

Response to Fed Solicitation for comments on Payment System Improvement

The Merchant Advisory Group is a merchant membership association focused on the U.S. payment system. The MAG members include many of the largest merchants in the United States; with members representing virtually every consumer-facing vertical. MAG sponsors include nearly all of the payment brands including regional PIN debit networks, as well as most of the largest merchant acquirer/processors in the United States. The MAG's mission is to drive positive change in the payments industry through collaboration and advocacy toward a vision of an improved and equitable payments ecosystem. The MAG is grateful to the Federal Reserve Banks for the opportunity to comment on the current state of payments and to make its recommendations for payment system improvement.

There is little doubt that the U.S. payment system is witnessing a remarkable period of technological innovation. Much of the innovation holds the promise of improving the cost-effectiveness of payments as well as improving convenience and access to financial services for the general public. The MAG believes there is some question as to whether payment system incumbents will embrace new technology which could lead to more efficient and cost-effective payments or resist change to protect revenue streams inherent in the present system. The MAG agrees that "market forces" have generally shaped payment services in the United States; however, we note these market forces have often worked to circumvent positive change. A notable recent example is the failure to adopt same-day ACH settlement. The MAG believes that intervention by a central coordinating body, as was the case when the Federal Reserve System was created, will likely be necessary in order for the U.S. to overcome the grip of entrenched interests resistant to change. Furthermore, we believe this intervention must occur in the relatively near-term in order for the United States to not fall further behind the rest of the world.

Merchants for the most part have played a relatively minor role in shaping payments in the United States. Payments was seen by merchants as primarily the domain of financial institutions and their networks. Until recently, merchants were willing to leave the business of payments to the financial institutions and networks. The situation has changed as merchants have come to the realization that most of the benefits of today's payment systems are not being shared and the cost of payments acceptance has continued to rise in the face of technological advances and economic improvement. We are at a critical juncture with the advent of the mobile device as a platform for retail commerce. There is an opportunity to revolutionize the shopping experience which can help the United States regain its traditional leadership role in commerce and payments. Merchants feel payments will play a part in the mobile revolution and they have little interest in payment system incumbents using their control of payments to capture the bulk of the economic benefits that will inure to those who embrace the mobile revolution. The MAG shares the Fed's interest in ensuring that payment system improvements meet the needs of "end users", including both consumers and merchants.

The MAG offers the following comments and suggestions to the Fed regarding the **Strategic Direction in Payments**:

- Merchants should be included as equal participants in collaborative efforts
- Merchants have some concerns over the Fed's insistence on near-term ubiquity in payments services since the insistence on ubiquity naturally tilts the scale of influence towards payment system incumbents
- Innovation cannot flourish in a payment environment controlled by forces defending or incentivized with retaining the status quo
- The Fed's traditional responsibility is to maintain the soundness of its financial institution clients, therefore other governmental bodies should be included in efforts to foster change in payments

The MAG generally agrees with the **Gaps/ Opportunities in Today's Payment System** noted by the Fed. The MAG offers some additional comments and suggestions as follows:

- The MAG notes that while check writing persists, major cost efficiencies shared by all constituents have been achieved in recent years due to Check21, a unique recent example of a public initiative in payments
- Many of the desired features listed under point 4 of the document's summary of gaps/opportunities were realized or nearly realized many years ago with the advent of PIN debit networks, unfortunately some of these features have not been fully assimilated by less efficient payments channels. Many of the less efficient payment channels are preferred by large issuers for business reasons which are more compelling to them than technical efficiency. PIN networks have been forced to acquiesce in order to retain their fractional share of the payments business. Cross-border payments are a marked example of the payment systems' failure to address obvious inefficiencies, likely due to the lack of economic motivation for those who could effect change
- Although fraud associated with U.S. card payments is relatively low as compared to markets outside the United States, merchants feel they are financially overburdened (because of PCI rules) with the responsibility of protecting the system from abuse by fraudsters. Traditional mag-stripe cards are susceptible to fraud, especially when they are coupled with signature authentication. The failure to adopt PINs is a notable example of the failure of payment system incumbents to embrace change and to prioritize revenue over security
- Card acceptance is becoming less cost-effective than other forms of payment for merchants due to the reluctance of payments systems incumbents to share the benefits of technological improvements with merchants, to the continuous increases in interchange fees charged to merchants and to the imposition of the costs associated with protecting the system against fraud being imposed on merchants through the application of PCI's pseudo-standards

