

COMMITTEE ON CAPITAL MARKETS REGULATION

May 8, 2024

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

VIA EMAIL AND ELECTRONIC PORTAL

Re.: Docket No. R-1818, RIN 7100-AG67, *Debit Card Interchange Fees and Routing*

Dear Ms. Misback:

The Committee on Capital Markets Regulation (the “Committee”) offers these comments to the Board of Governors of the Federal Reserve System (the “Fed”) on its proposed rule entitled “Debit Card Interchange Fees and Routing” (the “Proposal”).¹

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Proposal would reduce the cap on the fees that banks are permitted to receive from merchants for handling a bank customer’s debit card transactions (“interchange fees”). The Fed claims that lowering the interchange fee cap is justified because banks’ costs for handling such transactions have gone down and lowering the cap could benefit bank customers if merchants respond to lower fees by reducing their prices. However, the methodologies and data the Fed uses to estimate banks’ costs and to determine if a lower cap will benefit customers are fundamentally flawed. Indeed, the Fed’s economic analysis concludes that it cannot determine whether the Proposal would produce any net benefits or cost savings for customers or what the negative effects of the lower cap would be. It also fails to consider several empirical analyses, including those that the Fed conducted, indicating that the current cap on interchange fees has increased costs for bank customers and reduced the availability of bank accounts and debit cards to lower income populations.

¹ FEDERAL RESERVE SYSTEM, *Debit Card Interchange Fees and Routing* FED. REG. Vol. 88, No. 218, 78,100 (Nov. 14, 2023) [the “Proposal”], <https://www.govinfo.gov/content/pkg/FR-2023-11-14/pdf/2023-24034.pdf>.

The Fed should therefore withdraw the Proposal and conduct an economic analysis that addresses these flaws. Part I of our letter briefly summarizes the Proposal. Part II identifies five critical flaws in the economic analysis that warrant the Proposal’s withdrawal.

I. Summary of the Proposal

When a bank customer uses a debit card to make a purchase, the merchant pays the bank that issued the debit card (the “issuing bank”) a small fee known as an “interchange” fee. Interchange fees compensate the issuing bank for certain costs related to the debit card transaction, including processing and monitoring the transaction, and the risk of fraudulent use of the card. In 2010, the Dodd Frank Act required the Fed to publish a rule limiting interchange fees to a level that is “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”² As a result, the Fed issued a rule in 2011 that caps interchange fees for banks with at least \$10 billion in assets at a 21-cent base component plus 0.05% of the transaction value.³ The base component is increased by a 1-cent “fraud-prevention adjustment” for issuing banks that meet certain fraud prevention standards.

The Proposal would lower the interchange fee cap to a 14.4-cent base component plus 0.04% of the transaction value.⁴ Although the fraud-prevention adjustment would increase to 1.3 cents, the overall effect of the Proposal’s modified cap would be to reduce banks’ average earnings per transaction by 30%, from 22 cents to 15.7 cents.⁵ In addition, the Proposal would automatically re-calculate the cap at two-year intervals based on a biennial survey of issuing banks’ costs, thus potentially lowering the cap further.⁶

II. Analysis of the Proposal

In this Part II we highlight five critical flaws in the Fed’s economic analysis of the Proposal that warrant the Proposal’s withdrawal.

1. *The Proposal is based on inaccurate estimates of issuing banks’ costs.*

The Proposal is premised on the claim that, although certain fraud-related costs have increased, issuing banks’ overall costs for handling debit card transactions have gone down since the current cap was set, such that interchange fees can be lowered while still allowing banks to profit from

² Dodd-Frank Wall Street Reform and Consumer Protection Act, § 1075.

³ FEDERAL RESERVE SYSTEM, *Debit Card Interchange Fees and Routing* FED. REG. Vol. 76, No. 139, 43,393 (July 20, 2011), codified at 12 CFR part 235.

⁴ Proposal at 78,100.

⁵ Joint Trades Letter to the Federal Reserve Board on Financial Sector Opposition to Reopening Regulation II (Oct. 20, 2023), <https://www.aba.com/advocacy/policy-analysis/joint-trades-letter-to-the-federal-reserve-board-financial-sector-opposition-reopening-regulation-ii>.

⁶ Proposal at 78,100.

handling these transactions. But these claims are unreliable because they are based on flawed data and methodologies.

More specifically, the Fed estimates issuing banks' costs using data from the 2021 debit card issuer survey. But this survey fails to ask banks about several categories of fraud and operational costs related to debit card transactions that have increased significantly and thus likely underestimates banks' actual costs.⁷ Furthermore, the Proposal's cap does not account for any costs related to card production and delivery, staffing, or customer support. And, although fraud costs continue to grow quickly, the Proposal imposes a fixed fraud-prevention adjustment that fails to account for future cost increases. Indeed, the Fed's own research indicates that under the Proposal's lower cap, one third of issuing banks would not be able to cover their costs.⁸ The Proposal's automatic two-year re-calculation of the cap would be based on the same incomplete survey methodology and would continue to exclude categorically the costs noted above. As a result, the extent to which the interchange fee cap underestimates banks' actual costs is likely to increase, and fewer banks will be able to cover their costs under subsequent caps.

