

## BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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**Date:** October 18, 2023  
**To:** Board of Governors  
**From:** Staff<sup>1</sup>  
**Subject:** Proposed Revisions to Regulation II's Interchange Fee Cap

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### Action Requested

Staff requests approval to publish:<sup>2</sup>

- (1) the attached draft *Federal Register* notice and draft proposed rule, which would revise the interchange fee cap in Regulation II (Debit Card Interchange Fees and Routing); and
- (2) the attached draft biennial report on 2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions.

### Summary of Proposed Rule

Congress has required the Board to establish standards for assessing whether the amount of any interchange fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the debit card transaction. The statutory provision – known as the Durbin Amendment – also authorizes the Board to allow for an adjustment to such interchange fee in an amount that is reasonably necessary to make allowance for costs incurred by the debit card issuer in preventing fraud in relation to debit card transactions involving that issuer.

The Board implemented these and other provisions of the Durbin Amendment in 2011 and 2012 when the Board adopted Regulation II (Debit Card Interchange Fees and Routing). Under the current rule, each interchange fee received by a debit card issuer for a debit card transaction can be no more than the sum of (i) 21 cents (the “base component”), (ii) 5 basis

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<sup>1</sup> Matthew Eichner, Susan Foley, Mark Manuszak, Krzysztof Wozniak, Elena Falcettoni, Karen Juszczak, and Yonel Admasu (RBOPS); Mark Van Der Weide, Evan Winerman, Benjamin Snodgrass, Andrew Ruben, and Cody Gaffney (Legal).

<sup>2</sup> Staff requests the authority to make technical, non-substantive changes to the *Federal Register* notice and the biennial report prior to publication.

points multiplied by the value of the transaction (the “*ad valorem* component”), and (iii) for a debit card issuer that meets certain fraud-prevention standards, a “fraud-prevention adjustment” of 1 cent per transaction. Together, these three components comprise the “interchange fee cap.” The interchange fee cap applies to debit card transactions that do not qualify for a statutory exemption, the most significant of which is the exemption for debit card issuers with consolidated assets of less than \$10 billion. Issuers with consolidated assets of at least \$10 billion are referred to as “covered issuers” and are generally subject to the interchange fee cap.

The Board developed the current interchange fee cap using data reported to the Board by covered issuers on a voluntary survey that the Board conducted in 2010 during the original Regulation II rulemaking. As such, the current base component, *ad valorem* component, and fraud-prevention adjustment are based on the costs incurred by covered issuers in connection with debit card transactions performed in 2009.

Since that time, the Board has collected data from covered issuers on a mandatory basis every other year, as required by the Durbin Amendment. These data show that the costs incurred by covered issuers in connection with debit card transactions have changed significantly over time. In particular, the transaction-processing costs on which the Board based the base component have nearly halved, the issuer fraud losses on which the Board based the *ad valorem* component have fallen, and the fraud-prevention costs on which the Board based the fraud-prevention adjustment have risen. As a result, staff believes 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 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.

The proposed revisions would update all three components of the interchange fee cap based on the latest data reported to the Board by covered issuers regarding debit card transactions performed in 2021. Under the proposal, the base component would decrease from 21.0 to 14.4 cents, the *ad valorem* component would decrease from 5.0 basis points (multiplied by the value of the transaction) to 4.0 basis points (multiplied by the value of the transaction), and the fraud-prevention adjustment would increase from 1.0 cents to 1.3 cents.<sup>3</sup> The proposed

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<sup>3</sup> The maximum permissible interchange fee for a \$50 debit card transaction would be 17.7 cents under the proposal, down from 24.5 cents under the current rule.

base component was determined using a new methodology that is informed by the cumulative data that have been reported to the Board every other year since the original rulemaking. This methodology targets full cost recovery over time for a significant majority of transactions across covered issuers through a formula that relates the base component to a key metric of covered issuer costs. By contrast, the proposed *ad valorem* component and proposed fraud-prevention adjustment were determined using generally the same methodologies used in the original rulemaking.