Finally, the Fed has identified five **Desired Outcomes**, with which the MAG generally agrees. The MAG offers the following comments and suggestions regarding these five.

- The MAG shares the goal of having a collective effort to identify and embrace improvements. The Fed has created an atmosphere conducive to these efforts by opening its efforts to merchants and other payments stakeholders besides traditional payment system incumbents. The MAG believes much work remains unfinished in identifying key improvements
- The MAG agrees with the Fed's stated goals of keeping payments credentials confidential and providing payment receivers with confirmation of good funds. The MAG endorses the goal of ubiquity in a solution, but is hesitant to rely on existing "rails" to achieve ubiquity unless more public sector oversight is provided
- While the MAG agrees that greater electronification and process improvements have provided great efficiencies, the MAG believes the benefits of these efficiencies have not been shared with merchants and other payment stakeholders. Indeed, merchant costs have increased and antiquated processes such as chargebacks have persisted. Efficient markets usually create downward pressure on prices when technological improvements are introduced. Lack of competition in the U.S. market has resulted in both a failure to embrace improvements and increased costs to end-users
- The MAG suggests the addition of a desired outcome as one of improving the consumer experience across all payments channels. The attributes of this goal are a common, less fraud-prone authentication method and a more predictable and seamless consumer payment experience where costs and rules are transparent and market-driven

Fed Solicitation for Comments on Payment System

Merchant Advisory Group Response

Q1. Are you in general agreement with the payment system gaps and opportunities identified above? Please explain, if desired.

- 1. Check writing persists because checks have important attributes, including ubiquity and convenience, which are not well replicated by electronic alternatives for some transactions. Many receivers of checks prefer other forms of payment but exercise little control over the sender to request a preferred form of payment.**

Agree. It is unlikely that checks will disappear anytime soon; and they work well in many situations in which electronic devices are unavailable to conduct a transaction. Unfortunately, costly infrastructure has to be maintained by merchants to process a declining number of checks. Check 21 and advances in mobile deposits have helped with the Return on Investment (“ROI”) for check processing and have had the corollary effect of increasing the utility of checks. Many receivers of checks prefer the low marginal cost of processing checks as well as certain legal advantages provided by UCC rights afforded them, particularly the right to take legal action directly against fraudsters. Merchants have a much higher comfort level with the protections afforded them by the UCC as compared to the administration of card acceptance rules by card networks.

- 2. In a world where several other countries are moving to ubiquitous near-real-time retail payment systems, the U.S. payment system does not have this capability. The U.S. payment system has begun to migrate incrementally toward faster payments primarily through private-sector innovation; but these innovations, when considered in total, have not resulted in a ubiquitous near-real-time system.**

Agree. This is the unfortunate result of a U.S. system that is devoid of incentives to innovate; while providing many participants in the payment system handsome profits for maintaining the status quo. Private sector innovation is motivated by a desire to compete with the existing payment schemes since existing schemes have arbitrarily high costs for merchants and consumers. The United States could easily move to a system with the advantages mentioned, but those who benefit most from the existing paradigm have no incentive to facilitate improved payment systems in the United States

- 3. Most recent payment innovations have yet to gain significant market penetration and are still limited-participation systems where both sender and receiver must join. Legacy payment systems tend to be more ubiquitous, making them efficient and accessible for those who already maintain a transaction account with their bank (payers and payees of any transaction).**

Generally Agree. The problem is that legacy systems will not readily lend their support to payment innovators and have no incentive to innovate themselves. Payment system incumbents fear a loss of control and diminished revenue, both of which are likely outcomes of innovation and “socialization” of the U.S. payment system. Until this situation is addressed by regulators, the United States will continue to fall further behind the rest of the world. Legacy card payments are not particularly cost-effective for merchants or their customers given the steady increases in cost of acceptance over the decades since their inception. U.S. merchants welcome innovation, provided that such innovation delivers a strong business case for the merchant and a strong value proposition for our customers.

