May 12, 2024

Via email at: regs.comments@federalreserve.gov

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

Re: Docket No. R–1818, RIN 7100–AG67: Regulation II Debit Card Interchange Fees and Routing

Dear Secretary Misback:

The National Restaurant Association and the Restaurant Law Center appreciate the opportunity to provide comments in response to the Federal Reserve System Board of Governor's (Board's) "Debit Card Interchange Fees and Routing" Notice of Proposed Rulemaking (NPRM).[1] We agree with the Board's assertion that it must fulfill its congressionally mandated duty to revise Regulation II because the regulated debit interchange rate is no longer "reasonable and proportional" to the cost incurred by covered debit card issuers. Further, we urge the Board to adopt a final rule that lowers the base component of the interchange fee standards to 6 cents per transaction, and altogether eliminates the *ad valorem* while better policing eligibility for the fraud-prevention components of the fee cap to ensure that the new regulated debit rate is fair and equitable to restaurants of all sizes, their customers, and debit card-issuers alike.

[1] "Debit Card Interchange Fees and Routing" Notice of Proposed Rulemaking, available at https://www.govinfo.gov/content/pkg/FR-2023-11-14/pdf/2023-24034.pdf (hereinafter "NPRM")

Who we are and comments outline

Founded in 1919, the National Restaurant Association ("the Association") is the leading business association for the restaurant industry, which comprises more than 1 million restaurant and foodservice outlets and a workforce of 15.5 million employees. Together with 52 State Associations, we are a network of professional member organizations dedicated to serving every restaurant through advocacy, education, and food safety.

The Restaurant Law Center ("the Law Center") is the only independent public policy organization created specifically to represent the interests of the food service industry in the courts. Its expressed purpose is to promote laws and regulations that allow restaurants to continue growing, creating jobs, and contributing to a robust American economy. The Law Center's goal is to protect and to advance the restaurant industry and to ensure that the views of America's restaurant and foodservice industry are taken into consideration by giving its members a stronger voice, particularly in the regulatory arena and the courtroom. The Law Center files comments and pursues cases of interest to the restaurant industry. The Law Center joins these comments to emphasize that the Board meet its legal obligation to revise Regulation II.

Below, we outline key reasons why the Board:

1) Is legally obligated to review and revise Regulation II.

2) Should consider the impact an updated interchange fee cap would have upon small ticket merchants like restaurant operators.

3) Should decrease the base component of the interchange fee cap further than the proposed 14.4 cents to 6 cents.

4) Should altogether eliminate the *ad valorem* component of the interchange fee cap.

5) Should reduce the fraud-prevention adjustment from its current rate of 1 cent and condition this component of the interchange fee cap on demonstrated issuer effectiveness.

6) Should establish audit and enforcement plans to ensure its proposed biennial automatic update to the interchange fee cap remains reasonable and proportional to issuer costs moving forward.

1. <u>The Board is Legally Obligated to Review and Revise Regulation II</u>

In 2010, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress passed Section 920 of the Electronic Funds Transfer Act (EFTA or statute), often referred to as the Durbin Amendment. The provision "requires the Board to establish standards for assessing whether the amount of any [debit] interchange fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the debit card transaction."[2] The statute also requires the Board to prescribe regulations that consider "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction,"[3] but to forgo considering "other costs incurred by an issuer which are not specific to a particular electronic debit transaction."[4]

It should be noted that during the initial rulemaking process, the Board proposed two alternative standards to govern interchange fees. "Alternative 1" allowed each issuer to recover its actual incremental "authorization, clearance, [and] settlement" (ACS) costs up to a safe harbor of 7 cents per transaction if the issuer chose not to determine its individual allowable costs, and up to a cap of 12 cents if it did,[5] while "Alternative 2" set a cap at a flat 12 cents per transaction.[6] Notably, neither Alternative 1 nor Alternative 2 contemplated a pre-paid fraud loss percentage as an "allowable cost" to be included within a final interchange cap,[7] nor was the Board at that time "proposing a specific adjustment to the amount of an interchange fee for an issuer's fraud-prevention costs."[8]

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[2] Public Law 110–203, section 1075, 124 Stat. 1376, 2068 (codified at 15 U.S.C. 1693o–2)
[3] Id. § 1693o-2(a)(4), (4)(B)(i)
[4] Id. § 1693o2(a)(4)(B)(ii)
[5] 75 Fed. Reg. at 81736-38
[6] Id. at 81,738
[7] 75 Fed. Reg. at 81755
[8] 75 Fed. Reg. at 81726

