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National Association of Federally-Insured Credit Unions

August 10, 2021

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

RE: Notice and RFC on Debit Interchange Fees and Routing (RIN: 7100-AG15)

Dear Ms. Misback:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the notice and Request for Comment (RFC) issued by the Board of Governors of the Federal Reserve System (Board), regarding the proposed modifications to Regulation II that would clarify debit card issuers must enable, and allow merchants to choose from, at least two unaffiliated networks for card-not-present (CNP) transactions. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve 125 million consumers with personal and small business financial service products. NAFCU and its member credit unions appreciate the opportunity to provide input on this notice and RFC and wish to strenuously object to any reopening or modification of Regulation II. NAFCU requests that the Board immediately withdraw the proposed modification to Regulation II. To the extent that the Board continues in this rulemaking, NAFCU requests that the Board provide further analysis on the impacts of the proposed modification on the payment routing ecosystem, and that it consider the severe repercussions that the modification would have on credit unions and their members due to increased fraud risk and compliance costs, and decreased interchange income.

General Comments

Regulation II and the Durbin Amendment have been the definitive example of regulatory overreach, advantaging one industry over another to disastrous result. Regulation II and the Durbin Amendment should be repealed for the benefit of consumers — including many low-and-moderate income communities. NAFCU opposes any reopening of Regulation II and does not agree with the premise of this proposed rule. Advocates in favor of reopening Regulation II are trying to exact even more value from debit-card transactions, that have not and will not be passed back to consumers. Regulation II's promise of benefiting consumers with lower prices has not materialized. There is no evidence that merchants have passed along their savings to consumers in the form of price cuts. In fact, in 2014, the Federal Reserve Bank of Richmond presented research which found that 77.2 percent of merchants did not change their prices after the Durbin Amendment and Regulation II were implemented, and 21.6 percent of merchants actually increased prices.[1] There is, however, clear evidence regarding the loss of income that credit unions have experienced as a result of the regulatory burden imposed by the passage of Regulation II and the Durbin Amendment.

In 2019, the share of credit union respondents who reported a decrease in per-transaction rates relative to the period before Regulation II went into effect was 50 percent. NAFCU's monthly Economic and Credit Union Monitor surveys also indicate that the so-called "exemption" for institutions below $10 billion in assets that was included in the Durbin Amendment has provided little protection for those exempt institutions, as they have experienced per-transaction rate declines on par with the entire industry. In 2020, the share of credit union respondents below $10 billion in assets who reported a decline in per-transaction rates relative to the period before Regulation II went into effect was 39.7 percent. As the Board memo for the proposed rule states, single-message transactions for exempt institutions (i.e., a small debit card issuer, together with its affiliates, with assets of less than $10 billion) fell from 31 cents in 2011 to 25 cents in the most recent survey. These institutions have seen no relief from the Durbin Amendment's intended exemption. This may cause these smaller credit unions to introduce or increase fees for consumers while reducing debit card rewards, further diminishing access to financial services including restricting credit unions' ability to provide services to underserved communities.

The proposed rule would compound the trend toward reduction in per-transaction rates, transferring billions from exempt institutions to large retailers. Furthermore, these large multinational retailers that have experienced double-digit profitability increases during the pandemic would be the primary beneficiaries of the proposed rule, not small businesses. These retailers, unlike smaller merchants, have negotiated discount rates with specific networks to cover the card-present transactions covered by Regulation II, and are seeking to extend those discounted rates to CNP transactions too. These negotiated rates have padded the bottom lines of the largest merchants that already dominate the ecommerce sales where CNP transactions will be most useful.

The proposed rulemaking is significant and warrants additional analysis and scrutiny

The proposed rule, although presented as a "clarification," is in fact a substantive change that will have a negative impact on credit union interchange income and arbitrarily revokes existing guidance. The scope of the proposal brushes aside analysis regarding which entities would ultimately benefit from a routing mandate that disregards the unique security risks associated with CNP transactions. The proposal also requires credit unions to adopt processes fundamentally different from those currently used to comply with the rule. Credit unions generally face higher costs associated with payment routing and often are lower priorities for core providers. Most importantly, credit unions also have limited ability in general to shoulder the burden of additional compliance costs.

The compliance burden drains the few resources that small credit unions have, leaving them with precious little to devote to the business of actually growing and serving their members. NAFCU's

[1] Zhu Wang, Scarlett Schwartz, and Neil Mitchell (2014), "The Impact of the Durbin Amendment on Merchants: A Survey Study." Federal Reserve Bank of Richmond Economic Quarterly, Volume 100, Number 3.