4. **Some features that are desired increasingly by end users are generally lacking in many legacy payment systems, such as –**
- **A real-time validation process assuring the payee that the payer’s account exists and it has enough funds or available credit to cover the payment;**
 - **Assurance that a payment will not be returned or reversed;**
 - **Timely notification to the payer and payee that the payment has been made;**
 - **Near-real-time posting / availability of funds to both the payer’s and payee’s accounts; and**
 - **Masked account details, eliminating the need for end users to disclose bank account information to each other.**

Payment cards and wire transfers possess some, but not all of these features; check and ACH payments generally lack these features.

Agree. Real time validation helps create trust between the merchant and customer and reduces fraud and chargebacks. Chargebacks can be greatly curtailed with real time validation and timely notification. Consumers would benefit by having credits for returned goods immediately posted to their accounts. Masking and tokenization would protect account information and mitigate fraud. Implemented properly, tokenization will retain merchants’ visibility of the end user. Another important feature of the U.S. payment system desired by merchants is a lower cost of acceptance and price competition for their business. Note that cost of acceptance includes not just authorization, clearing and settlement costs, but also costs such as PCI data protection, associate training and awareness programs and chargeback losses. The fraud-prone nature of today’s system also threatens merchants with catastrophic fraud with the potential of putting them out of business. There is no competition for card services; banks are bound together in a system in which they only compete in limited ways, entirely for cardholders. Banks have no reason to innovate; in fact, innovation threatens their existing revenue streams. The United States has today a sub-optimal, dated and archaic payment system which stems from the lack of competition among payments providers.

5. **In general, cross-border payments from and to the United States are slow, inconvenient, costly, and lack transparency regarding fees and timing.**

Agree. Customers are typically not well informed of all of the costs associated with these payments, including costs associated with currency conversion. Cross-border payments are laden with fees, many of which are not readily apparent to customers. Unfortunately, those consumers affected are those who can least afford this costly and inefficient system. Today's legacy systems have negative consequences for not only all merchants but also for those who can least afford their lack of efficiency and unfair economic structure.

6. **Mobile devices have potential to transform wide ranging aspects of business and commerce, including the payment. Digital wallet applications on mobile devices provide merchants with valuable information that can be leveraged for commercial purposes such as consumer-specific location information, transaction history, and other context-specific data. With some digital wallet applications, the payment instrument is selected during the initial set-up phase and the payment takes place in the background thereafter, reducing the visibility and choice of payment instrument at the point of sale. Payment service providers are seeking to define their service offerings in this new world.**

Agree. The potential exists for legacy payments providers to hijack the migration to mobile to further their control of the marketplace. While payments are a small part of the shopping experience, payment provider incumbents aim to use their existing market power to extend their reach into the heart of the shopping experience, threatening consumer privacy by capturing sensitive consumer transaction data and reselling it to third parties.

- 7. Businesses (especially large ones) have payment and accounting systems that are complex and costly to change, making it difficult to achieve automated, straight-through processing of invoices, payments, and remittance information.**

Agree, however progress is inhibited in this area as well by the lack of incentive for innovation. Changing merchant payment and accounting systems requires a clear return on investment for the merchant community; thus far no such business case for the automated, straight-through processing of invoices, payments and remittance information has been developed.

