BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: December 13, 2010

To: Board of Governors

From: Janet L. Yellen JLY

Subject: Proposed rule on debit card interchange fees and routing

The Committee on Payments, Clearing, and Settlement has reviewed staff's recommendation that the Board request comment on a proposed rule that (1) establishes standards for determining whether an interchange fee received or charged by an issuer with respect to a debit card transaction is reasonable and proportional to the issuer's cost incurred with respect to the transaction and (2) prohibits issuers and networks from restricting the number of networks over which a debit card transaction may be routed and from inhibiting the ability of a merchant to direct the routing of a debit card transaction. The Committee is forwarding the attached staff memorandum and draft Federal Register notice to the Board for its consideration.

Attachment

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: December 13, 2010

To: Board of Governors

From: Staff[1]

Subject: Proposed rule on debit card interchange fees and routing

ACTION REQUESTED

Approval of the attached Federal Register notice requesting comment on a proposed new rule that (1) establishes standards for determining whether an interchange fee received or charged by an issuer with respect to a debit card transaction is reasonable and proportional to the issuer's cost incurred with respect to the transaction and (2) prohibits issuers and networks from restricting the number of networks over which a debit card transaction may be routed or inhibiting the ability of a merchant to direct the routing of a debit card transaction.

BACKGROUND

New section 920 of the Electronic Fund Transfer Act ("EFTA Section 920"), added by Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, directs the Board to issue rules relating to debit card interchange fees, network exclusivity, and transaction routing. EFTA Section 920 was enacted to address merchant concerns regarding the level of interchange fees and network routing rules and exclusivity arrangements. The provisions of EFTA Section 920 are discussed in more detail below.

[1] Division of Reserve Bank Operations and Payment Systems (Louise Roseman, Jeffrey Marquardt, David Mills, Jeffrey Yeganeh, Geoffrey Gerdes, Jennifer Williams, Edith Collis, and Joshua Hart), Division of Research and Statistics (Robin Prager, Elizabeth Kiser, and Mark Manuszak), Legal Division (Scott Alvarez, Stephanie Martin, Chris Clubb, and Dena Milligan), Division of Consumer and Community Affairs (David Stein, Ky Tran-Trong, and Vivian Wong), and Julia Cheney (on detail to the Board from FRB Philadelphia).

Payment card networks set a variety of fees paid by different parties in the network in order to process transactions through the card network. Interchange fees are set by payment card networks and are paid by merchant acquirers to card issuers. Merchant acquirers include the interchange fees in the merchant discount fees they charge to merchants. Although current interchange fees are not tied directly to issuer costs, issuers assert that interchange fees are used to cover the costs associated with their debit card programs, including fraud-prevention measures. In recent years, merchants have objected to what they believe are excessively high interchange fees. Payment card networks also charge other fees, including switch fees, to both issuers and merchant acquirers, which allow the networks to cover their costs and earn a return on investment.

Payment card networks also establish rules that issuers, acquirers, and merchants must follow in order to participate in the network. Among other things, network rules generally permit issuers or networks to determine how a particular transaction will be routed. In addition, the two major networks that carry signature debit card transactions (Visa and MasterCard) have established or purchased affiliated PIN-debit networks (Interlink and Maestro, respectively). Financial incentives from the two major networks have led some issuers to issue debit cards that can carry transactions over only one of these networks or its affiliates. Merchants have raised concerns about the competitive consequences of various network rules and exclusivity arrangements.

In order to inform this proposed rulemaking, staff distributed surveys to debit card issuers, payment card networks, and merchant acquirers in September. The surveys requested information about issuers' costs of processing transactions, current and historical interchange fees, other network fees, the incidence of and loss from fraud, fraud-prevention activities and

their associated costs, and network exclusivity arrangements and transaction routing restrictions. Staff analyzed the survey responses, and key results are discussed throughout this memorandum. In addition, staff has held a number of meetings with payment card networks, issuers, merchant acquirers/processors, merchants, and consumer representatives to better understand the debit card industry and has reviewed written submissions provided by interested parties.

