Board

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: April 30, 2021

To: Board of Governors

From: Staff[1]

Subject: Proposed Amendments to Regulation II (Debit Card Interchange Fees and Routing) to Clarify the Prohibition on Network Exclusivity; Biennial Report on 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions

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Action Requested

Approval to publish:

(1) the attached notice of proposed rulemaking (NPR), which would amend Regulation II and its official commentary, and

(2) the attached biennial report on 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions.[2]

Summary

Regulation II prohibits certain restrictions that issuers and payment card networks may place on the processing of debit card transactions to ensure that merchants have at least two unaffiliated payment card networks available when routing those transactions.[3] When the Board promulgated Regulation II, the market had not developed solutions to broadly support multiple networks for card-not-present transaction, such as online transactions, and the Board explained that it expected the market to develop such solutions in the years following the adoption of

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[2] Staff requests the authority to make technical, non-substantive changes to the NPR and report prior to publication, if needed.

[3] Regulation II, Debit Card Interchange Fees and Routing, codified at 12 CFR part 235. The provisions specifically related to the routing of debit card transactions are codified at 12 CFR 235.7. Regulation II also contains other provisions regarding interchange fees for certain debit card transactions.

Regulation II. In the decade since the adoption of Regulation II, spurred by the growth in online commerce, card-not-present transactions have become an increasingly significant portion of all debit card transactions, and technology has evolved to enable multiple networks for these transactions. Despite this, two unaffiliated payment card networks are often not available to process card-not-present transactions, such as online purchases, because some issuers do not enable multiple networks for such transactions. Staff members view such an outcome as inconsistent with Regulation II's requirement that at least two unaffiliated networks be available to process each debit card transaction. Accordingly, the attached NPR would amend Regulation II and its official commentary to (i) clarify that the regulation's requirement that each debit card transaction must be able to be processed on at least two unaffiliated payment card networks applies to card-not-present transactions, (ii) clarify the requirements that the regulation imposes on debit card issuers to ensure that at least two unaffiliated payment card networks have been enabled for debit card transactions, and (iii) standardize and clarify the use of certain terminology.

The changes proposed in the NPR would not affect other parts of Regulation II that directly address interchange fees for certain debit card transactions. This limit to the scope of the proposed revisions is explicitly noted in the NPR. The NPR states that the Board will continue to review the regulation in light of the most recent data collected by the Board and may propose additional revisions in the future.

In that regard, the attached report on 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions is the sixth in a series of biennial reports that the Board publishes as part of its responsibilities related to Regulation II. The report finds that most top-level numbers for 2018 and 2019 fall in line with long-term trends.

Background on Regulation II routing provisions and biennial report

In 2011, pursuant to Section 1075 of the Dodd-Frank Act, the Board promulgated Regulation II.[4] Section 1075 of the Dodd-Frank Act amends the Electronic Fund Transfer Act (EFTA) to add a new section 920 regarding interchange transaction fees for electronic debit

[4] Public Law 111-203, 124 Stat. 1376 (2010).

transactions (or “debit card transactions”) and rules for payment card transactions.[5] Regulation II implements, among other things, the statutory provisions that limit restrictions that issuers and payment card networks may place on the processing of an electronic debit transaction.

Regulation II specifically incorporates these statutory provisions related to issuers and payment card networks through two prohibitions.[6] First, the regulation prohibits an issuer or payment card network from restricting the number of networks on which an electronic debit transaction may be processed to *fewer than two unaffiliated networks* (“prohibition on network exclusivity”).[7] Second, the regulation prohibits an issuer or payment card network from directly or indirectly inhibiting any person that accepts debit cards for payment from directing the routing of an electronic debit transaction over any network that may process that transaction (“prohibition on routing restrictions”).[8] Together, these prohibitions under Regulation II aim to ensure that merchants or their acquirers can choose from at least two unaffiliated payment card networks when routing debit card transactions.

Separately, EFTA section 920 requires the Board to biennially report aggregate or summary information on the costs incurred, and interchange fees charged or received, by debit card issuers and payment card networks in connection with debit card transactions. To collect this information, the Board conducts an annual survey of payment card networks and a biennial survey of debit card issuers that are subject to the interchange fee cap in Regulation II (covered issuers).[9] The current report is the sixth in the series and summarizes information from these data

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[5] 15 U.S.C. 1693o-2.

