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Insights

FRB ACTION BRINGS LOWER COSTS TO MERCHANTS FOR ONLINE DEBIT CARD TRANSACTIONS

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SUMMARY

The purpose of the Durbin Amendment was to lower merchants' costs of accepting debit cards for customer payments. Up to now, because of technology limitations, online merchants were not provided lower cost debit card processing options that were available for cards used at "brick and mortar" locations, where customers and their cards are physically present. Recognizing that technical constraints have been overcome, the Federal Reserve Board recently took action meant to ensure that the Durbin Amendment's cost reductions are made widely available to merchants for their online debit card payments also.

LOWERING MERCHANTS' COSTS FOR DEBIT CARD TRANSACTIONS

Merchants pay fees for acceptance of card payments to their card payment processors, called a merchant discount or "swipe fees." Swipe fees cover the processors' costs and a profit for providing the card processing services. A major component of the processors' costs that are covered by swipe fees comprises interchange fees that card networks, such as Mastercard and Visa, collect from merchants' card processors on behalf of the card issuers. The networks each individually establish interchange fees that apply to various types of cards that carry the networks' respective brands. Those fees are charged to processors for each transaction and passed on to the card issuer that issued the card used in the transaction.[1] Limits on interchange fees that may be charged on certain debit card transactions were enacted in 2010 in the Durbin Amendment that was included in the Dodd-Frank Act.[2] Administration of the Durbin Amendment is delegated to the Board of Governors of the Federal Reserve System ("FRB" or "Board"). The Board adopted Regulation II to implement the Durbin Amendment in July 2011[3] setting a specific cap on the interchange fees that card issuers may charge for certain debit card payments. Prior to the Durbin Amendment, payment networks typically charged the same or nearly the same interchange fees for signature debit as for signature credit cards. As a result of the limits adopted by the FRB, the interchange fee portion of merchant discount fees was substantially reduced. On so-called "signature based" covered debit cards, the interchange fees were reduced from the prevailing interchange fee rates for credit card transactions, which ranged from approximately 1.75-2.25% of the transaction, to about 24 cents per transaction (21 cents plus .05%).[4] Durbin Amendment interchange fee restrictions also apply to PIN debit cards, but the reductions in interchange fees are not as dramatic, since those cards typically carried much lower interchange fees prior to the Durbin Amendment.

Signature based debit cards do not require that a cardholder enter a Personal Identification Number (or "PIN") to authorize a transaction, but instead are authenticated by the cardholder's signature on the charge slip, which was supposed to be compared to the cardholders signature on the back of the card. Since the adoption of chip cards, many merchants no longer require signatures at the point of sale when the chip is read by a chip card reader (either by inserting the chip card or by "near field communication" of chip data by tapping the card or using mobile phone card presentment technology.)

Credit cards are nearly all signature based cards and most card acceptance terminals and systems were designed to accept only signature based cards before debit card merchant payments were introduced to the market. PIN based debit cards differ in another important way from signature based credit and debit cards in that the architecture of the payments networks supporting them are different. PIN based debit cards that can be used to make purchases from merchants evolved from ATM card systems, which all required PIN entry to identify the cardholder. ATM and merchant point of sale PIN based card transactions are processed in a single message, which serves both the authorization and settlement functions. Each transaction is processed individually "in real time" based on the data in the single message. Signature based cards are processed in two messages, the first is a "real-time" individual transaction authorization message that says that the issuer will (conditionally) accept the transaction. The second message is usually a once-a-day group of transactions ("batch") that is presented to the pertinent card network for settlement. When PIN based ATM card acceptance was extended to allow purchases, merchants' physical card acceptance terminals and the elaborate and costly processing infrastructures supporting them had to be modified to accommodate PIN transactions.

Signature based cards, both credit and debit, are accepted in online CNP transactions without requiring that the cardholder sign, tap or enter a PIN. In such transactions, the merchant accepts greater risks of accepting unauthorized transactions that arises from the lack of authenticating procedures that require the presence of a card. The system modifications necessary to accommodate PIN based debit cards had not been widely adopted to support online acceptance of PIN-based debit cards at the time of the Durbin Amendment and the initial promulgation of Regulation II.

MERCHANTS' ONLINE ACCEPTANCE OPTIONS

The Durbin Amendment and Regulation II also included two provisions meant to ensure that merchants would receive the benefit of the interchange fee limit on covered debit card transactions.

These provisions are called the “routing provisions,” because they regulate the transaction processing routing options that must be provided to merchants for all covered debit card transactions. These routing provisions, as implemented in Regulation II: (1) prescribe that a debit card issuer must provide merchants the opportunity to choose between at least two unaffiliated card networks on which to process each particular type of debit card transaction;[5] and (2) prohibit card issuers and card networks from directly or indirectly inhibiting the merchants’ ability to route a given transaction over its preference among the card networks made available by the issuer as to each covered debit card. Card issuers typically meet this mandate by providing one dual message network system, either Visa or Mastercard, and one single message PIN based network that is not affiliated with the card’s dual message network. [6] Based on the Board’s pragmatic recognition that at the time, technology infrastructure did not widely support online acceptance of PIN based single message transactions, online transactions did not constitute a “particular type of debit card transaction” distinct from card present transactions, issuers were deemed to have met the routing provisions even if the PIN debit network provided could not be processed in an online transaction.

