From: Paul Close, President of Retail Automation Research

To: reqs.comments@federalreserve.gov

Subject: Regulation II – Debit Card Interchange Fees and Routing – a simple quick solution

From: Paul Close

February 21, 2011

To: Jennifer J Johnson
Secretary, Board of governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551

Comments on the ***Federal Reserve Board's proposed changes to interchange rules***, are Respectfully submitted to the Board of Governors of the Federal Reserve System.

I have been a consultant to a broad range of retailers and payment system providers (including Visa, American Express and CitiCorp) since the early days of Point-of-Sale. My work required a close monitoring of payment systems from the get-go. The following comments will attempt to briefly present several important issues that do not appear to be covered by the Durbin Amendment itself and/or the Board's proposed rules.

It is already clear that there will be legal hurdles for implementation of the proposed rules, and a complex, expensive implementation. The following comments may provide unique suggestions for review of the Amendment and Proposed Rules, and a simple solution that would quickly achieve much of the goals without non-productive dissent and regulation.

First, it is recommended that action on the amendment should be delayed as being discussed in Congress.

It is further suggested that Senator Durbin and his staff should re-visit the amendment with appropriate hearings to consider the issues more thoroughly. It is suggested that the delay be used to determine the actual total cost of card acceptance to Retailers of all classes and sizes, because issuer Interchange may only be a part of their total cost.

The simple proposal presented later, would deliver immediate impact with literally no need for dissent and regulation, It would give the Congress and the Fed room to improve the system without unnecessary and unproductive regulation. It is also uncertain how much of the savings would filter down to merchants, much less to consumers, but read on.

A number of very good rule changes that would involve little cost and controversy have been proposed:

- Network compensation to issuers
- Transaction Routing choice by the retailer.
- Restrictions on offering discounts for use of a form of payment at the POS.
- Restrictions on setting transaction minimums or maximums at the POS.
- Discrimination between debit and credit cards on the basis of the issuer.

It is suggested that some underlying assumptions be re-considered.

For example the first statement in the amendment under section 920 (a),
REASONABLE INTERCHANGE TRANSACTION FEES FOR ELECTRONIC DEBIT TRANSACTIONS and sub-paragraphs (4) (A)

"(A) consider the functional similarity between-

"(i) electronic debit transactions; and
"(ii) checking transactions that are required within the Federal Reserve bank system to clear at par;

The foregoing is just one of the assumptions that may be flawed as described below. There are others.

It is believed that both checks and Debit card transactions technically clear at PAR, they have to or no one could reconcile them. This statement infers that the Debit card is a new cost that did not exist when checks were predominant. That may be true, but it appears to overlook the fact that in the days when checks were more prevalent at the Point-of-Sale, the retailer paid an even bigger cost of authorizing, balancing and delivering them to the bank (which probably charged for accepting the deposit), and who in turn paid the Federal Reserve an ACH fee. Retailer's also bore the cost of collecting returned fraudulent checks (and the retailer sustains the loss unless covered by the insurance they have purchased),

It might be more correct to say that Debit transactions transferred all those functions at a lower cost to a more efficient system using Debit cards, a system paid for by the Issuers of the cards who deserve to receive an Interchange fee at the end of the month. The argument is how much should the interchange fee be, since it has grown rapidly over the past five or six years, coincidentally since the settlement of the Wal-Mart suit.

It is also suggested that the question of Signature vs PIN should be examined more carefully. The staff's recommendation did not adequately address the factors suggested by the Amendment (shown below) although they did develop a comprehensive statistical analysis that showed a difference in Interchange between Signature and PIN verification of about 1% of sales. This might indicate that, if PIN were implemented at all Points-of-Sale, the 1% savings would quickly pay the cost of equipment upgrading for many retailers and the savings would continue after that. The staff's recommendations did not appear to address the savings from PIN as directed by the amendment.

