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BY EMAIL – Interchange.Survey@frb.gov

Ms. Louise L. Roseman
Director, Division of Reserve Bank Operations
and Payment Systems
Board of Governors of the Federal Reserve System
Washington, DC 20551

Re: Comments on Draft Payment Card Network Survey

Dear Ms. Roseman:

On behalf of the Retail Industry Leaders Association (RILA), I am pleased to provide comments on the Federal Reserve Board's draft survey of the payment-card networks. The following comments reflect input from a number of RILA members on various aspects of the survey. They are generally organized along the six sections of the survey and its instructions.

In General

- In order to reflect the trends in the various data requested under the survey, it should cover more than just 2009. We believe the data should cover the last five years, and in some instances, the data should go back further. Given that Visa and MasterCard have maintained much of this data for litigation purposes the burden associated with reproducing it is this proceeding is greatly reduced.
- We recommend that the Federal Reserve request historical data on interchange and its rationale from 1990 (prior to Visa's acquisition of Interlink) forward as it has shifted over time and those shifting rationales are indicative of the true rationale for interchange – exercising market power to benefit the banks to merchants' detriment. The Federal Reserve should similarly request historical data on network fees, broken out by those paid by issuers vs. acquirers or merchants, to highlight the pattern of increasing fees that are applied to the merchant side of the business.
- The survey should request that all networks fill out all sections. Both Discover and American Express now have third-party issuers issuing on their networks.
- A general concern is how the Federal Reserve Board is going to verify the accuracy of the responses and ensure that respondents are not loading in extra costs.
- Section IV recognize that all participants in the payment system share in fraud prevention – Issuers share the costs of cardholder transaction monitoring; acquirers share the costs of merchant monitoring and evaluation of merchant security programs; merchants may utilize their own fraud prevention tools, and incur costs for scoring models, manual

review, etc. At some point, the Federal Reserve should solicit feedback from the other market participants to validate the data provided by the networks in this survey.

- We recommend that the Federal Reserve consider the incremental cost of a debit transaction when a bank is both the issuing bank and the acquiring bank and the role of card networks in these transactions.
- The survey should be limited to network-related information that is germane to the banks to which the Dodd-Frank Act applies – banks with $10 billion or more in assets.

New Categories

We recommend that the Federal Reserve add the following new categories to the payment card network survey:

- The percent and number of transactions that have cleared through the network during the last five years at each interchange rate, by merchant tier (if applicable) that is set by the network.
- The percent of purchase volume and dollar amount of purchase volume that has cleared over the network during the last five years at each interchange rate by merchant tier (if applicable) that is set by the network.
- The effective (or weighted average) interchange rate charged by a given network each and every year.
- The tiering structure used by a payment card network, including the rates applicable to each tier as well as the criteria that the network uses to assign a merchant to a particular tier (e.g., size of the merchant, sales or transaction volume on the network, etc.).
- For networks with international scope, detailed interchange and network fee schedules for each country in which they operate.
- For networks that have debit operations in Canada (Visa and MasterCard), the following information:
  - Applicable interchange rates, switch fees and network fees regarding debit transactions consummated in Canada.
  - The number and identity of issuers and cards in circulation for those programs.
  - Merchant acceptance of those programs.
  - Transaction count and dollar volume on those programs.
- All new or changed fees, interchange rates, assessments, other fees implemented in each of the last five years.
- Fees, fines and penalties assessed to merchants for operational and Payment Card Industry (PCI) Data Security Standard non-compliance as well as charges associated with breaches, including Risk Identification Service (RIS) program fees and fines.
- Any remuneration, compensation or payments made for any reason to issuers, including remuneration that issuers or network receive for fraud protection.