The Board's Final Rule, known as Regulation II, was published on July 20, 2011, and became effective on October 1, 2011. As its standard for assessing whether the interchange fee for a debit transaction is reasonable and proportional to the issuer's costs, the Board adopted "a modified version of proposed Alternative 2"[9] by forgoing a flat cap of 12 cents and creating two additional components that pertain to fraud losses and prevention measures. Since Regulation II has not been revised since its implementation, the rule currently holds that "each interchange fee received by a debit card issuer for a debit card transaction that does not qualify for a statutory exemption can be no more than the sum of (i) 21 cents (the ''base component''), (ii) 5 basis points multiplied by the value of the transaction (the ''*ad valorem* component''), and (iii) for a debit card issuer that meets certain fraud-prevention standards, a 'fraud-prevention adjustment' of 1 cent per transaction."[10]

Finally, in promulgating Regulation II, the Board stated that it would "periodically conduct surveys of covered issuers in order to reexamine and potentially reset the fee standard" because "[l]ower [issuer] costs should result in a lower interchange fee cap."[11] To this end, the Board in its NPRM acknowledges that data collected in its biennial survey of large debit card issuers "show that the costs [they have] incurred . . . in connection with debit card transactions have changed significantly over time."[12] More specifically, these surveys illustrate that issuer costs have rapidly and significantly declined since the original Regulation II rulemaking, thus rightfully triggering the Board's issuance of this NPRM to review and revise the debit interchange fee cap in order to remain compliant with the law.

2. <u>The Board Should Consider the Impacts of an Updated Regulation II on Small Ticket Merchants like Restaurants</u>

Between 2000 and 2023, restaurant sales in the U.S. grew from $379 billion to just over $1 trillion. This is because a majority of adults (60%) say restaurants are essential to

[9] 76 Fed. Reg. at 43404
[10] NPRM, p. 2
[11] 76 Fed. Reg. at 43422, 43433
[12] NPRM, p. 1

their lives, and nearly 9 in 10 people enjoy the experience of going to a restaurant.[13] Even in our current economy, people spend more than half of their food dollar outside the home.[14] This kind of enjoyment and reliance on the industry has fueled growth, and there are now more than 1 million foodservice outlets that employ more than 15.5 million people,[15] making the industry the nation's second-largest private sector employer.

While restaurants are ubiquitous in America, the industry is made up of hundreds of thousands of small businesses, running on slightly different business models. Seven in 10 restaurants are single unit operations and most restaurant locations (90%) employ fewer than 50 people.[16] The industry is highly competitive and constantly changing in response to trends and economic pressures, and the typical small business restaurant runs on a 3-5% pre-tax margin.[17] If we assume a restaurant's pre-tax income represents approximately 5% of sales for a typical restaurant as it did in 2019,[18] then the average restaurant with annual sales of $900,000 would translate to a pre-tax income of $45,000. If a restaurant today is making a total of $900,000, then they are suffering a pre-tax loss of -12.3%.[19]

For restaurant owners and operators, accepting debit and credit cards is an absolute imperative to best serve their customers, and ultimately, to stay in business. However, accepting card payments is one of the highest costs borne by an operator, often behind only labor and food. Because average food and labor costs were up nearly 30% during the last four years on top of already thin margins,[20] it is difficult to truly quantify the profoundly negative impact swipe fees have upon the industry.

Robust competition and thin margins have always defined the industry, but the explosive growth in food delivery is a trend all restaurant concepts have tried to leverage in

[13] "2024 State of the Industry Report," National Restaurant Association, February 28, 2023, available at https://restaurant.org/research-and-media/research/research-reports/state-of-the-industry/
[14] U.S. Department of Agriculture, Food Expenditure Series, available at https://www.ers.usda.gov/data-products/food-expenditure-series/
[15] https://restaurant.org/, last visited on May 12, 2024.
[16] https://restaurant.org/research-and-media/research/research-reports/state-of-the-industry/
[17] *Restaurant Operations Report 2016 Edition*
[18] https://restaurant.org/research-and-media/research/economists-notebook/analysis-commentary/bottom-line-impact-of-rising-costs-for-restaurants/
[19] *Id*
[20] https://www.bls.gov/ppi/ and https://www.bls.gov/ces/

recent years. Offering delivery is an important source of business growth and customer retention that has become essential in today's post-pandemic world. Currently, 65% of restaurant operators say delivery represented a higher proportion of sales in 2023 than it did in 2019, while only 15% of restaurant operators say delivery was a lower proportion of their total sales.[21] Additionally, 6 out of 10 operators expect off-premises sales to remain as strong as last year, and more than 4 in 10 restaurant operators are increasing investments in equipment and technology, including online ordering and digital payment options, to expand efficiency and productivity.[22]

Off-premises sales certainly represents a key area of growth for the industry, but the reality is that there are numerous cost increases required for restaurants to provide that service, most notably including increased fraud mitigation and chargebacks. Meanwhile, restaurants are forced by card-issuing banks to absorb all costs associated with fraud for food delivery, even if they provide the "compelling evidence" consisting of photos and other proofs of delivery to show that they are not responsible for the fraudulent claim.