2. The economic analysis fails to consider the empirical evidence of the effects of the current cap.

The economic analysis speculates that lowering the interchange fee cap may benefit bank customers who use debit cards if merchants lower their prices to reflect the lower interchange fees that they must pay to the issuing bank.⁹ However, this claim is directly contradicted by the findings of empirical analyses of the effect of the current interchange fee cap. These analyses show that the interchange fee cap has caused banks to recoup forgone revenue by charging customers higher account fees. By contrast, these analyses have produced no evidence that merchants have passed on any cost savings to customers through lower prices. The evidence thus indicates that customer costs have increased as a result of the cap, and that they will increase further as a result of the Proposal.

For example, Mukharlyamov & Sarin (2022) concluded that the implementation of the current interchange fee cap “led to higher checking account fees paid by consumers” and “likely accelerated the adoption of credit cards with higher interchange fees, thus diminishing – if not offsetting entirely – merchant savings.”¹⁰ Kay et al. (2018) concluded that banks subject to the cap “offset more than 90 percent of the lost interchange income through increases in deposit fees

⁷ Joint Trades Letter *supra* note 5.

⁸ *Id.*

⁹ Proposal at 78,114.

¹⁰ Vladimir Mukharlyamov & Natasha Sarin, *Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards* (2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3328579.

for account holders.”¹¹ And the Fed’s own study found that the current cap has harmed smaller depositors and reduced the availability of checking account services for low- and middle-income individuals by causing banks to “increase checking account prices by decreasing the availability of free accounts, raising monthly fees, and increasing minimum balance requirements.”¹² The economic analysis does not acknowledge these findings. The economic analysis does acknowledge Fed data showing that banks “significantly limited or eliminated” debit reward programs following the implementation of the current cap.¹³ However rather than acknowledging how this evidence fits a pattern of adverse effects for bank customers, the analysis suggests that such costs are unlikely to recur as a result from the Proposal because banks, having already eliminated or curtailed such programs, “may not be able to reduce such programs much further.”¹⁴

And in contrast to the significant evidence showing that the current cap increased bank customers’ costs, the Fed cites no evidence to show that merchants passed on savings from lower fees to customers through lower prices.

3. The economic analysis ignores the Proposal’s potential effects on customers of smaller banks.

The Fed’s economic analysis states that it does not believe that lowering the cap will have any indirect effect on the banks with less than \$10 billion in assets, which are exempted in the statute.¹⁵ But this claim is directly contradicted by the Fed’s own study of the implementation of the current interchange fee cap. The study concludes that smaller banks increased prices “as a competitive response” to price increases by larger banks reacting directly to the cap.¹⁶ Furthermore, the study cautions that “not accounting for such competitive responses underestimates the policy’s impact on the market, for both banks subject to the cap and those exempt from it.”¹⁷ The Proposal however ignores both the study’s key conclusion and its recommendation that such effects must not be ignored.

¹¹ Benjamin S. Kay et al., *Competition and Complementarities in Retail Banking: Evidence from Debit Card Interchange Regulation* (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2503652.

¹² Mark D. Manuszak & Krzysztof Wozniak, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FINANCE AND ECONOMICS DISCUSSION SERIES, *The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation* (2017), <https://doi.org/10.17016/FEDS.2017.074>.

¹³ Proposal at 78,115, Note 94.

¹⁴ *Id.*

¹⁵ *Id.* at 78,116.

¹⁶ Manuszak, *supra* note 12.

¹⁷ *Id.*

4. The economic analysis does not consider how the Proposal may cause banks to inefficiently change their behavior.

The economic analysis fails to consider how the debit interchange fee cap may have already caused banks, particularly those close to the \$10 billion asset threshold, to modify their behavior inefficiently in ways that impose costs on the bank and its customers. For example, banks may slow their own growth to avoid the cap's \$10 billion asset threshold or curtail certain debit card or checking account offerings because they are unable to recoup their costs under the cap, thus narrowing consumer choices. It also fails to consider how by lowering the cap further, the Proposal threatens to increase these costs.

5. The economic analysis concludes that it cannot measure the Proposal's costs and benefits.

Despite its claims about how banks' reduced costs warrant reduction of the interchange fee cap and how reducing the cap could benefit customers, the economic analysis ultimately concludes that it "cannot, at this time, determine whether the potential benefits of the proposal to consumers exceed the possible costs imposed on consumers and financial institutions."¹⁸ The Fed therefore has no rational basis to substantiate and quantify the Proposal's costs and benefits. It should therefore withdraw the Proposal and conduct an economic analysis that addresses the omissions and flaws noted above.

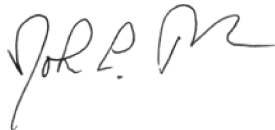
¹⁸ Proposal at 78,117.

COMMITTEE ON CAPITAL MARKETS REGULATION


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Thank you for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmksreg.org), at your convenience.

Respectfully submitted,



John L. Thornton
Co-CHAIR



Hal S. Scott
PRESIDENT



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