May 9, 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)

Submitted via electronic mail

Dear Ms. Misback:

The Federal Reserve's (Fed) notice of proposed rulemaking (the Proposal) to amend Regulation II (Reg. II), which sets standards for debit card interchange fee regulation, is arbitrary and capricious.[1] **Americans for Tax Reform (ATR),[2] and the undersigned organizations, recommend the Proposal be withdrawn.** The Proposal, as outlined, seeks to biennially adjust the debit card interchange fee framework for banks and credit unions with consolidated assets of at least $10 billion. The initial adjustment to the debit card interchange fee cap would be a decrease in the base component from 21 cents to 14.4 cents and a reduction of the *ad valorem* component from 5 basis points to 4 basis points, alongside a marginal increase in the fraud-prevention adjustment from 1 cent to 1.3 cents.

The Proposal neither offers a substantive cost-benefit analysis nor justifies a need to update the debit card interchange fee cap on a biennial basis. The Fed acknowledges that it "cannot determine at this time whether the potential benefits of the proposal to consumers exceed the possible costs imposed on consumers and financial institution."[3] This alone should be grounds for withdrawing the Proposal.

One other egregious provision in the Proposal is that the Fed will automatically update the debit card interchange fee cap "without inviting public comment"[4] on a biennial basis.[5] This is both arbitrary and affords the Fed with seemingly limitless authority to adjust the debit card interchange fee cap and fraud-

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[1] 88 FR 78100.
[2] ATR is a nonprofit, 501(c)(4) taxpayer advocacy organization that opposes all tax increases and supports limited government, free market policies. In support of these goals, ATR opposes heavy regulation and taxation of financial services. ATR was founded in 1985 at the request of President Ronald Reagan.
[3] https://www.federalregister.gov/d/2023-24034/p-243.
[4] https://www.federalregister.gov/d/2023-24034/p-23.
[5] https://www.federalregister.gov/d/2023-24034/p-3.

prevention component at will. Updating the fee every other year also lacks consistency and invites an excessive amount of uncertainty not just for banks and credit unions, but also small businesses and consumers.

The Proposal allows the interchange fee cap and fraud-prevention component to be updated regularly based on biennial data collected from card issuers made available by a provision mandated in the Durbin Amendment. Such a measure would be tantamount to granting the Fed price-fixing authority in what should be a free market space. Price controls have invariably resulted in distorted and suboptimal market outcomes, and this will be the case if the newly proposed Reg. II provisions are imposed onto the debit card market. If card issuers do not have the flexibility to determine interchange fees as they see fit, they may experience lower profitability, which would translate into a reduction of investment in fraud prevention services for consumers or higher fees tacked on elsewhere to compensate for a revenue shortfall from an artificially low interchange revenue stream.

The interchange fee adjustments also raise concerns under the *Administrative Procedure Act* (APA), which protects against arbitrary and capricious agency actions.[6] Congress authorized the biennial debit card surveys but not biennial updates to the interchange fee cap without stakeholder feedback. These automatic updates lack a clear congressional mandate required for such a substantial shift in policy, thus rendering the action vulnerable to challenge as exceeding the Fed's statutory authority. The Proposal's acknowledgement that it cannot determine the effects on consumers stands in contrast to the Fed's obligation to "examine the relevant data and articulate a satisfactory explanation for its action, including a 'rational connection between the facts found and the choice made.'"[7] The analysis is incomplete and calls into question the veracity of the claims made in favor of the Proposal's provisions.

The biennial updates to the interchange fee cap without a notice and comment procedure was not expressly authorized by Congress. The Fed claims it has the authority to skip the notice and comment process under the "good cause exemption."[8] However, "courts should give no deference to an agency's assertion of good cause."[9] In fact, the courts should be the sole entities to make that determination and ensure the exemption is "not abused."[10]

The Fed has not justified a good cause exemption because the Proposal's metrics are illogical. The calculations for the base component and *ad valorem* component

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[6] https://www.justice.gov/sites/default/files/jmd/legacy/2014/05/01/act-pl79-404.pdf.
[7] Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Automobile Ins. Co., 463 U.S. 29 (1983).
[8] https://uscode.house.gov/view.xhtml?req=(title:5%20section:553%20edition:prelim)%20OR%20(granuleid:USC-prelim-title5-section553)&f=treesort&edition=prelim&num=0&jumpTo=true.
[9] https://review.law.stanford.edu/wp-content/uploads/sites/3/2021/01/Schneider-73-Stan.-L.-Rev.-237.pdf.
[10] *Id.*

are flawed. The ratios are likely lower than they were in 2011 because of the surge in the usage in debit cards. According to the Fed's own data, in 2021, "[t]he number of non-prepaid debit card payments increased most of all card types."[11] Non-prepaid debit cards made up "approximately 56 percent of all card payments in 2021."[12] An increase in total debit card transactions would lower "the transaction-weighted average of per-transaction base component costs."[13] The Proposal states that the *ad valorem* ratio of issuer fraud losses to transaction value also declined. However, there is no discussion of the possibility that the increase in debit card usage from 2011 to 2021 could have contributed to a decline in that ratio. These ratios are fundamentally flawed because an increase in the usage of debit cards will automatically result in the Fed continuously lowering the interchange fee cap.