Of course, the rapid expansion of food delivery services represents just one factor of the larger growth in card-not-present (CNP) transactions within the industry. During the pandemic, restaurant operators were forced to adjust their business models to support off-premises dining by accepting orders made online, through websites, mobile applications, third-party delivery services, or via contactless payments during curbside pickup. These changes were made in direct response to consumer preferences: smartphone apps topped the list of tech options for limited-service customers, with 70% saying they would use an app to order and 65% saying they would use it to pay the check.[23] And according to a 2021 PYMNTS survey, 67% of the average restaurant's revenue came from food orders placed

[21] "2023 State of the Industry Report," National Restaurant Association, February 28, 2023, at https://restaurant.org/research-and-media/media/press-releases/2023-national-restaurant-association-state-of-the-industry-report-a-new-normal/ (hereinafter "2023 SOI Report")
[22] 2023 SOI Report
[23] *Restaurant Technology Landscape Report 2024*. National Restaurant Association. March 2024. See https://restaurant.org/research-and-media/research/research-reports/2024-technology-landscape-report/.

remotely, and quick-service restaurants (QSRs) on average generated as much as 75% of their sales from CNP transactions.[24]

Unsurprisingly, this trend within the restaurant industry directly aligns with the Board's 2021 data around CNP transactions, which found that CNP "transaction volume was almost one-third of total debit card transaction volume in 2021, at 32.1 percent . . . [and] the average transaction value of CNP transactions was once again higher than that of [card present] transactions, at $64.50 and $37.64, respectively."[25] While CNP transactions continue to cost more to facilitate than card present transactions for restaurant operators,[26] we appreciate the Board's recently issued clarification of Regulation II holding that all types of debit transactions, including CNP debit card transaction processing, must be enabled on at least two unaffiliated payment card networks, which will help to drive down CNP debit costs.[27]

It's also worth noting that restaurants perfectly encapsulate what it means to be a "small ticket" merchant. According to our estimates, the average full-service restaurant has about 40,000 transactions per year. The average individual ticket varies depending on the full-service segment, which can range from $11.76 at a family dining establishment, $16.62 at a casual dining establishment, and $48.12 at a fine dining establishment. The average quick-service restaurant (QSR) has about 85,000 transactions per year with an average individual check of $7.68, and the average coffee shop has about 70,000 transactions annually with an average individual ticket of $6.42.

Since the pandemic, the industry has also seen a huge increase in payments made via credit and debit cards in comparison to cash. According to data from Circana/CREST, among restaurant customers who paid the check using either a credit/debit card or cash in 2023, 70% said they used a credit or debit card. That was up from 53% in 2018. Among QSR customers who paid the check using either a credit/debit card or cash in 2023, 69%

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[24] https://www.pymnts.com/wp-content/uploads/2021/07/PYMNTS-Restaurant-Readiness-Index-July-2021.pdf
[25] 2021 Debit Issuer Survey Report, p. 9, available at https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2021.pdf (hereinafter "Debit Survey Report")
[26] Payment Network Pass-Through Fee Schedule (wellsfargomedia.com)
[27] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20221003a.htm

said they used a credit or debit card, up from 50% in 2018. And among full-service restaurant customers who paid the check using either a credit/debit card or cash in 2023, 77% said they used a credit/debit card, up from 65% in 2018.[28] Overall in 2023, over 30% of all restaurant payments are made via debit cards, while payments made via credit card and cash were each at roughly 27% of all transactions.[29]

These small ticket sizes and high proportionality of payments made via debit cards creates a unique challenge for our industry: unlike many other merchants, Regulation II made it more expensive for many restaurant operators to accept debit cards when compared to these costs prior to debit reform being enacted. According to a study survey conducted by the St. Louis Federal Reserve:

