measures regularly to reflect changes in fraud trends and available methods of fraud prevention. There is no evidence that issuers have fulfilled this directive as all of them have collected the $0.01 per transaction adjustment on all of their transactions in the decade-plus that Regulation II has been in effect. That is more consistent with a widespread dismissiveness for the requirements to qualify for the adjustment than with a perfect industry track record of complying with those requirements given the accompanying increase in total fraud losses. The 2019 issuer survey shows the decrease and then leveling off of issuer fraud losses over time, despite the increase in fraud as basis points per transaction. And also, inexplicably the digital tools that issuers have developed for card-not-present transactions are made available to merchants *at additional cost*, not as an inherent feature of the payment system—despite the fact that issuers receive the 0.05 percent per transaction purportedly to implement these exact safeguards.

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[15] 2019 Issuer Survey at 16.

[16] Fraud losses temporarily decreased when Regulation II was first adopted, but increased beginning with the 2013 Issuer Survey. 2019 Issuer Survey, Fig. 13.

[17] 2019 Issuer Survey at 4.

The bottom line is that issuers bear ever less of the responsibility for a fraud rate that has doubled since 2011. Issuers shift liability to merchants for online fraud, which is growing, and for which merchants shoulder 71.6 percent of fraud losses; charge merchants for fraud-prevention tools; *and continue to collect 0.05 percent plus $0.01 per transaction with no apparent justification*. Neither the *ad valorem* fee nor this increase is justified any longer.[18]

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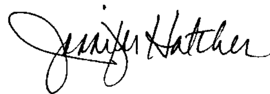
The evidence from the Federal Reserve's data is now abundantly clear. Regulated debit transaction costs have fallen significantly since Regulation II was originally finalized to the point that the regulation is no longer reasonable and proportional to those costs. In addition, the facts on the ground have changed with respect to fraud costs as merchants now shoulder a majority of those costs before considering interchange fees. And, increases in fraud and the routine application of the fraud prevention adjustment to every regulated transaction demonstrate that that adjustment has not helped to prevent fraud in practice. Given these changes in facts, by way of this petition we request that the Federal Reserve initiate a new rulemaking to reduce regulated debit interchange fees to a level that is reasonable and proportional to costs, remove the ad valorem fee for fraud, and remove the 1 cent per transaction fraud adjustment. These changes are necessary to bring Regulation II back into compliance with the relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Sincerely,



Jennifer Hatcher
Chief Public Policy Officer & Senior Vice President
FMI - The Food Industry Association

Doug Kantor
General Counsel
NACS

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[18] The EFTA enumerates seven factors for the Board to consider in determining whether an additional adjustment, over and above interchange fees, is "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud."[18] The factors are the nature, type, and occurrence of fraud; the extent to which fraud depends on whether customer authentication is based on signature, PIN, or other means; the means by which fraud may be reduced; the fraud-prevention and data security costs absorbed by stakeholders; the fraud costs absorbed by stakeholders; and the extent to which interchange fees reduce or increase parties' incentives to fight fraud. These factors must be interpreted in light of the EFTA's mandate that fraud fees be "reasonably necessary" to compensate issuers. Issuers, as already demonstrated, are highly compensated for both fraud prevention and fraud loss. The 2019 issuer survey shows the decrease and then leveling of issuer fraud losses over time, despite the increase in fraud as basis points per transaction, and *no increase in fraud-prevention* costs.[18] These fees are no longer "reasonably necessary" to incentivize issuers to prevent fraud.