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May 12, 2024

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Debit Card Interchange Fees and Routing (Docket No. R–1818, RIN 7100-AG67)

Dear Ms. Misback:

On behalf of the Competitive Enterprise Institute (CEI), I respectfully submit the following comments in response to the Federal Reserve's ("the Fed") Notice of Proposed Rulemaking to amend Regulation II, which governs debit card interchange fees and routing.[1] For the various reasons laid out in this comment letter, as well as separate comments in which CEI joined with other free-market organizations[2], CEI urges the Fed to withdraw this destructive rule.

Background:

CEI is a Washington-based free-market public policy organization, founded in 1984, that studies the effects of regulations on job growth and economic well-being. CEI also pursues public-interest litigation on behalf of consumers and small businesses to ensure that federal agencies follow the requirements of the underlying laws and, when applicable, the Administrative Procedures Act, and to ensure that agencies act within the constraints of the U.S. Constitution. Our mission is to advance the freedom to prosper for American consumers, entrepreneurs, and investors striving for a better life for themselves and their families.

[1] I would like to acknowledge the invaluable assistance in preparing these comments of CEI Research Associate Narupat Rattanakit and former CEI Research Associate Mitchell Thornton.

[2] Comment of Americans for Tax Reform et al., May 9, 2024, https://cei.org/coalition_letters/coalition-letter-re-debit-card-interchange-fees-and-routing-docket-no-r-1818-rin-7100-ag67/

CEI has long supported consumer choice and competition and has highlighted the harms of price controls in any sector of the economy. These comments are thus submitted with a great deal of concern about effects of the proposed rule that will reduce consumer welfare and likely harm the safety and soundness of many banks and credit unions as well.

The proposed rule would sharply curtail interchange fees charged by banks and credit unions to retailers to process debit cards. It would slash the maximum fee debit card issuers may charge retailers by almost one-third from 21 cents to 14.4 cents per transaction. In putting forth this rule, the Fed has, in an arbitrary and capricious manner, gone beyond what the law requires. The rule is arbitrary and capricious because in interpreting the language of the law, the Fed disregards standard regulatory and statutory interpretations of the word "reasonable" in setting rates and fees. In addition, the proposed rule raises constitutional concerns by potentially depriving banks and credit unions that issue debit cards of their property rights to a return on capital invested.

As written, Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act – also known as the "Durbin Amendment" -- mandates that interchange fees charged by debit card issuers be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." The law required the Fed to write regulations to implement this provision, which the Fed did in 2011, setting the price cap at its current level of 21 cents per transaction.

Section 1075 also allows, but does not require, the Fed to revise these regulations consistent with the law's intent. The Fed now does so based on a 2021 survey of the debit card marketplace, arguing that a slashing in the price controls for interchange fees to 14.4 cents is now justified because costs for the industry have supposedly decreased. But in proposing this new rule, the Fed treats the unique circumstances of the pandemic that affected costs in 2021 as normal and ignores the rampant inflation since 2021 that almost certainly has raised costs for banks and credit unions issuing debit cards.

I. The Fed inexplicably ignores the rampant inflation in the U.S since 2021 in proposing a rule that claims to reflect true costs.

The 2020s decade has been an especially challenging time for Americans and their families. First, a deadly pandemic and ill-conceived government responses caused unprecedented loss of lives and livelihoods. Then, because of massive monetary stimulus from the Fed and fiscal stimulus from Congress and presidential administrations in response to the pandemic, there has been rampant inflation. The U.S. rate of inflation as measured by the Consumer Price Index (CPI) reached 9.1 percent in 2022, the highest level in the U.S. since 1981.[3] The Producer Price Index, which measures business and wholesale costs, reached a near-record high of 11.2 percent that same year.[4]

[3] Su-Lin Tan, "Yellen warns inflation in the U.S. is 'unacceptably high'," CNBC, July 14. 2022, https://www.cnbc.com/2022/07/14/yellen-warns-inflation-in-the-us-is-unacceptably-high.html

