TransAction
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Federal Reserve System

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Debit Interchange Fees & Routing

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1. Introduction

1.1 Background

These are comments on the Federal Reserve System's (the Federal Reserve) proposal for implementation of the statute known as the "Durbin Amendment" which is Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted 21 July 2010. It takes the form of an amendment (new section 920) to the Electronic Funds Transfer Act and should be read within the context of that piece of legislation.

TransAction Resources is a specialist payments and loyalty consultancy founded in 1994 and based in Australia. We have been involved in payments reform and regulation in Australia, New Zealand, Europe and the USA. Our client base is primarily merchants and government internationally.

1.2 References

1. Federal Reserve System, Regulation II; Docket No. R-1404, *Debit Card Interchange Fees and Routing*, 16 December 2010

2. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, enacted 21 July 2010, pp 693 – 699

3. Electronic Funds Transfer Act, 1978

4. *SEPA Cards Framework*, version 2.1, European Payments Council, 16 December 2009

5. *SEPA Seventh progress report, Beyond Theory Into Practice*, October 2010, European Central Bank

6. *Competition Issues in Retail Banking and Payments Systems Markets in the EU*, Public Version, European Competition Authority, Financial Services Subgroup, May 2006

1.3 Terminology

Card Scheme - a card association or an entity that manages the rules, procedures and the brand of a card payment system (e.g. American Express, Discover, MasterCard, Star and Visa)

Scheme Debit – either a MasterCard Debit or Visa Debit card in Australia; equivalent to signature debit in the USA but may be either signature or PIN authorised

EFTPOS – the domestic PIN debit scheme in Australia; equivalent to PIN debit in the USA

2. Comments

2.1 Debit Interchange Fees

2.1.1 Statistical Consistency

For some reason it has been decided to quote the median per-transaction variable cost of 7.1 cents and to link this back to the chosen “safe harbor” value of 7 cents in Alternative 1.

> "The median per-transaction variable processing cost was 7.1 cents for all types of debit and prepaid card transactions." [1] p 15

However, average values and weighted average values are used throughout the rest of the paper and would seem to be a more appropriate choice than a median which can vary significantly depending upon the sample chosen. An average weighted by the number of transactions is more reliable and produces a result (in this case) well below the median.

> "Average per-transaction variable costs were approximately 4 cents per transaction when each issuer’s costs are weighted by the number of its transactions." [1] p 63

It is recommended that the median value should be largely disregarded and that weighted averages should be used consistently where possible.

2.1.2 Alternatives 1 & 2

> “The amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” [2] p 693

If the weighted average issuer variable cost is around 4 cents per transaction, then 7 cents is “reasonable” and “proportional to the cost” but 12 cents is not. It is not reasonable for interchange fees to be at a level of 300% of the weighted average cost and it is not reasonable to reward high cost issuers for being inefficient.

The 12 cent universal cap for debit interchange fees (Alternative 2) is too high and allows some issuers to recover 3 times their cost (a 200% margin). If issuers can achieve a 4 cent cost on average (thus many transactions have a cost below this figure), then all issuers should have an incentive to move their per-transaction cost toward or below the “safe harbor” level to improve payments system efficiency and to ensure continued high costs are not encouraged.

The draft regulation has a very large variance between the 7 cent “safe harbor” in Alternative 1 and the 12 cent “safe harbor” in Alternative 2. Issuers are not required to justify any of their costs in either of these cases but there is a 70% variation between these two proposed debit interchange fee levels. This is a very large variation with no apparent explanation as to why such a variation is required or how it may be justified.

If Alternative 2 is to be adopted to remove the requirement for reporting of costs and the potential for many different interchange rates by issuer, then the proposed 12 cent cap should be reduced to the level of 7 cents so the “safe harbor” amount is consistent between Alternative 1 and Alternative 2.

The cost of authorisation and clearing in the Canadian Interac network is around 0.7 cents per transaction. While it excludes the cost of settlement, this benchmark is worth considering. The Interac debit system operates on a cost-recovery transaction fee basis, without interchange.

