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April 19, 2011

Louise L. Roseman
Director
Division of Reserve Payment
Operations and Payment Systems
Board of Governors of the
Federal Reserve System

Re: Docket R-1404

Dear Ms. Roseman:

The attached memorandum supplements American Express' February 22, 2011 and March 23, 2011 Comments submitted in response to the Notice of Proposed Rulemaking "Debit Card Interchange Fees and Routing", Docket No. R-1404.

Please feel free to contact me if there are any questions.

Very truly yours,

Anne Segal

Anne L. Segal
Managing Counsel

Memorandum

This Memorandum responds to the Federal Reserve staff's questions as to what would be required of a three-party system like American Express to configure a prepaid card that is PIN-enabled for ATM transactions to be PIN-enabled for use at the merchant point-of-sale, and capable of being routed over unaffiliated third party PIN debit networks using a single-message transmission format. As our Comments noted, some American Express prepaid cards are PIN-enabled only to permit the cardholder to access ATMs for cash withdrawals. ATM transactions on our prepaid cards are processed through different, specialized systems that cannot be used for PIN-enabled transactions at a merchant point-of-sale.

For a three-party signature network like American Express, making such a change to our network is not a mere matter of flicking a switch or connecting two wires. It is a profound change that would represent a costly, disruptive and lengthy undertaking that would likely not provide economic benefits to merchants or consumers.[1] And, such an outcome is unnecessary.

The Durbin Amendment provisions on routing were clearly intended to address practices by which four party networks have restricted competition from unaffiliated PIN-debit networks for the routing of debit card transactions through exclusive routing agreements between the four-party networks and their issuers. The language of the statute itself can and should be interpreted to apply only to networks and issuers that affirmatively impose restrictions on routing, and not to three-party closed-loop networks whose inherent business model is that transactions can route only through the closed-loop. Routing solely through the closed-loop is simply how the three-party network business model is designed to operate and has always operated. It is not the result of restrictions remotely similar to those imposed by the dominant four-party networks that Congress sought to remedy through Section 920(b)(1). American Express did not create, and does not have, the problems that these routing provisions were intended to address, and therefore should not have this alternative routing solution force-fit onto its network.

Moreover, this interpretation is supported by Senator Durbin, the author of the routing provisions wherein he noted in his Comments filed with the Board that three-party systems were not the intended focus of these provisions.[2] Senator Durbin also expressly stated that the intent of the routing provision was to preserve competition for routing of PIN-debit transactions because price competition for routing of PIN-debit transactions had diminished as a result of large networks like Visa entering into exclusive arrangements with bank issuers under which the

[1] The deadlines in the Proposed Rule for implementing alternative routing are not reasonable. *See* American Express's Comments 6,12,15 (Feb. 22, 2011)

[2] Letter from Senator Durbin to the Board of Governors of the Federal Reserve System, February 22, 2011, p. 16 (see *http://www.federalreserve.gov/SECRS/2011/March/20110303/R-1404/R-1404_022211_67820_571445654740_1.pdf*).

network's affiliated PIN-debit network becomes the sole PIN network that would route the bank issuer's PIN debit transactions.[3]

1. **Three-Party Networks Are Configured in a Fundamentally Different Manner from Four-Party Networks.**

Three-party networks are different from four-party networks in many respects. The Board acknowledged an important difference in its Proposed Rule by pointing out that the "four-party system is the model used for most debit card transactions" while "the three-party model is used for some prepaid transactions, but not for other debit card transactions."[4] The reason for this distinction is grounded in the inherent nature of three-party and four-party networks.

In the four-party network model, multiple PIN debit networks, in addition to those PIN debit networks operated by Visa (Interlink) and MasterCard (Maestro) have the capability to route PIN debit transactions. These PIN debit networks can compete for merchants' business by quoting lower interchange and network fees. In recent years, as noted by Senator Durbin, Visa and MasterCard sought to stifle competition from these networks by entering into exclusive routing agreements with their issuers under which debit transactions were routed over only their affiliated signature and PIN debit networks.[5]

By contrast, American Express operates a closed-loop, three-party network in the United States where all American Express Card transactions at merchants -- whether conducted with charge, credit or prepaid cards -- are processed through the same proprietary system on which American Express is the sole acquirer.[6] Maintaining this closed-loop is critical to preserving a key feature that allows American Express to compete with the larger four-party networks. Moreover, as American Express noted in prior comments, nothing in the statute authorizes the Federal Reserve to require American Express to appoint third party acquirers.[7]

The overwhelming majority of American Express prepaid cards, which are prepaid gift cards, are not PIN-enabled for ATM cash access, although American Express has PIN-enabled certain of its prepaid cards for cash access through a worldwide network of ATMs. This cash access capability was built only to respond to a specific customer need – Cardmember access to cash at an ATM.[8] American Express built its ATM cash access infrastructure separate and apart

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[3] *See* Durbin Statement on TCF's Court Challenge of Interchange Law (Oct. 12, 2010), *available at* http://durbin.senate.gov/showRelease.cfm?releaseId=328221.

[4] 75 Fed. Reg. at 81,723. Moreover the February 21, 2011 comment letter filed by Congressman Gregory W. Meeks stated explicitly that the statute was "never to require prepaid cards to run on multiple payment networks." (see *http://www.federalreserve.gov/SECRS/2011/February/20110228/R-1404/R-1404_022211_67476_559260342101_1.pdf*)

[5] *See footnote 3.*

[6] In the United States, American Express does not license any third parties to act as merchant acquirers.

[7] *See* American Express's Letter to the Board (November 18, 2010).