[4] Christopher Rugaber, "US producer prices soar 10.8% in May as energy costs spike," Associated Press, June 14, 2022, https://apnews.com/article/biden-business-economy-prices-inflation-7d2fd525cb5ff2470856d771ec110bde

Yet inexplicably in writing this rule that will have huge ramifications for both consumer welfare and the safety and soundness of the nation's banks and credit unions, the Fed treats as normal some apparent reductions in costs of debit card processing in the year 2021 that can be attributed to unique factors from the pandemic. Then even more curiously, the Fed ignores costs that soared after 2021, when the tide of inflation hit all industries and households.

For instance, in 2020 and 2021, staffing costs fell dramatically in every industry, as employees were sick or had to tend to children at home due to closures of schools and childcare centers. Banks and credit unions were hit especially hard, as many employees with technical knowledge and skills proved difficult to replace.[5] One midsize financial institution reported that its salary costs were 40 percent lower during the pandemic.[6]

Even more egregious is that in writing this rule the Fed *stopped* looking at cost data after 2021, ignoring significant inflation that very likely contributed to cost increases for debit card issuers as it has for every industry. In its comments on the rule, Zions Bancorporation, a midsize regional bank based in Utah, noted that the CPI increased 17.27% between January 2021 and December 2023, in contrast to the significantly lower rate of 10.76% between January 2019 and December 2021.[7]

The rate of inflation shows how inappropriate the new price cap of 14.4 cents is. It is lower in inflation-adjusted dollars than the lowest rate of price cap of 12 cents per transaction the Fed was considering when it initially set the price cap in 2011. A CPI calculation shows that 12 cents in 2011 has the value of 16.24 cents today.[8] So the 14.4 cent price cap is the lowest the Fed has ever considered.

II. The Fed unreasonably excludes many costs of processing debit cards from the price controls it sets.

In addition, many costs of processing debit card transactions weren't even considered under the Fed's calculations. As the Zions Bancorporation comments note, "The 2021 data not only fails to reflect the rising CPI, but it lacks comprehensiveness by failing to encompass critical financial institution costs like card production, card and statement delivery costs, account maintenance, non-sufficient funds handling and losses, and fraud and monitoring costs."[9] Similarly, the coalition comments that we joined note: "The Proposal arbitrarily excludes consideration of certain expenses

[5] Garret Reich, "Banks Barely Keeping Up with Staff Shortages In a Covid World," The Financial Brand, September 7, 2021, https://thefinancialbrand.com/news/bank-culture/why-banks-are-barely-keeping-up-with-staff-shortages-in-a-covid-world-121433/

[6] Interview with industry source, April 29, 2024

[7] Comment letter of Zions Bancorporation, February 27, 2024, https://www.federalreserve.gov/SECRS/2024/March/20240301/R-1818/R-1818_022824_158546_337546312537_1.pdf

[8] Original calculation by the Competitive Enterprise Institute

[9] Comment letter of Zions Bancorporation

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, marketing costs, and research and development costs, which are funded by interchange fee revenue."[10]

In calculating costs, the Fed should not feel unnecessarily constrained by the law's admonition to focus on "incremental costs" of transactions. The Fed has acknowledged that a common economic definition of "incremental cost" includes fixed costs as part of the costs of per transaction.[11] For instance, distinguished economist William Baumol, a professor at Princeton and New York Universities, wrote in the *Yale Journal of Regulation* that "incremental cost" means "total costs" per additional unit produced, and noted that "marginal cost and incremental cost can differ substantially."[12] Similarly, management professors E. Earl Burch and William R. Henry wrote in *The Accounting Review* that "incremental cost is the change in total cost."[13] This is also common sense, because a business - be it a retailer or a bank - would likely not engage in many "particular transactions" if such transactions could not help defray operational costs such as that of renting or owning space in a building.