> "[I]nterchange fees unintendedly rose for small-ticket transactions (Wang 2014). Prior to the regulation, most networks offered discounted debit interchange fees for small-ticket transactions as a way to encourage card acceptance by merchants for those transactions. For example, Visa and MasterCard used to set the small-ticket debit interchange rate at $0.04 plus 1.55 percent of the transaction value for sales of $15 and below. As a result, a debit card would only charge a 7-cent interchange fee for a $2 sale or 11 cents for a $5 sale. However, in reaction to the regulation, card networks eliminated the small-ticket discounts and all transactions (except those on cards issued by exempt issuers) have to pay the maximum cap amount, $0.21+0.05%, set by the regulation. Since merchants may have different compositions of transaction sizes, they could be affected differently by the changes of interchange fees. However, merchants who specialize in small-ticket transactions would be most adversely affected."[30]

In sum, we urge the Board to consider these unique aspects of the restaurant industry (perhaps by establishing a new exception or tiered pricing structure for small

[28] Circana/CREST® U.S., 12 ME Oct Data
[29] Circana/CREST® U.S., 12 ME Dec 2023
[30] https://fraser.stlouisfed.org/files/docs/publications/frbrichreview/rev_frbrich2014q3.pdf p. 4

ticket merchants) in its formulation of a final rule and make the recommendations below as potential revisions to Regulation II.

3. <u>The Board's Final Rule Should Further Reduce its Base Component of the Interchange Fee Cap to Six (6) Cents Per Transaction</u>

The Board has proposed a decrease in the base component of Regulation II from the current rate of 21 cents per transaction to 14.4 cents per transaction.[31] This calculation is based on "a new methodology that . . . [utilizes a] fixed multiplier of 3.7, which targets full cost recovery for 98.5 percent of covered issuer transactions over time based on the cumulative data reported to the Board by covered issuers since the initial Debit Card Issuer Survey."[32] While we appreciate the Board's recognition that the base component of the interchange fee cap must be reduced from its current level, the proposed rate should instead be lowered to 6 cents for the reasons detailed below.

First and foremost, the Board's proposed change to the base component is not proportionate to the changes in allowable issuer costs since Regulation II went into effect. According to the Board's 2021 Debit Card Issuer Survey, the "average per-transaction ACS costs, excluding issuer fraud losses, among covered issuers were $0.039 in 2021, approximately half of the 2009 value [of $0.077]."[33] If the Board seeks to establish a new base component that is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction," then the proposed ~33% reduction from the current rate of 21 cents to 14.4 cents fails to meet this standard of proportionality. Given the ~50% reduction in costs to debit card issuers observed within the 2021 Report, the base component should, at the bare minimum, be reduced to 10.5 cents per transaction to be in compliance with the law. This rate would also be conveniently nestled between the "Alternative 1" and "Alternative 2" figures considered during the initial Regulation II rulemaking process.[34]

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[31] NPRM, p. 1
[32] NPRM, p. 2
[33] Debit Survey Report, p. 11
[34] Id. at 81,738

In addition to our concern with the proportionality of declining issuer costs, the proposed base component reduction also fails to meet the standard of reasonableness set forth within the Durbin Amendment. In its promulgation of Regulation II, the Board concluded that a base component of 21 cents "corresponds to the per-transaction allowable cost, excluding fraud losses, of the issuer at the 80th percentile, based on data collected by the Board in a survey of covered issuers."[35] In other words, this original methodology effectively applies a fixed multiplier of 2.7 to the transaction-weighted average of per-transaction base component costs across covered issuers,[36] which allowed the 80th percentile of covered issuers to fully recover the costs associated with their debit transactions in 2011.

Unfortunately, the Board explicitly chose to create an entirely new methodology in the NPRM for determining the base component by proposing an explicit fixed multiplier of 3.7 that targets at least full cost recovery for 98.5 percent of covered issuer transactions – in fact, the majority of transactions will likely be profitable at this level as the transaction-weighted average is less than 4 cents per transaction. According to the Board, "this cost-recovery target, and the base component that would result from multiplying this fixed multiplier and the transaction-weighted average of per-transaction base component costs, is reasonable because it would allow covered issuers to fully recover their base component costs over time for a significant majority of covered issuer transactions."[37] However, we disagree with the Board's claim of reasonableness here because its newly proposed methodology relies on unnecessarily dramatic increases to both the fixed multiplier (increasing from 2.7 to 3.7) and the target cost recovery percentile for covered issuers (increasing from the 80th to 98th percentile) when compared to the original formula.[38]

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[35] https://www.govinfo.gov/content/pkg/FR-2011-07-20/pdf/2011-16861.pdf p. 29
[36] NPRM p. 9
[37] NPRM p. 8
[38] Based purely on figures provided by the Board itself, we find that it would be more reasonable if the Board were to maintain its effective 2.7 multiplier from 2011, which would provide for full cost recovery of 95% of transactions and would equate to a reduction in the base component to 10.5 cents, matching the proportional decrease in allowable costs cited above. However, we ultimately urge the Board to adopt a base component of 6 cents per transaction.

