August 11, 2021

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

Re: Request for Comment on Proposal to Amend Regulation II (Docket No. R-1748; RIN 7100-AG15)

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the notice of proposed rulemaking captioned above ("proposal"),[2] issued by the Board of Governors of the Federal Reserve System ("Board"), regarding amendments to its Regulation II to clarify requirements for debit card transactions and to standardize and clarify the use of certain terminology. Importantly, the proposal seeks to ensure competition within the debit card payment system for "card-not-present" debit card transactions by (1) making it explicit that card-not-present debit card transactions must be able to be processed on at least two unaffiliated networks and (2) clarifying that it is the responsibility of card issuers to ensure at least two unaffiliated networks have been enabled for card-not-present debit card transactions.

Better Markets fully supports the efforts of the proposal to ensure a minimum level of competition within the debit card payment market for card-not-present debit card transactions. Such competition would promote lower interchange fees for these transactions and further industry innovation, which will ultimately benefit businesses and consumers. Additionally, although not in scope of the proposal, Better Markets recommends that the Board study whether any unintended negative impacts have occurred to the card-not-present debit card payment

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies— including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] 86 FR 26189

market as a result of the $10 billion threshold on applicability of the fee limit portion of Regulation II.

BACKGROUND

Debit card transactions involve a network of various parties that ensure that funds are transferred from the purchaser's bank account to the merchant's bank account and that all information is transmitted securely. Specifically, a transaction will involve five parties: the purchaser or card holder; the issuer of the card, typically the card holder's bank; the merchant; the merchant's bank; and a payment card network. Each transaction has fees associated with it that are split among the card issuer, the payment card network, and the merchant's bank, with the issuer's (card-holder bank's) fee being the so-called "interchange fee." The total fee is incurred directly by the merchant and incurred indirectly by the consumer to the extent the merchant passes on this fee through its prices.

Prior to the Global Financial Crisis and the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)[3] in 2010, there was insufficient competition among debit payment card networks. That is, there was no incentive for issuers to ensure the cards they issued were set up so that merchants could route the transaction through multiple payment card networks. If only one payment card network can be used by a merchant, then there is also limited incentive for issuing banks and preferred payment card networks to lower fees or to make their processes more efficient or robust for merchants and consumers.

Therefore, section 1075 of the Dodd-Frank Act amended the Electronic Fund Transfer Act (EFTA)[4] to limit the restrictions card issuers and card networks could place on the processing of a transaction for debit cards. Key to the amendments to EFTA were provisions that directed the Board to put in place regulations that prohibit (1) exclusivity arrangements between a card issuer and payment card networks and (2) issuers or payment card networks from establishing rules or restrictions that effectively force a merchant to route a transaction through a particular network or affiliated networks (such as enabling cards for only one payment card network). These amendments were put in place to ensure competition between payment card networks that would promote lower fees to and more efficient processes for merchants and consumers.

Additionally, and importantly, EFTA was amended to directly limit interchange fees on electronic debit transactions by requiring such fees to be "reasonable and proportional to the cost incurred by the issuer." It also authorized and required the Board to assess and enforce this limitation.

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[3] Public Law 111-203, 124 Stat. 1376 (2010)
[4] 15 U.S.C. 1693 et seq.

The Board accordingly finalized a rule in July 2011[5] implementing the prohibitions on network exclusivity and routing restrictions as well as the limit on interchange fees (Regulation II).[6] The limit on interchange fees was set to be a 21-cent fixed fee plus a 5 basis point ad valorem fee per transaction for all electronic debit transactions for issuers whose size, including affiliates, exceeds $10 billion in total assets. However, while the prohibitions on network exclusivity and routing restrictions were also implemented, they were not clearly made explicit for card-not-present debit card transactions, such as online purchases.

As the Board notes in the current proposal, the market had not yet developed solutions to support multiple payment card networks for card-not-present electronic debit transaction at the time Regulation II was initially implemented. But over the last ten years additional technological advances have been made (such as "PINless" capability) and online commerce has significantly increased, especially during the ongoing global pandemic. The Board therefore is proposing changes to address the insufficient optionality that is currently available for card-not-present debit card transactions.

SUMMARY OF KEY COMPONENTS OF THE PROPOSAL

The current proposal seeks to clarify Regulation II by modifying the language to make two points explicit:

1) The prohibition on network exclusivity applies to card-not-present transactions.
2) It is incumbent on the card issuers to ensure their debit cards are enabled for more than one unaffiliated payment card network for card-not-present transactions.

It should be noted the proposal does not discuss the portion of Regulation II that imposes a limit on the interchange fee per transaction.

