

November 13, 2023

Federal Reserve Proposes Sharp Reduction in Debit Card Interchange Fee Cap

Amendments Would Reduce the Maximum Interchange Fee for Covered Transactions and Establish an Automatic Process to Update the Fee Cap Every Two Years

SUMMARY

On October 25, 2023, the Board of Governors of the Federal Reserve System (the “Board”) issued a notice of proposed rulemaking¹ that would amend the Board’s Regulation II to reduce the maximum interchange fee that covered issuers—debit card issuers with \$10 billion or more in consolidated assets—generally may receive for debit card transactions. The proposed amendments would also establish an automatic mechanism that would update the interchange fee cap every other year based on data received by the Board in biennial surveys of covered issuers. The Board adopted Regulation II’s current interchange fee cap in 2011 and 2012 pursuant to Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the so-called “Durbin Amendment”). The Durbin Amendment requires the Board to establish standards for assessing whether the amount of any interchange fee is “reasonable and proportional to the cost incurred by the issuer with respect to” a debit card transaction.² Under the proposed amendments, for a \$50 debit card transaction subject to Regulation II, the maximum permissible interchange fee would be 17.7 cents, down from 24.5 cents under the current rule.³

The Board approved the proposed amendments by a vote of 6 to 1, with Governor Bowman dissenting. Comments are due 90 days after the notice of proposed rulemaking is published in the *Federal Register*.

BACKGROUND

Debit cards represent an important payment mechanism, with debit card transactions continuing to grow. In 2021, payment card networks processed 92.1 billion debit and general-use prepaid card transactions valued at \$4.3 trillion, with the total value of debit card purchase transactions growing 9.5% per year on average from 2009 to 2021.⁴ In comparison, in 2021 credit cards were used to process 51.1 billion transactions with an aggregate value of \$4.88 trillion.⁵

When a cardholder uses a debit card to pay for a merchant's goods or services, the merchant sends the transaction details, through its depository institution (the so-called "acquirer"), to a payment card network, such as Discover, Mastercard or Visa. The payment card network then sends an authorization request to the issuer of the debit card, which in turn verifies the card's details, checks for available funds and sends a response back through the credit card network to the acquirer. The acquirer then relays the response to the merchant enabling the merchant and cardholder to complete the transaction.

When a debit card is used in a transaction, the merchant pays a fee that is collected by the acquirer (often referred to as the merchant discount).⁶ That fee is distributed among the acquirer, the issuer and the payment card network. The portion of the merchant discount transferred to the issuer is the interchange fee.⁷ The payment card network, among other things, establishes the interchange fee paid by the acquirer to the issuer for each transaction.⁸

The Durbin Amendment requires the Board to establish standards for assessing whether the amount of any interchange fee received or charged by a covered issuer for covered transactions (*i.e.*, transactions not subject to an exemption⁹) is "reasonable and proportional to the cost incurred by the issuer with respect to" a debit card transaction.¹⁰

In 2011, the Board adopted Regulation II, which implements the Durbin Amendment. In developing Regulation II's interchange fee standards, the Board identified a set of "allowable costs" incurred by debit card issuers that would be considered in setting interchange fee standards.¹¹ These costs include (i) transaction-processing costs, including fixed and variable authorization, clearance, and settlement costs, networking processing fees (*e.g.*, switch fees), and the costs of processing chargebacks and other non-routine transactions; (ii) transaction-monitoring costs; and (iii) issuer fraud losses.¹²

Based on these allowable costs and using data collected in a voluntary survey of covered issuers regarding debit card transactions in 2009, the Board developed the currently applicable interchange fee cap.¹³ This cap is the sum of three separate components: a "base component," an "*ad valorem* component" and a "fraud-prevention adjustment." The following describes each of those components and how the Board determined the amount of each component in 2011.

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1. **“Base component.”** To determine the base component, the Board evaluated allowable costs other than fraud losses (fraud losses were considered in determining the *ad valorem* component). The Board observed that, when ranking the average per-transaction allowable cost from the lowest- to highest-cost issuers among those that responded to the voluntary survey, there was a distinct inflection point. Below an average per-transaction allowable cost of 21 cents, which represented the 80th percentile among the responding issuers, there was significantly less cost variation than among the issuers that had average per-transaction costs above 21 cents.¹⁴ The Board determined it would be inconsistent with the Durbin Amendment to permit interchange fees to be set to accommodate, in full, the average per-transaction cost of the highest-cost issuers and set the base component at 21 cents per transaction.¹⁵

