

**Board of Governors of the Federal Reserve System**



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***Impact of Regulation II on Small Debit Card Issuers***

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May 23, 2013

In conjunction with the issuance of the final rule for Regulation II in June 2011, the Board requested that staff assess the impact of certain provisions of the regulation on small debit card issuers. For the purpose of the rule, a small debit card issuer is an issuer that, together with its affiliates, has assets of less than \$10 billion.<sup>1</sup> The Dodd-Frank Act exempted small issuers from the interchange fee standard set in the regulation, but not from the statute's prohibition on network exclusivity. As a result, Regulation II requires every debit card issuer, regardless of size, to have at least two unaffiliated networks on every debit card.<sup>2</sup>

During the rulemaking process, numerous parties raised concerns that the exemption from the interchange fee standard would not be effective because networks would not establish separate interchange fee schedules for exempt issuers. These parties were concerned that merchants would route their transactions over the lowest-cost available network, placing downward pressure on interchange fees and thereby undermining further the effectiveness of the small issuer exemption from the interchange fee standard. Moreover, numerous parties raised concerns that the network exclusivity prohibition would impose costs on small debit card issuers.

The Board instructed staff to assess

- A. the extent to which networks established separate interchange fee schedules for exempt and covered issuers,
- B. how interchange fees received by exempt issuers compared with those prevailing before the rule became effective, for those networks that established separate fee schedules,
- C. how exempt issuers' interchange revenues have changed,
- D. whether there is evidence that merchants have rejected debit cards of customers of exempt issuers, and
- E. how the network exclusivity provisions have affected small issuer costs.

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<sup>1</sup> 12 CFR 235.5(a)(ii).

<sup>2</sup> 12 CFR 235.7(a).

The Board's annual data collection from payment card networks has provided the information necessary to address issues A, B, and C.<sup>3</sup>

A. *Separate interchange fee schedules for exempt and covered issuers.* All payment card networks provided a higher average interchange fee to exempt issuers than non-exempt issuers in 2012.<sup>4</sup> The average interchange fee per signature debit transaction for exempt issuers was slightly more than double that for non-exempt issuers. The average interchange fee per PIN debit transaction for exempt issuers was 1.3 times greater than that for non-exempt issuers.

B. *Change in exempt-issuer interchange fees since the implementation of interchange fee standard on non-exempt issuers.* In 2009, the average interchange fee for all issuers was 43 cents.<sup>5</sup> For the first three quarters of 2011, before the interchange fee standard took effect, exempt issuers received an average of 44 cents per debit card transaction. The average interchange fee per transaction received by exempt issuers has returned to the 2009 level of 43 cents since the implementation of the interchange fee standard.

C. *Changes in exempt-issuers' interchange revenues.* In 2012, exempt issuers received \$7.4 billion in total debit card interchange revenue, compared with approximately \$5.3 billion in debit card interchange revenue in 2009.<sup>6</sup>

To collect information related to evidence of discrimination by merchants against debit cards of small issuers (D) and small issuer costs of compliance with the regulation's network exclusivity provisions (E), the Board conducted a limited and voluntary survey of depository institutions with consolidated assets less than \$10 billion during the fall of 2012.<sup>7</sup> The Board randomly drew 1,000

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<sup>3</sup> See <http://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm>.

<sup>4</sup> One PIN network (Alaska Option) had no non-exempt issuers in 2012.

<sup>5</sup> The 2009 data represent aggregate information provided by the payment card networks for all issuers and cannot be disaggregated by exempt and non-exempt issuers.

<sup>6</sup> For 2012, payment card networks reported \$7.4 billion of interchange revenue paid to exempt debit card issuers. For 2009, payment card networks reported \$16.2 billion of interchange revenue paid to all debit card issuers before issuers were classified as either exempt or non-exempt. The \$5.3 billion estimate for exempt issuer interchange fee revenue in 2009 is 33 percent of that total, which represents the proportion of debt card transactions processed by exempt issuers in 2011, the first year for which data broken out by exempt and non-exempt issuers are available.

<sup>7</sup> See <http://www.federalreserve.gov/paymentsystems/files/smallissuersurvey.pdf>.

depository institutions from the list provided on the Board's website of institutions that are exempt from the interchange fee standard and invited those institutions to participate in a confidential online survey.<sup>8</sup>

In addition to some basic information about the existence and size of a respondent's debit card program, the survey instrument asked whether an institution had received any reports from cardholders about rejection or other discrimination with respect to the use of their debit cards at the point of sale because their cards are provided by an issuer that is exempt from the interchange fee standard. The survey also asked whether an institution had been required to enable an additional network on its debit cards to comply with the regulation, and, if so, the costs of any such adjustments, including costs associated with one-time changes to an institution's debit cards as well as estimated annual costs of meeting the regulatory requirements. Respondents were instructed to include costs such as legal fees, one-time and ongoing network connectivity fees, costs of updating systems, and ongoing membership or licensing fees.

