

**Meeting Between Staff of the Federal Reserve Board
and Representatives of Merchants and Merchant Trade Associations
September 23, 2020**

Participants: Justyna Bolter, Jess Cheng, Alex Cordero, Lacy Douglas, Elena Falcettoni, Mark Manuszak, Stephanie Martin, Larkin Turman, Kathy Wilson, and Krzysztof Wozniak (Federal Reserve Board)

Andrew Szente and Joe Vasterling (Best Buy); Alex Ellwood and Callum Goodwin (CMSPI); Jacie Duncan (Floor & Decor); Jennifer Hatcher and Hannah Walker (FMI); Tate Fenner (Foot Locker); Scott Anderson, Brett Layson, Beverly Reilly, and Ryan Zupancic (The Home Depot); Kathy Hanna (Kroger); Stewart Terbush (Love's Travel Stops & Country Stores); Lou Hayden (Lowe's); John Drechny and Beth Provenzano (MAG); Anna Ready Blom (NACS); Robert Yeakel (NGA); Leon Buck and Stephanie Martz (NRF); Austen Jensen and Jelena Matic (RILA); Doug Kantor (Steptoe & Johnson); Amy Oberhelman, Susan Smith, and Perry Starr (Target); Ken Grogan (Wakefern Food Corp.); Samantha Elleson and Berry Hanen (Walgreens); Mario de Armas (Walmart)

Summary: Representatives from the merchant community met with Federal Reserve Board staff to discuss their observations related to payment patterns in the COVID-19 environment, their concerns about routing of debit card transactions, and their request for the Federal Reserve Board to revise the interchange fee standard and fraud-prevention adjustment in Regulation II.

Attachments

Debit Routing in a Changing Retail Payments Landscape



September 2020

AGENDA



**Update on
Payments During
COVID-19**



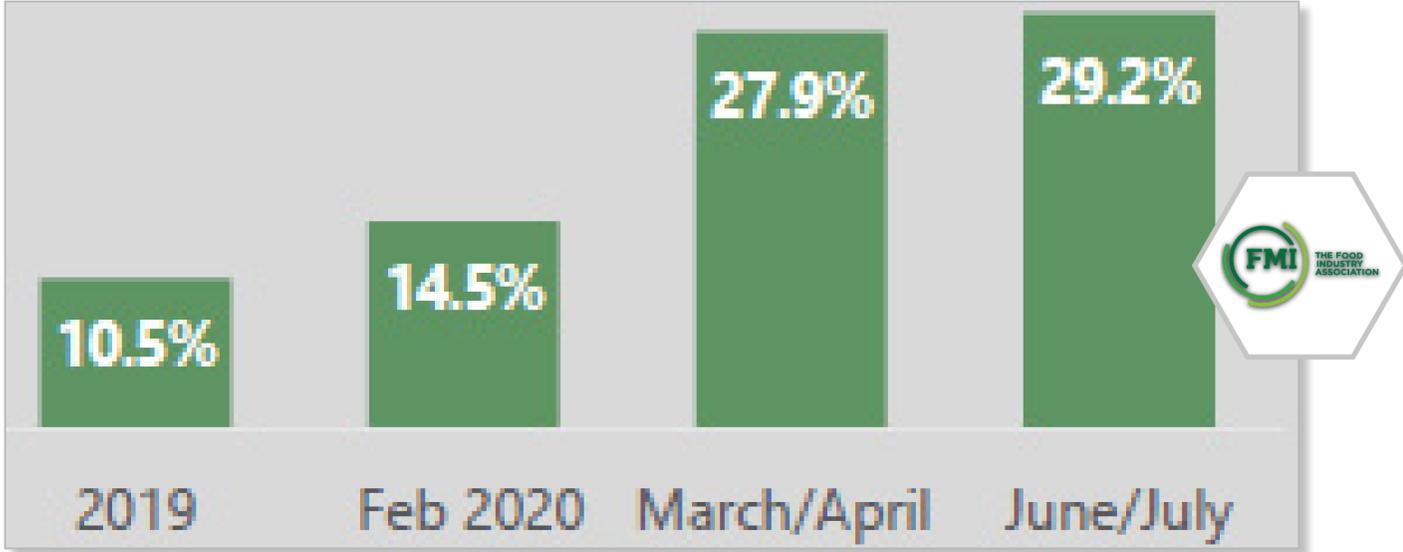
**Routing Issues
and Costs for
the Merchant
Community**



**Retail
Discussion on
the Regulated
Debit Rate**

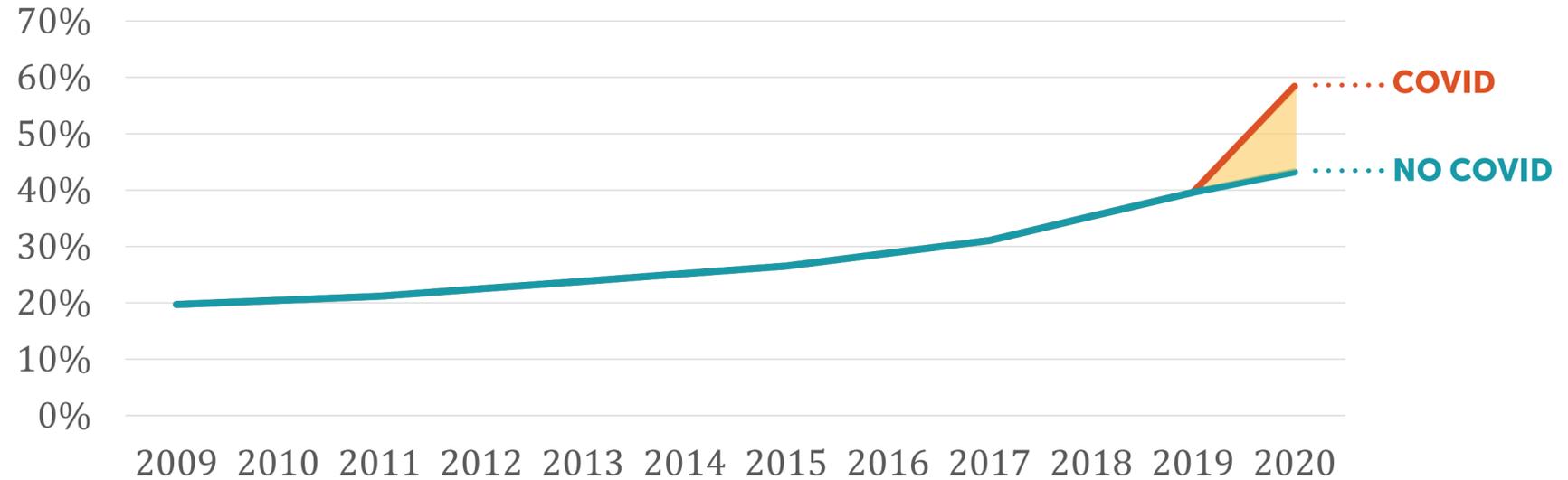
Changing Payments Landscape

WEEKLY ONLINE SHOPPING SPEND (AS A % OF TOTAL GROCER SHOPPING)



ONLINE DEBIT CARD VOLUME GROWTH

Sources: CMSPI Analysis & Estimates, Federal Reserve



69% increase in no-touch payments (i.e. contactless, online, and digital)

58% increase in those who accept contactless (up from 40% last year)

67% retailers that cited the rising cost of payments as their top concern

What's Routable?

