

**Meeting Between Federal Reserve Board Staff and  
Representatives of the Merchant Advisory Group (MAG), Food Marketing Institute (FMI), Retail  
Industry Leaders Association (RILA), National Association of Convenience Stores (NACS),  
National Retail Federation (NRF)**

**March 25, 2016**

**Participants:** Louise Roseman, Jeffrey Marquardt, Susan Foley, David Mills, Mark Manuszak, Jessica Stahl, Krzysztof Wozniak, Ian Spear, Aaron Rosenbaum, Slavea Assenova, Stephanie Martin, and Clinton Chen (Federal Reserve Board)

Hannah Walker (FMI), Austen Jensen (RILA), Anna Ready (NACS), Mallory Duncan (NRF), Elizabeth Provenzano (NRF) Elizabeth Garner (MAG), Pat Moran (Consultant)

**Summary:** Representatives of the MAG, FMI, RILA, NACS, and NRF met with Federal Reserve Board staff to discuss their concerns regarding the level of regulated interchange fees compared to issuer costs and the increase in interchange fees for low-value debit card transactions since Regulation II took effect. Representatives also discussed the Regulation II fraud prevention adjustment and network exclusivity/routing provisions.

Attachment

# **Federal Reserve Meeting to Discuss Regulation II**

Friday March 25, 2016

# Meeting outline / objectives

- Introductions
- Objectives
  - Share observations and suggestions regarding regulation II
  - Open dialogue for further discussion
  - Understand timeline for modifications to regulated interchange
  - Determine next steps

# Observations and suggestions about Reg ii

1. Regulated interchange compared to issuer cost
2. Interchange on low value transactions
3. Fraud
  - Losses
  - Prevention adjustment
4. Contracts and network rules
5. Suggestions

## Topic 1: Regulated interchange compared to issuer costs

Regulated interchange exceeds issuer costs that were included in the fee standard, and issuer costs have been dropping.

- Over 99% of covered issuer transactions have costs below the regulatory maximum
- Issuer per transaction costs have dropped markedly from 2009 to 2013
  - ACS costs have dropped 42% (from \$0.076 to \$0.044)
- Regulated interchange exceeds allowable issuer costs by \$4.8 billion annually\*

\* 33.67 billion trans multiplied by \$0.145 (Max regulated interchange of \$0.239 – allowable cost of \$0.093)

## Topic 1: Regulated interchange compared to issuer costs

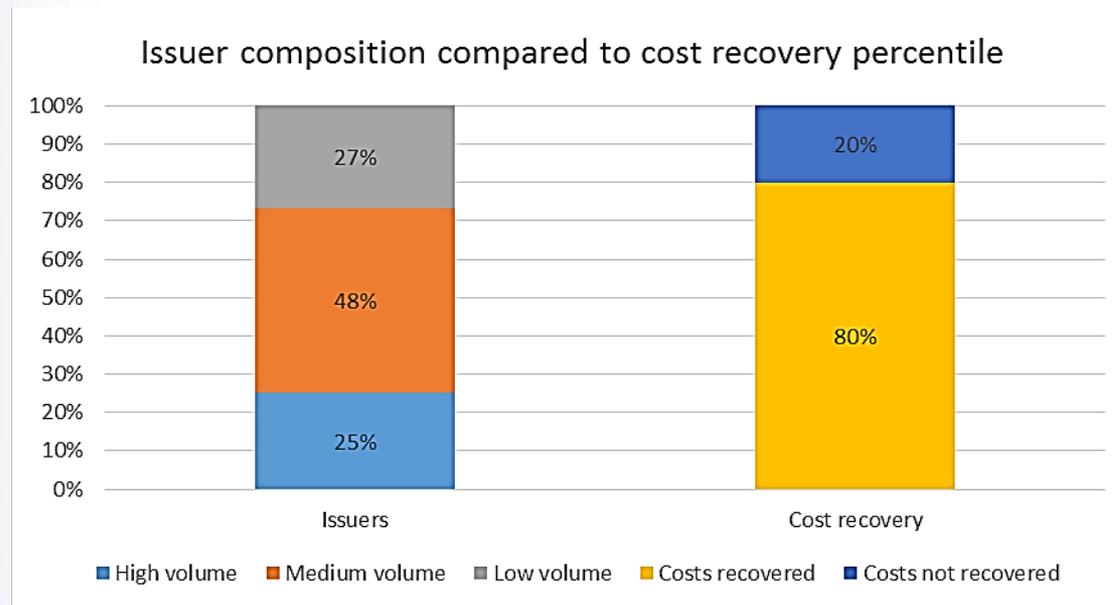
Covered issuers have been classified by debit transaction volume, which varies considerably across issuers. Debit cards are an incidental business line for small volume issuers.

