

The U.S. Payment Card Industry

Select Challenges and Issues From a
Hospitality Industry Perspective

Presenters



- W. Stephen Cannon, Chairman, Constantine Cannon LLP
- Former General Counsel, Circuit City Stores, Inc.; former Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice; former Chief Antitrust Counsel, Senate Judiciary Committee
- Active involvement in payment card issues, including testimony before the Senate and House Judiciary Committees on behalf of the Merchants Payments Coalition



- Mike McCormack, President, Palma Advisors LLC
- Payment card consultant with 20 years experience as officer at commercial bank, telecommunications merchant, and as an independent consultant
- Worked as a consulting expert witness on cases concerning payment cards, including merchant card acquiring, interchange fee and foreign currency conversion fee matters in the U.S. and New Zealand.

Hospitality Industry Payment Card Acceptance

- Recent Developments In Payment Cards Industry Make Payment Cards A “Mission Critical” Area For Hospitality Merchants
 - Escalating costs
 - Burdensome merchant acceptance rules and card processing agreements
 - Recent legislative and regulatory developments (or non-developments)

Payment Cards Are Critical

- Payment cards are the most predominant customer payment mechanism for hospitality merchants
 - Cards comprise over 80% of sales at lodging establishments, and 70% at higher priced table service restaurants
- Hospitality a highly reliant, mature merchant acceptance market
 - Perceived by card industry as less sensitive to fees

High Market Concentration

- Top 10 Acquirers processed 76.2% of Visa and MasterCard sales in 2008
 - Most top acquirers are issuers, and vice versa
- Top 10 Issuers comprise 81% of credit card sales and 76.2% of signature debit in 2008
- Visa and MasterCard branded cards
 - Comprise 71% of credit card spending
 - Comprise nearly 100% of signature debit spending

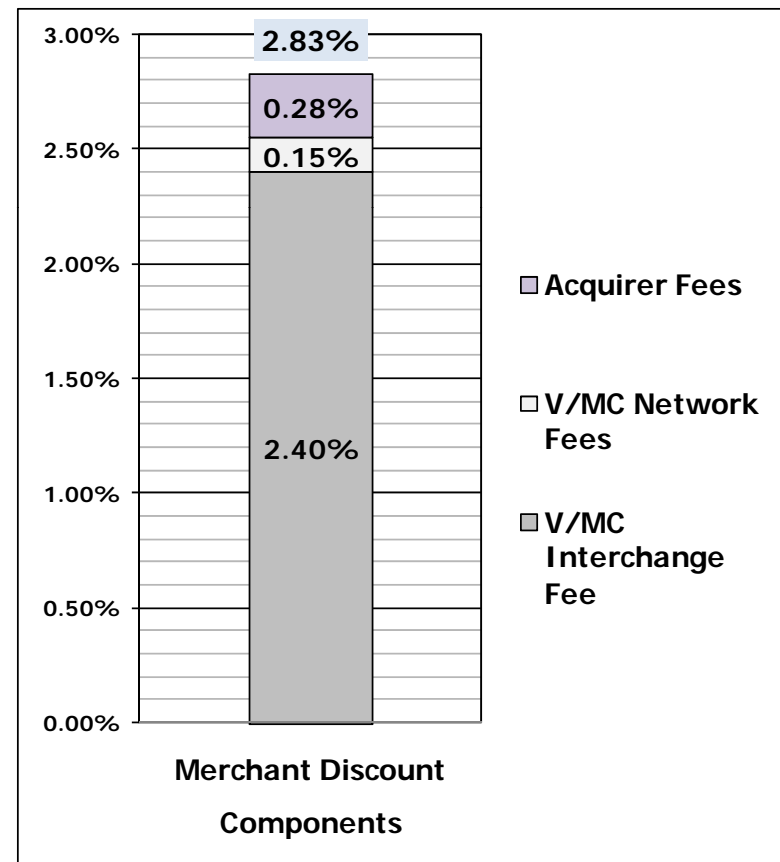
Acceptance Costs Increasing

- Interchange fees rising
 - Absolute increases in fees
 - Shifting of card products to higher cost categories
- Network fees increasing
 - A trade publication termed these fees a “gold mine” for networks
- Acquirer fees
 - Have declined over the past 20 years, but have been relatively stable more recently

