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February 22, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Proposed Rule on Debit Card Interchange Fees and Routing, Docket No. R-1404

Dear Ms. Johnson:

American Express Company ("American Express") respectfully submits these comments ("Comments") in response to the Notice of Proposed Rulemaking issued by the Board of Governors of the Federal Reserve System ("Board") to implement Section 920 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the "Durbin Amendment." Proposed Rule, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (Dec. 28, 2010).

American Express agrees with the Board's finding that there are significant differences between three-party, closed-loop payment card networks and four-party, open-loop networks.[1] We also appreciate the Board's recognition that difficult questions are presented concerning whether and how the Durbin Amendment should be applied to three-party systems, and its specific request for "comments on all aspects of applying the proposed rule to three-party payment systems." *Id.* at 81,728.

American Express operates a three-party payment card network in which it is the sole acquirer of all merchant transactions in the United States made with American Express cards. Its closed-loop business model is the most important competitor for the dominant four-party business model followed by Visa and MasterCard. American Express does not offer a debit card linked to a deposit account, but does issue various types of prepaid cards, which are the only American Express cards that are potentially subject to the Proposed Rule. These cards constitute a very small part of the overall universe of debit and prepaid cards that may be subject to regulation under the Durbin Amendment.

American Express respectfully submits that the Board has legal authority to treat three-party payment card networks like the American Express network differently from

[1] In the Comments, the terms "three-party network," "three-party system," and "closed-loop network" are used interchangeably to refer to American Express's payment card network and similarly configured payment card networks. The terms "four-party network," "four-party system," and "open-loop network" are used interchangeably to refer to the Visa and MasterCard payment card networks and similarly configured payment card networks.

the four-party, open-loop networks under the interchange fee and network exclusivity provisions of the Durbin Amendment. Moreover, there are strong economic and public policy reasons why such differences in treatment are warranted. We present the following arguments to support our position.

1. Interchange Transaction Fee.

The Board does not have authority under Section 920(a) of the Electronic Fund Transfer Act ("EFTA"), 15 U.S.C. § 1693o-2(a), to regulate the merchant discount fee that a three-party network like American Express charges participating merchants.[2] American Express is the issuer, the merchant acquirer, and the network for transactions conducted with its prepaid cards. More importantly and fundamentally, American Express does not establish, charge, or receive an interchange fee.[3] Thus, under the express language of the statute, there is no authority to impose a regulated price on American Express for a fee it does not charge.

Further, as demonstrated in the attached paper submitted by Professor Robert Willig, there is no reliable regulatory formula by which the Board could attempt to derive a surrogate interchange fee for American Express.[4] Such an action would put the Board in the unprecedented role of inventing a four-party network pricing model for a three-party network and then artificially forcing that model upon that network. Moreover, if the Board tried to impute a portion of American Express's merchant discount to be an interchange fee, which does not exist in a three-party network, especially a surrogate fee determined under the drastically reduced level provided by the Proposed Rule, its action would necessarily be arbitrary and would seriously threaten the ability of American Express to recover its costs and a reasonable rate of return on its investment.

The Board has acknowledged that "the statute does not restrict fees an acquirer charges a merchant . . . ." 75 Fed. Reg. at 81,727. Imposing such a limitation by regulatory fiat would grossly distort competition. It would have the effect of putting American Express, the smallest of the three major networks, at a clear disadvantage compared to each and every competitive merchant acquirer on the Visa and MasterCard networks, none of whose acquiring fees would be regulated or reduced. Neither law nor policy dictates or would justify such a result.

In addition, as Professor Willig demonstrates, if the Board were to attempt to derive a surrogate interchange fee for American Express, there is a real danger that it would establish an incorrect price given the fully integrated nature of American Express's network and end-to-end business model. That action would have unintended negative

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[2] In the Comments, the terms "merchant discount fee" and "merchant discount" are used interchangeably.

[3] In the Comments, the terms "interchange," "interchange transaction fee" and "interchange fee" are used interchangeably.

[4] For convenience, Professor Willig's paper also is being submitted as a separate document for the administrative record.

consequences in the marketplace. Such distortions would adversely affect American Express, and its ability to compete would be reduced, to the detriment of merchants and consumers. This reduction in competitiveness would be particularly serious because the three-party American Express business model is an important and meaningful alternative to the dominant four-party networks.[5] Even though American Express does not issue debit cards and the American Express prepaid card business is relatively small, American Express is an important competitor. For example, in September 2009, American Express was the first and only issuer of gift cards to eliminate all back end, maintenance, service, and dormancy fees, as well as any expiration of funds on its cards.[6] Its competitive vitality would be undermined by price regulation, which is neither justified under the law nor, as explained in Professor Willig's paper, by sound economic principles.

Section 920(a) is inapplicable to payment card networks that do not charge a separate interchange transaction fee, and the Board should incorporate that conclusion in the Final Rule. The statute sought to modify the level of the interchange transaction fee that issuing banks in a four-party system receive. That objective has no relationship to American Express. In its three-party system, American Express serves as both the issuer and acquirer for all prepaid card transactions in an integrated enterprise serving a single corporate purpose.[7] American Express does not compete with the four-party networks based on interchange fees. American Express competes – aggressively – with the four-party networks and other issuers and acquirers on the basis of value, service, innovation, and the merchant discount charged to merchants for accepting American Express prepaid cards. The Board has already concluded that it does not have statutory authority to regulate that merchant discount.

If the dominant four-party networks have kept prices artificially high, as it appears Congress concluded they had in passing the Durbin Amendment, then it follows that a regulated reduction in the prices charged by the four-party networks will certainly pressure other competitors to adjust their own prices to adapt to the new competitive landscape.

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[5] *See* United States v. Visa U.S.A., Inc., 163 F. Supp. 2d 322, 395-96 (S.D.N.Y. 2001):

> Because American Express and Discover are closed-loop systems that deal directly with merchants, those brands have the infrastructure to collect data and details about spending that many consider superior to defendants' [Visa and MasterCard] capabilities. Utilizing this resource, they could offer their bank issuers, merchants and consumers sophisticated data mining skills to provide targeted promotions to various consumer segments.

[6] American Express took this action well before the Credit CARD Act gift card rule became effective in August 2010 and went beyond what that rule requires. Some competitors have since followed American Express's lead and eliminated back end fees.

[7] There is one unique arrangement in which a former joint venture partner of American Express continues to issue certain corporate incentive prepaid American Express cards. However, there are no ongoing payments from American Express to the issuer relating to the cards that the entity issues.

Instead of attempting to derive an interchange fee for three-party networks where none exists, the Board should determine that these networks are not subject to regulation under the express language of Section 920(a). Competition will regulate American Express's prepaid card business. If, however, the Board finds it necessary to take some action with regard to three-party networks, it should follow the principle of forbearance, as discussed in Professor Willig's paper.

2. Definition of "General-Use Prepaid Card."

The Final Rule should provide that the term "general use prepaid card" incorporates the Exclusions from that term that are set forth in Section 915(a)(2)(D) of the EFTA, 15 U.S.C. § 1693l-*l*(a)(2).

3. The Network Exclusivity and Routing Provisions.

American Express appreciates that the Board has determined that it does not have the authority to compel a three-party network to open its network and allow third parties a right of access to that network to act as merchant acquirers for American Express prepaid card transactions.[8] American Express also appreciates the Board's findings about the unique nature of three-party networks. 75 Fed. Reg. at 81,727-28. The Board should continue to consider these unique characteristics and facts when it finalizes the rules implementing the network exclusivity and routing provisions, Section 920(b)(1) of the EFTA, 15 U.S.C. § 1693o-2(b)(1).

The network exclusivity and routing provisions were added to the Durbin Amendment in the final stage of its development and were not publicly debated. However, Senator Durbin has made clear that this provision is intended to address specifically practices by which four-party networks have restricted competition from unaffiliated PIN-based debit networks for the routing of debit card transactions through exclusive routing arrangements with issuers.[9]

American Express submits that its closed-loop system is not, and was never intended to be, covered by Section 920(b)(1). The Board should use its statutory authority to prevent such an inappropriate and unintended result. The basic construct of

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[8] American Express further notes that the network exclusivity and routing provisions of the Durbin Amendment and the Proposed Rule do not authorize a third-party to become an acquirer of American Express prepaid card transactions – that is, transactions conducted with prepaid cards that bear an American Express brand and American Express issuer identification (IIN/BIN) numbers.

[9] *See* Durbin Statement on TCF's Court Challenge of Interchange Law (Oct. 12, 2010), *available at* http://durbin.senate.gov/showRelease.cfm?releaseId=328221. Senator Durbin expressly stated that the intent of this provision was to preserve competition for routing of PIN-based debit transactions because price competition for routing of PIN-based transactions had diminished as a result of certain open-loop payment networks entering into exclusive arrangements with bank issuers requiring that merchants must use the online PIN network affiliated with the open-loop payment network as the exclusive routing for their PIN debit transactions.

the business model of a three-party network like American Express is that all transactions of the network's cards are routed solely over its own proprietary network. This routing is simply how the closed-loop network business model is designed to operate and has always operated. It is not the result of restrictions similar to those imposed by the dominant four-party networks that Congress sought to remedy through Section 920(b)(1).

In addition, American Express prepaid cards are not, and have never been, PIN-enabled for authorization of purchases at the merchant point-of-sale. In fact, alternative routing over unaffiliated PIN-debit networks has never been part of the design of the American Express network, as it has been for debit cards issued on the four-party networks. Exclusive routing over three-party closed-loop networks is integral to how such networks have always operated, and <u>not</u> the result of exclusivity arrangements with issuers. We therefore urge the Board to recognize the fundamentally distinctive nature of closed-loop systems when it issues the Final Rule and grant them an exception from application of Section 920(b)(1).

In the alternative, if the Board does not grant an exception for closed-loop systems such as American Express from Section 920(b), then at a minimum the Board should exempt certain prepaid cards from the network exclusivity/routing requirements. Specifically, issuers of prepaid cards should only be required to enable an unaffiliated network for routing prepaid card transactions if the issuer has already enabled the cards for dual-routing functionality (i.e., both PIN and signature) for transactions at merchants' point-of-sale. This exception is clearly in line with the legislative history and Congressional intent behind passage of Section 920(b)(1).

