MERCHANT ADVISORY GROUP®
4248 Park Glen Road
Minneapolis, MN 55416
952.928.4648
merchantadvisorygroup.org

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Mr. Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, DC 20551

Mr. Thomas J. Curry
Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency
400 7th Street S.W.
Washington, DC 20219

Mr. Robert E. Feldman
Executive Secretary, Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, DC 20429

Submitted electronically via www.regulations.gov

Docket ID FFIEC–2014–0001

Re: Review of Regulations under the Economic Growth and Regulatory Paperwork Reduction Act – Comments on 12 CFR Part 235 [Reg II] on Debit Card Interchange Fees and Routing

The Merchant Advisory Group (MAG)® greatly appreciates the opportunity to provide comments on 12 CFR Part 235 [Regulation II] on Debit Card Interchange Fees and Routing as part of the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA).

By way of background, the Merchant Advisory Group (MAG) was founded in 2008 by a small visionary group of merchants in the payments field dedicated to driving positive change in payments through multi-stakeholder collaboration. Today, the MAG represents over 100 of the largest U.S. merchants who account for nearly $2.6 Trillion in annual sales at over 430,000 locations across the U.S. and online. Roughly $1.5 Trillion of those sales are electronic representing over 41 Billion card payments. MAG members employ nearly 11.5 million associates.

Considerations in regard to Regulation II

I. Benefits to merchants and consumers

Regulation II has been critical in helping to correct inefficiencies in the United States debit card market. The existing regulations have improved marketplace efficiencies, made debit acceptance costs more reasonable and proportional for many merchants, and ultimately have benefited consumers. However, improved implementation of Regulation II could further enhance the competitiveness of the United States debit card market in comparison to other economies, such as Australia, Canada, and Europe who have adopted more advanced payment system reforms.

Australia is one of the most mature global markets for payment system reforms with the some of the early credit and debit interchange fee reforms taking effect in the early 2000's. As such, the Reserve Bank of Australia has studied the impact of payment system reforms more than many other entities. While the Australia and U.S. reforms are very different, debit card interchange fee reforms are covered by both. The Reserve Bank of Australia recently reaffirmed initial findings in a review of their reforms, which concluded "that the reforms had improved access, increased transparency and had led to more appropriate price signals to consumers."[1] It is the MAG's view that consequent findings will demonstrate the same outcome in the United States in instances where debit savings have been recognized and routing competition provisions are working as intended by Congress.

[1] Review of Payments Card Regulation. Reserve Bank of Australia. March 2015. http://www.rba.gov.au/payments-and-infrastructure/payments-system-regulation/regulatory-reviews/review-of-card-payments-regulation/pdf/review-of-card-payments-regulation-issues-paper.pdf.

II. Improved competition, but not entirely there

Prior to Regulation II, the dominant global card networks were striking a growing number of exclusivity deals with the largest U.S. issuers to ensure only their network brand and affiliates were available to route debit transaction on those cards. By requiring network routing competition on debit transactions, Regulation II has helped improve competition and efficiency in the debit card market benefiting merchants, consumers, and domestic PIN debit networks, as well as some global network brands.

Unfortunately, much of the progress towards restoring debit card competition in the U.S. was rolled back with the migration of U.S. payment cards to smart chip EMV (EuroPay, MasterCard, Visa) technology and the introduction of NFC contactless payments. We have concerns that the timing of the introduction of both technologies was not entirely predicated on the need to address fraud, but was also predicated on a desire by some owners of EMVCo to restore the competitive imbalance that preceded the enforcement of Regulation II's routing provisions. This situation gives rise to the need for additional oversight into potential routing competition circumvention by networks and issuers.

EMV is a closed system controlled exclusively by a handful of global card networks while traditional magnetic stripe technology was borne in an accredited open standards environment in which all networks and diverse stakeholders participated as equals. Failure by the global card brands to license the PIN debit networks as equals on the EMV chip technology invites additional oversight into whether or not EMV debit cards are truly enabled with the requisite multiple routing options. This dynamic is further exacerbated by technological barriers in contactless/NFC environments that may limit the data that can flow between a chip card and the merchant point-of-sale – data that is critical to how that transaction can be routed. There are early indications in contactless EMV that domestic PIN debit networks may be disadvantaged by the way the chip technology is set-up on the card.

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III. Specific EGRPRA questions

In our comments, MAG will seek to address five key components of the EGRPRA: 1) need for statutory change; 2) need and purpose of regulations; 3) overarching approaches/flexibility; 4) effect on competition; and 5) burden on community banks and other smaller, insured depository institutions.

Need for statutory change:

We do not believe there is a need for a statutory change. However, increased Federal Reserve Board and other regulatory oversight over card network rules, policies, and network-driven shift of related payment fees from issuers to acquirers (and ultimately the merchant) is critical to ensuring the regulations are not being circumvented.