- Copies of contracts with issuers, at least those portions that illustrate financial terms, marketing incentives, waivers of published fees and signing bonuses.
- The cost basis of network fees illustrating costs associated with operations, technical support, staffing, marketing, legal, and other material components.
- Network financial statements, including identification of the parties that have received profit distributions from the network.
- For entities that operate both signature and PIN debit networks, information concerning the degree to which signature debit operations subsidize PIN debit operations.
- Exclusivity agreements in which networks provide financial incentives to issuers in exchange for pledges of exclusive use of the network's services. Specifically, any issuer contracts that include lump-sum payments, discounted fees, or early termination penalties that require the repayment of previous benefits or other forms of liquidated damages or penalty provisions should the issuer fail to dedicate a specified percentage of their credit, debit, or combined credit and debit volumes. The Federal Reserve should ask for the credit card issuer deals as well, since they often cross-subsidize the debit issuer deals that result in de jure or de facto exclusive debit arrangements.
- Royalty fees imposed on competing networks or on any other party.
- The bank ownership interests in entities that own networks and board or committee representation within Visa and MasterCard. This request should include any mechanism whereby the banks control Visa or MasterCard ability to take positions regarding interchange in litigation or regulatory contexts, including the Visa Retrospective Responsibility Fund.
- Disclosures by Visa and MasterCard regarding any actual or proposed hybrid cards that combine credit and debit functionality on the same card or device, including any such cards or devices where the consumer will make a credit card transactions at the POS and then have the ability to have that transaction paid via their DDA, effectively converting it into a debit transaction.
- Data on the current deployment, if any, of PIN debit technology over the Internet.
- Any assessments of the costs of moving the U.S. payment system to Chip and PIN, including any assessments of the extent to which such costs would fall on merchants vs. issuers or networks.
- Data on the percentage of debit transactions that involve cash back.
- Number of Health Reimbursement Account Cards in circulation, and transaction counts and dollar volumes on all such cards that are designated as debit cards for purposes of Visa's or MasterCard's Honor-All-Cards rules.
- Number of Flexible Spending Account Cards in circulation, and transaction counts and dollar volumes on all such cards that are designated as debit cards for purposes of Visa's or MasterCard's Honor-All-Cards rules.

- Data on the extent to which issuers surcharge (or assess a fee on) PIN debit transactions but not signature debit transactions or otherwise engage in strategies to steer cardholders toward signature debit, such as extending rewards or other benefits only to signature but not to PIN debit.
- Information on the network's spring and fall releases (or similar announcements) for the past 5 years, including information indicating release initiatives that are designed to support new issuer products or to enhance support for existing issuer products as well as details on how these initiatives affect merchants.
- Information regarding the operating rules that networks have or plan to implement that shift the processing burden from the issuer to the merchant (e.g., Visa's product code identifier 62.23, partial authorization indicator, cash back indicator). The survey should also ask how many times in each of the past 5 years has the network implemented system changes on the acquirer/merchant vs. the issuer.
- Specifically for Visa and MasterCard, disclosure of all contracts and network rules or policies that exclude the other association from a contractual provision or rule that otherwise applies to Discover, American Express or other competitors.
- Specifically for Visa and MasterCard, any network fee that is applied irrespective of whether the particular transaction actually travels over their networks. MasterCard, for example, has a network fee that is charged to debit issuers for their total debit or ATM volume if the card is branded with MasterCard. Under that rule, the issuer is charged twice, once by MasterCard and a second time by a competing PIN debit network.
- Any contemplated changes to interchange, fees, issuer contracts, or network rules on co-branding of debit cards or network routing of debit cards that will go into effect in the next 12 months. This would include any planned changes to operating rules, network fees, merchant fees, issuer fees, processing modifications or system releases and the burden expected on each of the participating parties.