The Board has authority to adopt these provisions under Section 904(c) of the EFTA, 15 U.S.C. § 1693b(c), which provides that its rules "may contain such classifications [or] differentiations . . . and may provide for such adjustments and exceptions . . . as in the judgment of the Board are necessary or proper to effectuate the purposes" of the statute. [10]

If the Board declines to adopt either exception, then American Express submits that the implementation deadline must be extended significantly for three-party closed-loop networks. The Board has already recognized the unique nature of three-party systems and the disruption that such imposition of such an alternative routing requirement would create. It has, however, substantially underestimated the time that would be necessary for a network like American Express that is not now configured for

[10] The Board's authority to create exceptions and differences in treatment under Section 920 will not be affected by the transfer of authorities to the Consumer Financial Protection Bureau ("CFPB"). Section 1084(3) of the Dodd-Frank law provides that the Board shall have sole authority to carry out the purposes of Section 920. Section 1084(5) of the Dodd-Frank Act also expressly prohibits the CFPB from implementing any of the rules issued by the Board under Section 920. In addition, Section 904(c) of the EFTA is not essential to the Board's ability to grant exceptions or differences in treatment. This provision essentially codifies the agency's inherent authority to enact rules that are tailored to the facts in the administrative record and to utilize its statutory discretion to provide for differences in treatment for regulated entities when justified by the facts.

routing of its card transactions by other payment card networks to reconstruct its entire system to enable such routing. The implementation deadline should therefore be extended to no earlier than July 31, 2013. Alternative B goes beyond what is required by the statute and therefore should not be implemented.

4. Adjustments to the Interchange Transaction Fee for Prepaid Cards.

In addition to the strong legal and policy grounds showing why American Express should not be subject to the interchange and routing provisions of the Durbin Amendment, American Express also submits that there are other provisions of the Proposed Rule that fall within the Board's statutory authority and that should be modified. First, the Board has statutory authority to provide a higher interchange transaction fee for prepaid cards, particularly considering that the data cited by the Board prove that these transactions have higher costs. 75 Fed. Reg. at 81,737-38.

Second, the Board should not adopt the proposed Technology-Specific standard for allowing an adjustment of the interchange fee for fraud-prevention costs. The Non-Prescriptive approach should be applied both as a matter of law and under basic economic principles governing regulatory design.

Third, a greater adjustment should be allowed for the interchange fee for prepaid cards, in recognition of the greater fraud-prevention costs issuers incur for prepaid cards as opposed to debit cards.

5. Regulation of Non-Traditional and Emerging Payment Networks.

The payments system landscape is highly dynamic and evolving, as demonstrated by non-traditional participants, such as PayPal, which have entered the marketplace over the last several years to provide payment services to merchants and consumers. In some respects, these non-traditional payment networks built their payment systems on the existing infrastructure of traditional payment card networks. In other respects, however, they operate as separate payment networks through the issuance of proprietary payment products and acquisition of merchants to accept such products. Companies such as PayPal are no longer nascent start-ups; they are sizable payment networks that compete vigorously with the traditional payment networks. As such, to the extent that non-traditional and emerging payment networks operate payment systems that meet the definition of "payment card network" under the statute, they should be subject to the same regulatory treatment as traditional payment networks.

The Board should be cautious to avoid getting locked into a definition of payment card network based on a model created over fifty years ago. Rather, it should adopt an approach that regulates non-traditional payment system participants based on what these entities do and what products and services they provide in the payment system. The Board also should not draw conclusions based on the labels non-traditional and emerging payment networks place on themselves. It is in the interests of consumers, merchants, and the safety and soundness of the payment systems for the Board to maintain a broad perspective and have definitions that are flexible enough to ensure that no unfair advantages are gained by the non-traditional payment networks when in fact they perform the very same services performed by traditional payment networks that are subject to regulation. This is especially important given the rapid growth in on-line and mobile payments that is crucial to all networks. The Board should not "tilt" the regulatory structure in favor of any particular network engaged in these critical activities.

We discuss each of these points in greater detail below.

I. The Provision Imposing Price Controls on "Interchange Transaction Fees" Does Not Apply to Three-Party Networks.

A. The Board Does Not Have Legal Authority To Regulate the Merchant Discount American Express Charges Participating Merchants.

Section 920(a)(1) of the EFTA authorizes the Board to prescribe regulations "regarding any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction . . . ." (Emphasis added) The critical term "interchange transaction fee" is defined as "any fee established, charged or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction." Section 920(c)(8).

The phrase "interchange transaction fee" is a well-known, clearly understood term in the payment card industry. It refers to the specific fee that is charged only within four-party, open-loop networks -- the fee the acquiring bank pays to the issuing bank to compensate the issuer. When it passed legislation authorizing the Board to establish standards for "interchange transaction fees," Congress carefully and expressly chose only to regulate this single and particular fee that merchant acquiring banks pay to issuing banks within four-party networks for certain electronic debit transactions. Congress did not regulate all types of fees charged to merchants for debit card acceptance or the total amount of those fees. In particular, the statute does not regulate the "merchant discount," the fee that a three-party network charges merchants as an acquirer for acceptance of prepaid cards (just as the Durbin Amendment does not limit the ultimate amounts paid by merchants in a four-party network).

The legislative history also clearly confirms that Congress intended only to regulate a specific fee, the interchange transaction fee. Congress expressed great concern about imposition of what it viewed as excessive interchange fees for debit and prepaid cards within the four-party Visa and MasterCard networks.[11] Importantly, Congress did

[11] *See* Durbin Statement on TCF's Court Challenge of Interchange Law (Oct. 12, 2010), *available at* http://durbin.senate.gov/showRelease.cfm?releaseId=328221. ("[T]here is no constraint on Visa and MasterCard's ability to fix the [interchange] rates at unreasonable levels. This system is effectively an unregulated $20 billion per year transfer of wealth from merchants and their customers to card-issuing banks."). As the Board stated in its Memorandum in Support of Defendants' Motion to Dismiss in *TCF National Bank v. Bernanke*, No. 10-4149, D. S. Dak., filed Feb. 18, 2011(at page 34), "the overall purpose

not articulate any concerns about the merchant discount charged by an integrated three-party network that acts as the sole acquirer for all transactions within its network.

The Board recognized that "there is no explicit interchange fee" charged in a three-party, closed-loop network. 75 Fed. Reg. at 81,727. Instead, the network in its role as an acquirer charges a merchant discount fee, which is determined by direct negotiations and a contract between the network and the merchant. The Board also recognized that "the statute does not restrict fees an acquirer charges a merchant." 75 Fed. Reg. at 81,727. Under the plain language of the statute, it is clear that Congress expressly chose only to regulate the "interchange transaction fee." There is no statutory authority under Section 920(a)(1) to regulate the ultimate fee paid by merchants for card acceptance, much less the merchant discount fees charged by three-party networks for prepaid card acceptance. On this clear legal basis alone, the Board should conclude that the interchange transaction fee provision of the Durbin Amendment does not apply to the American Express network.

B. Fabricating a Surrogate "Interchange Transaction Fee" for a Three-Party Network like American Express Would Violate Sound Economic Policy.

In addition to the lack of statutory authority, there are compelling economic and practical reasons why the Board should not seek to stretch and transform the express language of the statute in an effort to convert part of the merchant discount fee a three-party network does charge into a surrogate for an interchange fee that it clearly does not charge.

As discussed in Professor Willig's paper, there is no reliable regulatory formula by which the Board could accurately allocate costs to set a fee for a separate interchange that simply does not exist within the American Express network. Any attempt to derive and regulate a surrogate interchange fee would almost surely produce the wrong price and cause unintended, unfair market distortions.

In addition, there is no sound public policy reason why the Board should take such action. American Express prepaid cards constitute a very small part of the overall universe of debit and prepaid cards regulated under the Durbin Amendment.[12] As Professor Willig discusses, if the prices Visa and MasterCard charge are reduced due to the Board's regulation of their debit and prepaid interchange fees, the competitive forces

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of the Durbin amendment was to give merchants, consumers, and small businesses leverage to negotiate reasonable interchange fees with Visa and MasterCard . . . ."

[12] *See, e.g.*, The Nilson Report, *Issue 948*, at 9 (May 2010), stating that in 2009, "Debit and prepaid cards, including transactions handled by regional EFT networks such as Interlink, Star and Pulse, generated $1.439 trillion, up 6.9% from 2008." American Express's prepaid card volume was $1.511 billion in 2009, barely one tenth of one percent of total U.S. debit and prepaid purchase volume.

of the marketplace will be the most effective and reliable regulator of American Express's prices.

C. Applying the Interchange Transaction Fee Provision to the American Express Merchant Discount Would Have Negative Economic Effects.

If the Board were to arbitrarily fabricate a surrogate interchange fee for American Express and then subject it to price controls, American Express would be forced to abandon its proprietary merchant discount model for prepaid card transactions, and would be compelled to use the same pricing model that Visa and MasterCard employ for debit and prepaid cards. The statute does not require, and should not be applied in such a manner as to require, a three-party network to change its core business model, to abandon the merchant discount fee it actually charges, and to adopt the fee structure that its competitors use. American Express's merchant discount structure is comparatively simpler than the structure used in the four-party networks, and provides merchants with an important competitive alternative. Having more choice in the marketplace has overall benefits for merchants and consumers. For example, American Express's innovation in eliminating all back-end fees and expiration of funds on its prepaid cards (*see* page 3) resulted in other competitors lowering their fees and providing greater benefits to consumers.

As discussed in Professor Willig's paper, imposing an artificially mandated price for a fee a three-party network does not now charge would be arbitrary and would very likely lead to the wrong result. Such misapplied and unauthorized price regulation would risk substantial reduction in American Express's revenues. This in turn would limit American Express's ability to remain competitive in the prepaid business and/or force American Express to raise other fees, cut back its investment in new product features, or potentially reduce commissions paid to merchants that sell its prepaid cards.

For the reasons discussed above, it would be arbitrary and unfair for the Board to fabricate and then regulate a hypothetical interchange fee for American Express. The Board should allow competition, rather than formulaic directives, to regulate the American Express prepaid card business.

As previously noted, American Express's prepaid card business represents a very tiny percentage (0.1%) of U.S. debit and prepaid card volume. With respect to American Express, we submit that, at most, the Board should take an alternative approach of forbearance, and monitor the competitive position of American Express. If at some point the Board were to conclude that American Express's pricing is not consistent with competitive levels (giving consideration to costs and value), the Board could consider what further actions, if any, were warranted, consistent with the law.

Moreover, as a small but important competitor in the prepaid card business, to the extent that Visa and MasterCard merchant discount rates decrease as a by-product of debit interchange regulation, American Express will be compelled to respond to competitive pressures in the United States, obviating the need for any future regulation.

II. Loyalty, Award, and Promotional Gift Cards Are Exempt from the Interchange Transaction Fee Provision.

In addition to the other reasons set forth in these Comments why the interchange transaction fee provision does not apply to prepaid cards issued by American Express, transactions conducted with loyalty, award, and/or promotional gift cards from any issuer should not be covered under Section 920(a) for both legal and policy reasons.

