

October 20, 2023

The Honorable Jerome H. Powell  
Chair  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue, N.W.  
Washington, D.C. 20551

Re: *October 25, 2023 Board Meeting – Financial Sector Opposition to Reopening Regulation II and Policy Reliance on Current Debit Card Data Collections*

Dear Chair Powell:

The undersigned nine trade organizations represent a broad coalition of federally regulated financial institutions, including community banks, credit unions, and military financial institutions who are concerned about regulatory actions impacting the sustainability and affordability of core deposit account services.

We write to urge the Board of Governors of the Federal Reserve System (“Board”) to reject merchant requests for the Board to propose further changes to Regulation II (Debit Card Interchange Fees and Routing).

*Our letter to you today is prompted by a Sunshine Act Notice (“Notice”) that indicates that the Board will meet on Wednesday, October 25 to discuss “[p]roposed revisions to the Board’s debit interchange fee cap.”* The Board has not released details of this scheduled discussion on potential revisions. To enable transparent and rigorous policymaking on a decision of this importance to American consumers, we respectfully request that this documentation be made available to the public this week.

Further, we are concerned that the Board has not collected and published comprehensive and current data about the costs of Regulation II on regulated entities and their checking account consumers prior to undertaking further debit card policymaking. This research should be undertaken first and pay particular attention to detecting whether Regulation II has created unequal and disproportionate access and inclusion impacts on important stakeholders, such as economically disadvantaged or marginalized communities and those serving in or retired from our military. There are good reasons to believe it has done so—and, as such, proceeding with regulatory actions that would magnify these effects should be avoided.

Any action the Board undertakes should be based on robust data and changes in market realities (i.e., fraud and cyber threat environment, transaction types, and routing in multiple environments). Since Regulation II was implemented more than a decade ago, there have been increases in fraud and operational costs that are not currently captured in the Federal Reserve survey.

The impact of a recent Board Regulation II rulemaking on card issuer costs and fraud trends is a key data gap. Simply put, the far-reaching amended routing mandate imposed upon debit card

issuers of all sizes on July 1, 2023 has direct bearing on the data—including authorization, clearing, or settlement (ACS) costs per transaction for lower-volume and mid-volume banks and credit unions that would presumably form the basis for justifying any proposed change to the covered issuer rate cap—but the Board has not collected any data quantifying how the routing rule has affected the market. To be clear, we believe that the Board’s most recent report on Regulation II (which relies on 2019 transaction data) does not support any change to the 21-cent baseline cap, the 5bp *ad valorem* fraud loss offset, or the 1-cent fraud mitigation component. However, in light of the new routing mandate—which is expected to reduce interchange revenues and offers no protection for smaller community banks and credit unions—we urge the Board to pause any efforts to make further changes to Regulation II until it conducts a detailed analysis of the effects of that recently completed rulemaking and its interaction with existing debit interchange restrictions.

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### *We Request an Opportunity to Rebut Merchant Assertions Prior to Any Board Votes*

The merchant petitions and presentations to the Board demanding action on Regulation II are riddled with errors, misleading statements, and false comparisons that appear designed to deceive. As in the merchant groups’ litigation against the Federal Reserve on Regulation II, there is consistent cherry-picking of facts and omission of “inconvenient evidence” that contradicts their advocacy efforts.

For example, we strongly contest many of the factual assertions made by merchant trade associations in a petition dated December 22, 2022 and in materials provided to Federal Reserve staff during a meeting on June 1, 2023. While we believe that Federal Reserve economists are savvy enough to see through the distortions, misrepresentations, and (in some cases) outright falsehoods on which these trade associations base many of their arguments, **we nonetheless respectfully request the opportunity to meet with you to correct the record prior to the Board’s scheduled open meeting on October 25, 2023.** Neither the flawed petition nor the subsequent and similarly flawed meeting materials should form the basis for the Board’s posture on these issues.

We urge the Board not to be misled. Contrary to merchant talking points, **Regulation II has caused significant real-world economic harm to our members and their consumers**—and its recent expansion by the Board is compounding that harm. The Durbin Amendment’s “exemption” of smaller financial institutions has proven to be largely illusory, as the Federal Reserve’s own data shows that regulatory thresholds in the interchange market do not insulate smaller issuers from harm. Specifically, Regulation II data indicate that the average per-transaction interchange fee for exempt single-message transactions has fallen by nearly 31% in inflation-adjusted dollars from 2011 to 2021.

### *Ending Processor Manipulation of Regulation II Should Be the First Priority*

Increasingly, merchants and processors and payments facilitators are manipulating Regulation II in ways that are not credibly supported by statute. We have brought this troubling trend to the Board’s attention several times over the years. Many of us also warned that the Board’s recent expansion of routing rights to card-not-present (CNP) transactions would encourage more

manipulation. Though the new rule has been in effect for only a few short months, our members have already reported that large merchants and processors are manipulating CNP transactions in ways that are introducing fraud risks and creating operational problems for debit card issuers.