The Australian average debit interchange fee is below zero (i.e. negative interchange) because the EFTPOS PIN debit system has negative interchange between 4 and 5 cents per transaction. Australian scheme (signature) debit cards are limited by a 12 cent weighted average cap on interchange, however the largest merchants are paying 4.4 cents interchange for scheme debit transactions and the market average for scheme debit is below 8 cents per transaction for card present transactions. The scheme debit cards in Australia have a much smaller market share than the EFTPOS PIN debit cards despite the interchange fee incentive for issuers being strongly in favour of the scheme debit system since the 1980's when both debit systems were introduced.

The German PIN debit system "Girocard" operates with a zero interchange fee, as does the Netherlands "Pinnen" system.

Debit interchange fee Alternative 1 seems to be much fairer and more "reasonable" as it allows issuers with costs above 7 cents to justify those costs in order to recover them up to a maximum of 12 cents per transaction (but with a zero margin). If those higher cost issuers wish to earn a margin on each transaction then they have an incentive to drive their cost below 7 cents which is clearly achievable and an economically desirable outcome for all.

Debit interchange fee Alternative 1 seems to be much closer to the wording and intent of the statute than Alternative 2 and therefore should be the preferred alternative for the final regulation. The "safe harbor" of 7 cents could be reduced to 6 cents and still offer the efficient issuers a margin of 50% or more above the weighted average which seems quite generous and "reasonable". In our view, Alternative 2 in its current form does not appear to meet the requirement that *"the interchange fee be reasonable and proportional to the cost"*.

2.1.3 Bilateral Agreements

What is to be the situation if an issuer and an acquirer directly negotiate a bilateral interchange rate between themselves? What happens if a merchant wishes to send debit payment transactions directly to the issuer on terms negotiated and agreed between them?

The Federal Reserve proposal seems to reflect a view that all debit interchange fees will be set by the card schemes and that all transactions to issuers should be routed across networks owned by the card schemes and these are the only networks issuers can choose from when delivering the routing options required by the Durbin Amendment. This is a very narrow interpretation of the Durbin Amendment. Is it intended that bilateral interchange fees should not be covered by the regulations? The statute does not appear to exclude them.

It is recommended that future bilateral interchange agreements be considered within the scope of these regulations and that the negotiation of such agreements should be allowed to bring more price competition to the debit card market.

It is also recommended that the definition of interchange fees be re-worded to ensure that not only bilateral interchange fees are covered by the definition, but that ATM interchange fees are also included (the current definition specifies that interchange fees must compensate the issuer, but for ATMs these fees are paid by the issuer to the ATM owner).

2.1.4 Allowed Costs

The statute [2] is very specific in limiting allowed debit issuer's costs to those of authorization, clearing and settlement. The Federal Reserve's interpretation of the statute in this regard is completely correct. No other issuer costs should be included in the calculation of the weighted average variable cost per debit transaction.

> "In prescribing regulations ... the Board shall ... distinguish between
> (i) the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered ...; and
> (ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered ..." [2] pp 693-694

It should be noted that the three allowed categories of cost are all those which do not vary according to the value of the transaction. They may all be expressed in terms of cents per transaction. Many regulators in other countries have concluded that ad valorem interchange fee rates should not be permitted for debit transactions. It is good to see the Federal Reserve expressing both its safe harbor and cap values in cents per transaction.

2.2 Fraud Prevention Adjustment

2.2.1 Adjustment Not Required

The Federal Reserve is not required to make any allowance or adjustment for the cost of fraud prevention unless it judges this to be "reasonably necessary".

> "The Board may allow for an adjustment to the fee amount ... if such adjustment is reasonably necessary ..." [2] p 694

The current proposed "safe harbor" amount is already 75% above the weighted average variable (allowed) cost and so could reasonably be said to already include some allowance for the recovery of any fraud prevention costs incurred by the issuer.

2.2.2 Merchant Contribution

Merchants have made considerable investments in payments infrastructure specifically intended to reduce fraud levels in the card payments market. Examples of such investments include:

- Address Verification System (AVS);
- communications links for online transaction processing;
- PIN Encryption Devices (PIN authorisation reduces the incidence of fraud);
- Triple DES encryption algorithm; and
- compliance with the Payment Card Industry Data Security Standard (PCI DSS).

