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FOOD MARKETING INSTITUTE
RESPONSE TO FEDERAL RESERVE PAYMENT SYSTEM IMPROVEMENT DISCUSSION PAPER
December 13, 2013

The Food Marketing Institute proudly advocates on behalf of the food retail industry. FMI's U.S. members operate nearly 40,000 retail food stores and 25,000 pharmacies, representing a combined annual sales volume of almost $770 billion. Through programs in public affairs, food safety, research, education and industry relations, FMI offers resources and provides valuable benefits to more than 1,225 food retail and wholesale member companies in the United States and around the world.

FMI applauds the Federal Reserve's interest in improving the payments system in the United States, and appreciates the opportunity to provide insight from the perspective of the food retail industry. FMI members range from large multinational chains to individual single store operators, all of which operate as the point of sale in the payments system. In short, grocers have direct contact with the consumer at the time of purchase, serving as the acceptor of the various forms of payment tender.

While retailers operate a vital role in the payments realm, with millions of point of sale locations processing over $8 trillion in transactions annually, they have historically not shared the influence in payment policy or market power of other stakeholders like the card networks and issuing banks. Grocers were naturally focused on selling food at an average 1% margin and keeping up with other retailer competitors, not the evolving payments market. As consumers moved to greater reliance on credit and debit, retailers saw dramatic increases in the cost of accepting non cash or check tender at the point of sale. In fact, retailers' cost of interchange or "swipe" fees is second only to their labor costs. The current market favors the two largest card networks and the legacy system currently dominating the payments industry. FMI and its members see an opportunity in the development of new technologies, including mobile payments, for costs of acceptance to go down while improving reliability and security in the system.

FMI and its member companies have released a guiding principles paper on mobile payments, and see it as a strong framework for building a secure, reliable system that benefits all stakeholders involved in transactions. The paper, titled "FMI Guiding Principles on the Evolving Payments Market" is attached to the end of FMI's comments for your review. As outlined in the paper, retailers view the transition to mobile as a truly transformational shift in the way consumers pay and the economics behind those payments. Rather than simply transferring the existing paradigm to mobile, merchants believe an opportunity exists to negotiate or improve the terms of acceptance in a manner that is more balanced, taking into account the costs, benefits and risks for all parties.

As retailers are focused on these developments, it is essential that we have a balanced and equitable regulatory system that does not artificially create a market tilted in favor of the legacy networks and institutions.

FMI in general agrees with the “gaps and opportunities” outlined in the Public Consultation Paper. However, FMI does draw some objection to the assumption that “[l]egacy payments systems provide a solid foundation for payments services.” While it may do so for the legacy providers, retailers have lacked any bargaining power with regards to cost or acceptance terms with the current providers. Additionally, the legacy system has successfully blocked any new entrants and competition into the market for decades. As we look to make improvements, and with regards to mobile, building an entirely new platform, relying on a legacy system simply furthers the challenges of retailers and potential entrants into the payments market. With that in mind, we suggest that in the “gaps and opportunities” section of the paper it identifies new technologies that enable “faster processing, enhanced convenience, and the extraction and use of valuable information that accompanies payments” the inclusion of reduced costs to merchants, increased competition and transparency in the marketplace.

In general, FMI agrees with the desired outcomes highlighted in the paper. With that in mind, food retailers are eager to play a vital role moving forward. One suggestion is the creation of an Advisory Board on a national scale that includes all stakeholders including equal representation from merchants. This board would give retailers a long awaited “seat at the table” with regards to payments policy, not just with existing payment forms, but as the market moves into mobile and beyond. In the end, retailers will be tasked with investing significant capital into new point of sale equipment, software, and training. Before making those decisions, retailers should have an opportunity to participate in the formation of the policy and payment structure on the front end. Additionally, retailers could finally enjoy increased bargaining power with regards to acceptance cost, which should be very low, and terms associated with the new payment types.

With regards to specific desired outcomes, FMI in general agrees with the concepts and offers a few thoughts. First with regards to ubiquitous near-real-time payments, FMI supports the general concept, but has concerns with the insistence that it is ubiquitous, as it could tilt the market toward legacy networks insulating them from additional competition. However, FMI supports immediate and accurate notification that the account is in existence and has adequate funds.

