Comment Letter
Submitted via regs.comments@federalreserve.gov

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

RE: Notice of Proposed Rulemaking on Regulation II; Docket No. R-1818, RIN-7100-AG67

Dear Ms. Misback:

I welcome the opportunity to comment on the Notice of Proposed Rulemaking (NPR") submitted by the Board of Governors of the Federal Reserve System ('the Board") regarding Regulation II of the Durbin Amendment. As a former staff economist at the FDIC and the Department of Justice, I can certainly appreciate the effort required to craft regulations that implement the law, with due consideration to both the investment of resources and the impact of regulatory changes on all stakeholders. I commend the Board for its efforts.

In my view, the Board has done a commendable job of crafting an update to Regulation II, which caps debit interchange fees paid by consumers on debit transactions by establishing standards for assessing whether the amount of an interchange fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the transaction." I appreciate the analytical approach used to update the interchange fees for debit transactions. It appears that the framework proposed for timely updating of interchange fees for debit card transactions is objective and quantitative, as the proposed biennial updates to debit interchange fees are set using quantitative data reported by the banks impacted by the regulation. That being said, I believe the NPR requires some additional modifications to address the substantial operational and economic impacts the proposed changes will have on stakeholders throughout the financial system.

In principle, the proposed updates appear to be an effective way of aligning—and keeping aligned—current and future interchange fees with issuer costs. My

comments stand in general agreement with the principles of the NPR and are focused on ways to facilitate a smooth transition between the current and new fee regimes. To this end, in the pages that follow I identify three modifications to the current NPR that I believe will further enhance the efficacy of Regulation II as it currently stands. I offer my comments in the spirit of regulatory efficiency and efficacy, as a means of building upon the thoughtful work of the Board in a way that moves the regulation and the industry forward while reducing business disruption and regulatory burden for stakeholders.

A high-level summary of my comments, in which I propose specific modifications to the NPR, is listed below:

Summary of Comments

I. To avoid excessive operational costs related to industry compliance with Regulation II, biennial updating of interchange fee cap parameters (base, *ad valorem*, and fraud-prevention adjustment components) should occur only if changes exceed a certain size threshold (e.g., +/- 10% or +/- 20%). In addition, to mitigate the effects of outlier years on changes in fee cap parameters, consider averaging cost components over the last *two* Debit Card Issuer surveys.

II. Delay issuance of the final rule until 2023 cost data are available and are incorporated into the fee cap parameter adjustments.

III. Use a higher cost-recovery target than the proposed 98.5% to determine the multiplier used in calculating the base component of interchange costs.

I. Set a Minimum Change Threshold

The Board's NPR proposes to change the parameters of the formula for calculating the maximum interchange fee that can be charged on covered" transactions, from the current:

$0.21 + 0.0005 * Transaction Value + $0.01

to the proposed:

$0.144 + 0.0004 x Transaction Value + $0.013.

An average-sized debit transaction of $50 would be charged a maximum interchange fee of 24.5 cents under the current parameters and 17.7 cents under the proposed parameters, a 38% decrease. Certainly, the proposed updated fee structure is a substantial departure from the status quo that will lead to substantial

decreases in fee income for covered financial institutions. Once the initial update is implemented, the NPR states that subsequent updates will occur every two years thereafter.

Debit card issuers will necessarily incur costs related to implementing updates to the interchange fees, regardless of the size of the updates. Such costs will include IT costs related to change implementation, testing, validation, and auditing. These costs are a typical cost of doing business, but take on added significance here because the costs are regulatory in nature and thus are mandatory. For non-mandatory and non-regulatory changes, financial institutions are able to compare the cost of updating fee schedules with the monetary benefit of doing so. In contrast, updates associated with Regulation II will be required, not optional, and initially will lead to dramatically reduced revenues for debit card issuers, with further decreases likely over time. However, if past history is any indication, we can expect that for some update years there will be only small changes to the fee parameters. For those years, the costs of implementing small changes are likely to outweigh the benefits.

Given the costs associated with updates, it would be reasonable for the Board to consider reducing Regulation 's regulatory burden while continuing to fulfill its requirements and purpose. One way of doing so would be to modify the regulation so that a biennial update of interchange fee caps would be implemented only if the changes in each of the components of the interchange fee caps exceed certain percentage thresholds. This minimum threshold provision would replace the automatic, mandatory biennial update of Regulation II fee cap parameters proposed in the published NPR.