		<b>Debit Program Classification</b>		
		Large	Medium	Small
Transactions (in millions)	Minimum	100	1	n/a
	Maximum	n/a	100	1
	Average	968	28	0.18

Source: Derived from statistics in *2013 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*.

# Topic 1: Regulated interchange compared to issuer costs

Currently per transaction cost recovery is set at the 80<sup>th</sup>\* percentile of issuers, which implies that some issuers from each volume size will have costs covered.

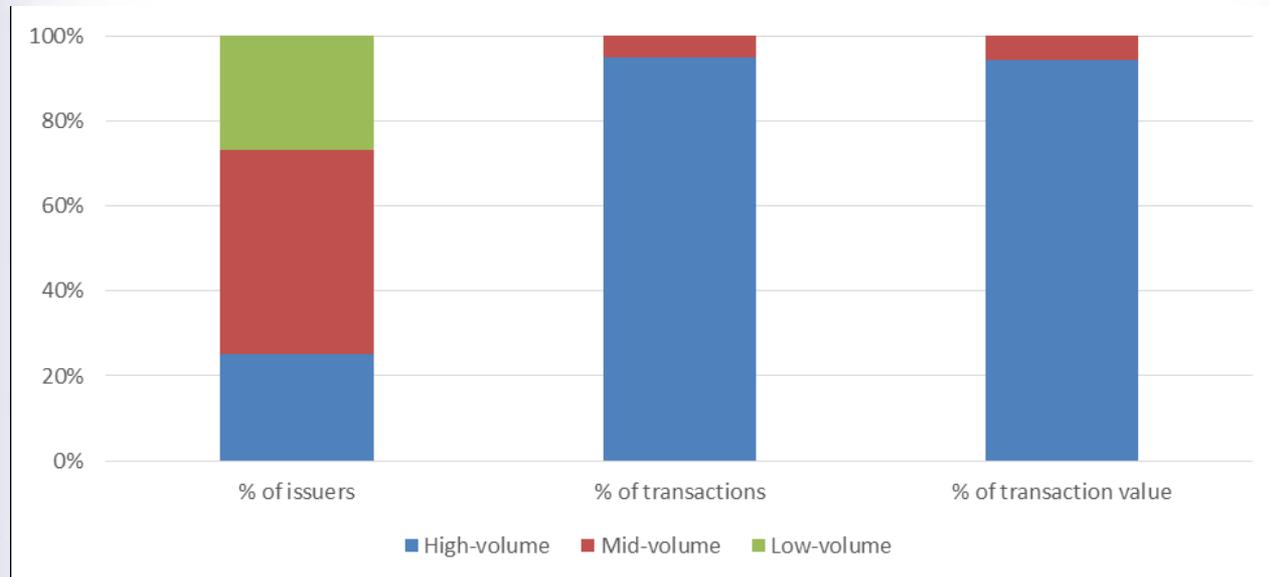


\* Except the fraud which is covered at the 50<sup>th</sup> percentile.