The Board received responses from 102 small depository institutions that had been invited to participate in the survey. Because responses were voluntary and, consequently, were conditioned on the willingness and ability of participants to provide information, the results of the survey may not be representative of the experience of small issuers overall. Instead, the results reflect the effects of the regulation on this set of respondents and may be suggestive of some of the potential effects of the regulation on small issuers more broadly.

The respondents include community commercial banks, credit unions, and thrifts. Of the 102 respondents, 97 reported having debit card programs, most of which were fairly small. For these 97 respondents, Table 1 provides summary information about the number of debit cards outstanding as of December 31, 2011, and the volume and value of transactions settled during 2011. The average transaction value for debit cards issued by the respondents was approximately \$41, which is largely consistent with the average transaction size for the industry as a whole.

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<sup>8</sup> See <http://www.federalreserve.gov/paymentsystems/regii-interchange-fee-standards.htm>

**Table 1:** All respondents with debit card program

	<i>Average</i>	<i>Maximum</i>	<i>Median</i>	<i>Minimum</i>
Number of cards	17,560	227,445	3,829	303
Transaction volume (millions)	2.66	38.12	0.385	0.0056
Transaction value (\$ millions)	110.00	1054.60	19.97	0.2660

*D. Evidence of discrimination against cards issued by exempt issuers.* Of the 97 respondents with debit card programs, 3 reported having received complaints from their cardholders about treatment of their debit cards, although it is not clear that any complaints were directly due to the fact that the cards were exempt from the interchange fee standard. One respondent reported that its cards are being declined at certain merchants and indicated it had received 10 complaints from cardholders regarding this treatment. The second respondent reported receiving approximately 200 complaints about denial of PIN-based transactions, which required resubmission of transactions as signature-based transactions. The third respondent reported receiving 5 complaints and noted that many small merchants are not allowing transactions under \$5 in the respondent's geographic area.

*E. Cost to small issuers of adding a second unaffiliated network.* Of the 97 respondents with a debit card program, 84 percent indicated that they did not have to add a payment card network to any debit card to comply with the network exclusivity prohibition of Regulation II. The remaining 16 percent reported needing to add a network in order to comply with the regulation's prohibition on network exclusivity; the number of affected cards ranged from 450 to 132,302.<sup>9</sup> The average and median number of cards that required the addition of an unaffiliated network were 15,387 and 4,116 cards, respectively.

On a per card basis, the 16 respondents that added a second network reported one-time costs that ranged from \$0 to \$3.47 per card, with an average and median cost of \$0.54 and \$0.38, respectively. Focusing only on the 12 issuers that reported positive one-time costs, the average one-time adjustment cost across respondents was \$0.72 per card, with a median of \$0.50 per card. If all one-time costs are

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<sup>9</sup> These numbers reflect the respondents' debit cards outstanding as of December 31, 2011, that required the addition of a payment card network.

aggregated across all 16 respondents and divided by the total number of cards that required adjustment, the average one-time cost of compliance was approximately \$0.38 per card.

In terms of estimated ongoing annual costs of compliance, the reported costs for the 16 respondents that had to add an unaffiliated network ranged from \$0 to \$6.67 per card, with an average and median cost of \$1.04 and \$0.66 per card, respectively. Focusing only on the 14 issuers that reported positive ongoing annual costs, the average ongoing compliance costs was \$1.19 per card, and the median was \$0.74 per card. If all ongoing annual costs are aggregated across all 16 respondents and divided by the total number of cards that required adjustment, the average annual cost of compliance was approximately \$0.29 per card.

**Table 2:** Respondents that added a network to comply with Regulation II

	<i>All respondents that added a network<sup>1</sup></i>				<i>Respondents with non-zero costs<sup>2</sup></i>			
	<i>Average</i>	<i>Maximum</i>	<i>Median</i>	<i>Minimum</i>	<i>Average</i>	<i>Maximum</i>	<i>Median</i>	<i>Minimum</i>
Number of cards requiring additional network	15,387	132,302	4,116	450	14,240	132,302	2,816	450
Total one-time cost of compliance (\$)	5,810	68,500	500	0	7,747	68,500	1,250	250
Per card one-time cost of compliance (\$/card)	0.54	3.47	0.38	0	0.72	3.47	0.50	0.02
Total annual ongoing cost of compliance (\$)	4,477	27,000	1,710	0	5,117	27,000	2,142	50
Per card annual ongoing cost of compliance (\$/card)	1.04	6.67	0.66	0	1.19	6.67	0.74	0.002

<sup>1</sup> 16 respondents reported adding an unaffiliated network.

<sup>2</sup> 12 and 14 respondents reported one-time and annual ongoing costs, respectively.