The Board suggested in a footnote in the Proposed Rule that such incentive cards are subject to regulation under the interchange transaction fee provision by using a canon of construction that every clause of a statute should, if possible, be given separate effect. 75 Fed. Reg. at 81,730 n.40. We respectfully disagree with that interpretation and submit that the Board should include within the categories of cards that are exempt from the interchange fee provisions the types of incentive cards that are expressly exempt from the definition of "general use prepaid card" as that term is applied in other parts of the EFTA.

The definition of "debit card" in Section 920(c)(2)(B) "includes a general-use prepaid card, as that term is defined in section 915(a)(2)(A)." Section 915(a)(2)(A) is modified by Section 915(a)(2)(D) of the EFTA, which excludes from the definition of "general-use prepaid card" the following six types of prepaid cards:

an electronic promise, plastic card, or payment code or device that is—

(i) used solely for telephone services;
(ii) reloadable and not marketed or labeled as a gift card or gift certificate;
(iii) a loyalty, award, or promotional gift card, as defined by the Board;
(iv) not marketed to the general public;
(v) issued in paper form (including for tickets and events); or
(vi) redeemable solely for admission to events or venues at a particular location or group of affiliated locations, which may also include services or goods obtainable—

(I) at the event or venue after admission; or
(II) in conjunction with admission to such events or venues, at specific locations affiliated with and in geographic proximity to the event or venue.

As noted above, the definition of "debit card" in Section 920(c)(2)(B) includes "a general-use prepaid card, as that term is defined in section 915(a)(2)(A)." The Board has proposed to apply the interchange fee to all types of cards that are included in the first part of the definition of "general use prepaid card" in Section 915(a)(2)(A) of the EFTA, 15 U.S.C. § 1693*l*-1(a)(2)(A), but then proposes to ignore the Exclusions from that definition that are set forth in Section 915(a)(2)(D).

The six Exclusions are an integral part of the definition of "general use prepaid card" as that term has been applied since it was added to the EFTA in 2009. Properly construed, the types of prepaid cards listed in (i)-(vi) above, including "loyalty, award, and promotional gift cards" as set forth in Section 915(a)(2)(D)(iii), are not part of the definition of "general-use prepaid card" and therefore should not be subject to the interchange fee provision.

In its footnote, the Board rejects this interpretation on the ground that if it were correct, Congress would not have needed to separately include an exception for "reloadable prepaid cards that are not marketed or labeled as a gift card" in Section 920(a)(7)(ii)(V). With respect, this canon of construction is not applicable and is countered by the canon that a provision of the statute should not be considered in isolation, but must be considered in the context of the statute as a whole. In context, it is clear that the intent of Congress was to make prepaid cards "marketed or labeled as a gift card" subject to the interchange fee. Considering the statute as a whole, there is nothing to suggest that Congress intended to subject to interchange transaction fee regulation the six other types of prepaid cards that are <u>excluded</u> from the definition of "general-use prepaid card" elsewhere in the EFTA.

Moreover, prepaid loyalty, award and promotional gift cards far more closely resemble the government benefit cards that Congress expressly wished to exempt from interchange regulation than gift cards, which Congress clearly intended to cover. For example: loyalty cards are given to consumers as an incentive to shop at a particular merchant or as a reward for frequenting a particular merchant; award cards are provided to employees by an employer to reward the employee for performance or some other employment-related achievement; and promotional cards are provided to consumers as an added benefit for purchasing or trying a particular product or service. These types of incentive cards, like government benefits cards, are not mass market, retail, direct-to-consumer products like gift cards. Unlike gift cards, but similar to government benefit cards, these incentive cards are provided only to specific, qualified individuals for specific reasons, and are not offered to the public at large on a mass market basis.

Accordingly, the Board should modify its interpretation and provide in the Final Rule that the types of cards described in Section 915(a)(2)(D) are exempt from the interchange fee provision.

III. The Board Should Except Three-Party Networks Like American Express from the Requirement To Enable a Second Payment Card Network To Route Transactions Back to Itself for Acquisition.

In the Proposed Rule, the Board found that the network exclusivity provision, Section 920(b)(1) of the EFTA, sought to preserve price competition for PIN-based routing of traditional debit cards that Visa and MasterCard had stifled by entering into exclusive agreements with issuers requiring merchants to use an online PIN network affiliated with the four-party network as the exclusive router for all debit transactions. 75

Fed. Reg. at 81,748-49. Three-party closed-loop networks like American Express were not part of the problem Congress sought to address and indeed were never mentioned.

The Board also clearly recognized that "the nature of a three-party system could be significantly altered by any requirement to add one or more unaffiliated payment card networks capable of carrying electronic debit transactions involving the network's cards" and that the costs and operational changes necessary to enable a second payment network would be substantial. It also acknowledged that addition of another network to a closed-loop would result only in "more circuitous routing" of the prepaid transactions back to the three-party network for acquisition. 75 Fed. Reg. at 81,727-28, 81,749, 81,753. The costs of enabling a second network would be high, and the ostensible benefits to merchants would be illusory. Under these circumstances, grant of an exception to the network exclusivity provision for three-party closed-loop networks is consistent with the purposes of the statute.

In the alternative, should the Board not grant an exception for three-party systems, then it should at minimum except prepaid cards that are not enabled for PIN functionality at the point-of-sale from this requirement. Specifically, this alternative exception should provide that issuers of prepaid cards are only required to enable an unaffiliated network for routing prepaid card transactions if the issuer has PIN-enabled the prepaid card for transactions at the merchant point-of-sale. Either of these two approaches is fully consistent with the legislative history and the Congressional intent behind passage of Section 920(b)(1).

If the Board does not grant either exception, then the proposed implementation deadlines associated with either Alternative are infeasible for a three-party system such as American Express, which has not PIN-enabled its prepaid cards for authorization of purchases at the point-of-sale. The deadline should be extended to at least July 31, 2013.

A. There Is No Legal Authority To Adopt Alternative B.

The Board has proposed two Alternatives for implementing Section 920(b)(1). Under Alternative A, the issuer or payment card network may not limit the number of payment card networks on which debit transactions may be processed to less than two unaffiliated networks, and the issuer has discretion whether the second network it enables will be a signature debit or a PIN debit network. Under Alternative B, an issuer may not limit the number of payment card networks on which debit transactions may be processed to less than two unaffiliated networks for each method of authorization enabled – that is, a card enabled for both signature and PIN debit authorization must have at least two unaffiliated signature and two unaffiliated PIN debit networks enabled.

Alternative B goes beyond what the law permits. The text of the statute is unambiguous. Section 920(b)(1)(A) authorizes the Board to promulgate a rule that prohibits an issuer or payment card network from restricting the number of payment card networks on which an electronic debit transaction may be processed to (i) one network;

or (ii) two or more networks that are owned, controlled, or otherwise operated by affiliated persons or networks affiliated with the issuer of the debit card.

B. The Board Should Exercise Its Statutory Authority To Create an Exception from Section 920(b)(1) for Three-Party Payment Systems.

In adopting the Final Rules, the Board should take its own findings into account concerning the unique nature of three-party networks, and the costs and operational burdens that would be incurred to add a second network to a three-party system. 75 Fed. Reg. at 81,727-28, 81,749, 81,753. We urge the Board therefore to except three-party networks such as American Express from Section 920(b)(1).

Unlike four-party networks, the American Express closed-loop, three-party system is neither configured nor designed to route its prepaid card transactions over another payment card network. In fact, all American Express prepaid card transactions are routed over the same signature-based system that American Express uses for its charge and credit cards. As referenced earlier, unlike four-party systems, the American Express network has never enabled PIN functionality at the point-of-sale, and no American Express prepaid cards have PIN functionality at the point-of-sale.[13] Adopting either Alternative without an exception for three-party systems would have a disproportionately negative impact on a three-party system like American Express. For example, issuers on four-party systems already have the ability to quickly enable unaffiliated networks by choosing an alternative PIN-debit network. This option does not exist for American Express.

Because American Express prepaid cards cannot route over PIN-debit networks, American Express would be forced to incur costs to enable routing over a second network, whether signature or PIN. These are costs that issuers on four-party networks can avoid because such issuers can simply rely upon the PIN functionality they use today for their debit cards to enable another PIN-debit network. The result is that Section 920(b)(1) would have disproportionate impact on American Express, contrary to the stated purpose of this provision, which was to prohibit the exclusive routing agreements by the four-party networks. The Board has the authority to prevent this result and should do so by providing an exception to three-party systems under Section 904(c).

Congress prohibited exclusive routing arrangements to encourage competition in the open loop systems that would result in lower cost routing options for merchants. However, if American Express were forced to incur the substantial and ongoing costs and burdens of adding an alternative payment network to its closed-loop system, merchants would likely experience cost increases, not savings. Whatever theoretical benefit there

[13] Some American Express prepaid cards are PIN-enabled to access ATMs for cash withdrawals. However, ATM transactions are entirely different from purchases at merchants. ATM transactions do not run on the same systems as the rest of the network through which purchases at merchants are authorized. American Express created specialized systems to provide ATM access for these cards that could not be used or configured in any way for point-of-sale transactions.

might be to merchants from adding a second network would be outweighed by a potential increase in fees, decrease in commissions paid to merchants for prepaid card sales, or reduced investment in the prepaid card business by American Express to recoup the substantial implementation and ongoing costs incurred to implement alternative network routing. The ostensible purpose of the statute would not be fulfilled by forcing American Express to break its closed-loop for routing prepaid transactions. All that would occur, as the Board explicitly recognized, is that American Express prepaid transactions would simply be subject to "more circuitous routing" back to American Express for acquisition.

For these reasons, the Board should grant American Express an exception to the routing provisions.

C. <u>Alternative Exception for Prepaid Cards.</u>

In the alternative, the Board should grant an exception for prepaid cards that an issuer has not PIN-enabled for transactions at the merchant point-of-sale. Debit cards would remain covered by the statute, as clearly required and intended by the law. But the evolving category of prepaid cards would receive an exception from the alternative routing requirements if the issuer determines that PIN-enablement is not a feature included on the prepaid card. This is a reasonable exception because it is consistent with the legislative history and Congressional intent behind passage of section 920(b).

As already noted, Section 920(b) was designed to preserve price competition for PIN-based routing of debit cards. Congress was not focused on prepaid cards, likely because the substantial majority of prepaid cards are only enabled to route over signature networks. In fact, the Board determined through its own analysis of the Survey responses that almost 75% of all non-reloadable prepaid cards are enabled only to route over signature networks.[14] In some instances, issuers have likely determined that it is infeasible and illogical to include PIN functionality on prepaid cards that are designed to be used only for a limited number of transactions (e.g., gift cards), or that including PIN functionality is cost-prohibitive given the higher costs issuers incur to operate prepaid card programs.[15] For American Express, which operates a closed-loop signature network, enabling PIN functionality at the merchant point-of-sale is literally not an option currently available to it as an issuer of prepaid cards.