'(B) RULEMAKING REQUIRED.-
'(i) IN GENERAL.—The Board shall prescribe regulations in final form not later than 9 months after the date of enactment of the Consumer Financial Protection Act of 2010, to establish standards for making adjustments under this paragraph.
"(ii) FACTORS FOR CONSIDERATION—In issuing the standards and prescribing regulations under this paragraph, the Board shall consider—

"(I) the nature, type, and occurrence of fraud in electronic debit transactions;
"(II) <u>the extent to which the occurrence of fraud depends on whether authorization in an electronic debit transaction is based on signature, PIN, or other means</u>;
'(III) the available and economical means by which fraud on electronic debit transactions may be reduced; (which seems a little far afield from the basic intent).

Mandating PIN for all Debit transactions within some reasonable period of time would be simple, and effective.

Basically, standardization on PIN would eliminate the dual mode debit card over time. It is believed to be unique to the United States. This could reduce cost of Debit to retailer's who cannot take PIN now by about 1% of the Debit sales and eliminate the fraud losses and confusion of signature Debit which were not anticipated. The expense savings would probably be even more because the rewards cost of signature Debit would be eliminated too (see exhibit 1). While such a change would cause a reduction of Debit revenue to the issuer, the net effect on Issuer's revenue might be less than if the Fed were to impose an Interchange cap with all the expense that would entail, and might not include allowance for Fraud. While there is some discussion as to whether the 1% savings would be passed through to merchants, it would be relatively easy for Merchants to measure and acquirers to explain (see exhibit 2). The push for Mobile/NFC might bring pressure to (at retailer's option) forego PIN on low-value transactions <$25, but non-signature of smaller transactions at present signature rates is actually less expensive to the retailer than PIN – as well as faster, so the risk might be acceptable.

This could measurably reduce retailer's cost of card acceptance and make pricing more competitive without putting the Fed in the undesirable, if not improper, role of setting prices. Other Fed proposals open the door to more competitive pricing. PIN capable equipment needed by most smaller retailers would be cost justified. Most non-PIN equipment in place has a median life in the range of about 3–4 years and if the mandate allowed that for conversion, cost would be minimized. Regulation would be simple and unarguable. According to the Fed, a significant minority of retailers already accept PIN but the majority of debit transactions in stores are already made with PIN – with the Signature Debit cost burden borne by smaller retailers.

The Dual mode Debit card was a simple and ingenious way to expand the use of cards - then.

It all started with the first acceptance of Debit (ATM) cards at the retail POS starting with Dahl's Supermarkets in Iowa, who in 1984 implemented the first POS with PIN pads attached to accept ATM cards in payment at the Point-of-Sale.
Over the next 10 years the growth of ATM card availability continued, as did POS technology. Finally, by the mid-90's a significant number of Supermarkets had upgraded their Point-of-Sale systems with PIN Pads and magnetic stripe card readers

and were beginning to reduce check volume and it's expense at the Point-of-Sale. Checks were at that time the predominant type of payment in Supermarkets. Consumers often used checks over the amount of sale to get cash, which was much more convenient than going to the bank or finding a still rare (at that time) ATM.

The Supermarkets, as did all retailers who accepted checks, bore the cost of check acceptance, authorization, balancing in the back office, settlement by delivery to the bank, delayed access to funds while the bank transferred the checks to a processing center which in turn forwarded the not-on-us checks to the Federal Reserve (or to a correspondent bank) for clearing to the bank holding the account – all before the check was known to be good. Consumers of course enjoyed the "float" since they could write the check before they had the money – but retailers waited for their funds. The significant share of checks which "bounced" had to physically follow the same torturous route back to the retailer who then had to absorb that cost plus the cost of collection (for which they might or might not charge a modest fee) or they absorbed the loss unless it was covered by insurance which they paid for.

The so-called "Check Card" created by Visa in the mid-90's which, along with the MasterCard "Money Card" was the catalyst that brought about the rapid growth in use of Debit cards by consumers. The result today is that Debit Cards are the predominant and preferred method of non-cash payment at almost all retail points of sale.