PROPOSAL

The proposal has two main components: (1) rules establishing the interchange fee standards and a request for comment on standards for fraud-prevention adjustments to those fees and (2) rules prohibiting network exclusivity and routing restrictions.

I. Interchange fee standards

EFTA Section 920 directs the Board to establish standards for assessing whether the amount of any interchange fee that an issuer receives or charges with respect to a debit card transaction is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." In prescribing regulations, the statute directs the Board to consider the functional similarity between debit card transactions and check transactions, which are required to clear at par through the Federal Reserve System. The statute also directs the Board to distinguish between the incremental cost incurred by the issuer for the issuer's role in the authorization, clearance, and settlement of a particular debit card transaction, which shall be considered in setting the standard, and other costs incurred by an issuer that are not specific to a particular debit card transaction, which shall not be considered in setting the standard. The interchange fee restrictions do not apply to issuers that, together with affiliates, have assets of less than $10 billion, or to debit card transactions made using debit cards issued under government-administered programs or certain reloadable prepaid cards.

A. Allowable costs

As noted above, EFTA Section 920 requires the Board to consider the incremental cost of authorization, clearance, and settlement of a particular transaction, but prohibits the Board from considering other costs that are not specific to a particular transaction. The statute does not address issuer costs that are specific to a particular transaction, but are not incurred for authorization, clearance, and settlement of the transaction.

Staff recommends that the proposed standards allow issuers to recover through interchange fees their variable costs that are directly attributable to authorization, clearance, and settlement of the transaction (including fees paid to processing agents for those activities). Staff also recommends the proposed standards not allow an issuer to recover through interchange fees other costs of debit card programs—either costs that are not specific to a particular transaction (e.g., the cost of producing and distributing debit cards, general costs of deposit accounts, branch costs, and overhead) or costs that are specific to a particular transaction, but not incurred for authorization, clearance, and settlement (e.g., costs associated with cardholder rewards and responding to certain customer service inquiries). Given the statute's mandate to consider the functional similarities between debit card transactions and check transactions, staff recommends that allowable costs under the proposal be limited to those that the statute specifically allows to be considered, and not be expanded to include additional costs that a payor bank in a check transaction would not recoup through fees from the payee's bank. Staff also recommends that the Board specifically request comment on whether network processing fees (e.g., switch fees) that issuers pay to payment card networks for each transaction processed should be included in allowable costs. Allowing these fees to be recovered through the interchange fee, however,

could put merchants and acquirers in the position of effectively paying all covered issuers' network processing fees.

As noted above, EFTA Section 920 requires the Board to consider the "incremental cost" of authorization, clearance, and settlement of "a particular transaction." Staff believes there is no standard definition of "incremental cost" that could be readily applied to a particular debit card transaction, and recommends that average variable cost be used as the means of calculating incremental cost.[2] This approach would exclude fixed costs (i.e., costs that do not vary with changes in output, up to existing capacity limits) because such costs cannot be attributed to any "particular transaction."

Staff considered proposing to define the incremental cost of a particular transaction as marginal cost. However, marginal cost can be different for each unit of output, and it is unclear which unit of output's cost should be considered, although often it is assumed to be the last unit of output. Measurement of marginal cost generally relies on estimation of econometric models using large samples of cost data. Because of the difficulty associated with measuring marginal cost and the opacity of the estimation process, staff does not recommend adopting a marginal cost standard.

B. Proposed interchange fee standards

The statute requires the Board to establish standards to ensure that an interchange fee is reasonable and proportional to the issuer's costs.[3] Staff recommends that the Board assess reasonability of an interchange fee by considering whether it is fair and proper in relation to both

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[2]. Many economic definitions of "incremental cost" refer to the difference of the costs of two production alternatives; for example, producing a product line versus not producing the product line. In general, these definitions contemplate production alternatives that are much larger in size than a single unit of the good, and therefore these definitions contemplate the inclusion of fixed costs that are affected by the decision made.