It follows that if issuers find it cost-prohibitive to issue prepaid cards with PIN functionality, then an alternate signature network would need to be enabled on the issuer's prepaid card to meet the requirements of either Alternative. But, as the Board determined, enabling multiple signature networks entails substantial cost and operational burdens to many parties, including prepaid card issuers, without a discernible benefit to merchants. Thus, applying Section 920(b)(1) to prepaid cards that are not PIN-enabled

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[14] 75 Fed. Reg. at 81,725.

[15] *See* Section IV.A and B of this letter for further discussion of costs applicable to issuing prepaid cards.

by the issuer would be an inappropriate application of the provision to a product category that Congress never intended to cover and never discussed or debated.

The Board has the authority to adopt provisions that differentiate between various types of prepaid cards in the Final Rule. The Board should do so by providing an exception for prepaid cards that an issuer has not PIN-enabled for purchases at merchants.

D. Recommendations to Board and Proposed Exception Language.

Based on the above analysis, the Board should exercise its authority under Section 904(c) of the EFTA to conclude that it is "necessary or proper to effectuate the purposes" of the statute to grant an exception to the network exclusivity provision to a three-party network; or at a minimum to provide an exception that issuers of prepaid cards should only be required to enable an unaffiliated network for routing prepaid card transactions if the issuer has PIN-enabled the prepaid card for transactions at the merchant point-of-sale.

American Express submits that in promulgating the Final Rule, the Board should amend Proposed § 235.7 and add the following provision to grant a general exception for three-party networks:

> (__) The requirements of paragraphs (a) and (b) of this section shall not apply to: (i) any three-party payment card network in which the network acts as the issuer, network and acquirer for the electronic debit transactions on that network; or (ii) any issuer with regard solely to electronic debit transactions that route over a three-party payment network.

If instead the Board determines that an exception is warranted for issuers of prepaid cards that do not PIN-enable the prepaid cards for transactions at the merchant point-of-sale, then American Express submits that in promulgating the Final Rule, the Board should amend Proposed § 235.7 and add the following provision:

> (__) The requirements of paragraphs (a) and (b) of this section shall not apply to any issuer of prepaid cards that are not PIN-enabled for authorization of transactions at the merchant point-of-sale.

E. The Proposed Deadline for Adding a Second Payment Card Network to a Closed-Loop System Is Infeasible and Should Be Extended.

If the Board determines not to grant the requested exceptions, then the proposed implementation deadline should be extended for three-party, closed-loop networks because it is infeasible. In light of the significant amount of time and resources that would be required to change core functions of the American Express network, the implementation deadline should be extended to at least July 31, 2013.

IV. The Board Should Ensure that the Interchange Transaction Fee for Prepaid Cards Reflects the Higher Costs Incurred in Authorization, Clearing, Settlement and Fraud-Prevention than for Debit Cards.

As stated earlier, there is no statutory authority or economic basis to regulate any portion of American Express's merchant discount. Without conceding that point, American Express respectfully submits that the Board should consider the following Comments which are addressed to other issues presented by the Proposed Rule.

First, based on its own prior findings, the Board should allow recovery of a higher interchange fee for prepaid card transactions in recognition of the greater costs incurred in their authorization, clearing, and settlement. Second, the Board should, as a matter of law and policy, adopt the Non-Prescriptive approach to adjusting the interchange fee for fraud-prevention costs and reject the Technology-Specific approach. Third, under the Non-Prescriptive approach, the Board should allow issuers of prepaid cards to recover a larger adjustment, and thus a higher interchange fee, than issuers of debit cards because of the greater fraud-prevention costs associated with prepaid card transactions.

A. The Final Rule Should Reflect that the Costs of Authorization, Clearing and Settlement for Prepaid Cards Are Higher than for Debit Cards.

Under Section 920(a)(2) of the EFTA, the Board may only prescribe standards that allow an issuer to receive an interchange transaction fee that is "reasonable and proportional to the costs it incurs for authorizing, clearing, and settling a transaction." The Board is not required to set a specific fee amount, a capped amount, or the same fee for all covered electronic debit transactions. Rather, this provision grants the Board discretion to permit issuers of prepaid cards to receive a higher interchange fee than issuers of debit cards upon a showing that their costs of authorizing, clearing, and settling prepaid card transactions are higher.

In the Preamble to the Proposed Rule, the Board noted that its analysis of the Survey responses showed that the total costs incurred by issuers of prepaid cards exceed those for issuers of debit cards ($0.636 for prepaid cards versus $0.137 for signature debit cards and $0.079 for PIN-debit cards.) 75 Fed. Reg. at 81,725 n. 25.

Based on the evidence already in the administrative record, American Express submits that the Board should take these higher costs into account if it imposes an interchange transaction fee for prepaid card transactions. Indeed, the "reasonable and proportional" standard could be read to require such an enhanced adjustment for prepaid cards given the Board's prior factual findings.

B. The Board Should Ensure that the Interchange Fees Reflect the <u>Greater Fraud Prevention Costs for Prepaid Cards than for Debit Cards</u>.

In implementing Section 920(a)(5)(A) of the EFTA, the Board should follow the Non-Prescriptive approach and should allow a higher interchange fee adjustment for issuers of prepaid cards in recognition of the higher anti-fraud costs they incur.

1. The Board Should Adopt the Non-Prescriptive Approach and Reject <u>the Technology-Specific Approach to Fraud-Prevention Standards</u>.

Section 920(a)(5)(A) does not, by its own terms, require that the Board adopt a "Technology-Specific" – or design standard – approach, under which it would identify specific technologies that an issuer must adopt to qualify for an interchange fee adjustment. Rather, the provision is silent on this point. Accordingly, the governing legal standard is established by Section 904(a)(1) of the EFTA, 15 U.S.C. § 1693b(a)(1), which provides that in prescribing regulations to carry out this statute, "the Board shall . . . . take into account, and allow for, <u>the continuing evolution</u> of electronic banking services and technology utilized in such services." (Emphasis added).

Section 904(a)(1) reflects the core principle of re gulatory design that, unless specifically required by the underlying statute, agencies generally should avoid Technology-Specific or design standards, and should adopt Non-Prescriptive, performance-based standards. The literature on regulatory design shows that performance standards are generally considered superior to technology-specific standards because they enhance efficiency and encourage innovation, by permitting regulated entities to take different approaches to satisfying the regulatory goal.[16] The Office of Management and Budget has articulated this principle as follows:

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[16] Professor W. Kip Viscusi has summarized the principle as follows:

> The central advantage of performance standards is that the firm has the opportunity to select the least costly means of compliance. The cost savings do not stem solely from the fact that businessmen have greater technical expertise than government officials, though this may be a pertinent factor. The greatest gains from this discretion arise from the wide variations in technologies of different vintage and type. Although one compliance approach may be most efficient in many contexts, uniform risk reduction technologies will seldom be optimal in all situations.

RISK BY CHOICE: REGULATING HEALTH AND SAFETY IN THE WORKPLACE 130-31 (1983). Similarly, then Professor, now Justice, Stephen Breyer has observed:

> [D]esign standards limit the firm's flexibility. A firm that finds a cheaper or more effective way of achieving the regulation's objective must undertake the heavy burden of forcing a change in the standard before it can use its new method. It thus has diminished incentive to look for better methods. For the same reason, a design standard tends to freeze existing technology and to favor those firms already equipped with that technology over potentially innovative new competitors.

REGULATION AND ITS REFORM 105 (Harvard University Press 1982).

> Performance standards express requirements in terms of outcomes rather than specifying the means to those ends. They are generally superior to engineering or design standards because performance standards give the regulated parties the flexibility to achieve regulatory objectives in the most cost-effective way. In general, [the agency] should take into account both the cost savings to the regulated parties of the greater flexibility and the costs of assuring compliance through monitoring or some other means.[17]

Indeed, just last month President Obama specifically reminded the Heads of Executive Agencies that the Regulatory Flexibility Act, 5 U.S.C. § 603(c)(3), requires favorable consideration of the flexibility of "performance standards rather than design standards."[18] The Regulatory Flexibility Act applies to the Board in this rulemaking.

As the Proposed Rule recognizes, the Technology-Specific standard "would cause issuers to under-invest in other technologies that may be more effective and less costly than those identified in the Board's standards." 75 Fed. Reg. at 81,742. By contrast, the Non-Prescriptive, performance-based approach would provide issuers with the ability to innovate and provide "flexibility in responding to emerging and changing fraud risks." *Id.* Stated another way, if it mandated adoption of a specific technology, the Board would have only one chance to solve the problem correctly, for all possible situations. If the Board were to force all issuers to implement technology that later proved to be sub-optimal, the adverse effects of that decision on the industry would be substantial and long-lasting.

Finally, a rule dictating a standardized anti-fraud technology that all issuers must adopt could have the unintended consequence of making the U.S. financial system less secure. In this scenario, criminals would have an easier time attacking the integrity of the payments system. They would have only one publicly-known technology to reverse engineer and circumvent, rather than multiple, non-public approaches, and could concentrate their energies on trying to determine vulnerabilities in that one technology. If they were successful in attacking any one network, then the adverse effects would likely be experienced system-wide. Issuers would then have the double burden, and double expense, of developing new methods to thwart the fraudsters, while also being compelled to maintain a regulator-mandated technology that was no longer effective.

For these reasons, imposition of a Technology-Specific standard would contravene the Board's statutory obligation to allow for "the continuing evolution" of the technology utilized by payment card networks. The Board therefore should follow the Non-Prescriptive, performance-based approach in adopting fraud-prevention standards.

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[17] OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, OMB CIRCULAR NO. A-4, Regulatory Analysis at 8 (2003).

[18] Regulatory Flexibility, Small Business, and Job Creation, Memorandum for the Heads of Executive Departments and Agencies, 76 Fed. Reg. 3,827, 3,828 (Jan. 18, 2011).

2. The Board Should Not Require that Issuers of Non-Reloadable Prepaid Cards Install Chip and PIN Technology.

Sections 904(a)(2) and (3) of the EFTA require the Board to take into account the costs and benefits of its rules on financial institutions. Applying these provisions, the Board should, in particular, reject imposition of the Chip and PIN technology discussed in the Proposed Rule. Imposing such a requirement would be both prohibitively expensive to implement for non-reloadable prepaid gift cards and would produce little, if any, benefit in fraud prevention.

