ABA Staff Analysis: ABA Summary of Final Debit Card Interchange and Routing Regulation
July 2011

On June 29, 2011, the Federal Reserve Board released its final rule implementing the debit card interchange and routing regulation pursuant to the "Durbin amendment" of the Dodd/Frank Act. The final rule sets caps on permissible interchange debit card fees and requires that debit cards provide at least two unaffiliated payment card networks through which merchants may route transactions. While small banks are exempt from the interchange debit card rule, the networks are not obligated to maintain differential pricing. In addition, all banks, including those with assets under $10 billion, must comply with the routing requirements.

INTERCHANGE RULE

Permissible interchange fee.

The final rule provides an interchange fee composed of:

- A base fee of 21 cents for transactions costs;
- 5 basis points to cover fraud losses; and
- 1 cent for fraud prevention efforts (interim final rule) (except for monitoring which is included in the base transaction costs).

Accordingly, for the average $40 transaction, the interchange fee is capped at 24 cents. For a $500 transaction, the fee could not exceed 47 cents, both higher than the proposed 12 cent cap. While the regulation permits networks to charge up to the cap, they are not required to. Thus, for example, the interchange fee might be lower for small dollar transactions.

The Board is requesting comment on the interim final rule related to the one cent fraud prevention adjustment. Comments are due September 30, 2011.

Effective date.

As ABA had requested, the Board has pushed the effective date back from the statutory effective date of July 22, 2011 for the interchange fee provisions. The effective date is now October 1, 2011.

Costs considered in the permissible interchange fee.

The Board re-evaluated its interpretation of allowable costs to be considerably more inclusive. Originally, allowable costs with respect to each transaction were generally limited to the variable costs attributable to the issuer's role in authorization, clearance, and settlement of debit transactions.

Costs incorporated into the calculation of the permissible base fee of 21 cents now include:

- Total transaction processing costs, including costs reported as fixed and variable authorization, clearance, and settlement costs. (Proposal only allowed variable costs.) In addition to the variable authorization, clearance, and settlement costs included in the proposal, costs included in the fee now include:
  - Network connectivity
  - Computer equipment
  - Staff to operate and maintain computer equipment;

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Network processing fees (excluded in proposal);
Costs of processing chargebacks and other non-routine transactions; and
Transaction monitoring (excluded in proposal).

Excluded from the 21 cent base fee cost calculation:

- Corporate overhead costs;
- General debit card program costs such as card production and delivery;
- Research and development;
- Rewards;
- Customer inquiries; and
- Payment guarantee costs.

In the proposal, the Board had deliberately excluded recovery of fraud losses and had not incorporated any fraud prevention adjustment. Both are included in the final permissible interchange fee. Fraud losses are recovered in the 5 basis points added to the 21 cent base fee. Fraud prevention costs are recovered through an additional 1 cent if effective fraud prevention measures are adopted. To be eligible to receive the fraud-prevention adjustment, an issuer must develop and implement policies and procedures reasonably designed to:

1. Identify and prevent fraudulent electronic debit transactions;
2. Monitor the incidence of, reimbursements received for, and losses incurred from fraudulent electronic debit transactions;
3. 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
4. Secure debit card and cardholder data.

This approach, endorsed by ABA, is more flexible than the proposed alternative technology-specific approach that would have required issuers to implement technologies identified by the Board as major innovations likely to result in substantial reductions in fraud losses.

**Small bank exemption.**

The Board adopted the small bank exemption largely as proposed, but acknowledged that the law does not require networks to adopt it. However, the Board will publish a list of exempt institutions to make it easier for networks to identify exempt institutions and to minimize documentation and administration burdens for small banks. In addition, the Board plans to survey payment card networks annually and publish a list of the average interchange fees each network provides to its covered and exempt issuers. The Board is taking steps to monitor and report to Congress on the effectiveness of the exemption for small issuers.

**Exemption for prepaid cards.**

Pursuant to the statute, the final rule exempts certain reloadable prepaid cards. The Board has added a clarification that the exemption only applies if the card “is the only means of access to the underlying funds, except when all remaining funds are provided to the cardholder in a single transaction.” The Supplementary Information advises, “The Board believes that reloadable cards that provide access to the funds underlying the card through check, ACH, wire transfer or other method would not be exempt.”

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PROHIBITION ON NETWORK EXCLUSIVITY: ROUTING REQUIREMENTS

Overview.

The statute requires the Board to implement requirements to prohibit network exclusivity arrangements on debit cards and ensure merchants have choices in how debit card transactions are routed. Unlike the interchange fee provision, no asset threshold exemption applies to the exclusivity requirements. Accordingly, unless their debit cards are currently enabled with unaffiliated PIN and signature networks, banks will have to change their business processes and contractual arrangements, regardless of asset size. In addition the network exclusivity and routing requirements apply to both debit cards and prepaid cards.

The Board adopted the approach endorsed by the ABA in its comments to the Board identified as Alternative A in the proposed rule. Specifically, the final rule requires that issuers make two unaffiliated networks available without regard to the method of authentication (PIN or signature), a more practical alternative than proposed Alternative B, which would have required that debit cards be enabled with both multiple PIN networks and multiple signature networks and would have created a technological and branding challenge.

A card issuer may comply with the network exclusivity requirement by enabling the debit card to process transactions through one signature network and one unaffiliated PIN network. Thus, a card issuer that currently processes PIN and signature transactions through affiliated networks will have to enable an unaffiliated PIN network on their debit cards. Card issuers do not have to remove a PIN network affiliated with the signature network so long as the merchant has the option to choose an unaffiliated PIN network. Card issuers will not be required to display added PIN network logos on the debit cards, eliminating reissuance costs. Cards that are only usable with PINs must be enabled with two unaffiliated PIN networks.

Card issuers that currently offer an unaffiliated PIN network on their debit cards will not have to take action to comply with the rule. ATM transactions are not subject to the routing and exclusivity regulation.

Effective Dates.

- **October 1, 2011.** Payment card networks must allow merchants to direct transactions to all networks enabled on debit cards. Thus, if an issuer has enabled routing through one network, another network may not prohibit the merchant from using that network through an exclusivity contract.

- **April 1, 2012.**
  - Most debit cards must comply with the rule. Issuers with cards that currently do not offer an unaffiliated PIN network must do so by this date. Deadline is extended for certain types of debit cards as described below.

- **April 1, 2013.**
  - Compliance extension for the network exclusivity requirements for a limited number of types of debit cards expires. These include health flexible spending accounts and health reimbursement accounts that are required by the Internal Revenue Service to use advanced technologies at the point of sale to ensure that only eligible medical transactions be processed. Currently, other PIN networks lack capacity for that function.

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- All non-reloadable general use prepaid cards sold after this date must comply with the network exclusivity and routing requirements. Non-reloadable cards sold prior to April 1, 2013 are not subject to the rule.

- All reloadable general use prepaid cards sold after this date must comply with the rule.

- **May 1, 2013.**
  - All reloadable general use prepaid cards that were sold and reloaded *prior* to April 1, 2013 must comply with the rule.

- **Special rule for certain reloadable general use prepaid cards.** For reloadable general use prepaid cards sold *prior* to April 1, 2013 and reloaded *after* April 1, 2013, the effective date is 30 days after the date of reloading.

  Questions? Contact Nessa Feddis or Steve Kenneally for more information.