# Comments on the Federal Reserve Payment System Improvement Public Consultation Paper

TO: FEDERAL RESERVE BANKS; FEDERAL RESERVE FINANCIAL SERVICES

VIA: E-MAIL TO: comment@fedpaymentsimprovement.org

INDUSTRY: BUSINESS MERCHANT TRADE ASSOCIATION – RESTAURANT AND FOODSERVICE

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**Introduction:**

The National Restaurant Association is the leading trade association for the restaurant and foodservice industry. The restaurant and foodservice industry consists of roughly 980,000 locations nationwide with estimated sales of $660 billion accounting for roughly 4% of our nation's GDP. The industry is also the 2nd largest private employer in the United States with over 13.1 million employees. Roughly 90% of the industry consists of small business owners. For an industry of this size and scope in which we serve roughly 130 million meals a day, the impact of a healthy United States payments market is tremendous.

Our industry is extremely diverse encompassing many different types of point-of-sale environments that create unique challenges beyond what many Main Street brick and mortar businesses face. At quick service and fast casual restaurants, there are traditional pay-at-the-counter services, but there are also drive-thru operations. These types of businesses are also exploring the use of kiosks as well as online and mobile phone ordering. At pizza companies, customers often use e-commerce channels to order online. At foodservice locations, such as sports stadiums, there are a growing number of concession options, such as in-seat food delivery. At catering operations, transactions may be run at locations away from the company headquarters. At food trucks (many brick and mortar restaurants now have them) the payment is also transacted offsite using handheld card readers. At lodging and hospitality venues, reservations requiring pre-authorizations are held on credit cards. Finally, at most table-service restaurants the server takes a card away from the table to run it at a point-of-sale station. We are also one of the most tip-oriented industries in the United States, which creates additional payment transaction challenges.

The nation's nearly 1 million restaurants are extremely excited about the emerging mobile commerce market, and the payments efficiencies and improvements that can be recognized in a mobile environment. For restaurants and retailers, innovation in payment-card pricing has been non-existent for more than 60 years. Restaurateurs see real potential in mobile commerce to change that dynamic, and are ready to embrace any technology that can provide guests with secure, efficient, less costly payment options. Price competition, and the increased innovation and efficiencies that come with more competition, will benefit both restaurateurs and our guests. Restaurateurs also believe that mobile commerce will open up new ways to interact with guests and create the potential for a more open and transparent payments system. Payment trends in restaurants show that guests are demanding new options.[1]

[1] http://www.restaurant.org/downloads/pdfs/advocacy/restaurant_payments

We commend the Federal Reserve Board for their leadership in consulting with a variety of payments stakeholders as part of an open process, and our industry looks forward to continuing discussions well beyond this consultation paper. The future of payments is critical to how our industry will ultimately interact with our customers as the United States begins to adopt new ways to pay, including payments as one component of mobile commerce and other emerging technology solutions. Our comments will address the need for an open and interoperable payments standards process in the United States that emphasizes consumer value, while focusing on cost efficiency and security – items we view as necessary improvements from the existing legacy payments system. While we understand the value of near ubiquity in the current payments landscape, we would argue that such ubiquity and the dominance of just a couple of large market players has led to a lack of efficiency and innovation in the payments space over the past several years. Opening the marketplace to a more fair and transparent dynamic will help cultivate an environment for new market entrants and will drive innovation and competition that will benefit the restaurant industry and ultimately our customers.

Thank you again for the opportunity to provide feedback as part of the consultation process, and we look forward to continuing discussions in regard to the future of payments in the United States.

## **Current Environment**

The introduction of mobile commerce to the United States presents a tremendous opportunity to address and correct many of the shortcomings and inefficiencies in the current legacy payment systems. The National Restaurant Association published a policy paper on mobile commerce earlier this year available here. Those changes to the legacy system as the United States transitions to a mobile commerce environment will only reach their greatest potential in improving speed, efficiency, accessibility, and security if the burden of those changes is shared equally by all stakeholders. In our view, there are numerous inefficiencies in the current payment system. While legacy systems enjoy a great deal of ubiquity, we believe the societal costs of systems that lack competition have greatly outweighed both the merchant and consumer benefits. Despite improvements in technology and increases in volume, the market dominance possessed by certain incumbents in the credit card market has resulted in significant card acceptance cost increases since the mid-1990's. This is in part because the market power of the major brands has allowed them to force take-it-or-leave-it card acceptance rules upon merchants without any real negotiation. The negative impact of this approach is that card networks effectively force merchants who do accept cards to keep those costs hidden, resulting in inflated fees to all consumers. Those inflated fees are reflected in the cost of all goods and services resulting in higher prices for all consumers regardless of what payment mechanism a customer uses to complete the purchase. Credit card market concentration has also led to lack of product innovation, and huge security concerns for merchants and our customers as we struggle to protect a customer product that relies on 1970's technology. We strongly urge the Federal Reserve to closely examine why the U.S. payment card security market has severely lacked in any real innovation to the product over the past several decades, and we encourage the Federal Reserve to take a more active role in encouraging the creation and acceptance of fair, balanced, and effective third-party governed fraud prevention standards that apply equally to all business stakeholders in the payments chain.