In the future, if the US card issuers decide to invest in EMV chip technology to reduce fraud levels at the point of sale, merchants will be subject to Liability Shift rules and will also be required to upgrade indoor and outdoor card terminals with EMV compliant chip readers. Experience in other countries suggests this cost for US merchants will be significant.

While issuers make investments in fraud prevention, merchants also make considerable investments at each of their retail locations. We do not believe that US merchants should be required to make further contributions via a fraud prevention adjustment to debit interchange fees.

2.2.3 Recommendation

It is recommended that no fraud prevention adjustment should be made at the present time and that the Federal Reserve should monitor ongoing fraud prevention costs over time (incurred not only by issuers, but also by acquirers and merchants) in order to determine whether an adjustment should become “reasonably necessary” in the future.

2.3 Debit Card Routing

2.3.1 Alternatives A & B

> **Alternative A**: An issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks. [1] p 138

The main issue with the debit card transaction routing alternatives is the fact that 75% of US merchant locations do not have a PIN Encryption Device (PED) at the point of sale. Nor can Internet transactions be processed via the PIN debit networks. Because of this, and the need to give merchants a choice of debit processing networks, we believe Alternative A is not acceptable in its current form. To give merchants the option to select between one signature debit network and one PIN debit network effectively gives the majority of US merchants no choice at all because they are unable to initiate PIN debit transactions. This would leave 75% of US merchants in the same position they are in today and this clearly is not the intent of the statute. The statute has the intent of increasing the amount of competition in the US debit payments market and the routing provisions apply to all debit issuers with no exemptions.

> **Alternative B:** An issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks for each method of authorization that may be used by the cardholder. [1] p 138

Alternative B has been drafted specifically to deal with this problem in order to ensure that merchants which can only initiate signature debit transactions (including Internet merchants) will be able to make a choice between at least two unaffiliated networks.

In its commentary the Federal Reserve has identified some potential implementation issues with Alternative B. Its primary concern seems to be the technical work and potential time delay that may come from requiring the two existing signature debit networks to become inter-operable with each other and requiring all signature debit issuers to establish connections to a second signature debit network if they do not already have such connections in place. This submission attempts to explain that other options exist which would allow Alternative B to be implemented by any debit issuer with less cost, less effort and less time delay.

Regardless of the implementation issues, however, **Alternative B is the only alternative, of the two offered by the Federal Reserve, which will deliver the increased market competition and the merchant choice that is required by the statute.**

2.3.2 Implementation Dates

Rules preventing or restricting the use of alternative networks or routing options should be prohibited from 21 July 2011. This is important to ensure that the "no bypass" rule and any rules with similar effect (e.g. charging an assessment fee for a network that has not been used to process the transaction) are abolished as soon as possible. This will increase the range of transaction routing options available in the market and will stimulate competition.

The implementation date for requiring issuers to comply with either Alternative A or Alternative B can be a separate later date established as the Federal Reserve deems appropriate.

2.3.3 Payment Card Network Definition

This is a critical issue, in our opinion. The Federal Reserve has taken a narrower view of the term "Payment Card Network" than the Durbin Amendment and this has implications for future network choice and competition in the US payments market.

The statute definition is as follows:

> "The term 'payment card network' means an entity that directly, or through licensed members, processors, or agents, provides the proprietary services, infrastructure, and software that route information and data to conduct debit card or credit card transaction authorization, clearance, and settlement, and that a person uses in order to accept as a form of payment a brand of debit card, credit card or other device that may be used to carry out debit or credit transactions." [2] p 699

This definition from the statute is broad enough to include entities such as ADS, First Data, Paymentech, TSYS and other payment networks beyond those of the card schemes such as American Express, Discover, Pulse, Visa, Interlink, MasterCard, Maestro and NYCE.

The Federal Reserve definition of "Payment Card Network" is at proposed 235.2(m) [1] p 152. Significantly, this definition is very different from that contained in the statute (above).