# Topic 1: Regulated interchange compared to issuer costs

Medium volume issuers generate 5-6% of transactions and \$ volume while small volume issuers generate less than 0.1%

## Composition of covered issuers and transaction volume/value of covered issuers in 2013

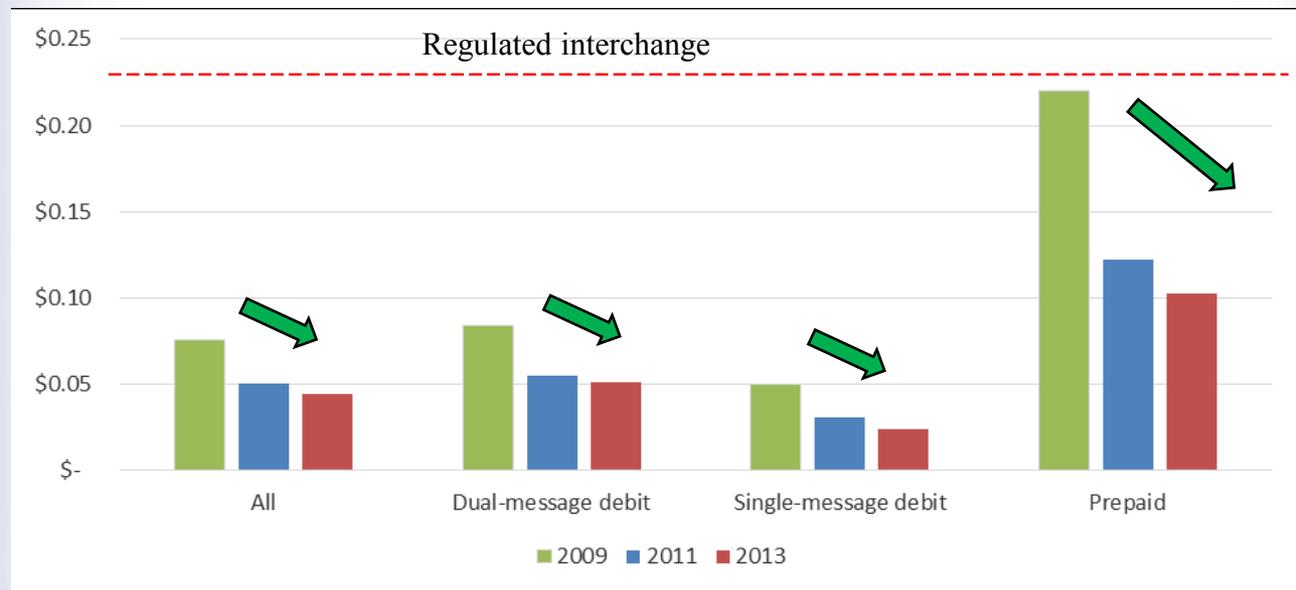


Source: *Exhibit 2. 2013 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*. Page 6.

# Topic 1: Regulated interchange compared to issuer costs

Average ACS costs are decreasing.....

**Average ACS costs, excluding issuer fraud losses, by transaction category**

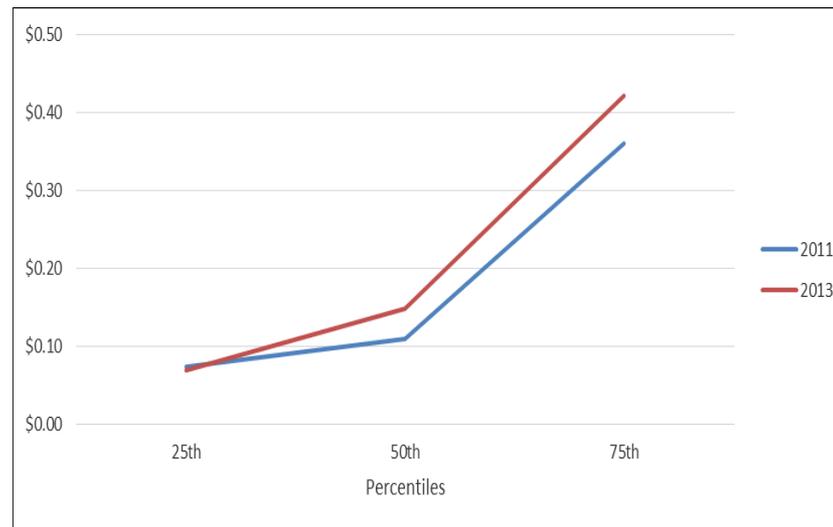


Source: *Exhibit 18. 2013 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*. Page 20, and analysis.

# Topic 1: Regulated interchange compared to issuer costs

.. but ACS costs have gone up at the 50<sup>th</sup> and 75<sup>th</sup> percentiles....

