

Summary of Final Debit Interchange Rule

The final rules issued by the Federal Reserve to implement the Durbin amendment include several pieces. This document briefly summarizes each piece of the rules and provides some context for the conclusions reached by the Fed. This document is not meant to evaluate the wisdom (or lack thereof) of any choices made by the Fed; it simply seeks to explain them.

The different aspects of the rules that this document will address include:

- Reasonable and proportional debit fee amounts
- Fraud prevention adjustment to the debit fee amounts
- Exemptions from the debit fee rule
- Circumvention or evasion of the rules
- Network non-exclusivity
- Reporting and record retention

All of the provisions of the rules become effective on October 1, 2011 with the exception of the network non-exclusivity provisions. With respect to non-exclusivity, the following effective dates apply:

- The requirement to have at least 2 unaffiliated networks applies to issuers on April 1, 2012.
- For certain types of debit cards that present technological or other operational impediments to an issuer's ability to comply with the rule, the effective date for the requirement to have at least 2 unaffiliated networks is delayed until 2013 (see discussion below).
- On October 1, 2011, payment card networks will not be able to restrict issuers from having at least 2 unaffiliated networks compatible with their debit cards.
- The prohibition on networks and issuers restricting merchant routing choices becomes effective on October 1, 2011 (for all types of debit cards).
- Emerging technologies that meet the definition of "debit card" were not provided with any additional delays of the effective dates for these provisions.

A brief summary of each aspect of the rules follows.

Reasonable and Proportional Debit Fees

Final Rule: An issuer may not charge or receive any interchange transaction fee that exceeds the sum of 21 cents plus 5 basis points of the transaction's value.

The Fed will allow debit card issuing banks to charge interchange fees of up to 21 cents plus 0.05% of the transaction amount on every debit card transaction. This acts as both a safe harbor and a cap so that every bank covered by the regulation (those with more than \$10 billion in assets) can charge that amount no matter what their actual costs are. Banks are not required to charge the full amount on any given transaction. They could, for example, charge less than 21

cents for small transactions. But banks (in conjunction with their card networks) will have the discretion to charge the full amount on every single debit transaction. In addition, as further explained below, banks likely will be able to charge an additional 1 cent per transaction to cover fraud prevention costs.

By way of background, the 21-cent figure is based upon the Federal Reserve's calculation of the number at which 80 percent of covered banks would recover all of the costs that the Fed determined were allowable under the Fed's reading of the law. The 0.05% charge is based on the average per-transaction fraud losses of the median issuer, based on the Fed's survey data.

The Fed's final rule on fees differs significantly from its proposed rule. The proposed rule included two options: a 7-cent safe harbor and 12-cent cap approach; and a 12-cent figure representing both the safe harbor and cap. The Fed adopted the second option in its final rule – a combined safe harbor and cap – and raised the cap from 12 cents to more than 21 cents, including the ad valorem amount to cover fraud losses which were not part of the proposed rule.

The Fed arrived at the new fee standard by including issuer costs that were not considered under the proposed rule. In the proposed rule, the Fed considered only per-transaction costs incurred for authorization, clearance, and settlement (ACS) that vary with the number of transactions within the reporting period (average variable cost). Considering only average variable ACS costs, the Fed arrived at a cost basis of 4 cents per transaction. In the final rule, however, the Fed dramatically expanded the bank costs it considered and arrived at a 19-cent per-transaction cost. For the final rule, the Fed took into account *all* costs – variable or fixed – which it considered to be specific to a particular transaction. Those costs include:

- Processing costs (maintaining and using network connectivity; maintaining and using computer equipment; labor to maintain and use computer equipment; and equipment, hardware, software and associated labor);
- Costs of processing chargebacks and other non-routine transactions;
- Network fees; and
- Transactions monitoring costs (enrolling in or maintaining programs that monitor transactions prior to making the decision to authorize the transaction).

The ad valorem component was included to compensate issuers for fraud losses (distinct from the fraud adjustment piece discussed in further detail below). Fraud losses, as defined by the Fed, are those losses incurred by the issuer, other than losses related to nonsufficient funds, that are not recovered through chargebacks to merchants or debits to or collections from customers. This portion of the fee standard was set as an ad valorem component because, according to the Fed, an issuer takes on greater risk when approving a high-value transaction because the amount of potential loss is greater. Issuers that incur fraud losses at a level below the 5 basis-point cap may retain the difference between their costs and the cap.