The Board further justifies its updated calculation for the base component using an "efficiency gap" metric intended to calibrate "the ratio of the transaction-weighted average of per-transaction base component costs for covered issuers whose transactions are above the target percentile to that for covered issuers whose transactions are below the target percentile."[39] However, the Board should recognize that only the highest volume issuers are truly incentivized to be efficient by the regulation because they are the only entities that depend on debit interchange as a material aspect of their business. By tying this metric to the target cost recovery percentile of 98.5%, it appears the NPRM seeks to expand its scope to cover mid- and low-volume issuers who handle a small percentage of covered issuer debit transactions and whose debit interchange revenues are immaterial to their overall business,[40] which skews the proposed base component rate of 14.4 cents toward the highest volume issuers. We also note that the "efficiency gap" metric was never explicitly contemplated within the promulgation of Regulation II, and thus further urge the Board to throw out this seemingly excessively high efficiency gap metric in its consideration of the final base component formula.

As such, we ultimately urge the Board to adopt a final base component rate of 6 cents per transaction. Rather than pursuing the new methodology proposed within the NPRM, we suggest that the Board could pursue another new methodology by simply tying the base component rate to issuer profit margins. If this were to be done, the Board could set the base component rate at 6 cents which would effectively provide covered issuers with a very reasonable return of a 35% debit interchange profit margin.[41]

This solution would meet the definition of a reasonable and proportional rate as it is an industry standard margin for banking services[42] — this 6-cent figure is also conveniently half of the flat, 12-cent "Alternative 2" proposal made by the Board during the

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[39] NPRM p. 8
[40] Table 12 in 2021 Debit Survey Report
[41] See attached white paper, "Considerations for the Federal Reserve Board's Proposed Rule for Debit Interchange," Pat Moran.
[42] CSI Market, in its "Regional Bank Industry Profitability" & "Money Center Bank Industry Profitability" Reports indicate profit margins of 25.7% and around 20% respectively. MacroTrends Financial Institution Pre-Tax Margin averaged 28.7% from 12/09 – 9/23

initial promulgation of Regulation II, which coincides with the Board's observation that issuer costs have decreased by 50% since 2011. If the Board were to disregard this approach, we would urge you to consider adopting a "tiered approach" to the debit interchange cap as proposed by the Retail Industry Leaders Association (RILA) rather than the proposed single cap applicable to the largest and smallest issuers alike.

In sum, we kindly remind the Board that Congress did not empower it to make policy judgments that would result in significantly higher interchange rates.[43] We urge the Board to avoid the same mistake it made during its earlier promulgation of this Regulation that led to higher interchange rates for small-ticket merchants. Establishing a final base component rate of 6 cents per transaction would make sure that small-ticket merchants, like restaurant operators, would not be, once again, unfairly and adversely affected by the updated interchange fee cap.

4. The Board's Final Rule Should Further Reduce or Altogether Eliminate the *Ad Valorem* Component of the Interchange Fee Cap

The Board has proposed a reduced *ad valorem* (or fraud loss) component of Regulation II from its current rate of 5 basis points to 4 basis points.[44] This calculation is based on "the median ratio of issuer fraud losses to transaction value among covered issuers (multiplied by the value of the debit card transaction), which is the same methodology the Board used to determine the *ad valorem* component during the original Regulation II rulemaking."[45] While we appreciate the Board's recognition that the *ad valorem* component of Regulation II must be reduced, we find the NPRM's proposed reduction from 5 basis points to 4 basis points to be insufficient and its methodology for this minimal reduction to be flawed. Instead, we urge the Board to altogether eliminate the *ad valorem* component of Regulation II and allow fraud losses to be absorbed by the responsible party or parties when they occur so that all entities within the debit ecosystem are incentivized to mitigate fraud on an equitable basis.