Calculating the *ad valorem* component as a "median ratio of issuer fraud losses to transaction value among covered issuers" is a misleading figure because the transaction may increase over time merely due to greater usage of debit cards. Even though the overall ratio has declined, the Fed "has observed an overall increase in fraud losses."[14] It can be deduced then that transaction values rose at a greater rate than overall fraud losses. Transaction values may likely go up when the economy is strong or there is widespread usage of debit cards. If this is the case, and assuming fraud prevention technology were to advance, then the automatic adjustments may consistently lower the *ad valorem* component and thus the interchange fee cap. This would greatly reduce revenue for banks and credit unions and would limit services to consumers.

The Proposal admits that government intervention could make banks and credit unions' "checking account and debit card programs less attractive to consumers."[15] The Fed acknowledges that the Proposal could force certain banks and credit unions "to downsize or potentially discontinue their debit card programs."[16] After the Durbin Amendment was enacted, debit card rewards programs were largely eliminated.[17] Finalizing the Proposal is likely to result in similar effects on debit card accessibility and affordability.

The Proposal arbitrarily excludes consideration of certain expenses that are related to the revenue generated from interchange fees. Banks and credit unions have expenses such as rewards programs, "card production and delivery costs,

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11 https://www.federalreserve.gov/paymentsystems/fr-payments-study.htm.
12 *Id.*
13 https://www.federalregister.gov/d/2023-24034/p-91.
14 https://www.federalregister.gov/d/2023-24034/p-120.
15 https://www.federalregister.gov/documents/2023/11/14/2023-24034/debit-card-interchange-fees-and-routing#p-222.
16 https://www.federalregister.gov/documents/2023/11/14/2023-24034/debit-card-interchange-fees-and-routing#p-224.
17 https://www.nerdwallet.com/article/credit-cards/is-congress-going-to-kill-credit-card-rewards.

marketing costs, and research and development costs," which are funded by interchange fee revenue.[18] A surprise reduction in fee revenue from automatic biennial updates could devastate these services. The Fed is dictating how banks and credit unions can earn revenue to fund their operations. This fundamentally flawed government-mandated price control is distortionary and increases costs on other banking products for consumers. According to an article posted by the American Bar Association, "[m]arket distortions inevitably result from price regulation, and this proposed rule, which would amend Regulation II, is no exception."[19] This is evidenced by a recent report from the Government Accountability Office (GAO). In 2022, the GAO highlighted several studies that found the enactment of the Durbin Amendment and implementation of Regulation II increased the cost of checking accounts.[20] Excluding these costs from the calculation for determining the interchange fee cap is fundamentally flawed and harms consumers—contradicting the Fed's claim that the Proposal could pass savings down to consumers. The GAO report shows historical evidence of price controls eliminating options for consumers. Continually tweaking debit card interchange fees will likely result in higher costs on services for consumers.

The Durbin Amendment did not result in merchants passing down savings to consumers. The Federal Reserve Bank of Richmond published a study showing that after the Durbin Amendment was enacted, only 1 percent of merchants lowered prices.[21] Businesses "tend to pass on cost increases far more quickly than cost reductions."[22] As services are less accessible due to the Proposal's government-mandated price controls, businesses will likely pass down these costs to consumers. It is widely observed that "[o]utput prices tend to respond faster to input increases than to decreases" in the producer and consumer goods markets.[23] Adoption of the Proposal will likely fail to pass down savings to consumers.

The Proposal's price controls on the interchange fee cap are prohibiting banks and credit unions from achieving full cost recovery for all debit card transactions. The Fed views full cost recovery as excessive and not in line with the definition of "reasonable."[24] In one footnote, the Fed acknowledges that since 2011:

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[18] https://www.federalregister.gov/d/2023-24034/p-67.

[19] https://www.americanbar.org/groups/business_law/resources/business-law-today/2023-november/fed-proposes-sea-change-debit-card-interchange-fee-regulation/.