**Distribution of average ACS costs, excluding issuer fraud losses, across issuers**

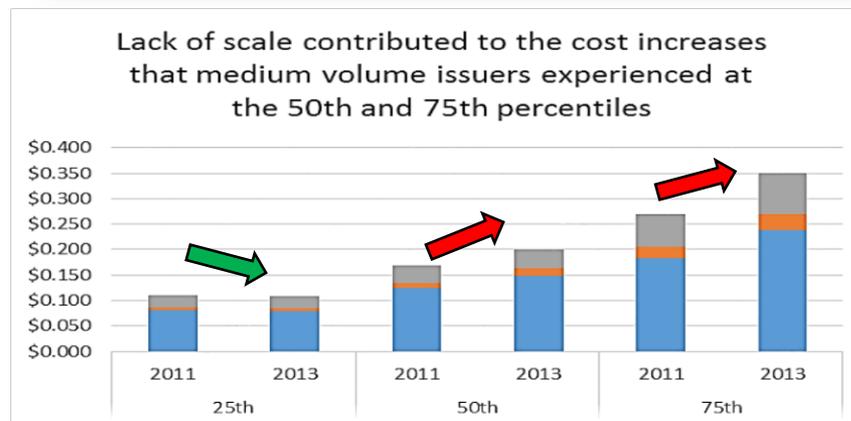
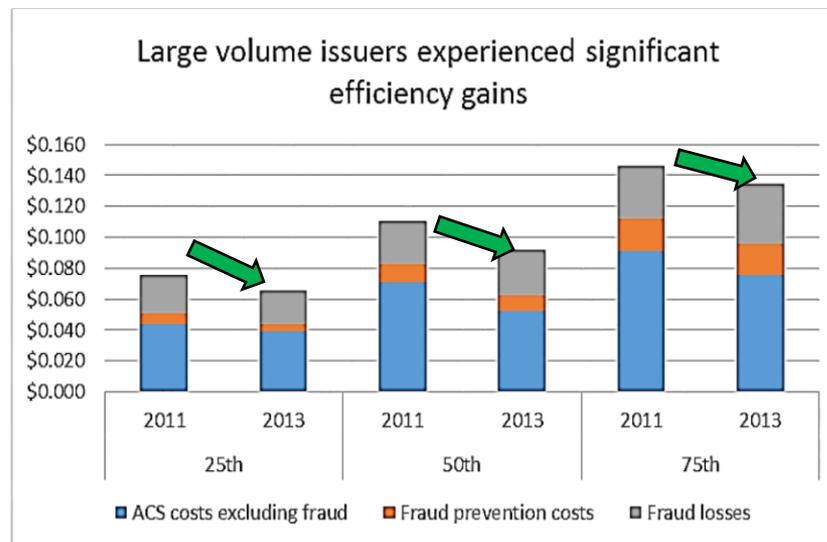


Source: *Exhibit 19. 2013 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*. Page 21.

# Topic 1:

## Regulated interchange compared to issuer costs

.. however large volume issuers and efficient medium volume issuers which make up the bulk of the transactions are reducing costs.



# Topic 1: Regulated interchange compared to issuer costs

All large volume issuers and likely only 1 low volume issuer had total costs below the regulatory maximum.

