MICHIGAN CREDIT UNION LEAGUE & AFFILIATES

May 12, 2024

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-1818 / RIN: 7100-AG67

Dear Sirs and Mesdames of the Board of Governors,

The Michigan Credit Union League (MCUL), on behalf of our member credit unions, appreciates the opportunity to submit comments to the Board of Governors of the Federal Reserve System's notice of proposed rulemaking regarding modifications to Regulation II. The MCUL is a statewide trade association representing 184 credit unions located in Michigan and their nearly 6 million members. We are writing to express our strong opposition to the proposed changes to Regulation II concerning debit card interchange fees.

Regulation II and the Durbin Amendment have posed significant challenges to credit unions, showcasing regulatory overreach that harms small financial institutions. Instead of nurturing a level playing field, these measures have unfairly favored certain industries, exacerbating the decline of the financial services sector. Claims of consumer benefits through reevaluating debit interchange rates are misleading, as past data shows no evidence of such savings being passed on. Studies by the Federal Reserve Bank of Richmond[1] in 2014 and George Mason University[2] corroborate this, demonstrating that merchants mostly maintained or even increased their prices post-regulation. Large banks offset their interchange fee losses by cutting free checking, raising fees, and imposing higher balance requirements. More recent research by Vladimir Mukharlyamov and Natasha Sarin in 2019 further confirms that consumers gained no financial advantage from these regulations.[3] Multiple studies, including the Federal Reserve's own data,[4] reinforce the negative impacts on both financial institutions and consumers. Small and medium-

[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, available at https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2014/q3/pdf/wang.pdf

[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, available at https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3048&context=faculty_scholarship

[4] Manuszak, Mark D. and Krzysztof Wozniak, "The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation," Finance and Economics Discussion Series 2017-074, Washington: Board of Governors of the Federal Reserve System, 5 (2017), available at https://www.federalreserve.gov/econres/feds/files/2017074pap.pdf.

sized financial institutions have borne the brunt of these effects, struggling to compete in an increasingly skewed market landscape.

Unfortunately, the proposal at hand does not appear to give weight to available research and studies that show how the last attempt to set an interchange cap did not function as intended. In the years since Regulation II was first introduced, no businesses passed their savings onto consumers – some even raised prices.[5] In 2018, the Electronic Payments Coalition reported that consumers have lost $6-8 billion each year as retailers failed to execute on their promises and lower prices, noting that over one third of voters believe that if savings aren't being passed along to consumers, then the Durbin amendment should be repealed.[6] More, financial institutions, particularly small community institutions, are increasingly burdened with fraud costs, none of which merchants shoulder. Federal Reserve Board Gov. Michelle Bowman, the only governor to vote against the proposal, reiterated many of these same points in her dissent.[7] Evidence-based policy is key to the success of a healthy economic system, and yet this proposal ignores the actual evidence that this experiment has been an outright failure and, instead, doubles down on bad policy.

The Proposal Will Negatively Impact Small, Exempt Issuers

As noted at the start of this letter, MCUL represents 184 credit unions in Michigan, all but one of which is technically exempt from the current Regulation II and will continue to be technically exempt under this proposal. However, the Durbin Amendment's impact on all financial institutions, extensively documented over the past decade, has been profound. A comprehensive report by the Government Accountability Office (GAO)[8] revealed a 25 percent reduction in annual interchange revenue for covered issuers. While exempt institutions weren't technically subjected to price caps, the mandate on routing had significant financial repercussions, diminishing crucial revenue streams supporting checking account services. Many banks and credit unions felt compelled to consolidate to bolster their customer base, especially debit card holders, due to the financial strain induced by Regulation II.

Reports from the Board on debit interchange paint a troubling picture: between the enactment of Regulation II and 2019, covered institutions saw a decline in per-transaction revenue from $0.31 to $0.25. Additionally, there was a distressing 19.3 percent revenue loss on debit card interchange transactions processed on single-message networks for credit unions and community banks falling below the $10 billion asset threshold—technically exempt institutions. These figures highlight the severe repercussions the Durbin Amendment and Regulation II have had on small and medium-sized financial institutions and underscore the urgent need to staunchly oppose any proposals that could worsen their already precarious financial situation by reducing the interchange rate.

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[5] 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, available at https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2014/q3/pdf/wang.pdf

[6] Electronic Payments Coalition, "7 Years On, Durbin Amendment Still Costing Consumers at the Register." (2018). Available at: https://electronicpaymentscoalition.org/resources/infographic-7-years-on-durbin-amendment-still-costing-consumers-at-the-register/

[7] Board of Governors of the Federal Reserve System, "Statement on Proposed Revisions to Regulation II's Interchange Fee Cap by Michelle W. Bowman" (Oct. 6, 2023), available at https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231025.htm.

[8] GAO-22-104468 (February 2022), available at https://www.gao.gov/assets/gao-22-104468.pdf.

