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 Sir or Madam:

I am writing on behalf of the California and Nevada Credit Union Leagues (Leagues), which together form one of the largest state trade associations for credit unions in the United States. We represent the interests of approximately 285 credit unions and their more than 13.6 million members.

In October 2023, the Board of Governors of the Federal Reserve System (FRB) proposed amendments to 12 C.F.R. Part 235 ("Regulation II") regarding debit card interchange fees. Under the proposal:

(1) The base component of the interchange fee cap [§235.3(b)(1)] would decrease from 21 cents to 14.4 cents.
(2) The ad valorem component [§235.3(b)(2)] would decrease from 5 basis points (multiplied by the value of the transaction) to 4 basis points (multiplied by the value of the transaction).
(3) The fraud prevention adjustment would increase from 1 cent to 1.3 cents for regulated transactions [§235.4(a)].
(4) The proposal would codify in Regulation II an approach for updating the above three (3) components of the interchange fee cap every two years, beginning July 1, 2025 to June 30, 2027 [Appendix B to Part 235]. These updates would be based on the most recent data reported to the FRB by covered issuers. *Historically, the FRB has published data two years after its collection (e.g., the 2023 report covered 2021 data, the 2021 report covered 2019 data.*
    - Publication would be scheduled for odd-numbered years by March 31, to take effect on July 1. The FRB believes these biannual determinations would be exempt from the need for notice and public comment, as they will apply the approach specified in proposed Appendix B.

The Leagues strongly oppose the proposed changes to Regulation II concerning debit card interchange fees. We believe these changes will adversely impact not only the operations of credit unions in California and Nevada but also their members who rely on them for affordable and secure financial services.

Below are our specific comments and concerns for your consideration.

**General Comments: *The Credit Union Difference***

We would first like to highlight the distinctive nature of credit unions as compared to other financial service providers. The credit union structure is vastly different than that of for-profit entities. Credit unions are member-owned, democratically governed, not-for-profit cooperatives whose purpose is to promote thrift and improve access to affordable credit for their member-owners, particularly those of modest means.

"Owners" are not just shareholders in a business whose primary goal is to maximize individual shareholder profits. Instead, credit union owners or shareholders are the member accountholders of the cooperative. Credit union earnings are passed on to their member-owners in the forms of reduced fees, higher savings rates, and lower loan rates. They have a volunteer board of directors comprised of members and elected by the members. Each member has one vote, regardless of the amount of shares (funds) held in the credit union. Credit unions exist for the financial benefit of their member-owners, but they are ultimately driven by the philosophy of people-helping-people.

We firmly believe that the unique role of credit unions within the financial services marketplace and the invaluable contributions they make to their members and the communities they serve cannot be understated.

As not-for-profit entities, credit unions often lack diverse revenue streams. They do not have extensive fee-based services or large investment divisions to compensate for lost interchange fee revenue. As a result, any reduction in interchange fees could disproportionately affect covered credit unions, putting them at a competitive disadvantage compared to larger financial institutions.

***1. The proposed rule creates revenue constraints and competitive pressures for credit unions.***

The FRB's proposed rule imposes significant constraints on how credit unions can generate revenue for their operations. Overlooking essential expenses such as card production, delivery, marketing, and research and development costs, the proposed rule fails to consider the comprehensive financial landscape credit unions and other financial services providers navigate.

Studies conducted by the Government Accountability Office (GAO) in 2022 underscored the impact of the Durbin Amendment and Regulation II enforcement on checking account costs.[1] Since the implementation of Regulation II, there has been a marked decrease in the availability of free checking accounts. Before the regulation, about half of non-interest checking accounts offered by covered institutions were free. After its implementation, this figure dropped to less than one-third, as highlighted by the GAO:

> "[*U*]*sing this framework, the Board defined the allowable costs that the Board considered in establishing the interchange fee standards set forth in § 235.3. For reasons explained in the preamble accompanying the 2011 final rule, allowable costs comprise (i) transaction-processing costs, including fixed and variable authorization, clearance, and settlement costs, network processing fees (e.g., switch fees), and the costs of processing chargebacks and other non-routine transactions; (ii) transaction-monitoring costs; and (iii) issuer fraud losses. 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*."

The FRB's assumption that reducing interchange fees will boost debit card transaction volumes overlooks critical factors, such as the pandemic's impact and the rise of e-commerce, which significantly influences

[1] *See* U.S. Government Accountability Office Report to Congressional Requesters "Banking Services: Regulators Have Taken Actions to Increase Access, but Measurement of Actions' Effectiveness Could Be Improved" available at: https://www.gao.gov/assets/gao-22-104468.pdf.

consumer preferences. And there is no indication that interchange fee reductions ultimately translate into consumer savings.

