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To: Federal Reserve Banks' Financial Services Policy Committee

Comments of the National Retail Federation on
September 10, 2013 Public Consultation Paper
Payment System Improvement

Introduction

The National Retail Federation (NRF) appreciates this opportunity to provide comments on Payment System Improvement – Public Consultation Paper. By way of background, NRF is the world's largest retail trade association, representing discount and department stores, home goods and specialty stores, Main Street merchants, grocers, wholesalers, chain restaurants and Internet retailers from the United States and more than 45 countries. Retail is the nation's largest private sector employer, supporting one in four U.S. jobs – 42 million working Americans. Contributing $2.5 trillion to annual GDP, retail is a daily barometer for the nation's economy. As the predominate payees in the consumer marketplace, NRF's members are particularly affected by the current and evolving state of payments.

The Federal Reserve's serious examination of these issues is both very much appreciated by the retail community and essential to our nation's long term financial health. Significant portions of the U.S payment system have lagged that in other industrialized nations and will continue to do so unless the current imbalances are righted. We commend the Federal Reserve for taking this opportunity to offer a fresh, broad look at the many aspects of legacy and emerging payment systems. Continued efforts in this regard facilitate not only the Federal Reserve's own work, but will allow the Fed to provide particularly meaningful insights to both business and legislative entities.

For too long other commentators have viewed payments primarily from the perspective of the financial services industry. While that view is of obvious importance, it is not synonymous with a fully functioning payments system. The Federal Reserve's willingness to look beyond that box and explore the "end-to-end payment process" provides a necessary balance to the too focused perspective of the past. The Consultation Paper ("the Paper") raises intriguing questions. We anticipate there will be several specific responses. Consequently, NRF would like to address some of the broader issues. These comments approach the questions in an order more reflective of the retail industry's focus.

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The Paper summarizes in part: *The challenge for the industry is to provide a payment system for the future that combines the valued attributes of legacy payment methods – convenience, safety, and universal reach at low cost to the end user – with new technology that enables faster processing, enhanced convenience, and the extraction and use of valuable information that accompanies payments.* We agree, although not all of these elements are of equal importance.

Ubiquity versus End User Experience

At the outset, we urge the Fed not to place too high a premium on "near ubiquity." One needs to keep clear the distinction between payment systems and payment. Payment may be individualized. From an end-to-end perspective, trade may be accomplished through simple mechanisms of exchange such as bartering or denominated tokens. The accumulation of such transactions may create an inherent and reasonably satisfactory payment program. Importantly however, although the program may ultimately tie into a more ubiquitous mode of payment, such as currency, these programs can be successful despite the fact that they are not themselves anywhere near ubiquitous. Ubiquity of all systems, while somewhat desirable, need not be an essential element.

We raise this point because outside of the immediate payment of cash, the simple method of credits and debits for many years formed the basis of retail payment programs. In small town stores consumers made payments "on account," settled periodically with cash – as commonly occurs with B2B programs today. The point, however, is that many merchants ultimately expanded these accounts to develop very extensive "retail credit programs," developed solely under state law, and totally independent of the banking-based consumer credit with which we are all now familiar. A limited number of retailers still maintain retail credit systems.

A prominent feature of those programs is that they could generate tremendous customer loyalty benefits to the offering retailer in the terms of regular, repeat sales based on convenience of use for the consumer and unique knowledge of the customer by the retailer. The beneficial effect was to make operation of the payment program near costless to the merchant.[1] In this way, these payment programs resembled the low (or at par) costs associated with other forms of payment such as cash and (due to the Fed's involvement) checks. While the latter two forms of payment are not entirely costless – either can be counterfeited and collection must be completed – the party handling that immediate portion of the payment process has a natural incentive to ensure the reliability of the transaction and seek the most cost effective method of doing so.

[1] This should be distinguished from the fungibility of the accounts should the merchant seek to sell the business or trade against the receivables.

Cost

Thus, in examining payment systems, one important characteristic for Fed consideration, is the perceived cost of that system to end-users. It is not surprising that the most prominent of the newly emerging payment programs attempt to reprise the retail credit model and combine data analysis and ease of use with payment in order to minimize net cost. While the popularity of state-based retail credit programs fell out of fashion due to cyclical business trends and legal changes (e.g. the growth of interstate banking simplified state-by-state credit granting at the expense of the programs being turned over to financial services intermediaries) the principles underlying their operation remain.