The Proposal Fails to Adequately Consider the Full Costs of Fraud

The rise in card fraud, particularly in Card Not Present (CNP) transactions, alongside the regulatory impact of interchange caps, presents a dual challenge for financial institutions. The 2021 Nilson Report revealed an 18 percent surge in U.S. fraud volume, reaching close to $12 billion in losses, showcasing the evolving nature of fraud despite technological advancements aimed at prevention. The shift to CNP fraud, accelerated by the surge in online transactions during the COVID-19 pandemic, contrasts with the original intentions behind the Durbin Amendment.

The Board's proposal to adjust interchange fee standards disregards the need for more robust recovery of fraud costs for many issuers, particularly smaller ones. This disparity is compounded by the increasing magnitude of fraud per transaction, which disproportionately affects smaller issuers with lower transaction volumes. Despite escalating fraud, credit unions are investing heavily in prevention activities, but the Board's narrow definition of allowable fraud prevention costs overlooks certain types of fraud losses, such as those resulting from foreign transactions involving stolen U.S. debit cards. Aside from direct fraud losses, financial institutions face substantial costs in fraud prevention and management. Interchange caps, intended to reduce transaction costs, constrain revenue streams crucial for fraud prevention efforts. This strain is especially pronounced for smaller institutions like credit unions. The disparity in resources between large banks and smaller credit unions exacerbates the challenge. While big banks can invest in advanced fraud prevention technologies, smaller institutions struggle with reduced revenue streams. Any reduction in interchange rates would further constrain their ability to invest in fraud prevention, potentially leading to increased fraud losses and further consolidation within the financial sector.

The Proposal Will Negatively Impact Consumers

The previously mentioned Government Accountability Office (GAO) study highlighted the Durbin Amendment as a significant factor affecting basic banking services, leading to increased costs and reduced availability of free checking accounts. The proposed reduction in the fee cap is expected to further harm consumers by limiting access to affordable banking products. Despite evidence suggesting that merchants have not and are not likely to pass on cost savings to consumers, the Board's analysis lacks depth, failing to adequately consider historical evidence and empirical research. A study by the Richmond Federal Reserve indicates limited positive effects of Regulation II on consumers, with the majority of merchants not passing on savings to customers. Despite significant losses in interchange revenue for issuers, the Board's assumption that merchants will share more cost savings with consumers lacks empirical support and overlooks the potential negative impact on credit union members.

In the years since the passing of the Durbin amendment and the implementation of Regulation II, multiple studies have been conducted reviewing the efficacy and impact on consumer financial inclusion, particularly the impact on low-moderate income consumers. A 2017 study conducted by researchers at the International Center for law and Economics found that millions of households were adversely affected by Durbin, and that "hundreds of thousands of low-income households have chosen (or been forced) to exit the banking system" as a result.[9] In a 2014 study by the same researchers, it was found that between 2009 and 2012, fee-free accounts more than doubled the minimum monthly holding requirement to avoid said fees and that for non-free accounts, the average monthly fees doubled.[10] This report also found that these fee increases and loss of access to free checking, "contributed to an increase in the unbanked population of approximately 1 million people, mainly among low-income families." For a regulation that was supposed to ease consumer price burdens by lowering merchant fees, it is abundantly clear that the current paradigm has not worked. Likewise, the proposed tightening of price controls is likely to have a similar effect, pushing marginal consumers out of the banking system. These findings suggest that although the aim of regulating debit card fees may be to safeguard consumers, the real consequences have disproportionately disadvantaged the most vulnerable members of our society.

Responses To Specific Requests for Comment

1. *As stated in paragraph (a) of proposed appendix B to Regulation II, the Board would determine the base component,* ad valorem *component, and fraud-prevention adjustment for every two-year period, beginning with the period from July 1, 2025, to June 30, 2027. Is the proposed two-year cadence appropriate, or should the Board determine these amounts more or less frequently?*

   The League does not support any revisions to Regulation II at this time. As introduced, this two-year cadence would occur without opportunity for effected parties to provide comment. The League does not support this. We have over a decade of data showing that the original rule has not worked as intended – cost savings to retailers were not passed to consumers and, instead, were retained by merchants. Additionally, small financial institutions were not insulated by the asset size threshold, resulting in less funding available for fraud prevention and mitigation efforts. The proposed rule will introduce yet another a shift in revenue from financial institutions to retailers, with no benefit to the consumers.

2. *As described in paragraph (c)(1) of proposed appendix B to Regulation II, the Board would determine the base component as a fixed multiple of the transaction-weighted average of per-transaction base component costs (i.e., allowable costs (excluding fraud losses)) across covered issuers. As described in section III.B,* supra, *the fixed multiplier corresponds to the percentage of covered issuer transactions for which the Board believes covered issuers should fully recover their base component costs over time. Should the Board select an alternative cost-recovery target from among the possibilities below, or another cost-recovery target not included below? If so, why?*

   The discussion around "covered issuers" is a red herring, as evidence has shown small issuers are not insulated from the current rule. Likewise, small issuers will not be insulated from the proposed rule. While technically exempt, credit unions below the asset threshold will experience a similar reduction in fee income as the covered issuers. The Board's methodology does not account for this – the Board's methodology should include an analysis

[9] Zywicki, Todd, Manne, Geoffrey and Morris, Julian, "Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses." (2017). Available at https://laweconcenter.org/wp-content/uploads/2017/08/icle-durbin_update_2017_final-1.pdf

[10] Zywicki, Todd J. and Manne, Geoffrey and Morris, Julian, Price Controls on Payment Card Interchange Fees: The U.S. Experience (June 4, 2014). George Mason Law & Economics Research Paper No. 14-18, Available at SSRN: https://ssrn.com/abstract=2446080 or http://dx.doi.org/10.2139/ssrn.2446080

of how the proposed rule will impact small issuers below the $10 Billion asset threshold both directly and indirectly.