In addition to updating the interchange fee cap for the first time since the original rulemaking, the proposed revisions would codify in Regulation II an approach for updating the three components of the interchange fee cap every other year going forward based on the latest data reported to the Board by covered issuers.<sup>4</sup> By directly linking the interchange fee cap to data from the Board’s biennial survey of covered issuers, this approach should ensure going forward that, to the extent practicable, any interchange fee subject to the cap will be reasonable and proportional to the cost incurred by the issuer with respect to the transaction, as required by the Durbin Amendment. These future updates to the interchange fee cap would be published without inviting public comment and would be published by March 31 of odd-numbered years, with the new amounts taking effect on July 1 and remaining in effect for two years.

Finally, the proposed rule would make various technical changes to Regulation II.

### **Background on the Debit Card Industry, the Durbin Amendment, and Regulation II**

Debit cards are the most popular noncash form of payment in the United States.<sup>5</sup> A debit card transaction typically involves at least five parties: (i) the cardholder; (ii) the entity, typically a depository institution, that issues the debit card to the cardholder (the “issuer”); (iii) a merchant that accepts debit card payments; (iv) the merchant’s depository institution (the “acquirer”); and (v) a payment card network. When a cardholder presents a debit card to a merchant for payment, the merchant, through its acquirer, routes the transaction for processing to one of the payment card networks that the issuer has enabled to process transactions performed with the debit card.

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<sup>4</sup> The proposal also would renew the Interchange Transaction Fees Survey (FR 3064; OMB No. 7100-0344) and request comment on whether § 235.8 of Regulation II should be amended to specify that a covered issuer is required to retain records supporting the data that the covered issuer reports on the Debit Card Issuer Survey (FR 3064a).

<sup>5</sup> See Board of Governors of the Federal Reserve System, *The Federal Reserve Payments Study: 2022 Triennial Initial Data Release*, <https://www.federalreserve.gov/paymentsystems/fr-payments-study.htm>.

The network facilitates the exchange of information and transfer of funds between the issuer and acquirer. The network also establishes rules and certain fees for transactions processed by the network, including the interchange fee paid by the acquirer to the issuer for each transaction. The acquirer charges the merchant a merchant discount (*i.e.*, the difference between the face value of a transaction and the amount the acquirer transfers to the merchant) that includes the interchange fee and other fees.

Congress enacted the Durbin Amendment in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>6</sup> The Durbin Amendment seeks to address concerns regarding the level of interchange fees for debit card transactions in two main ways. First, the Durbin Amendment provides that the amount of any interchange fee that an issuer may receive with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction, and grants the Board regulatory authority over debit card interchange fees.<sup>7</sup> Specifically, the statute requires the Board to establish standards for assessing whether the amount of any interchange fee that an issuer may receive with respect to a debit card transaction is reasonable and proportional to the cost incurred by the issuer with respect to the transaction (the “interchange fee standards”). The statute also authorizes the Board to allow for an adjustment to an interchange fee if such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to debit card transactions involving that issuer.<sup>8</sup> Second, the Durbin Amendment requires the Board to prescribe regulations concerning the routing of debit card transactions.<sup>9</sup>

The Board’s Regulation II implements the Durbin Amendment.<sup>10</sup> As described above, the current interchange fee standards provide that, for a debit card transaction subject to the

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<sup>6</sup> Public Law 111-203, 124 Stat. 1376 (2010). The Durbin Amendment refers to section 1075 of the Dodd-Frank Act, which added new section 920 to the Electronic Fund Transfer Act. The Durbin Amendment is codified at 15 U.S.C. 1693o-2.

<sup>7</sup> See 15 U.S.C. 1693o-2(a).

<sup>8</sup> See 15 U.S.C. 1693o-2(a)(5). To be eligible to receive the fraud-prevention adjustment, the Durbin Amendment requires the issuer to comply with fraud-prevention standards established by the Board. The statute contains exemptions from the interchange fee standards for government-administered payment programs; general-use reloadable prepaid cards; and, most significantly, debit card issuers with consolidated assets under \$10 billion. See 15 U.S.C. 1693o-2(a)(6)–(7).

