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Viewpoint

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Sen. Durbin Has Unleashed a Deluge of Unintended Consequences on the Prepaid Industry (with the Fed's Help)

By Brad Fauss, Executive Vice President and General Counsel, Prepaid Solutions Inc.

The purpose of this Viewpoint is (1) to describe the unintended consequences created by the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was compounded by the actions of an overly cautious Board of Governors of the Federal Reserve System (the Fed) in drafting the proposed implementing regulations (See 12 CFR Part 235: Regulation II; Docket No. R-1404; "Debit Card Interchange Fees and Routing") (the Proposed Regulations) and (2) to encourage each reader to provide a written response to the Fed before the expiration of the public comment period on Feb. 22, 2011, and adoption of the final implementing regulations by the Fed (the Final Regulations).

As you will see after reading this Viewpoint, Sen. Durbin has wreaked havoc on the debit card payment infrastructure without any apparent consideration of how the system operates today, which probably shouldn't be too surprising after reviewing much of the other over-regulation that came out of Washington, D.C., in the 111th Congress. In addition, it is clear that the Fed now has adopted a much more literal approach in interpreting legislation after getting beaten up repeatedly by certain members of Congress for not being tough enough on various industries. The end result is the extremely harmful over-regulation that appears in the Proposed Regulations promulgated by the Fed.

The Durbin Amendment and the Proposed Regulations regulate prepaid cards in three primary areas. In particular, the Proposed Regulations provide for the following:

1. Cap on debit card interchange fees;

2. Network exclusivity restrictions; and

3. Transaction routing requirements.

Provided is a brief description and commentary on each of the key components of the Proposed Regulations.

Cap on Debit Card Interchange Fees

Durbin Amendment Requirements. The Durbin Amendment requires the Fed to adopt regulations that will cap debit card interchange fees at an amount that is "*reasonable and proportional*" [emphasis added] to the cost incurred by the issuer with respect to the transaction. In addition, the Durbin Amendment permits (but

Brad Fauss is executive vice president and general counsel for Prepaid Solutions Inc., a payments company offering comprehensive prepaid debit card solutions for corporate clients, self-banked and underbanked consumers including payroll cards; general purpose reloadable cards; and loyalty, award and promotion cards. Fauss is a payments industry veteran with more than 10 years of electronic transaction processing experience, including leadership positions at Global Payments and TSYS Prepaid, as well as law firms Parker Poe Adams & Bernstein LLP and Alston & Bird LLP. Fauss is an active member of the NBPCA and sits on both its board of directors and executive committee.

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does not require) the Fed to adjust the allowable interchange fees for certain fraud prevention costs incurred by the issuer but only if (i) such adjustment is reasonably necessary to make allowance for the costs incurred by the issuer in preventing fraud for its own electronic debit transactions (e.g., not for other parties involved in processing electronic debit transactions such as merchants) and (ii) the issuer complies with fraud prevention standards established by the Fed.

Direction to the Fed. In prescribing the interchange fee regulations, the Fed was directed to consider the functional similarities between (i) electronic debit transactions and (ii) checking transactions that are required to clear through the Federal Reserve System at par. The Fed also was directed to distinguish between "(i) the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction," which can be included in determining the allowable costs and "(ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction," which costs cannot be included in the determination of allowable costs.

Interpretation by the Fed. As a result of its analysis of surveys received from card issuers, the Fed provided alternative proposals to implement the above requirements: (i) an issuer could recover an amount equal to its average variable costs to process a debit card transaction, subject to a safe harbor of 7 cents per transaction (without having to perform any calculation) and a cap of 12 cents per transaction; or (ii) each issuer can recover a flat amount equal to 12 cents for every debit card transaction.

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> —Brad Fauss, Prepaid Solutions Inc

Commentary. After reviewing the Proposed Regulations, my first question is: when in American history has the government imposed a fee cap that didn't at least cover the regulated entity's costs? The most astonishing point with respect to the two interchange proposals is the fact that the surveys collected by the Fed determined that the median total transaction costs for processing a prepaid card transaction is more than 63 cents per transaction—without figuring in any fraud costs (see footnote 25 to the Proposed Regulations). In addition, the Proposed Regulations didn't factor in the vastly different cost structures for processing signature-based debit transactions vs. PIN-based debit transactions.

For example, a signature-based debit transaction generally is processed over the rails of the card brands (Visa, MasterCard, American Express or Discover) and provides zero liability protection to the cardholder, which, by itself, has an inherent cost to the issuer. In contrast, a PIN-based transaction generally is processed over the rails of a debit payment network, such as NYCE, Maestro or Interlink, which has a completely different cost structure.