Consider the table below, which shows the cost components upon which Regulation 's parameters are determined, from 2009 through 2021, as reported to the Board in their biennial Debit Card Issuer Survey of covered banks.[1] As the table shows, the majority of two-year changes are small (less than 10% or 20%), with the largest change (excluding the initial 2009-2011 change in average ACS costs) being the 29% increase in average covered-issuer fraud losses from 2013 to 2015. The historical pattern of changes seems to suggest that a percent change threshold of +/-20% seems reasonable for triggering updates to the Regulation II parameters. Such a threshold would keep stakeholders from being forced to make small adjustments in years where costs have changed little. In fact, if a 20% threshold had been in place since the implementation of Regulation II in 2011—with updates occurring only if each of the three cost components has changed by more that 20% compared to then-current values—the parameters would have been updated only once, in 2015. Updates would have been skipped in 2013, 2017, 2019 and 2021. Alternatively, under a 10% threshold the parameters would have been updated twice, in 2015 and 2017.

[1] https://www.federalreserve.gov/paymentsystems/files/regiireportsdata.xls.

Year	Average ACS costs, all issuers and transactions	Percent change from previous period	Average covered-issuer fraud losses (bps)	Percent change from previous period	Average fraud prevention costs	Percent change from previous period	Update triggered with 20% threshold?	Update triggered with 10% threshold?
2009	0.077							
2011	0.051	-34%	4.660		0.015			
2013	0.046	-9%	5.090	9%	0.016	7%	no	no
2015	0.042	-9%	6.550	29%	0.017	6%	yes*	yes
2017	0.036	-15%	5.341	-18%	0.015	-13%	no	yes
2019	0.039	9%	4.403	-18%	0.015	1%	no	no
2021	0.039	0%	3.993	-9%	0.013	-13%	no	no

Source: https://www.federalreserve.gov/paymentsystems/files/regiireportsdata.xls tabs 13 and 14.

* The update would be triggered as average fraud prevention costs were set initially at 0.01 in 2011. The cumulative percentage change in 2015 was thus +70% from the then-current value.

As shown above, instituting a percent change threshold of at least 10% promotes regulatory efficiency, as it implements Regulation II at a lower cost for all stakeholders.

A related issue concerns the possibility of aberrant costs being reported and subsequently used to update the fee parameters in some survey years. As the NPR is written currently, if the Board implements an automatic two-year adjustment cycle based entirely on the costs reported in the most recent Debit Card Issuer Survey, there is nothing that allows for further adjustments to the parameters in potentially outlier" years, where costs rose or fell by a large amount, only to reverse course and revert back toward their previous values. The cost parameters would adjust automatically, leading to a potentially abnormally large drop (or increase) in fee revenues for two years.

Consider an example where average covered-issuer fraud losses increased by 25% in survey year X, then decreased by 25% two years later, in survey year X+2.[2] Under the proposed Regulation II revision in the NPR, interchange fees would adjust twice, with the end result after four years being: a) fees are essentially unchanged, while b) financial institutions, payment networks, and other market participants have incurred operational and adjustment costs on two separate occasions.

[2] This example is not far from reality, as average fraud losses increased by 29% in the 2015 Debit Card Issuer Survey, only to decrease by -18% in the 2017 Survey.

One way of mitigating this risk of outlier" cost changes would be to average the cost components over the previous two surveys—taking a two-survey moving average—and to use these averages to compare against specified minimum change thresholds as recommended above. This method would effectively reduce the likelihood of mean-reverting fee adjustments in consecutive two-year periods (by reducing the variance in costs) while also reducing the average size of fee adjustments. Yet another method would entail utilizing a four-year adjustment period. In any case, I believe it is desirable to institute some sort of self-dampening mechanism for fee calculations in order to manage the risks associated with changing fee structures (and revenue streams) across a large portion of the financial payments system.

II. Use 2023 Survey Data to Update Parameters

The proposed updates to the interchange fee structure are the first since the inception of the Durbin Amendment and Regulation II in 2011. As such, it is important to make sure that changes are based on the best and most reliable data possible. The current NPR would adjust the rates based on data from the Board's 2021 Debit Card Issuer Survey. However, 2021 was not a typical year. The global covid-19 pandemic altered shopping behavior; quarantines and masking requirements meant less foot traffic in retail establishments and fewer in-person transactions. Moreover, 2021 does not capture the spike in inflation experienced in the US in 2022 and the first half of 2023. High inflation can bring out the worst in consumers (and retailers), including a rise in fraud and a subsequent increase in the use of fraud- and theft-mitigation strategies. If fraud-related costs rose in 2022-2023, the current proposed update to Regulation II will not account for it, meaning that market participants will not be adequately compensated for those fraud-related costs, and the updated cost structure will be outdated from day one.