3. *As described in paragraph (d)(1) of proposed appendix B to Regulation II, the Board would determine the* ad valorem *component, for a particular debit card transaction, as the median ratio of issuer fraud losses to transaction value among covered issuers, multiplied by the value of the transaction. Should the Board adopt an alternative methodology for determining the* ad valorem *component? If so, why?*

   The League supports the inclusion of fraud losses in the ad valorem component, but we will note again how both the current and the proposed rule have not and will not insulate technically exempt small issuers from decreased fee revenue. As such, with respect to any updates, the Board should account for the fraud losses of these exempt small issuers when establishing future ad valorem rates.

4. *As described in paragraph (e)(1) of proposed appendix B to Regulation II, the Board would determine the fraud-prevention adjustment as the median per-transaction fraud-prevention costs among covered issuers. Should the Board adopt an alternative methodology for determining the fraud-prevention adjustment? If so, why?*

   The Board should also consider the fraud prevention costs of small issuers.

9. *As stated in paragraph (f) of proposed appendix B to Regulation II, going forward, the Board would publish the base component,* ad valorem *component, and fraud-prevention adjustment in the* ***Federal Register*** *no later than March 31 for an applicable period beginning July 1. Would this timeline provide sufficient notice to covered issuers, payment card networks, and other industry stakeholders to prepare for changes to these amounts? Should the Board increase or decrease the period between publication of these values and the beginning of the next applicable period?*

   We will reiterate here that we oppose the proposed rule outright, and we oppose the inclusion of a two-year update cycle in the proposed rule. We also believe that instituting any changes without also providing an opportunity for affected parties to comment is misguided, particularly when such changes will affect more than just covered issuers. However, if the rule is to be implemented and such a cycle is to be included without opportunity to respond, we believe that a period of three months is insufficient notice for covered issuers, payment card networks, and other industry stakeholders to prepare for the impending changes.

10. *Proposed comments 235.3(b)–4 and 235.4(b)–1 would provide that, for purposes of determining in which two-year period a debit card transaction is considered to be performed, a debit card transaction is considered to be performed on the date on which it is settled on an interbank basis. Is this proposed convention sufficiently clear? For example, should the Board specify which time zone is controlling for purposes of determining the date on which a transaction is settled on an interbank basis? Should the Board adopt an alternative standard, such as considering a transaction to be performed on the date on which the cardholder presents the debit card to the merchant for payment?*

    We once again reiterate our opposition to the proposed rule and its implementation. With respect to our previous comment, if the Board determines to go forward with the rule change, we believe that the proposed convention is sufficiently clear. Introducing time zone considerations is unnecessary, except to note that settlement should be accounted for in local time.

12. *Does the Board's economic analysis of the proposal, set forth in section VIII.A, appropriately describe the likely impact of the proposal on various participants in the debit card market? Are there additional impacts of the proposal that the Board has not considered?*

    As previously discussed, the League does not agree with the Board's conclusion that the proposal would only affect covered issuers and any proposal in this space will have reverberating effects throughout the debit card market, particularly on small issuers. The Board's own data shows this. As such, The Board should withdraw this proposal. Barring that, the Board should consider fully the impacts technically exempt issuers will encounter and adjust appropriately before publishing a final rule.

Conclusion

While merchants have thrived without government price controls as consumer costs rise, credit union issuers grapple with managing debit card program expenses under existing price controls and the looming threat of further interchange fee reductions. The Board's proposal ignores the past and potential harm to consumers and the increased costs to technically exempt credit unions, in particular the costs associated with fraud mitigation and recovery efforts. Moreover, the decision appears both unnecessary and premature, lacking sufficient data on recent CNP routing rule changes and relying on flawed methodologies that jeopardize full cost recovery for many issuers. Exclusion of pertinent costs from fee cap calculations and underestimation of the proposal's impact on technically exempt issuers, notably small credit unions serving disadvantaged populations, further underscores the need for withdrawal.

The Michigan Credit Union League strongly opposes any reduction in debit interchange rates and the anticipated detrimental effects on credit unions and their communities. As such, we respectfully urge the Board to withdraw this proposal. If we can answer any questions or provide you with additional information, please do not hesitate to contact Director of Compliance and Regulatory Affairs Brad Willett at Bradley.Willett@mcul.org.

In cooperation,

Bradley Willett

Bradley Willett
Director of Compliance and Regulatory Affairs