The underlying objective of the Check Card was to entice Supermarkets to accept general purpose cards issued by banks, other then ATM cards, in payment for goods and services. The Supermarkets, and the banks (issuers) were both interested in eliminating checks at the Point-of-Sale because of the expensive processes necessary.

The Check Card changed all that, reducing chargebacks because of the on-line authorization and settlement. The much lower cost of authorization was paid by the retailer in the form of Interchange, and they got rid of a huge expense and headache plus next day availability of funds without chargebacks when PIN was used at Point-of-Sale. Since the new check card also allowed cash back at Point-of-Sale the consumer was happy except that they did lose float when using PIN.

The dual mode check card began double digit annual growth because it could be accepted at any POS that accepted credit cards – but with signature when they couldn't take PIN. Consumers like it because they can better control their spending. They still got some float by electing to use signature at the Point-of-Sale but modern systems have virtually eliminated float. However, the use of Signature opened the door to fraud, by simply copying a card number and using it with signature. A consumer's checking account could be quickly emptied without their knowledge – and getting the money back from the bank often slow.

The Check/Money card was successful, and Checks (and their costs) have now virtually disappeared in many Supermarkets and other retailers. But the check card has been confusing, fostered fraud and became an unwarranted income to the check card issuers, but they are few and far between – since about 10 of the largest banks issue about 90% of Debit Cards.

Issuers are believed to have started with a flat (Interchange) fee for authorization and acceptance of PIN Debit (all of course electronic, and just as the Iowa Transfer System did at Dahl's). The proposed costs by the Fed are in the same range and in the same range as Canadian Debit which has existed, without signature, for much longer than in the US.

Today, issuers along with the card associations prefer "off-line" Debit verified by signature because the transactions are routed via their networks and they received the larger interchange. No matter that the retailer has to wait for funds and pay the cost of authorization, signature storage and disputes when the cost of the dispute might be more than the sale. Merchants prefer Debit with PIN, except on very small transactions, settlement is automatic on authorization. Funds are usually available next day.

With signature, settlement is delayed at an extra cost, as are the funds and of course there is a higher Interchange fee marked up along the way by the rest of the delivery chain – plus the reward cost added by the issuers to encourage consumers to use less secure Signature instead of PIN. With Signature the retailer may have to absorb any chargebacks, which are more likely when signature is used rather than PIN, whereas with PIN the issuer stands the loss. The issuer, also generates a loan and a handsome overdraft fee and a nice Interchange based on a percentage of the transaction value.

The Amendment seems clear on the considering the lower cost of fraud when PIN is used. And the Proposed regulation correctly concludes that there is little difference between the transaction cost of PIN and Signature – but appears to be ignoring the added cost to the merchant of fraud, storage of receipts, speed of checkout, loss of float and so on. (see exhibit 3).

Please see
Exhibit 1, a recent article by Steven Pearlstein of the Washington Post.
Exhibit 2, a recent Editorial by John Stewart Editor-in-Chief of Digital Transactions.
Exhibit 3 Statement by Richard Oliver, from the U.S. Federal Reserve Bank of Atlanta.

Exhibit 1 **Credit card companies figure out how to spin straw into gold**
By Steven Pearlstein - Washington Post Staff Writer (with permission)
Saturday, February 5, 2011

Credit card companies are amazing. Not only do they now offer cards with no annual fees and low teaser rates, they even give you a rebate for 1 percent of everything you buy. Get an American Express card through Fidelity and you can get 2 percent of your purchases rebated to your investment account. Discover offers 5 percent on selected categories of purchases - groceries, gasoline, travel, clothing - depending on the month and the season. Can 7 percent be far behind?

Of course, you may be wondering, as I did, where the credit card companies come up with all the money for these rewards and rebates, which are now a feature on half of all credit cards in active use. At first blush, the money appears to be coming from retail merchants, who are paying ever-escalating fees for the privilege of swiping your credit card through their registers. But according to a wide range of government and private economists, ultimately it's you, the consumer, who is paying for those rebates, as merchants raise their prices to cover those additional costs. When all is said and done, all that's really happening is that the credit card companies are taking money out of your left pocket, setting aside a hefty fee for themselves and putting what's left back in your right pocket.