- 8. Consumer fears about payment security sometimes inhibit adoption of electronic payments.**

Agree. Again, the root cause of the problem with payment fraud is the unwillingness on the part of dominant market forces to innovate. These forces have successfully transferred to merchants through PCI and chargebacks much of the cost associated with fraud and fraud protection. There remains little incentive for them to make the system more secure unless they can impose the costs of doing so on merchants. Unfortunately for everyone, payment fraud has serious long-term consequences which delay consumer adoption of new forms of payments given consumers' lack of confidence in traditional providers. Consumer fears are heightened by the failure of card networks to enforce rules that require issuers to post timely credits to consumer accounts for returns and other credits. The problem could best be addressed by requiring real-time credit to consumer accounts.

- i. What other gaps or opportunities not mentioned in the paper could be addressed to make improvements to the U.S. payment system?**

More economical, efficient, timely and cost-effective payments are needed. More equitable participation and control over payments standards.

- Q2. Are you in general agreement with the desired outcomes for payment system improvements over the next 10 years? Please explain, if desired.**

Desired outcome 1: Key improvements for the future state of the payment system have been collectively identified and embraced by payment participants, and material progress has been made in implementing them.

Agree, however we have little hope of progress unless objective leadership is imposed on the incumbent providers of payment services. Merchants must be included in the process.

Desired outcome 2: A ubiquitous electronic solution(s) for making retail payments exists that does not require the sender to know the bank account number of the recipient. Confirmation of good funds will be made at the initiation of the payment. The sender and receiver will receive timely notification that the payment has been made. Funds will be debited from the payer and made available in near real time to the payee.

Agree. Also, in addressing the solution, the payment process should not interfere with the merchant/customer relationship or give payment providers unwarranted access to merchant and consumer data.

Desired outcome 3: Over the long run, greater electronification and process improvements have reduced the average end-to-end (societal) costs of payment transactions and resulted in innovative payment services that deliver improved value to consumers, businesses, and governments.

Agree, however merchants believe the economics of the present system are seriously flawed. Small, incremental improvements will not enable the United States to materially progress towards an innovative and ubiquitous real-time payments system, nor overcome many of the obstacles inherent in the present system.

Desired outcome 4: Consumers and businesses have better choice in making convenient, cost-effective, and timely cross-border payments from and to the United States.

Agree

Desired outcome 5: The Federal Reserve Banks have collaborated, as appropriate, with the industry to promote the security of the payment system from end-to-end amid a rapidly evolving technology and threat environment. In addition, public confidence in the security of Federal Reserve financial services has remained high.

Generally Agree. However, we suggest the Fed take an approach that provides merchants with representation equal that of the banks and networks when examining the security of the payment system. Historically, the Fed has accorded substantial weight and, perhaps, deference to existing networks and a small number of money-center banks when examining certain aspects of the payments system. We believe this leads to outcomes biased in favor of maintaining the status quo and the particular interests of these entities. Without the equal participation of all parties, the security of the payment system may suffer and public confidence may be diminished.

i. What other outcomes should be pursued?

Merchants should be able to rely on payments without the threat of chargebacks except as required by federal regulation. The present chargeback system is another relic of the past which effectively transfers costs associated with fraud from issuers to merchants. Again, little incentive exists for issuer-oriented networks to change the system so this merchant problem is largely ignored.

Q3. In what ways should the Federal Reserve Banks help improve the payment system as an operator, leader, and/or catalyst?

The Fed could play the key role in bringing payments stakeholders together in an effort to achieve the outcomes presented here. The Fed could use its current role as an operator of the ACH system to enhance the ACH and make it a model to which other systems would aspire. The Fed needs to separate this effort from its traditional role as overseer of federally-chartered financial institutions in order to maintain objectivity.

Q4. In discussions with industry participants, some have stated that implementing a system for near-real-time payments with the features described in the second desired outcome (ubiquitous participation; sender doesn't need to know the bank account number of the recipient; confirmation of good funds is made at the initiation of the payment; sender and receiver receive timely notification that the payment has been made; funds debited from the payer and made available in near real time to the payee) will require coordinated action by a public authority or industry group. Others have stated that current payment services are evolving toward this outcome and no special action by a public authority or industry group is required.

i. Which of these perspectives is more accurate, and why?