2. **“Ad valorem component.”** The Board determined that, unlike base component costs, the amount of fraud losses varies with the amount of a transaction. Accordingly, the Board determined that a cap on fraud losses would best be determined through a separate *ad valorem* component.¹⁶ Among the issuers that responded to the voluntary survey, the Board observed that average per-transaction fraud loss (as a percentage of transaction value) varied significantly. Accordingly, the Board set the *ad valorem* component at the median ratio, among the responding issuers, of fraud losses to transaction value, which was 5.0 basis points (multiplied by the value of the transaction).¹⁷

3. **“Fraud-prevention adjustment.”** Under the Durbin Amendment, the Board may permit an adjustment to the interchange fee received or charged by a covered issuer if the adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to debit card transactions involving the issuer. The fraud-prevention adjustment is conditioned on the issuer complying with fraud-prevention standards established by the Board.¹⁸ In a 2012 amendment to Regulation II, the Board finalized fraud-prevention standards.¹⁹ Under these standards, to receive the fraud-prevention adjustment, an issuer must develop and implement policies and procedures reasonably designed to take effective steps to reduce the occurrence of, and costs to all parties from, fraudulent debit card transactions.²⁰ Issuers must review these policies and procedures at least annually and make updates as necessary.²¹ For issuers that satisfy these standards, the Board determined that a fraud-prevention adjustment of up to 1.0 cent per transaction would be appropriate based on the fraud-prevention cost of the median issuer among the respondents to the Board’s voluntary survey.²²

As contemplated by the Durbin Amendment, the Board requires covered issuers to complete a debit card issuer survey every other year on debit card transactions processed in the previous year.²³ The Board publishes a biennial report summarizing the collected data, and the Board published the most recent report, regarding data collected in 2022 regarding transactions processed in 2021, on October 25, 2023, concurrently with the issuance of the proposed amendments.²⁴

PROPOSED AMENDMENTS

According to the Board, although “the interchange fee standards have remained the same since [Regulation II] was adopted, several data points show that the allowable costs incurred by [covered issuers] have fallen significantly.”²⁵ The Board, therefore, determined that the current interchange fee cap “may no longer be effective for assessing whether, for a debit card transaction subject to the [cap], the amount of any interchange fee received or charged by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the transaction,” as required by the Durbin Amendment. As a result, the Board concluded that “it is necessary to revise the interchange fee standards” and to update the components of the interchange fee cap “regularly and predictably.”²⁶ The proposed amendments would revise the interchange fee cap in Regulation II by changing each of the three components:

- the base component would be reduced from 21 cents to 14.4 cents;
- the *ad valorem* component would be reduced from 5.0 basis points to 4.0 basis points (in each case, multiplied by the value of the transaction); and
- the fraud-prevention adjustment would be increased from 1.0 cents to 1.3 cents.

The interchange fee cap based on these amounts for the three components would apply to covered transactions from the first day of the next calendar quarter that begins at least 60 days after the final rule is published in the *Federal Register* until June 30, 2025.²⁷

The proposed rule would also establish an automatic mechanism to update each of the three components every other year based on responses to the debit card issuer survey. The first automatic update would be determined based on data collected in 2024 regarding transactions processed in 2023, would be published in the *Federal Register* no later than March 23, 2023, and would be in effect from July 1, 2025, to June 30, 2027.²⁸ The automatic updates would be implemented based on an established methodology and would not be subject to public comment when published.²⁹

The following describes, for each component, the Board’s methodology to derive the proposed change and how that methodology would be used for future automatic updates.

1. “Base component.” Under the amendments, the Board would use a different methodology than was used in 2011 to determine the base component. The Board would calculate the base component as (i) the “transaction-weighted average of per-transaction base component costs” across covered issuers multiplied by (ii) a fixed multiplier of 3.7, with the result rounded to the nearest tenth of a cent.³⁰

- [Transaction-weighted average of per-transaction base component costs](#). This average would be calculated as the aggregate allowable costs minus fraud losses (what the Board refers to as “base component costs”) for all covered issuers that reported these costs on the most recent debit card issuer survey, divided by the total number of debit card transactions reported by these issuers (rounded to the nearest tenth of a cent).³¹ The Board indicates that this average “can be viewed as

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a broad measure of whether covered issuers collectively are becoming more or less efficient at processing debit card transactions.”³²