2020 report on credit unions showed that, on average, 24 percent of credit unions staff's time was devoted to regulatory compliance. Four out of five respondents expect to add staff in the next three years to better manage current and anticipated compliance burdens. Credit unions estimate that regulatory burden related to IT compliance has expanded 72 percent since 2016.

Yet Section IV of the proposal attempts to avoid completing the detailed analyses triggered and required by the Electronic Funds Transfer Act (EFTA), Paperwork Reduction Act (PRA), and Regulatory Flexibility Act (RFA). The proposed rule requires debit card issuers to enable, and allow merchants to choose from, at least two unaffiliated networks for CNP transactions. In practice, this necessitates issuers enabling one single-message network and one dual-message network. Enabling a single-message network for CNP transactions would result in transactions routed over that network being PINless.

The proposed rule would have the effect of creating a de facto technology mandate that would drive the majority of transactions across rails and with authentication methods which credit unions may judge to be inferior and not best-in-class. Credit unions may not trust single-message networks to handle the increased risk of fraud associated with CNP transactions. Instead, like most issuers, credit unions utilize dual-message networks for CNP transactions, which are robust enough to support sophisticated security systems, incorporating tools such as tokenization, geolocation, and better audit trails to identify and prevent fraud in CNP transactions.

In 2015, former Federal Reserve Chair Janet Yellen issued the following statement:

> "In our role as supervisor, the Federal Reserve does not mandate use of a specific technological approach to payment card security in recognition of the evolving nature of payment card fraud threats and of the variety of tools that can be employed to address these threats. This approach is intended to allow financial institutions and other industry participants sufficient flexibility to design policies and procedures that most effectively reduce fraud losses to all parties involved in payment card transactions.
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> The Federal Reserve supports a layered approach to payment card security that does not mandate a particular security technology."[2]

PINless transactions present a variety of concerns and challenges for credit unions that have not been adequately considered by the Board. These include uncertainty regarding which party would be liable for instances of fraud in PINless transactions and how the lack of chargeback rights would affect issuers and consumers. With this uncertainty would come increased compliance and increased fraud prevention costs. In 2016 the Federal Reserve Banks of Boston and Atlanta found that the introduction of chip cards at point-of-sale had caused fraud to move largely to CNP

[2] March 5, 2015 Letter from Federal Reserve Chair Janet Yellen to Sen. Warner (D-VA).

transactions.[3] The proposed rule would force issuers to partner with networks, some of which lack adequate anti-fraud security for this new scale, into an operating environment they fundamentally cannot handle and where fraud is currently most rampant.

NAFCU members also face an increased likelihood of fraud in transactions with entities that are not subject to the same rigorous oversight and supervision as credit unions and other federally examined institutions. While depository institutions have had a national standard on data protection since the passage of the Gramm-Leach-Bliley Act (GLBA) over two decades ago, other entities who handle consumer financial data are not held to the same standards. NAFCU's members have serious and justifiable concerns with merchant data security practices, which directly impact the prevalence of payments fraud. The expansion of Regulation II contemplated by this rule would essentially reverse the Federal Reserve's stated policy position (as well as contemporaneous statements by the Federal Deposit Insurance Corporation (FDIC), Consumer Financial Protection Bureau (CFPB), and Office of the Comptroller of the Currency (OCC)), greatly reducing the flexibility that financial institutions could employ in being discerning selectors of payments rails for their customers.

Finally, if this proposal rule were enacted, thousands of issuers of greatly varying size and resources would be simultaneously required to implement this technology mandate, leaving smaller financial institutions such as credit unions in the difficult position of trying to get the attention of the national PIN networks. In this environment, many credit unions would be forced to cobble together a patchwork of more regional, potentially less reliable or scalable networks. This would tax the resources of institutions that are already threatened by extraordinarily thin margins, undermining their ability to offer affordable, core deposit products like free checking, and undermining their ability to compete in an era where payment system costs are rising.