This leads to a corollary. The Paper notes the lagging adoption of new payment systems in the U.S. and correctly attributes some of that to high *entry* costs for near ubiquitous system development. Again, near ubiquity of new systems is not the highest priority for all end users. An equally important consideration is that, in the absence of coercion, users are reluctant to migrate to a system that presents unacceptably high *operating* costs or other restraints. Instead, they will first seek mechanisms that potentially reduce the operating costs within legacy systems. Some merchants' efforts to reduce credit card costs by deploying reloadable in-house payment devices is one example.

From an end-to-end perspective, the importance of operating cost as an impediment to payment system development cannot be overstated. Most sophisticated end users are exquisitely sensitive to cost. For example, to reference another industry, health insurance companies are limited in the amount they can collect for all non-health related purposes to approximately twenty percent of premiums. Property and casualty insurers are often limited by state law. If the cost of payments approaches 2 percent, then conceivably ten percent or more of their potential operating expense is subsumed in just the act of receiving direct payment. Consequently paper checks are strongly encouraged by insurers.

The retail industry does not face the same legal constraints, but is restrained by competition such that net profit margins are in the range of 1 to 3 percent. All other things being equal, the comparably high cost of alternative payments systems would exert a significant drag on adoption. These costs are borne only because the legacy systems' existing market power makes their adoption near unavoidable, regardless of how unacceptable. However, new payment systems will not be welcomed unless they can address this burden without undermining other factors involved in retail/customer interaction. Unfortunately, too many of the supposed new entrants, seeing the high costs of entry and the ability of established players to use that same market power to thwart the potential entrants' viability, instead co-opt their payment system developments and instead "add on" twists to already expensive legacy systems. While the twists may be innovative, the final cost is prohibitive.

Competition

The Paper asks what role the Federal Reserve Banks might play. Minimizing friction in payment systems is a goal the Fed should encourage. Competition is one means of achieving it. Where the Fed can establish mechanisms to encourage competitive development, it potentially enhances the operation of all payment systems. Retailers' use of decoupled debit builds on current structures. To go further, expanding and improving the relatively inexpensive ACH network, as suggested, could not only provide the backbone along which new entrants could fashion enhanced, contemporary "add on" services, it and they would provide a competitive check against excessive rent taking by other systems, minimizing friction.

Competition works, but only where markets are truly open and pricing is transparent. There are too many situations in today's payment ecosystem where neither is the case. Strategic intervention when either is missing should not be discounted.

Security

Electronification of payment systems offers enormous potential, but it is not an unalloyed good. It can enhance the speed of transactions and carries the potential to lower many costs. However, as the Paper acknowledges, the transformation of "money' into electronic digits can raise significant security concerns. The speed, reach and *etherness* of electronic transactions means their attractiveness to criminals is particularly potent. Current card technology is especially vulnerable. Pending Chip and PIN implementations in the U.S. (and most certainly Chip and Signature implementations) are already a generation out of date.

For example, the enormous growth in what is referred to as "identity theft" is in large part a consequence of the electronification of essentially alpha-numeric identities. Depending on the nature of the theft, the resolution and subsequent protection cost for individuals can be significant. The equivalent consequence in the financial payments sphere has been an ever escalating series of security requirements which, since it is within the power of the legacy payment system operators to impose, are borne predominately by end users. That is neither appropriate nor efficient. The cost of eliminating fraud in an electronic payment system should primarily be borne by the entity promulgating adoption of the system. They are in the best position to control that system.

By way of comparison, the U.S. government has undertaken yeoman efforts to maintain the integrity of paper currency, shielding end users from other than generally expected and accustomed costs of criminal activity. It is perhaps in part for this reason that, as the Paper notes, "use of currency has held steady in recent years and is expected to remain an important component of the U.S. payment system." Alternative payment systems that violate these precepts are unlikely to maintain anything other than an artificially supported viability. Open competition ultimately will negate that temporary advantage.

The use of mobile technology, essentially very powerful computer technology, is a potential avenue for broader, safe adoption of electronification. One goal of the Fed should be to ensure that mobile remains a neutral platform for competition and that existing payment systems operators do not muscle out relatively frictionless entrants by using “Honor All Cards” rules or other arbitrary and mandatory “Rule” mechanisms to dominate this emerging technological opportunity

Conclusion

In conclusion, we appreciate the willingness of the Fed to meet with end users, to consider our concerns, both specific and policy, and to incorporate those into future actions with regard to payment systems. The potential the Paper paints is real and would be welcomed. Its realization depends on the encouragement of transparency and competition and the vigilance and guidance of those in a position to oversee the essential elements of U.S. payments.

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