Need and purpose of the regulations

The need for regulation has grown even greater with the deployment of card technology in the United States that is governed by a closed, non-competitive entity. The purpose of debit card fee regulations was to inject competition into a marketplace with limited competitive pressures that had seen significant cost increases despite improvements in technology and growing transaction volume that should have resulted in per transaction economies of scale. Competitive market dynamics did not exist prior to Regulation II. EMV smart cards that are being deployed in the United States are governed by EMVCo, which is operated by six major global card brands. As such, the EMV technology deployment is predisposed to putting those businesses interests ahead of domestic debit card networks, which have traditionally been more secure and efficient than their global competitors in the debit transaction space. Mobile commerce solutions that utilize any portion of EMVCo's technical specifications also run the same risk of disadvantaging PIN debit networks, limiting competition, and ultimately harming downstream users of the system – both merchants and consumers.

Overarching approaches/flexibility

MAG would encourage the Federal Reserve Board of Governors to lower the maximum allowable reasonable and proportional debit card fee level, improve oversight into network and issuer rules and activities related to routing competition, and analyze stakeholder investments in the EMV deployment in the United States, as well as chargeback fraud liability loss shifts and growing e-commerce and m-commerce fraud

losses, which are predominately borne by merchants. We will address each of these items in greater detail below.

Effect on competition

Regulation II has been effective in improving competition and efficiency in the debit transaction marketplace. Specifically, the Regulation II provisions that require more than one network to be available for the routing of a debit card transaction enhance competition. The effect on competition can be further improved through additional Board oversight and action to ensure both issuers and networks are enabling access to more efficient and secure e-commerce dual routing solutions, such as the PaySecure solution from Acculynk. It is also critical under the evolving payments landscape that debit routing competition remain a reality for mobile commerce transactions, which should involve Board or other regulator oversight of EMVCo licensing arrangements regarding the use and technology capacity of the common application or AID, which houses the domestic PIN debit networks on the EMV microchip.

Burden on community banks and other smaller, insured depository institutions:

A recent report from the Philadelphia Federal Reserve Bank describes the following as the impact of Regulation II on small banks and financial institutions demonstrating no short-term negative impact of Regulation II on small banks:

"There is substantial evidence that the ceiling did lower interchange fees collected by banks with assets above $10 billion, from around 44 cents to about 22 cents per transaction. But there was no such decline for small banks. Furthermore, after the ceiling was imposed, the volume of transactions conducted with cards issued by exempt banks grew faster than it did for large banks. Finally, Zhu Wang shows that interchange revenue fell substantially at large banks after the fee ceiling was imposed but continued rising for small banks.

In sum, the evidence does not support the claim that competitive forces have effectively imposed the interchange fee ceiling on small banks, although it is possible that longer-term competitive effects might yet put small banks at a disadvantage."[2]

[2] DiSalvo, James and Johnston, Ryan. "Banking Trends: How Dodd-Franks Affects Small Bank Costs." Federal Reserve Bank of Philadelphia Research Department. First Quarter 2016. https://www.philadelphiafed.org/newsroom/press-releases/2016/022916

Potential Improvements/Increased Enforcement of Regulation II:

Overall, the MAG believes the Federal Reserve Board and other regulatory entities could improve Regulation II by reassessing the level and structure of the reasonable and proportional debit interchange fee standard, implement a fee level and structure that addresses low value transactions, increase oversight into network rules, card technology, and market dynamics that may impact routing competition, and reassess the fraud prevention adjustment post-EMV liability shift for most industries.

I. Fee Level & Structure

The MAG believes that the current level of debit interchange fees is way too high given the market dynamics of covered issuers – those with $10 billion in assets or greater. The majority of covered issuer transactions – well over 90% - occur at high volume issuers. Costs borne by those high volume issuers are well below half the current level of maximum allowable interchange costs.

There is no indication that any regulated issuer is collecting debit interchange fee revenue below the maximum allowable level demonstrating that despite regulation, there are still limited competitive forces at work in the interchange market. Nowhere is this more evident than for low dollar transactions where both Visa and MasterCard – who control over 99% of the signature debit market – raised all low dollar debit transaction costs to the maximum allowable level. The signature debit networks' response to Regulation II has resulted in almost $1 billion in increased debit interchange fees on small ticket. This is neither reasonable nor proportional, and MAG encourages the Federal Reserve Board to reassess the interchange fee level calculation and structure. By way of comparison, Europe recently capped their low value transaction fees at the either 0.2% of the transaction or 5 cents.