[8] This ATM network is not owned by American Express, but established through a series of contractual arrangements with independent ATM networks and ATM owners worldwide.

from the technology infrastructure that it uses to authorize, clear, and settle transactions at a merchant point-of-sale. There is not a single American Express prepaid card that is enabled for single message PIN-debit transactions at the merchant point-of-sale.[9]

The American Express ATM service for Cardmembers is managed separately from our Card business. The business relationships that American Express has entered into with ATM acquirers and networks are specific only to ATM access. These ATM relationships, and the technology infrastructure that was built specifically to facilitate single-message transmission of PIN-enabled transactions at ATMs, do not provide American Express Cardmembers with any ability to conduct PIN transactions at a merchant point-of-sale device. This is a critical point. Providing ATM access through third party ATM networks does not impact the American Express closed-loop network, which is the model for the American Express Card business and which is a valuable asset to our Company. By contrast, in providing its ATM service for Cardmembers, American Express is a participant on numerous separate and independent ATM networks.

2. Reconfiguring the Entire American Express Network to Accept PIN-Enabled Prepaid Card Transactions At the Merchant Point-Of-Sale Would Be Costly and Burdensome, and Would Not Result in Widespread Adoption.

As the Board also noted, "the infrastructure for PIN debit networks differs from that for signature networks."[10] Unlike bank issuers and acquirers on the four-party networks, American Express has not developed connections with the regional and national PIN networks to create a technology infrastructure that would allow PIN-debit transactions to occur at both ATMs and the merchant point-of-sale. As a result, there is no existing infrastructure, other than the American Express signature-based closed-loop network, to route transactions effected with American Express prepaid cards at the merchant point-of-sale.

If American Express were forced to modify its network to enable PIN-based transactions at the merchant point-of-sale, substantial systemic changes would be required to re-configure our entire signature-based processing infrastructure to permit it to recognize and support single message transaction processing over PIN-debit networks – a move that is antithetical to the way in which our closed-loop network is configured. In addition, such a fundamental reconfiguration would have significant impacts at multiple levels of the payment processing system, as addressed briefly below.

[9] "Single message transmission format" means a format that allows the debit transaction to be completely settled from an authorization request. If the transaction is approved, funds are withdrawn from the debit cardholder's account at the time of the transaction and the funds for the transaction are guaranteed to the merchant. This is also referred to as "online debit" by the four-party networks. "Dual message transmission format" means a format in which the authorization message occurs at the time of the transaction using one message, and the settlement message is communicated separately at a later time. Debit transactions using dual message transmission format are processed like credit card transactions, in which the billing to the cardholder's account occurs several days after the transaction. The four-party networks refer to this as "offline debit" or "signature debit."
[10] 75 Fed. Reg. at 81,723.

Network Level - The system which is used by American Express to facilitate the single-message transmission process for authorizing ATM transactions is only built to support ATM transactions. Therefore, American Express would have to incur substantial costs to build additional technology infrastructure to support the upgrades associated with single-message transmissions and PIN approval requirements for point-of-sale transactions for our own signature-based network , as well as establish a connection to another PIN-based debit network for alternative routing.

Issuer Level - American Express would have to modify and replace the prepaid cards themselves so that they would be compatible with the technology that would route the transaction to a PIN-debit network.

Merchant and Acquirer Level –Every participating merchant in the American Express network would have to update its point of sale terminals simply to support the use of an American Express PIN encryption key. This process would be complicated and would require a substantial effort over several years. All PIN pads used for debit and check card networks must be encrypted. Encryption at the point-of-sale is a security protocol used throughout the industry, and there are multiple types of encryption programs used by processors so that each one is unique. These encryption programs cannot be downloaded remotely. They must be physically downloaded to each PIN pad by injecting the encryption keys in person.

If the alternative routing requirements were applied to American Express, and American Express was forced to incur the costs and operational burdens to implement routing for prepaid card transactions over another network, there will be no benefit to merchants. Since, as previously noted, the Federal Reserve has no statutory authority to compel American Express to appoint third party acquirers, American Express will remain the sole merchant acquirer who can set the discount rate for merchants to accept prepaid cards. American Express would have to find a way to recover the additional costs of implementing an alternative PIN-debit network, potentially through higher pricing to merchants or to cardholders.

The likeliest potential consequence of applying the alternative routing requirements to American Express would be, as the Board noted, less efficient, "more circuitous routing"[11] of transactions through a third party network back to American Express, and potentially higher prices to merchants and consumers. This unfortunate outcome would only undermine American Express' ability as a network to be an effective competitive constraint on the dominant four-party networks, and this cannot be an outcome that the Board would find desirable. This is also not a result which is mandated by the statutory language.

[11] 75 Fed. Reg at 81727-81728.

Conclusion

Transactions at merchants with American Express prepaid cards have always been routed over only one network — the American Express closed-loop signature-based payment network, because that is how the network operates. That is not the case for the four-party networks, on which multiple network routing for PIN-based debit transactions is a capability that already exists. Therefore, merchants who accept debit cards issued on the four party networks may benefit when competitive PIN-debit networks become free of contractual restraints imposed by the four-party networks to compete for merchant business. However, forcing American Express to reconfigure and reissue our prepaid cards to allow for PIN based authorization, reconfigure our own signature based network to authorize, clear and settle these transactions for merchants, reprogram merchant POS terminals to accept the PIN transactions, and establish a connection to another PIN-debit network for routing, will not benefit merchants or consumers because this will only provide a more cumbersome and therefore less efficient and more costly way to route the transactions to American Express as the acquirer.

Based on the language of the statute itself, and the intent of the statute, as confirmed explicitly by its author, the Board would be on solid ground to interpret Section 920(b)(1)(A) to apply only to networks or issuers that *affirmatively place restrictions* on routing by other networks that are capable of routing the debit card transactions and not to apply to a closed-loop three-party network, where the basic business model of the network is that transactions route *only* over a single network.