Merchants have little confidence that they will be treated equitably in this quest by existing payment service providers and suggest the Fed lead this effort. There is little evidence that current payment providers have progressed materially towards these goals and there is good reason to doubt their interest in doing so.

ii. What other perspective(s) should be considered?

The consumer perspective should be included. The Fed may need to gather input from third-parties or conduct surveys to prove/ disprove many of the assumptions regarding consumers that are made in this inquiry. The Fed may also want to gain input from those outside the United States who have successfully addressed some or all of the desired outcomes mentioned here.

Q5. The second desired outcome articulates features that are desirable for a near-real-time payments system. They include:

- a. Ubiquitous participation**
- b. Sender doesn't need to know the bank account number of the recipient**
- c. Confirmation of good funds is made at the initiation of the payment**
- d. Sender and receiver receive timely notification that the payment has been made**
- e. Funds debited from the payer and made available in near-real time to the payee**

i. Do you agree that these are important features of a U.S. near-real-time system? Please explain, if desired.

Agree. All of these features are desirable outcomes.

ii. What other characteristics or features are important for a U.S. near-real-time system?

Elimination of merchant handling of unmasked cardholder data and relief from one-sided PCI rules. Any new system should replace the use of sensitive credentials with tokens and other one-time-use account access mechanisms. Merchants today ask themselves, "why am I paying so much for payments and still being forced to fund most of the costs of protecting the system?" A better system would be free of the many inherent inadequacies of the present system and would not require end-users (merchants) to spend significantly to mitigate its shortcomings. The proposed migration to a near-real-time system should also result in an overhaul of the existing chargeback rules and a more efficient and equitable dispute resolution process.

Q6. Near-real-time payments with the features described in the second desired outcome could be provided several different ways, including but not limited to:

- a. Creating a separate wire transfer-like system for near-real-time payments that leverages the relevant processes, features, and infrastructure already established for existing wire transfer systems. This option may require a new front-end mechanism or new rules that would provide near-real-time confirmation of good funds and timely notification of payments to end users and their financial institutions.**
- b. Linking together existing limited-participation networks so that a sender in one network could make a payment to a receiver in another network seamlessly. This option may require common standards and rules and a centralized directory for routing payments across networks.**
- c. Modifying the ACH to speed up settlement. This option may require a new front-end mechanism or new network rules that would provide near-real-time confirmation of good funds and timely notification of payments to end users and their financial institutions. Payments would be settled periodically during the day.**
- d. Enhancing the debit card networks to enable ubiquitous near-real-time payments.**

e. **Implementing an entirely new payment system with the features described in the second desired outcome above.**

i. **What would be the most effective way for the U.S. payment system to deliver ubiquitous near-real-time payments, including options that are not listed above?**

No response

ii. **What are the likely pros and cons or costs and benefits of each option? What rule or regulation changes are needed to implement faster payments within existing payment processing channels?**

No response

iii. **Is it sufficient for a solution to be limited to near-real-time authorization and confirmation that good funds are on their way, or must end-user funds availability and/or interbank settlement take place in near-real time as well?**

Existing PIN debit network infrastructure accomplishes most of the desired outcomes. With appropriate guidance and protection from the Fed, there is good reason to believe the goals of confirmation as well as settlement can be met by leveraging this infrastructure.

iv. **Which payment scenarios are most and least suitable for near real-time payments? (B2B, P2P, P2B, POS, etc.)**

No response

Q7. Some industry participants have said that efforts to make check payments easier to use, such as by enabling fully electronic payment orders and/or by speeding up electronic check return information, will incrementally benefit the payment system. Others argue the resources needed to implement these efforts will delay a shift to near-real-time payments, which will ultimately be more beneficial to the payment system. Which of these perspectives do you agree with, and why?

Improvements should be made whenever feasible and so long as an appropriate ROI can be identified. Merchants have concerns that those who argue scarce resources must be used exclusively to shift to near real-time payments have vested interest in a sub-set of existing payments systems.