The costs of prepaid gift cards are driven by the cost of producing the card and the number of times the card is used. American Express estimates that implementation of a Chip and PIN requirement could cost as much as $2.50 per card. Most non-reloadable prepaid gift cards are currently issued in small denominations (i.e., $25, $50, or $100), and the added cost of this technology would significantly inhibit an issuer's ability to offer such low denomination cards. This in turn would restrict consumer choice. Moreover, non-reloadable prepaid gift cards are used in far fewer transactions than debit cards before the funds on the card are depleted. With such limited transaction volume per card, it would be much more difficult to defray the cost of incorporating such expensive fraud protection technology in these cards. Indeed, a substantial proportion of the investment required to install this technology in non-reloadable prepaid gift cards would be a deadweight loss because of the "shrinkage" factor -- the fact that a substantial percentage of the prepaid gift cards produced are not ultimately sold to consumers, but are destroyed.

The only way for an issuer of non-reloadable prepaid gift cards to offset these added costs would be to increase the purchase price of those cards or impose other fees. Any such increase or additional fees, however, would have a chilling effect on a consumer's willingness to purchase lower-denomination gift cards and would call into question whether such cards could be viable in the marketplace.

Moreover, Chip and PIN technology is designed to assist a merchant accepting the card in authenticating the identity of the person presenting the card. This approach may be feasible for debit cards, where the issuer has substantial information concerning the identity of the authorized cardholder. But it is not feasible and would produce little in the way of benefits for gift cards, where the issuer does not know the identity of the purchaser, much less the person to whom the purchaser may have given a gift card. The costs of adding this technology would greatly outweigh the putative benefits. For these reasons, the Board should not require that issuers of non-reloadable prepaid gift cards include Chip and PIN technology.

3. The Board Should Authorize a Larger Fraud Prevention Allowance for Prepaid Cards Because Their Fraud-Prevention Costs <u>Significantly Exceed Comparable Costs for Debit Cards.</u>

Significant differences exist in the fraud-prevention efforts that are required for prepaid cards than for debit cards.

a. Relative Anonymity of Purchasers. Non-reloadable prepaid cards, such as gift cards, have a greater level of anonymity associated with them than debit cards and therefore subject the issuers to greater fraud risk. A traditional debit card is linked to a demand deposit account, and the issuer obtains a substantial amount of information about the cardholder through the "Know Your Customer" process at account opening and during the ongoing banking relationship. In addition, debit cards may be used repeatedly and over a long period of time. The history of the cardholder's prior spending pattern is a major tool used by issuers to manage debit card fraud.

Prepaid gift cards, by contrast, possess neither of these features and thus present greater risks of fraud. There is no underlying deposit account to which the purchaser of a gift card is linked. The issuer also does not have an ongoing relationship with the purchaser, much less with the person to whom the purchaser may give the card. An individual gift card is used in far fewer transactions than debit cards, so there is little spending profile to model, and the issuer thus cannot rely upon this major anti-fraud tool.

Without information about the cardholder and the prior spending pattern, issuers of non-reloadable prepaid gift cards must address the risk of fraud in different, more expensive ways, such as by imposition of more restrictive program parameters. For example, American Express has built custom spending fraud logic programs for gift cards to help manage fraud, and has worked closely with individual merchants that are at risk of fraud, especially in the "card not present" and web-based or mail order/phone order situations.

b. Mass Distribution. Prepaid gift cards are sold through a mass distribution model, which presents very different fraud-prevention challenges from the traditional debit card model. Because of the mass distribution model, issuers of gift cards must make larger investments in such areas as secure retail packaging, managing retail fraud risk, and distribution fraud. In determining the appropriate allowance, the Board should consider all these costs, which are not incurred by issuers of debit cards.

Much of the fraud associated with non-reloadable prepaid gift cards comes from counterfeit cards or cards that have been switched, compromised, or skimmed in the mass retail distribution environment, which is far less secure than the issuance of debit cards by a bank as a feature of a deposit account. A key element of fraud prevention efforts for these cards occurs through the development of secure retail packaging, which comprises a significant percentage of the cost of producing such cards.

In addition, a substantial percentage of prepaid cards are sold on-line and paid for by a transfer from a credit card. This increases the consumer payment risk experienced by the issuer of such prepaid cards. Prepaid issuers need to invest in preventing fraud at the funding source, in contrast to a debit card which is funded by the customer's demand deposit account that the issuing bank can monitor closely.

In sum, there are significant differences between prepaid gift cards and traditional debit cards as shown by the fraud-prevention efforts that issuers must undertake. The Board should recognize these differences and allow issuers of non-reloadable prepaid gift cards an adjustment to the interchange fee that reflects those differences.

V. The Board Should Regulate Non-Traditional and Emerging Payment Networks If They Set Rules For Issuers and/or Acquirers Involved in Processing Electronic Debit Transactions on the Payment System.

The Board specifically requested comment on whether non-traditional or emerging payment systems would be covered by the statutory definition of "payment card network" as clarified by proposed Section 235.2(m)(2). 75 Fed. Reg. at 81,733.

American Express submits that if a non-traditional or emerging payment system (1) provides the infrastructure through which debit cards (as defined in the statute) are accepted and electronic debit transactions are authorized, cleared, and settled; (2) issues (or licenses third-parties to issue) debit cards on its system; (3) acquires (or licenses third-parties to acquire) merchants on its system; and (4) establishes guidelines, rules or procedures that covers its (or licensed third-parties') activities as issuer and acquirer on its network, then the payment system meets the definition of payment card network and should be regulated as such. This is consistent with how the Board approached the issue in the Proposed Rule.

The Board defined traditional closed-loop networks, like American Express, where the network serves multiple roles of network, issuer and/or acquirer, and establishes guidelines, rules, or procedures to cover its activities as issuer or acquirer, to be "payment card networks" under the regulation. The Board should take the same approach when evaluating whether a non-traditional or emerging payment system meets the definition of "payment card network." If it does, then the entity's offerings should be regulated in a manner consistent with the Board's regulation of similar products offered by the traditional payment card networks.

The Board specifically referenced PayPal when it asked for comments as to whether non-traditional payment systems would be covered by the statutory definition of "payment card network." PayPal, which launched its payment services over ten years ago, has had substantial growth. In fact, as of the end of 2009, PayPal's approximately 81 million active users in over 190 markets have conducted transactions through the PayPal network in the tens of billions of dollars.[19] PayPal leverages traditional payment

[19] eBay, Inc., Annual Report (Form 10-K) (Feb. 17, 2010).

card networks and the existing financial infrastructure of bank accounts to support its users' choice of funding transactions. But PayPal also allows its users to fund electronic debit transactions through existing PayPal balance accounts that PayPal issues, manages and administers for its users. In fact, PayPal balance transactions represent 17% of total payments volume on PayPal.[20]

The Board noted that some debit card transactions involving a non-traditional payment system, such as PayPal, may be subject to rules and procedures established by other networks. But there are certain electronic debit transactions -- such as the PayPal prepaid balance account referenced above -- that are <u>not</u> subject to rules of other networks but only to PayPal's own network rules. As the Board also noted, and as publicly available information would suggest is the case with PayPal's prepaid balance accounts, transactions using funds that are held by the non-traditional payment system are subject to rules and procedures established by that system. PayPal has established specific rules and procedures that govern PayPal in its role as the issuer of the electronic debit transaction, in this case the prepaid balance account. And because PayPal itself acquires the merchants that use its services, including the acceptance of the PayPal prepaid balance account, PayPal's own network rules and procedures also govern its role as the merchant acquirer.

Accordingly, even though characterized by the Board as a non-traditional payment system, we believe that PayPal fits the Board's definition of "payment card network" because it is operating a three-party network by serving the multiple roles of network, issuer and acquirer, and PayPal establishes rules for itself as issuer and merchant acquirer with regard to PayPal's proprietary issued products, in this example the PayPal prepaid balance account. Thus, regardless of whether PayPal calls itself a "merchant of record," in its operation of the PayPal prepaid balance account, we believe that PayPal fits squarely within the definition of "payment card network" set out in the Proposed Rule, and therefore should be regulated as such by the Board.

While traditional, non-traditional, and emerging payment systems likely have, or will develop, other models that differ from the example set forth above, the payment system (whether traditional or non-traditional) should be deemed a "payment card network" under the Durbin Amendment if the entity sets rules that govern the rights and obligations of issuers and/or acquirers involved in processing electronic debit transactions through the payment system. As Professor Willig explains, asymmetric regulation of three-party networks and other emerging systems would distort innovation and marketplace evolution, and reduce competition. In this case, if the Board is going to regulate American Express as a payment card network, it should regulate non-traditional payment networks on a fair, uniform, and even-handed basis.

The volume of commerce effected through on-line transactions and alternative payments is growing rapidly, and these payment methods offer convenience, ease, and

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[20] CREDIT SUISSE, eBay, Inc. Upgrade Rating at 29 (Mar. 25, 2010).

other benefits to merchants and consumers. It is important that the Board permit these payment methods to develop competitively and fairly, and at the same time not to prematurely designate certain payment networks as having a regulator-endorsed, favored position that frees them from regulatory constraints when they perform the same functions as other networks that are regulated.

Conclusion

For the reasons stated above, American Express respectfully requests that the Final Rule exempt three-party networks such as American Express from the interchange transaction fee and the network exclusivity and routing provisions of the Durbin Amendment. We also respectfully request that the Board treat non-traditional networks in the same manner as it treats traditional payment card networks under the Final Rule, and modify the Final Rule in the other respects discussed in these Comments.

Thank you for your consideration of these Comments. If you have any questions or wish to discuss the Comments, please do not hesitate to contact me.

Respectfully submitted,

Anne Segal

Anne Segal
Managing Counsel

ATTACHMENT

Avoiding Misapplication to American Express of the Proposed Debit Card Interchange Fee Rules: An Economic Assessment

Professor Robert D. Willig

February 22, 2011

Prepared at the Request of
Counsel for American Express Company

I. Introduction

My name is Robert D. Willig. I am a Professor of Economics and Public Affairs at the Woodrow Wilson School and the Economics Department of Princeton University. Previously, I was a Supervisor in the Economics Research Department of Bell Laboratories. My teaching and research have specialized in the fields of industrial organization, government-business relations, and welfare theory. From 1989 to 1991, I served as Chief Economist in the Antitrust Division of the US Department of Justice, where I led the development of the 1992 *Merger Guidelines*. I am the author of *Welfare Analysis of Policies Affecting Prices and Products,* and *Contestable Markets and the Theory of Industry Structure* (with William Baumol and John Panzar), and numerous articles, and I have served on the editorial boards of *The American Economic Review, The Journal of Industrial Economics* and the MIT Press Series on Regulation. I have served as a consultant and advisor for the Federal Trade Commission and the Department of Justice, for OECD, the Inter-American Development Bank, and the World Bank, and for governments of many nations.