Credit

	Verification Method		
	PIN	PINless	Signature
Dip	✗	✗	✗
Tap	✗	✗	✗
Online	✗	✗	✗
Mobile Tap	✗	✗	✗
Swipe	✗	✗	✗
Key Entered	✗	✗	✗

Debit

	Verification Method		
	PIN	PINless	Signature
Dip	✓	!	✗
Tap	✓	!	✗
Online	!	!	✗
Mobile Tap	!	!	✗
Swipe	!	✗	✗
Key Entered	✗	✗	✗



Not route-able



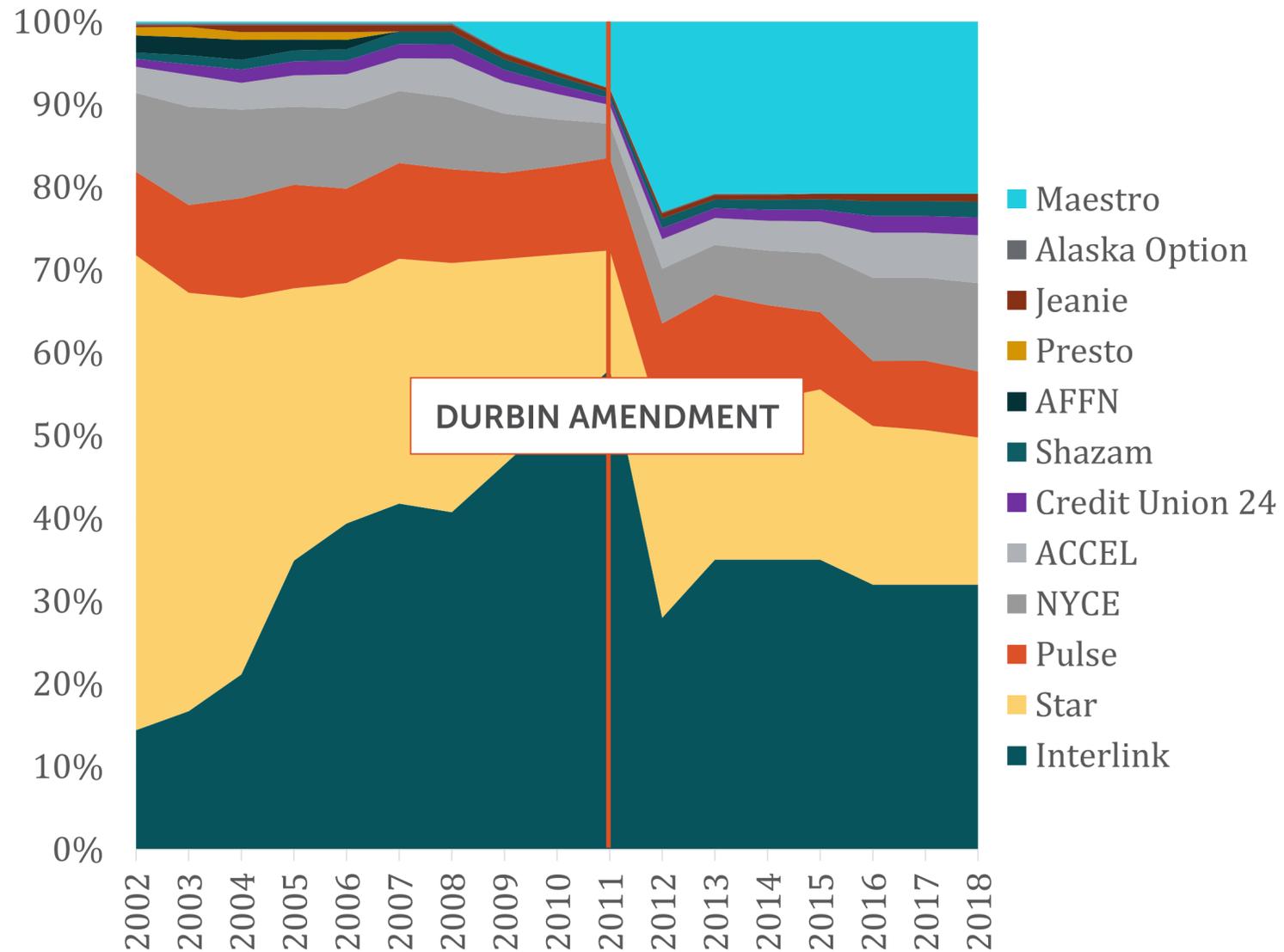
Route-able, but with sizeable barriers



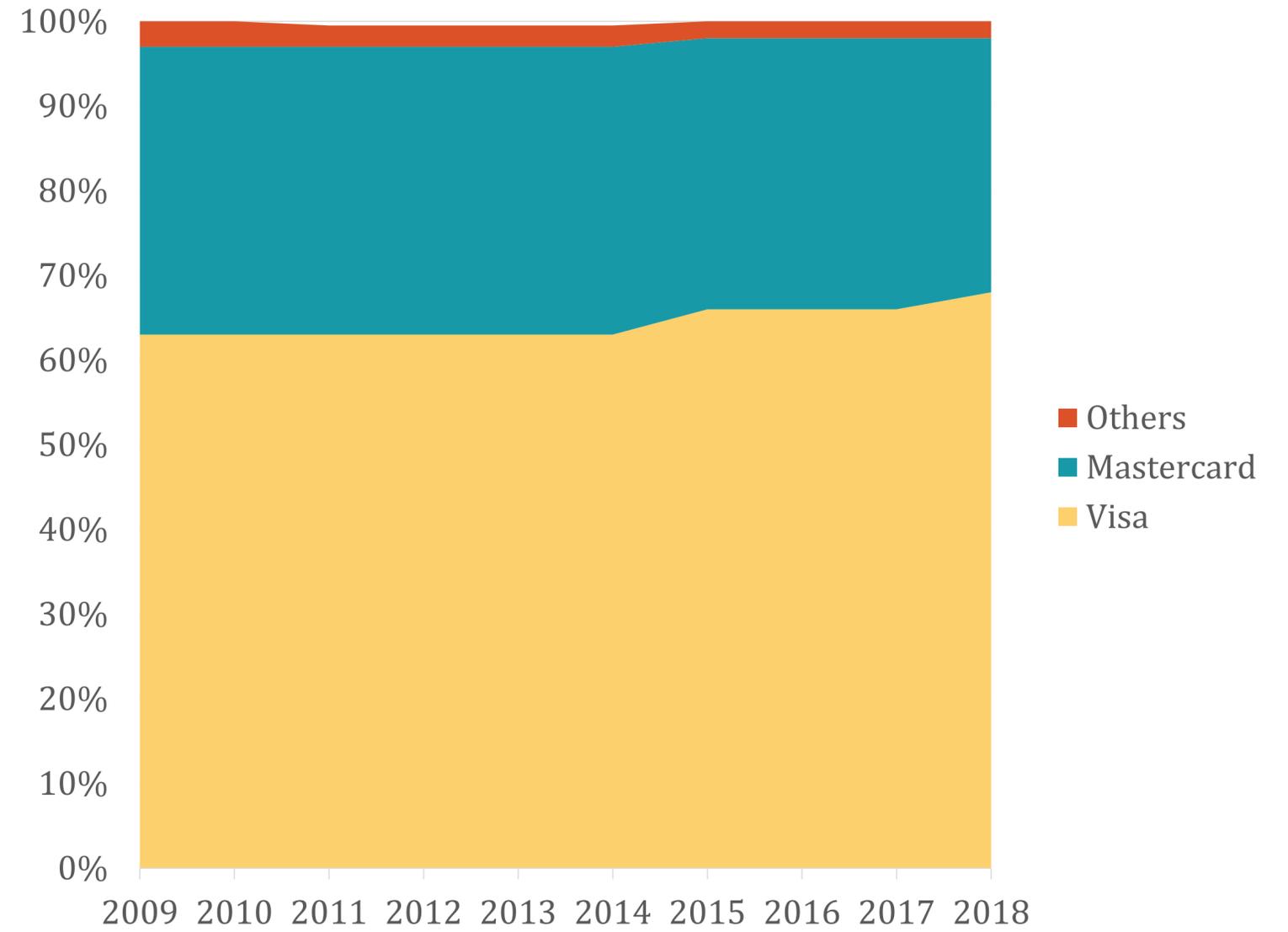
Route-able

What's Routable?