Illustrative Merchant Acceptance Cost

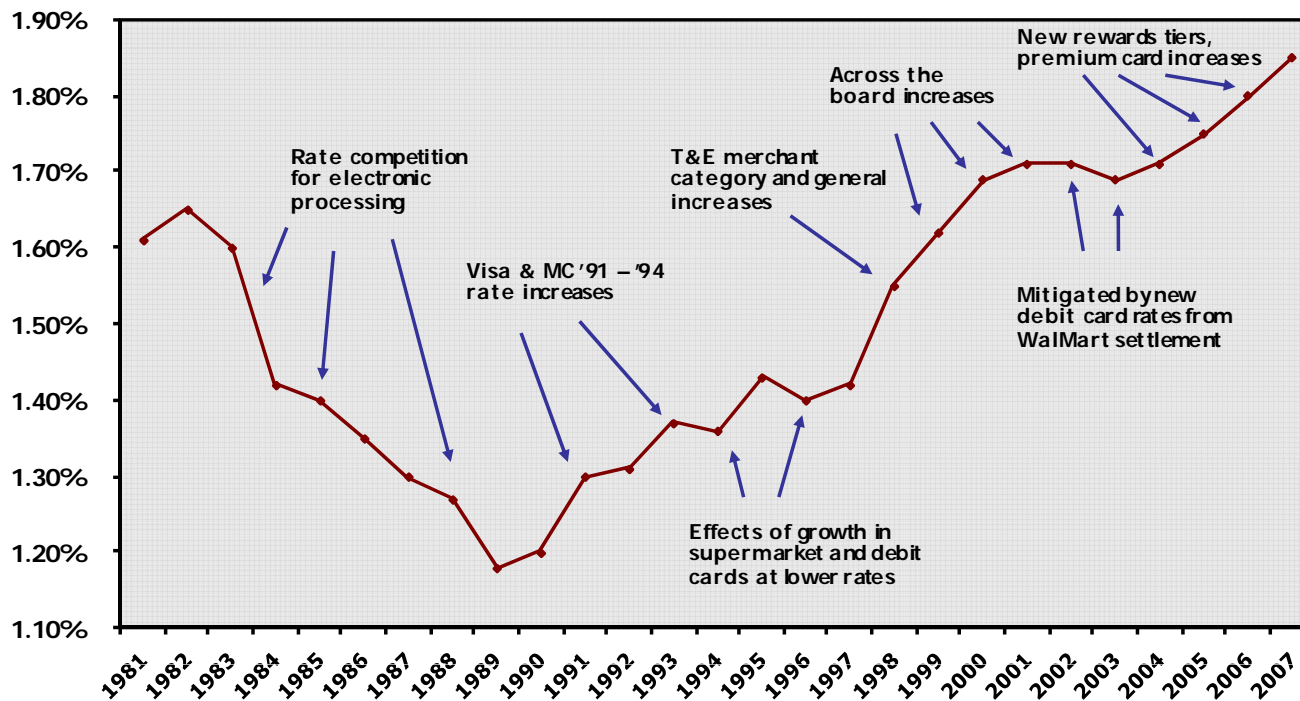
- Interchange fee (2.40%)
- Network Fees (.015%)
 - Assessments
 - Processing
 - Cross-border
- Acquirer Fee (0.28%)