Counsel for American Express Company ("American Express") has requested that I prepare this economic analysis of the Notice of Proposed Rulemaking ("NPRM") issued by the Board of Governors of the Federal Reserve System ("Board") concerning the implementation of the Durbin Amendment of the Dodd-Frank Act (the "Durbin Amendment").[1]

In this paper, I provide an economic assessment of the proposed rules relating to the regulation of prepaid card interchange fees and the symmetric application of regulations to non-traditional payment systems. The views expressed here are my own, based upon my expertise and experience with issues of regulation, competition and the public interest impacts of policies at the interface of government and business, as well as information provided by American Express.

II. Executive Summary

The Board proposes regulating the interchange fees for transactions using debit and prepaid cards. American Express, which does not issue debit cards, is the sole acquirer and

[1] Proposed Rule, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (December 28, 2010).

issuer of American Express prepaid cards in the US,[2] as well as the operator of the American Express network used by American Express prepaid cards. As noted later in this paper, American Express prepaid cards account for a very small fraction of the volume of US debit and prepaid card transactions.

Because of its integrated three-party network architecture for prepaid cards, American Express has no "interchange fee" paid by independent acquirers to compensate independent issuers. No market transactions in the operation of integrated three-party networks such as American Express reflect what could possibly be considered an "interchange fee" analogous to such fees in the context of four-party networks.

Moreover, there is no reliable regulatory formula to manufacture a surrogate for interchange fees in the context of American Express's three-party network, because the economic function performed by interchange fees in four-party networks does not exist in the American Express prepaid cards architecture. Four-party networks attempt to attract third-party issuers (and cardholders) as well as merchant acquirers (and merchants). In order to balance these two sides of the payment platform, whose services are provided by multiple independent parties, four-party networks generate cash flows between the two sides of the network. Interchange fees set by four-party networks are a key element of this balancing act. Increasing the interchange fee attracts more issuers (and thus cardholders) even as it increases cost to merchant acquirers (and thus merchants). Reducing the interchange fee does the opposite. Four-party networks set the interchange fee at a level intended to strike the right balance between the independent players on the two sides of the payment platform.

Integrated three-party payment platforms such as American Express also have to balance the card issuance/cardholder side with the merchant acquisition/merchant side. However, this is a purely internal process; there is no interchange fee for prepaid products that is used as a means of achieving such balance. Prices paid by cardholders and merchants are set without reference to an interchange fee. Thus, there is no element of the American Express prepaid card business structure that serves the same economic function as interchange fees in the context of four-party networks.

In addition, the issuance, acquisition and network functions of American Express prepaid cards share common costs and revenues with each other and with other businesses in American

[2] I understand that there is one unique arrangement in which a former joint venture partner of American Express continues to issue certain corporate incentive prepaid American Express cards, but there are no ongoing payments from American Express to the issuer relating to the cards that the entity issues.

Express's integrated structure. In order to manufacture an interchange fee for American Express prepaid cards for the purpose of regulation, the Board would need to find a meaningful – as a matter of economics and policy – and reliable formulaic way to allocate common costs, values and revenues to a hypothetical prepaid card interchange function that for American Express does not exist. Any attempt to do so using a regulatory formula would be arbitrary because there is no way that such a formula could reflect the necessary information on costs, economic value and revenues generated by the integrated issuance, acquisition and network functions of American Express.

The economics literature relevant to the analysis of payment cards networks highlights the difficulty of appropriately regulating interchange fees even in four-party networks. The risks of faulty regulation are substantially elevated in the context of three-party networks where regulators would be attempting to regulate a hypothetical interchange fee where none exists. In the case of four-party networks, the Board is attempting to regulate observed market-based interchange fees; there is no need to manufacture a regulatory surrogate for such fees. In contrast, for American Express, the Board would have to attempt to manufacture a formulaic surrogate for interchange fees that it would then regulate. Any such attempt would produce an unreliable and likely incorrect proxy for interchange fee for the reasons mentioned above. A mistaken proxy that reduces American Express's fees below its costs would force American Express to recover its costs or reduce its investments in ways that would be detrimental to the ability of American Express to compete effectively, and ultimately harm merchants and consumers as well.

In addition, I believe that if the price-setting or price-capping mechanism described in the NPRM were applied to American Express, the result would be seriously damaging to the Company's prepaid business and, again, ultimately to merchants and consumers. I understand that the proposed 12-cent cap is based on averaging the cost of processing debit and prepaid cards, with the cost of debit card processing being significantly lower than the cost of processing prepaid cards. Since there are many more debit card transactions than prepaid card transactions, the 12-cent cap is more likely to be reflective of the costs of debit cards than prepaid cards. If so, on average, issuers face a higher risk that the regulated cap will not cover their costs, let alone allow for a reasonable return, for prepaid card transactions than for debit card transactions. This is especially the case for American Express, which issues prepaid cards but no debit cards.

If confining regulation prevents American Express from recovering its transaction processing costs and if it were to attempt to recover its costs through other fees paid by prepaid cardholders, then even if merchants were to benefit in the short run from the proposed regulation, cardholders would be left worse off. Moreover, because sales of prepaid gift cards often occur at local supermarkets, drug stores and shopping malls, merchants that act as authorized sellers of prepaid gift cards would likely be harmed in the longer run if American Express were forced to reduce commissions offered to merchants who sell prepaid gift cards, thus inhibiting the ability of American Express to compete in this growing area. Merchants would also be harmed if American Express were forced to reduce investment in prepaid cards, thereby potentially reducing both the sale of cards and the sale of goods that would have been purchased with those cards. Finally, disinvestment by American Express would no doubt further weaken its ability to compete.

Given the absence of a reliable way to impose a "right" price or price ceiling on a hypothetical American Express interchange fee, the Board should allow competition to regulate American Express.

If, despite American Express's *de minimis* share of the universe of transactions potentially covered by the Durbin Amendment, and the infeasibility of appropriate formulaic regulation of American Express fees and the attendant risk of unintended negative consequences, the Board nonetheless believes that it needs to take some action to ensure that competitive forces continue to restrain American Express, an alternative approach to direct formulaic price regulation is to apply the principle of *forbearance*. Under this approach, the Board would monitor, on a periodic basis, the role of American Express as a small but innovative competitor in this space. If there were evidence that American Express's pricing (taking into account the costs and value of its products and services) was inconsistent with competitive levels, the Board could reconsider whether further action is warranted.

In any event, any new regulations should treat symmetrically American Express and other three-party, non-traditional network providers of debit transactions. Any exemption from regulations received by such non-traditional providers (because they do not conform to the traditional notions of a payment card network model) should also apply to American Express. Asymmetric regulation of players (like American Express and PayPal) who have very small shares of this line of business and who are clearly driven by competition would distort innovation and marketplace evolution.

III. Interchange Fee Regulations

1. American Express has no interchange fee, and there is no reliable regulatory formula to manufacture a surrogate.

The proposed interchange fee regulation cannot be appropriately applied to American Express's three-party architecture. Interchange, which is a fee set by four-party card networks such as Visa and MasterCard to compensate issuers when Visa and MasterCard debit and prepaid cards are used to make purchases at merchants, does not exist in the context of a closed loop network such as American Express's integrated card issuing, merchant acquiring and network business model. American Express is the sole acquirer and issuer[3] of American Express prepaid cards in the US as well as the operator of the American Express network, and there is no interchange fee structure to compensate third party issuers or acquirers. Instead, American Express charges merchants a "merchant discount" for transactions conducted with its prepaid cards. No market transactions in the operation of American Express reflect what could possibly be considered an "interchange fee."[4]

Moreover, there is no reliable regulatory formula to manufacture a surrogate for interchange fees in the context of American Express's three-party network for several reasons. First, the economic function performed by interchange fees in four-party networks does not exist in the American Express prepaid cards architecture. Four-party networks attempt to attract issuers (and cardholders) as well as merchant acquirers (and merchants). In order to balance these two sides of the payment platform, whose services are provided by multiple independent parties, four-party networks generate cash flows between the two sides of the network. Interchange fees set by four-party networks are a key element of this balancing act. Increasing

[3] *See* footnote 2, *supra*.

[4] Even if American Express had third-party issuers of prepaid products, the American Express network would still have no separate and identifiable payment flows to third-party issuers that would be equivalent to interchange fee payments in four-party networks. Interchange fee payments are due, and flow, from acquirers to issuers in a four-party network and are merely facilitated by the network. I understand that the interchange fee in a four-party network is readily identifiable and separable from other network payment flows because it is paid to the issuer by the acquirer, is centrally established and imposed through the network's governance bodies, and sets the floor for the acquirers' price to the merchants. In sharp contrast, under the three-party architecture employed by American Express, I understand that all cash flows to the independent issuer are based on a holistically and bilaterally negotiated amalgam of fees payable directly between the network and the issuer that reflect the integrated services provided by American Express. Hence, these flows cannot reliably be separated by a regulatory formula into a surrogate for an interchange fee.

the interchange fee attracts more issuers (and thus cardholders) even as it increases cost to merchant acquirers (and thus merchants). Reducing the interchange fee does the opposite. Four-party networks set the interchange fee to strike the right balance between the independent players on the two sides of the payment platform. Integrated three-party payment platforms such as American Express also have to balance the cardholder side with the merchant side of the network. However, given the integrated nature of such platforms, there is no interchange fee that is used as a means of achieving such balance. Prices paid by cardholders and merchants are set without reference to an interchange fee.

Second, a reliable regulatory formula to identify a surrogate interchange fee is infeasible because prepaid cards share common costs and revenues with other businesses in American Express's integrated structure. I understand that American Express's issuing, network and merchant acquiring functions share significant costs and resources. For example, I understand that the American Express prepaid card division uses the Credit Authorization System ("CAS"), which is integrated into the American Express network, in order to manage fraud risks. More generally, I understand that the prepaid card business group is supported by staff and technology resources shared with American Express credit and charge card issuing, network and merchant acquiring businesses. Moreover, unlike the four-party networks, in which the issuing, acquiring and network businesses are operated by separate and unaffiliated entities, in an integrated company like American Express, decisions to incur costs and make financial investments in new initiatives are made on the basis of the interests of American Express as a whole, not just the distinct and independent interests of the prepaid card issuer, the acquirer and/or the network functions within American Express.

In order to manufacture an interchange fee for American Express for the purpose of regulation, the Board would need to find a meaningful (as a matter of economics and policy) and reliable formulaic way to allocate common costs, economic values and revenue generated by the integrated issuance, acquisition, and network functions to a hypothetical prepaid card interchange service that for American Express does not already exist. Under these circumstances, there is no reliable way that a regulator could develop and apply a regulatory formula to establish price caps such that these caps would be anything but arbitrary and unreliable because a three-party network like American Express's – unlike the four-party networks – simply has no interchange fee due to its integrated architecture and end-to-end business model.