Yet in this rule, the Fed arbitrarily_disregards this standard definition of "incremental costs" to produce a result that is more harmful than necessary to banks, credit unions, and consumers. Even at the 21-cent level set in 2011, the Fed's implementation resulted in banks sharply reducing free checking for low balance accounts and in debit card rewards virtually disappearing, as the bulk of the costs of processing debit cards shifted from retailers to consumers. And academic studies showed that little if any of the retailers' savings from the price controls were passed on to consumers. [14]

III. The rule's excluding of costs conflicts with the law and potentially the Constitution.

I have shown that the proposed rule ignores the inflation of the past two years in calculating costs. In addition, the preamble states explicitly that certain significant costs are not being considered in

[10] Comments of American for Tax Reform et al.

[11] 88 Fed. Reg. 78100, 78104 (Nov. 14, 2023)

[12] Wiliam J Baumol and J. Gregory Sidak, "The Pricing of Inputs Sold to Competitors," *Yale Journal of Regulation*, Vol. 11, No. 1 (Winter 1994), p. 176, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=289386

[13] E Earl Burch and William R. Henry, "Opportunity and Incremental Cost: Attempt to Define in Systems Terms: A Comment," *The Accounting Review*, Vol. 49, No. 1 (January 1974), p. 119, https://www.jstor.org/stable/244804

[14] John Berlau, "Don't Save Restaurants by Shafting Consumers," Competitive Enterprise institute blog, March 20, 2020, https://cei.org/blog/dont-save-restaurants-by-shafting-consumers/; Todd J. Zywicki, Geoffrey A Manne, and Julian Morris, "Price Controls on Payment Card Interchange Fees: the U.S. Experience," *George Mason University Law and Economics Research Paper Series,* No. 14-18, https://www.law.gmu.edu/assets/files/publications/working_papers/1418.pdf

setting the new price controls.[15] This exclusion of costs conflicts with the underlying Dodd-Frank legislation and potentially the U.S. Constitution.

As these comments stated previously, Section 1075 of the law requires that the Fed set interchange fee caps that are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." It does not authorize the exclusion of any relevant costs from the Fed's calculations. Also, the term "reasonable" in statutes in the context of rate-setting – unless specified otherwise – most commonly has the meaning of total costs plus a minimal rate of return.[16]

In addition to potentially being deemed arbitrary and capricious by courts, this proposed rule may come into conflict with both the Due Process and Takings Clauses of the 5th Amendment, as it may be found to deprive banks and credit unions that issue cards of their property rights to a return on capital invested. The Supreme Court case of *Duquesne Light v. Barasch*[17] affirmed the principle that a government-set "rate is too low if it is 'so unjust as to destroy the value of [the] property for all the purposes for which it was acquired,' and in so doing 'practically *** deprive[s] the owner of property without due process of law.'"[18]

Conclusion: withdraw the rule

American consumers face many headwinds today with high gas and food prices and inflation. They should not be punished with a rule that will likely result in higher bank and credit union fees and more costly financial services. Because this rule conflicts with most Americans' values of freedom and responsibility – as well as potentially the underlying statute and the U.S. Constitution – the Fed should stay true to its mission of protecting consumers and financial stability by withdrawing this rule promptly.

Thank you for this opportunity to present our views. If you have any questions, please feel free to contact me at John.Berlau@cei.org or (202) 331-1010.

Sincerely,

John Berlau

[15] 88 Fed. Reg. 78100, 78104 (Nov. 14, 2023) ("Allowable costs do not include other costs incurred by debit card issuers in connection with their debit card programs, such as corporate overhead and account-relationship costs, general debit card program costs (*e.g.,* card production and delivery costs, marketing costs, and research and development costs), or costs of non-sufficient funds handling, cardholder rewards, and cardholder inquiries.").

[16] Bonbright, James C., Danielson, Albert L. and Kamerschen, David R., Principles of Public Utility Rates, 2nd Edition, Public Utilities Reports, Inc. (1988), p. 10

[17] 488 U.S. 299 (1989).

[18] *Id.* at 307-8 (quoting *Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 597 (1896)).

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