= 2.83% Acceptance fee



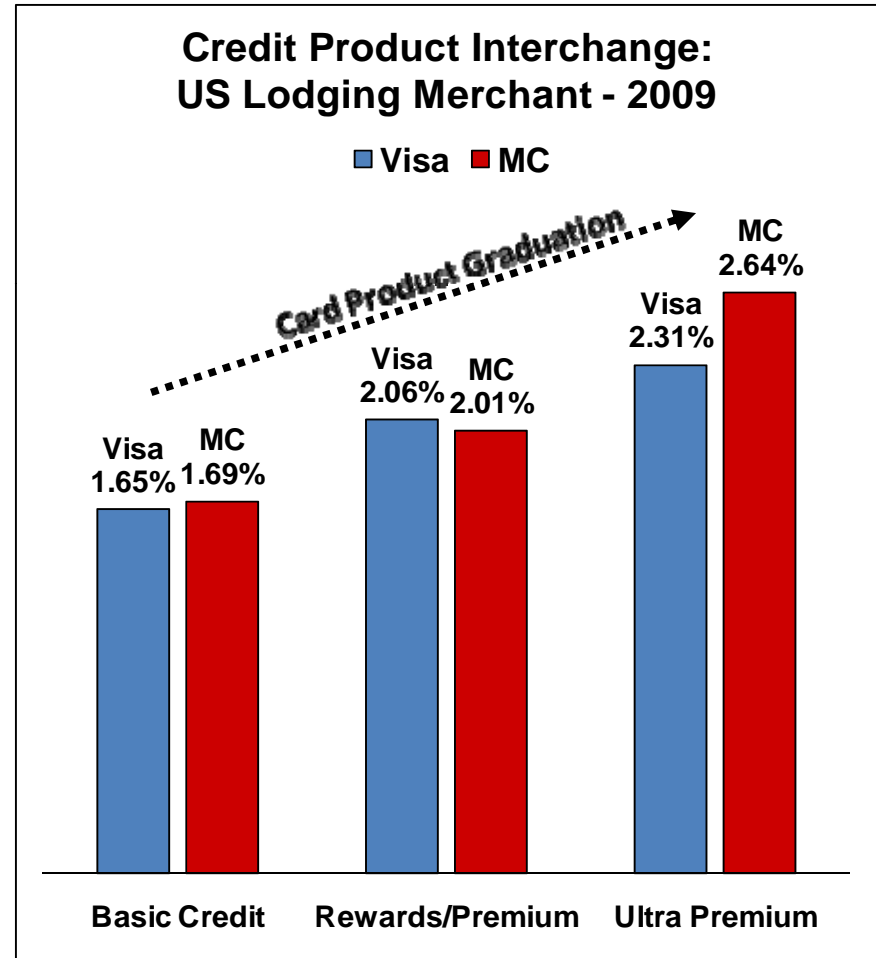
Interchange fees rising

**U.S. Visa/MC Average Interchange Rates 1981 – 2007
(Credit & Signature Debit Products)**



Card products redefined as rewards and premium cards with higher fees

- Card product graduation
 - Processes developed by Visa and MasterCard 2005 - 2007
 - Cards dynamically reassigned to higher interchange fee categories by banks
- Stealth interchange fee increases
 - Merchants unaware of higher acceptance costs until after card transaction is settled and additional fees charged



Visa And MasterCard Operating Rules

- What You See Is Not Necessarily What You Get
 - Rules historically not provided to merchants
 - Shortened truncated versions made available to merchants in 2006
 - But the merchant is still bound, even if they have no ability to have actual knowledge of the operating rules' contents
- Network rules extended to merchants through the agreement with the acquirer

Telling the merchants how and what to charge customers

- Networks restrict merchants from:
 - Advertising prices other than those associated with the use of a branded payment card
 - Promoting discounts, incentives, or rewards at the point of sale for using a merchant's co-branded card
 - Extending cash discounts to non-cash payment methods
 - Surcharging types of cards to reflect differences in the cost of their acceptance

Payment Systems Security Rules

- Card systems have simply presumed themselves to have governmental powers of punishment through mandated compliance with their rules
- Merchants are subject to significant financial jeopardy arising from a detailed system of penalties and liabilities administered by Visa and MasterCard for alleged PCI-DSS violations

Merchant Agreements

- Visa and MasterCard enforce rules against acquirers, processors, and merchants with a system of fines and penalties
- Merchant agreements channel Visa's and MasterCard's rules and enforcement powers to the merchant
 - Require merchant follow all network rules, whether disclosed or not

Conduit to Merchants' Funds

- Merchant agreements provide the collection mechanism for the penalties
- Agreements usually
 - Indemnify the bank against all liabilities from acceptance services provided to a merchant
 - Grant acquirers access and offset rights to the merchant's funds
 - Hold merchants liable for security breaches that are the fault of a merchant's software or service vendors

Is this system legal?

- Is this system of card system-imposed fines and penalties really legal?
 - Not yet answered definitively
 - Contract law of many states hostile to penalties
 - Penalty schedules not negotiated between card networks and merchants
 - Acquirers ambivalent as they pass fines through to merchants

Is Relief On the Way?

- The two dominant card systems use their members' merchant acceptance agreements as vehicles for unilaterally imposing increasingly burdensome merchant fees, rules, and data security penalty/liability mechanisms
- Discussion in the public policy arena concerning these trends, yet few concrete developments to counteract them

Legislative Developments

- Federal Reserve / EFTA
 - Authority to require debit cards clear at-par
 - Pending financial services reform legislation may transfer this authority to the CFPA
- Senate bills
 - S. 1212, the “Credit Card Fair Fee Act of 2009,” introduced by Sen. Durbin
 - Collective bargaining with baseball-style arbitration

Legislative Developments

- House bills
 - H.R. 2695, introduced by Rep. Conyers.
 - Similar to S.1212, without arbitration, but with Justice Department assistance to negotiations
 - H.R. 2382, Rep. Welch, the “Credit Card Interchange Fees Act of 2009”
 - Attempts to affect fee levels indirectly by outlawing specific payment system rules (no steering, no refusal of cards with higher fees, etc.)
 - Gives FTC rulemaking authority to prohibit practices that are anticompetitive or are unfair or deceptive to consumers and merchants

Steps Merchants Can Take

- Larger firms may have sufficient clout with their processors to seek modification of the most onerous indemnification terms that pass card system penalties through to the merchant.
- All merchants should attempt to limit liability for assessments that are the fault of the merchant's software or systems vendors.

Steps Merchants Can Take

- At a minimum, merchants should attempt to forestall the automatic deduction from their card payment cash flow of penalties and liabilities for claimed security breaches.
- Simply put, those in the hospitality industry should resist being at the bottom of the hill as liability cascades downward from all others in the card processing chain.