<sup>9</sup> See 15 U.S.C. 1693o-2(b). The proposed rule would not substantively amend these routing provisions.

<sup>10</sup> Regulation II (Debit Card Interchange Fees and Routing), 12 CFR part 235. The Board adopted the interchange fee standards in 2011 and adopted the fraud-prevention adjustment by an interim final rule in 2011 and a final rule in 2012.

standards, the amount of any interchange fee that an issuer receives may be no more than the sum of (i) a base component of 21 cents and (ii) an *ad valorem* component of 5 basis points multiplied by the transaction value. In addition to this amount, an issuer may receive a fraud-prevention adjustment of no more than 1 cent per transaction, provided the issuer complies with fraud-related standards in Regulation II. These three components – the base component, the *ad valorem* component, and the fraud-prevention adjustment – comprise the interchange fee cap.<sup>11</sup>

In developing the current interchange fee standards, the Board first identified a set of “allowable costs” incurred by debit card issuers – transaction-processing costs and issuer fraud losses – that could serve as the basis of the interchange fee standards, consistent with the statute.<sup>12</sup> The Board collected information regarding these allowable costs for transactions performed in 2009 via a voluntary survey of covered issuers conducted during the original Regulation II rulemaking. Based on these data, the Board adopted a base component of 21 cents, which corresponded to a notable inflection point in the distribution of per-transaction transaction-processing costs across covered issuers that reported these costs on the Board’s voluntary survey.<sup>13</sup> Recognizing that issuer fraud losses are unique because the size of a fraud loss varies with the size of the transaction, the Board adopted an *ad valorem* component of 5 basis points (multiplied by the value of the transaction), which corresponded to the median ratio of issuer fraud losses to transaction value among covered issuers that reported these costs on the Board’s voluntary survey. In a similar way, in developing the fraud-prevention adjustment, the Board first defined the fraud-prevention costs incurred by debit card issuers that could serve as the basis of the fraud-prevention adjustment. The Board adopted a fraud-prevention adjustment

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<sup>11</sup> See 12 C.F.R. 235.3 (interchange fee standards) & 235.4 (fraud-prevention adjustment). Notably, the current regulation specifies the values of these components of the interchange fee cap; it does not codify the methodologies that the Board used to determine those values or a process for updating them.

<sup>12</sup> Transaction-processing costs include fixed and variable authorization, clearance, and settlement costs, network processing fees (*e.g.*, switch fees), the costs of processing chargebacks and other non-routine transactions, and transaction-monitoring costs. For the reasons explained in the notice accompanying the 2011 final rule, allowable costs do not include other costs incurred by debit card issuers in connection with their debit card programs, such as corporate overhead and account-relationship costs, general debit card program costs (such as card production and delivery costs, marketing costs, and research and development costs), or costs of non-sufficient funds handling, cardholder rewards, and cardholder inquiries. See 76 FR 43393, 43427–29 (July 20, 2011). The Board’s construction of the statute regarding allowable costs was challenged in litigation, but the Board prevailed on appeal. See *NACS v. Board of Governors of the Federal Reserve System*, 746 F.3d 474, 488–89 (D.C. Cir. 2014).

<sup>13</sup> Per-transaction transaction-processing costs ranged from 3 cents to 66 cents per transaction, with a considerable majority of covered issuers concentrated in the range of costs below 21 cents, and a scattered set of covered issuers having significantly higher costs above 21 cents.

of 1 cent, which approximated the median per-transaction fraud-prevention costs among covered issuers that reported these costs on the Board's voluntary survey.