As we begin to assess the future of the payments landscape in our establishments, the core industry priority is a smooth integration of a well-functioning mobile commerce marketplace. There are several components to the mobile landscape that we hope will deviate from the existing legacy systems. First, balanced and inclusive stakeholder involvement is critical. <u>The Federal Reserve's initiative and leadership as a facilitator of conversation in the consultation process is a tremendous step in the right direction.</u> Second, balanced and inclusive stakeholder input into an open, interoperable, and widely-accepted payments system is the base component to helping alleviate other existing concerns and drive other priorities to fruition. Third, increased transparency in the entire system will help merchants and consumers make informed choices about payment acceptance products and services.

With strong leadership from the Federal Reserve and other facilitators, we believe the adoption of the first three priorities will help lead to cost efficiencies for both merchants and consumers on a per transaction basis, as well as in regard to business infrastructure investment options. Additionally, adoption of those priorities should lead to a more balanced approach to payment card security in the United States that incentivizes all stakeholders to invest in the most secure technologies available. The Payment Card Industry (PCI) Data Security Standards do not allow for appropriate input and influence by the merchant and cardholder communities, and is not a sustainable business model for the future. The PCI Council must be replaced by a legitimate standards making body. In no way should the Payment "Card" Industry Data Security Standards be the fallback standard as we transition to mobile commerce and different emerging technologies and access "devices." The PCI standards group has yet to prove any real effectiveness in creating a less fraud prone product or reducing the marketplace for illegally-obtained consumer card data in the United States.

**Priorities for the Future:**

1. **Standards development:** The creation and maintenance of open standards is critical so that operators have the tools to budget and plan IT projects, as well as to make infrastructure investment decisions on both hardware and software. Standards are also critical to creating a ubiquitous system for different payment processes, such as refunds, returns, fraud, and system outages regardless of the technologies used to access the payment. Additionally, merchants partner with a variety of technology hardware and software providers – any of which may touch a single transaction at some point – and uniform standards are critical to ensuring those technology providers have systems that are able to "talk" or interact with one another. Having a single, interoperable standard will help simplify payments for the consumer, not just the business.

   One challenge with the Federal Reserve facilitating the creation of uniform, interoperable payment standards going forward is what enforcement authority, or lack thereof, might exist to press full stakeholder adoption of such a standard. While industry is usually a proponent of voluntary principles, the National Restaurant Association has concerns that if certain stakeholders – such as the major card brands – try to push alternative standards, it will limit the value of a voluntary standard. In this instance, as a result of the ubiquity of the major brands, the industry and other merchants will have additional compliance and investment burdens with any network-mandated (and penalty-enforced) changes or policies. This is one primary reason current network rules should only be applicable to a plastic card environment; automatic card network enforcement of many of the rules on mobile commerce transactions has tremendous capacity to stifle innovation, which is bad for business, bad for the consumer, and bad for the economy.

   We recognize technology and consumer payment preferences are advancing rapidly, but these new consumer expectations require significant infrastructure investment by merchants, and we would rather slow down and develop a reliable, and possibly wholly new platform, as opposed to continually patching holes in a broken system. As the Federal Reserve contemplates standards creation, it is critical that adequate phase-in timeframes are discussed and all business stakeholders share equally in the cost of supporting the system.

2. **Transparency:** Costs of card acceptance are largely hidden to both the customer and the business-owner. With over 300 different Visa and MasterCard credit card rates[2], and no strong identifiers on the cards in market, it is virtually impossible for businesses to reconcile whether or not they are being charged correct (or

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[2] http://www.gao.gov/new.items/d1045.pdf. Pg. 15.

listed) fees on the plastic cards passing through their systems. With new dis-intermediaries potentially involved in mobile commerce payment transactions, it is more critical than ever that the system and costs be made fully transparent and clear for small merchants. Small business owners and franchisees need to be able to comparison shop in order for a truly competitive environment to exist.