- **Fixed multiplier.** This multiplier would be determined based on a target selected by the Board for a reasonable percentage of covered debit card transactions that should recover base component costs in full. The Board proposes that covered issuers should recover base component costs in full for 98.5% of their covered transactions. The Board believes this percentage would be “reasonable because it would allow covered issuers to fully recover their base component costs over time for a significant majority of covered issuer transactions” and “full cost recovery for the highest-cost covered issuer transactions would not be reasonable.”³³ Based on the distribution of per-transaction costs across covered issuer transactions since 2009, as reported to their Board in debit card issuer surveys, a fixed multiplier of 3.7 would yield full recovery of base component costs for 98.5% of covered transactions.³⁴

In the most recent debit card issuer survey, the transaction-weighted average of per-transaction base component costs was 3.9 cents. This average, when multiplied by the fixed multiplier of 3.7 and rounded to the nearest tenth of one cent, would result in a base component of 14.4 cents.³⁵ This base component would apply from when the proposed amendment takes effect until June 30, 2025. For each subsequent two-year period (beginning with the period from July 1, 2025, to June 30, 2027), the base component would be recalculated using the transaction-weighted average of per-transaction base components costs reported in the then-most recent debit card issuer survey, with the fixed multiplier of 3.7 remaining unchanged.

2. “Ad valorem component.” The Board would not revise the methodology it used in 2011 to determine the *ad valorem* component.³⁶ Accordingly, the Board would determine the *ad valorem* component by calculating the median ratio of issuer fraud losses to transaction value among covered issuers, rounded to the nearest quarter of one basis point, multiplied by the value of the transaction, using data from the most recent debit card issuer survey.³⁷ The Board would retain this methodology because “the median ratio of issuer fraud losses to transaction value among covered issuers is a representative metric of the cost of fraud incurred by covered issuers.”³⁸ The median ratio of issuer fraud losses to transaction value among covered issuers based on data reported in the most recent debit card issuer survey was 4.0 basis points,³⁹ and this would be the *ad valorem* component from when the proposed amendment takes effect until June 30, 2025. The same methodology using the then-most recent debit card issuer survey would be used to determine the *ad valorem* component for each subsequent two-year period.

3. “Fraud-prevention adjustment.” The Board also would keep a similar methodology to what it used in 2012 to determine the fraud-prevention adjustment.⁴⁰ Accordingly, the fraud-prevention adjustment would be the median per-transaction fraud-prevention costs among covered issuers.⁴¹ The Board believes this methodology “will continue over time to reflect an amount that is reasonably necessary to make allowance for costs incurred by an issuer in preventing fraud in relation to debit card transactions involving that issuer.”⁴² The median per-transaction fraud-prevention cost reported in the most recent debit card issuer survey was 1.3 cents per transaction.⁴³ Accordingly, 1.3 cents per transaction would be the fraud-prevention adjustment available to covered issuers that satisfy the Board’s fraud-prevention standards from when the proposed amendment takes effect until June 30, 2025. The same methodology using the then-most recent

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debit card issuer survey would be used to determine the fraud-prevention adjustment for each subsequent two-year period.

The proposed amendments come at a tumultuous time for the regulation of interchange fees. Just last year, the Board adopted a rule amending Regulation II to specify that the requirement that each debit card transaction must be able to be processed on at least two unaffiliated payment card networks applies to card-not-present transactions (*i.e.*, transactions in which a cardholder performs payment without physically presenting a debit card to a merchant) to clarify the requirement that debit card issuers ensure that at least two unaffiliated networks have been enabled to process debit card transactions and to standardize and to clarify the use of certain terminology.⁴⁴ In June 2023 Senator Durbin reintroduced his Credit Card Competition Act, which would require banks with assets over \$100 billion to enable at least two credit card networks to be used on their credit cards and require that at least one of those networks be a network other than Visa or Mastercard.⁴⁵ Finally, on September 29, 2023, the Supreme Court of the United States granted certiorari of the North Dakota Retail Association's and the North Dakota Petroleum Marketers Association's ("Plaintiffs") appeal of the Eighth Circuit's dismissal, on statute of limitations grounds, of Plaintiffs' case alleging that interchange and processing fees paid by merchants in debit card transaction are arbitrary and capricious, contrary to the APA and in violation of the Durbin Amendment.⁴⁶ Beyond debit card fees, there have been broad challenges to fees charged by banks on services involving consumers.⁴⁷

REQUEST FOR COMMENT

The Board is seeking comment on all aspects of the proposed amendments including, but not limited to, the following:

