



# Financial Services Management

## Debit Card Interchange Fees and Routing

Retail Banking

Corporate Planning  
Action Item

### Cite

FRB

Final Rule and Interim Final Rule

Regulation II

Debit Card Interchange Fees and Routing

### Recommended Distribution

Retail Banking, Payment System, Corporate Planning, Legal, Government Relations

### Website

<http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110629a1.pdf>;

<http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110629b1.pdf>

## Overview

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As required by the Dodd-Frank Act,<sup>1</sup> the Federal Reserve has finalized its controversial rule to limit interchange fees on debit cards and increase routing options for merchants. Rejecting issuer arguments and, to some degree, siding with merchants, the FRB has retained its proposed approach and imposed a specific limit on interchange fees instead of issuing broader standards to ensure that the fees are, as dictated by law, “reasonable and proportional.” However, the final fee limits are more generous than the initial proposal. The FRB has also issued an interim final rule (IFR) to address unresolved issues related to accounting for fraud-related costs on debit-card transactions, allowing a one cent adjustment to the interchange fee if the issuer institutes appropriate fraud-prevention standards. The FRB will track the impact of these provisions to assess their near- and long-term impact. The Board was uncomfortable with much in these rules, but decided on them based on its read of the governing statute. As a result, issuers – likely including even the small ones the law intended to exempt – will see significant

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<sup>1</sup> See CONSUMER14, *Financial Services Management*, July 19, 2010.

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reductions in income associated with debit cards, likely leading to widespread changes in retail payment products.

## Impact

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As the rules detail, debit cards have eclipsed checks as the principal form of third-party non-cash payment method, with prepaid cards of various types now also entering the payment system at a rapid clip. Given the wide use of these payment instruments and the fees issuers receive from them, changes here pose major strategic challenges for providers of retail payment services and the merchants that handle these cards. Reflecting the sums at stake and the controversy surrounding these policy issues, the FRB received over 11,500 comments on its initial proposal.<sup>2</sup> As noted, the final rule is less stringent than the proposal – costing issuers an estimated \$10 billion, not the projected \$20 billion in reduced fees initially projected. Merchants have strongly protested this on grounds that the fees in fact should have been reduced well below those proposed, arguing that these cost reductions would be largely transferred to consumers in reduced cost of goods and services. Merchant advocates have suggested they may pursue remedies to force a more stringent rule, while bank interests continue to pursue litigation to force the FRB to drop the specific interchange-fee limits and/or to change the treatment of small issuers.

In fact, the small-issuer provisions were perhaps the most controversial of all of those in this contentious rule. The Dodd-Frank provisions – generally known as the Durbin Amendment – exempt issuers with less than \$10 billion in assets on grounds that they cannot sustain reduced fees due to their higher operating costs. Small issuers argued, however, that the specific limits in the FRB's standards will still adversely affect them because two-tier pricing may be inconsistently provided by networks and/or fade over time. Small issuers thus advocate solutions such as mandatory two-tier pricing, but this is not included in the final rule. Instead, as noted, the Board plans to monitor pricing and other factors and make public any concerns so that Congress could reconsider the small-issuer exemption and strengthen it if needed.

Although the FRB's final rule increases permissible interchange fees as noted, it still does not include many direct and indirect costs in the allowable ones on which the new fee cap is based. Many of these costs are the indirect ones of particular concern to small issuers, but issuers of all sizes believe that the Board's approach does not adequately reflect the true cost of processing debit cards. For example, allowable costs do not include corporate overhead, essentially pricing the service at cost, a provision made worse by the fact that the calculation exclude related costs (e.g., research and development) or those associated with product features (e.g., rewards programs) long associated with this product. Issuers believe that the Board's approach to calculating allowable costs will discourage them from providing many services required to support efficient, competitive and reasonably-profitable debit-card

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<sup>2</sup> See INTERCHANGE2, *Financial Services Management*, January 4, 2011.