In addition, the card brands generally provide for multiple levels of debit interchange to be paid by merchants because of varying risk levels for each type of transaction. For example, a card-present signature-based transaction at a grocery store has a much lower level of risk than a card-not-present transaction processed by an Internet retailer, and the different levels of interchange reflect the varying levels of risk to the issuer, which retains the liability for fraud losses under the card brand rules.

The one-size-fits-all approach adopted by the Fed may provide all industry members with an easier means of compliance, but it completely ignores the numerous factors (and varying costs) that are incorporated into the debit card interchange system. While I cannot completely fault the Fed as it inherited a virtually impossible task, I believe the Fed's approach in implementing regulations affecting the complex debit card interchange system today demonstrates some of the many flaws in the Durbin Amendment including the dangers of having senators and congresspeople draft

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legislation on topics on which they have only superficial knowledge and then pushing the legislation through the process without any substantive hearings on the topic.

The point is brought home by the fact that the two members of Congress whose names are on the comprehensive legislation in which the Durbin Amendment was attached, Sen. Christopher Dodd (D-Conn.) and Rep. Barney Frank (D-Mass.), have spoken out publicly regarding the fact that the proposed interchange caps are entirely too low and that they believe the Fed is overreaching in its Proposed Regulations.

Furthermore, the Fed should have concluded, as part of its analysis, that there aren't many functional similarities to a check being cleared at par through the Federal Reserve System. When the costs of the manual processes involved in processing a check are included, a prepaid card is a significantly less expensive substitute.

In addition, the fixed costs necessary to process prepaid card transactions through the network rails (Visa, MasterCard, American Express and Discover) are significant compared to the fixed costs required to build the infrastructure necessary to process checks. If the Fed wants to develop the infrastructure necessary to process debit and prepaid card transactions, it has had ample opportunity to do so. The Fed, however, has not engaged in building out this complicated and resource-intensive infrastructure, leaving it to the ingenuity of private enterprise. But now, the Proposed Regulations suggest that private enterprise should be willing to provide this service *at a significant loss.*

Exceptions to the Interchange Cap

Durbin Amendment Requirements. Pursuant to the Durbin Amendment, there are three primary exemptions to the interchange fee restrictions which are described below:

1. Any issuer that, together with its affiliates, has assets of less than $10 billion;

2. Any debit card or general use prepaid card that is provided pursuant to a federal, state or local government administered program; and

3. Any reloadable general use prepaid card that is not tied to a specific account held by or for the benefit of the cardholder (other than a subaccount or other method of recording or tracking funds purchased or loaded on the card on a prepaid basis) and is not marketed as a gift card.

After July 21, 2012, these latter two exceptions will be lost if (i) the issuer charges an overdraft fee or (ii) the issuer charges a fee for the first ATM withdrawal per month that is part of the issuer's designated ATM network.

Commentary. Although these exemptions on their face appear to be helpful to the prepaid industry, it is not entirely clear that they will be beneficial in the long run. When implementing the lower interchange levels required by the Proposed Regulations, it certainly will be easier for the card brands to install one debit card interchange rate across the board rather than developing a certification system for all of its exempt issuers and exempt program types.

It will be time consuming, complicated and likely expensive for each card scheme to implement a system to certify each of its issuers by asset size as well as each of its programs by BIN type and whether or not each program meets the strict definitions of each exemption. In fact, the Fed hasn't even proposed a method for providing a certification system and has asked those commenting on the Proposed Regulations to provide their input on how this issue should be handled. Furthermore, the card brands will be under intense pressure from the larger financial institutions (from which the card brands receive a majority of their revenues) to impose the lower interchange fee structure across the board to level the playing field between large and small issuers.

The key point is that the card brands are not required to maintain the current debit card interchange structure for exempt programs. The Proposed Regulations require lower debit interchange fees on covered programs but are silent as to whether or not the card brands need to keep higher rates in place for exempt programs. Although Visa recently has announced that it will implement a two-tiered interchange system to differentiate between large and small issuers, MasterCard has refused to take a position on the issue until the Final Regulations have been adopted by the Fed. Furthermore, the card brands' ability to implement a two-tiered system may be difficult, if not impossible, depending on the requirements contained in the Final Regulations.

In addition, there are some concerns regarding the exemption for general use prepaid cards because of the requirement that the prepaid card cannot be tied to a specific account held by or for the benefit of the cardholder (other than a subaccount).

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Although most prepaid card programs utilize a pooled account structure, there are certain prepaid program types that attach to a specific account for the cardholder. For example, certain payroll card programs, student tuition refund programs and FSA/HSA programs for health care purposes utilize demand deposit accounts (DDAs) or other segregated accounts unique to the cardholder (rather than a subaccount) and theoretically would be excluded from the general use prepaid exemption.

