

**Meeting Between Governor Waller and Staff of the Federal Reserve Board and  
Representatives of the Bank Policy Institute (BPI)**  
**February 27, 2024**

**Participants:** Governor Christopher J. Waller and Robert Sarama (Federal Reserve Board)

Greg Baer, John Court, and Paige Paridon (BPI)

**Summary:** Governor Waller and staff of the Federal Reserve Board met with representatives of BPI to discuss a range of issues including the Board's notice of proposed rulemaking on Regulation II. The BPI representatives verbally expressed views in the meeting consistent with those expressed in their written presentation.

Attachment



# **Federal Reserve Board Proposed Amendments to Regulation II**

Feb. 27, 2024

# Costs the Board May Consider: 2014 Litigation

- In assessing costs, the Board is directed to 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” and prohibited from considering “other costs incurred by an issuer which are not specific to a particular electronic debit transaction.”
- **In interpreting the statute, the Board:**
  - Explicitly rejected the notion that only variable/marginal costs could be considered.
  - Instead, allowed any cost that was necessary to transactions occurring, which included fixed costs such as hardware and software.
  - Disallowed only those costs that would be incurred whether or not debit transactions were occurring – e.g., card production and delivery costs.
- **D.C. Circuit:**
  - “In our view, the Board reasonably distinguished between costs issuers could recover and those they could not recover on the basis of whether those costs are “incurred in the course of effecting” transactions. For instance, the Board's rule allows issuers to recover equipment, hardware, software, and labor costs since “[e]ach transaction uses the equipment, hardware, software and associated labor, and no particular transaction can occur without incurring these costs.” By contrast, the rule precludes issuers from recovering the costs of producing and distributing debit cards because “an issuer's card production and delivery costs are incurred without regard to whether, how often, or in what way an electronic debit transaction will occur.” (emphasis added)

# Costs the Board May Consider: 2014 Litigation (Contd.)

- **D.C. Circuit (Contd.):**
  - “[T]he Board interpreted section 920(a)(4)(B) as allowing issuers to recover costs they must incur in order to effectuate particular electronic debit card transactions but precluding them from recovering other costs too remote from the processing of actual transactions.”
- As described in the following slides, the broad reading of allowable costs by the Board and the D.C. Circuit is not reflected in the data gathering undertaken by Board staff. Multiple costs necessary to the processing of transactions are excluded.

# Banks Are Entitled to Recover Their Costs and a Reasonable Return

- The statute requires interchange fees to be “*reasonable and proportional*” to a covered issuer’s costs—not “equal to” those costs.
- The Board did not consider the meaning of this phrase in its rule, and Board staff did not raise it as a defense in the litigation.
- Courts have routinely held that price-control regulations that fail to allow a reasonable return are unconstitutional. *See, e.g., Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 595-596 (6th Cir. 2001). This is likely why Congress used the language “reasonable and proportional” which is akin to the phrase “fair, just and reasonable,” which is frequently used in utility rate-setting statutes.
- In short, if Congress had meant for the cap to be “equal” to costs, it would have said “equal.” And that would have been unconstitutional.
- The Board should ask counsel to revisit the meaning of “reasonable and proportional.”

# The Board's Survey Excludes Relevant Costs

See below a list of all costs incurred by a debit card issuer. Those in **bold** were not included in the Board's calculation of the cap, despite repeated public comments requesting that they be included.

## Included Issuer Costs:

- Authorization, clearance, and settlement costs: costs incurred by debit card issuers for authorization (including authorization transaction monitoring), clearance and settlement of U.S. debit card transactions (excluding ATM transactions).
- Issuer fraud losses – fraud losses incurred by debit card issuers in connection with U.S. debit card transactions.
- Fraud-prevention costs – costs incurred by debit card issuers related to fraud prevention in connection with U.S. debit card transactions.

## Excluded Costs:

These excluded costs appear to be within the definition of allowable costs adopted by the Board and affirmed by the D.C. Circuit.

