

Insights

LOWER DEBIT CARD FEES FOR MERCHANTS

FEDERAL RESERVE LOWERS CAP ON DEBIT CARD INTERCHANGE FEES TO 17.7 CENTS.

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The Federal Reserve Board ("FRB") proposes to lower fees for debit card purchases. The FRB announced proposed rulemaking to reset its Durbin Amendment cap on interchange fees to 17.7 cents on an average transaction from 24.5 cents, a 28 percent reduction.^[1] The FRB limits interchange transaction fees that certain debit card issuers may be paid through payment networks on merchant transactions conducted on most types of debit cards.^[2] These regulated fees constitute a substantial portion of merchants' costs for acceptance of covered debit cards for purchases to the extent they are passed through by their card payments processors.

Since 2012 when the fee cap was first implemented, covered interchange fees have been limited to no more than the sum of: (i) 21 cents, plus (ii) 5 basis points (.0005) of the transaction value, plus (iii) 1 cent. This 3-part formula yielded a charge of 24.5 cents on an average-sized \$50 debit card purchase. This initial cap on interchange fees, which is currently in effect, was based on data collected from large debit card issuers in 2009. On Oct. 25, The FRB proposed to lower the fee to 17.7 cents on the average \$50 debit card transaction, based on data collected in 2021. This new average fee is based on proposed components of (i) 14.4 cents, plus (ii) 4 basis points (.0004) of the transaction value, plus (iii) 1.3 cents. This would be the first adjustment to the initial fee cap in twelve years. The FRB's proposal describes a new methodology for determining the appropriate cap on interchange fees. Going forward, the FRB would adjust the cap automatically every other year without seeking public comment, based on applying its new methodology to data derived from data reports from large debit card issuers. The FRB would publish the new values for the fee cap components for an applicable period no later than March 31st to take effect on the following July 1st.^[3] Other technical amendments to the regulation are also proposed. Comments must be submitted to the FRB within 90 days after publication of the notice of proposed rulemaking in the Federal Register.

DURBIN AMENDMENT CAPS

The FRB caps debit card interchange fees pursuant to authority granted in the "Durbin Amendment" to the Dodd-Frank Wall Street Reform and Consumer Protection Act.^[4] The Durbin Amendment

mandated that the FRB ensure that the interchange fee received by a covered debit card issuer for a transaction on a covered debit card be “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”^[5] The Durbin Amendment specified several factors that the FRB must consider when regulating interchange fees, including the “functional similarity between debit card transactions and checking transactions that are required within the Federal Reserve bank system to clear at par.”^[6] The FRB implemented the Durbin Amendment fee caps in Regulation II, published in 2012.^[7] At that time, the FRB defined the costs incurred by debit card issuers that the FRB would consider, and established a methodology for determining interchange fees relative to the allowable costs.^[8]

Allowable costs comprise (i) transaction-processing costs, including fixed and variable authorization, clearing and settlement costs, network processing fees, and the costs of processing chargebacks and other non-routine transactions; (ii) transaction-monitoring costs; and (iii) fraud losses.^[9] The FRB divided the allowable costs into a “base component” representing the fixed costs per transaction to be allocated to a transaction regardless of the amount of the transaction (21 cents), and an “*ad valorem*” component for issuers’ fraud losses, which the FRB determined varied proportionally to the amounts of debit card transactions (5 basis points - .0005x). The FRB defined a third component to implement the statutory allowance for an issuer’s costs of reducing fraud for issuers who take qualifying measures for reducing fraud (1 cent).^[10] In setting its new proposed cap, the FRB confirmed that its original elements of allowable costs are still valid,^[11] although the values had changed substantially.

PROPOSED METHODOLOGY CHANGES FOR BASE COMPONENT

Importantly especially because of the proposal for automatic bi-annual adjustments to the cap, the FRB has proposed a new statistical analysis methodology to determine values for the first component, relating to transaction-processing and transaction-monitoring, which is the largest component of the fee cap. In setting its initial fee cap, the FRB used a methodology that identified an “inflection point” or “a clear discontinuity” in the data plot at 21 cents. Based on this “scatter” pattern, the FRB determined that establishing a standard to accommodate higher cost issuers above this 21-cent level would not yield a cap that is “reasonable and proportional” to allowable costs.^[12] The FRB’s new methodology recognizes that examination of data plots based on biennial data collected since the 2009 survey have not exhibited such inflection points. Accordingly, the FRB determine the base component “as a function of the transaction-weighted average of per transaction base component costs across covered issuers.” This methodology applied to the fresh data reported every other year, the FRB believes –

“will ensure that the maximum interchange fee that a covered issuer receive will be proportional to the base component costs incurred by covered issuers with respect to the average covered issuer transaction, consistent with the Durbin Amendment.”^[13]

To implement this methodology, the proposal would codify in Regulation II a “fixed multiplier” to apply to the transaction-weighted average of per-transaction base component costs. The fixed multiplier would remain constant over time, although the application to new data every other year would yield “proportional” adjustments in the amount of the base component. The FRB determined that a fixed multiplier of 3.7x would provide debit card issuers full cost recovery of allowable costs for 98.5% of covered transactions over time.^[14] This codified multiplier will facilitate the “automatic” calculation of a revised base component to take effect bi-annually.