### **Rationale for Proposal and Proposed Revisions**

When the Board established the interchange fee standards in 2011, the Board stated that it would regularly collect data on the costs incurred by covered issuers in connection with debit card transactions and, over time, would adjust the interchange fee standards based on reported costs, if appropriate. The Board also noted that lower costs should result in a lower interchange fee cap as issuers become more efficient.<sup>14</sup> Since that time, the Board has collected data from covered issuers on a mandatory basis every other year, as required by the Durbin Amendment.<sup>15</sup>

Analysis of data collected by the Board shows clear changes in costs underlying each of the three components of the interchange fee cap since Regulation II was adopted. Significantly, the transaction-processing costs of the average debit card transaction declined by nearly 50 percent, from 7.7 cents in 2009 to 3.9 cents in 2021.<sup>16</sup> Data collected by the Board also indicate that issuer fraud losses have declined over this period.<sup>17</sup> Finally, fraud-prevention costs have increased from 2009 to 2021.<sup>18</sup>

Given these developments, staff believes that the interchange fee standards may no longer be effective for assessing whether, for a debit card transaction subject to the standards, the amount of any interchange fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Further, staff believes that the current fraud-prevention adjustment may not reflect an amount that is reasonably necessary to make allowance for costs incurred by the debit card issuer in preventing fraud in relation to debit

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<sup>14</sup> See 76 FR at 43432. When the Board adopted the current fraud-prevention adjustment in 2012, the Board similarly stated that it would take into account data collected in the future when considering any future revisions to the fraud-prevention adjustment. See 77 FR 46258, 46266 (Aug. 3, 2012).

<sup>15</sup> The most recently collected data pertain to debit card transactions performed in calendar year 2021. To view the Board's biennial data reports and the underlying survey instruments, see Board of Governors of the Federal Reserve System, *Regulation II (Debit Card Interchange Fees and Routing): Reports and Data Collections*, <https://www.federalreserve.gov/paymentsystems/regii-data-collections.htm>.

<sup>16</sup> The metric used is the transaction-weighted average of per-transaction transaction-processing costs across covered issuers, which can be viewed as a broad measure of whether covered issuers collectively are becoming more or less efficient at processing debit card transactions.

<sup>17</sup> The median ratio of issuer fraud losses to transaction value among covered issuers declined from 5.0 basis points in 2009 to 4.0 basis points in 2021.

<sup>18</sup> The median per-transaction fraud-prevention costs among covered issuers increased from approximately 1.0 cents in 2009 to 1.3 cents in 2021.

card transactions involving that issuer.

The proposed revisions would update all three components of the interchange fee cap based on the latest data reported to the Board by covered issuers regarding debit card transactions performed in 2021. Under the proposal, the base component would decrease from 21.0 cents to 14.4 cents, the *ad valorem* component would decrease from 5.0 basis points (multiplied by the value of the transaction) to 4.0 basis points (multiplied by the value of the transaction), and the fraud-prevention adjustment would increase from 1.0 cents to 1.3 cents for debit card transactions subject to the interchange fee cap.

Furthermore, the proposed revisions would codify in Regulation II an approach for updating the three components of the interchange fee cap every other year going forward based on the latest data reported to the Board by covered issuers.<sup>19</sup> By directly linking the interchange fee cap to data from the Board's biennial survey of covered issuers, this approach should ensure that, to the extent practicable, the interchange fee standards will be effective going forward for assessing whether, for a debit card transaction subject to those standards, the amount of any interchange fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Similarly, this approach should ensure that, going forward, the fraud-prevention adjustment reflects changes in the fraud-prevention costs incurred by covered issuers.

The proposal would adopt a new methodology for determining the base component that is informed by the cumulative data reported to the Board every other year since the original rulemaking. Based on those data, the Board's original methodology of determining the base component by reference to an inflection point in the distribution of per-transaction transaction-processing costs across covered issuers is no longer tenable. Specifically, such inflection points do not consistently appear across data collections, and when they do appear, they do not necessarily reflect the overall trend in transaction-processing costs across covered issuers.