U.S. SINGLE MESSAGE DEBIT MARKET SHARES



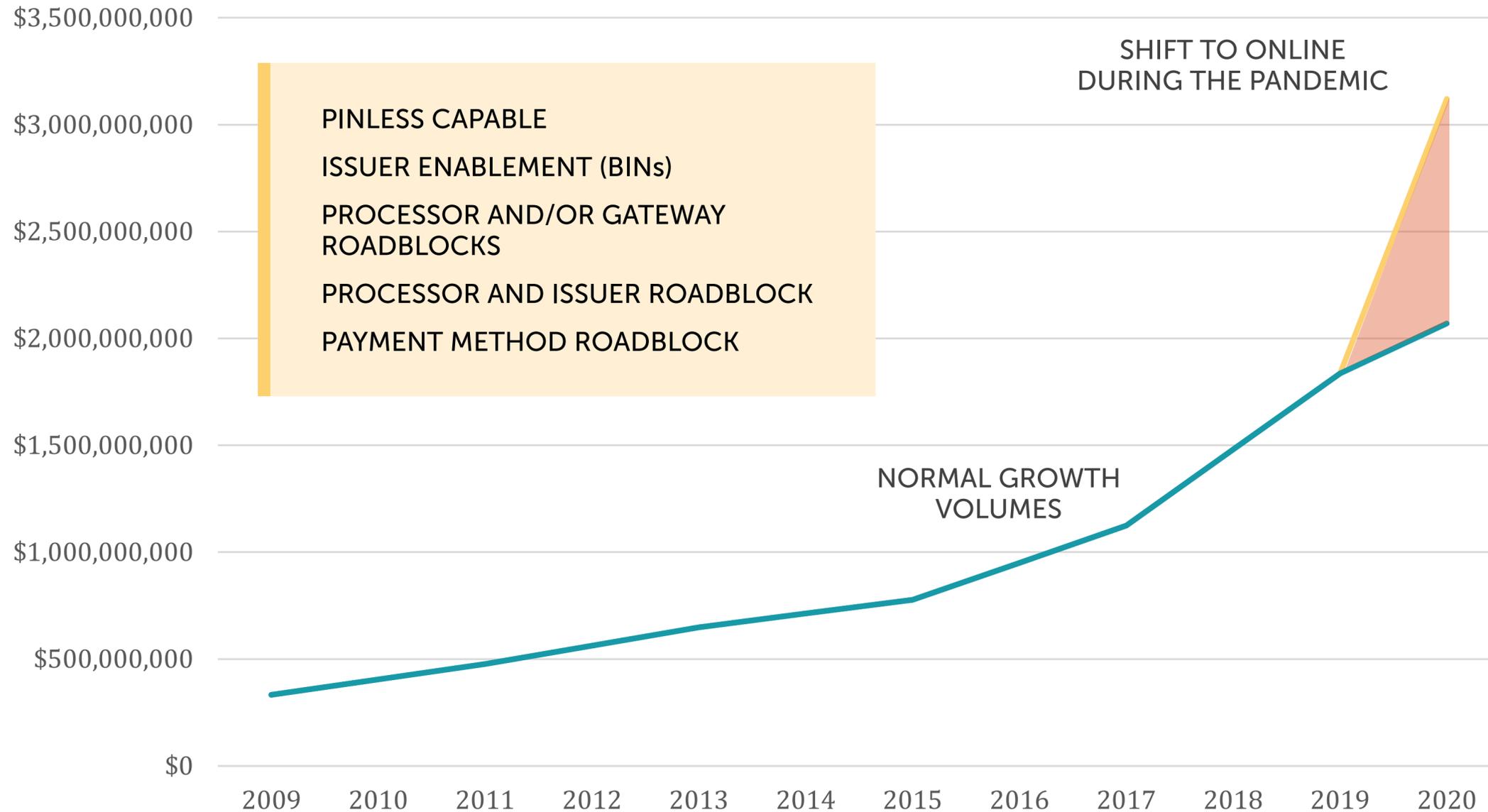
U.S. DUAL MESSAGE DEBIT MARKET SHARES



Sources: CMSPI Analysis & Estimates, Federal Reserve

Macro Analysis: Barriers to Routing Online

MERCHANT ROUTING SAVINGS IF CNP PINLESS WAS MORE PREVELANT



MACRO IMPACT: \$2.1BN

Merchants stood to lose out on because of the barriers to routing online.

MACRO IMPACT: \$3.1BN

This number has increased dramatically in 2020 due to the shift to online.

ASSUMPTIONS:

- Routing was as available as it is in a CP environment (i.e. PINless)
- Pandemic volumes extrapolated over a full year

Key Takeaways



1

The routable portion of the pie is shrinking rapidly and transactions will continue to get more expensive



2

PINless BIN enablement is preventing the majority of merchants from taking advantage of competition for online txns and contactless txns



3

Regulators could/should issue a clarification to the Durbin amendment explaining that retailers should have routing options regardless of where and how the card is presented

		Verification Method		
		PIN	PINless	Signature
Debit	Dip	✓	!	✗
	Tap	✓	!	✗
	Mobile Tap	!	!	✗
	Online	!	!	✗
	Swipe	!	✗	✗
	Key Entered	✗	✗	✗
Credit	Dip	✗	✗	✗
	Tap	✗	✗	✗
	Online	✗	✗	✗
	Mobile Tap	✗	✗	✗
	Swipe	✗	✗	✗
	Key Entered	✗	✗	✗



Route-able, but with sizeable barriers



Route-able



Not route-able

Thank You

**Debit Routing in a Changing
Retail Payments Landscape**

 cmspi

July 27, 2020

The Honorable Jerome H. Powell
Chairman
The Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Lael Brainard
Governor
Committee on Payments, Clearing, & Settlement
The Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Randal K. Quarles
Governor
The Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Michelle W. Bowman
Governor
The Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Richard H. Clarida
Governor
The Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Federal Reserve Chairman Powell and Governors Brainard, Quarles, Bowman, and Clarida:

On behalf of the merchant community, we want to thank you for the ongoing dialogue over the years regarding Section 920 of the Electronic Fund Transfer Act (“EFTA”) and the regulated interchange rate for electronic debit transactions. The Federal Reserve established vital regulations implemented in 2011 to protect American consumers and retailers. In the ensuing nine years, the payment industry has experienced significant technological and structural changes but the regulations have remained the same. We believe that the regulations have failed to keep pace with this evolving market.

As the Federal Reserve Board (“the Board”) anticipates the results of its 2019 survey of issuer costs, the undersigned companies and trade associations which represent more than 200 businesses and 65 million employees across the merchant landscape believe that significant changes are needed to the regulated debit interchange rate, which has remained unchanged since it was established almost 10 years ago. We also request that the Board undertake regular and periodic adjustment of the debit interchange rate to align with the statutory mandate that the interchange fee charged on a debit transaction be reasonable and proportional to the cost incurred by the issuer.

The Regulated Debit Interchange Fee Should Be Adjusted Regularly

The EFTA requires that the interchange fees received by covered debit card issuers be “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”¹ When the Board established the initial limit on debit interchange fees, it anticipated that adjustments to that regulatory limit would be required: *“The Board recognizes that issuers’ costs may change over time, and the Board anticipates that it will periodically conduct surveys of covered issuers in order to reexamine and*

¹ Electronic Fund Transfer Act § 920; 15 U.S.C. § 1693o-2(a)(2) (2012).

potentially reset the fee standard [emphasis added].”² The Board correctly stated that the regulated rate should not be maintained at the initial level indefinitely, saying:

*“The Board will use the data collection authority provided in Section 920(a) to regularly collect data on the costs incurred by issuers in connection with electronic debit transactions and, over time, will adjust the standards based on reported costs, if appropriate. **Lower costs should result in a lower interchange fee cap as issuers become more efficient** [emphasis added].”³*

Consistent with the Board’s stated intent (and as contemplated by the statute), the Board has conducted regular bi-annual surveys of covered issuer costs since the rule was enacted in 2011. These surveys are a valuable resource to gain an understanding of current market activity for both issuers and merchants. The information collected demonstrates a clear trend of decreasing issuer costs, yet despite the Board’s stated intent to use the data as a basis to adjust the standard, the rate has remained at its original level. The time has come for the Board to revise the interchange fee standard based on updated issuer cost information and other changes in the market, as described below. Indeed, revisiting the standard is essential to fulfill the statutory mandate passed by a bipartisan majority in Congress that interchange fees remain *reasonable* and *proportional* to issuer transaction costs.