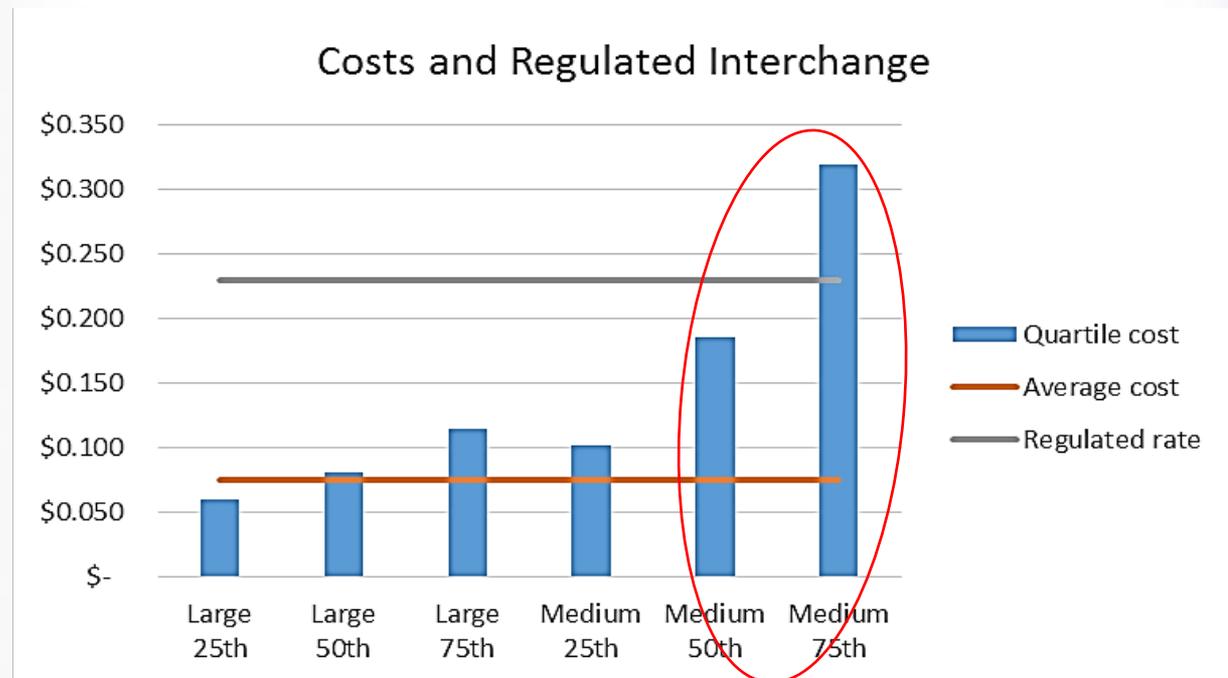
Estimated Issuer distribution\*

Issuer volume & total costs	High	Medium	Low	Total
Costs below maximum	33	41	1	75
Costs above maximum	0	22	21	43
Incomplete (estimated)	0	0	13	13
<b>Total</b>	<b>33</b>	<b>63</b>	<b>35</b>	<b>131</b>
<b>Costs below</b>	<b>100.0%</b>	<b>65.1%</b>	<b>4.5%</b>	<b>63.6%</b>

\* Source: Derived from Table 15 (used % below cost to back into the estimated number of small issuers with incomplete survey information) in *2013 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*. Page 35.

# Topic 1: Regulated interchange compared to issuer costs

Accordingly, the current approach allows full cost recovery somewhere between the 50<sup>th</sup> and 75<sup>th</sup> percentiles for medium volume issuers, where costs jump markedly compared to earlier quartiles.



Difference from avg	-20%	9%	53%	36%	148%	326%

Source: Table 14; <http://www.federalreserve.gov/paymentsystems/regii-data-collections.htm> and analysis.

## Topic 1: Regulated interchange compared to issuer costs

Debit cards appear to be an insignificant business line for all small issuers as well as some medium volume issuers, yet they are impacting the level of regulated interchange.

	Potential issuer interchange by volume size (millions)					
	Large		Medium		Small	
Maximum		n/a	\$	23.95	\$	0.24
Minimum	\$	23.95	\$	0.24		n/a
Calculated average	\$	231.69	\$	6.69	\$	0.047

\* Source: Derived from statistics in *2013 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*, using average transaction values and the regulatory maximum interchange fee.

