AN INDUSTRY DISCUSSION

"Should changes be made to Reg II in order to increase competition between payment networks?"

Overview

The processes for determining ATM transaction routing in the U.S. are essentially dominated today by the agreements between debit networks and larger issuers; and heavily influenced even further by the global payment networks. The ATM Industry Association (ATMIA) has growing concerns that competition between these networks is eroding due to the unintended consequences of the Durbin Amendment – both with how it was implemented and how it impacts EMV migration in the U.S.

ATMIA contends that competition between networks could be increased, creating downward pressure on network fees, by providing ATM operators with the ability to make transaction routing decisions. That change could be accomplished with a modest addition of language to Reg II; which would appear to be within the purview of the Federal Reserve Board to implement, without the need for new legislation.

Current environment for ATM transaction routing

The payment networks determine and manage most of the rules and fees associated with both retail and ATM transactions. Although ATM operators receive interchange fees for transactions on their terminals, they also pay fees to the networks for handling those transactions. And even the largest independent ATM operators have no influence over how those network fees are set.

Issuers, particularly the larger ones, do have opportunities to influence those fees, by entering into agreements that concentrate volume with a particular network, in exchange for more attractive pricing. In other words, although the issuers are indeed the party paying ATM interchange, they are also in a position to influence how the networks set those rates.

Based on the business relationships in place and the fees agreed to with the networks, issuers then decide which networks to enable on their debit cards. Because the Durbin Amendment requires a debit card used for point of sale purchases to have at least two unaffiliated networks enabled, two unaffiliated debit networks will typically be available for ATM transaction routing, as well. And today, network rules also give issuers the right to make ATM network routing choices.

The net result of these practices has been a significant increase in debit transaction market share for the global networks, at the expense of most of the regional networks. In fact if this trend continues, it raises serious concerns over the ability of regional debit networks to effectively compete for ATM transaction volume.

Complications introduced by EMV migration

The payments industry recognized very early on that implementing EMV for debit transactions while complying with Durbin requirements would be a challenge. And the solution which emerged after two years of effort is not a perfect one; nor is it yet complete. It relies on the availability of specific programmability for all ATM terminals and the efforts of all ATM operators to implement it.

Technological obstacles aside, the complexity of the U.S. payments system itself is already creating challenges for early adopters of EMV. In addition to the global payment networks and 16 or so regional networks, debit transactions may pass through reciprocal parties, gateways/switches, and processors. Many transactions are not simple point-to-point journeys, but travel multiple legs along the way.

In order for a transaction to begin and end as fully EMV compliant, the parties at each end of any given transaction leg must be EMV certified with each other. Getting all those potential "connections" certified will be resource intensive, time consuming, and very costly. What that means is that there will be an extended transition period, perhaps even five years or more, when not all of the potential connections are EMV certified.

If a transaction begins as fully compliant EMV, but cannot be sent on to the next party as EMV, "mag stripe equivalent" data may be sent in its place. In which case it will likely be seen by the issuer as a "fallback" transaction (an EMV card that was swiped due to a technical issue/failure of the chip reader). This scenario is already being seen today and most of the transactions are being declined.

The other possibility is that a regional network has been selected, and because the transaction cannot be properly routed, it defaults to the global network. As a result, global payment network transaction volume share may increase artificially during the EMV migration transition period – further exacerbating what is already an unhealthy trend.

ATMIA recommends changes to Reg II

One of the objectives of the Durbin Amendment was to place "limitations on anti-competitive network restrictions"[1]. The Federal Reserve Board has done a commendable job of implementing a confusing and poorly written piece of legislation. However, by specifically carving out ATM

[1]Durbin Amendment to the *Restoring American Financial Stability Act of 2010*, Sec 920(a)

transactions[2] from these limitations, it has left those same anti-competitive network restrictions in place for the ATM channel; affecting 5.8 billion cash withdrawal transactions annually and nearly $700 billion in cash value[3].

ATMIA U.S. Executive Director, David Tente, and several ATMIA U.S. Board members met with the Federal Reserve Board in Washington, DC on July 22nd. Executive management for the Retail Payments Section of the Reserve Bank Operations and Payments Systems Division were present, along with legal counsel and one of their senior economists.

For ATMIA, it was a rare opportunity to familiarize the Fed Board with the ATM industry in general, as well as to highlight issues of concern. Additional industry perspectives were provided by ATMIA Board members representing regional networks, processors, and independent ATM deployers (ISO/IADs).

In order to increase competition between debit payment networks and stem the erosion of regional network transaction share, ATMIA has recommended that a prohibition on ATM network routing restrictions, similar to what is already in place for retail merchants at the point of sale, be implemented for ATM operators. Such action would introduce new market forces and a downward pressure on network fees, since networks would also have to compete for routing selection by operators.

This change could be accomplished by adding new language to Title 12 Code of Federal Regulations, Banks and Banking, Part 235 Debit Card Interchange Fees and Routing. Although ATMIA has deliberately not advocated for changes in the existing definitions or other language due to concerns over the complications that might create, we would certainly defer to the Fed as to how best to implement this recommendation.

