Debit-Card Routing Requirements

Cite

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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.
- Debit-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 may create greater compliance and legal risk.
- Tech-platform firms' control over the payment system could increase if they also have significant control over alternative networks that would be among those issuers offer.
- Consumers may 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 intact – at least for now – the Federal Reserve has finalized its proposal expanding on its existing requirement[1] that all debit-card transactions must be enabled for processing on at least two unaffiliated payment-card networks for card-not-present transactions.[2] Although the rule does not address the still more contentious question of the ceilings on debit-card interchange fees, it does indicate that the FRB may turn to these. Any change 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 merchants pass along any savings and new networks prove robust.

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

2 See **INTERCHANGE8**, *Financial Services Management*, May 18, 2011.

Impact

As this rule 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 found that the routing choices required in the Dodd Frank Act[3] 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, will 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 rule 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 the proposal showed that, while fraud losses have generally increased, issuers have significantly reduced their share of fraud risks over the past decade. However, fraud remains a significant risk banks fear would return at least to prior levels as 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 less 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.[4] Reopening the rule now to address routing and laying the groundwork for still more change clearly raises the prospect for a significant price-ceiling decrease. 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

3 See **INTERCHANGE**, *Financial Services Management*, December 16, 2010.

4 See **INTERCHANGE6**, *Financial Services Management*, June 29, 2011.

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.[5] The Board generally rejected this concern in the final rule along with issuer assertions that the new requirement will prove so costly as to threaten the ability of some institutions to survive. Conversely, the Board generally agreed with merchant comments that this network choice is not only required by current law and rule, but also that competitive forces will result in better network opportunities and, where merchants compete with each other, lower consumer costs. The Board's focus on marketplace competition is unusual in rules of this sort, likely reflecting growing pressure on all of the banking agencies to do what they can to increase U.S. competition along lines laid out in President Biden's executive order on this concern.[6]

Finally, it is important to note that this rule 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[7] and to open payment-system access.[8] Altered revenue combined with new capabilities and expanded access[9] could redefine the role of regulated banks.

What's Next

This final rule was released on October 3; it is effective on July 1, 2023. Issuers pressed strongly for delayed compliance deadlines were the Fed to finalize the proposal they strongly opposed, but the Fed decided that this deadline suffices because issuers were aware of their obligations not only from a read of the underlying interchange-fee regulation, but also the initial NPR. The Fed is also facing litigation from a merchant group contesting the rule as a whole.

Analysis

As noted, the Board changes to Regulation II and its commentary 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 for which two unaffiliated payment card networks must be available. The rule emphasizes issuer responsibility in this arena, stating that it is the issuer's responsibility to enable multiple networks for card-not- present transactions and expands on the commentary along with definitions in it and in the Board's rules. The term "enable" as used for describing issuer responsibility is now defined reflecting issuers' role enabling payment-card network access.

Standardized terms 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,

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

6 See *Client Report* **MERGER6**, July 9, 2021.

7 See **PAYMENT20**, *Financial Services Management*, August 13, 2020.

8 See **PAYMENT25**, *Financial Services Management*, August 18, 2022.

9 See **PAYMENT22**, *Financial Services Management*, May 10, 2021.

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 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.

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