In its commentary the Federal Reserve explains its belief that it is not necessary to state that a payment network is an entity "that a person uses in order to accept as a form of payment a brand of debit card ... that may be used to carry out debit ... transactions." However, large numbers of US merchants use a processor network in order to have the capability to accept payment cards from their customers. These merchants are not directly connected to any of the card scheme networks and use their processor network as a gateway (or switch) to all of them. **The words "in order to accept" in the statute definition are at least as important as the words "as a form of payment"**. [1] p 43

> "Instead, the Board believes that the better interpretation is that in general, the term 'payment card network' only applies to an entity that establishes the rules, standards, or guidelines that govern the rights and responsibilities of issuers and acquirers involved in processing debit card transactions through the payment system." [1] p 43

It is clear that this interpretation by the Federal Reserve is far from the definition given in the statute and has the effect of eliminating many US payment card networks from the scope of the regulations. This decision will limit the network choices of both issuers and, more particularly, merchants, and potentially restrict the number of competitors for the card schemes in the US payments market. We believe this is an undesirable outcome for merchants, consumers and the US economy.

A processor payment network has the capability to deliver debit card transactions from a merchant to an acquirer without using a card scheme network and also has the capability to deliver debit card transactions from a merchant directly to an issuer without using a card scheme network provided it has the required issuer card prefix data. In fact, First Data was doing exactly this for many transactions until Visa introduced the "no bypass" rule specifically to prevent this from happening. These processor networks have national geographic reach, economies of scale and are already connected to large numbers of US merchant locations.

When it comes to implementing the routing provisions of the statute, these processor networks have a very important role to play. They already offer the required connectivity, robustness and security needed. Even a very small debit card issuer can quickly establish a single link to a processor network and have immediate connectivity to most of the US card scheme networks without taking any further action. This is a practical and low cost alternative to re-engineering the card scheme networks to become interoperable with each other. All that is required is to enforce changes to the card scheme rules that currently prevent such network routing from taking place (e.g. the Visa "no bypass" rule).

It is also necessary to ensure that no network may be permitted to charge a network processing fee or an assessment fee for a transaction if that network is not used in the processing of that transaction.

It is recommended that the Federal Reserve reconsider its definition of "payment card network" and amend it to become much closer to the definition contained within the statute.

We feel that the observations made by Governor Warsh, in his summing up at the (webcast) Board Meeting on 16 December 2010, is relevant in this case:

> "We should be bound ... by a couple of principles. One is we're looking for a dynamic **competitive** marketplace for payments broadly ..."
>
> "Finally, the other principle is: **it's not our job to substitute our judgement for the judgement of Congress**."

2.3.4 'Issuer to Processor' Routing Alternative

Most US merchants are linked to a processor's card payment network "in order to accept" payment cards from their customers. The processors typically offer terminal rental, switching, clearing and settlement services to their merchant customers. These processors (e.g. ADS, First Data, Paymentech, TSYS etc.) are, in turn, linked to most of the US card schemes. When the processor receives a card payment message from a merchant card terminal it then decides which card scheme to send the transaction message on to. This decision is based upon the card prefix and the routing preferences of the merchant where a choice is available. The processor then re-formats the message (translates it) into the message format required by the card scheme it is to be sent to.

The processors have the message formats, and the associated security, for each of the card schemes they are connected to. These are the same message formats used by the issuers of these card schemes. Each US debit card issuer must have the message formats and security for each of the card schemes whose cards they issue. In most cases this is more than one and it will be several for the larger issuers.

The diagram below illustrates the typical links in place today between a merchant, its processor and various different card schemes. Each card scheme is, in turn, linked to each of its issuers.