Only it's worse than that. Because while everyone pays the higher retail prices necessary to cover the "swipe fees," only those with rich rewards cards actually get the kickback. In effect, they are subsidized by those who pay those higher retail prices with cash, debit cards or standard-issue credit cards.

To understand how we got to this point, you need to understand the unique economics of the credit card business.

Credit cards are a "network" business, one in which everyone benefits when there are more customers using the same network. Cardholders prefer cards that are accepted by more merchants, and merchants prefer to take the cards that have the largest number of cardholders. So once one card company begins to get a lead, it's difficult for the others to catch up or enter the fray. The result is that, in most network industries, all the business winds up in the hands of very few companies, at least until some new disruptive technology comes along. Certainly that's the case with credit cards. Visa, Mastercard and American Express now account for more than 90 percent of the market. And with that much concentration comes the power to charge higher prices than would be possible in a market with many competitors.

The other unusual characteristic of credit cards is that it is what economists call a "two-sided market," where firms compete both for merchants and cardholders. In the industry's early years, more of the revenue came from cardholders as companies competed to get more retailers into their networks. Keeping merchant fees low was an essential part of that strategy, and card companies made up for that by charging card holders annual fees and high interest rates on unpaid balances.

Over time, however, the competitive dynamic changed. Once consumers began using credit cards to make a majority of their big purchases, merchants realized that they simply couldn't stay in business if they didn't accept all the major credit cards. At that point, the credit card companies had the upper hand, allowing them to push through fee increases with relatively little drop-off in merchant participation.

Card companies now face a competitive landscape where the price sensitivity of their merchant customers is so low, and the price sensitivity of their cardholders is so high, that the winning strategy is to push merchant fees ever higher and use the money to offer ever more lavish rewards and cash rebates to win new cardholders and get them to use their cards to make more of their purchases.

What makes this strategy so effective is that the costs are largely hidden. Although the merchant fees eventually translate into higher retail prices, consumers can't really see that. What they can see, on the other hand, is that those wonderful card companies are giving them a 5 percent kickback every time they go to the supermarket.

The credit card companies, you won't be surprised to learn, dismiss this analysis, claiming that rewards programs are a win for consumers, a win for merchants and a win for their shareholders. How can that be? Because, the argument goes, credit cards have brought so much efficiency to retail operations that they have actually lowered retail prices, not raised them. The credit card companies have figured out a way to spin straw into gold!

This argument is not as fanciful as it might sound. The widespread use of credit cards by consumers and retailers probably has made the payments process less costly and more efficient, particularly once those clunky mechanical systems were replaced with easy swipes of the card. But those efficiencies were pretty much realized a decade ago, when most retailers adopted the latest technology. It's hard to see how there could have been enough additional efficiencies since then to justify the big jump in typical merchant fees since 2005. The Government Accountability Office found that not only have fees for transactions with standard cards increased about 25 percent but also that there has been a significant jump in merchant revenue as a result of the extra half-percentage point that card companies impose for purchases made with premium rewards cards.

In an effort to deal with this perverse competitive dynamic, the Justice Department brought an antitrust suit against Visa, Mastercard and American Express in October. In settling the suit, Visa and Mastercard agreed to change their contracts so that merchants can inform customers of the transaction fees and use discounts or gentle persuasion to encourage them to use cash or cards that have lower fees. The intent is to bring some price competition back into the market for merchant participation. At most retailers, however, the new rules won't go into effect until a similar agreement is either negotiated with American Express or imposed by a federal court.

Certainly this is a good first step. It would have been better if Justice had also insisted that merchants be given the option of adding surcharges for credit card purchases or the right to refuse to accept higher-fee cards altogether. Both are prohibited under credit card contracts.

In the end, there is only so much under existing antitrust law that the Justice Department can do. Given the hammerlock that Visa, Mastercard and American Express have on the market, the only sure way to prevent them from charging excessive fees and earning monopoly-like profits is through direct regulation. Congress recently mandated just that for debit-card fees, which the Federal Reserve now proposes to cut by more than 80 percent. It was only political push back from the banks and credit card companies that prevented similar regulation of credit cards.