Instead, under the proposal, the base component would be determined using a formula derived from the cumulative data collected by the Board since 2009 and designed to target full

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<sup>19</sup> As noted above, these future updates to the interchange fee cap would be published without inviting public comment. The updated interchange fee cap would be published by March 31 of odd-numbered years, with the new amounts taking effect on July 1 and remaining in effect for two years.

cost recovery for 98.5 percent of transactions across covered issuers over time.<sup>20</sup> The formula recognizes that covered issuers should fully recover their transaction-processing costs for a significant majority of transactions, but that allowing the outlying, highest-cost issuers to fully recover their transaction-processing costs would not be reasonable. Under this formula, the base component would be the product of the transaction-weighted average of per-transaction transaction-processing costs across covered issuers and a fixed multiplier of 3.7, rounded to the nearest tenth of one cent.<sup>21</sup> Consistent patterns observed in the data collected from covered issuers make it possible to derive such a formula, and due to the persistence of those patterns over time, staff expects that, going forward, the formula should achieve the target cost recovery of 98.5 percent of transactions over time.

Under the proposal, the *ad valorem* component and the fraud-prevention adjustment would generally be determined using the same methodologies that the Board used to determine those components in 2011, but would be based on the latest data reported to the Board by covered issuers. Data collected by the Board since Regulation II was adopted shows that the key metrics underpinning both methodologies remain representative of the relevant costs incurred by covered issuers. Specifically, the *ad valorem* component for a particular debit card transaction would be 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 debit card transaction. The fraud-prevention adjustment would be the median per-transaction fraud-prevention costs among covered issuers, rounded to the nearest tenth of one cent.

In addition to the above-described changes, the proposed rule would make various technical changes to Regulation II. In general, these proposed revisions are intended to make Regulation II clearer. For example, the proposed rule would codify “covered issuer” as a defined term in the regulation.

The proposed rule would, if adopted, become effective at least 60 days after the final rule is published in the *Federal Register*. The *Federal Register* notice accompanying the proposed

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<sup>20</sup> As described in the attached *Federal Register* notice, the proposed approach would not guarantee this precise level of cost recovery in any particular year. Rather, in some years, covered issuers may fully recover their transaction-processing costs for more than the target percentage of covered issuer transactions; in other years, covered issuers may fully recover their transaction-processing costs for less than the target percentage of covered issuer transactions. Over time, however, staff expects that the actual cost recovery of covered issuer transactions should be close to the cost-recovery target.

<sup>21</sup> Based on 2021 data, this formula yields a base component of  $3.9 * 3.7 = 14.4$  cents.

rule provides a 90-day public comment period and requests comment on all aspects of the proposal, including the approach for regularly updating the interchange fee cap, the fixed cost-recovery target of 98.5 percent of transactions across covered issuers, and the proposed technical changes to the regulation.<sup>22</sup>

### **Effects of the Proposed Revisions**

The draft *Federal Register* notice contains a statutorily required analysis of the economic effect of the proposed rule on different parties in the debit card industry. The analysis concludes that the proposed rule may affect the various parties in the debit card industry in different ways; moreover, the effect of the proposed rule on a specific party will generally depend on that party's particular circumstances.

With respect to merchants, the proposal should lower merchants' costs of accepting debit card transactions. Merchants, in turn, may pass on some portion of their savings from lower interchange fees to consumers. Furthermore, lower debit card acceptance costs could lead merchants to adopt debit cards in market segments where acceptance may be lower, such as card-not-present (*e.g.*, e-commerce) transactions.

With respect to issuers, the effect of the proposal would depend on whether an issuer is subject to the interchange fee cap. The proposal would reduce covered issuers' interchange fee revenues. Covered issuers<sup>23</sup> may seek to offset lost revenue through a combination of cost reductions and adjustments to consumer terms and fees, although the latter effect would be tempered by competition between issuers.<sup>23</sup> While some of these changes could make checking account and debit card programs less attractive to consumers, the growth in debit card popularity following the introduction of the current interchange fee cap in 2011 suggests that this effect is likely to be muted. By contrast, issuers exempt from the interchange fee cap (*i.e.*, those with consolidated assets of less than \$10 billion) are likely to be unaffected by the proposal: following the adoption of the current interchange fee cap, average per-transaction interchange fees for

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<sup>22</sup> The *Federal Register* notice would not invite public comment on the allowable costs that the Board considered in establishing the interchange fee standards. Rather, the notice would state that the Board has reviewed its construction of the Durbin Amendment and prior analysis regarding allowable costs, and believes that this prior analysis remains sound.