[3] Although "reasonable and proportional" standards have been used in certain other statutes, specifically statutes governing public utility rate setting and credit card penalty fees, the standards have different connotations when applied in those statutes than when applied to interchange fees.

the individual issuer's costs as well as the costs incurred by all covered issuers. In considering whether an interchange fee is proportional to the issuer's costs, staff recommends that the Board not require identical cost-to-fee ratios for all issuers (although a constant cost-to-fee ratio would result from the issuer-specific standard discussed below for issuers with allowable costs below the cap). Rather, staff recommends that the cost-to-fee ratio of any issuer that received fees at or below the amount of a safe harbor or cap that the Board determined to be reasonable (discussed below) be considered to meet the proportionality standard.

Staff recommends that the proposal request comment on two alternative frameworks for assessing "reasonable and proportional" interchange fees. Alternative 1 uses a combination of three approaches: issuer-specific standards, a cap, and a safe harbor. Alternative 2 uses only the cap.[4] Under Alternative 1, each issuer would be permitted to determine the maximum amount of an interchange fee that it may receive with respect to a debit card transaction by calculating its average variable cost for authorization, clearance, and settlement of electronic debit transactions. To minimize burden and facilitate compliance, an issuer would be permitted to rely on a safe harbor, instead of determining its maximum allowable fee based on its costs. The proposed standard would set the safe harbor at 7 cents per transaction, which corresponds to the median issuer's average variable cost for authorization, clearance, and settlement based on the Board's survey results. The safe harbor would give an issuer receiving an interchange fee at or below the safe harbor an incentive to reduce its costs below 7 cents per transaction.

Under Alternative 1, issuers with costs in excess of the safe harbor would be permitted to recover their average variable costs for authorization, clearance, and settlement up to a cap. The

[4] Staff considered a pure issuer-specific approach whereby the standards would set neither a safe harbor nor a cap. In addition to the problems with economic incentives described in this memorandum, staff believes that a pure issuer-specific approach would be significantly more burdensome than the proposed alternatives to implement and enforce.

proposed standard sets a cap of 12 cents per transaction, which corresponds to approximately the 80th percentile of allowable costs across issuers that responded to the survey. The issuers that reported costs above the 80th percentile may have higher costs for a number of reasons, including small debit card programs targeting high-net-worth customers and newer start-up programs that have not achieved economies of scale. Setting a cap ensures that no issuer is able to receive an interchange fee at an unreasonably high level.[5] Without a cap, issuers that choose to report their costs to receive an interchange fee above the safe harbor would not have an incentive to control cost, compared to those issuers that accept the safe harbor, because they would receive no mark-up on costs. With a cap however, these issuers would have an incentive to control their per-transaction costs to keep them below the cap.

Under Alternative 2, the proposed standard sets a cap on the amount of an interchange fee that any issuer could receive. Alternative 2 uses the same cap as Alternative 1—12 cents per transaction. Under this alternative, any interchange fee at or below 12 cents per transaction would be permitted. This approach provides an incentive for all issuers to reduce costs below the cap in order to retain a mark-up over costs. Consistent with Alternative 1, an interchange fee above 12 cents per transaction would not be reasonable.

Under either alternative, the Board would reevaluate the cap (and would reevaluate the safe harbor under alternative 1) every two years based on cost information collected from issuers. Under either alternative, the interchange fee standard would not limit the ability of an issuer to earn revenue from other sources, such as by charging fees to its cardholders.[6]

C. Circumvention and evasion

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[5] The highest-cost issuers in our sample have costs that exceed existing interchange fee rates. These issuers, therefore, appear to have made a business decision to operate their debit card programs despite not fully recovering debit card operating costs from interchange fee revenue.

[6] An issuer's ability to earn revenue from the network, however, would be limited by the proposed rule's circumvention and evasion provisions.

EFTA Section 920 gives the Board the authority to issue rules to prevent circumvention and evasion of the interchange fee regulations. The statute gives the Board specific authority to prescribe regulations that ensure that a network fee is not used to directly or indirectly compensate an issuer with respect to a debit card transaction and is not used to circumvent or evade the restrictions of the interchange fee provisions. The Board also has general authority to prescribe rules to address other forms of circumvention or evasion.