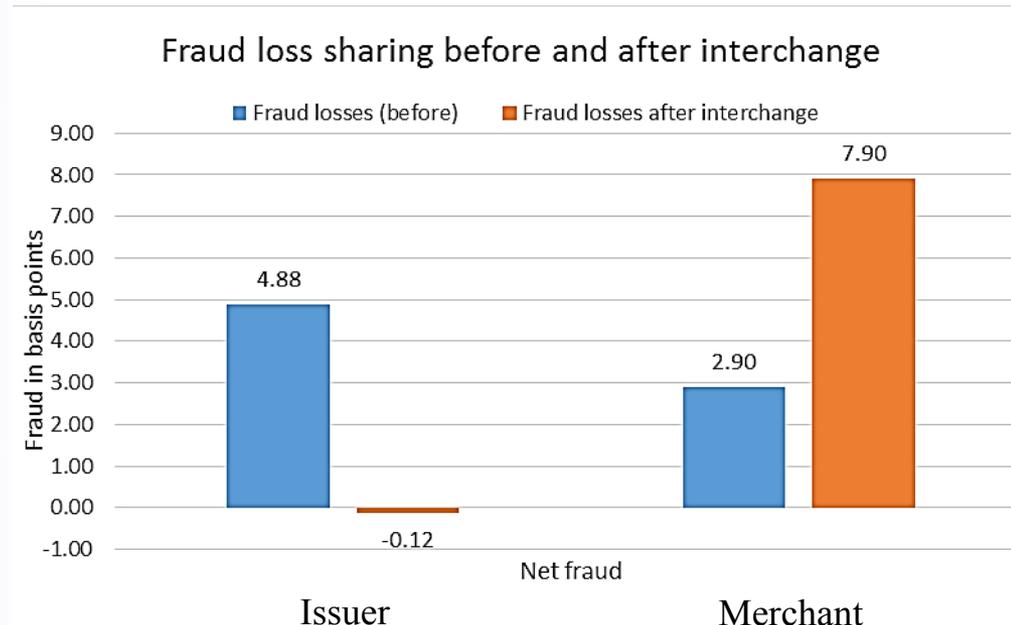
## Topic 2: Interchange on low value transactions

- Many debit transactions can be considered “low value”
  - 13% of transactions < \$5.00\*
  - Another 18% fall between \$5.00 and \$10.00\*
- Interchange has increased over \$900\* million on low value transactions
- Network interchange structures currently provide lower interchange for exempt low value transactions
- Issuer costs are also lower on low value transactions
  - Fraud losses (even when expressed in basis points) are lower on low value transactions
  - Transaction monitoring costs should also be lower
  - Some network fees vary by transaction size, and thus are lower on low value transactions
  - Fewer exception items take place on low value transactions (e.g. chargebacks sometimes prohibited, copy requests sometimes not applicable)

\*2013 Federal Reserve Payments study indicated that 13% of debit transactions were < \$5 and another 18% were between \$5 and \$9.99; assuming average transaction values of \$3 and \$8 for each dollar band respectively and comparing the regulated rate of \$0.22 + 5bps per transaction to a common low value rate of \$0.04 + 1.55% results in a \$940 million annual difference for transactions from covered issuers, which generated 65.9% of debit volume in 2012.

## Topic 3: Fraud losses

When the 5bp variable component of interchange is considered, merchants essentially absorb all fraud losses



## Topic 3: Fraud prevention adjustment

Sizable merchant investment in EMV to avoid losses that were previously borne by issuers suggests the fraud prevention adjustment may need to be reduced / eliminated.

- Merchant direct investment in EMV technology exceeds issuer investment by over \$5 billion\*
- Merchants must make the EMV investment to avoid liability to which they previously were previously not exposed
  - Prior to October 2015, issuers were liable for counterfeit fraud on electronically read transactions
- Merchants also incur relatively more customer training costs
- Fraud prevention adjustment
  - Final rule indicates that to qualify for the fraud prevention adjustment an issuer must implement procedures to reduce fraud costs to all parties
  - Issuers receive about \$330 million annually

## Topic 4: Contracts and network rules

### Rules and contracts may limit routing competition

- Network policies regarding consumer choice
  - Eliminates a merchant's right to have routing options, including more secure alternatives
  - Are not consistent with the determination that issuers do not need to display all routing options on debit cards, and provides advantage to large dual-message networks
  
- Contracts between acquirers and networks
  - Depending upon how contracts and merchant disclosures are written, it is possible that a merchant may effectively be precluded from routing transactions to all available networks and not even know it.

## Suggestions

In light of the previous analysis, we suggest the following:

- Reduce the maximum regulated debit interchange
- Reduce the portion that merchants pay for fraud through interchange
  - Merchants effectively absorb all fraud
  - EMV liability shift and investment
- Implement a regulated maximum interchange that effectively addresses low value transactions
- Gather data and investigate to ensure contracts and network rules are compliant