- The appropriateness of the two-year cadence for determining the base component, *ad valorem* component and fraud-prevention adjustment.
- The appropriateness of the 98.5% cost recovery target.
- The appropriateness of determining the *ad valorem* component using the median ratio of issuer fraud losses to transaction value among covered issuers, multiplied by the value of the transaction.
- The appropriateness of determining the fraud-prevention adjustment as the median per-transaction fraud-prevention costs among covered issuers.
- The appropriateness of the rounding used by the Board in determining the various components of the interchange cap (*i.e.*, (1) rounding base component to the nearest tenth of one cent; (2) the *ad valorem* component to the nearest quarter of one basis point; (3) the fraud-prevention adjustment to the nearest tenth of one cent; and (4) the transaction weighted average of per-transaction allowable costs (excluding fraud losses) across covered issuers to the nearest tenth of one cent).
- The existence of any reporting and retention challenges associated with the debit card issuer survey (FR 3064a).
- The adequacy of the 60-day transition period from the effectiveness of the final rule.
- The sufficiency of the time between the latest point an update to the interchange cap can be published (March 31) and when that update becomes effective (July 1).

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- The clarity of how the timing of the performance of a transaction is to be determined.
- The possibility for unintended consequences caused by the Board's technical amendments.
- The adequacy of the Board's economic analysis.

Comments are due 90 days after publication of the notice of proposed rulemaking in the *Federal Register*.

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ENDNOTES

- 1 Debit Card Interchange Fees and Routing, Notice of Proposed Rulemaking (Oct. 25, 2023), available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-reg-ii-20231025.pdf> (hereinafter “NPRM”).
- 2 15 U.S.C. § 1693o-2(a)(2), (3)(A).
- 3 Staff Memo to the Board of Governors of the Federal Reserve System re: Proposed Revisions to Regulation II’s Interchange Fee Cap 2 n.3 (Oct. 18, 2023), available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/reg-ii-memo-20231025.pdf>.
- 4 Board of Governors of the Federal Reserve System, 2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions 1, 9 (Oct. 2023) (hereinafter “2023 Survey Report”), available at https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2021.pdf.
- 5 Board of Governors of the Federal Reserve System, The Federal Reserve Payments Study: 2022 Triennial Initial Data Release (July 27, 2023), available at https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2021.pdf. The compounded annual growth rate for the number of credit card transactions and the aggregate value of those transactions for the period from 2018 to 2021 was 4.5% and 7.0%, respectively. *Id.*
- 6 This discussion assumes a so-called four-party network scheme (such as Visa and Mastercard transactions) given that the Durbin Amendment does not apply to so-called three-party systems.
- 7 A debit card transaction may also be processed through a “three-party system,” such as the network operated by American Express. In this model, one entity serves as issuer and system operator, and often as acquirer as well. Debit Card Interchange Fees and Routing, Final Rule, 76 Fed. Reg. 43,394, 43,395 (July 20, 2011) (hereinafter “2011 Final Rule”). Third-party systems do not charge explicit interchange fees and transactions through these systems are not subject to Regulation II. 2011 Final Rule, 76 Fed. Reg. at 43,404–05.
- 8 Darryl E. Getter, Cong. Rsch. Serv., R41913, Regulation of Debit Interchange Fees 2 (2017).
- 9 Exempted transactions generally include those in which a person uses (1) a debit card 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 debit card or general-use prepaid card to transfer or debit funds, monetary value, or other assets that have been provided pursuant to such program or (2) certain general-use prepaid cards. See 15 U.S.C. § 1693o-2(a)(7).
- 10 15 U.S.C. § 1693o-2(a)(3)(A). “Overall merchant discount fees may not decrease if card networks, issuers, or acquirers respond to decreased interchange fees by increasing other fees that make up total merchant discount fees.... However, representatives of...card networks told us that...fee limits likely would affect them indirectly because they would have to decrease their merchant discount fees to compete with the other card networks.” U.S. Gov’t Accountability Off., GAO-10-45, Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Poses Challenges 53 n.2 (2009).
- 11 2011 Final Rule, 76 Fed. Reg. at 43,429-31; see also 15 U.S.C. § 1693o-2(a)(4)(B).
- 12 2011 Final Rule, 76 Fed. Reg. at 43,329.
- 13 The Durbin Amendment permits the issuer to receive compensation for the “incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction,” but not for other costs. 12 U.S.C. § 1693o-2(a)(4)(B).
- 14 2011 Final Rule, 76 Fed. Reg. at 43,433.
- 15 *Id.* at 43,433–34.