For these reasons, it would seem prudent to delay the implementation of any final updates to Regulation II until data from the 2023 survey can be incorporated. Doing so seems reasonable given the time it would likely take for the Board to review public comments and update and release a finalized NPR. If precedent holds, the NPR would go into effect three months after the end of the quarter in which the NPR is finalized, which could be sometime in the second half of 2024 at the earliest, or more reasonably in early 2025 if the NPR is revised with an additional comment period. By then the Board should have the 2023 survey results in hand, given that 2021 survey respondents were given until May 1, 2022 to complete it, and the Board reported those results in the fall of 2022. The Board should also consider the timing of network interchange amendments, which are implemented in April and October each year, generally with 4 to 5 months lead time. Taking these entrenched industry schedules into account most likely would further increase the implementation time required by stakeholders after publication of the final rule, which supports the use of 2023 survey data.

n addition, we should remember that the Board's Regulation PR is not operating in a regulatory vacuum. Financial institutions and payment networks will also have to adapt to the Board's recent expansion of Regulation II that requires online debit card transactions to have two unaffiliated payment networks enabled for processing, as well as the CFPB's new proposed rules to limit overdraft fees, in addition to the finalized rules for compliance with modernized Community Reinvestment Act (CRA) regulations. These regulatory changes are likely to interact with each other in potentially unpredictable and costly ways, leading to significant impacts on consumers as well as financial institutions.

The proposed updates to Regulation II will have major impacts on both debit issuers and networks, even more so with the current NPR proposal to set the biennial updates on autopilot. Therefore, it is crucially important for the Board to do everything possible to set the fee parameters properly from the start, which might necessitate taking additional time before implementation.

III. Use a Minimum 99% Cost-Recovery Target

The table below, reproduced from the NPR,[3] shows the parameters associated with various cost-recovery targets. The NPR proposes that the target be set to 98.5 percent, which would lead to a sizable reduction in the base component of interchange fees, from the current 21.0 cents to 14.4 cents. I appreciate the concept of setting the multiplier with the objective of targeting the recovery of the cost of a certain percentage of transactions, as it facilitates the quantitative posture of the implementation of Regulation II. One should keep in mind, however, that if there are legitimate costs associated with processing debit transactions that have been omitted, it is possible that even a 100 percent cost recovery target would not cover reasonable and proportional" costs completely.

I recommend the use of at least a 99 percent target—instead of 98.5 percent—for several reasons. First, statistically, there is not much difference between a 98.5% target and a 99% target. The Board specifically references a metric called the efficiency gap," a measure of the relative efficiency of covered issuers above versus those below the cost-recovery target. The efficiency gap is 5.8 with a 99 percent cost-recovery target and 5.2 with a 98.5 percent target—a difference of 0.6, which is close to the 0.5 difference between 98 percent and 98.5 percent. The difference in efficiency gaps between 99 percent and 99.5 percent targets, however, is 1.9—three times higher. (Apparently, the 99.5 percent target contains some large cost outliers in the 0.5 percentile tail of the distribution.) A 99.5 percent target would have the advantage of reducing the shock to the financial system caused by the fee recalibration, thus easing the transition from the old regulatory regime.

[3] Federal Register, Vol. 88, No. 218 / Tuesday, November 14, 2023, p. 78113.

Second, a 99 percent target implies base component costs that are only slightly higher than under the proposed 98.5 percent target—15.6 cents versus 14.4 cents—implying a 26 percent decline in base component costs from the current 21.0 cents, versus a 31 percent decline under the proposed 98.5 percent target. Once again, a 99.5 percent target would be even more effective in easing the transition for stakeholders.

To be sure, the consideration of reducing the shock" to the payments system associated with reducing the fee cap is a normative one. A proposed 31 percent reduction in fess under a 98.5 percent cost recovery target falls to a 26 percent reduction under a 99 percent target, and is cut in half, to a 16 percent reduction, under a 99.5 percent target. Even a 16 percent reduction in base fees represents a substantial loss of revenue and will not go unnoticed. The loss of revenue will be very real and will have real impacts on the activities of covered debit issuers. Depending on which cost recovery threshold is chosen, the revenue loss may induce financial institutions to limit some banking services, such as free or low-balance checking accounts, in response.[4]

Cost-recovery target (percentage of covered issuer transactions) (%)	Fixed multiplier	Base component (based on 2021 data)[83] (cents)	Decline in base component relative to current (based on 2021 data) (%)	Efficiency gap with respect to transaction processing between covered issuers whose transactions are above and below the cost-recovery target (based on 2021 data)[84]	Percentage of covered issuers that would have fully recovered their base component costs in 2021 had the relevant base component been in effect in 2021 (based on 2021 data) (%)
Current	....	21.0	....	....	77
99.5	4.5	17.6	16	7.7	76
99.0	4.0	15.6	26	5.8	71
*98.5	3.7	14.4	31	5.2	66
98.0	3.5	13.7	35	4.7	63
95.0	2.7	10.5	50	3.8	52

* Proposal.

