Meeting Between Staff of the Federal Reserve Board and Representatives of the Retail Industry Leaders Association
December 5, 2019

Participants: Julian Alcazar, Justyna Bolter, Elena Falcettoni, Mark Manuszak, Stephanie Martin, Emily Massaro, and Krzysztof Wozniak (Federal Reserve Board)

Andrew Szente and Joseph Vasterling (Best Buy); Scott Anderson, Brett Layson, and Beverly Reilly (The Home Depot); Kathy Hanna and Matthew Perin (Kroger); Beth Provenzano (Merchant Advisory Group); Brennan Duckett and Austen Jensen (Retail Industry Leaders Association); Amy Oberhelman and Perry Starr (Target); Barry Hanen, Alethia Jackson, and Kristy Kaiser (Walgreens); Reed Luhtanen (Walmart)

Summary: Staff of the Federal Reserve Board met with representatives from the Retail Industry Leaders Association (RILA) to discuss debit card transaction and fraud-prevention costs in connection with the interchange fee cap and fraud-prevention adjustment in Regulation II. The representatives also discussed their observations of market developments related to shifts in fraud liability over time.

Attachment

RETAIL INDUSTRY LEADERS ASSOCIATION

December 5, 2019

Key Points in Reg II Report

- Card-not-present transactions accounted for 18.9 percent of transaction volume in 2017, but card-not-present volume grew much faster from 2016 to 2017 than card-present volume, with the card-not-present growth rate of 22.6 percent almost ten times the card-present growth rate of 2.3 percent. As in previous years, the average transaction value of card-not-present transactions, $62.98 in 2017, was nearly double that of card-present transactions ($32.47 in 2017).

- In 2017, interchange fees across all debit and general-use prepaid cards (exempt and covered) totaled $20.73 billion, an increase of 5.9 percent since 2016.

- In 2017, merchants absorbed 53 percent of losses from fraudulent transactions at covered issuers, up from 39 percent in 2015, with issuers absorbing 42 percent, down from 58 percent in 2015.

- The average per-transaction authorization, clearing, and settlement (ACS) cost, excluding issuer fraud losses, across issuers covered by the interchange fee standard in Regulation II fell to 3.6 cents in 2017. This is a cumulative decline of 54 percent since data collection began in 2009.

- The base interchange fee standard in Regulation II of 21 cents plus 5 basis points times the value of a transaction exceeded the average per-transaction ACS cost, including issuer fraud losses, for 76.0 percent of covered issuers and 99.7 percent of covered transactions in 2017. This is a substantial increase in the percentage of covered issuers and a slight increase in the percentage of covered transactions compared with 2015.

Issuers' costs differ dramatically, but the Federal Reserve established and maintains the same rate for all issuers

The statute requires the Federal Reserve to ensure that the amount of any interchange fee that an issuer receives with respect to a debit transaction shall be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."

The statute uses the singular "the issuer" as the baseline for determining whether the fees are "reasonable and proportional," but the Federal Reserve established and maintains a single standard for all issuers, despite knowledge that issuers' costs vary significantly

Low volume issuers are predominantly large investment banks that offer debit cards as an ancillary service and large foreign banks with relatively small operations in the United States.