<u>Section I – Fees</u>

- We consider information on past interchange to be relevant only to the extent that it shows the true rationale for interchange – market power. Such information does not cast light on the viability of at-par pricing.
- The survey should request information that enables it to compare the distribution of network fees between the issuer and acquirer as compared to the distribution of fees associated with the Federal Reserve's operation of the check clearing and settlement process.
- The survey should include instructions on how to reflect fees relating to Discover and American Express, since the card issuer and network are the same. Since other financial institutions can issue cards under the Discover or American Express brand, there likely are some card portfolios with a separate interchange fees and network fees. Rather than lumping all Discover and American Express fees under Section I.D and I.E, an alternative

would be to utilize a new section for "merchant discount" fees, when the merchant is charged a single rate that includes both interchange and network fees. This might allow a better comparison for evaluating the total cost of acceptance by card brand. In addition, the Federal Reserve should request the interchange payments or their equivalents that Discover and American Express make to the third-party issuers that issue on their networks.

- For the "Fee Program Description" in Section I.A, the instruction should reference not only the types of transactions or merchants, but also the types of cards. For example, the debit networks are now charging merchants different rates (such as the All-STAR rate) when STAR issuers exclusively use that brand.
- Section I.A includes a column for the "Dollar cap of fee." At least one PIN Debit network now charges a minimum fee amount.
- Section I.A can be read as differentiating interchange fees by rate (i.e., general, AFD, supermarket, etc.), but not differentiating the rate for a network exclusive bank (e.g., NYCE, Star, Pulse and announced this week ACCEL). The survey should be more explicit on the latter as a separate interchange category, and possibly add a separate question as to whether the network provides an incentive for a bank to be restrictive in network routing, either in unit-fee differential or with an upfront payment.
- Section I.F references discounts on licensing fees for hitting sales volumes. These fees should include ALL types of compensation that a network can provide to issuing banks. A non-exhaustive list of such compensation includes:
    - Signing bonuses upon execution of contract.
    - Bonus payments for hitting volume targets.
    - Discounts for network fees.
    - Licensing fee discounts or rebates for hitting volume targets.
    - Advertising/marketing support (including reimbursement for advertising, sweepstakes).
    - Payments to cover card issuance costs.
    - Providing premium offers to activities or events (Tickets to World Cup or Super Bowl).
- We recommend that the Federal Reserve also request penalties that are contractually or otherwise imposed on issuers for non-compliance with contractual volume targets, including provisions that require the repayment of past benefits or that require the issuer to transfer volume from competing networks to comply with a contractual requirement. All such examples in the past ten years should be provided.
- To ensure that this information is complete, the survey should request copies of all contracts and addendums between the network and any issuing bank, which would provide visibility to all cash flows between the networks and the issuers. To limit the volume of material, contracts/addendums could be requested for just 10 largest issuers, as those agreements will likely reflect the most innovative arrangements.

- To help the Federal Reserve understand the reasoning behind network-fees information in Section I, the survey should request a narrative description of the network's methodology for determining the amount of each fee type.

Section II – Fraud Prevention

- The instructions to Section II need more definition on how networks are to express fraud-prevention costs. Is the intent of this section to show the net cost of fraud prevention services that are included in the Section I fees? Some of the "Specialized authorization services" offered by the brand come with a fee to either the merchant, or to the card issuer. For example, merchants generally pay for Address Verification Services. Issuers may pay the brands to receive risk scores or other fraud prevention products. We recommend that any such merchant and issuer fees paid should be reflected as an offset to the gross expense.
- Section II asks for Data Security Costs separate from Fraud Prevention Activities and Costs. Since data security may be considered by many to be a fraud-prevention cost, a network could easily double count this cost. The survey should state clearly that any costs already listed in IIA should not be reported in IIB.
- To provide some context for Section II (and to permit a better comparison of expense rates of the various networks), the survey should ask for the total number and dollar value of debit transactions processed over the network during 2009. This information will also be informative with respect to Section III.
- The survey should request that PIN debit fraud information be broken out separately by POS fraud and ATM fraud.
- Section II should indicate that a network should NOT include any costs related to ATM networks that it may operate and that if any of the costs reported (e.g., fixed data security costs) are shared between its ATM networks and debit networks, only the portion attributed to the debit network should be reported.
- Net fraud-related costs should be calculated as a percentage of the issuer's portfolio.
- Sections II should clarify (similar to the issuer survey) that for any reported costs considered to be a capital expenditure, it should include only the amount depreciated or amortized during the relevant year.