In order to prevent circumvention and evasion, the proposed rule would prohibit an issuer from receiving net compensation from a network for debit card transactions.[7] For example, any compensation provided by the network to the issuer, such as per-transaction rebates or incentive payments, could not exceed the total amount of fees paid by the issuer to the network.

D. Fraud-prevention adjustment

EFTA Section 920 states that the Board may allow for an adjustment to the permitted interchange fee if such an adjustment is reasonably necessary to allow for an issuer's fraud-prevention costs in relation to debit card transactions and if the issuer complies with fraud-prevention standards established by the Board.[8] These standards must take into account any fraud-related reimbursement the issuer receives from other network participants and must require an issuer to take effective steps to reduce the occurrence of and costs from fraud, including implementing cost-effective fraud-prevention technology. EFTA Section 920 also requires the Board to consider several factors when establishing standards for receiving an adjustment for fraud-prevention costs, and provides the Board with flexibility to consider other factors it deems relevant.[9]

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[7] As noted above, interchange fees are considered to be compensation from acquirers, not the networks.
[8] An issuer's fraud losses would not be considered a fraud-prevention cost.
[9] Specifically, the Board must consider (1) the nature, type, and occurrence of fraud in electronic debit transactions; (2) the extent to which the occurrence of fraud depends on whether the authorization in an electronic debit

In the issuer survey, issuers reported a large number of different fraud-prevention and data-security activities. Based on cost information, if all reported fraud-prevention and data-security costs are considered, the median amount spent by respondents on fraud prevention activities was 1.8 cents per transaction. Staff believes, however, that many of these reported costs include fraud-prevention activities that may not be appropriate for consideration in an adjustment. For example, many of the costs reported related to the overall account relationship, and were not specific to debit card transactions.

In addition, from the list of fraud-prevention and data-security activities obtained through the survey and other information obtained thus far, there is insufficient information to enable staff to make an informed recommendation to the Board at this time regarding which activities are effective in reducing fraud and cost-effective and what adjustment amount is reasonably necessary to take into account an issuer's costs of such activities. Therefore, the proposal does not include a specific adjustment to the amount of an interchange fee for an issuer's fraud-prevention costs. Instead, the notice of proposed rulemaking sets forth two general approaches to the fraud-prevention adjustment framework and asks several questions related to the alternatives.

One approach would use the fraud adjustment as a catalyst for spurring implementation of major innovations that would likely result in substantial reductions in total, industry-wide fraud losses. For the fraud adjustment to serve that purpose effectively, the Board would need to identify the paradigm-shifting technology(ies) that would reduce debit card fraud in a

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transaction is based on a signature, PIN, or other means; (3) the available and economical means by which fraud on electronic debit transactions may be reduced; (4) the fraud prevention and data security costs expended by each party involved in the electronic debit transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers, and payment card networks); (5) the costs of fraudulent transactions absorbed by each party involved in such transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers, and payment card networks); (6) the extent to which interchange transaction fees have in the past reduced or increased incentives for parties involved in electronic debit transactions to reduce fraud on such transactions; and (7) such other factors as the Board considers appropriate.

cost-effective manner, and determine the issuers' costs of implementing the new technology in order to set the adjustment that the issuer would receive. One potential unintended consequence of such an approach is that standards could lock issuers into specific technologies that are not as effective at reducing fraud, or not as cost effective, as other technologies that are not identified in the standards. Substantial challenges would also remain in measuring the effectiveness of such technologies and identifying the cost of implementing new technologies in order to set an appropriate adjustment.

The second approach would use the fraud adjustment to encourage issuers to continue to engage in new or existing fraud-prevention activities. This approach would establish more general standards that an issuer must meet in order to be eligible for the adjustment. Such standards could require issuers to take steps reasonably necessary to maintain an effective fraud-prevention program but not prescribe specific measures or technologies that must be employed as part of the program. Under this approach, the fraud adjustment would be set to reimburse the issuer for some or all of the costs of an issuer's current fraud-prevention and data-security activities and the costs of research and development for new fraud-prevention techniques, perhaps up to a cap. A potential unintended consequence of this general approach is that issuers may not have much incentive to control costs or to shift from less effective to more effective fraud-prevention activities over time.