Adjustments to Regulation II could have profound implications for credit unions, impacting revenue generation and competitiveness. Faced with dwindling interchange revenue, credit unions may be forced to look to other member fee increases at a time when regulators, including the Consumer Financial Protection Bureau (CFPB), continue their focus on limiting sources of fee income. Additionally, issuer cost reductions may be necessary to offset income losses. While these adjustments may offer some financial relief, they could render checking account and debit card programs less attractive to consumers.

As a result, consumers may opt for larger issuers or alternative payment methods, exacerbating the potential revenue constriction for credit unions as they struggle to retain their member base in a fiercely competitive financial services marketplace.

It's crucial for the FRB to carefully consider the far-reaching consequences of this proposal on covered credit unions and how it could significantly impact their ability to serve their members and maintain financial stability in their communities.

***2. Codifying automatic updates to the interchange fee cap would freeze out stakeholders and consumers.***

The Leagues strongly disagree with the FRB’s proposed revisions pertaining to automatic updates to the interchange fee cap every two years based solely on data from covered issuers' prior reports to the Board. While the FRB staff believes this approach ensures that interchange fees remain "reasonable and proportional" to issuer costs, we believe it overlooks crucial factors and poses significant challenges for credit unions for the following reasons:

1. The proposed automatic updating mechanism limits the FRB’s transparency and accountability by bypassing the public comment process. By making adjustments to the interchange fee cap without soliciting input from stakeholders, including credit unions and their members, the FRB risks implementing changes that may not adequately reflect the diverse needs and the most current conditions of the banking industry.
2. By not accepting public comments on the allowed costs considered by the FRB when establishing the interchange fee standard, the proposal fails to provide an opportunity for meaningful dialogue and feedback. This omission hampers the ability of credit unions to voice concerns and provide insights into the real-world impact of interchange fee regulations on their operations and members that may not be reflected in reports based on information from two years prior.
3. The biennial update schedule creates uncertainty and the potential to disrupt long-term planning for credit unions. The lack of flexibility in adjusting interchange fees outside of this rigid timeline could hinder the ability to respond swiftly to changing market conditions and evolving consumer preferences.

We urge the FRB to reconsider these provisions and engage in a more transparent and inclusive process that takes into account the diverse needs and perspectives of all stakeholders in the banking industry.

***3. There is insufficient evidence that merchants pass savings on to consumers.***

In the staff memorandum to the Board of Governors of the Federal Reserve, it states:

> *"[W]ith respect to merchants, the proposal should lower merchants' costs of accepting debit card transactions. Merchants, in turn,* ***may*** *pass on some portion of their savings from lower interchange fees to consumers. Furthermore, lower debit card acceptance costs could lead merchants to adopt debit cards in market segments where acceptance may be lower, such as card-not-present (e.g., e-commerce) transactions." [emphasis added]*

However, this has not been observed in practice. Merchants failed to fulfill their promise to consumers by not lowering the prices of consumer goods, despite the anticipated savings from lower interchange fees. In fact, a study conducted by the Federal Reserve Bank of Richmond and Javelin Strategy & Research revealed that 75 percent (75%) of merchants did not change prices due to Regulation II. Moreover, the study found that:

1. Many merchants implemented debit restrictions (such as a minimum purchase or surcharge) as their costs of accepting debit cards increased.
2. Twenty-two percent (22%) of merchants chose to increase prices.
3. Only one percent (1%) of merchants passed savings on to customers.

Consumers face higher costs of potentially $1 to 2 billion per year if this rule is finalized as proposed. It is evident that the interchange fee cap's anticipated cost savings touted by many merchants is unproven and likely unmeasured.[2]

We urge the FRB to consider this reality and reassess its approach.

***4. There are unintended consequences for consumers, particularly in underserved communities.***

The proposal poses a significant threat to consumers, particularly those in underserved communities, who could see reduced access to financial services and higher costs for basic necessities. We encourage the FRB to reconsider the available evidence and prioritize the welfare of consumers over the profit motives of merchants. Failure to do so will only exacerbate the struggles faced by unbanked consumers, further widening the gap between financial inclusion and exclusion.

As highlighted by the GAO's February 2022 study, debit card interchange fee regulations have already increased the cost of checking accounts. Further limitations would not only burden credit unions in California and Nevada with higher operating costs for their debit card programs, but also harm consumers, especially those in underserved communities. Credit unions, as nonprofit financial cooperatives, have long aimed to minimize fees for their members, especially for consumers of modest means. However, lowering interchange fees could eventually lead to reduced access to financial services and increased costs for basic services, disproportionately affecting the most financially vulnerable consumers.

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[2] *See* Bourke, Nick, "How Proposed Interchange Caps Will Affect Consumer Costs" (January 24, 2024). Available at: https://ssrn.com/abstract=4705853 or http://dx.doi.org/10.2139/ssrn.4705853

This proposal threatens to escalate the problem by triggering increases to checking account fees, thereby reducing the availability of free accounts and increasing the number of unbanked consumers. Initiatives like the BankOn program[3], in which many credit unions participate, already face challenges as they strive to connect consumers with safe and affordable bank or credit union accounts featuring low or no fees, no overdraft charges, online bill pay, and other essential attributes. The proposal could have a detrimental impact on unbanked consumers and the vital role credit unions play in providing accessible financial products and services. Upholding the affordability and accessibility of financial services is crucial for promoting financial inclusion and ensuring the well-being of all consumers, especially those in underserved communities.