Under the final rule, an issuer may not receive an interchange fee that exceeds the sum of a *base component*, intended to address the per-transaction allowable costs⁴ of the issuer, and an *ad valorem component*, intended to reimburse a portion of the issuer’s per-transaction fraud losses. In addition, in a separate rulemaking, the Board exercised its discretion under Section 920 to allow a fraud-prevention adjustment on each electronic debit transaction for issuers that meet certain fraud-prevention standards.⁵ As a matter of practice, the card networks set interchange fees at the maximum for essentially all covered issuers, and almost all receive the full fraud-prevention adjustment. We believe that both components of the interchange fee, as well as the fraud-prevention adjustment, should be reassessed and revised to reflect current conditions.

Due to changes in issuer costs over time, we believe that the base component should be determined by reference to the average issuer allowable costs, rather than the allowable costs of the issuer at the 80th percentile, and should be significantly reduced. In addition, in light of transformational developments in the nature of debit card payments that have reallocated fraud liability between issuers and merchants, eroding the foundation for the ad valorem component and the fraud-prevention adjustment, the ad valorem component and the fraud-prevention adjustment should be eliminated entirely.

The Base Component is No Longer Reasonable and Proportional

The Board’s 2011 rulemaking set the base component, intended to correspond to the issuer’s per-transaction allowable costs, at \$0.21 per transaction. This amount equaled the average per-transaction costs of a representative issuer at the 80th percentile in the Board’s 2009 issuer survey, in which issuer participation was voluntary. The 80th percentile was identified as a demarcation in the distribution of costs across the covered issuers who chose to respond; below that point, there was little

² “Debit Card Interchange Fees and Routing; Final Rule.” 12 CFR Part 235. Federal Register 76:43394 (July 20, 2011) p. 43422.

³ *Id.* at 43432.

⁴ The Board defined “allowable costs” for the base component as those associated with issuer authorization, clearing and settlement (ACS costs), excluding fraud losses, which are reflected in the ad valorem component. *Id.* at 43404.

⁵ “Debit Card Interchange Fees and Routing.” Federal Register 77:46258 (August 3, 2012).

difference between similarly-ranked issuers, while above that point, per-transaction costs by issuer varied significantly.⁶

The Board recognized that the distribution of costs across issuers was skewed and that it would not be reasonable to set a standard that fully covered the significantly higher costs of the issuers falling above the 80th percentile:

*It appears that some of these higher-cost issuers may face unique circumstances regarding their overall business orientation; for example, some of the issuers with high reported costs appear to be organizations whose commercial banking operations (and associated debit card programs) are small relative to their overall operations. **The Board therefore does 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** [emphasis added].⁷*

Subsequent surveys were not optional and generated significantly greater issuer response than the 2009 survey.⁸ This more comprehensive data diverges from the initial survey data in an essential respect. Comparing the 2011 issuer survey to the baseline 2009 survey, while reported average allowable costs decreased 34%, the costs of the issuer at the 75th percentile doubled.⁹ This suggests that the additional responses in 2011 included a substantial number of issuers with small, high-cost debit card portfolios.¹⁰ The continued inclusion of data from a larger number of high-cost portfolios in subsequent issuer surveys has further distorted the results, preventing an apples-to-apples comparison of more recent data to the 2009 survey on which the Board's decisions were based.

In addition, comparisons among the 2011 and later studies, where the number of respondents were similar, show that the allowable costs of a specific issuer percentile over time are highly inconsistent. For example, the reported costs of the 75th percentile swung more than \$0.23, between a low of \$0.185 and a high of \$0.422.¹¹ An individual issuer's costs presumably do not vacillate so dramatically from year to year; rather, the volatility signifies that the representative issuer at a particular percentile is likely not the same institution from year to year due to shifts in the relative size of issuer portfolios over time. In addition, comparing the cost trend among issuers based on volume reveals that the greatest fluctuation occurs among low-volume issuers.

The survey data demonstrates that the allowable costs of a representative issuer or an issuer percentile are inherently volatile over time, and thus a particular percentile is not a suitable benchmark for the base

⁶ 76 Fed. Reg. 43433.

⁷ *Ibid.*

⁸ There were 131 survey responses in 2011, almost 50% higher than the 89 responses in 2009.

⁹ Although the 80th percentile was chosen as the benchmark to set the base rate in 2009, that data point has not been reported in subsequent surveys. In the absence of directly corresponding information, the closest available substitute for purposes of this discussion appears to be the 75th percentile. Board of Governors of the Federal Reserve System (U.S.). *regiireportsdata.xls*. Table 14. Last Modified 2/25/2019.

¹⁰ "Covered issuers" are those with assets of \$10 billion or more. However, some of the largest institutions have comparatively small debit card portfolios – only about 60 covered issuers are within the top 100 debit issuers see the analysis of OP 50 U.S. Debit Card Issuers and the Second 50 Largest U.S. Debit Card Issuers in *The Nilson Report*, Issues 1129 and 1131 (April and May 2018). As a result, atypically high-cost low-volume portfolios are included in the analysis, while larger and more efficient portfolios are exempt.

¹¹ Federal Reserve Board, *supra* note 9, at Table 14.

component of the interchange fee standard. Rather than the 75th or 80th percentile, the *average* allowable cost per transaction for *all* covered issuers is the appropriate reference point. This 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).

The biannual issuer surveys also show that issuers' allowable costs have decreased significantly since implementation, and as a result, the interchange fee established in 2011 is neither reasonable nor proportional to current issuer costs, as required by the EFTA. Interchange can be a contentious topic for the key participants in an electronic debit transaction. Reasonableness should be an objective standard. While the word is not defined in the statute, the Board addressed the meaning in its comments, saying:

*"The statute's use of the term 'reasonable' implies that, above some amount, an interchange fee is not reasonable. The term 'reasonable' commonly is defined as meaning 'fair, proper, or moderate' or 'not excessive,' and what is 'reasonable' generally depends on the facts and circumstances [footnote omitted; emphasis added]."*¹²

The current base component has become excessive because the allowable costs it is intended to compensate have come down significantly while the rate has stayed the same. The average allowable costs have consistently decreased with each of the five issuer surveys conducted to date, showing a clear trend towards greater efficiency. By 2017, average allowable costs had decreased to \$0.036, which is 54% lower than in 2009,¹³ but the base component has not changed. The \$0.21 base component is almost six times the 2017 issuer average allowable costs of \$0.036.

Notably, according to the 2017 issuer survey, the base component exceeds the issuer's costs on over 99.7% of transactions.¹⁴ In its comments to the regulation, the Board stated that it was establishing a rate that was less than the costs of the highest-cost issuer because it *"does 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."*¹⁵ We recognize that the percentage of transactions is not the same measure as the percentage of issuers, but this is another reflection of how the base rate is no longer reasonable. We believe it is inconsistent with the statutory purpose to permit fees that accommodate the full recovery of costs on all but a fraction of transactions.

Issuers also derive benefits from electronic debit transactions outside of interchange. For example, debit cards have become the principal means for account holders to access their deposit accounts to make payments and so are a necessary feature to retain existing customers and attract new account holders. The deposits in those accounts, in turn, provide a low-cost source of funds for issuers to support lending and other profitable activities. Debit cards have supplanted paper checks, which are required by the Federal Reserve to clear at par, shifting issuer costs to merchants for payment transactions as to which each participant previously bore its own costs.¹⁶ The regulated interchange rate should not serve as an additional profit center for covered issuers.

