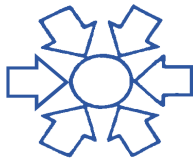

Financial Services Management

Interchange Requirements

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FRB, Notice of Proposed Rulemaking, Debit Card Interchange Fees and Routing

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Impact Assessment

- Banks could suffer fee decreases and greater liability risk if alternative networks are less remunerative and/or less resilient to fraud or cyber-risk.
- Card issuers would come under a more explicit duty to ensure that the rule's network-exclusivity requirements are met, a duty binding all issuers regardless of size that creates greater compliance and legal risk.
- Tech-platform control over the payment system could increase if they have significant control over alternative networks that would have to be among those issuers offer absent greater choice.
- Consumers might experience reductions in the price of goods and services if merchants choose to pass these along, but fraud losses and changes to other banking services might also ensue.
- Overall payment-system structure could alter in concert with other FRB actions.

Overview

Leaving its interchange-fee restrictions[1] intact – at least for now – the Federal Reserve is proposing to expand on its existing requirement that all debit-card transactions must be enabled for processing on at least two unaffiliated payment-card networks for card-not-present (e.g., online) transactions. The NPR does not address the still more contentious question of the ceilings on debit-card interchange fees, but it does indicate that the FRB may turn to these. Any change

[1] See **INTERCHANGE7**, *Financial Services Management*, July 11, 2011.

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in permissible fees would have still more dramatic impact on bank and network-provider income, benefiting merchants, tech-platform companies, small networks, and perhaps also consumers if other changes in response to this action do not prove adverse to their interests.

Impact

As this NPR emphasizes, online transactions were a minimal part of the retail marketplace when the interchange-fee rule was finalized in 2011. Now, of course, they are not, but the Board has concluded that the routing choices required in the Dodd-Frank Act[2] are generally not offered by issuers (i.e., banks) when debit cards are not presented. These transactions were 23 percent of all debit-card transactions in 2019, a total that has dramatically accelerated due to changes to transaction patterns during the pandemic.

The Board also notes that networks supporting card-not-present transactions were undeveloped in 2011 but are now well advanced. However, competition in this sector has not advanced to the Board's satisfaction. It finds that issuers have not enabled multiple unaffiliated networks with single-message capability for card-not-present transactions, concluding this violates the law and Regulation II.

It is clear that merchants, including tech-platform companies with considerable market clout, would benefit from this approach, putting strong pressure on card issuers and network providers and thus likely reducing revenue from the card-not-present channel. Overall, net earnings from interchange fees for issuers totaled $22.6 billion, making it clear that changes to fees for routing would be expensive to issuers and going farther would be still more costly. Merchants have strongly asserted that this approach also benefits consumers, but the Board's analysis takes a more ambivalent stand, saying only that this will depend on market evolution.

The Board's proposed approach also raises operational questions, including the extent to which alternative networks have well-developed fraud and cyber-risk capabilities. A study issued in conjunction with this NPR shows that, while fraud losses have generally increased, issuers have significantly reduced their share of fraud risks the past decade. However, it remains a significant risk of major cost proportions banks fear would return at least to prior levels if networks they now choose not to offer must be included as options for merchants in the fast-growing card-not-present sector. This sector may also pose additional systems challenges that new networks may similarly not be able to handle, although merchants contest both concerns on grounds that current systems options are unduly concentrated, insufficiently innovative, and more fraud-resistant or resilient than other options.

As noted, the Board also indicates that it may soon take up interchange fees based in part on this recent study. The study says that costs in 2019 were 4 cents, about half of what they were in 2009. However, interchange fees now average 31 cents versus 43 cents in 2009. In 2011, the Board in fact proposed a twelve-cent interchange-fee ceiling, one increased to the 22 cents in the current rule only after prolonged debate and Congressional action.[3] Reopening the rule now to address

[2] See **INTERCHANGE**, *Financial Services Management*, December 16, 2010.

[3] See **INTERCHANGE6**, *Financial Services Management*, June 29, 2011.

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routing and laying the groundwork for still more change clearly raises the prospect for a significant price-ceiling drop. This might well benefit consumers and would surely benefit merchants, but it could not only fail to benefit consumers on its own, but also have a compound, adverse impact on the availability of other banking services. For example, a Fed study of the current price ceiling found that the fee reductions it mandated led to a significant decrease in the availability of free checking accounts.[4]

Finally, it is important to note that this proposal comes at a time of others that could dramatically alter the structure of the U.S. payment system. Most notable among those are actions by the Fed to create an instant payment system[5] and to open payment-system access. Altered revenue combined with new capabilities and expanded access[6] could redefine the role of regulated banks.

What's Next

This NPR was published in the Federal Register on May 13; comments are due by July 12. The Fed is also facing litigation from a merchant group contesting the rule as a whole.

Analysis

A. Proposal

As noted, the Board is proposing changes to Regulation II and its commentary to clarify the applicability of the prohibition on network exclusivity to card-not-present transactions, stating expressly that card-not-present transactions are a particular type of transaction forwhich two unaffiliated payment card networks must be available. The NPR emphasizes issuer responsibility in this arena, stating that it is the issuer's responsibility to enable multiple networks for card-not-present transactions.

The NPR also expands on the commentary along with definitions in it and in the Board's rules. The term "enable" as used for describing issuer responsibility would for example now be defined reflecting issuers' role enabling payment-card network access. Standardized terms would define aspects of this obligation, with card-not-present transactions now expressly included in those for which at least two unaffiliated networks are required and defined as those in which a cardholder initiates a card payment without physically presenting the card to a merchant (e.g., on the phone, online, etc.); "means of access" now replaces the word "form" to signal that debit cards accessed without plastic (e.g., on a smart phone) are also

[4] Karen Petrou, *Engine of Inequality: The Fed and the Future of Wealth in America* (Hoboken: John Wiley & Sons, Inc., 2021), 132.

[5] See **PAYMENT20**, *Financial Services Management*, August 13, 2020.

[6] See **PAYMENT22**, *Financial Services Management*, May 10, 2021.

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covered. Authentication methods are redefined and expanded to, for example, now cover biometric methods and those to be developed in the future. The commentary also provides examples of activities and scenarios that would clearly comply.

B. Request for Comment

The Board does not specify issues in which it is most interested in comments.

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