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operations. This may well, they argue, lead issuers to delete card features consumer like or offer payment products exempted from the fee limits, possibly exposing customers to still greater fees and/or more problematic account features (e.g., limited merchant acceptance).

The Board did not disagree with this, but indicated that it believed the allowable-cost approach is mandated by law. It will include this issue among those it plans to monitor, as well as turn to rulemaking on reloadable prepaid cards to prevent these from becoming the next challenge to consumers and/or merchants. The final rule also includes a stringent definition of exempt prepaid cards, permitting them to avoid the interchange-fee caps only if the issuer is small (see below) or the card lacks payment functionality (e.g., bill-paying capability over the ACH network).

As noted, fraud was a significant concern in the proposal and the cost calculations then proposed. The law permits an additional fee to reflect fraud-prevention costs, but only if the methods for reducing fraud meet Board specifications. Reflecting the complexity of this issue, the FRB has issued an interim rule that will set initial parameters for an additional one-cent cost factor to be calculated in the basic interchange-fee limits while broader matters related to fraud prevention and transaction authentication are finalized.

In addition to fees, the rule covers debit-card network-exclusivity and routing, which the Dodd-Frank Act addressed to expand choices for merchants and consumers on grounds that this would increase service options and reduce cost. The final rule includes an option supported by issuers to prevent network exclusivity, under which issuers may use no more than two unaffiliated networks regardless of the authentication method chosen by the consumer. Issuers opposed the proposed alternative, in which two unaffiliated processing options would have been required for each authentication method, on grounds that it would confuse consumers with little offsetting benefit. Merchants strongly protested this on grounds that consumers would in fact have little choice since only one option would be provided for each authentication method (i.e., PIN and signature).

Also as desired by large issuers and payment-card networks, the final rule excludes ATM networks from coverage under the law's exclusivity and routing requirements. Advocates of this approach argued that it would enhance competition in this area, thus benefiting small ATM operators, merchants and consumers. However, the Board countered that ATMs provide cash (the same reason debit-card transactions on ATMs are not subject to interchange-fee restrictions) and thus not within the law's purview.

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## What's Next

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The Board voted 4-1 to approve the final rule on June 29. Much in it is effective on October 1, 2011, although the network-exclusivity provisions are for issuers delayed until April 1, 2012. The effective date is delayed until April 1, 2013 for certain cards that use transaction qualification or substantiation systems. Non-reloadable general-use prepaid cards sold on or after April 1, 2013, must comply with the rule. Non-reloadable general-use prepaid cards sold prior to April 1, 2013, are not subject to the rule. Reloadable general-use prepaid cards sold on or after April 1, 2013, must comply with the rule. With respect to reloadable general-use prepaid cards sold and reloaded prior to April 1, 2013, the effective date is May 1, 2013. With respect to reloadable general-use prepaid cards sold prior to April 1, 2013, and reloaded after April 1, 2013, the effective date is 30 days after the date of reloading.

Further, exemptions from the fee restrictions for certain exempted transaction features end on July 21, 2012. The merchant routing provisions are effective on October 1, 2011. However, issuers and payment card networks may voluntarily comply with these rules prior to these dates. The IFR is effective as of October 1, with comments due by September 30.

In the run-up to this action, Members of the House<sup>3</sup> and Senate<sup>4</sup> introduced legislation to delay the rule and require reconsideration of much in it. Ultimately, the Senate failed to advance this legislation, meaning that the Board felt compelled to advance the rule as required by the Dodd-Frank Act. To date, no legislation to repeal the provisions in law or otherwise alter the rule has been introduced and the chances of passage are slim were any in fact now to be introduced. Thus, the impact of the rule will be addressed only in the courts, where challenges to it continue.

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## Analysis

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The analysis below addresses strategic issues in the lengthy final rule, which also subsumes a detailed commentary addressing numerous definitional, implementation and systems issues.