¹² 76 Fed. Reg. at 43423.

¹³ Federal Reserve Board, *supra* note 9, at Table 13.

¹⁴ *Id.* at Table 15.

¹⁵ 76 Fed Reg. at 43433.

¹⁶ It is worth noting that the EFTA requires the Board to consider the functional similarity of electronic debit transactions to checking transactions in establishing the interchange fee standards. 15 U.S.C. § 1693o-2(a)(4)(A).

In its rulemaking comments, the Board said: “*The use of the term “proportional” requires a relationship between the interchange fee and costs incurred. [...] The term “proportional” has a variety of meanings, including ‘forming a relationship with other parts or quantities’ or ‘corresponding in degree, size, or intensity.’*”¹⁷ The original proportionality of the base component to the average covered issuer’s allowable costs has badly deteriorated over time as average allowable costs have steadily decreased. Specifically, 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. The same base component is now 5.9 times higher than the \$0.036 average allowable costs in the 2017 survey.¹⁸

The Board initially rejected a “mathematical” interpretation of proportionality that would require a constant relationship across all “quantities.”¹⁹ In doing so, the Board said its standard fulfilled the proportionality requirement by allowing only quantities or costs with the required relationship to an electronic debit transaction. However, we believe these comments were intended as support for the initial regulated interchange fee, not as a rationale to proscribe adjustments to the standard over time. As the Board acknowledged, if issuers become more efficient, the resulting lower costs should result in a lower interchange fee. It follows that the standard should also result in consistent proportionality over time between the regulated fee and average allowable costs.

Most observers would not consider the base component “reasonable” or “proportional” when it pays issuers almost six times their aggregate allowable cost, over and above the separate value issuers receive from accounts and customer activity, including deposits. Nor is it “fair, proper or moderate” that the base component alone fully reimburses issuers’ costs on over 99.7% of transactions, even for the least efficient institutions. The Board should reset the base component of the interchange rate to be not more than the original multiple of 2.7 times average allowable costs. Based on the 2017 issuer survey, this would reduce the base component from \$0.21 to \$0.097. This adjustment would restore the rate’s original proportionality and still fully reimburse the issuer’s costs on over 96% of transactions.²⁰

Because of the growing disproportionality of the base component, merchants – and, through the resulting higher prices, consumers – have paid an estimated \$30 billion more since the regulation was implemented than they would have paid if the rate had been adjusted over time to maintain its original proportionality to issuer costs.²¹ In 2020 alone, the additional cost to merchants and consumers is expected to exceed \$5 billion.²² We ask that the Board act expeditiously to begin the process of resetting the standard. We also propose that the Board establish regular review and adjustment procedures, based on the results of the biannual issuer surveys, to ensure the rate remains reasonable and proportional over time.

The Ad Valorem Component is No Longer Appropriate

Consistent with the base component, the ad valorem component of the interchange fee is required to be reasonable, which the Board defined to mean fair, proper and moderate. The ad valorem component was intended to allow issuers to recover a portion of their per-transaction fraud losses. The Board’s 2011 rulemaking set this component at five basis points per transaction, which equaled the per-transaction

¹⁷ 76 Fed. Reg. at 43423.

¹⁸ Federal Reserve Board, *supra* note 9, at Table 13.

¹⁹ 76 Fed Reg. at 43423.

²⁰ Estimated from Federal Reserve Board, *supra* note 9, at Tables 12 and 14.

²¹ Federal Reserve Board, *supra* note 9, at Tables 3 and 13.

²² Projection does not account for potential changes in spending patterns due to pandemic.

fraud losses of the median issuer in the 2009 survey. Due to significant changes in the environment since 2011, the ad valorem component no longer serves its intended purpose, and it should be eliminated.

The Board contemplated that issuers would continue to bear the cost of some fraud losses, and that this would serve as an incentive for issuers to reduce fraud: *“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* [emphasis added].”²³

According to the 2017 issuer survey, the ad valorem component is reimbursing covered issuers more than the entire amount of their fraud losses on electronic debit transactions, not just a portion of their losses as the Board had contemplated.²⁴ This is fundamentally unreasonable and unfair, and the inequity has been exacerbated by a substantial increase in merchants’ own liability for fraud losses. Merchants now directly incur the majority of debit transaction fraud losses – survey data shows that merchants’ overall share increased from 38% in 2011 to 53% in 2017²⁵.

Any discussion about allocation of fraud losses must acknowledge the fact that issuers are the ones who put payment products in the market and determine what security features those products will have, both by design of the product and by network selection. Issuers have a variety of options to minimize fraud through product design and functionality, yet the ad valorem component creates an incentive for them to invest elsewhere since their fraud losses are more than fully reimbursed.

In establishing the ad valorem component, the Board evidently adopted the issuer commenters’ rationale that merchants are *“in a unique position to prevent fraud losses by checking for cardholder identification or signature, among other things.”*²⁶ Discussing the merchant’s role, the Board said: *“[N]etwork rules that are vague with respect to merchant requirements for authenticating a signature may lead to fraud losses being borne by the issuer when the merchant was in a position to compare the cardholder’s signature with the signature on the back of a card and prevent the fraud* [emphasis added].”²⁷ Essentially, the Board was saying that the fraud loss should be borne by the party in the best position to prevent it, in this case placing special emphasis on the merchant’s role in checking signatures to detect fraudulent use of a card (even while acknowledging that the networks had been unable or unwilling to articulate how to do so). Still, whether or not this rationale for the ad valorem component was sound in 2011, it has since been rendered obsolete.

EMV chip card technology was introduced by the networks in the United States in 2014. EMV provides issuers with additional data to analyze in deciding whether to authorize a card-present transaction. Because the technology operates at the physical point of sale, merchants incurred enormous costs in replacing all point of sale terminals and reprogramming payment acceptance systems (including, it must be noted, the incremental work required to counter tactics employed by the networks to inhibit merchant routing choice, of which the Board and its staff are aware). As 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 at the point of sale. As reflected in the issuer survey data, EMV technology has

²³ 76 Fed. Reg. at 43431.

²⁴ According to the 2017 Issuer Survey, total issuer fraud losses were .0475% as a share of transaction value. The ad valorem component is .05%. Federal Reserve Board, *supra* note 9, at Table 11.

²⁵ *Ibid.*

²⁶ 76 Fed. Reg. at 43431.

²⁷ *Ibid.*

substantially reduced fraud on card-present transactions, minimizing issuers' actual fraud losses correspondingly.

After implementing EMV, all four major card networks²⁸ ended the requirement that merchants capture a signature at all, let alone attempt to authenticate it, thereby acknowledging at last that signatures never added any real value in fraud prevention²⁹ and also eliminating a key reason that the Board originally determined that merchants should reimburse issuers' fraud losses. The merchant's role in preventing card-present fraud is largely dependent upon the fraud control features put in place by the issuers and networks. Now that signature comparison is no longer required, fraud control at the merchant level consists primarily of technology upgrades to comply with EMV requirements at the physical point of sale, as well as additional procedures to mitigate card-not-present fraud. EMV technology – when used at the physical point of sale - clearly puts issuers in the best position to identify potential fraud at the physical point of sale. Where issuers are in the best position to prevent fraud, it is unreasonable to require that merchants reimburse issuers' fraud losses through the ad valorem component.

Unfortunately, fraud on all digital transactions has increased, and merchants' fraud liability has increased accordingly. As directed by network rules, merchants have always incurred most of the fraud losses on electronic debit transactions in the digital space.³⁰ This is in spite of the fact that issuers and networks are in many cases in the stronger position to identify potentially fraudulent digital transactions – a merchant's view of the customer is limited to its own experience, while the issuer can evaluate a transaction in the context of all account activity as well as accountholder information. Despite this network allocation of fraud liability, merchants continue to pay the ad valorem component on every digital transaction. In effect, the merchant is "reimbursing" the issuer for theoretical fraud losses on a transaction where the issuer has no actual fraud exposure.