Additionally, the merchant community is greatly concerned with protecting consumer data and sharing it only on a “need to know” basis. FMI’s mobile payment paper’s second guiding principle says “ensure consumer data is protected by limiting access by unnecessary parties and requiring clear, conspicuous consumer facing options regarding data." This principle applies not only to mobile, but any retailer-consumer experience. FMI agrees with the concept that in a near-real-time payment transaction the sender should not need to know the recipient's account number, and vice-versa, that recipient should not have access to the sender's sensitive information. This is a large current weakness in today's system. Current electronic retail transactions require the exposure, transmission and often storage of sensitive personal information of the consumer. FMI supports the tokenization of data as outlined in our Mobile Position Paper. Our first guiding principle states "Provide consumers with greater security by leveraging the security enhancing features of mobile devices." Further in the principle, one best practice is to "Leverage dynamic, tokenized payments." This would greatly reduce and even eliminate the use of actual account numbers or credentials. By tokenizing the data, it leaves it essentially of no use to criminals.

Finally, FMI agrees that greater electronification and process improvements have brought greater efficiencies into the system and lowered some stakeholder's costs; others have not enjoyed those savings. While technology has improved, merchants' costs of accepting credit and debit have skyrocketed. As we continue to explore improvements to today's and future payments systems, the current cost to retailers should not be a baseline as it is artificially inflated by the current anticompetitive marketplace. The first step to rectifying this imbalance is to bring real competition and transparency into the marketplace, giving merchants leverage in accepting various payment tenders.

FMI thanks the Federal Reserve Board of Governors for their interest in finding improvements to the payments system in the United States. FMI sees this as the beginning of a productive process, and looks forward to continuing to work to find real solutions for all parties.

Sincerely,

Erik R. Lieberman
Regulatory Counsel

FMI Guiding Principles On
The Evolving Payments Market
December 2013

Food Marketing Institute[1] believes the transition to the use of mobile devices, such as smartphones, feature phones and tablets, will mark an important inflection point in the way consumers make payments, the way cardholder data is secured and the fundamental relationships between merchants that accept payments, networks that process payments and banks that issue payment devices. Mobile devices present a unique opportunity to improve the welfare of all payments stakeholders. When compared to the existing magnetic stripe or integrated circuit chip technology that pervades in the marketplace, mobile devices allow for tremendous enhancements to the ways stakeholders communicate, payments are processed and sensitive information is secured.

Where we are now

Historically, the U.S. payments market has been dominated by two stakeholders. The networks, Visa and MasterCard, which operate virtually free from any real competition, and the card-issuing financial institutions, which profit from this existing status quo, and have always operated in a duopolistic manner. This operation has left the market bereft of competition from new market entrants, whose attempts to compete with the entrenched networks has been squelched by the existing duopoly. Meantime, the existing participants have no interest in upsetting the current dynamic by competing with each other. The lack of competition has allowed the banks and networks to reap huge profits, while other stakeholders – consumers and merchants – have paid in excess of $50 billion annually.[2]

Innovation

Mobile payments remain an emerging industry in both technology and device application. Today's environment does not have one dominant system that retailers and consumers have adopted. There is a broad and diverse group of offerings currently in the marketplace (Appendix). As a key stakeholder, retailers should play a pivotal role in the development of technology and crafting of policy as more transactions shift toward mobile payments platforms.

Guiding Principles

FMI's view is that the transition to mobile payments must provide benefits to all stakeholders. To that end, FMI proposes the following guiding principles for mobile payments:

1. Provide consumers with greater security by leveraging mobile devices' security-enhancing features.
2. Ensure consumer data is protected by limiting access by unnecessary parties and requiring clear, conspicuous consumer-facing options regarding data.
3. Introduce competition that will benefit consumers through a broad reduction in consumer prices.

Guiding Principle One. *Provide consumers with greater security by leveraging the security-enhancing features of mobile devices.*

Background. The payment system we use today is not as secure as it should be. The networks were developed decades ago, using the best technology that was available at that time. The current system relies on archaic magnetic stripe technology, which is capable of holding sensitive data in a static manner that is easily duplicated with inexpensive and readily available equipment.[3] Near field communications changes the way the card's credentials are passed from the card to the payment terminal, but the data elements themselves are basically the same. Banks and networks have shown little interest in securing the system. Instead, they push the costs of fraud back onto merchants through chargebacks and Payment Card Industry Data Security Standards, an onerous set of rules promulgated by the card brands that force merchants to expend millions to try and protect inherently vulnerable payment card information.

Mobile Opportunity. The transition to mobile payments provides all stakeholders with an opportunity to truly secure the payments infrastructure. Mobile devices possess sophisticated hardware and software, which far exceeds the capabilities of existing, card-based form factors. Given this potential, it is essential that the existing status quo is not preserved as the payments industry transitions to mobile.