***5. The proposal will increase challenges for exempt credit unions.***

The FRB believes that the proposal would affect covered issuers (those with $10 billion or more in assets) but not debit card issuers otherwise exempt from the interchange fee cap. However, the Leagues strongly disagree, as these changes would also impact smaller exempt institutions, particularly credit unions.

Despite the FRB's assertions, Regulation II and the Durbin Amendment have posed significant challenges for smaller exempt credit unions. Since Regulation II's initial implementation, exempt financial institutions have reduced free services to consumers due to decreased interchange revenue. For instance, the availability of free, non-interest-bearing checking accounts offered by exempt financial institutions declined by 15.5 percent[4] following the imposition of the interchange fee cap.

Additionally, while Regulation II initially exempted financial institutions with less than $10 billion in assets ("exempt institutions"), the changes imposed on larger institutions will impact smaller institutions. The non-interest income of an exempt institution is essential for operating its debit card program securely and covering critical areas such as card fraud technology, dispute resolution, risk mitigation, core and online banking debit card technology, plastic and digital issuance, and cybersecurity. However, the proposed changes to Regulation II will directly impact the financial viability and operational capabilities of other credit unions, as the reduction in fee income would have cascading effects, limiting credit unions' ability to invest in technology, security measures, and member services, ultimately harming both credit unions and their members.

We urge the FRB to reconsider its approach and consider the significant impact of these changes on exempt credit unions and their ability to effectively serve their members and communities.

***6. The proposal would impede the ability to cover significant technology investments and fraud prevention costs.***

In today's landscape of escalating fraud costs, it's clear that credit unions have been facing intensified challenges over the years. This not only threatens their financial stability but also their ability to provide essential financial services, especially to underserved communities. Importantly, the impact on exempt

[3] *See* BankOn initiative available at: https://joinbankon.org/.
[4] *See* Manuszak, Mark D. and Krzysztof Wozniak, "The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation" 5-6 (2017), available at https://doi.org/10.17016/FEDS.2017.074

institutions, including credit unions, has been significant, yet the FRB has overlooked this issue in formulating the interchange fee cap.

As fraud continues to proliferate, credit unions may be forced to implement stricter payment policies to mitigate losses. This could lead to a higher rate of declined payments, ultimately reducing the volume of commerce received by merchants. Interchange fees play a vital role in offsetting the costs associated with fraud for issuers.

However, it's essential to recognize that fraud protection is a shared responsibility across all stakeholders in the payments value chain. Credit unions, as issuers, bear the burden of identifying fraud, while merchants focus on their products and services. Any weakening in components like fraud identification could swiftly erode interchange usage and revenue.

A research study conducted by America's Credit Unions (formerly the Credit Union National Association (CUNA)) and the American Association of Credit Union Leagues (AACUL) between 2020 and 2021 revealed that, among surveyed credit unions, fraud-related expenses surged while interchange revenue declined[5].

While the proposed rule does marginally increase the amount credit unions can charge for fraud prevention from 1 cent to 1.3 cents for regulated transactions, these adjustments may prove inadequate to address the mounting challenge of combating fraud. The majority of credit unions in California and Nevada have witnessed substantial upticks in fraud rates, and any reduction in revenue from interchange fees would severely hinder their ability to invest in and deploy innovative fraud prevention technologies.

To safeguard the stability and resilience of credit unions in combating fraud, we urge the FRB to reconsider its approach.

**Conclusion**

We appreciate your consideration of our views on this critical matter. We strongly oppose the FRB's proposal and urge its immediate withdrawal due to the significant challenges it poses for credit unions in California and Nevada. This proposal would greatly diminish a credit union's non-interest income, which is vital for securely operating their debit card programs.

The proposed rule is deeply flawed and misguided, jeopardizing the crucial role credit unions play in providing affordable and accessible financial solutions to their members. By limiting non-interest income, the proposal would hinder credit unions' ability to compete and offer affordable financial products and services, especially to underserved consumers. And the automatic two-year adjustments proposal fails to take into consideration the economic realities.

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[5] *See* America's Credit Unions (formerly the Credit Union National Association (CUNA)), the American Association of Credit Union Leagues (AACUL) and Cornerstone Advisors, "The True Impact of Interchange Regulation: How Government Price Controls Increase Consumer Costs and Reduce Security" available at: https://www.cuna.org/content/dam/cuna/advocacy/priorities/documents/True-Impact-of-Interchange-Regulation-CornerstoneAdvisors-June-2023.pdf

We urge the FRB to withdraw the proposal and instead engage in meaningful collaboration with stakeholders across the financial services industry to develop a more fair and balanced solution.

Sincerely,

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