COMMENTS ON PROPOSED MODIFICATIONS

A. The clarifications on Regulation II are necessary and sensible clarifications that would promote competition for card-not-present debit card transactions

Better Markets fully supports the proposed clarifications as they would ensure that issuers and payment card networks are unquestionably aware that the prohibitions on network exclusivity and on effective or imposed limitations to network routing both apply to card-not-present debit card transactions. These clarifications are necessary because Section 1075 of the Dodd-Frank Act clearly never intended for there to be a distinction between card present and card-not-present electronic debit transactions. The Section makes no reference to that distinction and in fact uses language that is intended to capture all types of electronic debit transactions.

[5] 76 FR 43394; press release at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20110629a.htm
[6] 12 CFR Part 235

Similarly, Regulation II does not make the distinction. In fact, as the Board has indicated in their proposal, the distinction is being added through clarifications to the Official Board Commentary on Regulation II[7] that add card-not-present debit card transactions as an example of a "particular type of transaction" in order to ensure the applicability is explicit.

Additionally, as detailed in the Board's proposal, the issue has become material and yet obviously avoidable. Through information collected by the Board, the proposal outlines that

1) Most single-message networks, which formerly primarily processed PIN-authenticated transactions which are infrequently utilized in online commerce,[8] are now able to process card-not-present transactions due to technological innovations.
2) Despite this, issuers that account for 50 percent of all debit card transactions as well as 50 percent specifically of card-not-present debit card transactions did not conduct any card-not-present debit card transactions over single-message networks in 2019.
3) The increase in online commerce has grown the card-not-present debit card transaction share of total debit card transactions from less than 10 percent in 2009 to almost 23 percent in 2019.

Even if the share of card-not-present transactions had not increased so materially, the clarifications would still be necessary because the Board has made it clear that issuers are simply not complying with the regulation despite having the means to do so. Furthermore, the absence of the technological innovations should not have been reason for the industry to fail to fully comply with Regulation II for such an extended period. If anything, it should have been reason for the Board to have pushed for the innovation and compliance with the regulation sooner instead of waiting for the industry to innovate before issuing these proposed clarifications.

In addition to being necessary, the proposed changes are sensible and beneficial to businesses and consumers. As noted, they simply bring issuers into full compliance with Regulation II as originally intended, i.e., applicable to all types of debit card transactions including card-not-present transactions. Just as for card-present debit card transactions, the clarifications would promote lower fees and more technological innovation for card-not-present transactions that would benefit businesses and consumers, particularly small businesses and by extension low-to-moderate income consumers.

The Board should implement these clarifications as proposed and enforce them as soon as possible to encourage competition in the payment industry for card-not-present debit card transactions and finally bring issuers into full compliance with Regulation II.

[7] 12 CFR Appendix A to Part 235
[8] This is in contrast to dual-message networks, which are processed in two steps. The fist step is the initial authorization by the purchaser's bank, and the second step is the clearing and settlement process.

B. Although outside the scope of the proposal, the Board should also be studying the effects of the $10 billion threshold for interchange fee caps

In an apparent attempt to make regulations less onerous for smaller banks, Section 1075 of the Dodd-Frank Act made the "reasonable and proportional" limit on debit card interchange fees only applicable to banks (and affiliates) whose (combined) total assets are above $10 billion. This threshold, however, could have unintended consequences in its creation of a "dual market" in which smaller banks face no cap on debit card interchange fees and larger banks face a strict cap. For example, smaller banks tend to service low- to moderate-income communities, and so, if card-present/in-person debit transactions within a community are conducted primarily with debit cards from a smaller bank within that community, this would lead to relatively higher interchange fee costs to small businesses in that community than if transactions were primarily conducted with debit cards issued by a larger bank. Indeed, according to the Board's own data on debit card interchange fees, the average fee for banks and affiliates below the $10 billion threshold was 1.2 percent in 2019, as opposed to 0.56 percent for banks that are subject to the limit.[9]

Additionally, the entry of financial technology (FinTech) firms to the banking services industry has further complicated the payments market. Such firms have been partnering with banks under the $10 billion threshold, essentially using them as a deposit base from which they can offer financial services. In these partnerships the FinTech firms bring the consumer-reach of marketable online- and app-based platforms, targeted advertising, and branding to smaller banks that are able to hold the actual deposit accounts. Since the FinTech firms effectively only offer an interface and thereby essentially maintain the status of a third-party service provider, the implication is that they would be able to partner with as many banks below the $10 billion threshold as they want. In effect this allows the FinTech firms to have access to a depositor base that would normally only be available to larger banks (those above the threshold) without being subject to the fee limit. While these FinTech firms are not banks, they possibly would be creating distortions to the market that would otherwise not exist without their presence.

Better Markets recommends the Board to analyze and assess these potential issues caused by the $10 billion threshold and release a report for consumption by the public and lawmakers. Ultimately, it is lawmakers that would have to modify the threshold as it has been codified in the Dodd-Frank Act.

CONCLUSION

Better Markets supports the intention of the proposed clarifications to Regulation II, but recommends the Board to study potential issues with the $10 billion threshold.

[9] Data available on the website of the Board of Governors of the Federal Reserve System at https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm

Sincerely,

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