It is also important from an economic efficiency standpoint, that consumers understand the social costs of paying with certain forms of payment. Those costs are largely hidden by card network rules in the legacy payments environment, but it is critical to make those costs more transparent in a new landscape to encourage consumers from using the most egregious and expensive products. Lastly, more transparency for merchants around which products (i.e. prepaid cards) are being swiped at the point-of-sale would help our industry better manage complicated transactions, such as prepaid or network-branded gift card sales in a tipped environment. Requiring card issuers to provide detailed information about product BIN numbers or other identifiers would help reduce problems in managing payments on certain complex card products.

3. **Cost Efficiency:** The number one concern restaurant treasury professionals have with the current system is escalating costs. For debit cards, according to Federal Reserve survey data, over 90% of covered issuer transactions under the debit card fee reasonable and proportional cost standards, cost less than two cents to process. The fees previously and still currently being charged on these transactions grossly exceed those amounts. The average debit card swipe prior to the debit fee reforms was over forty cents – that's an exceptional markup from cost. The average rate after the rulemaking is closer to 22 cents - still a tremendous markup of well over ten times the actual cost - and evidence that the market is not functioning in a truly efficient manner. Allowing inefficiencies such as this to persist in the marketplace creates disincentives for the development of more innovative and secure products.

   Additionally, many quick-service restaurants with low-dollar average tickets saw their debit card rates increase as a result of the manner in which the Federal Reserve implemented rulemaking authority under Section 920 of Dodd-Frank. The way in which the two major signature debit card brands responded to the rule by increasing rates on these small dollar transactions is further evidence the competition is still deficient in the system, and needs to be improved going forward.

Credit card fees are closer to 2 to 3% of transaction costs – some estimates from Aite Group even indicate our industry average is over 4%[3] - and while the business model for products are different, the transaction processes are similar, and should have similar authorization, clearance and settlement costs. Fostering a competitive environment for all types of card transactions is essential to creating cost efficiencies across the board.

Network and other processing fees outside of interchange fees, are major cost components of card acceptance. Network fees also need additional oversight and transparency. A few years ago, the major card brands changed their network fee structures increasing fees by over 200%, and both major brands did so within 6 months of one another. This behavior need to be heavily scrutinized going forward, as do ever-changing fee structures, such as the Visa FANF, that have the potential to severely limit competition from other market entrants.

Competition authorities in several countries, such as Australia, Canada, and Europe have sought to limit fees, as well as reform card network rules that keep costs hidden from businesses and consumers. While the banking system is in the United States is different from systems abroad, we strongly encourage the Federal Reserve to review the efficiencies gained by reforms and proposed reforms abroad, including how curbing issuer fee revenue has facilitated investment in better fraud prevention technologies by all stakeholders.

4. **Legacy Rule Limitations:** The most prohibitive card network rule is the Honor All Cards rule, which pigeonholes merchants into accepting multiple different products offered by a single brand without knowing what costs will be associated with such products. Rules like this should not be tolerated in the future payments system. This rule is about forced product acceptance, not about acceptance of large issuer cards vs. small issuer cards, which we do not in any way discern. Not only does Honor All Cards limit the ability of merchants to choose not to accept certain card brand products with the highest costs, it also limits opportunities for new market entrants.

   We firmly believe plastic credit and mobile credit transactions associated with a singular brand are not covered by the Honor All Cards. Given the ubiquity of the major card brands, any application of the rule across mediums – making plastic and mobile synonymous - would help legacy leader's cement a stranglehold on the emerging mobile commerce and payments markets to the detriment of

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[3] Horovitz, Bruce. "Twitter Icon Wants to Fix How Fast Food Does Business." *USA Today*. April 29, 2013. http://www.usatoday.com/story/money/business/2013/04/29/jack-dorsey-square-register/2113529/

innovation and progress in payments system security, efficiency, and accessibility.

Additionally, any card network rules or procedures that limit merchants from making network routing decisions on any type of transaction could have negative impacts on the efficiency of the overall system.

5. **Payment Security Improvements:** Merchants and issuers (not networks) bear the majority of fraud losses in the system. Most of the fraud exists because stakeholders are being forced to protect an old, lackluster card product. According to Consumer Reports, the United States is the only country in the industrialized world still relying on 1970's magnetic (mag) stripe technology.[4] Any interoperable, uniform standards should include fraud prevention, mitigation, and resolution provisions in order to ensure the United States is able to remain competitive with the rest of the industrialized world to prevent rampant fraud from flowing across our borders into the country.

   The current system is not working for our industry. Fraud protection and prevention is important to our brands and our customers; however, the Payment Card Industry (PCI) Data Security Standards are too complex for the average small business, and the standards are more about assigning blame in the event of a data breach than preventing it in the first place. The PCI standards are costly to implement and maintain, and they provide no liability protections for merchants because if a merchant is breached, they are no longer in compliance even if they passed an audit seconds before. The certification and audit process is also costly and inefficient. In short, the PCI standard is not sustainable for the restaurant industry and we are hopeful that a balanced approach to fraud prevention and mitigation will be undertaken by a true, accredited standards-setting organization that facilitates equal participation from all stakeholders.