[6] An electronic debit transaction typically involves at least five parties: (i) a cardholder, (ii) the entity that issued the debit card to the cardholder (the issuer), (iii) a merchant, (iv) the merchant’s depository institution (the acquirer), and (v) a payment card network. The issuer provides the cardholder with a debit card that is enabled to process transactions over various payment card networks. The cardholder can initiate a debit card transaction at a merchant that accepts the networks enabled on the cardholder’s card. To process the transaction, the acquirer routes the transaction over one of the payment card networks available on the card.

[7] Absent this prohibition on network exclusivity, an issuer could enable only a single payment card network, or only two affiliated networks, to process a debit card transaction, thereby foreclosing the ability of the merchant or its acquirer to choose among multiple competing networks to process the transaction.

[8] Absent this prohibition on routing restrictions, an issuer or payment card network could establish rules or other restrictions that override a merchant’s routing preferences, thereby preventing the merchant or its acquirer from routing a transaction over a network with, for example, lower fees for merchants.

[9] Covered issuers are those with worldwide assets, including affiliates, of $10 billion or more.

collections for 2018 and 2019.

Current issue addressed in the NPR for card-not-present debit card transactions

Since Regulation II was adopted, issues related to the regulation's prohibition on network exclusivity have become increasingly pronounced for card-not-present debit card transactions, such as online purchases, resulting in a lack of routing choice for merchants among at least two unaffiliated networks for those transactions.[10] Two types of payment card networks currently exist to process debit card transactions – single-message networks and dual-message networks.[11] The market has evolved such that, for card-present transactions, the vast majority of issuers enable one dual-message network and one or more single-message networks on their cards. Such an arrangement generally complies with Regulation II, provided at least two of the networks enabled by an issuer are unaffiliated.

At the time Regulation II was promulgated, for card-not-present transactions, the market had not developed solutions to broadly support multiple networks for each transaction. While dual-message networks had long been able to conduct card-not-present transactions, single-message networks had limited ability to process such transactions at that time. Methods of PIN authentication for card-not-present transactions, such as PIN entry in an online setting, were not well-established when Regulation II was adopted. Because single-message networks primarily processed PIN-authenticated transactions, this technological limitation posed an impediment to the use of those networks for card-not-present transactions. This difficulty, along with the industry practice of enabling only one dual-message network on each card, meant that card-not-present transactions could often only be processed on that one dual-message network.

When it promulgated Regulation II, the Board explained that it expected the market to develop solutions to facilitate the use of single-message networks for card-not-present

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[10] Card-not-present transactions are those in which a cardholder initiates a card payment without physically presenting the card to a merchant. Card-not-present transactions typically involve remote commerce, such as internet, telephone, or mail-order purchases.

[11] Single-message networks, which developed from automated teller machine (ATM) networks, typically use a single message to authorize and clear a transaction and have traditionally processed transactions authenticated using a cardholder's PIN (personal identification number). Because of their historical reliance on PIN authentication, single-message debit card networks were traditionally known as "PIN debit networks." Dual-message networks, which developed from credit card systems, typically authorize and clear a transaction through two separate messages and have traditionally processed signature-authenticated transactions. Because of their historical reliance on signature authentication, dual-message debit card networks were traditionally known as "signature debit networks."

transactions in the years following the adoption of Regulation II.[12] In the decade since the adoption of Regulation II, technology has evolved to address these barriers, and nearly all single-message networks have introduced capabilities to process card-not-present transactions.[13] At the same time, spurred by the growth in online commerce, card-not-present transactions have become an increasingly significant portion of all debit card transactions.[14] Recent evidence indicates that growth in card-not-present transactions has accelerated further in the Coronavirus-19 (COVID-19) environment, as consumers have shifted from in-person to remote purchases.[15]

Despite these developments, merchants are not always able to choose from at least two unaffiliated networks when routing card-not-present transactions. Data collected by the Board document that single-message networks collectively process a small share of card-not-present transactions compared with their share of card-present transactions.[16] Additional data collected by the Board and information from industry participants, including individual merchants, merchant trade associations, and representatives of single-message networks, indicate that the low prevalence of card-not-present transactions over single-message networks may have occurred because issuers have not consistently enabled single-message networks for card-not-present transactions. In particular, data collected by the Board and summarized in the attached report document that covered issuers accounting for approximately 50 percent of all debit card transactions and 50 percent of all card-not-present transactions did not conduct any card-not-present transactions over single-message networks in 2019.