Additional Impact Analysis Needed

Credit unions have not yet modeled the potential impacts of the proposed rule on their costs and services due to insufficient time to gather the input of vendors and processors. Further compounding this are the limited number of vendors who are capable of putting these systems into place and the thousands of issuers who would need to gather input from vendors in the same timeframe. The costs associated with simply understanding the impact of the proposed rule, both financial costs and relationship costs, would be impractical and damaging to undertake for many credit unions. This is largely because the requirements currently in place under Regulation II are fundamentally different from the requirements that would exist under the proposed modification and significantly more time is necessary to fully evaluate the potential implications. The Board,

[3] "Enabling EMV chip card acceptance at POS reduces card-present counterfeit fraud by removing the opportunity for fraudsters to compromise payment card credentials. However, this is driving fraudsters to attack the more vulnerable online and mobile card-not-present (CNP) channels with weaker authentication protocols, at a time when consumers are increasing their use of mobile phones to make CNP purchases." Crowe, Marianne and Susan Pandy, and David Lott (2016). "Getting Ahead of the Curve: Assessing Card-Not-Present Fraud in the Mobile Payments Environment" Federal Reserve Bank of Boston and Federal Reserve Bank of Atlanta.

by issuing a proposal with such a scarcity of evidence about potential impacts, has essentially shifted the burden and cost of modeling this proposed change to the credit unions and other financial institutions that would be governed by it. Credit unions differ from other financial institutions in their cooperative, member-owned, not for profit structure. By imposing a new routing mandate that allows merchants to circumvent guardrails to mitigate fraud, the member-owners of the credit union are ultimately losing.

While the magnitude of the proposed rule's negative impact on credit unions remains unknown, the modifications would unquestionably lead to several predictable consequences. These include, most importantly, the loss of interchange revenue as merchants choose the lowest cost network, without regard for any corresponding reduction in payment security. Simultaneous to this loss of revenue, credit unions would experience a variety of cost increases, including compliance costs, costs associated with mass re-issuance of debit cards, and increased fraud protection and security costs associated with novel and less secure transaction processes.

Increased costs combined with decreased income makes it more challenging for credit unions to offer their members affordable products and services. We need look no further than the severe quantifiable impact that the passage of Regulation II has had on credit unions to understand a portion of the impact of the proposed modifications. One study by the Federal Reserve found that financial institutions offset approximately 30 percent of lost interchange revenue with higher fees on deposit services.[4] Another study by the Federal Reserve found that 35 percent of financial institutions were less likely to offer consumers free checking because of capped debit interchange fees, and debit cardholder reward recipients declined 30 percent since the law passed.[5] Additionally, lost income from interchange that credit unions contribute to ongoing security and fraud-prevention investments would be reduced with this proposal.

Research investigating the effects of the Durbin Amendment suggests that introducing additional network requirements that are complex and costly to oversee could further erode the availability of affordable consumer deposit products. While credit unions would prefer to avoid reallocating resources to support new requirements for card programs, the reality is that small credit unions do not have operating margins capable of absorbing the cost of network expansion and Regulation II compliance without some adverse effect on products or services. Many of these smaller credit unions are low income designated credit unions and those that serve disadvantaged and minority

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[4] Kay, Benjamin S., Mark D. Manuszak, and Cindy M. Vojtech (2014). "Bank Profitability and Debit Card Interchange Regulation: Bank Responses to the Durbin Amendment" Finance and Economics Discussion Series 2014-77. Washington: Board of Governors of the Federal Reserve System.
[5] Manuszak, Mark D. and Krzysztof Wozniak (2017). "The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation," Finance and Economics Discussion Series 2017-074. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.074.

communities.[6] A 2017 study by Boston University School of Law Review of Banking and Financial Law found that price controls and routing mandates cost average low-income consumers roughly $160 annually.[7] It also found the number of unbanked Americans increased by roughly one million, post-debit regulation. Just as these negative impacts would be the inevitable result of the proposed modifications, it is also inevitable that damage to consumer welfare will be concentrated, in line with the evidence, among lower-income consumers who depend on affordable deposit products and would feel most acutely the changes resulting from further recalibration of these products to account for lost interchange income.

Conclusion

NAFCU appreciates the opportunity to comment on the proposed rule and RFC regarding debit interchange routing. Considering the many unknown impacts and the foreseeable damage of the known impacts of this proposal, NAFCU requests that the Board withdraw this proposed rule. If you have any questions or concerns, please do not hesitate to contact me at 703-842-2268 or jakin@nafcu.org.

Sincerely,

James Akin
Regulatory Affairs Counsel

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[6] At the end of 2020, the NCUA regulated 520 federally insured credit unions with the MDI designation, up from 514 at the end of 2019. *See* https://www.ncua.gov/newsroom/press-release/2021/minority-depository-institution-credit-unions-see-year-growth. MDI credit unions tend to be smaller institutions; the average assets of an MDI credit union in 2020 were slightly above $98 million. See NCUA, Minority Depository Institutions Annual Report to Congress (2020).
[7] Ryan McCarthy, The Durbin Amendment: Summary, Impact, and Reform, 37 REV. BANKING & FIN. L. 68 (2017).