Issuers actually have implemented tools for fraud mitigation on digital transactions - but these tools are made available to merchants at an additional cost, not as an inherent feature of the functionality, despite the fact that merchants are also paying the ad valorem component AND the additional fraud prevention adjustment.

Moreover, recent survey results show that the percentage of transactions that are digital is increasing dramatically. Digital transactions now include not only traditional card-not-present internet purchases but also a rapidly growing number of transactions where payment occurs online but delivery is made at or from the physical store through a variety of strategies, such as mobile checkout within stores, in-store pickup, curbside pickup, and same-day delivery from the store. In addition, while overall fraud has not decreased, the introduction of EMV technology has merely shifted fraudulent activity to digital commerce. As a result, because of the way network rules allocate fraud liability for digital transactions, merchants' share of fraud losses continues to increase, while merchants also continue to reimburse issuers more than the full cost of their fraud losses.

²⁸ Visa, Mastercard, American Express and Discover.

²⁹ As the Board acknowledged, network rules for signature authentication were vague (and in some cases limited a merchant's ability to decline a transaction). 76 Fed Reg. at 43431. In addition, if signature comparison was effective in reducing fraud, the networks would not have abandoned it – EMV technology detects counterfeit cards, but it does not prevent fraudulent use of a stolen card.

³⁰ According to the 2017 survey, merchants directly bear 71% of digital fraud losses. This figure has remained relatively consistent since 2009. Federal Reserve Board, *supra* note 9, at Table 11.

The Board in its comments also cited merchant or acquirer data breaches as a source of fraud outside the issuer's control that warranted requiring merchants to pay for fraud losses that the network rules allocate to the issuer: "*Payment card network rules allocate responsibility for fraudulent transactions, but this allocation does not necessarily result in the loss ending up with the party that was in the best position to prevent the fraud. For example, the loss may have occurred from a data breach at a merchant or acquirer not involved in the fraudulent transactions.*"³¹ It isn't clear why the Board determined that the network rules (including those specifically intended to address data breaches, such as Visa's Global Compromised Account Recovery (GCAR) program) were inadequate in their allocation of fraud liability, or to what extent this consideration was determinative in the Board's decision to establish an ad valorem component reimbursing issuers for fraud losses. Retailers are not the sole source of data breaches. When fraud occurs on an account through unauthorized access to card numbers and cardholder personal information, identifying how the information may have been compromised is rarely precise. This cardholder information can be obtained through a variety of channels, including via phishing attacks or simple cardholder carelessness.

Furthermore, issuers and other service providers have also been compromised by data breaches. Notably, the 2017 breach of the issuer service provider Equifax was particularly harmful due to the breadth of data exposed, which we believe worsened the problem of account takeovers and digital fraud losses – which, again, are borne by merchants rather than issuers.³² Meanwhile, the ad valorem component applies to every covered transaction without regard for how the network rules allocated the actual loss or who may have been in the best position to prevent it.

The EFTA's stated purpose is to "*provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund and remittance transfer systems. **The primary objective of this subchapter, however, is the provision of individual consumer rights** [emphasis added]."*³³ We believe this purpose encompasses a policy goal of reducing debit card fraud losses because of the direct and indirect costs such fraud imposes on consumers. While consumers are generally protected from direct fraud losses, indirect costs include a sense of victimization as well as inconvenience when a debit card must be reissued. Although ideally businesses would choose to protect their customers, the *raison d'être* for EFTA is that sometimes there is a misalignment of interests.³⁴

The most effective way to accomplish an overall reduction in fraud is to make sure all parties have an incentive to combat fraud. The ad valorem component of the debit interchange fee has proven antithetical to this objective. The Board's theory was that issuers would have an incentive to reduce fraud losses even though they are reimbursed by a static ad valorem component. In fact, the incidence of fraud on covered transactions has more than doubled since the ad valorem component was implemented, rising from 3 basis points in 2011 to 7.2 basis points in 2017.³⁵ Meanwhile, industry changes have significantly reduced the fraud losses borne by issuers; merchants are now incurring a greater proportion of the cost directly while also reimbursing issuers at an inflated rate.

³¹ 76 Fed. Reg. at 43431.

³² Verizon Enterprise Solutions, 2019 Data Breach Investigations Report, page 30.

³³ 15 U.S.C. § 1693(b).

³⁴ Issuers have cited their obligation under the EFTA to hold accountholders harmless for unauthorized transactions as justification for using interchange to recover fraud losses from merchants, but this is a red herring. Where the EFTA creates issuer liability, the issuer is reimbursed as provided by the allocation of fraud liability amongst issuers, merchants, and other industry participants under the card network rules to which the issuer contractually agreed.

³⁵ Federal Reserve Board, *supra* note 9, at Table 10.

We again respectfully ask for the Board to consider a different approach. The market has changed for both issuers and merchants. Fraud loss and fraud prevention are a shared burden in practice, and we submit that it is objectively unfair to require that merchants reimburse issuers for fraud losses. For all the aforementioned reasons, the Board should eliminate the ad valorem component.

A Fraud-Prevention Adjustment is No Longer Appropriate

The final element of debit interchange for covered issuers is the fraud-prevention adjustment, which the EFTA authorized the Board to establish **if** “(i) such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer; and (ii) the issuer complies with the fraud-related standards established by the Board.”³⁶ In its rulemaking, the Board indicated that a fraud-prevention adjustment would be appropriate to reimburse issuers for the expense of implementing fraud prevention measures such as transaction monitoring, research and development, card activation systems, PIN customization, merchant blocking, and card authentication systems.³⁷

The Board established the adjustment at \$0.01 per transaction, which represented the median issuer fraud prevention costs (not including transaction monitoring, which is included in allowable costs compensated by the base component of the interchange rate). However, changes in the industry and in the nature of debit card fraud have rendered the fraud-prevention adjustment ineffective, inconsistent with the original policy objective, and unfair to merchants.

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.”³⁸ These factors include the nature, type, and occurrence of fraud; the extent to which fraud depends on whether authentication is based on signature, PIN, or other means; the means by which fraud may be reduced; the fraud-prevention and data-security costs expended by each party (including consumers, merchants, issuers, and networks); the fraud costs absorbed by each of the same parties; and the extent to which interchange transaction fees reduce or increase parties’ incentives to reduce fraud. Importantly, these factors are clearly and intentionally not limited to consideration of only issuers’ fraud exposure or fraud-prevention costs. The assumption underlying the fraud-prevention adjustment is that issuers’ fraud prevention measures protect merchants, and merchants should therefore compensate issuers for their costs.

In reality, the nature of fraud and fraud prevention, as well as the allocation of fraud and data security costs among the parties to a transaction, have transformed in the intervening years to the point that requiring merchants to reimburse issuers for their fraud-prevention costs is obsolete. Accordingly, the fraud-prevention adjustment is not reasonably necessary and should be eliminated. Merchants as well as issuers incurred enormous costs in implementing EMV, which served primarily to reduce issuers’ exposure.³⁹ In addition, with the dramatic surge in digital transactions, merchants have invested even more heavily in fraud prevention procedures and technology systems to mitigate fraudulent transactions.

³⁶ 15 U.S.C. § 1693o-2(a)(5)(A).

³⁷ 76 Fed. Reg. at 43397.

³⁸ 15 U.S.C. § 1693o-2(a)(5)(A).