Best Practices. FMI recommends the following best practices for mobile payments applications:

1. ***Leverage dynamic, tokenized payments***. Reduce or eliminate the use of actual account numbers or credentials. Instead, use one-time tokens and sophisticated algorithms to ensure that sensitive data within the system is of no use to criminals seeking to compromise consumer accounts if a breach occurs.
2. ***PIN Security.*** PIN authentication has been around for decades. Banks insist on the use of PINs to withdraw funds from ATMs because it is highly effective as a means of cardholder authentication. PIN remains the most secure method for user authentication on the market. Mobile payments applications should be PIN-secured to reduce the risk if a device is lost or stolen.

Guiding Principle Two. *Ensure consumer data is protected by limiting access by unnecessary parties and requiring clear, conspicuous consumer-facing options regarding data.*

Background. For centuries consumers have trusted merchants with information regarding some of their most personal decisions, such as prescription information and food choices. For centuries merchants have built this relationship of trust over billions of transactions. In addition to streamlining traditional customer-service scenarios, such as prescription refills and “the usual” coffee order, merchants are able to, with the customer’s permission, use the data to provide customers with increasingly rich experiences, borne out of an ever-deepening relationship. Merchants take their role as the protector of this sensitive information seriously, and take considerable steps to limit access to only those areas of the business that need to know.

Mobile Opportunity. Mobile payments can be a catalyst for even greater customer service opportunities for merchants. The computing capabilities of mobile devices have been truly transformational, and they provide merchants with an opportunity to communicate directly in a way that is highly relevant to each individual customer. With this enhanced capability, though, comes risk. New, extraneous participants in the stakeholder chain might seek to obtain this data that was traditionally protected by the merchants. This additional exposure of data threatens consumer privacy, potentially undermining the merchant-customer relationship.

Best Practices. FMI recommends the following best practices for safeguarding customer data:

1. ***Limit exposure.*** Merchants who engage in mobile payments must ensure they are fully aware of all the parties to whom sensitive customer data will be exposed, and limit exposure accordingly. They should ensure that these third parties protect this data in the same manner the merchant does.
2. ***Transparency.*** Ensure that the customer is made fully aware of the use of data, and provide that customer with a thoughtful, intuitive method to restrict or prevent the use of the data. A short-term boost in sales is not worth the long-term risks associated with undermining the trust merchants have built with their customers.

Guiding Principle Three. *Introduce competition that will benefit consumers through a broad reduction in consumer prices.*

Background. As discussed, for decades the payment card brands, and by association the banks, have successfully leveraged increasing levels of market power to extract high swipe fees from merchants. This inexorably leads to ever-escalating consumer prices. FMI believes that this dynamic is unfair for its members, harmful to consumers and damaging to the economy.

The principle vehicles the networks have used to expand their market power into additional payments markets are their so-called “Honor All Cards” rules. Historically, this rule was used to ensure universal acceptance of a card brand’s credit cards. Some have argued that this was necessary for consumers to understand the products with which they were confronted. Over time, however, Visa and MasterCard have continually expanded their definitions of honor all cards. First, they expanded the definition from credit only to include both credit and debit. More than ten years ago, merchants successfully sued Visa and MasterCard, resulting in a settlement that forced the networks to untie the acceptance of debit from the acceptance of credit. Since that time, the networks have continued to expand the definitions of debit to capture things like Flexible Spending Account cards and prepaid cards.

This rule has served as a tremendous barrier to entry in the card payments industry. In the 30 years since Discover Cards were introduced, not a single new card brand has emerged as a viable competitor to Visa and MasterCard. Rather than having to compete with individual issuers, would-be competitors must compete with a duopoly that controls over 80% of the combined credit and debit card markets.[4]

Mobile Opportunity. Many merchants view the transition to mobile as a truly transformational shift in the way consumers pay and the economics behind those payments. Rather than simply transitioning the existing paradigm to mobile, merchants believe an opportunity exists to negotiate or improve the terms of acceptance in a manner that is more balanced, taking into account the costs, benefits and risks for all parties.

Best Practices. FMI recommends the following best practices to introduce mobile payment competition:

1. ***Insist on a new paradigm.*** Merchants' believe that accepting only those mobile solutions that truly reinvent the payments paradigm is the way to create the best opportunity to maximize value for consumers. Merchants cannot upset the legacy paradigm by allowing legacy solutions to simply graft onto mobile technology.
2. ***Ensure a more equitable allocation of costs.*** Implementing the various mobile payments infrastructure is expensive for merchants. A merchant who is willing to go through the expense of software development and re-terminalization at the point of sale should ensure that some of those costs are borne by the mobile payments provider in the form of advantageous, long-term rates and more favorable rules regarding authentication, chargebacks, and settlement timing.