“When the Board promulgated Regulation II, the market had not yet developed solutions to broadly support multiple networks over which merchants could route card-not-present debit card transactions.[11]At the time, many networks could not process such transactions at all, while others could do so only with technology that was not widely deployed in the marketplace. In particular, the lack of widely-deployed methods for online entry of PINs was an impediment for single-message networks that traditionally required PIN entry during transaction authorization. In the decade since the adoption of Regulation II, however, technology has evolved to address these barriers, and most networks have introduced capabilities to process card-not-present transactions. Recent data collected by the Board confirm that most single-message networks are now capable of processing card-not-present transactions.”[7]

WHAT THE BOARD HAS DONE NOW

The Board has now made it clear that it expects issuers to accommodate acceptance of both of their chosen card types when presented in a card not present environment, even though one may be a PIN based card. Specifically, the Board’s Final Rule revises the Official Board Commentary on Regulation II to specify that card not present transactions constitute “a particular type of debit card transactions” and therefore the multiple routing options (non-exclusivity) must be afforded to that type of transaction:

“Particular type of transaction: An issuer complies with the rule only if, for each particular type of transaction for which the issuer's debit card can be used to perform an electronic debit transaction, the issuer enables at least two unaffiliated payment card networks. <u>For example, an issuer could comply with the rule by enabling two unaffiliated payment card networks that can each process both card-present and card-not-present transactions.</u>”[8]

The Final Rules includes other amendments to Regulation II also. For example, The Final Rule also amends section 12 C.F.R. §235.7(a)(2) so that it "provides an issuer satisfies the prohibition on network exclusivity only if the issuer enables at least two unaffiliated networks to process an electronic debit transaction, where such networks satisfy two requirements. First, the enabled networks in combination must not, by their respective rules or policies, or by contract with or other restriction imposed by the issuer, result in the operation of only one network or only multiple affiliated networks for a geographic area, specific merchant, particular type of merchant, or particular type of transaction. Second, the enabled networks must have each taken steps reasonably designed to be able to process the electronic debit transactions that they would reasonably expect will be routed to them, based on expected transaction volume."[9]

This Final Rule takes effect on July 1, 2023.[10]

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[1] In a network card transaction, the merchant fee for processing a sale is collected by the merchant's card processor by withholding a discount of the value of the amount of sales proceeds that the merchant receives for the sale. The card issuer receives its interchange fee by paying the network an amount equal to the face amount of the transaction minus the interchange fee, and charges the cardholder the full amount of the purchase. The processor retains for its fee the amount by which the merchant discount (the swipe fee) exceeds the amount of the interchange fee. (This simplified description ignores other fees that may apply to card transactions.)

[2] §1075, The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, P.L. 111-203 124 Stat. 1376 (2010); 15 U.S.C §1693o-2.

[3] 12 C.F.R. part 235.

[4] For example, on a $40 card transaction, assuming a 2% interchange fee, this simplified example represents a reduction of 56 cents or 70%. (($40 x .02)-$.24=$.56). The percentage reduction increases as the size of the transaction increases, since the Durbin rate is a flat fee per transaction. Note that this reduction only applies to the interchange fee portion of the merchant discount. The Durbin Amendment does not directly prescribe the amount of the processors' fees charged to merchants nor the amount of the interchange fee reduction that a merchant must pass on to its customers. Over time, the interchange fee rates have changed somewhat, but the overall differential for debit cards subject to Durbin limits have remained significantly lower. For example, Visa's complex interchange fee structure is publicly available at https://usa.visa.com/content/dam/VCOM/download/merchants/visa-usa-interchange-reimbursement-fees.pdf

[5] 12. C.F.R. § 235.7(a).

[6] In practice, the merchant's options are limited by the menu of card brands that the merchant's card processor supports, which is not mandated by Regulation II. Therefore, if both of the card

options provided by the card issuer on a particular card are not supported by the card processor, the merchant will not have the network routing choice that the Durbin Amendment seeks to provide. This is acknowledged in the Final Rule: “Comment 235.7(a)-2 of the final rule clarifies that § 235.7(a) does not require an issuer to ensure that two or more unaffiliated networks will actually be available to the merchant to process every electronic debit transaction. Rather, comment 235.7(a)-2 clarifies that, to comply with the requirement in § 235.7(a), it is sufficient for an issuer to configure each of its debit cards so that each electronic debit transaction performed with such card can be processed on at least two unaffiliated networks, even if the networks that are actually available to the merchant for a particular transaction are limited by, for example, the card acceptance technologies that a merchant adopts or the networks that the merchant accepts.” 87 FR 61217, 61222 (October 11, 2022)

[7] 87 FR 61218 (October 11, 2022).

[8] 87 FR 61217, 61218 (October 11, 2022)(emphasis added).

[9] 7 FR 61217, 61221-61222 (October 11, 2022).

[10] *Id.* at 61217.

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