There are two other reasons for the public to be concerned about the arms race in premium awards card.

The first is that the current kickback arrangement is highly regressive. A study by the Federal Reserve Bank of Boston found that households with annual incomes of less than $20,000 pay an extra $21 a year in higher retail prices as a result of merchants' credit card fees, while households with incomes of $150,000 benefit by $750. The reason is simple: Poorer people tend to do more of their business in cash and don't qualify for many high-reward cards.

The other is debt. One common rationale that the industry gives for high-reward cards is that they help to "lift" merchant sales by getting customers to spend more than they otherwise would. While that might be true for an individual merchant, it can't be true for all merchants unless it increases overall household income (unlikely) or induces consumers to save less and take on more debt. And, indeed, that's exactly what appears to have happened during the recent credit bubble - a bubble, we should remember, that led to a financial crisis, a prolonged recession and, ironically, tens of billions of dollars in bad debt write-offs by credit card issuers.

That hardly seems like the kind of social and economic benefit that the credit card industry wants to brag about.

pearlstein@washpost.com

Exhibit 2, December 25, 2010 Editorial by John Stewart Editor-in-Chief of Digital Transactions

Christmas in April for Acquirers

With a mere four months or so remaining until the Federal Reserve, as directed by the Dodd-Frank Act, must release its debit card regulations, it seems to be a timely moment to restate a fact of life in the payments industry that is so well-known it is often, perversely, overlooked: Interchange isn't paid by merchants; it is paid by acquirers.

So, with that fact in mind, let's take another look at what is likely to happen come April, The Fed's spanking new regs on debit card interchange will, by most accounts, slash rates by 80% or more. This is to meet the law's mandate that rates bear a "reasonable" relation to actual costs, and that the Fed give due consideration to the notion that debit cards are functionally similar to checks, which after all clear at par value. Now, who will pay this vastly reduced interchange? While the public—and, I daresay, many merchants—would say it's merchants, you know better. Merchant acquirers pay interchange to issuers, and then pass the cost on to merchants.

The big question for merchants, then, is: how much of the savings will you really see? If you're an acquirer, Dodd-Frank could wind up being the best thing that ever happened to you. If 40% of your portfolio is debit (a not atypical mix), and a significant chunk of that is based on tiered pricing (not interchange plus, which doesn't leave much wiggle room), you could pass on, say, half the savings and still reap a pretty decent windfall. One acquiring executive 1 spoke to recently said he'd be "shocked" if any acquirer in this position gave back more than a quarter of the savings to merchants.

Now, competitive forces in the business will ultimately compel acquirers to give up more and more of the booty. But that's a process that could take 'years. So here's our advice to our readers in retail: Keep track of what the Fed is doing, watch your statements closely, and be ready to challenge your acquirer if you're not seeing the savings you expected. But, of course, when you realize the full benefits of Dodd-Frank, you'll pass your savings on to your customers, won't you?

Exhibit 3 - Federal Reserves Richard Oliver Says Its Time for EMV

The U.S. Federal Reserve Bank of Atlanta's Richard Oliver says a transition to EMV chip and PIN payment is the only sensible move for U.S. payment advancement because universal cross-border payments are going to become impossible to facilitate if the United States continues to stick with the old magnetic stripe payment card standard.

Oliver says the time for an EMV switchover is right because the rest of the world is making commitments to eliminating the mag-stripe standard. "Sooner or later, the inconveniences of this and the problems with this, with respect to consumers and their utilization of cards and businesses and their utilization of cards, across the globe are going to be a defining factor, and it's going to cause action to be crystallized," he predicts.

Adding weight to Oliver's argument for a move to chip and PIN is the shrinkage of fraud in countries that have adopted the system, which is likely to drive fraudsters to countries where the system is not in use, such as the United States. He says it would likely cost $8 billion to $13 billion to build out the chip and PIN infrastructure across the United States.