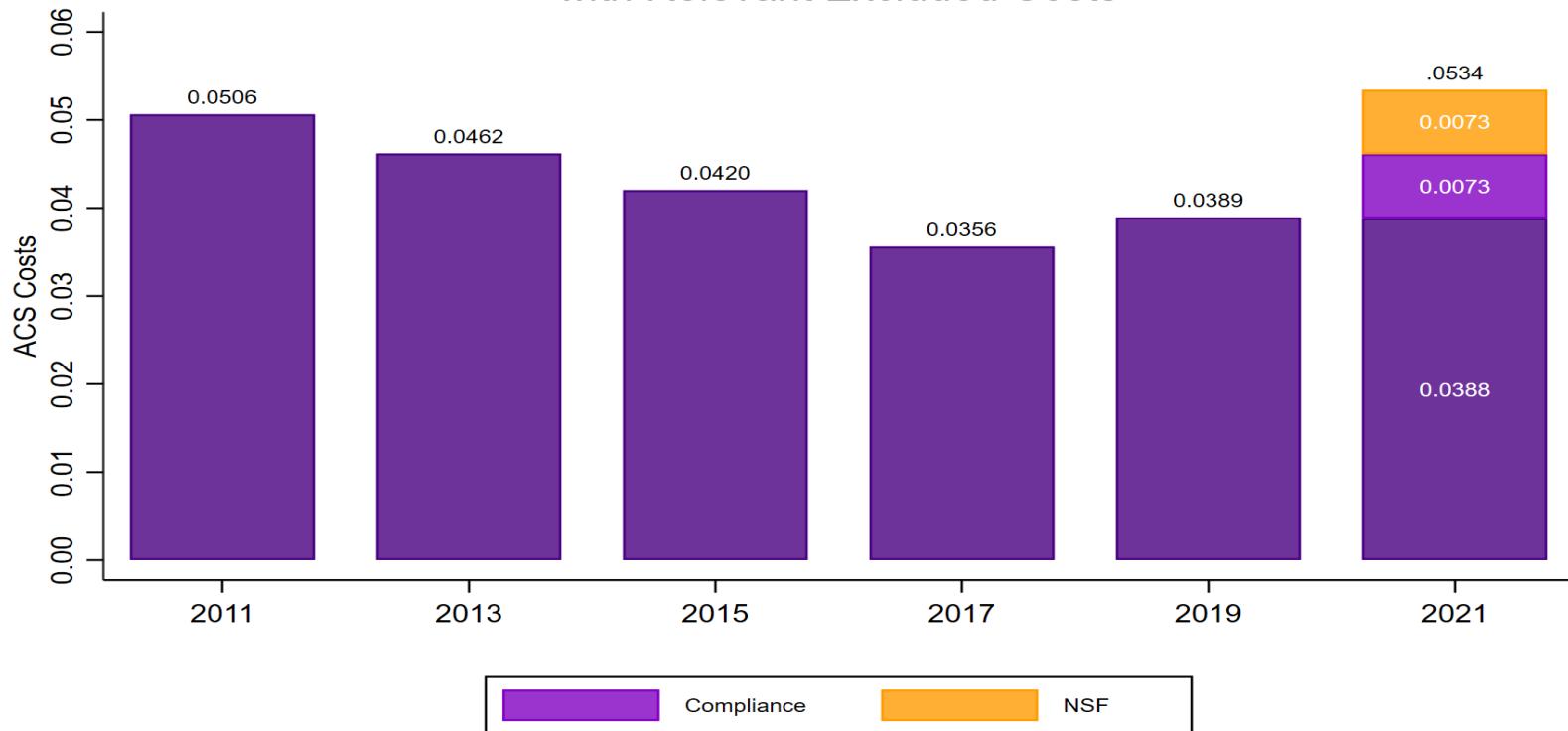
- **Non-sufficient funds handling costs**
- **Non-sufficient funds losses**
- **International transaction fraud costs/losses**
- **Dispute handling and management costs**
- **Debit program compliance costs (e.g., laws and network rules)**
- **Other transaction-monitoring and evaluation costs**
- **Other network fees not currently included by the Board**
- **Costs of establishing and maintaining a debit card relationship with the cardholder**
- **Cardholder rewards costs**
- **Cardholder inquiry costs**
- **Research and development costs**

