# Electronic Payments: The Winds of Change, A Call to Action

## Will 2011 Be An Eventful Year in the History of Payment Card Security?

# Presenter

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- Active involvement in payment card issues, including testimony before the Senate and House Judiciary Committees on behalf of the Merchants Payments Coalition and representation of the Coalition in current Federal Reserve Board rulemaking proceedings

# Recent Payment Card Developments

- Offer first real “light at the end of the tunnel” from merchants’ battles with major card networks
- May lead to “paradigm shift” away from fraud-prone authentication methods
- Will be subject to a payment industry counter-attack
- Create opportunities for hospitality industry counsel

# Payment Cards Are Crucial

- Payment cards are the predominant customer payment mechanism for hospitality merchants
  - Cards comprise over 80% of sales at lodging establishments and 70% at higher-priced table service restaurants
- Debit card's share of payments has dramatically increased in certain segments:
  - To 29% in 2008 from 7% in 1999 in mid-priced restaurants
  - To 33% in 2008 from 2% in 1999 at quick service restaurants

# Card Acceptance Has High Burdens

- Data security rules that place merchants at significant liability risk for alleged data breaches and claimed fraud
- High interchange fees (paid to card issuers) and network fees imposed on merchants’ card acceptance
- Network restrictions on merchants’ ability to incent customers to use low-cost cards and to route to preferred network

# 2010 Developments Promise Relief In 2011

- The “Durbin Amendment” to the Dodd-Frank Financial Reform Act was enacted on July 21, 2010
  - Becomes new section 920 of the Electronic Fund Transfer Act
  - Requires the Federal Reserve Board to limit debit interchange fees
  - Permits issuer fraud prevention fee adjustment—but only if Board-specified fraud reduction standards are met
  - Gives merchants network routing rights
- The Board’s implementing rulemaking was issued December 16 and is to be completed by April 21, with rules generally effective July 21, 2011
- Justice Department’s October 4 proposed settlement with Visa and MasterCard gives merchants greater rights to steer customers to preferred payment forms, including by network and type of credit or debit card

# Networks Impose High Fraud Costs

- Merchants face significant compliance, monitoring, and liability costs as a result of card networks' PCI data security standards
- Liability includes charge-backs and "Account Data Compromise" systems of penalties and assessments for PCI violations or claimed data breaches
  - Unilaterally imposed by Visa and MasterCard based on "common point of purchase" and "expected fraud" algorithms
  - Limited appeal rights dependent on acquirers
  - Collected through indemnification provisions of merchants' agreements with their acquirers and processors

# New State Law Invokes Judicial Due Process

- 2010 Washington State statute makes large merchants (6 million card transactions) liable for issuers’ reasonable actual credit and debit card replacement costs (RCW 19.255.020)
  - Merchant must have failed to take “reasonable care” to guard against unauthorized access to card information
  - The failure must be the “proximate cause” of a data breach
  - Liability apportioned by “trier of fact” among “every entity” that was proximate cause of damages
  - Merchant can defend on basis of (a) data encryption or (b) PCI compliance certification

# Nevada and Minnesota Approaches

- The 2009 Nevada statute imposes PCI standards for card data retention (NRS 603A.215)
  - PCI compliance is liability defense for damages based on a breach
  - Scope of statutory liability not defined
- The 2007 Minnesota statute more broadly permits financial institution recovery of reasonable damages from breach (Minn. Statutes 325E.64)
  - Merchant or its service provider must have retained “full track” mag stripe data, card security codes, or PINs after authorization
  - Damages include reissuance and cardholder notification costs, and reimbursements for unauthorized charges, if not recovered through network procedures

# The Problem of Signature Debit

- Merchants' fraud costs are exacerbated by issuers' promotion of fraud-prone signature authentication for credit and debit card transactions
  - The Fed found signature debit has 3.75 times higher average fraud losses than PIN debit (13.1 basis points v. 3.5 basis points); 4 times higher for card-present transactions
  - 96 percent of PIN debit losses are borne by issuers; in contrast, 45 percent of signature losses are borne by merchants, 76 percent in the case of card-not-present transactions

# More Secure Technologies Exist

- “Chip and PIN” authentication is card-based, not network based
  - No transmission of authentication data
  - Being deployed in major U.S. trading partners, e.g., European Union, Canada, Australia
  - But may impose costs on merchants needing terminal upgrades
- “Tokenization” and end-to-end encryption were identified by the Board as also reducing the opportunity for compromise of transmitted authentication data

# The Fed's Rules May Promote a Transition To More Secure Methods

- Section 920(a)(5) permits a fraud prevention cost adjustment to interchange fees based on Board standards that promote use of cost-effective, low-fraud card authentication technology
- The Board asked for comments on whether the standards should promote a "paradigm shift" in authentication to less fraud-vulnerable methods
- The merchants' proposal argued for a such an approach:
  - Allowing an adjustment (up to a cap) for technologies that cost-effectively reduce fraud to levels substantially below those of PIN debit
  - The direction of the adjustment should be based on the relative costs incurred by issuers and merchants/consumers

# Debit Interchange Is Substantial

- The Board found debit and prepaid card interchange fees were a $16.2 billion burden in 2009
- Fees varied by authentication method
  - All methods: 44 cents or 1.14 percent
  - Signature: 56 cents or 1.53 percent
  - PIN: 23 cents or 0.56 percent