Q8. How will near-real-time payments affect fraud issues that exist with today's payment systems, if at all?

i. **Will near-real-time payments create new fraud risks? If yes, please elaborate on those risks.**

A real-time system is inherently fast as it is designed to eliminate float and enable speedier fund movement, irrespective of the nature of the transaction being genuine or fraudulent. The solution lies not in restricting transaction speed but in mitigating fraud related risk, both systematically and by overlaying mitigating controls.

Q9. To what extent would a ubiquitous near-real-time system bring about pivotal change to mobile payments?

No response

Q10. What would be the implication if the industry and/or the Federal Reserve Banks do not take any action to implement faster payments?

The United States would fall further behind the rest of the world. Domestic payments stakeholders may find themselves at a competitive disadvantage. Payments could become more fragmented and less efficient, particularly cross-border payments. Consumer trust in the U.S. payment system will be further eroded.

i. What is the cost, including the opportunity cost, of not implementing faster payments in the United States?

No response

Q11. To what extent will the industry need to modernize core processing and other backend systems to support near-real-time payments?

i. What is the likely timeframe for any such modernization?

No response

Q12. Some industry participants suggest that a new, centralized directory containing account numbers and routing information for businesses and/or consumers, to which every bank and other service providers are linked, will enable more electronic payments. A sender using this directory would not need to know the account or routing information of the receiver.

i. What are the merits and drawbacks of this suggestion?

No response

ii. What is the feasibility of this suggestion?

No response

Q13. Some industry participants say that check use is an enduring part of the U.S. payment system and that moving away from checks more aggressively would be too disruptive for certain end users.

i. Is accelerated migration from checks to electronic payment methods a high-priority desired outcome for the U.S. payment system? (Accelerated means faster than the current trend of gradual migration.)

No response

ii. Please explain, if desired.

iii. If yes, should the Federal Reserve Banks establish a target for the percent of noncash payments to be initiated via electronic means, by a specific date? For example: "By the year 2018, 95% of all noncash payments will be made via electronic means."

No response

iv. What is the appropriate target level and date?

No response

Q14. Business-to-business payments have remained largely paper-based due to difficulties with handling remittance information. Consumer bill payments also are heavily paper-based due to the lack of comfort some consumers have with electronic alternatives. In addition, many small businesses have not adopted ACH for recurring payments due to technical challenges and/or cost constraints. The payment industry has multiple efforts underway to address these issues.

i. To what extent are these efforts resulting in migration from checks to other payment types?

No response

ii. What other barriers need to be addressed to accelerate migration of these payments?

No response

iii. What other tactics, including incentives, will effectively persuade businesses and consumers to migrate to electronic payments?

No response

iv. Which industry bodies should be responsible for developing and/or implementing these tactics?

No response

Q15. To what extent would the broader adoption of the XML-based ISO 20022 payment message standards in the United States facilitate electronification of business payments and/or cross-border payments?

No response

Q16. What strategies and tactics do you think will help move the industry toward desired outcome four - consumers and businesses have greater choice in making convenient, cost-effective, and timely cross-border payments?

No response

Q17. Payment security encompasses a broad range of issues including authentication of the parties involved in the transaction, the security of payment databases, the security of software and devices used by end users to access payment systems, and security of the infrastructure carrying payment messages.

i. Among the issues listed above, or others, what are the key threats to payment system security today and in the future?

No response

ii. Which of these threats are not adequately being addressed?

No response

iii. What operational or technology changes could be implemented to further mitigate cyber threats?

No response

Q18. What type of information on threat awareness and incident response activities would be useful for the industry?

i. How should this information be made available?

No response

Q19. What future payment standards would materially improve payment security?

i. What are the obstacles to the adoption of security-related payment standards?

No response

Q20. What collaborative actions should the Federal Reserve Banks take with the industry to promote the security of the payment system from end to end?

No response

Q21. Please share any additional perspectives on U.S. payment system improvements.

No response