<sup>23</sup> An issuer seeking to reduce costs may reduce transaction-processing costs and/or other types of costs. Under the proposed approach, the former could result in a reduction to the interchange fee cap once data collected by the Board show a reduction in the transaction-weighted average of per-transaction transaction-processing costs across covered issuers.

exempt issuers across all payment card networks did not decline.<sup>24</sup>

With respect to consumers, the proposal could generate benefits to the extent that merchants pass on savings from lower debit card acceptance costs (*e.g.*, in the form of lower prices, forgone future price increases, or increases in service quality), but could have negative effects to the extent that covered issuers increase fees associated with debit cards or deposit accounts. The net effect on consumers, both individually and in the aggregate, will depend on which of these two effects predominates, which would in turn depend on many factors and is thus difficult to predict. The proposal's potential impact on lower-income consumers is similarly unclear. On the one hand, these consumers in particular could benefit from merchants potentially passing on savings from lower debit card acceptance costs and also could benefit from increased debit card acceptance (*e.g.*, for card-not-present transactions). On the other hand, lower-income consumers may be negatively affected by higher costs of banking services (*e.g.*, if issuers increase fees associated with debit cards).

### **Biennial Report on 2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions**

The attached draft report provides summary information on debit card volumes and values; interchange fees and other fees associated with debit card transactions; covered issuer, merchant, and cardholder fraud losses; and covered issuer costs. To collect this information, the Board conducts an annual survey of payment card networks and a biennial survey of covered issuers. The attached draft report is the seventh such report and summarizes information from these data collections for 2020 and 2021.

As discussed in the report, interchange fees remain the biggest fee category for debit card transactions. In 2021, interchange fees across all debit card transactions totaled \$31.6 billion, a 19.1 percent increase from 2020. Transactions subject to the interchange fee standards (*i.e.*, those performed with debit cards issued by covered issuers and that do not qualify for another exemption) accounted for 40.9 percent of total debit card interchange fees, at \$12.9 billion.

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<sup>24</sup> Average per-transaction interchange fees for exempt issuers have remained at a level substantially higher than average per-transaction interchange fees for covered issuers, with the latest data collected by the Board documenting that average per-transaction interchange fees for exempt issuers increased in 2020 and 2021. *See* Board of Governors of the Federal Reserve System, *Regulation II (Debit Card Interchange Fees and Routing): Average Debit Card Interchange Fee by Payment Card Network*, <https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm>.

The information presented in the attached draft report informed the proposed revisions to Regulation II. In particular, the report documents that the metric that would be incorporated into the proposed formula for determining the base component (*i.e.*, the transaction-weighted average of per-transaction transaction-processing costs across covered issuers) was 3.9 cents in 2021.<sup>25</sup> This value represents a decline of nearly 50 percent since 2009 (7.7 cents) and over 23 percent since 2011 (5.1 cents), the first year for which the Board collected data on a mandatory basis. Similarly, the metric on which the *ad valorem* component is based has also declined since the adoption of Regulation II, with the median ratio of issuer fraud losses to transaction value among covered issuers falling from 4.7 to 4.0 basis points between 2011 and 2021.

The report documents that, largely due to the decline in both of these metrics, the current interchange fee standards in Regulation II (21 cents, plus 5 basis points multiplied by the value of the transaction) exceeded the average per-transaction allowable costs for 77.4 percent of covered issuers and 99.5 percent of covered transactions in 2021.

The report further documents that median per-transaction fraud-prevention costs among covered issuers have increased since the adoption of Regulation II and were 1.3 cents in 2021.

The report also provides analyses of other statistics and trends in debit card volumes and values across network types and transaction categories. Finally, the report presents an overview of the information reported on the fraud losses borne by the different industry stakeholders across network types and transaction categories.

## Attachments

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<sup>25</sup> For a description of allowable costs, see *supra* note 12 and accompanying text. The draft report refers to these costs as authorization, clearing, and settlement (ACS) costs.