[20] https://www.gao.gov/assets/gao-22-104468.pdf.

[21] https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_quarterly/2014/q3/pdf/wang.pdf.

[22] https://www.cuna.org/content/dam/cuna/advocacy/priorities/documents/True-Impact-of-Interchange-Regulation-CornerstoneAdvisors-June-2023.pdf.

[23] https://www.jstor.org/stable/10.1086/262126.

[24] https://www.federalregister.gov/d/2023-24034/p-114.

the Board did not believe that it was consistent with the statutory purpose to permit networks to set interchange fees in order to accommodate 100 percent of the average per-transaction costs of the highest-cost issuers.[25]

The Fed also rejected the notion that the fraud-prevention adjustment should be directly aligned with costs or be able to fully recover the costs for fraud:

The Board rejected an interpretation that would require a direct connection between the fraud-prevention adjustment and actual issuer costs. The Board also did not interpret the statute to require the fraud-prevention adjustment to permit each (or any) issuer to fully recover its fraud-prevention costs.[26]

The continuation of these arbitrary determinations limit banks and credit unions from being able to recover costs from fraudulent activity, which contributes to anemic investment in newer fraud protection technologies. The cost recovery cap may also artificially limit card issuance and the size of rewards programs. It is also another example of imposing distortionary price controls that will permeate through the market.

The Proposal may be in contravention to the major questions doctrine affirmed by *West Virginia v. EPA*.[27] The doctrine mandates explicit congressional authorization for decisions of vast economic and political significance. This is corroborated by the American Bar Association, which posted an article stating that the implications for the Proposal "will reverberate across the payments and banking industries."[28]

The Fed is required to "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions."[29] However, the proposal fails to account for these considerations and appears to fall short of meeting the APA's requirement for reasoned decision-making grounded in a holistic evaluation of relevant factors. Although banks and credit unions with less than $10 billion in consolidated assets are ostensibly exempt from the debit interchange fee cap, this has not been observed. According to a 2014 survey conducted by scholars at the Mercatus Center, nearly half of small banks reported being affected by the Durbin Amendment with "reported decreases in revenue ranging from seven to thirty percent."[30] The Proposal dismisses the notion that small community banks or credit unions would ever be affected by the amendments to the debit card interchange fee cap. However, this is not a consensus viewpoint. One member of

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[25] https://www.federalregister.gov/d/2023-24034/p-114.
[26] https://www.federalregister.gov/d/2023-24034/p-149.
[27] West Virginia v. Environmental Protection Agency, 597 U.S. ___ (2022).
[28] https://www.americanbar.org/groups/business_law/resources/business-law-today/2023-november/fed-proposes-sea-change-debit-card-interchange-fee-regulation/.
[29] https://www.federalregister.gov/d/2023-24034/p-205.
[30] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2435206.

the Board of Governors stated that community banks may be negatively affected by the Proposal because they "use the same payment rails, and smaller issuers inevitably face some degree of pricing pressure, at least indirectly, from the interchange fee cap."[31]

Another article points out that "many community banks that offer credit cards do so through an agent relationship with an issuing bank. For many that is TCM Bank, operated by the Independent Community Bankers of America."[32] Small community banks "will continue to face ongoing fee pressure in operating debit card programs" if the Proposal is finalized.[33]

The Fed must reevaluate the Proposal thoroughly, considering the impact of market dynamics and the statutory framework governing debit card transactions. Conducting and analyzing a quantitative impact study, especially for consumers and low-and moderate-income communities, prior to finalizing the Proposal would be a positive step in the right direction. **Therefore, ATR and the undersigned organizations urge the Fed to withdraw its rule in the interests of fostering a regulatory environment that promotes innovation, competition, and security in the payments ecosystem—a goal that is consistent with the broader public interest and benefits consumers.**

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If you have any questions or need any additional information, please contact Bryan Bashur at bbashur@atr.org.

Sincerely,

Americans for Tax Reform
Americans for Prosperity
American Commitment
The American Consumer Institute
Center for Freedom and Prosperity
Competitive Enterprise Institute
Consumer Action for a Strong Economy
The Heartland Institute
Heartland Impact
R Street Institute
Small Business & Entrepreneurship Council

31 https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231025.htm.
32 https://thefinancialbrand.com/news/banking-trends-strategies/durbin-2-0-threat-banks-credit-unions-brace-for-significant-impact-154844/#:~:text=Merchant%20groups%20have%20hailed%20the,largely%20funded%20by%20interchange%20fees.
33 https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231025.htm.

60 Plus Association
The American Association of Senior Citizens