In addition to rethinking the appropriate level of reasonable and proportional fees, MAG would encourage the Federal Reserve to remove the 5 basis points percentage fee that is included in the interchange fee structure to offset issuer fraud loss risks. The Federal Reserve's own data, as well as a recent report from the Kansas City Federal Reserve Bank, demonstrate that merchants bear at least roughly 5 basis points of fraud losses in the card ecosystem already. Plus, with the growth in e-commerce and m-commerce transactions, which are generally classified by the global

card networks as card-not-present transactions, data shows that merchants bear anywhere from 70% to 100% of total fraud losses. And, with the recent counterfeit liability shift associated with EMV deployment, even more fraud losses are flowing to merchants. In short, the fraud landscape – namely who bears the liability for fraud losses – has shifted significantly since the original legislation passed in 2010. MAG has serious concerns that the global card brands roadmap for EMV simply shifts U.S. fraud losses between different parties in the system – issuers and merchants are the primary bearers of all payment card fraud losses in the U.S. according to the Federal Reserve's own data – whereas true fraud prevention innovation as intended under the fraud prevention adjustment would help eliminate fraud from the system.

II. Fraud prevention adjustment

With the deployment of EMV in the United States, card-present counterfeit fraud shifted to the party least capable of accepting EMV. Card-present counterfeit fraud was not previously borne by merchants. EMV does not protect against card-not-present fraud, which is primarily borne by merchants. Meanwhile, the U.S. EMV transition, which does not require issuers to enable PINs on EMV cards does not protect against lost and stolen card misuse – a bucket of fraud losses shared by merchants and issuers.

By not taking the simple step of requiring issuers to enable PINs on EMV, card networks and issuers are leaving 3 times, if not more, the total potential U.S. payment card fraud on the table. *Nilson Report* data from 2015 shows that signature debit fraud compared to PIN debit fraud is 3 to 1 in international markets. Any issuer that did not include PIN enablement on their EMV deployment should not be eligible for the fraud prevention adjustment.

Furthermore, MAG has significant concerns regarding the timeline of the EMV liability shift. Many merchants who installed the proper hardware prior to the October 1, 2015 liability shift data are still waiting on their vendors to test and certify the EMV solutions in their stores so that they can fully deploy EMV. Merchants expended incredible efforts to be ready for EMV by October 1, 2015, but the backlog in the marketplace kept on-time deployment from becoming a reality for many.

Many EMV-ready and non-EMV ready merchants have seen an incredible uptick in payment card chargebacks and ultimately fraud losses since the liability shift date. Many of these are EMV-related chargebacks – some of which are even taking place at

EMV-ready merchants. MAG would encourage the Board and other regulators to review three items related to the EMV liability shift: 1) how fraud liability shift may impact the fraud prevention adjustment given issuers are now not entirely responsible for an area of fraud they previously were; 2) some merchants had to choose between deploying an EMV solution that was not compliant with the routing competition provisions required under Regulation II to meet the liability shift deadline – how prevalent was this, what was the financial impact to merchants, and who is responsible for Reg II routing competition not being appropriately made available on EMV debit; and 3) are card issuers and networks abusing or misusing the chargeback system.

Specifically, MAG would encourage the OCC to investigate issuer chargeback revenue on both credit and debit cards to see what impact these revenues are having on issuer balance sheets. MAG would also encourage the other regulators to investigate the financial interests of the global card networks in the signature debit driven chargeback structure, including what revenue networks derive from chargeback procedures, and whether or not such financial interests may have motivated global card brands to perpetuate the signature debit product in the migration to EMV. Chargebacks are virtually non-existent on PIN debit transactions.

Furthermore, EMVCo and their Board of Managers have proven inept in their ability to manage the US transition to EMV. They, and their Board of Managers, should be heavily scrutinized in this capacity, as well as any impact the organization may have on competition and the efficiency of debit transactions in the mobile commerce space.

III. Routing competition

The aforementioned low value transaction example is evidence that the realization of the competition in routing provisions still has major room for improvement. MAG strongly encourages the Board to investigate routing capabilities on both contact and contactless EMV chip cards in the United States, and specifically whether or not the common application on EMV, which houses domestic PIN debit networks, is held as an equal to the global application by EMVCo, networks, issuers, and through technical capabilities and licensing agreements on the more than 20-year old technology.

MAG would additionally encourage the Board to increase oversight of network rules and procedures that may violate the Regulation II competition in routing provisions. Given

the set-up of the two different EMV applications, any rule or procedure that attempts to require the merchant to bypass having a customer enter their PIN number where available for a transaction, should be considered such a violation in both card present and card-not-present environments. Not to mention, most merchants are asking for the customer PIN in an effort to provide better security for their customer and for their business, and such a business practice should not be inhibited nor discouraged

IV. Conclusion

Thank you in advance for the opportunity to provide feedback on Regulation II – Debit Card Interchange Fees and Routing. MAG strongly supports Regulation II and the increased competition and transparency these regulations have brought to the debit card market. Meanwhile, we would impress upon the Federal Reserve Board of Governors and other regulators to continue considering areas for improvement in the regulations that help promote a more efficient, transparent, and competitive landscape. We look forward to answering any questions or follow-up you may have regarding our submission.

Sincerely,

/s/

Liz Garner
Vice President
Merchant Advisory Group