### A. Interchange Fees

#### 1. Total Fees

The final rule limits interchange fees to no more than the sum of 21 cents and a five basis point ad-valorem charge based on the Board's final determination of the allowable costs to be considered in ensuring that interchange fees are "reasonable and proportional" to the transaction (as required by the law). This is up from the proposed twelve cent maximum fee.

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<sup>3</sup> See INTERCHANGE5, *Financial Services Management*, April 24, 2011.

<sup>4</sup> See INTERCHANGE4, *Financial Services Management*, March 22, 2011.

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The Board rejected an array of issuer comments that “reasonable and proportional” did not require a set cap and/or that the costs used to set the standard should be more broadly construed. It also rejected merchant and consumer-group comments that wanted either a limit based on each issuer’s specific allowable costs or a far lower cap.

## **2. *Evasion***

The rule, like the law, requires the Board to prevent any evasion or circumvention of these fee caps. In the final rule, the FRB rejected suggestions that it mandate that fees be the same as they flow from merchants through the network to an issuer, but it said it would monitor these to be sure that fees are not altered in this process to evade the limit. The final rule also defines “issuer” and “issue” of the debit card so that fee caps cannot, the Board believes, be evaded by routing transactions through a small issuer that is exempt from the fee cap or some other third-party processor.

The FRB also rejected suggestions of issuers and a federal regulator that it use its authority to prevent circumvention of the law to ensure that networks give effect to the small-issuer exemption. The Board was thus urged to mandate two-tiered pricing. However, as noted, it declined to do so.

## **B. Fraud**

As noted, this issue is largely addressed in the IFR. Criteria to receive an additional adjustment for fraud-prevention costs are provided and the adjustment – one cent – is set. However, to receive the adjustment, issuers must institute policies to prevent fraud, monitor related losses, ensure that suspicious activities are detected and averted and, then, certify its performance on all these points to payment-card networks it uses.

## **C. Exemptions**

### **1. *Small Issuers***

As noted, the final rule follows the law and provides an exemption from the fee caps for issuers with assets under \$10 billion, with the FRB planning to monitor this to determine the degree to which an exemption is in fact maintained.

### **2. *Accounts***

Debit-card accounts are defined to include both consumer and business accounts, but not trusts. However, debit cards that act as health savings accounts or similar accounts are covered despite their similar nature to trusts unless they are actually trusts under applicable law or are reloadable prepaid cards that are also exempt. Finally, only accounts located in the U.S. are covered by the fee restrictions.

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### **3. Debit Cards**

As noted, this term is defined to include general-use prepaid cards, with the rule defining this term in detail and including within it “selective-authorization” cards.

Excluded from this definition are:

- cards or similar devices redeemable only at a single merchant or affiliated merchant group;
- checks and similar instruments;
- government-administered payment programs;
- reloadable prepaid cards that are not gift cards. However, as noted, for purposes of this exemption, general-use reloadable prepaid cards may not offer ancillary services that access a bank account or use the ACH; and
- account numbers used to initiate an ACH transaction to debit an account.

As proposed, debit-card use for ATM cash transactions are not subject to the interchange fee. However, when cash is received in connection with a transaction involving goods or services, the fees apply to the value of the cash.

### **D. Network Exclusivity and Routing**

The exemptions discussed above for small issuers, government cards and covered reloadable prepaid cards do not apply to these network-related provisions.

#### **1. Coverage**

Payment-card networks are defined as entities that provide services, infrastructure, routing, and software for authorization, clearance, and settlement, excluding three-party systems but including four-party ones. As proposed and consistent with the provisions related to interchange fees, ATM networks are excluded from these requirements.

#### **2. Exclusivity**

As noted, the final rule indicates that compliance with provisions barring network exclusivity is met through use of two unaffiliated networks that do not have express service limitations or intentional capacity restrictions.

#### **3. Routing**

The rule also implements the law with regard to allowing merchants to select network routing. Reflecting requests by issuers, merchants need not disclose the network they select, but the rule does make clear that they may not route transactions over a network not selected under the exclusivity provisions noted above by the issuer.