[43] NRA Lawsuit, https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2011cv2075-38
[44] NPRM, p. 1
[45] NPRM, p. 6

As noted previously, the *ad valorem* component as it exists today was not contemplated during the initial rulemaking process for Regulation II – it was a discretionary decision by the Board to establish this prepaid fee component to compensate all covered issuers in advance for predicted fraud losses in the final rule. Unfortunately, the Board chose to incorporate this new component when issuing the final rule in 2011. However, it is worth pointing out that the Board "originally determined the *ad valorem* component using only those fraud losses absorbed by covered issuers,"[46] but that "the share of such fraud losses absorbed by covered issuers has declined during that time . . . [and similarly that] the median ratio of issuer fraud losses to transaction value among covered issuers has declined from 2011 to 2021, despite the overall increase in fraud losses to all parties."[47]

To this end, the Board found in its 2021 Debit Issuer Survey Report that "from 2011 to 2021, the percentage of losses from fraudulent transactions reported by covered issuers absorbed by merchants steadily increased from 38.3 to 47.0 percent, while the percentage of losses absorbed by issuers steadily decreased from 59.8 to 33.5 percent."[48] In other words, since 2011, restaurant operators and other merchants have absorbed a growing percentage of total debit fraud losses that now exceeds the losses borne by issuers to the tune of 13.5%. Over that same time period, however, data from the Report paints an even bleaker picture with respect to the percentage of debit fraud losses absorbed by consumers, which has "increased from 1.8 percent in 2011 to 8.2 percent in 2019, [and then] more than doubled from 2019 to 2021, reaching 19.5 percent."[49]

Simply put, financial institutions have been able to foist two-thirds of all fraud losses onto merchants and consumers between 2011 and 2021, while they themselves have nearly halved their own fraud losses since the promulgation of Regulation II. This data points to a significant and immediate need to at least reduce the proposed *ad valorem* component of

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[46] NPRM, p. 9
[47] NPRM, p. 9
[48] Debit Survey Report, p. 11
[49] Debit Survey Report, p. 11

the NPRM to less than 4 basis points as proposed by the Board, if not eliminate the component altogether.

Unfortunately, these trends are not at all surprising to the restaurant industry. Rather than taking straightforward and effective actions to fight fraud, we can see how the card networks have actively pushed most of the costs of fighting fraud onto merchants. For instance, during the EMV liability shift and accompanying switch to chip cards that took place in the U.S. in 2015, card networks did not require the entry of personal identification numbers (PINs) or using other means of authenticating the person making the transaction to help combat fraud like they did elsewhere in the world.

In fact, Visa and Mastercard threatened to levy fines against merchants who tried to require PINs for debit transactions.[50] Rather than implementing this common-sense anti-fraud measure that had been successful around the world, merchants were forced to spend upwards of $30 billion[51] to upgrade their point-of-sale equipment and software to make the transition to chips without the protection of PIN usage.

In addition to the exorbitant costs required to become EMV-compliant, restaurant operators and other merchants are also responsible for covering the cost of fraudulent card transactions themselves, which come in the form of a "chargeback." Chargebacks have become an ever-growing problem for the restaurant industry given the aforementioned boom in remote online and delivery orders, and they can occur without notice even months after the transaction takes place. With respect to food delivery chargebacks in particular, a fraudster's objective isn't to convert stolen credit or debit card numbers into goods that can be resold for cash – instead, these are small-scale fraud attempts looking to get free food rather than aiming for significant financial gain.[52]

[50] Robin Sidel, "Kroger Sues Visa Over PIN Debit Transactions," Wall Street Journal (June 27, 2016) at Kroger Sues Visa Over PIN Debit Transactions - WSJ.
[51] https://store.legal.thomsonreuters.com/law-products/news-views/corporate-counsel/emv-chip-technology-and-the-new-liability-shift-rule-coming-to-a-retailer-near-you
[52] https://www.chargebackgurus.com/blog/food-delivery-fraud#:~:text=What%20Are%20the%20Common%20Types%20of%20Food%20Delivery,Account%20Takeover%20Fraud%20...%203%20Friendly%20Fraud%20

The same can be said about fraud losses resulting from in-app purchases and other remote and online orders which, given current industry trends, will continue to represent an increasing share of the overall fraud restaurant operators see in the future. On top of losing the entire ticket or cart, the taxes and the accompanying swipe fees (that are prepaid to cover fraud) for a charged-back transaction, restaurant operators and other merchants must also pay an additional separate fee to actually facilitate the chargeback itself.

While the Board "does not propose to revise the original methodology . . . used to determine the *ad valorem* component" of the interchange fee standards,[53] the proposed reduction of 1 basis point (that would still be pegged to 100% of the fraud losses on debit cards paid by the average bank covered by the regulation) is unreasonable. This is because 1) the fraud loss percentage share outlined by the 2021 Debit Issuer Survey Report indicates that merchants and consumers already pay for roughly 66% of all fraud in the debit system; 2) chargebacks and other fraud losses borne by merchants will continue to rise given its increasing shift to CNP channels; and 3) issuers are therefore no longer incentivized to implement strong fraud protections because the current system allows fraud to be a guaranteed profit center for many of the banks covered by the regulation because merchants are required to prepay for these costs. As such, we urge the Board to further reduce or altogether eliminate the *ad valorem* component in its entirety and instead allow fraud losses when they occur to be absorbed by the responsible parties, which would incentivize each party to do their best to reduce fraud, rather than have merchants subsidize issuers in advance for their losses.