The cumulative and underappreciated result of these developments is a reduction in consumer access to affordable core financial products and higher costs. We are disappointed that, so far, the Federal Reserve has steadfastly refused to acknowledge that community financial institutions are facing rising costs and falling revenues because of this manipulation—costs that are on top of the 20% increase in per-transaction ACS costs for low-volume issuers that has occurred over the last decade, according to the Board’s most recently published Regulation II report—and has failed to take action to curb it. Adding to this disappointment is the Board’s willingness to acquiesce to merchant requests regarding practices they consider to be “unfair.” While we acknowledge and appreciate the important role that merchants play in the payments ecosystem, ensuring the soundness and sustainability of all stakeholders, including debit card issuers of all sizes—including community banks and credit unions, many of which are already facing rising debit costs and declining interchange revenues—is, in our view, a more important policy imperative for a financial regulator.

#### *Current Data Collections, Particularly on Debit Fraud, are Not Fit for Further Policymaking*

As noted earlier, current data collections by the Federal Reserve are more than a decade old, reflecting a world of costs and risks that could not have been envisioned then. The data collection instruments are ill suited for purpose and do not adequately reflect the dynamic impacts of Regulation II’s routing mandate, including the Board’s recent expansion to cover CNP transactions.

The data also do not account for changes in processing behavior by merchants, such as radically different transaction types than in the past, such as CNP, fraud mitigation and liability practices, and forced bundling of core bank and credit union software and debit card processing by hybrid debit network/core processors. We also note that some of these processors impose significant fees upon merchants and their markup is too often attributed to issuing bank and credit union interchange, when they are in fact distinct.

#### *Static Measurement of Relevant Factors is Misleading and Outdated*

The Board’s data does not reflect that the payment card market is a two-sided market (a fact affirmed by the U.S. Supreme Court) and treats connected factors in outdated and unrealistic isolation. The Board’s current data collections use a static and outdated model which does not reflect market evolutions and shifts since it was formulated based on market understanding that is at least 12 years old. A two-sided market requires more nuanced analyses that acknowledge changing conditions and the interplay of factors, such as routing choices, transaction types, fraud mitigation, and the delicate balance between issuers, merchants, and debit card users that payment networks must ensure. In light of these data gaps and with the additional uncertainty introduced by the final rule on CNP transactions, any proposal to reopen Regulation II would be premature until such time as this data is collected and analyzed.

*Any Board Action on Merchant Demands is Fully Discretionary*

The Board is under no obligation to act upon the merchants' requests for changes to Regulation II. Merchants are not entities regulated by the Federal Reserve and face no regulatory burden from this rule—from their standpoint, while they benefit tremendously from the U.S. electronic payments system (which is the most advanced in the world because of the investments that issuers and networks have made for decades), any reduction in the cost of accepting electronic payments is a win. We urge a balanced consideration of the interests of all parties—including regulated financial institutions of all sizes and their consumers—before any action is taken. These merchant requests and their characterization of data should not be treated as rebuttable presumptions, but rather as only one perspective among many stakeholders.

*The Scale of Regulation II's Impact on Consumers Demands Caution*

This is not merely a question about routing or interchange, and it does not only affect thousands of financial institutions. Hundreds of millions of consumer checking accounts are inexorably linked to debit card processing and as the Supreme Court has found, cardholder interests matter too. We are concerned that the most recent Regulation II rulemaking did not acknowledge this.

Simply put, the merchants' request for Board action at this time is motivated by a selective reading of narrow and incomplete data. Just as their past claims about consumer savings from promised "pass-throughs" and the effectiveness of "exemptions" have been thoroughly disproven by a bevy of research from leading academics and the Board's own research economists, any promises or representations they make now should be viewed with robust skepticism. We urge you to "stop, look, and listen" so that a baseline of timely, accurate, and comprehensive data about the effect of existing regulations can be developed and analyzed before further action is taken on new rules related to debit card routing and/or interchange.

Sincerely,

AMERICAN BANKERS ASSOCIATION

AMERICAN ASSOCIATION OF CREDIT UNION LEAGUES

CONSUMER BANKERS ASSOCIATION

CREDIT UNION NATIONAL ASSOCIATION

ELECTRONIC PAYMENTS COALITION

INDEPENDENT COMMUNITY BANKERS OF AMERICA

MID-SIZE BANK COALITION OF AMERICA

NATIONAL ASSOCIATION OF FEDERALLY-INSURED CREDIT UNIONS

NATIONAL BANKERS ASSOCIATION