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Two Sparrows Consulting
Federal Reserve - Request for Commentary
December 13, 2013

Two Sparrows Consulting is a management consulting firm for the financial services industry. We specialize in payments consulting with an emphasis on credit/debit/prepaid debit products, automated clearinghouse transactions, merchant acquiring, ATM transaction processing, electronic bill payment and presentment, and emerging payments such as internet payments, integrated chip cards and mobile payments. We also provide merger and acquisition advisory services for companies involved in payments processing.

Our clients include leading payments processors, payment networks, ACH associations, financial institutions, merchants, venture capital fund managers and industry associations.

Two Sparrows Consulting appreciates the opportunity to contribute the following commentary to the Federal Reserve on the Payment System Improvement – Public Consultation Paper.

Two Sparrows Consulting Views on Roles for the Federal Reserve

1. Speeding up retail payment clearing and settlement and extending the current channels requires improvements in current methods of authentication, repudiation policies, and risk mitigation. This will require a clear understanding of the various aspects of fraud perpetrated on retail payments. Although there are many studies available to help measure this fraud, all of them have flaws and gaps. The Federal Reserve has the opportunity to do as Central Banks have done in other countries and implement a process to accurately collect data on fraud statistics. There are trade associations, such as the SRPc, that might be able to assist by providing recommendations on categories of fraud that should be tracked, with particular emphasis on online fraud.
2. Regarding the role of the Federal Reserve in the development of a new payment system, Two Sparrows Consulting is not convinced that a new payment system would be cost-effective to build or maintain, rather improvements and modifications can be made to existing systems to add any requisite functionality that is currently missing.
3. The Federal Reserve could play a vital role in changing the equation on the finality of online purchases. The current environment needs better authentication methods including authentication of the users and the seller, especially when the seller does not have a brick and mortar retail presence. We are not suggesting that the Federal Reserve become the manager of the database of authorized users, but that standard setting catalysts and industry leadership are logical roles for the Federal Reserve.
4. There may be a role for the Federal Reserve as the responsible entity for managing federated IDs that relying parties can use to mitigate risk. The Federal Reserve could play a role in creating the legal structure around this process.

Thoughts on Questions for the Public

Q4. <u>The Need for</u> <u>Ubiquitous Near-Real-Time Payments</u>. Relying on trade groups to enhance the current systems may be difficult. As payments companies have consolidated and grown market share, the payments world is a much different place than the '60's when both the ACH and Card systems were born. Back then it was much easier for a "true industry" perspective to be developed. Now, the largest players have vested interests that may unfairly affect smaller participants from obtaining equal access to new offerings. The Federal Reserve should consider playing the role of ensuring that large player vested interests do not tip the scale inappropriately.

Q8. Impact of Near-Real-Time Payments on Fraud. Near-Real Time Payments will affect fraud issues. Again, the industry does not measure such fraud issues in a satisfactory manner today and the Federal Reserve should take an active role in correcting this measurement deficiency. That being said, risk mitigation will become much harder in a near real-time world especially in the online transaction segment. Authentication flaws for both authorized user/buyer and authorized merchant/seller will create additional fraud. Use of non-protected or static payment tokens in a real-time payments construct will open the door to greater fraud. Liability for fraud will also be a point of contention. If liability shifts to merchants occur without improvements in authentication, tokenization or point-to-point encryption, then merchants will have to spend more on risk mitigation efforts or avoid the near-time service. If issuers /receiving financial institutions absorb more liability, then they will either have to increase risk mitigation expenditures or pass along costs to consumers or merchants. Speeding up payments without improving transaction security and certainty will cause great harm.

Q19. Future payment standards will materially impact payments security. Standards that cost-effectively improve payment security are very important. But those standards must truly be industry-wide, open and consensus standards. They must not be used as competitive weapons by large market share participants. A perfect example of this is EMV in the U.S. On paper, EMV seems to be a good way to reduce certain fraud types and provide a net gain to all. But in practice EMV, especially with regard to debit, has proven to be a very problematic implementation is the U.S.

Respectfully submitted,
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