   We also believe standards will be able to re-address current chargeback practices, especially the most egregious ones related to tip pre-authorizations. Real-time clearing has significant potential to create a more efficient payment processing system in tipped environments and we are supportive of the Federal Reserve's efforts to transition U.S. payments to a real-time clearing system. In many restaurants, we are hearing of more and more issuers charging back (or essentially keeping for themselves) any tipped amount that's over the 20% pre-authorization limit. This is an egregious emerging practice that must be stopped before it becomes commonplace. Consumers split restaurant checks in a variety of

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[4] http://www.consumerreports.org/cro/magazine-archive/2011/june/money/credit-card-fraud/overview/index.htm

different ways so there are numerous examples in which the consumer will tip more than 20%.

Real-time clearing may also help alleviate the practice of issuers placing holds on transactions and posting payments out of transaction order. Both practices create scenarios in which the merchant might get blamed for an overdraft incident, but whereby the issuer was the responsible party for the posting order. This practice is bad business for restaurants and our customers, and we support market solutions that would help limit it.

6. **Mobile Commerce Advancement:** The room for market efficiencies in mobile commerce is significant. As we have noted, the restaurant and foodservice industry is extremely engaged in bringing customer-facing technology to our patrons. According to the *2014 Restaurant Trends Survey*, forty-eight percent of restaurant operators said they plan to devote more resources to customer-facing technology in 2014, including mobile payment options. However, restaurant operators also cited numerous challenges that make it more difficult for their restaurant business to add these technology options, including cost of implementation (72%) and per transaction/usage costs (38%). Looking forward, 76% of limited-service operators and 53% of full-service operators said mobile payment options (one of the many components of broader mobile commerce strategies) will become more popular in their respective segments in the future.

   The technology capacity to reduce fraud on a mobile commerce transaction is also exceptional compared to the capacity on a plastic magnetic stripe card. We believe there could be an opportunity to provide payment guarantee on card transactions by eliminating chargebacks. If card networks and issuers want to claim merchants receive a payment guarantee when card products are used, this is something that must be made whole as the U.S. payments system moves forward because merchants receive absolutely no guarantee in the current environment. Payment guarantees may be possible due to the potential improved authorization capacity in mobile, especially to determine the validity of a transaction in real-time. These capabilities should help reduce or eliminate counterfeit and lost and stolen fraud, as well as the practice of charging back tip amounts above the 20% tip pre-authorization threshold – something, as we previously noted, we believe is becoming more commonplace even when fraud is not expected or reported on the charge. With real-time clearing, tip <u>pre</u>-authorization could become an outdated practice, which would benefit the industry and our customers.

   Additionally, there are several policy issues that need to be addressed in relation to mobile commerce. An open standards process can help flesh out some of those issues. For example, a common, technology-neutral contactless chip card standard with open access for all networks would be efficient from an infrastructure and end-user competition standpoint. Furthermore, liability and fraud processes need to be outlined to allow stakeholders to reasonably estimate their fraud risks, and give consumers the proper tools to report and combat any payment card fraud associated with a transaction initiated from their device.

Lastly, it is critical that there are clear standards distinguishing between an e-commerce (website/desktop computer) transaction and a mobile smartphone transaction, especially in the event that card-not-present rates are maintained separately and have different rules and rates than card-present transactions. In the event of a smartphone transaction, geo-fencing technology and user verification technology may be implemented if a customer is in certain proximity to the restaurant. We expect these enhanced verification methods will be taken into account and will also enable standards organizations to eliminate card-not-present rates on the majority, if not all, smartphone transactions.

**Conclusion:**

We again commend the Federal Reserve for their leadership in this initiative. We are hopeful that in moving the United States payments landscape forward, we can shed the preconceived notions that ubiquity in the current system is an asset. As we have noted, we believe ubiquity, while it may provide some convenience to businesses and our customers, has led to a severe lack of innovation and efficiency in the payments system. Mobile commerce and emerging technologies provide a free market avenue to correct these inefficiencies.

Increased transparency, the creation and governance open and interoperable standards, and limiting the ability of duopolies to dictate payments standards, fees, and rules are all steps in the right direction toward maintaining U.S. competitiveness in the global payments system. The restaurant and foodservice industry is excited about the prospects of increased security, payment guarantee, cost efficiencies, real-time clearing, and other features that can be realized as the U.S. payments landscape evolves over the next decade, and we look forward to working constructively with the Federal Reserve on these initiatives.

Thank you again for the opportunity to provide feedback.