As I explain below, the economics literature related to payment card networks highlights the difficulty of appropriately regulating interchange fees in four-party networks. The risks of faulty interchange fee regulation are substantially elevated in the context of three-party networks where regulators would be attempting to regulate a hypothetical interchange fee. In the case of four-party networks, regulators are attempting to regulate observed market-based interchange fees; there would be no need to construct a surrogate for such fees. Any attempt to construct a surrogate interchange fee using a regulatory formula to delineate some portion of the American Express merchant revenue from prepaid cards as a hypothetical interchange fee would produce an unreliable and likely incorrect proxy for the reasons mentioned above.

A mistaken proxy that in effect forces American Express's prepaid card merchant discount rate down to a level that does not enable American Express to recover its costs and achieve a reasonable return on its investments would result in misaligned incentives and would create a significant risk of harm to merchants and consumers. I explain this in the next section.

2. If the NPRM's seriously flawed price-setting or price-capping mechanism were applied to American Express, the result would be seriously harmful to the Company's prepaid business, merchants and consumers.

a. Proposed Board price formulae appear to be based primarily on costs of debit cards.

The Board proposes to regulate fees based on the average variable per-transaction costs of authorizing, clearing and settling, as well as a future adjustment for fraud prevention costs.[5] The Board's proposed fee cap of 12 cents per transaction, as reflected in the NPRM, appears to rely mainly on estimates of such costs for debit cards.[6] However, I understand that these costs are considerably higher for prepaid cards. Indeed, in the NPRM, the Board acknowledges this fact: "By transaction type, the median variable per-transaction processing cost was 6.7 cents for signature debit, 4.5 cents for PIN debit, and 25.8 cents for prepaid cards."[7]

[5] 75 Fed. Reg. at 81,726.

[6] The 12-cent cap is based on costs reported by issuers who submitted data to the Board in response to a September 2010 Board survey of issuers and networks covered by the Durbin Amendment. 75 Fed. Reg. at 81,737. The NPRM provides few details regarding the calculation of the 12-cent cap. If the Board pooled debit and prepaid card transactions in this calculation, then since debit card transactions/issuers likely dominated the pool of transactions/issuers, the 12-cent cap would be based largely on the costs of debit card transactions. The Board acknowledges that the 12-cent cap does not differentiate between prepaid card transactions and other types of card transactions covered by the proposed rule. 75 Fed. Reg. at 81,737.

[7] 75 Fed. Reg. at 81,737-38. *See id.* at 81,725 n.26.

Additionally, the risks of fraud associated with American Express prepaid cards are higher than for typical debit cards for several reasons. First, debit card holders typically use debit cards for many transactions, and issuers monitor spend patterns on debit cards to detect and prevent fraud. I understand that this is not a tool available to prepaid card issuers because prepaid cards are typically used only a few times. For example, on average, American Express non-reloadable prepaid gift cards are used for just 2.6 transactions.

Second, the issuer of a debit card acquires information about the card holder at the time the cardholder opens the demand deposit account associated with the debit card. The issuer also has an on-going relationship with the cardholder as a result of the demand deposit account. This is not the case with non-reloadable prepaid gift cards, where American Express knows relatively little about either the purchaser or the end user of the card, and no on-going relationship is contemplated – when the funds on the card are depleted, no relationship continues. I understand that this relative anonymity of cardholders exposes such cards to a greater risk of fraud, and commensurately higher costs of preventing these risks. I understand that because of the higher fraud risk associated with prepaid cards, American Express has higher costs and spends relatively more resources on fraud prevention.

In any event, if the 12-cent cap is more likely to be reflective of the costs of debit cards than prepaid cards, then, on average, issuers face a higher risk of receiving compensation that does not cover their costs – let alone a reasonable return – for prepaid card transactions than for debit card transactions. This is especially the case for American Express, which issues prepaid cards but no debit cards. As such, a price-cap formula that does not recognize the higher costs associated with prepaid cards would impact American Express far more negatively than other networks (which have issuers that issue both debit and prepaid cards).

Those effects could cause a cascade of negative consequences, including suboptimal returns and disinvestment. Thus, having different formulae that recognize the higher costs of prepaid cards and permit issuers of such cards to recover their costs and earn a reasonable rate of return is essential to promote competition and efficiency. It should also be noted, however, that although the Board has recognized the potential need to have different price-cap formulae for prepaid and debit cards,[8] even differential price-cap formulae would be insufficient to prevent the competitive harm from inappropriate regulation of an integrated three-party network, for reasons stated above.

[8] 75 Fed. Reg. 81,737-38.

b. If applied to American Express prepaid cards, the proposed price regulations would be likely to harm merchants as well as consumers.

If American Express prepaid-card merchant discount fees were regulated at a level that did not take accurate account of costs (which, for the reasons stated above, is a real danger) and did not allow for a reasonable return (as addressed in the following section), then American Express would need either to try to recover its costs in some other distorted fashion, or, if it were unable to recover the costs of investments in the business, to stop issuing prepaid cards. If it were to attempt to recover its costs through other fees paid by prepaid cardholders, then even if merchants were to benefit in the short run from the proposed regulation, cardholders would be left worse off.

Besides increasing cardholder fees, American Express may be forced to attempt to replace any lost fees by decreasing the commission offered to merchants who sell prepaid gift cards, thus reducing their economic benefit from selling the card, and potentially reducing output in the sale of cards and output in the sale of goods that would have been purchased with those cards. Merchants might be harmed in other ways as well if American Express lost the ability to offer attractive terms and to innovate in ways that attract consumers to purchase the cards. I understand that merchants profit from increased and incremental sales to customers using American Express prepaid cards.[9] A reduced flow of consumers using American Express prepaid cards means less business for merchants who accept those American Express cards. For at least some merchants, these losses (and lost commissions) could substantially offset or even potentially outweigh the perceived benefits from a potential reduction in fees due to the application of the Durbin Amendment to American Express.

Misapplied regulation of American Express prepaid card fees that prevents American Express from recovering its costs, earning a reasonable profit and choosing its business model would impair its ability to innovate, serve customers and compete effectively. Such unintended consequences of faulty regulation can be observed in the public harms resulting from misdirected price regulations in some other industries. For example, it is generally agreed that non-economic governmental restrictions upon pricing conduct (as well as other forms of conduct and structure) in the railroad industry prior to the reforms brought by the *Staggers Rail Act* in 1980 were

[9] I understand that up to 30% of gift card sales are spent back at the American Express retail partner that sold the cards. I also understand that retail partners made tens of millions of dollars in fees from sales of gift cards in 2010 and that American Express gift cards entail little or no selling cost to retail partners.

responsible in large part for the poor financial condition of the railroads, for the deterioration of the rail plant, for the suppression and delay of cost-reducing innovations, for the mediocre quality of rail service and, most dramatically, for the disabling bankruptcies of major carriers.[10] After the beginnings of deregulation of the US railroad industry in the late 1970s, and especially with the passage of the *Staggers Rail Act*, the industry began a period of rapid output and productivity growth.[11] The 1999-2000 energy crisis in California is another example of serious problems caused (in part) by misdirected non-economic rate regulation -- in that case, the regulation (or flawed partial deregulation) of California's electricity markets.[12]

In both of these examples, many of the negative impacts stemmed from the fact that rate regulations in those industries did not permit key players (in these examples, railroads and electric utilities) to cover costs and generate adequate returns.[13] Not only were rates regulated by some ceilings that were too low relative to costs, but some important regulations impelled cross-subsidization that suppressed demand and stultified competitive reactions to market needs and opportunities. Similarly, faulty regulation of American Express prepaid card fees (as a result of an effort to regulate a surrogate for a non-existent "interchange fee") that prevents American Express from recovering its costs, earning a reasonable profit and choosing its business model would also impair its ability to innovate, serve customers and compete effectively.

[10] Kessides Ioannis and Robert Willig. 1995. "Restructuring Regulation of the Rail Industry," in *Private Sector, Quarterly* No. 4, at 5 - 8; Kessides Ioannis and Robert Willig .1996. "Competition and Regulation in the Railroad Industry," in *Regulatory Policies and Reform: A Comparative Perspective*, C. Frischtak (ed.), World Bank; Kessides, Ioannis. 2004. *Reforming Public Infrastructure: Privatization, Regulation and Competition*, Oxford University Press, at 184-204.

[11] Bitzan, John D. and Theodore E. Keeler. 2007. "Economies of Density and Regulatory Change in the US Railroad Freight Industry," *Journal of Law and Economics*, Volume 50, at 157-179; Wilson, W. W. 1997. "Cost Savings and Productivity in the Railroad Industry," *Journal of Regulatory Economics*, Volume 11, at 21–40; Braeutigam, R. 1993. "Consequences of Regulatory Reform in the American Railroad Industry," *Southern Economic Journal*, Volume 59, at 468–80.

[12] Joskow, Paul. 2001. "California's Electricity Crisis," NBER Working Paper 8442. National Bureau of Economic Research, Cambridge, Mass; Borenstein, Severin.Winter 2002. "The Trouble with Electricity Markets: Understanding California's Restructuring Disaster," *Journal of Economic Perspectives*, Volume 16, at 191-211.

[13] *See* footnotes 10, 11 and 12, *supra*.

c. *Even if regulation of any part of American Express's prepaid card fees were mandated by the law, prices that are optimally regulated for the public interest are not based only on costs.*

Even if the language of the Durbin Amendment could be read to require the regulation of some portion of American Express's fees or revenues, the proposed methodology for determining fees, as it would apply to American Express, is far from optimal for the public interest, as a matter of economics. Optimally regulated prices do not rest on costs alone. For example, since (as noted above) some of the costs associated with American Express prepaid card issuance are shared with other card products or with elements of the network employed by credit and charge card transactions, then under optimal (Ramsey) pricing principles,[14] the portion of such shared costs allocated to prepaid card issuance would depend, in part, on the relative valuations placed on prepaid cards by all customers (here, both cardholders and merchants). For a regulator to allocate costs in order that they can be recovered in an economically efficient manner would require accurate information on not just the full panoply of American Express costs but also the relative values delivered to all users (including cardholders and merchants) by the various integrated functions. This is a task that would be inescapably arbitrary, unreliable and likely harmful if implemented by applying a confining regulatory formula to a non-existent interchange fee in the integrated American Express prepaid card network.

The economics literature relevant to the analysis of payment card networks predicts that the economically efficient level of transaction prices (i.e., prices that maximize social welfare and ensure a reasonable rate of return) will not be solely dependent on the costs of providing the services, but will also reflect other elements, including value to cardholders and merchants, interaction elasticities (i.e., the extent to which the presence of merchants on the network increases cardholders' value from participating in the network, and *vice versa*), and presence of important network externalities.[15] This means that prices to cardholders and merchants cannot each be compared solely to narrow measures of cost in order to assess whether prices are inefficiently elevated.