³⁹ “In evaluating the cost of a particular technology, an issuer should consider whether and to what extent other parties will incur costs to implement the technology, even though an issuer may not have complete information about the costs that may be incurred by other parties, such as the cost of new merchant terminals. In evaluating the costs,

Meanwhile, issuers appear to have undertaken little of the escalating fraud prevention expense for digital transactions, despite their obligation to respond to new or changing fraud risks. The Board stated in its final rulemaking: “To be eligible to receive the fraud prevention adjustment under § 235.4(a)(1), an issuer must develop and implement policies and procedures reasonably designed to take **effective steps to reduce the occurrence of, and costs to all parties from, fraudulent electronic debit transactions, including through the development and implementation of cost-effective fraud-prevention technology** [emphasis added].”⁴⁰ Consistent with the statutory mandate, the issuer’s fraud-prevention measures are required to address fraud on every type of transaction:

*“[A]n issuer should consider whether its policies and procedures are effective for **each method used to authenticate the card** (e.g., a chip or a code embedded in the magnetic stripe) and the cardholder (e.g., a signature or a PIN), **and for different sales channels** (e.g., card-present and card-not-present) [emphasis added].”⁴¹*

A critical obligation for issuers is that they review their fraud-prevention procedures *at least annually* (and more frequently, if warranted) and make updates based on (i) whether the procedures are effective in reducing *both the occurrence and the cost* of fraudulent transactions; (ii) cost-effectiveness; and (iii) changes in the types of fraud, methods used to commit fraud, and available methods for detecting and preventing fraudulent transactions.⁴² In practice, it is unclear if issuers have evaluated the effectiveness of their fraud prevention efforts. The biannual survey results have not reflected any changes issuers have made in this regard. Merchants question whether issuers are implementing this directive to evaluate and adjust their fraud prevention processes on a regular basis. Moreover, merchants are not aware of any issuer not qualifying for the one cent fraud prevention adjustment. If that is correct, it indicates that issuers are not being held to account for ensuring that their fraud prevention practices are effective.

As the Board observed, “*in certain circumstances, an issuer’s policies and procedures may be effective notwithstanding a relative increase in the transactions that are fraudulent in a particular year. However, continuing increases in the share of fraudulent transactions would warrant further scrutiny.*”⁴³ We submit that the systematic failure to evaluate fraud prevention practices, combined with the increase in fraudulent transactions, demonstrates that the fraud prevention adjustment has been ineffective and is obsolete.

Responses to the Board’s biannual surveys do not elaborate on where issuers focus their fraud-prevention efforts and expenditures, but experience would indicate they have not effectively managed their policies to adapt to trends in the occurrence and the cost of fraud. Issuers’ fraud-prevention procedures, funded in large part by the adjustment, did not prevent the incidence of fraud from more than doubling in six years, from 3 basis points in 2011 to 7.2 basis points in 2017. Moreover, due to changes in the industry as described above, liability for these fraud losses has increasingly fallen on merchants. Over the same period, merchants’ share of this growing pool of fraud losses rose from 38% to 53%. This indicates that

an issuer should consider both initial implementation costs and ongoing costs of using the fraud-prevention method.”
77 Fed Reg. at 46281.

⁴⁰ *Id.* at 46279.

⁴¹ *Id.* at 46281.

⁴² *Id.* at 46280.

⁴³ *Id.* at 46281.

issuers have not met the burden of updating their policies and procedures in light of changing circumstances, including the relative increase in fraud on digital transactions.

In fact, issuers may be more lenient in their fraud scoring when they do not bear the fraud liability, which is in direct contradiction to their regulatory obligations:

*“An issuer should take steps reasonably designed to reduce the number and value of its fraudulent electronic debit transactions relative to its non-fraudulent electronic debit transactions. These steps should reduce the costs from fraudulent transactions to all parties, not merely the issuer. For example, **an issuer should take steps to reduce the number and value of its fraudulent electronic debit transactions relative to its non-fraudulent transactions whether or not it bears the fraud losses as a result of regulations or network rules** [emphasis added].”⁴⁴*

We’ve heard this anecdotally, but more importantly, it is apparent in the numbers. In digital commerce, where merchants bear the fraud risk, issuers approve fraudulent transactions at a rate that is many times higher than in stores, where issuers bear more of the fraud risk. Merchants are left to apply their own underwriting on digital transactions to cancel fraudulent orders and mitigate the risk of loss. The fraud-prevention adjustment does not account for this shift in fraud prevention costs, particularly on digital transactions.

It is apparent that neither the ad valorem component nor the fraud-prevention adjustment serves as an incentive for issuers to reduce fraud. Both are merely additional elements of the amount merchants are charged by covered issuers for electronic debit transactions. Merchants are spending an increasing amount on fraud prevention and data security while bearing the bulk of fraud losses. The fraud-prevention adjustment, like the ad valorem rate, is based on an outdated assessment of both fraud exposure and fraud prevention activity, and it too should be eliminated.

* * *

The Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act was meant to protect merchants, and by extension consumers, against the unchecked escalation of debit interchange fees. Electronic debit transactions have evolved significantly since 2011, and substantial changes in the interchange fee standards established by the Board are long overdue. We propose that the base component be reduced to reflect current data on allowable costs, and that both the ad valorem component and the fraud-prevention adjustment be eliminated.

Further, the Board should establish an objective and repeatable process to re-evaluate the rate periodically in response to updated information. The regulated rate established by the Board in 2011 has remained static for nine years now, despite the steady reduction in issuer costs that is evident from the Board’s bi-annual surveys. Merchants have not enjoyed the benefit of the efficiencies that have reduced issuers’ allowable costs, as the Board originally contemplated. Instead, we – and by extension, the consumers we serve – are once again paying an unreasonable and disproportionate premium. We recommend that the Board revise the current rate structure and implement changes expeditiously to restore fairness as required by the EFTA.⁴⁵

⁴⁴ *Ibid.*

⁴⁵ It must be noted that the current imbalance is the result of the construct established in the 2011 rulemaking. The Board was directed to establish “standards for assessing” whether an interchange transaction fee satisfies the

Once again, we thank you for your attention over the past several years on this topic and for your consideration in addressing the important issues outlined in this paper. We are prepared to provide any additional information the Board may request to help expedite this process, and we welcome the opportunity to discuss these issues at your convenience.

Sincerely,

3088 Investments LLC dba Island Chevron and Grill
36 Lyn Refuel Station
7-Eleven, Inc.
Acme Fresh Market
Alabama Grocers Association
Alabama Retail Association
Alabbasi Group
Aldi
Alex Lee, Inc.
Amazon.com
Ampal Group
Arizona Food Marketing Alliance
Arizona Petroleum Marketers Association
Arizona Retailers Association
Atlanta Retailers Association
Bader's Food Mart, Inc.
Bambury, Inc. dba BONNEAU
Best Buy
Big O's Git & Go Inc.
Bill's Automotive Repairs & Mobil Gas
Blarney Castle Oil Co.
Bobby and Steve's Auto World
Boots Bros. Oil Co., Inc..
Braney Holdings LLC, DBA Eagle Point Fuel
Brian Head General Store
C.E. Taylor Oil, Inc. dba Chuckles
California Fuels & Convenience Alliance
California Grocers Association
Callaway Oil, Incorporated
Carl & Amy's Naalehu, LLC
Carolinas Food Industry Council
Carroll Motor Fuels

Casey's General Stores, Inc.
Certified Oil
Champlain Farms
Chesley's Mini Mart Inc.
Circle K Stores Inc.
Coastal Convenience Store Group, dba Tinee
Giant Food Mart
Colorado Retail Council
Columbia Fast Serv, LLC
Colville Fuels, LLC
Community Service Stations, Inc.
Connecticut Food Association
Connecticut Retail Merchants Association
Convenience King Food Stores
Crawford Oil Co, Inc.
Crossroads Pantry, Inc.
Cumberland Farms
Cusick Corporation DBA 7th St Valero
CVS Health
Davenport Energy Inc.
DC Oil Company, Inc.
Delaware Food Industry Council
Der Markt Food Store
Dollar General
Domino Food and Fuel, INC.
Douglass Distributing Company
DuPont Grocery
E Z Stop Food Marts Inc.
E&C Mid Atlantic Ventures LLC / E&C Enterprises
E&K Convenience Inc.
Eastern Petroleum Corporation, dba EP Mart

statutory mandate. 15 U.S.C. § 1693o-2(a)(2). The Board elected to fix a regulated interchange fee rate rather than establishing criteria to assess whether a particular interchange fee is reasonable and proportional relative to the issuer's cost for that transaction. By requesting relief within the construct established by the initial rulemaking, merchants do not concede that the approach taken in the rulemaking is the proper implementation of the mandate.