Source: Federal Register, Vol. 88, No. 218 / Tuesday, November 14, 2023, p. 78113.

IV. Other Considerations

Beyond the specifics of the NPR discussed above, the Durbin Amendment brings to the fore larger issues of equity and access to banking services throughout the consumer financial system. One issue is the notably higher interchange fees charged by non-covered debit card issuers—issuers below $10 billion in size and therefore exempt from the Durbin Amendment fee caps. The table below, sourced from the Board's reporting of Regulation II data, illustrates the increased

[4] If the Board implements the updates to Regulation II using 2023 data, as proposed in Section II above, the impact of the update may be greater or smaller than what is proposed in the current NPR.

divergence of interchange fees on covered transactions compared to Regulation II-exempt transactions. While interchange fees on covered transactions have fallen 12 basis points from 2013 through 2021, fees on Regulation II-exempt transactions have *increased* by 6 basis points.

This divergence leads to the question of why. While there may be many reasons, two possibilities come to my mind: 1) the underlying costs of providing debit services have increased over time, and 2) debit services now involve new costs, related perhaps to new technologies or more sophisticated fraud detection protocols. In both scenarios, exempt issuers, by virtue of not being subject to interchange fee caps (but still subject to normal competitive pressures), have had the ability to adjust their fee structure as deemed necessary to account for changes in underlying costs and service provision, while covered issuers have remained locked into the Durbin fee caps. Seen in this light, the data in the table below suggest that the current Regulation II-based fee structure for covered transactions does not appear excessive. Thus, there may be unintended consequences associated with a policy that drastically decreases fee caps without fully considering recent developments driving the costs associated with debit transactions—new technology, fraud monitoring and prevention, cardless transactions (e.g., cellphone tap-to-pay), and the like—for covered and exempt issuers alike.

Interchange Fees as a Percent of Transaction Value

Year	Exempt transactions	Covered transactions	Difference
2013	1.13%	0.60%	0.53%
2014	1.14%	0.59%	0.54%
2015	1.14%	0.60%	0.54%
2016	1.15%	0.60%	0.55%
2017	1.15%	0.59%	0.56%
2018	1.16%	0.57%	0.58%
2019	1.18%	0.56%	0.61%
2020	1.15%	0.51%	0.64%
2021	1.19%	0.48%	0.72%

Source: https://www.federalreserve.gov/paymentsystems/files/regiireportsdata.xls, tab 5.

Another issue is the phenomenon of banks reducing access to banking services such as free checking accounts and low-minimum-balance accounts in response to reductions in their collections of interchange fees.[5] The availability of such affordable banking products is important for fostering equitable access to banking, especially for individuals and communities of modest means who traditionally have

[5] See for example, https://www.federalreserve.gov/econres/feds/files/2017074pap.pdf.

had only limited access to banking services. One empirical study[6] found that banks have offset their reduction in interchange revenue by reducing the share of free checking accounts from 61 percent to 28 percent as a result of the Durbin Amendments, while increasing average fees on checking accounts from $3.07 to $5.92 per month. The higher fees are borne by low- and moderate-income consumers who are unable to keep the monthly minimum balances in their accounts necessary to qualify for fee waivers. Low-income and other marginalized consumers have limited low-cost banking options. As a result, some may turn to smaller community banks who charge higher interchange fees. Unfortunately, many of those banks are fighting to remain viable as they slowly disappear through mergers and acquisitions. Other consumers find themselves among the ranks of the unbanked, subject to the whims of payday lenders, check-cashing outlets, and other expensive alternative banking services.

The extant empirical evidence strongly suggests that consumers have been, and will continue to be, impacted by the existence of fee caps. This is yet another example of the oft-cited mantra in economics There is no such thing as a free lunch" —or checking account. The money to provide a service must come from somewhere. It is my hope that in due course the Board will look beyond Regulation II to examine more broadly the equity implications of the Durbin Amendments, and other intersecting regulations, in an effort to improve market outcomes for all consumers—particularly the most economically vulnerable, who need expanded access to banking services most of all.

I greatly appreciate the opportunity to provide comments on the proposed updates to Regulation II. Please feel free to contact me at chris@PerceptionNexus.com with any questions regarding my comments.

Sincerely,

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PerceptionNexus Analytics LLC

[6] Mukharlyamov, Vladimir and Sarin, Natasha, Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards (November 24, 2022). Available at SSRN: https://ssrn.com/abstract=3328579.