Section III – Fraud Activity

- The instructions to Section III need more definition on how networks are to express costs relating to fraud activity. Do the networks need to report fee income received from fines assessed on breaches in Section I.E?
- Section III should report fraud associated with new accounts or card mailing in separate categories.
- Section III should indicate that a network should NOT include any costs related to ATM networks that it may operate and that if any of the costs reported (e.g., fixed data security

costs) are shared between its ATM networks and debit networks, only the portion attributed to the debit network should be reported.

- Sections III should clarify (similar to the issuer survey) that for any reported costs considered to be a capital expenditure, it should include only the amount depreciated or amortized during the relevant year.
- With respect to Sections III.A and III.B, the survey should request costs for the following fraud activity categories:
  - Fraud Application.
  - Lost/Stolen.
  - Not Received (NRI).
  - Counterfeit/Skimming.
  - Account Take-Over (ATO).
  - Mail-order/telephone-order and Internet.

<u>Section IV – Additional Fraud Questions</u>

- Question IV.E should include the costs associated with additional means to reduce fraud. For example, if Chip cards are suggested, the networks need to include costs of retrofitting all POS devices and reissuing all cards.
- Section IV.E should be more specific and ask the network to comment on the effectiveness of PIN vs. signature in preventing fraud.
- Section IV (following question B) should include a question asking whether existing interchange fees have increased incentives for any party (issuers) to promote transactions that are more prone to fraud (e.g., banks steering customers to signature debit instead of PIN debit despite the higher fraud risk).
- Question IV.A should read: "Is the level or incidence of fraud (or the costs of avoiding fraud) influenced in any way by the method for authenticating an electronic debit transaction by using a PIN or signature in a card-present environment?"
- Question IV.B should read: "Have existing interchange fees influenced incentives for each party …." And if the answer is yes, has the influence increased or decreased incentives to reduce fraud?
- We recommend adding the following questions to Section IV regarding fraud occurrence and mitigation:
  - Is there any industry data available of fraud losses and/or costs that compare PIN vs. signature debit experience?
  - Is there any industry data citing fraud experience by issuer?
  - Based on fraud experience, what's the most effective fraud prevention tool in minimizing overall fraud loss (e.g., PIN, Card Verification Value, etc.)?
  - Are there industry accepted fraud prevention standards to which issuers must adhere? Are assessments performed to ensure compliance? Networks should please explain programs and qualification requirements, if either question is answered in the affirmative.

<u>Section V – Exclusivity and Routing</u>

- Section V needs to clarify how a network, which one of the two networks on a dual-bugged card, is to respond. It may be necessary to reword some of the questions to address exclusivity on one or ***two*** networks.
- The survey should also specifically ask if the network itself has priority routing rules as well as whether the network pays (or is planning to pay) an interchange premium for exclusivity.
- Question V.A should be clearer in subsection 2 to include situations where, due to priority routing, the rule suppresses, but perhaps does not eliminate, the issuer's ability to have transactions routed over other networks.
- Question V.B should include contracts that require volume commitments on the part of the issuer and that impose penalties, including lost discounts and the repayment of past benefits, if the issuer does not meet the targets.
- Question V.C should include volume targets where the deal is not exclusive, and it should also ask for details on penalties, such as liquidated damages, lost discounts and repayment of past benefits.
- The survey should ask each network to specify the percentage of financial institutions with assets of $10 billion or more that are connected to its network.

RILA appreciates the opportunity to comment on the payment card networks survey, and we would be pleased to discuss RILA's views with you further at your convenience.

Respectfully submitted,

John Emling
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