The Fed justified the expansion of costs considered under the final rule by relying on a revised interpretation of the Durbin amendment (as opposed to its initial interpretation, which limited cost considerations to ACS costs only). According to the Fed, there is a grey area of costs on which the statute is silent. Those costs are specific to a particular electronic debit

transaction but are not incremental costs related to the issuer's role in ACS. Based on the language of the statute, the Fed reasoned, all costs related to a particular transaction *may* be considered, and some (ACS-related costs) *must* be considered. Under the Fed's reasoning, the only costs excluded were: corporate overhead, the cost of establishing and maintaining an account relationship, and general debit card program costs (card production and delivery, marketing, R&D, non-sufficient funds handling).

Interim Final Rule on Fraud Prevention Adjustment

Interim Final Rule: If an issuer meets standards set forth by the Board, it may receive or charge a fraud-prevention adjustment of no more than 1 cent per transaction to any interchange transaction fee it receives (effective concurrent with the interchange fee standard on October 1, 2011).

In its proposed rule, the Fed requested comment on two approaches to designing a fraud-prevention adjustment to the interchange fee: a technology-specific approach and a non-prescriptive approach. The Fed adopted the non-prescriptive approach in its final rule in order to permit issuers to determine the best methods to detect, prevent and mitigate fraud losses for the size and scope of their debit card program. The Fed concluded that the technology-specific approach does not provide sufficient flexibility.

Under the final rule, to be eligible for the fraud-prevention adjustment, an issuer must develop and implement policies and procedures reasonably designed to:

- Identify and prevent fraudulent electronic debit transactions;
- Monitor the incidence of, reimbursements received for, and losses incurred from fraudulent electronic debit transactions;
- Respond appropriately to suspicious electronic debit transactions so as to limit the fraud losses that may occur and prevent the occurrence of future fraudulent electronic debit transactions; and
- Secure debit card and cardholder data.

Issuers must review their fraud-prevention policies and procedures at least annually, and update them as necessary to address changes in prevalence and nature of fraudulent transactions and available methods of detecting, preventing and mitigating fraud. Issuers must certify, on an annual basis, compliance with the Fed's standards to the payment card networks in which the issuer participates. The Fed expects the networks to develop their own processes for identifying issuers eligible for the adjustment. In other words, the Fed appears to have deputized payment card networks as the arbiters of whether banks that issue their cards are effectively preventing fraud. As long as this certification is made, bank issuers can receive the additional 1 cent on every debit transaction (whether it be PIN or signature) regardless of the individual bank's fraud prevention costs.

The Fed arrived at the 1-cent adjustment by taking the median amount spent by issuers on all reported fraud-prevention activities (1.8 cents per transaction) and subtracting the cost of

“transactions monitoring activities” (.7 cents) because the cost of those particular activities are now recoverable through interchange fees.

Comments on the Interim Final Rule on Fraud Adjustment

Comments on the interim final rule are due by September 30, 2011. The Fed has specifically requested comment on the following topics:

- Whether the rule should include a definition of “fraud” or “fraudulent electronic debit transaction,” and if so, what the appropriate definition would be.
- Whether an issuer’s policies and procedures should require an issuer to assess whether its customer rewards or similar programs provide inappropriate incentives to use an authentication method that is demonstrably less effective in preventing fraud.
- Whether the rule should establish a consistent certification process and reporting period for an issuer to certify to a payment card network that it meets the Board’s fraud-prevention standards and is eligible to receive or charge the fraud-prevention adjustment.
- Whether there should be any differentiation between signature and PIN transactions.

Exemptions from Fee Limits

The Durbin amendment instructed the Fed to implement exemptions for debit card issuers with less than \$10 billion in assets, government benefit cards, and certain reloadable prepaid cards. The Fed’s final rule does not differ in any significant way from its proposed rule in this area other than to offer comments and additional language for clarification purposes. In its final rule, the Fed clarified that a debit card only needs to qualify for one of the exemptions in order to exempt transactions made with that card from coverage under the rule.

The small issuer exemption applies where: (i) the issuer holds the account that is debited; and (ii) the issuer, together with its *worldwide* affiliates, holds *banking and nonbanking assets* (other than trust assets under management) of less than \$10 billion as of the end of the previous calendar year. Issuers that become covered because they gain assets above \$10 billion at the end of a calendar year have until July 1 of the following year to comply with fee standards, fraud-prevention standards, and anti-circumvention rules. The Fed plans to publish a list of bank issuers with more than \$10 billion in assets in order to assist with compliance and assist networks that wish to allow exempted banks to receive higher interchange fees. The Fed will use its data collection authority under the Durbin amendment to monitor and report to Congress on the effectiveness of the small issuer exemption (e.g., the Fed will conduct an annual survey of issuers and networks and publish an annual list of average interchange fees for covered issuers and exempt issuers).