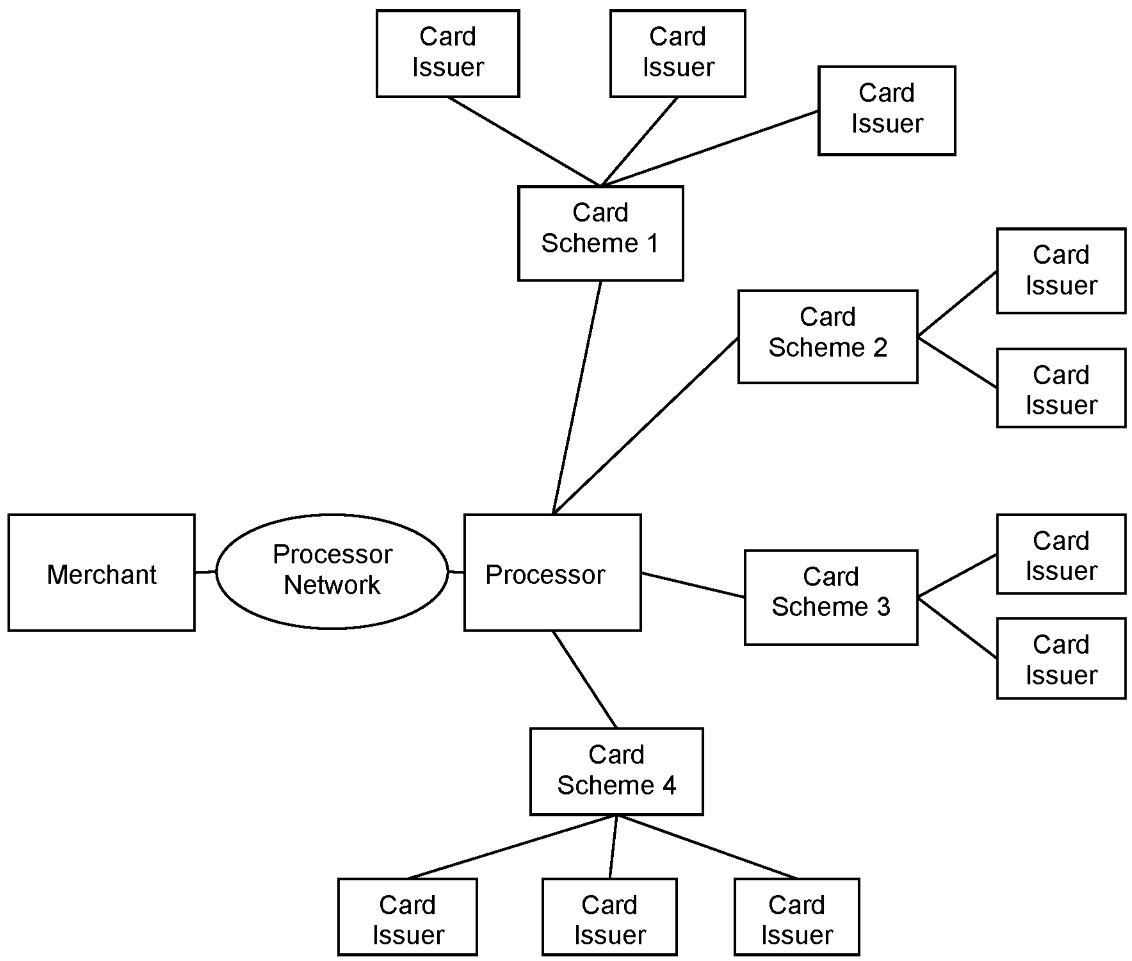

Diagram 1: Typical links between merchant, schemes & issuers via a processor

Note that the processors already have the scheme message protocol formats for both signature debit and PIN debit transactions. The issuers use these same message formats to exchange transaction messages with the card scheme. Therefore the work to be done for a debit issuer to build a direct link to the processor using the same card scheme message formats is minimal. Even for the smallest debit card issuer, this is not a large or time consuming task.

The processor needs to receive the issuer's card prefixes in order to build the routing table for that issuer. If the processor receives a transaction from the merchant for which it does not have a direct issuer link, then that transaction could be sent to one of the card schemes exactly as it is today.

From a technical perspective, this provides a simple, low cost alternative to re-engineering the current card scheme signature debit networks to become inter-operable. This alternative should allow an implementation date earlier than 1 January 2013.

The card scheme is still able to "see" these transactions if it wishes to do so by receiving them from the issuer.

The diagram below illustrates the potential new "issuer to processor" links using card scheme protocols that both the issuer and the processor already have in operation.