ENDNOTES (CONTINUED)

- 16 *Id.* at 43,431.
- 17 *Id.* at 43,434.
- 18 15 U.S.C. § 1693o-2(a)(5).
- 19 Debit Card Interchange Fees and Routing, Final Rule, 77 Fed. Reg. 46,258 (Aug. 3, 2012) (hereinafter “2012 Final Rule”).
- 20 *Id.* at 46,262–63.
- 21 *Id.*
- 22 This amount was determined based on the difference in the survey between median per-transaction fraud-prevention costs among responding covered issuers, including transaction-monitoring costs (1.8 cents), and the median per-transaction transaction-monitoring costs among responding covered issuers (0.7 cents). Transaction-monitoring costs were excluded in determining the permitted fraud-prevention adjustment because they were included in determining the permitted base component. *Id.* at 46,263. Fraud-prevention costs include a variety of fraud-prevention activities but do not include transaction-monitoring costs because those costs are included in the allowable costs for the purposes of the interchange fee standard.
- 23 See 15 U.S.C. § 1693o-2(a)(3)(B); 12 C.F.R. § 235.8(b). The debit card issuer survey is completed by covered issuers on Form FR 3064a.
- 24 2023 Survey Report, *supra* note 4. The report also includes data collected from card networks.
- 25 NPRM at 20.
- 26 *Id.* at 22.
- 27 *Id.* at 47.
- 28 *Id.* at 47–48.
- 29 *Id.* at 6. The proposed rule would also make various technical amendments to Regulation II.
- 30 *Id.* at 25.
- 31 Proposed Annex B(c)(3) to Regulation II.
- 32 *Id.* at 21 n.36. The Board notes that “[f]or the proposed cost-recovery target of 98.5 percent of covered issuer transactions... covered issuers whose transactions are above the 98.5 percentile are, on average, more than five times less efficient than covered issuers whose transactions are below the 98.5 percentile. Accordingly, the Board believes that targeting full cost recovery over time for 98.5 percent of covered issuers transactions is reasonable.” *Id.* at 28–29.
- 33 *Id.* at 26.
- 34 The Board would derive this multiplier based on the shape of the distribution observed in reported data of per-transaction base component costs across issuer transactions. According to the Board, when this data is arranged from lowest- to highest-cost covered issuer transactions, it “closely approximates the Weibull distribution.” *Id.* at 25 n.42. The Board generated scale and shape parameters for this distribution using survey data collected since 2009, *id.* at 26 n.43, and based on those parameters, determined that a fixed multiplier of 3.7 would correspond to the Board’s proposed cost-recovery target of 98.5%. *Id.* at 27–28. Further, the Board notes that “[a]lthough the proposed new methodology for determining the base component would ultimately rely on a simple formula (i.e., the transaction-weighted average of per-transaction base component costs across covered issuers multiplied by 3.7), the Board appreciates that the underlying statistical analysis is complex.” *Id.* at 29.
- 35 *Id.* at 31–32.
- 36 *Id.* at 30.

ENDNOTES (CONTINUED)

- 37 Proposed Annex B(d) to Regulation II.
- 38 NPRM at 30.
- 39 *Id.* at 32.
- 40 *Id.* at 40–41.
- 41 Proposed Annex B(e) to Regulation II.
- 42 NPRM at 39–40.
- 43 *Id.* at 39.
- 44 Debit Card Interchange Fees and Routing, 87 Fed. Reg. 61217 (Oct. 11, 2022).
- 45 Dick Durbin, *Short Summary of the Credit Card Competition Act of 2023*, <https://www.durbin.senate.gov/imo/media/doc/The%20Credit%20Card%20Competition%20Act%20of%202023%20-%20one-pager.pdf> (last visited Oct. 28, 2023).
- 46 *N. Dakota Retail Ass’n v. Bd. of Governors of the Fed. Rsrv. Sys.*, 55 F.4th 634, 637 (8th Cir. 2022), *cert. granted sub nom. Corner Post, Inc. v. Bd. of Governors*, 2023 WL 6319653 (U.S. Sept. 29, 2023).
- 47 CFPB Proposes Rule to Rein in Excessive Credit Card Late Fees, CFPB (Feb. 1, 2023), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-proposes-rule-to-rein-in-excessive-credit-card-late-fees>; CFPB Issues Guidance to Halt Large Banks from Charging Illegal Junk Fees for Basic Customer Service, CFPB (Oct. 11, 2023), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-issues-guidance-to-halt-large-banks-from-charging-illegal-junk-fees-for-basic-customer-service>.

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