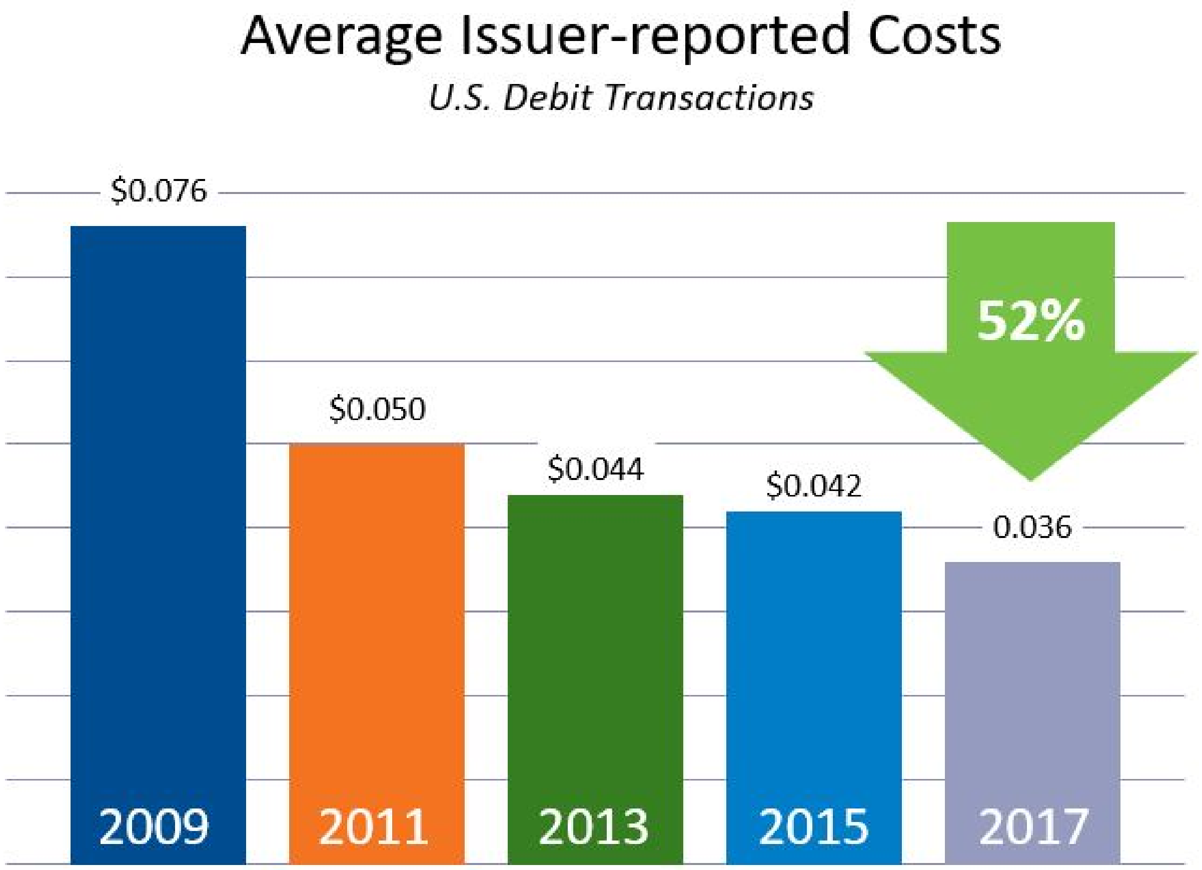
	High-Volume Issuers *(more than 100M annual trans)*	**Mid-Volume Issuers** *(1-100M annual trans)*	**Low-Volume Issuers** *(Less than 1M annual trans)*
Regulated Rate	$0.22 + 0.05%		
Avg. Cost/tran	$0.033	$0.122	$0.477
Margin	658%	105%	(48%)
# of Issuers	38	59	18
% of Trans	96%	4%	.01%

38 large banks account for 96% of regulated debit transactions, and are currently enjoying margins in excess of 650%