The exemption for government benefit cards applies where the interchange transaction fee is charged or received with respect to a debit transaction made using a debit or general-use prepaid card that has been provided to a person pursuant to a federal, state or local government-administered payment program, in which the person may only use the card to transfer or debit funds, monetary value, or other assets that have been provided pursuant to such program. Some

cards that access Health Savings Accounts (HSAs), Flexible Spending Accounts (FSAs), and Health Reimbursement Accounts (HRAs) will qualify for the exemption if they are offered in connection with a person's employment by a government employer. The full scope of cards subject to this exemption, however, is not entirely clear. The Fed does not plan to publish a list of accounts that qualify for this exemption. Instead, networks are expected to develop their own processes for identifying and exempting qualified card programs based upon the rule.

The exemption for prepaid cards applies to general use, reloadable prepaid card that will not debit an account for the cardholder (such as a checking account). After receiving numerous comments from merchants regarding the potential for issuers to restructure accounts in order to satisfy this exemption and circumvent interchange regulations, the Fed has clarified that reloadable cards that provide access to the funds underlying the card through check, ACH, wire transfer or other methods do not meet the exemption requirements. The funds can only be accessed on a recurring basis through use of the card (though removing all the funds and closing the account may be done by other means). The Fed also added a comment to provide examples of activities that may warrant additional scrutiny to determine whether they are attempts to circumvent or evade regulation (e.g., if an issuer replaces debit cards with prepaid cards that are linked to customers' accounts).

One other exception to note in the rule is for three-party payment card networks. American Express and Discover are examples of three-party networks that traditionally have not had banks issue their cards. Under the Fed's rule, three-party networks are not networks at all and are not subject to any part of the rule. If those networks have banks issue their debit cards (as both are doing to some extent with credit cards), however, then they would be four-party networks with respect to those cards and covered by the Fed's rules. Operating a three-party debit card network would be far more difficult than doing the same thing with credit cards. The network likely would have to have the deposit account itself (because the deposit account holder is the issuer under the Fed's rule). While some have raised questions about Visa and MasterCard remaking themselves as three-party networks to circumvent the Fed's rules, it is difficult to see how this could be done.

Prohibition on circumvention or evasion

Final rule:

- 1. Issuers and networks are generally prohibited from circumventing interchange fee restrictions.***
- 2. Issuers are prohibited from receiving net compensation from networks.***

Like the proposed rule, the final rule includes a general prohibition on circumvention of interchange fee restrictions as well as a rule prohibiting issuers from receiving net compensation from payment card networks. Circumvention may include situations in which an issuer receives net compensation from a payment card network with respect to electronic debit transactions or

other debit-card related activity. If networks reduce their fees in order to cushion bank issuers' lost interchange revenue, however, that may or may not amount to circumvention of the rules.

An issuer receives net compensation (and runs afoul of the rule) when the total amount of payments or incentives the issuer receives from the payment card network during a calendar year in connection with electronic debit transactions or other debit-card related activities exceeds the total of all fees paid by the issuer to the network for those activities. The prohibition includes "indirect" compensation from the networks and is not limited to volume-based or transaction-specific payments, incentives, or fees (but also includes things like bonuses to convert a card base, marketing incentives, and signing bonuses to retain or attract an issuer's debit card portfolio). In calculating net compensation, bonuses will be allocated over the life of the debit card contract. Payments and incentives that do not need to be included in the net compensation calculation include pass through payments such as: interchange transaction fees passed through to the issuer by the network; funds passed through by networks to issuers as a result of chargebacks or fines paid by merchants or acquirers; and settlements and recoveries from merchants or acquirers to offset the costs of fraudulent transactions or data breaches.

The Fed excluded from the net compensation analysis fees paid by an issuer to a network or network affiliate for processor services. The Fed also excluded switch fees from the calculation because those are now incorporated in the interchange fee standard. Fees that may be included are: network membership and licensing fees, network administration fees, and non-processor optional fees such as risk management services.

Network Non-Exclusivity and Merchant Routing Choice

Final Rule:

- 1. The rule requires a debit card to work with at least two unaffiliated payment card networks.***
- 2. Payment card networks are prohibited from restricting or otherwise limiting an issuer's ability to contract with any other payment card network that may process an electronic debit transaction involving the issuer's debit cards.***
- 3. Issuers and networks are prohibited from inhibiting, directly, or through any agent, processor, or licensed member of the network, by contract, requirement, condition, penalty, or otherwise, a merchant's ability to route electronic debit transactions over any payment card network that may process such transactions.***

In its proposed rule, the Fed requested comment on two approaches to network non-exclusivity: requiring at least two unaffiliated payment card networks on each debit card; and requiring at least two unaffiliated payment card networks for each method of authentication available to the debit cardholder. The Fed adopted the former approach so that an issuer satisfies the requirement by having only one nationwide signature network and one nationwide PIN network operable on a debit card.