5. The Board's Final Rule Should Reduce the Fraud-Prevention Adjustment and Condition its Eligibility on Proven Issuer Effectiveness

The Board has proposed a roughly 33% increase in the "fraud-prevention adjustment" component of the regulated debit interchange cap from the current rate of 1 cent per transaction to 1.3 cents per transaction due to "increased fraud-prevention costs faced by issuers since 2009."[54] As the NPRM notes, EFTA section 920(a)(5)(A) "allow[s] for

[53] NPRM p. 9
[54] NPRM p. 12

an adjustment to the interchange fee received or charged by an issuer under the interchange fee standards if such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to debit card transactions involving the issuer, provided that the issuer complies with fraud-related standards established by the Board."[55]

However, we point to the aforementioned Board-generated data showing that fraud-prevention costs in 2009 were 1.7 cents,[56] which has actually decreased to 1.3 cents in 2021.[57] More importantly, we find that the Board's "standards" to determine eligibility amount to little more than a literal "check-the-box" exercise that does not require any real action to be taken by covered issuers to demonstrate compliance with the statute. Rather than increasing the fraud-prevention adjustment from 1 cent to 1.3 cents per transaction, we urge the Board to reduce the fraud-prevention adjustment to less than 1 cent, as well as condition eligibility for this component on an issuer's clear demonstration of effectively combatting fraud in their debit transactions.

According to the statute, an issuer can be eligible for receiving or charging a fraud-prevention adjustment for each of its debit transactions if they "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."[58] However, the Board was not particularly prescriptive as to what these policies and procedures must look like, merely requiring that eligible issuers have measures in place to "identify and prevent fraudulent debit transactions," "monitor the volume and value" of fraudulent transactions, issue "appropriate responses" to suspicious activities, and maintain the ability to "secure" debit card and cardholder data.[59] Finally, a covered issuer self-certifies to its payment card networks that it abides by these ambiguous standards in order to be eligible for the fraud-prevention adjustment.

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[55] NPRM, p. 3
[56] Table 13 in 2009 Debit Survey Report
[57] Table 14 in 2021 Debit Survey Report
[58] https://www.ecfr.gov/current/title-12/chapter-II/subchapter-A/part-235/section-235.4
[59] Id

These self-certification standards are not rigorous enough to warrant merchants pre-paying for fraud prevention to the tune of 1.3 cents per transaction as proposed by the Board. To date, it appears as if the Board determines eligibility for the fraud-prevention adjustment by simply taking issuers at their word given that it does not seemingly collect nor publish within its biennial Debit Issuer Surveys any specific processes, procedures, data, or any other key metrics that demonstrate whether, or how much, an issuer has taken actionable, concrete steps toward preventing fraudulent transactions aside from reporting the aggregated costs associated with fraud-prevention and transaction-monitoring.[60] In fact, it's unclear whether the Board even attempts to collect copies of the annual self-certification that issuers are legally required to submit to their payment networks. Given this overly *laissez-faire* status quo, it is unsurprising that the Board appears to have awarded the fraud prevention adjustment to every covered issuer on every transaction for more than a decade.

It should also be noted that the same logical fallacy addressed in the previous section regarding the *ad valorem* component occurs within the fraud-prevention adjustment component – the NPRM proposes that restaurant operators and other merchants should pre-pay for both fraud losses and fraud prevention costs through interchange fees without proof of issuers meeting certain fraud prevention standards, while also paying for and deploying their own (or a third party's) fraud-prevention techniques and technologies on top of the interchange fee. Restaurant operators remain frustrated that they continue to hold up their end of the bargain with respect to purchasing and implementing fraud-prevention measures, yet at the same time issuers are effectively unaccountable for implementing these measures on their end.

Ultimately, we assert that because the median fraud prevention costs have decreased from $0.017 per transaction in 2009 to $0.013 per transaction in 2021, it would not be reasonable and proportional for the Board to increase the fraud-prevention adjustment from 1 cent to 1.3 cents per transaction. Instead, we urge the Board to reduce this component to less than 1 cent and recommend that eligibility for the fraud prevention

[60] NPRM, p. 12 at footnote 70.

adjustment should be conditioned on issuers' spending actually being an effective way to prevent fraud.