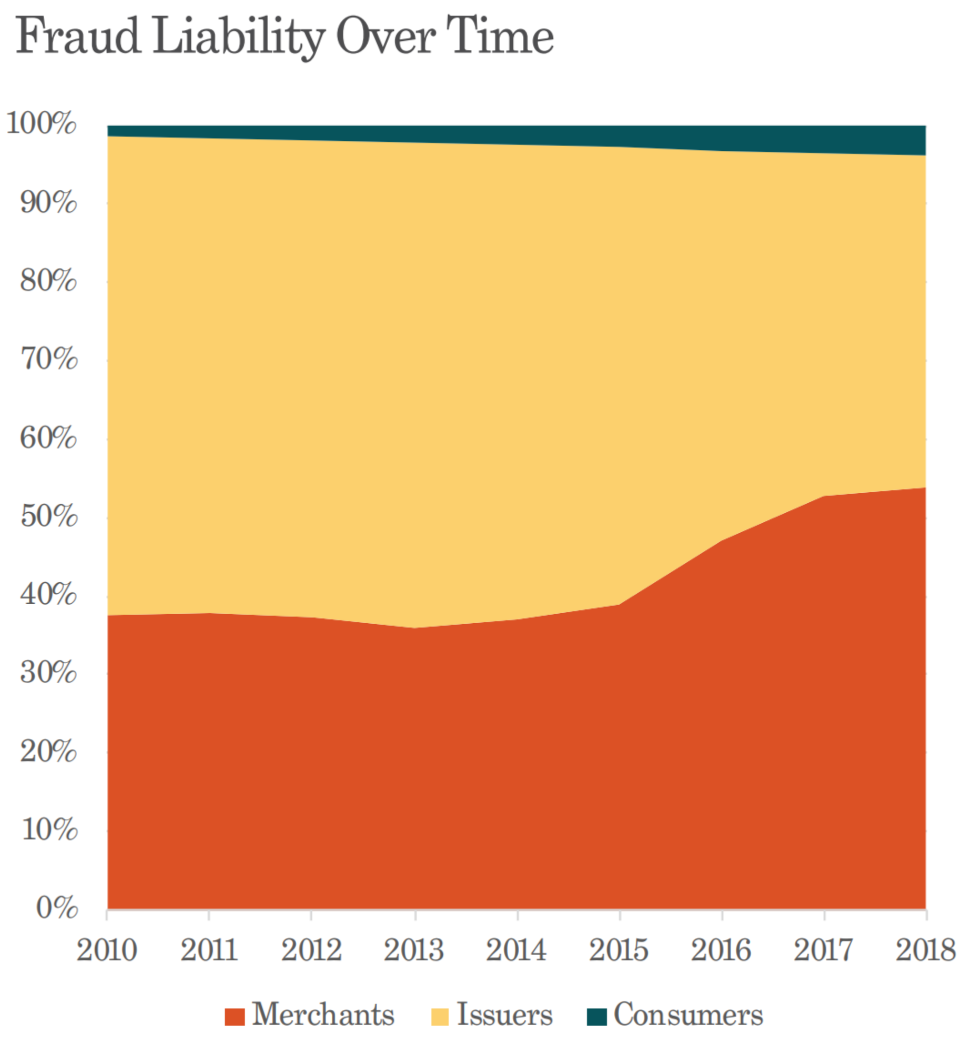
Despite a 52% decrease in issuers' costs since 2009, the Federal Reserve has chosen not to adjust the regulated rate