<u>Public comment on Reg II prior to implementation</u>

Prior to the Fed's implementation of Durbin (late 2010/early 2011 time frame), public comment was solicited on the proposed rules. Thousands of commenters submitted material – including ATMIA. Mike Lee, ATMIA's CEO submitted a 7-page letter that advocated for ATM operator routing choice, based on many of the same arguments contained within this paper. The final proposed rule (Reg II) with comments, dated June 29, 2011[4], makes for interesting reading. It provides a fairly extensive discussion of the comments received and the reasoning behind elements of that proposed rule.

Comments on network exclusivity and routing were found in numerous sections of the above referenced document. As noted below, the Fed Board does attempt to provide both sides of the argument.

[2]Part 235.2(h)(2) Debit Card Interchange Fees and Routing, Definitions, Electronic Debit Transaction, July 20, 2011

[3]The 2013 Federal Reserve Payments Study, July, 2014; 2.6.1.2, ATM Cash Withdrawals

[4]Federal Reserve System, 12 CFR Part 235, Regulation II; Docket No. R-1404, Debit Card Interchange Fees and Routing, Board of Governors of the Federal Reserve System, Final rule

"With respect to ATM transactions, almost all comments received on the issue agreed that interchange fees on ATM transactions should not be covered because they flow from the issuer to the ATM operator. Although representatives of ATM operators supported applying the network exclusivity and routing rules to ATM transactions, issuers and networks opposed applying the network exclusivity and routing rules to ATM transactions because of different economic incentives for ATM transactions."

Although all of the above statements are correct, there is no further explanation as to why "different economic incentives" are problematic or why that invalidates the argument presented by the ATM operators. Other subsequent comments appear to make an attempt at supporting the decision to exclude ATM transactions.

"Commenters also expressed concern that, if the network exclusivity provision applied to ATM cards and networks, the establishment of settlement arrangements with multiple networks would create a large burden on issuers, which could result in higher consumer fees."

However, that statement appears to indicate some confusion as to how ATM operator choice might work in the real world. Based on ATMIA's recommendations, ATM operators would simply be choosing from networks already enabled by the issuers on their cards. We can only speculate that perhaps there were previous recommendations by other ATM industry advocates, which called for ATM operator freedom to select <u>any</u> network – even those not currently supported by the issuer.

ATMIA also contends that there is confusion and inconsistency created by some of the definitions and the subsequent language used to exclude ATM transactions from certain aspects of the rule. The following two paragraphs are examples.

"Consequently, a card is not a debit card by virtue of its being issued or approved for use through an ATM network, which, in turn, means that the ATM transaction is not an electronic debit transaction‖ as those terms are defined in EFTA Section 920."

"As discussed below (§ 235.2(m)), ATM operators do not accept payment in exchange for goods or services. Rather, ATM operators facilitate cardholders' access to their own funds. The Board has revised § 235.2(l) so as to not limit the purposes for which a person accepts payment to being in exchange for goods or services (see § 235.2(h) and comment 2(h)-2). This expansion does not include ATM operators within the definition of merchant."

ATMs today sell lottery tickets, prepaid cards, stamps, charitable contributions, and other goods and services – and that trend will expand at an accelerating pace as emerging technologies enable the offering of new types of payments and products. Which begs the question then, what is that if not "payment in exchange for goods or services"?

Similar confusion is caused by language addressing cash withdrawals at the point of sale. Comments state that an ATM withdrawal simply changes an asset from one form to another – from being part of the account balance to hard cash. However, changing that asset from one form to another at a retail establishment does qualify as a payment; so long as it follows a purchase – unless the purchase and additional cash are withdrawn from the ATM at that retail establishment.

Clarification and guidance from the Fed Board on the above issues would be greatly appreciated by ATM operators and acquirers.

Summary and moving forward

ATM operators today have very little influence over ATM transaction routing. Business relationships between issuers and networks determine which networks are enabled on debit cards. And network rules generally give issuers the right to make routing choice, as well.

Confining all of these decisions to relationships between the network and issuer works to limit competition. ATMIA recommends adding language to Reg II prohibiting restrictions on ATM operator routing selection between the networks enabled on an issuers debit card. This would create new competition between networks for routing selection by those operators and result in downward pressure on network fees.

Although ATMIA defers to the Federal Reserve Board as to how best to implement such a change, it is suggested that adding new language to the rule, rather than changing existing language, may result in a smoother implementation. That approach should create only minimal, if any, disruption of existing language and intent.

Moving forward, ATMIA believes that these changes are important and necessary for the health of the ATM industry, which continues to serve as the consumer's preferred channel for convenient access to cash. They will also have a positive impact on other electronic payment channels, since many of those networks offer both merchant and ATM services. Therefore, ATMIA will continue to advocate for ATM operator routing choice and keep this discussion alive in the public arena.