We suggest that the Board establish more rigorous criteria that requires covered issuers to show either reduced fraud on their transactions or slower growth in fraud than the mean in order to receive fees to cover their fraud prevention spending. At the same time, an issuer that has not demonstrated overall reduced per-transaction fraud losses (or slower increases than the mean) over a period of time should lose eligibility for the adjustment until they can demonstrate that they are taking effective fraud prevention steps.

6. <u>We Support the Biennial Update to the Interchange Fee Cap, but with Revised Methodologies and Independent Audits</u>

Finally, the Board has proposed "codify[ing] in Regulation II an approach for updating the three components of the interchange fee cap every other year going forward based on the latest data reported to the Board by large debit card issuers. By directly linking the interchange fee cap to data collected by the Board from large debit card issuers every other year, the proposed approach should ensure that the interchange fee cap will reflect changes in the costs incurred by debit card issuers."[61]

We appreciate and support the Board's recommendation to update the interchange fee cap on an automatic, biennial basis, because it has taken far too long for Regulation II to be updated since its issuance in 2011. However, we urge the Board to lock in the correct methodologies with respect to the three separate interchange fee components to ensure that the automated update starts in the right place so that issuers do not continue to collect interchange revenue that far exceeds their costs as they have for the last decade.

As discussed in Section 3 of our comments, the Board's proposal to establish the future base component rate by applying a fixed 3.7 multiplier to actual costs promotes inefficiency, and this new methodology does not result in a base component that passes the statute's test of reasonability and proportionality. The proposed 3.7 multiplier may also

[61] NPRM, p. 2

encourage issuers and networks to game the system by shifting costs around and using the multiplier to circumvent the statute's reasonable and proportional standard. For instance, many restaurant operators have seen myriad network fee increases since the implementation of Regulation II[62] that have been used to benefit the networks themselves as well as the issuers in their networks. These should be removed from an issuer's actual cost calculation. In addition, in order to meet the reasonable and proportional standard set forth in the statute while also reconciling the unique cost challenges endured by small ticket merchants like restaurant operators, it is critical that the Board further reduce the updated base component to 6 cents per transaction.

As discussed in Section 4, we urge the Board to altogether eliminate the *ad valorem* component of the interchange fee standard due to the overarching liability and costs of debit fraud shifting from issuers to merchants and consumers since 2011. We kindly remind the Board that it exercised its own discretion to establish this component during the initial promulgation of Regulation II, and we recommend that the Board exercise that same level of discretion in this current proposed rule by phasing out this cost that restaurant operators and other merchants already pay for in numerous other ways.

The same principle can be applied to our comments in Section 5 regarding the fraud-prevention adjustment, and, at the same time, the Board acknowledges that this cost to issuers has decreased from 1.7 cents in 2009 to 1.3 cents in 2021, which makes the proposed net fraud-prevention adjustment increase from 1 cent to 1.3 cents unjustifiable. If the Board is to have the interchange fee cap updated automatically, both the *ad valorem* and fraud-prevention components must be further reduced or altogether eliminated.

Most importantly, if the Board moves to adopt the proposed automatic updating process to adjust the regulated debit rate based on issuer-reported costs in the future, the Board must conduct more rigorous oversight of the data collected from issuers to ensure that their costs have not been misstated or inflated in an attempt to circumvent the reasonable and proportional standard set forth within the statute. As such, we urge the

[62] https://merchantspaymentscoalition.com/mastercard-plans-raise-credit-and-debit-card-fees-over-250-million-despite-settlement

Board to establish a plan in its final rule for issuers to be independently audited to ensure there is no manipulation of this data, as well as a new type of enforcement mechanism to hold covered issuers accountable for the costs they report and safeguards small ticket merchants like restaurant operators from potential abuse with respect to debit interchange fees.

Conclusion

In sum, we agree with the Board's assertion that it is legally obligated to review and revise Regulation II and appreciate the Board's willingness to undergo that process. In doing so, we urge the Board to consider the impact an updated interchange fee cap would have upon small ticket merchants like restaurant operators, decrease the base component of the interchange fee cap further than the proposed 14.4 cents to 6 cents, altogether eliminate the *ad valorem* component of the interchange fee cap, reduce the fraud-prevention adjustment from its current rate of 1 cent and condition this component of the interchange fee cap on demonstrated issuer effectiveness, and establish audit and enforcement plans to ensure its proposed biennial automatic update to the interchange fee cap remains reasonable and proportional to issuer costs moving forward.

Sincerely,

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