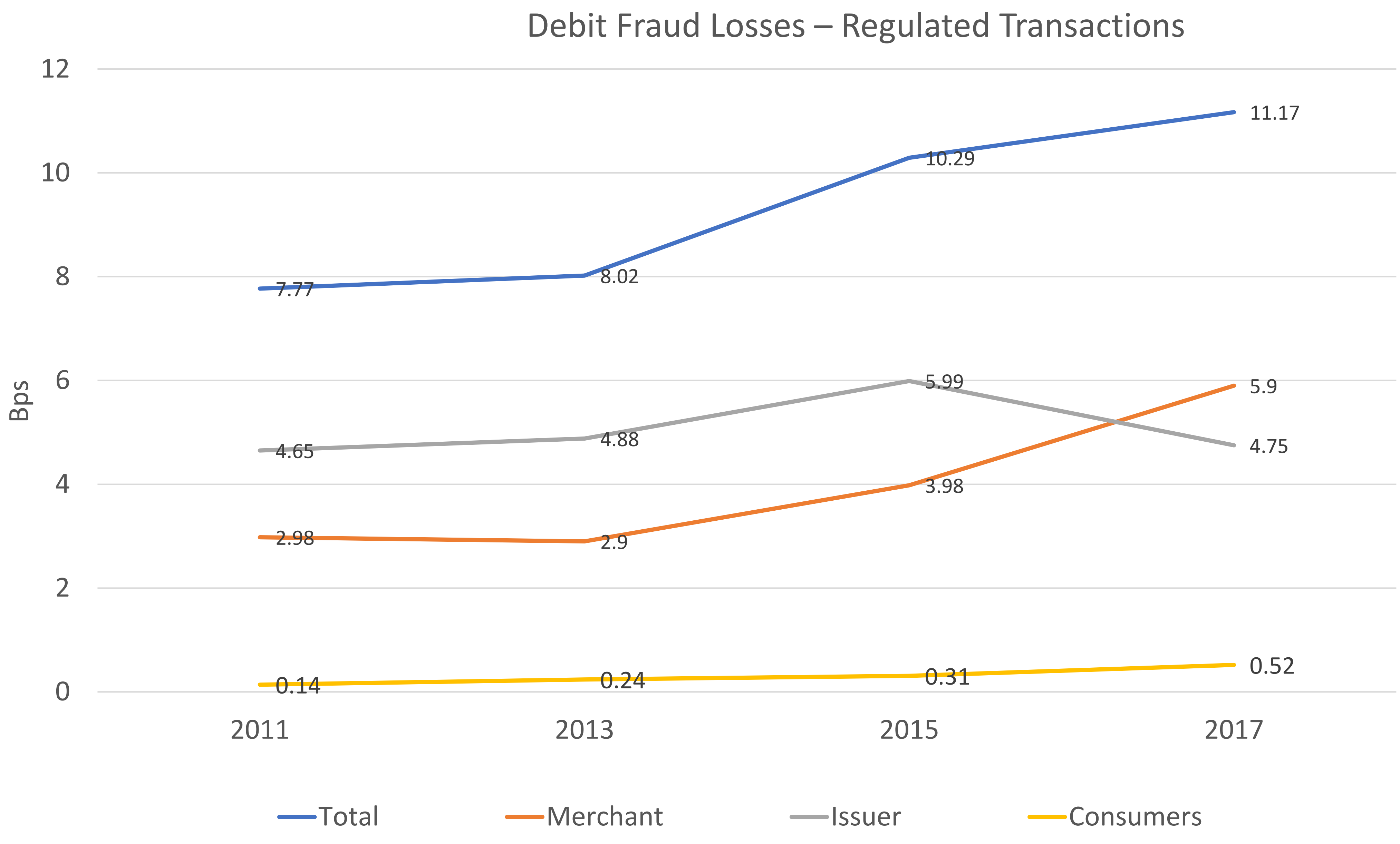
The statute requires the Federal Reserve to evaluate issuers' costs every two years to ensure the regulated rate continues to be "reasonable and proportional" to their costs.

However, despite continual decreases in issuers' costs, the Federal Reserve has not adjusted the regulated rate.