As a result, the out-of-pocket costs to cardholders for these types of programs likely will increase as issuers will need to recoup the lost revenue somewhere. I seriously doubt that this was the intention of Sen. Durbin, but it again highlights the dangers of pushing through legislation without appropriate knowledge of the subject matter. The key message is that issuers will not provide these beneficial products at a loss. If Congress desires to regulate all fees that are being charged for prepaid card products, the end result is that these hugely beneficial products no longer will be offered.

Network Exclusivity Restrictions

Durbin Amendment Requirements. The Fed is required to adopt regulations that prohibit an issuer or payment network from restricting the number of payment card networks through which a transaction may be processed to (i) one such payment card network or (ii) two or more payment card networks that are owned, controlled or otherwise operated by affiliated persons or networks affiliated with such issuer.

Interpretation by the Fed. The Fed interpreted these requirements and proposed two alternative methods of compliance:

1. An issuer may not restrict the number of payment card networks through which an electronic debit card transaction can be carried to fewer than two unaffiliated networks (e.g., one signature-based and one PIN-based or two signature-based); or

2. An issuer may not restrict the number of payment card networks through which an electronic debit card transaction can be carried to fewer than two unaffiliated networks for each method of authorization that the cardholder may select (e.g., two signature-based and two PIN-based).

Commentary. The problem with the first alternative is that most prepaid cards are issued only as signature-based cards because of the higher potential fraud loss and money laundering risk when cash access is provided for the card. The Fed's own survey determined that more than 74 percent of prepaid debit cards were enabled for use on signature networks only. As further explained below, since there is no practical method to enable a prepaid card for use on two signature-based networks, the first alternative will require issuers to expose themselves to additional risks from fraud losses and money laundering due to the cardholder's ability to obtain cash access from prepaid cards when it was previously restricted.

As bad as the first alternative seems to be, the second alternative is even worse and, at this point, nearly impossible to implement. In particular, the requirement to enable two signature-based networks combined with the merchant routing restrictions described below would be an operational nightmare (if not impossibility). Can you picture a prepaid card with both a Visa and MasterCard logo on the front? This is really no different than forcing Target to place a Walmart logo on the front of its closed-loop cards and accepting funds funneled through Walmart as a source of payment.

What the drafters of the Durbin Amendment failed to understand is that each network utilizes a unique numbering scheme for its card products, so they can be processed through the payment network rails by a merchant acquirer. For example, the first several digits of a prepaid card signify the BIN range, which enables the merchant acquirer to route the transaction through the proper card brand or payment network to the proper issuer in order to obtain an authorization or decline of the particular transaction. In this regard, Visa card numbers generally begin with a 4 and MasterCard numbers generally begin with a 5, which instructs the merchant acquirer where to route the transaction.

If you layer on top of that the merchants' right to determine where to route the debit transaction (as further described below), how would this new system work? Would all prepaid cards have to begin with the same first digit (one BIN range for all networks) and then the merchant would decide which network attached to the particular card would be used to route the transaction? How would the merchant even know which networks were associated with a particular card if there were no differentiation by BIN range?

The card brands have become extremely efficient at processing their

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own transactions over the years and this new paradigm would virtually require each network to throw out much of its infrastructure that it has perfected over the past 25-plus years to figure out a way to process transactions under the new rules. In fact, it might not even be possible as smarter minds than mine have been trying to figure it out for several weeks without success.

Transaction Routing Requirements

Durbin Amendment Requirements. Finally, the Durbin Amendment requires the Fed to proscribe regulations that provide that an issuer or payment network cannot inhibit the ability of a merchant to direct the routing of debit card transactions.

Commentary. This is the opposite of the paradigm today where the payment networks and the issuers generally have the ability to direct the routing of transactions. As you can see from above, when combined with the network exclusivity requirements, the Proposed Regulations potentially create an environment where no issuer or payment network will be able to comply. In addition, as merchants become more savvy and develop technology to determine the costs of each payment option in real time (which certainly will occur), there is a strong possibility that merchants will refuse to accept prepaid cards that are exempt from the interchange cap requirements. As a result, the usefulness of prepaid cards to unbanked and underbanked consumers will be greatly diminished as merchant acceptance rates significantly decline over time.

Conclusion

While I have attempted to describe many of the negative impacts of the Durbin Amendment and the Proposed Regulations, my commentary only scratches the surface on the numerous impacts of the Proposed Regulations on the prepaid industry as whole. I would encourage all participants in the prepaid industry to review the Proposed Regulations in detail and provide your written comments to the Fed. The comment period to respond to the Proposed Regulations expires Feb. 22, 2011. However, if you don't have time to analyze how the Proposed Regulations will profoundly affect your business, you still should submit a comment letter to the Fed stating that you support the positions taken by the Network Branded Prepaid Card Association (NBPCA) in its comment letter, which should be submitted at least a week before the deadline and posted at www.nbpca.org.

If there ever was a time to speak up about the over-regulation of the prepaid industry, that time is now!