Conclusion.
The mobile payments industry has yet to be well-defined. There are numerous start-ups and emerging mobile wallet providers all seeking to become the mobile payment brand of choice for consumers, issuers and merchants. Some have met with limited success; some have developed into successful niche providers, while others are in the early stages of incubation. Merchants have long been the validators of currency. Only once merchants are willing to accept a form of payment does that payment gain ubiquity in the marketplace. No level of issuer profitability or consumer rewards can overcome a lack of adoption within the merchant community. This action gives merchants the responsibility to ensure that all stakeholders, especially consumers, benefit from the transition to mobile payments, if there truly is to be a transition.

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[2] NRF Quick Facts: Interchange Fees
[3] Wave3.com: "Technology advances make stealing credit and debit cards easier than ever"
[4] *The Nilson Report*: September, 2013

Appendix

Isis. Isis, a joint venture among three of the largest telecommunications companies, is developing (and charging a fee for[1]) the technology that enables mobile transactions at the point of sale. It ultimately seeks to replicate the existing payments infrastructure – relying on Visa, MasterCard, American Express and Discover to authorize, clear and settle these transactions. Isis relies on near field communication (NFC) to perform a contactless transaction in the same way as is done using a contactless card.[2]

Google Wallet. Google Wallet is a card emulation wallet that uses a staged wallet approach. Consumers load their payment card into the application, which they use to pay for the transaction. From the merchant perspective, the Google Wallet transaction looks like a MasterCard prepaid debit card transaction. It is unclear whether or how it complies with the network routing requirements of Regulation II, as it appears to limit the merchant's routing options to a single network. It relies on legacy NFC technology;[3] merchants enabled to accept contactless payments will be enabled to accept Google Wallet transactions at the applicable interchange and network fee rates. Google has stated that its motivation behind Google Wallet is to gain access to rich transaction-related consumer data.[4]

PayPal. As yet, PayPal has not introduced a true mobile payments platform. That said, PayPal has been making a concerted effort to gain a foothold in brick and mortar payments. PayPal has pioneered an "empty hand" payment wherein the consumer enters a phone number and personal identification number to initiate the payment. PayPal also offers account-holders the option to use a plastic card to complete payments at the point of sale. Further, PayPal has recently announced it will venture into mobile payments, using a QR code and a four digit short code to effect the payment.[5] PayPal accepts all major credit and debit cards, as well as cash and direct transfers from bank accounts to fund its wallet.[6]

MCX. MCX, or Merchant Customer Exchange, is a mobile payment company owned by many of the largest merchants in the United States. MCX has not yet announced the details of its operations, but has made it clear that its vision is to enhance efficiency in payments by providing a secure transaction processing environment, protecting private data and forcing a more equitable approach to the financial dynamics of payments. While many details regarding MCX are not yet public, MCX has announced its intent to leverage QR Code (also known as 2D barcodes) technology in its initial implementation.[7]

Paydiant. Paydiant is a cloud-based, white label mobile wallet and payment solution that enables banks, retailers and processors to deploy a branded contactless mobile wallet. It has a unique offering where existing payment instruments can be used in the mobile payment platform. It provides the retailer with the opportunity to initiate targeted offers to the consumer while maintaining ownership of the data. It provides multiple possibilities for acceptance with security as a key component.

Visa and MasterCard. Neither network has been active in developing a mobile platform of its own. Both appear content to allow others to develop platforms that simply replicate the status quo of mobile payments. This approach, unfortunately, will prevent consumers from enjoying the greatest possible benefit from mobile payments. Replicating the existing infrastructure leaves consumers vulnerable to that infrastructure's existing security flaws, prevents consumers from leveraging all their mobile device's communication capabilities and leaves in place the existing arrangements, which enrich the big banks.

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[1] *NFC Times*: "Paying to Play: Planned Isis Fees Rankle Some Issuers"
[2] Isis Frequently Asked Questions
[3] Google Wallet Frequently Asked Questions
[4] *Huffington Post*: "Google Wallet: Tech Giant Doesn't Want Your Money, Just Your Data"
[5] *Payments Journal*: "PayPal Launches Payment Code for Mobile Transactions"
[6] PayPal Customer Support
[7] *Payments Journal*: "MCX Announces Planned Use of QR Codes"