Eastgate Travel Plaza, LLC dba Hat Six Travel Center
EG America
Ernie's Truck Plaza, Inc.
Family Express Corporation
Fastrac Markets
Feather Petroleum Company
Fill-n-Chill Convenience Stores
Florida Petroleum Marketers Association
Florida Retail Federation
Flying Tigers
FMI – The Food Industry Association
Folk Oil Company/PS Food Mart
Food Giant, Inc.
Food Industry Alliance of New York State
FoodShop, Inc.
Gastrak Operators
GATE Petroleum Company
Gelson's Market
Georgia Association of Convenience Stores
Georgia Food Industry Association
Georgia Oilmen's Association
Giant Eagle, Inc.
Glassmere Fuel Service
Golden Pantry Food Store, Inc.
Grand View General Store
Granite State Convenience
Granite State Hospitality, LLC
GSC- Epsom, LLC
GSC-Concord St., LLC
GSC-S.Willow, LLC
GSC-Tenney, LLC
GT Petroleum Co.
Harps Food Stores
Hellenic LLC, dba Stazione Deli Markets
Hemrick's Grocery
High's Stores
Hy-Vee, Inc.
Idaho Lodging & Restaurant Association
Idaho Petroleum Marketers and Convenience Store Association
Idaho Retailers Association
Idleld Retail, LLC
Illinois Food Retailers Association
Illinois Petroleum Marketers Association/Illinois Association of Convenience Stores
Illinois Retail Merchants Association
Indiana Food & Fuel

Indiana Grocery & Convenience Store Association
Indiana Retail Council
Iowa Grocery Industry Association
J. McCormick, LLC
Jayen Inc.
Jeff Montgomery Associates LLC, dba Chevron at Hunter's Crossing
Johnny Junxions
Johnson Junction
Jordan Oil Company of the Carolinas
Juniper Ventures of Texas
Kansas Food Dealers Association
Kent Kwik Convenience Stores
Kentucky Grocers and Convenience Store Association
Kentucky Petroleum Marketers Association
Kentucky Retail Federation
KNC Holdings, Inc.
Kohl's
Kwik Chek Food Stores
Kwik Shop
Kwik Trip
Latitudes
Leathers Fuels
Leo's Market & Eatery
Lidl US, LLC
Loaf 'N Jug
Lorraine's Snack Bar
Lou Perrine's Gas and Groceries
Louisiana Oil Marketers & Convenience Store Association
Louisiana Retailers Association
Lowe's Companies
M. M. Fowler, Inc. dba Family Fare
Mahalaxmi Petroleum Inc. dba Sixes Road
Texaco
Maine Energy Marketers Association
Maine Grocers & Food Producers Association
MAPCO Express, Inc.
Maryland Association of Chain Drug Stores
Maryland Retailers Association
Massachusetts Food Association
McIntosh Energy Co.
Merchant Advisory Group
Metro Petro
Michigan Petroleum Association/Michigan Association of Convenience Stores

Michigan Retailers Association
 Mid-Atlantic Petroleum Distributors Assn
 Midwest Petroleum Company
 Mighty Moose Marts LLC
 Minit Mart
 Minnesota Grocers Association
 Minnesota Petroleum Marketers Association
 Minnesota Retailers Association
 Minnesota Service Station & Convenience Store Association
 Mississippi Petroleum Marketers & Convenience Stores Association
 Missouri Grocers Association
 Missouri Petroleum Marketers & Convenience Store Association
 Missouri Retailers Association
 Missouri Tire Industry Association
 Morton's Truck Stops Inc.
 Mountain Counties Supply Company
 Music Station Inc.
 National Association of College Stores
 National Association of Convenience Stores
 National Grocers Association
 National Retail Federation
 Nebraska Grocery Industry Association
 Nebraska Petroleum Marketers & Convenience Store Association
 Nebraska Retail Federation
 Neighborhood Market Association
 Nevada Petroleum Marketers and Convenience Store Association
 Nevada Retail Association
 New Distributing Company
 New England Convenience Store & Energy Marketers Association
 New Hampshire Grocers Association
 New Jersey Food Council
 New Mexico Retail Association
 New York Association of Convenience Stores
 North American Association of State and Provincial Lotteries
 North Carolina Retail Merchants Association
 North State Grocery Inc.
 Northgate Market
 Ohio Council of Retail Merchants
 Ohio Grocers Association
 Oklahoma Grocers Association
 Oklahoma Petroleum Marketers and Convenience Store Association
 Oregon Neighborhood Store Association
 Otter Creek Country Stores, Inc.
 Palm Harbor Mobil & Automotive PAQ, Inc.
 Parker's
 Pay and Save Inc. dba Lowe's
 Pennsylvania Food Merchants Association
 Pennsylvania Petroleum Association
 Pester Marketing Co.
 Petroleum & Convenience Marketers of Alabama
 Petroleum Marketers and Convenience Store Association of KS
 Petroleum Marketers Association of America
 Pilot Travel Centers LLC
 Plaid Pantries
 PMCA of Kansas
 Potash Markets
 Q Squares
 QuickChek Corp.
 Quik Stop
 QuikTrip Corporation
 RaceTrac Petroleum, Inc.
 Retail Association of Maine
 Retail Association of Nevada
 Retail Grocers Association of Greater Kansas and Missouri
 Retail Grocers Association of Greater Kansas City
 Retail Industry Leaders Association
 Retailers Association of Massachusetts
 Rhode Island Food Dealers Association
 Rmarts LLC
 Rocky Mountain Food Industry Association (serving Colorado & Wyoming)
 Rudy's Markets Inc.
 Russell's Convenience
 Rutter's
 S and L Enterprises, LLC
 Sageland Petroleum, Inc.
 Santa Fe Petroleum
 Sendik's Food Market
 Shahani Inc.
 Short Stop Food Stores
 Siskiyou Development Company, Inc. d.b.a.
 Sports & Spirits Chevron

Smoker Friendly/Gasamat
South Carolina Convenience & Petroleum
Marketers Association
South Carolina Retail Association
Space Age Fuel, Inc
Speedee Mart, Inc.
Speedway LLC
Sprint Food Stores, Inc.
Square One Markets Inc.
Stinker Stores
Sunset Marts Inc.
Target
Tennessee Grocers & Convenience Store
Association
Texas Food and Fuel Association
Texas Retailers Association
The Common Man Roadside
The Convenience Group, LLC
The Ferndale Market
The HanDee Corporation
The Home Depot
The Hub Convenience Stores, Inc.
The Kroger Co.
The Liquor Well Inc.
The Local Yokel
The Maryland Food Industry Council
The PRIDE Stores, Inc.
The Spinx Company, Inc.
Tiger Fuel Co
Tiger Mart
Tobies Station
Tom Thumb
Toms Sierra Co. Inc.
Tooley Oil Company

Town Center Petroleum
Tri State Jewelers Association
Triple S Oil, dba Mr. Gas
Tri-State Petroleum
Turkey Hill
Tustin Arco
Utah Food Industry Association
Utah Petroleum Marketers & Retailers
Association
Utah Retail Merchants Association
Vallarta Supermarkets
Valley Convenience Stores, Inc.
Valley Petroleum, LLC, dba Northsider VPRacing
Fuels
Vapor Source Inc.
Verge Management LLC
Vermont Petroleum Association
Vermont Retail & Grocers Association
Virginia Food Industry Association
Virginia Petroleum and Convenience Marketers
Association
Virginia Retail Merchants Association
W.S. Badcock Furniture
Wakefern Food Corp
Walgreens
Wallis Companies
Walmart
Washington Food Industry Association
Washington Retail Association
Wawa Inc.
Weeler's Service Station
Wisconsin Grocers Association