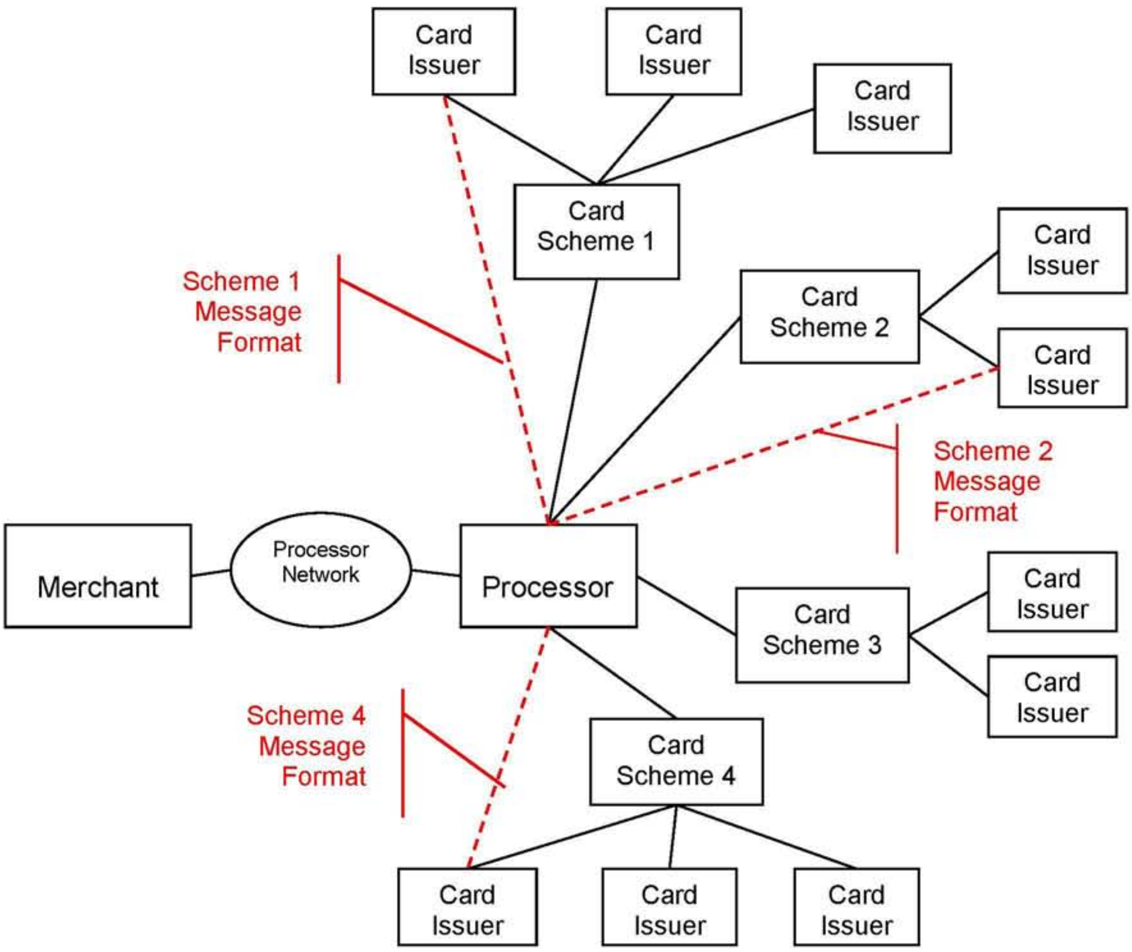

Diagram 2: Alternative routing between merchant and issuers via a processor

This approach offers the US payments market a viable alternative to the established signature debit networks and enables more competition between networks in the future. In order to implement this alternative, it will be necessary to abolish the "no bypass" rule and to prevent any network charging a fee if its network is not used to process the transaction.

Both issuers and merchants would still be free to use the established card scheme networks if they prefer to do so. The "issuer to processor" option simply would offer more choice to both sides of the market.

This 'issuer to processor' alternative is one example of other ways in which debit transaction routing might be achieved. There may well be other alternatives in the market which are not considered in this submission.

It is important to amend the definition of "payment card network" to be closer to the statute definition in order to include the existing US processor networks within the definition for implementation of the routing provisions.