# Key Durbin Interchange Mandate

- Section 920(a) requires the Board adopt standards that assure debit interchange fees are "reasonable and proportional" to issuers' costs of a debit transaction
- In setting the standard, the Board is to take into account:
  - Functional similarity between debit transactions and checks' clearance through banks at par (face value)
  - Issuers' "incremental" costs of "authorization, clearance, and settlement" ("ACS")
  - But must exclude issuers' costs that do not vary per transaction
- Issuers with less than $10 billion in assets are exempt from limits

# The Fed's Proposal Would Reduce Debit Interchange

- Board's proposal based on "average variable" ACS costs and either:
  - A "cap" of 12 cents per transaction (80th percentile of issuer costs in Board survey), subject to issuer cost justification, and a 7 cent "safe harbor" (50th percentile) with no justification, or
  - A 12-cent cap, with no need for issuer justification;
- Issuers and/or networks could have flexibility in structuring fees under either option so long as average is met
- Merchants' proposal based on a presumption that debit card interchange should be at par (face value)

# New Routing Rules Should Empower Merchants

- Section 920(b) requires issuers to have more than one non-affiliated network able to process their debit cards' transactions
  - Networks and issuers forbidden to have exclusive or incentive agreements that undercut this outcome
  - Merchants have the right to direct the choice of available networks to route a transaction
- While merchants believe there should be a choice of at least two networks both for PIN and for signature authorization, the Board has sought comment on need for two networks for each authorization method

# Merchants Gain New Rights to "Steer" Customers In DOJ Settlement

- On October 4, 2010, DOJ filed a civil complaint against American Express, Visa, and MasterCard challenging their merchant steering restraints
- DOJ's proposed settlement should expand merchants' rights beyond those of Durbin Amendment
  - Visa and MasterCard agreed not to prohibit a broad range of merchant incentives for customer use of lower costs cards
  - However, American Express refused to settle; until the litigation is resolved, Amex may enforce its merchant agreement non-steering rules
- Section 920(b)(2), which is effective without the need for Board regulations, also prevents networks from restricting point-of-sale discounts and other incentives by type of payment, but *not* by network or issuer

# The DOJ Settlement Needs Clarification

- The proposed DOJ-Visa-MasterCard decree is currently undergoing a public interest (Tunney Act) review before DOJ and the US district court in Brooklyn
- The settlement permits merchants to create incentives for customer use of lower-cost cards, including differentiation not only among networks but also:
  - By type of credit and charge cards (e.g., premium rewards, rewards, and no-rewards)
  - By "form of payment," including between signature and PIN debit
- However, these rights are without impact if there is no way to determine, visually and electronically, a card's fee level, and there is no such requirement in the settlement
  - The settlement thus may have limited practical effect unless clarified to ensure the availability of such information, as requested in comments to DOJ by a key merchant group

# The Proposed Durbin Amendment Rules Are Subject to Counterattack

- Major card networks and their issuers have made know to the Board and to Congress their displeasure with the Board's proposed rules
  - Legislative changes to the Durbin Amendment may be attempted
  - Sen. Durbin recently told the Senate, "I am hunkered down and ready for the fight that is coming."
- TCF Financial has filed a suit in South Dakota to enjoin the Federal Reserve's enforcement of the forthcoming interchange fee rules
  - Alleges that the rules: (1) deny it due process as "confiscatory" ratemaking regarding its demand deposit and/or retail banking businesses; (2) deny it equal protection because of the small issuer exception; and (3) would constitute a taking entitling it to "just compensation"
  - A hearing will be held on TCF's preliminary injunction motion on April 4 with significant *amicus* participation

# There Are Multiple Opportunities for Hospitality Industry Counsel

- To monitor regulatory, legislative, and judicial developments
  - To protect client interests in the face of a financial industry counterattack
  - To identify potential client benefits in a dynamic legal environment
- To work with financial, marketing, information technology, and vendor relations staffs regarding implementation plans

# Strategies for Lowering Debit Interchange Costs Need to Be Developed

- Relative interchange fees by payment type need to be understood as fee standards become effective
- Network priorities should be developed for acquirers'/processors' routing tables based on networks' cost, service, and liability rules
- Steering methods to promote usage of lower cost payment methods need to be assessed, balancing cost savings against the potential for customer confusion or resistance at the point of sale

# Negotiations for Preferred Network Status May Be Possible

- The proposed DOJ settlement allows merchants to negotiate with payment networks for preferred provider status
  - Merchants may agree with networks to provide incentives to steer customers to the network
  - However, such arrangements must be individually negotiated and not part of a "standard agreement" and may not be imposed by the network as a condition of card acceptance
- Merchants may gain leverage in such negotiations as a result of their section 920(b) powers to specify their priorities for routing debit transactions among networks
- However, the usefulness of such an agreement may be limited by a merchant's desire to provide a broad range of customer payment options

# Methods of Reducing Fraud Liability Should be Pursued

- Current charge-back losses and PCI compliance liability under merchant acceptance agreements should be analyzed
- The costs and benefits of migrating to more secure authentication methods, if encouraged by Board rules, should be assessed, particularly if fraud chargebacks can be eliminated
- Negotiations with networks and acquirers regarding routing priorities and preferred provider status should also attempt to prevent merchants from being at the bottom of the hill as liability cascades down the card processing chain from claimed PCI violations

# In Sum, 2011 Will Be Interesting

- There is a good prospect that merchants will gain new rights and leverage with respect to the major payment networks
- The Federal Reserve may create incentives for a “paradigm shift” in card authentication
- The impact of these developments will be affected by hospitality industry counsel’s efforts to identify new opportunities and translate those opportunities into successful legal and business strategies