Under the proposed rule, a network that is not accepted on a nationwide basis or is limited to certain merchants or merchant types does not satisfy the need for having at least two unaffiliated networks – though an issuer could cobble together nationwide coverage through enabling multiple regional networks. Merchants expressed concern that issuers may add capacity-constrained networks that would not be able to handle the volume of transactions received so that the other network on the card would become the default. Responding to these concerns, the Fed noted in the final rule that issuers must take “reasonable steps” to enable the network to be able to process the debit transactions that the issuer reasonably believes will be routed to it, based on projected transaction volume.

The Fed based its decision to adopt the more limited approach of only requiring 2 networks on a card (rather than 2 for signature transactions and 2 for PIN transactions) largely on comments from issuers and networks claiming that the other option is not currently feasible, that it would be costly and onerous for small issuers to implement, and that it would cause consumer confusion and frustrate consumer choice to the extent a cardholder has rewards or card features tied to the use of a particular network. The issuers and networks also claimed that the other approach would discourage investment in new authentication technologies.

The Fed decided that the law does not *require* that there be two network options for each method of authentication. The Fed acknowledged that many issuers – particularly small issuers – are already in compliance with the rule it chose to adopt and, in many cases, issuers already have multiple routing options for PIN transactions.

To enable issuers to comply with this rule, the Fed prohibited any network rule that prevents other networks from being usable on an issuer’s debit cards. This includes a prohibition of network rules or guidelines that allow only that network’s (or its affiliate networks’) brand, mark, or logo to be displayed on a particular debit card, or that otherwise limit the ability of network brands, marks, or logos to appear on debit cards. Nothing in the final rule, however, requires that a debit card identify the brand, mark, or logo of each network over which the debit transaction may be processed.

If two networks become affiliated (when they previously had not been), the rule gives issuers six months to bring all of their cards into compliance.

The final rule clarifies that these provisions apply to all debit cards, though, as noted below, the Fed gave additional time for certain types of cards to comply with the rule.

The Fed rule also states that networks and issuers may not inhibit merchants’ choices regarding which networks to use for routing transactions. Merchants cannot choose any network in existence – only those the issuer makes operable on the card in question. Issuers are prohibited from having any rules that prevent merchants from steering cardholders to use a particular method of authentication (e.g., PIN or signature). The rule does not prohibit a network from offering payments or incentives to merchants to encourage the merchant to route transactions through its network. It should also be noted that the rule does not prohibit issuers or networks from designating a default network for routing in the event a merchant or the merchant’s processor does not indicate a routing preference.

Effective dates for routing provisions

- The requirement to have at least 2 unaffiliated networks on a debit card applies to issuers on April 1, 2012.
- HSAs, FSAs, and HRAs do not need to comply with the 2 unaffiliated network requirement until April 1, 2013.
- If a reloadable prepaid card is sold and reloaded prior to April 1, 2013, the card must comply by May 1, 2013. If the reloadable card is sold before April 1, 2013 and reloaded after April 1, 2013, the compliance date is 30 days after the date of reloading.
- Non-reloadable general-use prepaid cards sold prior to April 1, 2013 are not subject to the routing rules.
- On October 1, 2011, payment card networks will not be able to restrict issuers from having at least 2 unaffiliated networks compatible with their debit cards.
- The prohibition on networks and issuers restricting merchant routing choices becomes effective on October 1, 2011 (for all types of debit cards).
- Emerging technologies that meet the definition of “debit card” were not provided with any additional delays of the effective dates for these provisions.

Reporting requirements and record retention

Final Rule: Issuers and payment card networks must submit reports to the Fed (as requested by the Board), and retain records for five years.

Covered issuers and networks will be required to provide information on costs related to debit transactions, interchange fees, network fees, fraud-prevention costs, fraud losses, and any other information requested by the Fed. Additionally, the Fed will require issuers and networks to provide information about transaction value, volume and type (in order to better monitor the adoption and success of a two-tiered system for interchange fees). The Fed expects initially to require different reporting frequencies for issuers and networks – the networks will be required to report on their interchange fee structures on an annual basis, while issuers will report on costs every two years. The Fed decided not to specify the frequency of required reporting in the regulation text in order to retain flexibility.