Although EFTA Section 920 states that the Board may allow for a fraud adjustment, it also states that the Board must prescribe regulations in final form to establish standards for making such fraud adjustments not later than nine months after the date of enactment of the Dodd-Frank Act (i.e., April 2011). Staff recommends that the proposed regulatory text include a reserved section for a fraud adjustment in order to allow the Board to collect additional

information to construct an appropriate proposal. The Board may then make a specific proposal to address the fraud adjustment, which would then be subject to another round of comments. While this might delay adoption of a final rule on the fraud adjustment beyond April 2011, it is likely to result in a better crafted and supportable decision. Staff will make every effort to complete its review as quickly as possible.

II. Network exclusivity and routing

EFTA Section 920 requires the Board to issue rules prohibiting issuers and networks from restricting the number of networks over which a debit card transaction may be routed to one such network or to two or more affiliated networks (a practice known as “network exclusivity”). The statute also requires the Board to issue rules prohibiting issuers and networks from inhibiting the ability of a merchant to direct the routing of debit transactions over a particular network. The network exclusivity and routing provisions apply to all issuers and to all debit cards and prepaid cards, including those that are exempt from the interchange fee restrictions.

Currently, debit card transactions are routed over one of two types of networks depending on the method of authorization selected by the cardholder. In general, if a cardholder enters a personal identification number (PIN) at the point-of-sale, the transaction is routed over a network that uses network infrastructure similar to that used for ATM transactions, with a single message to authorize and clear the transaction. In contrast, if a cardholder uses a signature to authorize the transaction, the transaction is routed over a network that uses the same network infrastructure that is used for credit card transactions, with two messages to complete the transaction—one for authorization and one for clearing.

With respect to the prohibition on network exclusivity, the proposal requests comment on two alternative approaches to determining whether there are at least two unaffiliated payment

card networks available to carry a transaction. Under Alternative 1, a debit card satisfies the non-exclusivity requirement if it can be used to initiate transactions over two unaffiliated networks, without consideration as to the authorization method chosen by the cardholder. For example, a debit card would have two unaffiliated networks if it enables debit card transactions to be carried by one signature-based network and one PIN-based network, provided the networks are not affiliated. Under this approach, once the method of authorizing the transaction is chosen, a merchant would not have a choice over which network to route the transaction if only one signature debit network and one unaffiliated PIN network are enabled on a debit card. This configuration of networks enabled on a card—that is, one signature network and at least one PIN network—would avoid significant compliance costs and be less likely to necessitate major changes to existing network infrastructure.

Under Alternative 2, a debit card satisfies the non-exclusivity requirement if it is enabled with more than one unaffiliated network for each method of authorization (currently signature and PIN). For example, if a card is enabled for signature and PIN debit, Alternative 2 would require that there be two unaffiliated signature networks and two unaffiliated PIN networks available. Ensuring two routing options for each method of cardholder authorization would facilitate the merchant-routing choice provisions (discussed below), but would substantially increase the cost of compliance for issuers and networks and likely would require major changes to existing network and processor infrastructure. Although networks, issuers, and merchant acquirers currently have the technological ability to handle multiple PIN networks on the same debit card, they do not currently have the systems in place to handle multiple signature-based networks on the same debit card.

With respect to merchant-routing choice, the proposed rules prohibit issuers and networks from restricting a merchant's ability to direct the routing of debit card transactions over a particular network. A merchant's choice of networks, however, would be limited to those networks that are enabled for carrying transactions on the particular debit card.

CONCLUSION

For the reasons more fully set forth in the attachment, staff recommends the Board approve the publication of the attached notice of proposed rulemaking in the Federal Register with the comment period ending on February 22, 2011.[10] The staff will prepare a final proposal after reviewing the comments received.

Attachment

[10] The statute directs the Board to issue final rules for the interchange fee standards by April 21, 2011 and final rules on network exclusivity and routing by July 21, 2011.