A failure by an issuer to enable at least one unaffiliated single-message network for card-not-present transactions, combined with the common industry approach of only enabling one dual-message network on each card, results in only one network – the dual-message network –

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[12] "Debit Card Interchange Fees and Routing; Final Rule," 76 FR 43393 (Jul. 20, 2011). More specifically, the Board expressed the view that, by requiring two unaffiliated networks for each debit card transaction and removing limitations on merchant routing choice, Regulation II would promote innovation related to network availability for card-not-present transactions.

[13] For example, many single-message networks no longer require PIN entry for some transactions, including card-not-present transactions and low-value card-present transactions. Data on network activity collected by the Board confirm that nearly all single-message debit card networks conducted card-not-present transactions in 2019. In contrast, fewer than half of single-message networks reported such activity when Regulation II was adopted in 2011.

[14] As documented in the attached report, the number of card-not-present debit card transactions grew approximately 17 percent per year, on average, from 2009 to 2019, in contrast to the 6 percent average annual growth in card-present transactions over the same period.

[15] For information about aggregate patterns in e-commerce, see "Latest Quarterly E-Commerce Report," available at https://www.census.gov/retail/index.html#ecommerce.

[16] As documented in the attached report, single-message networks processed only 6 percent of all card-not-present debit card transactions in 2019, compared to over 40 percent of card-present transactions.

being available to process card-not-present transactions. In this situation, merchants do not have routing choice for such transactions. Staff members view these practices by issuers for card-not-present transactions as inconsistent with the prohibition on network exclusivity in Regulation II because they restrict the number of payment card networks on which card-not-present transactions can be processed to fewer than two unaffiliated networks.

Proposed changes to Regulation II in the NPR

The NPR proposes changes to Regulation II to clarify that debit card issuers should enable, and merchants should be able to choose from, at least two unaffiliated networks for card-not-present transactions. Specifically, staff members propose revisions to the commentary to clarify that card-not-present transactions are a particular *type of transaction* under Regulation II's existing prohibition on network exclusivity for which issuers must ensure at least two unaffiliated payment card networks have been enabled.[17] This change is not intended to impose new obligations with respect to card-not-present transactions, but rather to clarify the regulation's applicability to those transactions.

The NPR further proposes changes to Regulation II that clarify the responsibilities of the debit card issuer in ensuring that at least two unaffiliated networks have been enabled to comply with the regulation's prohibition on network exclusivity. Specifically, Regulation II with the proposed amendments would provide that an issuer satisfies the regulation's prohibition on network exclusivity only if, for every particular type of transaction (as well as every geographic area, specific merchant, and particular type of merchant) for which the issuer's debit card can be used to process an electronic debit transaction, the *issuer has enabled* at least two unaffiliated payment card networks to process the transaction. The proposed amendments reflect the fact that the issuer is the entity that configures a debit card such that electronic debit transactions initiated with that card can be processed over a particular payment card network. Staff members do not intend these amendments as a substantive change to the regulation but rather as a clarification of

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[17] Section 235.7(a)(2) currently states that an issuer satisfies the prohibition on network exclusivity under § 235.7(a)(1) "only if the issuer allows an electronic debit transaction to be processed on at least two unaffiliated networks, each of which does not, by rule or policy, restrict the operation of the network to a limited geographic area, specific merchant, or *particular type of merchant or transaction*, and each of which has taken steps reasonably designed to enable the network to process the electronic debit transactions that the network would reasonably expect will be routed to it, based on expected transaction volume" (italics added).

the existing language.

In addition to these changes, the NPR proposes revisions to standardize, update, and clarify certain terms and phrases in the commentary. For example, new proposed standardized terms would include "payment card network" (which would replace the shorthand "network" or "card network") and "method of cardholder authentication" (which would replace variations of "authentication" or "authorization"). The NPR also proposes updating the examples of cardholder authentication methods listed in the commentary to better align with current industry practices. The proposed revisions add biometrics to the list of cardholder authentication methods in the commentary, which currently only includes signature and PIN authentication.[18] The NPR would further replace the term "form factor" used in the commentary with "means of access" to better align with the terminology that is used in the industry.[19] In addition to replacing the term "form factor" with "means of access," the proposed revisions would also add "information stored inside an e-wallet on a mobile phone or other device" as an example of a means of access to capture recent technological developments.[20]

Biennial report on 2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions

The attached draft report provides summary information on debit card volumes and values, interchange fees and other fees associated with debit card transactions, covered issuer, merchant, and cardholder fraud losses, and covered issuer costs. The volume of debit card transactions continued to increase, with a growth rate of 7.0 percent from 2018 to 2019.

