From: Entandem Inc., Jack Dale

Subject: Reg I I - Debit card Interchange

Comments:

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Name: Jack Dale
Affiliation: Entandem Inc.
Category of Affiliation: Commercial
Address:
City:
State:
Country:
Zip:
PostalCode:

Comments:

I am CEO of Entandem Inc., a payment systems consultancy, and I am writing to provide my comments on Regulation II - Debit Card Interchange Fees and Routing [R-1404] The bank card system was originally created to provide merchants with a cost saving alternative to providing their own in-house credit plans. In 1975, Visa introduced debit cards to provide a cost effective and convenient alternative to paper checks and cash. Merchants have benefitted from a lift in sales of goods and services when plastic cards, whether credit or debit, are used. Both consumers and merchants have benefitted from the investment the financial services industry has made to build the complex technology of the global payment systems infrastructure. The disingenuous arguments of the merchant community overlook the benefits that they have received for almost 40 years. I do not believe that the proposed Debit Interchange rules take into account the interests of any stakeholder in a debit card transaction other than the merchant community. It is apparent that consumers, financial institutions that issue cards and/or acquire transactions, third party issuer and acquirer processors, and the networks have been disregarded in the promulgation of these rules. Further it is apparent that the proposed rules overlook the immense complexity and investment necessary to make the changes needed to be in compliance with the proposed rules. If the rules are enacted, they will result in: stifling competition and innovation; reducing financial institutions' revenues by billions of dollars; reducing third party processor revenues as financial institutions seek to reduce costs of providing this service to consumers; and, increasing costs to consumers as financial institutions seek to recover lost Debit Interchange fees estimated to be $11 to $16 billion dollars. And, it is extremely doubtful that all merchants will benefit from the reduction of interchange fees or pass along those savings to consumers. Other specific concerns are detailed below. COSTS NOT TAKEN INTO ACCOUNT The Debit Interchange rules only take into account the cost of authorization, clearing, and settlement. Costs associated with: marketing; fraud losses and mitigation; cardholder customer service, including dispute

resolution and miscellaneous account inquiry; card production, procurement, personalization, and fulfillment; fees paid to third party processors to support the aforementioned issuer functions; and, network fees have not been taken into account in determining the true cost of PIN or signature debit cards. Acquirer costs have also been disregarded and their margins are significantly less than issuers. SIGNATURE VERSUS PIN DEBIT The proposed rules, including routing and exclusivity, equate PIN debit and signature debit despite the fact that these two products are significantly different when it comes to point of sale acceptance and geographic coverage. The routing alternatives overlook
the considerable cost to acquiring stakeholders to accommodate PIN at the point of sale. Currently, an estimated one-fifth of all US retailers have terminals that accept PIN debit transactions. More importantly, even the largest PIN networks e.g. Interlink, Maestro, and STAR have relatively limited national coverage. To qualify as a PIN debit solution in compliance with the proposed routing rules, there will be significant increased costs to networks and acquirers. More importantly, the proposed rules seem to be at odds. Under the proposed rules, there would be no difference between PIN debit and signature interchange. Therefore, it is unclear why the draconian proposed rules for routing are even necessary. Interchange fees are being lowered and regulated which should satisfy the needs of merchants, whether they are accepting PIN debit or not. Requiring the brand of an unaffiliated network on a card is simply anti-competitive and unnecessary. BUSINESS DEBIT CARDS Business
debit cards are often used in a "card not present transaction", e.g. internet. In addition, these products depend on enhanced interchange to improve very slim margins. Thus, further analysis should be done before subjecting them to the proposed Debit Interchange rules as well as the routing rules that require PIN, which will be difficult, complex, and expensive to accommodate in a "card not present transaction". APPLICABILITY TO PREPAID The exemption of general use reloadable prepaid products from the Debit Interchange rules is appropriate. However, the requirement that these products be subject to routing rules is not. The profit margins for prepaid cards are extremely thin while the functional support for these products is the same as true debit cards e.g. Visa check card. Costs associated with supporting point of sale PIN on a signature based product will reduce the already thin margin of Prepaid. Thus, many underbanked and underserved consumers that this product as developed to serve, may be negatively impacted as many of the issuers of general use reloadable prepaid products may elect to exit the business due to its lack of profitability. Clarification is needed as to the applicability of the PIN routing requirement on prepaid gift cards. If this requirement is applied to gift cards, which is carried by an anonymous cardholder, then the product becomes a vehicle for money laundering. Currently, network rules do not require ATM access and do not permit cash back at the point of sale to mitigate the opportunity for money laundering. FRAUD PREVENTION Today, issuers use various "neural network" solutions in an effort to mitigate fraud and the industry has moved to a environment where virtually all transactions are authorized. Any attempt by the Federal Reserve Board to move the payments industry to a particular technology, e.g. chip and PIN, should be carefully analyzed with the participation of all stakeholders. Chip and PIN are not a proven fraud
prevention technology and their implementation will be significant in terms of investment and resources from all stakeholders in the payment systems infrastructure. This would be difficult to justify financially based on the proposed changes to Debit Interchange fees and without some participation in the investment by the merchant community.