AD VALOREM AND FRAUD-REDUCTION COST COMPONENTS

The FRB does not propose to revise the original methodology that it used to determine the *ad valorem* component, “i.e., the median ratio of issuer fraud losses to transaction value among covered issuers, multiplied by the value of the transaction.”^[15] The FRB notes that the share of fraud losses absorbed by covered issuers has declined between 2011 and 2021, although total fraud losses has increased. The FRB ascribes the fraud decrease in part to the introduction of increased security for in-person card payments, such as chip-based EMV cards and tokenization of authentication credentials, and attributes increasingly more fraud to ecommerce and remote fraud.^[16] The proposed *ad valorem* component of 4.0 basis points is the median ratio of issuer fraud losses to transaction value among covered issuers reported on the 2021 Debit Card Issuer Survey.^[17]

To provide issuers the third component of the fee cap for reimbursement of costs related to fraud reduction measures, the Durbin Amendment requires that the FRB condition each issuer’s qualification to receive the allowance on the issuer’s compliance with certain fraud-related standards.^[18] Regulation II does not specify particular measures that issuers must implement, recognizing that “fraud prevention involves a broad range of activities in which an issuer may engage before, during and after a debit card transaction.” However, the initial methodology excluded certain costs, several of which were allowable in calculating other components of the cap.^[19] The FRB does not propose to change those standards, but due to improvements in data reporting requirements, the FRB adjusted its methodology to calculate the median per-transaction fraud prevention costs among issuers, rounded to the nearest tenth of one cent. The FRB proposes to raise the allowance for implementing qualifying measures from 1 cent to 1.3 cents. The FRB bases the proposed increase on the increase in the median per-transaction fraud-prevention costs among covered issuers reported in the FRB’s biennial survey in 2021.^[20]

TECHNICAL AMENDMENTS

The FRB also proposes a number of “technical” revisions to Regulation II, including:

- Adding a definition of “covered issuer” to mean an issuer that, together with its affiliates, for a particular calendar year has assets as of the preceding calendar year of \$10 billion or more, subject to certain specified exclusions. (No changes are intended to alter any issuer’s qualification for the “small issuer” exemption.)
- Adding a specific requirement that covered issuers file reports consistent with the FRB’s practices in effect since 2011. These reports include the annual Payment Card Network Survey and the biennial Debit Card Issuer Survey.
- Clarifying that the fraud-prevention adjustment is in addition to any interchange fee an issuer receives or charges in accordance with §235.3 (base component and *ad valorem* component).
- Clarifying that temporary transitional relief provided to newly covered issuers would not apply to issuers that would not otherwise qualify for such transition relief.^[21]

EFFECTIVE DATES

The FRB provides that the revisions take effect on the first day of the next calendar quarter that begins at least 60 days after the final rule is published in the *Federal Register*.^[22]

CONCLUSION

This proposal for substantial change to interchange fees will impact covered debit card issuers’ revenues, and will impact merchants’ card acceptance costs to the extent reductions are passed on by their card acceptance processors. Impacts on consumers will be indirect and in every case depend on differing independent actions that may be taken by issuers and merchants to pass impacts on to customers. If you have questions about the Federal Reserve Board’s proposal, please contact us.

FOOTNOTES

[1] <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231025a.htm>

[2] The Durbin Amendment provides exemptions from the cap for smaller banks and for certain types of debit cards regardless of the size of the issuer.

[3] Notice of Proposed Rulemaking, p. 51.

[4] Public Law 110-203, §1075, 124 Stat. 1376, 2068, 15 U.S.C. 1693o-2 (2010).

[5] EFTA 920(a)(2); The Durbin Amendment added section 920 to the Electronic Funds Transfer Act (“EFTA”).

- [6] EFTA 920(a)(4).
- [7] 12 CFR part 235.
- [8] Notice of Proposed Rulemaking, p. 15.
- [9] Notice of Proposed Rulemaking, p. 16.
- [10] Notice of Proposed Rulemaking, pp. 12-13.
- [11] Notice of Proposed Rulemaking, p. 16.
- [12] Notice of Proposed Rulemaking, pp. 18, 23.
- [13] Notice of Proposed Rulemaking, p. 24.
- [14] Notice of Proposed Rulemaking, p. 27.
- [15] Notice of Proposed Rulemaking, p. 30.
- [16] Notice of Proposed Rulemaking, p. 30, fn 50 and pp. 65-66.
- [17] Notice of Proposed Rulemaking, pp. 31-32.
- [18] EFTA, §920(a)(5)(A); implemented in Regulation II, 12 CFR 235.4(b).
- [19] Notice of Proposed Rulemaking, p. 37.
- [20] Notice of Proposed Rulemaking, pp. 40-43.
- [21] Notice of Proposed Rulemaking, pp. 43-47.
- [22] Notice of Proposed Rulemaking, p. 47. The FRB proposes one exception, namely that the proposal to clarify the availability of the transition period for newly covered issuers by deleting 12 CFR §235.4(a)(4) would take effect on January 1, 2027.

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