2.3.5 International Trends

The current trend in the international regulation of card payment markets is towards "unbundling" and removing "tying" of payment services in the market. It is important to abolish rules designed to protect vertically integrated markets where the use of a particular entity for all routing, switching, authorization, clearing and settlement is mandated according to the brand that appears on the front of the card. European regulators have begun to take action to remove these market restrictions and to encourage more competition.

The European Central Bank has been overseeing the implementation of the Single Euro Payments Area (SEPA) in Europe. The "SEPA For Cards" has expression in the SEPA Cards Framework [4] which spells out the requirement for the separation or "unbundling" of card scheme governance and brand management activities from processing, switching, authorization, clearing and settlement. No card scheme may mandate that its network or clearing services must be used for transactions where the card carries its brand. Instead, the card scheme participants must be permitted to use whichever entity they prefer to perform those services.

> "The principle of the separation of scheme management functions from processing, which is one of the key requirements of the SEPA Cards Framework (SCF), is an important element in the creation of a competitive cards market in SEPA. Card scheme participants should be free to choose their processors and clearing and settlement service providers." [5] p 24
>
> "A SCF compliant card scheme is a scheme that allows unbundling of functions whilst applying the same pricing per card product to national Euro and SEPA transactions of the same type. Separation of SEPA card schemes' brand governance and management from the operations that have to be performed by service providers and infrastructures under these SEPA schemes is mandatory. A card scheme may offer additional services (e.g. processing services) but their usage cannot be mandated.
>
> "Scheme rules may not require as a condition of participation that any particular provider of processing services (e.g. network management, authorisation, switching, clearing, settlement) be used.
>
> ".... no card scheme will discriminate when pricing services or charging any fee between banks and payment institutions who use additional services offered by the said card scheme, and banks and payment institutions who do not, or only partially so." [4] p 15

In 2006 a Financial Services Working Group representing the European National Competition Authorities delivered a report [6] on Retail Banking and Payment Systems and various relevant competition issues perceived to be significant in those markets. It was concluded that competition issues receive minimal consideration by payments system supervisory bodies such as central banks and that stability and security issues gain more attention than potential anti-competitive practices or structures. The Working Group agreed that there were three main areas of competition concern in relation to European payment systems. These were scheme governance, dominant market positions and the bundling of roles.

The quotes below reflect some of the thinking in relation to vertical integration and bundling of payment services:

> "National Competition Authorities are of the opinion that, in some Member States, access to payment markets may be restricted by unnecessarily high barriers, which may be reinforced through prohibitive access conditions and the bundling of payment services." [6] p7

> "... the Working Group recommends National Competition Authorities to consider the promotion of ..... unbundling in the supply of payment services (e.g. branding and processing) where other, less potentially anti-competitive, solutions are available ... " [6] p7

> "Formal separation of roles (e.g. branding from processing, system provision from value-added services) in the payment system is another way of increasing competitive pressure on incumbent participants. From an economic point of view, only in some existing payment systems – if any (e.g. possibly in smaller countries) – is a one-supplier situation possibly justified. However, additional services to that respective system do not necessarily need to be provided by the incumbent provider, but can alternatively be supplied by independent firms (e.g. network service providers, independent processors, acquiring processors)." [6] p 35

Unfortunately, the definition of "Payment Card Network" proposed to be adopted by the Federal Reserve is likely to have the effect of reinforcing the "bundling" of payment card services by the card schemes in the USA. The long established processor networks have performed a valuable role in the evolution of the US market and should be encouraged to expand their role in the future. They provide the potential for genuine competition to the card scheme networks and are already established with direct links to a very large proportion of US merchants today.

If the definition of a Payment Card Network proposed by the Federal Reserve is adopted, this will move the USA in the opposite direction to Europe (and many other countries). While Europe and other countries are moving towards increased competition by unbundling a card scheme's brand and governance activities from the processing and settlement, the Federal Reserve's proposed definition of a Payment Card Network actually mandates that the card schemes' networks must be used, thereby reducing competition and limiting merchants' and processors' options and choices for transaction routing.