# The Excluded Costs Are Material

- For example, the Board reports that based on 2021 survey data, the transaction weighted average cost of non-fraud-related, transaction-specific cardholder inquiries was 3 cents. (The Board collects, but does not include this information in the cap.)
- Simply adding that component would increase the pre-multiplier base component from 3.9 cents to 6.9 cents per transaction (resulting in base component cost recovery of 25.5 cents per transaction after applying the Board's chosen multiplier of 3.7).
- In addition, BPI conducted a survey asking BPI/TCH/ABA member banks to quantify several of the excluded cost items.
- The next slide demonstrates the transaction weighted average costs that would be included in the cap if just these two additional categories were included:
  - Compliance
  - NSF losses and handling costs

# The Board's Survey Excludes Relevant Costs

Transaction-Weighted Average ACS Costs (Excluding Fraud Losses)  
with Relevant Excluded Costs



Sources: Federal Reserve Board, BPI & Trade Groups Survey.

# Issuer Costs Do Not Justify Lowering the Fee Cap

- The previous slide also demonstrates that issuer costs as measured by transaction weighted average do not support a 30% reduction in the interchange fee cap.
- The transaction weighted average of per-transaction base component costs across covered issuers has fallen only 1.2 cents since 2011.
- That metric was 3.9 cents in 2021, and 5.1 cents in 2011.
- This is well within the range of uncertainty for this type of data collection exercise and the lack of consensus around what costs are appropriate to include.
- Yet, the Board proposes to reduce the base component from 21 cents to 14.4 cents, a 30% reduction, which is disproportionate to the reduction in transaction weighted average base component costs.

# The Proposal's Shift in Methodology is Unexplained and Unwise



- The largest change in the cap comes from a change in methodology, not from changing costs. The proposal changes from issuer-weighted cost to transaction-weighted cost.
  - If the proposal had retained the original methodology for setting the ACS component of the cap – even based on the limited set of costs the Board considers – the cap would have increased from its current 21 cents.
- Transaction weighting skews the allowable base component toward high-volume issuers.
- Because of scale, the very largest issuers have the lowest costs, so the move to transaction weighting significantly lowers the cap.
- Bottom line: the proposal would not allow **34% of covered issuers – approximately 55 of 163 total issuers** – to recover even the limited universe of costs considered by the Board, up from 23% in 2021 using the existing methodology.
- The proposal provides no justification for this change.

# The Board Is Required to Consider the Effect of the Proposal on Consumers

- Section 904 of EFTA requires the Board to: (a) consider the “costs and benefits to financial institutions, consumers, and other users of electronic fund transfers” of the regulation prior to issuing the regulation; (b) consider the ways that the proposed regulation affects “competition in the provision of electronic banking services among non-exempt and exempt financial institutions and the availability of such services to different classes of consumers, particularly low-income consumers”; and (c) to the extent practicable, “demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions.”
- *This requirement is fully consistent with the statute, as properly read, given that (as noted above) allowing a rate of return as part of a “reasonable and proportional” price would allow for consumer interests to be factored into the cap, whereas the proposal’s focus solely on cost has not.*
- The stakes are significant. Prior to the Board’s imposition of the Interchange Fee Cap in 2011, nearly 60 percent of large financial institutions offered free checking account options to consumers.
  - In first few years after the cap was imposed, that number fell to below 20 percent.
  - Consumers also experienced substantial increases in the amounts of fees on fee-based checking accounts. Within the first few years after 2011, average checking account fees for consumers nearly doubled, from roughly \$4 per month to more than \$7 per month.
  - Reduced interchange fee revenue also likely reduces innovation and investment in the payments system by covered issuers.

# The Board Is Not Required to Amend Reg. II

- There is no statutory or regulatory requirement that the Board revise the interchange fee cap either periodically or with reference to any particular data point (and certainly not by reference to a transaction-weighted average cost).
- In releasing the Regulation II final rule in 2011, the Board stated in the preamble to the rule that it would “periodically conduct surveys of covered issuers in order to reexamine and ***potentially reset*** the fee standard.”
- Thus, the Board has all the time it needs to gather the relevant data, factor in a required rate of return, more fully consider the effect of the proposal on consumers, financial institutions and consumers, and reissue the proposal, if it determines that a proposal is appropriate.



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