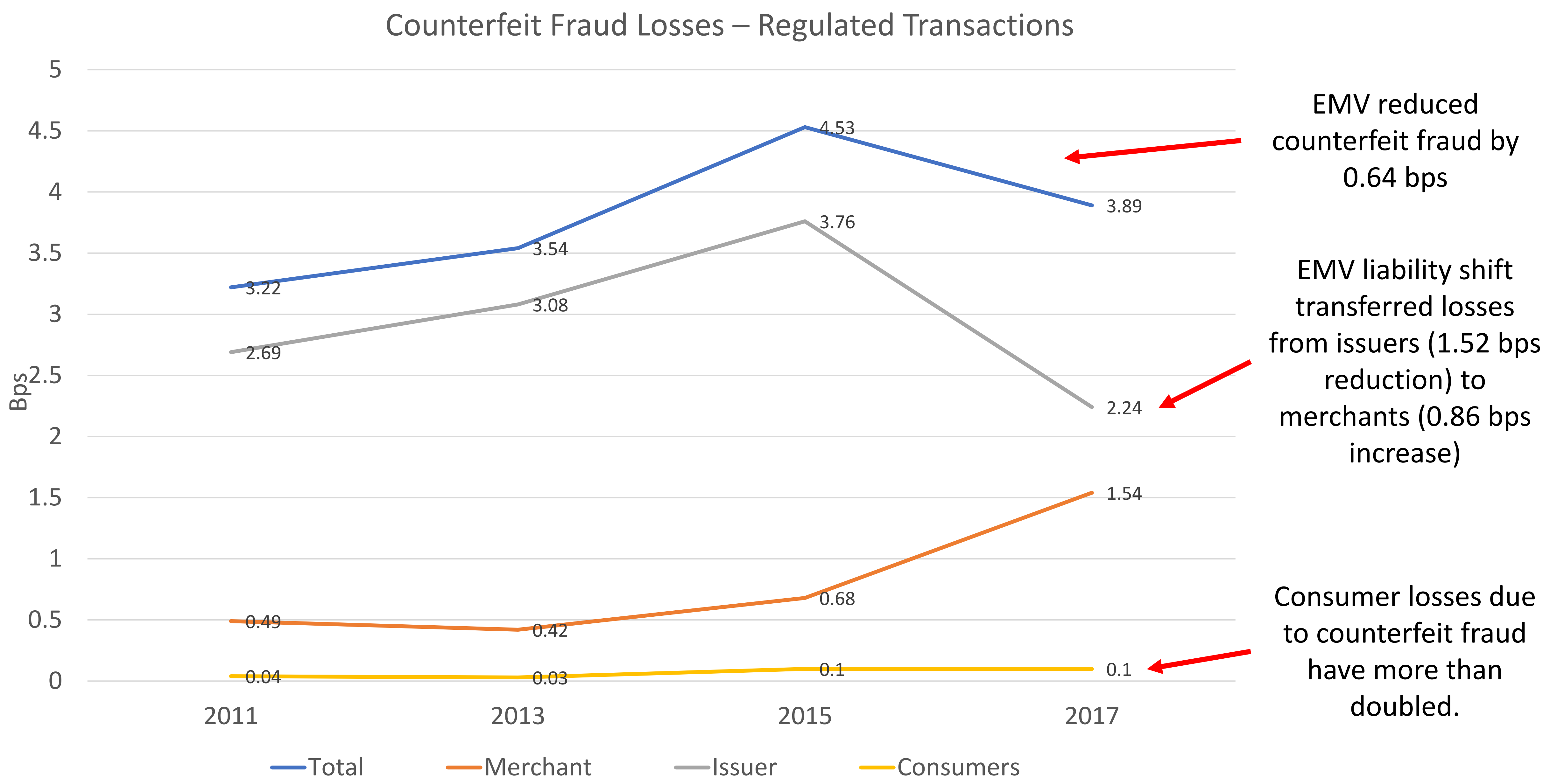
Fraud Liability Over Time

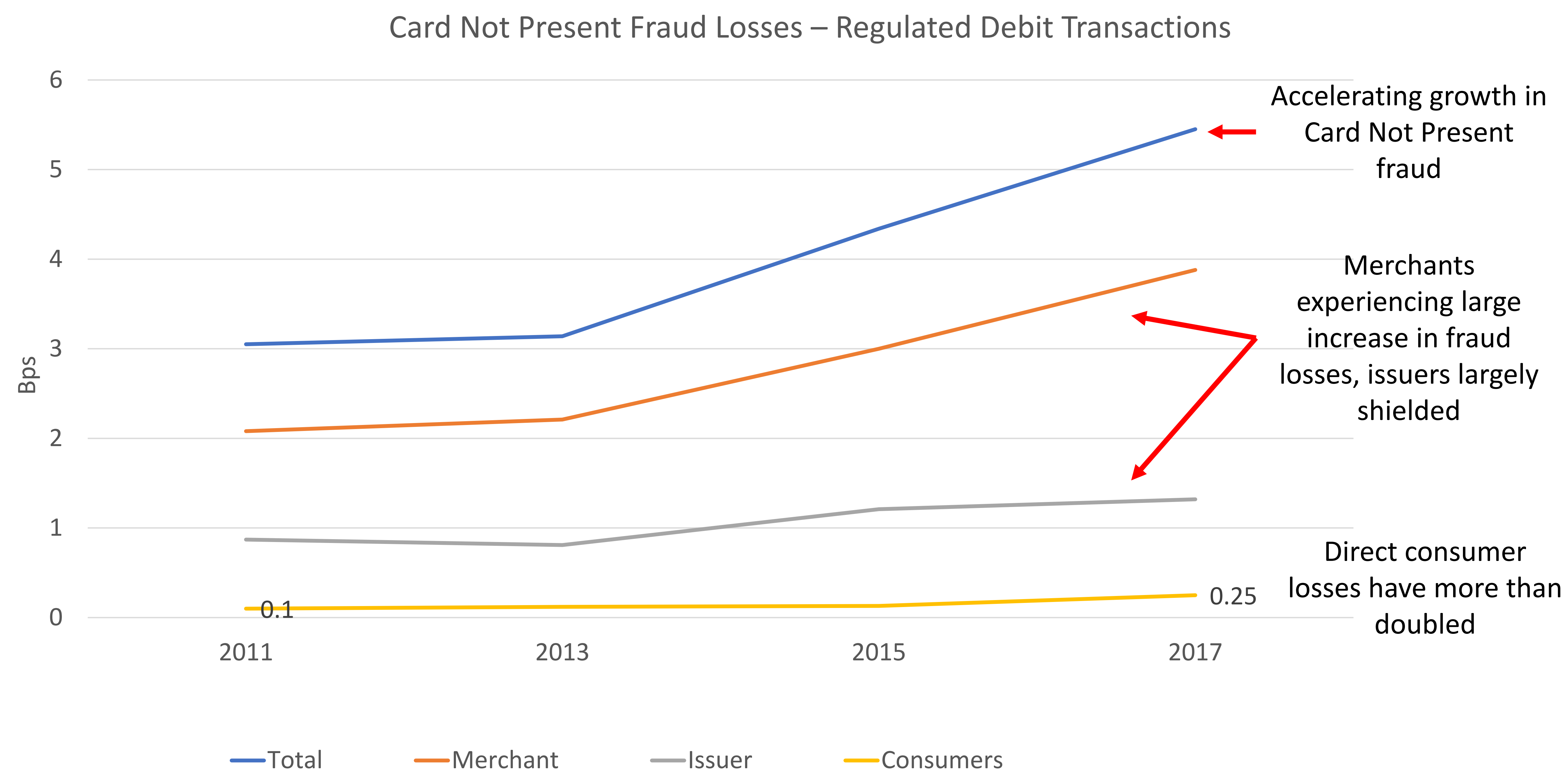


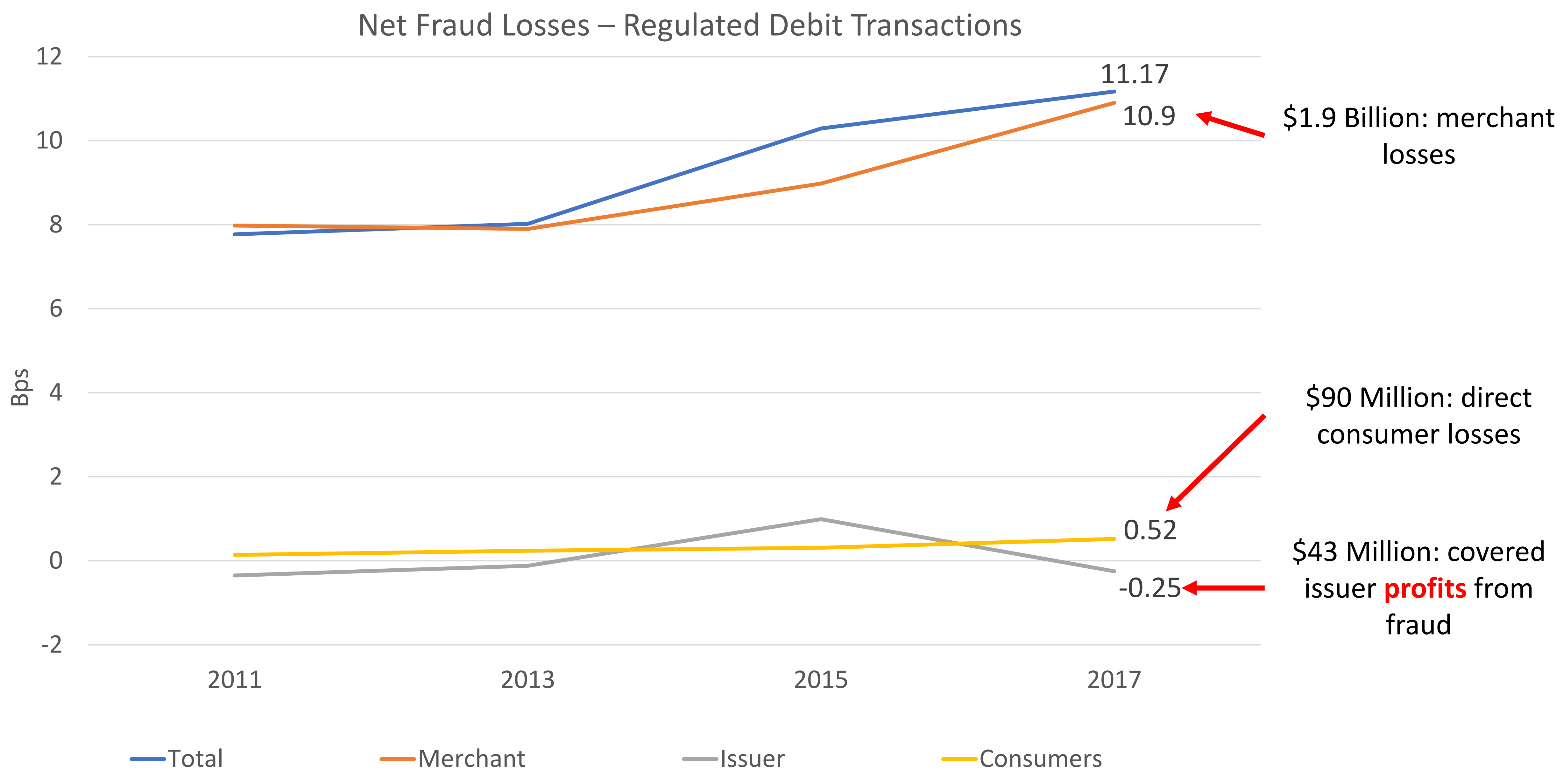


Introduction of EMV only marginally slowed the growth in fraud

Issuer losses have declined while merchant and consumer losses have increased.


Counterfeit Fraud Losses – Regulated Transactions
Bps
5
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
2011
2013
2015
2017
3.22
3.54
4.53
3.89
2.69
3.08
3.76
2.24
0.49
0.42
0.68
1.54
0.04
0.03
0.1
0.1
Total
Merchant
Issuer
Consumers
EMV reduced counterfeit fraud by 0.64 bps
EMV liability shift transferred losses from issuers (1.52 bps reduction) to merchants (0.86 bps increase)
Consumer losses due to counterfeit fraud have more than doubled.


Card Not Present Fraud Losses – Regulated Debit Transactions
6
5
4
3
2
1
0
Bps
0.1
0.25
2011
2013
2015
2017
Accelerating growth in Card Not Present fraud
Merchants experiencing large increase in fraud losses, issuers largely shielded
Direct consumer losses have more than doubled
Total
Merchant
Issuer
Consumers


Net Fraud Losses – Regulated Debit Transactions
Bps
12
10
8
6
4
2
0
-2
2011
2013
2015
2017
11.17
10.9
0.52
-0.25
$1.9 Billion: merchant losses
$90 Million: direct consumer losses
$43 Million: covered issuer **profits** from fraud
Total
Merchant
Issuer
Consumers