The report documents that the base interchange fee standard in Regulation II of $0.21 plus 5 basis points times the value of a transaction exceeded the average per-transaction authorization, clearing, and settlement (ACS) costs, including issuer fraud losses, for 78.6

[18] The NPR further proposes adding "or any other method of cardholder authentication that may be developed in the future" to capture cardholder authentication methods that do not yet exist and that would still be captured by Regulation II if they were to be developed. The proposed revisions also recognize instances where no method of cardholder authentication is used.

[19] Comment 235.7(a)-7. The commentary currently refers to "form factor" in clarifying that the regulation's prohibition on network exclusivity applies regardless of whether the debit card is issued in plastic card form and also applies to any supplemental device that is issued in connection with a plastic card, even if that plastic card fully complies with the rule.

[20] The NPR further proposes adding "or another means of access that may be developed in the future" to capture means of access that do not yet exist and that would still be captured by Regulation II if they were to be developed.

percent of covered issuers and 99.4 percent of covered transactions. As noted previously, the NPR states that the Board will continue to review the parts of Regulation II that directly address interchange fees for certain debit card transactions in light of the most recent data collected by the Board and may propose additional revisions in the future.

As in years past, interchange fees were the biggest fee category for debit card transactions. In 2019, interchange fees across all debit and general-use prepaid card transactions totaled $24.3 billion, an increase of 7.4 percent since 2018.[21] Since Regulation II took effect on October 1, 2011, the average level of interchange fees has remained broadly stable for covered transactions, at between $0.22 and $0.24 per transaction.[22] By contrast, average interchange fees for exempt transactions have changed gradually since Regulation II took effect, with the average fee per transaction on dual-message networks rising from $0.51 in Q4 2011 to $0.54 in 2019, and the average fee per transaction on single-message networks falling from $0.31 to $0.25.[23]

The report also documents a continued rise in fraud for debit card transactions of covered issuers. For those transactions, total fraud losses, comprising losses to issuers, merchants, and cardholders, as a share of transaction value grew more than 50 percent between 2011 and 2019, from 7.8 to 12.4 basis points. The report further shows that fraud losses in 2019 fell mostly on merchants, who absorbed 56 percent of total fraud losses, while issuers absorbed 35 percent, and cardholders absorbed the remainder. Although fraud losses increased across all network and card types from 2011 to 2019, total fraud losses continued to be substantially higher in 2019 for dual-message debit card transactions and prepaid card transactions, at 16.2 and 15.3 basis points, respectively, than for single-message debit card transactions, at 5.7 basis points.

The final set of figures in the report pertain to the information that the Board used to establish the Regulation II's interchange fee standard and fraud-prevention adjustment.[24] The

[21] Network fees from issuers and acquirers totaled $8.3 billion in 2019, considerably more than the $2.5 billion issuers and acquirers received from the networks in payments and incentives. While acquirers paid almost two-thirds of the network fees, they received around half of the payments and incentives.

[22] Covered transactions are those conducted by covered issuers that do not qualify for another exemption in EFTA section 920 from Regulation II's interchange fee standard. Exempt transactions include those conducted by exempt issuers, as well as those made using certain reloadable general-use prepaid cards and debit cards issued pursuant to government-administered payment programs.

[23] In addition to the biennial report, since 2011, the Board has annually released summary information about average interchange fees by payment card network, using data collected through the annual survey of those networks. The most recent information for 2019, released in November 2020, is available at https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm.

[24] Regulation II currently caps debit card interchange fees for covered issuers at $0.21 plus 5 basis points of the

report documents that average per-transaction ACS costs, excluding issuer fraud losses, for covered issuers equaled $0.039 in 2019. The 2019 figure is a small increase from the 2017 average of $0.036 but is approximately half of the 2009 value, reflecting a substantial decrease in the average value from 2009 to 2017. Fraud losses for the median covered issuer in 2019 were 4.4 basis points, while the median issuer's fraud-prevention and data security costs were $0.015.

Attachments

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transaction value, plus a $0.01 fraud-prevention adjustment, if eligible. The current values are based on costs and fraud losses of covered issuers in 2009, collected through a voluntary survey of those issuers that was administered as part of the original rule-writing. In particular, the $0.21 base component is based on summary information about ACS costs, excluding issuer fraud losses, of covered issuers. The 5 basis point ad valorem component and the $0.01 adjustment reflect the fraud losses and fraud-prevention and data security costs, respectively, incurred by the median covered issuer in 2009.