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[14] Ramsey prices maximize social welfare subject to the constraint that the market participants do not lose money. (*See* Viscusi, Kip, John Vernon, and Joseph Harrington. 2000. *Economics of Regulation and Antitrust*, MIT Press, at 350-53.)

[15] Rochet, J.C. and Jean Tirole. 2003. "Platform Competition in Two-Sided Markets," *Journal of the European Economic Association*, Volume 1, at 990–1029; Armstrong M. 2006. "Competition in Two-Sided Markets," *Rand Journal of Economics*, Volume 37, at 668-691; Evans, David and Richard Schmalensee. 2005. "The Economics of Interchange Fees and Their Regulation: An Overview," Kansas City Federal Reserve Bank Conference.

Given the complexity of determining efficient prices in payment card platforms, the relevant economics literature does not provide practical methods for a regulator to impose an efficient transactions price in this context.[16] Board economists have themselves discussed the difficulties of determining the "right" level of interchange, even for four-party networks that, unlike American Express, have explicit interchange rates as part of their business model:

- "Although no findings [of economic studies] are completely robust, most models suggest that, when merchant prices do not vary by payment method,...[i]n theory, privately-set interchange fees [which constitute the largest portion of transactions prices in four-party networks] can be either too high or too low relative to the efficient interchange fee, depending on a number of factors, including the cost and demand considerations underlying the merchant decision to accept cards and the extent of competition among issuing and acquiring banks."[17]
- Prager et al (2009) conclude that the "efficient interchange fee for a particular card network is difficult to determine empirically."[18]

These recognized difficulties with determining the right fee for four-party networks that price and offer interchange in the normal course of business are compounded when a regulator attempts to impose an "interchange fee" on an integrated three-party network that does not even have such a fee.

Finally, as I understand it, the Durbin Amendment calls for regulation under which interchange fees are "reasonable" and "proportional to costs." As a matter of economics, "proportional" does not mean "equal." For example, Ramsey prices are proportional to marginal costs without being equal to such costs. Moreover, it is "reasonable" for providers to recover their full costs of providing prepaid and debit-like transaction processing services as well as a reasonable return. Inasmuch as the regulations proposed by the Board would not allow American Express to recover its full costs of providing transaction processing services, not to mention a reasonable return on its investments, the regulated prices would not be "reasonable."

[16] Evans, David and Richard Schmalensee. 2005. " The Economics of Interchange Fees and Their Regulation: An Overview," Kansas City Federal Reserve Bank Conference.

[17] Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski. 2009. "Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues," Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., at 4.

[18] *Ibid* at 3.

3. Given the lack of a reliable way to design and impose a regulated fee for a non-existent interchange service, the Board, consistent with the goals of the Durbin Amendment, should allow competition to govern American Express pricing.

For the reasons set forth above, because American Express operates an integrated network, acquiring and issuing business for its prepaid cards without an interchange fee, there is no economic basis for applying the Durbin Amendment's regulation of interchange fees to it. More broadly, competition is by far more effective, reliable and reasonable than arbitrary regulatory rules or formulae can be in ensuring that American Express's fees are reasonable and proportional to costs, as well as reflective of value, in a manner that best serves the interests of merchants, consumers and the overall economy.

Any inquiry into the extent to which American Express faces competition must begin by noting the small size of American Express prepaid card volume relative to payment cards generally and, more specifically, to the total volume of debit and prepaid cards that I understand are subject to the Durbin Amendment. Among the total debit and prepaid card transactions subject to the proposed regulation, American Express is a very small player, accounting for just 0.1 percent of the total volume of transactions in 2009.[19]

Within the context of its competition from credit, charge, debit and other forms of payment, I understand that American Express is subject to competition in its prepaid card business from the dominant open loop card networks (Visa/MasterCard), issuers (typically banks), program managers (such as Incomm, Black Hawk and Green Dot)[20] that support other reloadable and non-reloadable prepaid cards, and non-traditional payment networks such as PayPal. American Express also competes with issuers and acquirers of "closed-loop" prepaid cards (i.e., cards that can be used only in the stores affiliated with the firm that issued the card).

To maintain and grow its prepaid business, American Express has had to set competitive prices and to innovate. I understand that American Express has traditionally set its US merchant discount rates for prepaid cards at levels that are at or below the levels charged for Visa and

[19] Debit and prepaid card transactions in the US totaled about $1.44 trillion in 2009. (The Nilson Report, May 2010, Issue 948.) American Express's prepaid charge volume in 2009 was $1.51 billion. (Information provided by American Express in response to Federal Reserve Board survey in 2010.)

[20] I understand that these program managers' fees would not be regulated under the Durbin Amendment because they are not "issuers" or networks. To the extent that American Express provides services that are competitive with these players' services, to be an effective competitor American Express must similarly be free to provide those services without the distorting effects of confining regulation.

MasterCard general purpose debit and prepaid cards, and well below the levels charged for general purpose credit and charge cards.

In addition to offering competitive prices, American Express has also been an important innovator in this space. I understand that American Express pioneered general use prepaid cards[21] when it introduced such cards in 2003. Since then, American Express has introduced other innovations that other industry participants have adopted. Examples include eliminating all maintenance, dormancy, and recurring fees on prepaid gift cards, and eliminating any expiration of funds on prepaid gift cards.[22] Further innovations include the "split tender" functionality[23] of prepaid cards, and "holiday shippers" (special displays used to sell gift cards during the holidays).

Thus, American Express has responded to competition and has itself been an important source of competition and innovation with respect to prepaid gift cards. Regulatory rules and pricing formulae imposed on American Express are not only unnecessary to assure that its prices are reasonable and proportional to costs, but would be destructive to the opportunities for consumer and merchant benefits achieved through innovation and improved products and services because innovation is driven by the prospects of earning profits from successful product developments, and formulaic cost-based price regulation effectively eliminates the possibility of returns necessary to justify risky investments in innovation. As explained earlier, American Express faces a greater risk of misplaced "interchange fee" regulation than four-party networks since American Express does not have an interchange fee and also because the price cap formula proposed by the Board does not appear to acknowledge the higher costs of prepaid cards.

If the Board believes that debit card interchange fees are artificially high, and that the debit card interchange fees of Visa and MasterCard will be reduced following the implementation of proposed fee caps, then under the Board's theory, American Express prepaid card merchant discount fees would likely be affected by those reduced prices. Put differently, competition as a result of reduced Visa and MasterCard debit card interchange fees, rather than

[21] "General-purpose" prepaid cards are cards that can be used in a wide variety of stores, not just stores affiliated with the issuer of a store prepaid card.

[22] I understand that American Express took this action well before the Credit CARD Act gift card rule became effective in August 2010 and went beyond what that rule requires, and that some competitors have since followed American Express's lead and eliminated back-end fees.

[23] If an American Express prepaid card holder attempts to purchase an item whose price exceeds the remaining card balance, the "split tender" feature of the card prevents the transaction from being rejected. Instead, the cashier would be prompted to ask the cardholder to pay by other means the portion of the price not covered by the card balance.

direct formulaic regulation of American Express's pricing, would put additional competitive pressure on American Express's prepaid card fees. Given the absence of a reliable way to impose a "right" price as a hypothetical American Express interchange fee, the Board should allow this competition to regulate American Express. Additional regulation of prepaid cards that prevents American Express from recovering reasonable costs associated with prepaid cards may impede the growth and innovation of American Express's prepaid card products at the incipient stage of the business, when growth and innovation are particularly important, or at worst, cause American Express to exit the business segment.

4. At most, the Board should apply forbearance and monitor competitive effects as appropriate.

In light of American Express's *de minimis* share of the total US debit and prepaid card volume potentially regulated by the Durbin Amendment and the difficulties of formulaic regulation in the absence of interchange fees, an alternative approach to direct formulaic price regulation is to apply the principle of *forbearance*. Under a forbearance approach, the Board would periodically monitor American Express's responsiveness to competition. If the Board were at some point to conclude that American Express's pricing was not consistent with competitive levels (with due regard to underlying costs and product value), the Board could consider whether further action is warranted. Forbearance instead of formulaic rate regulation would benefit merchants and consumers. Forbearance would also avoid the type of counterproductive price regulations experienced in the past in the context of industries such as railroads (as noted earlier).

The forbearance approach has been successfully adopted by other regulatory agencies. For example, the Federal Communications Commission (FCC) has adopted a policy of forbearance with respect to wireless communications.[24] The FCC, as part of its regulatory due diligence, regularly monitors the state of wireless competition. Wireless services have expanded and consumers have benefitted.[25] Railroad regulation provides another example of successful regulatory forbearance. Following the *1980 Staggers Rail Act*, which further deregulated the railroad industry and permitted the ICC selectively to adopt a forbearance approach to railway

[24] "The Third Way: A Narrowly Tailored Broadband Framework," Chairman Julius Genachowski, Federal Communications Commission, May 6, 2010.
[25] *See*, for example, Federal Communications Commission. January 2009. *13th Annual CMRS Report.*

regulation, rail transport rates have declined, costs have fallen, and the financial health of railroads has improved.[26]

The argument in favor of regulatory forbearance here is made all the more compelling by the fact that the relevant economics literature does not indicate that American Express's prepaid card fees should be presumed to be "too high" due to market failures. The economics literature related to transactions pricing in payment card platforms does not support the view that market (i.e., unregulated) transactions prices are necessarily or even tend to be elevated above socially optimal levels.[27] This is even less likely in the context of non-dominant prepaid card providers such as American Express.

Because the relevant economic literature does not imply the presumption that transactions prices in payment cards platforms are inefficiently high; because American Express has no interchange fee to regulate at all; because American Express is a small but innovative provider of prepaid cards and an important competitor to the dominant networks; because the risks of a mistake are high; and because (I understand) the law does not, in fact, mandate rate regulation of American Express, the Board should proceed with as much flexibility as possible towards allowing American Express's prepaid card business to work under the discipline of unimpeded competition rather than confining regulation. A heavy-handed and over-reaching intervention in American Express's prepaid card business to dramatically drive down one arbitrarily-derived component of price will likely have unintended negative repercussions on merchants and consumers. Given the difficulty – acknowledged by Board's economists – in arriving at the right prices or even the right direction for intervention in interchange fee setting in four-party networks, a difficulty that is further compounded for three-party networks for the reasons addressed above, regulatory forbearance for American Express's prepaid card business would be the better approach.

IV. Alternative Payment Systems

I understand that like American Express, non-traditional and emerging payment systems may operate closed loop payment networks with business models that are consistent with the structure of the three-party architecture. Any new regulations should treat symmetrically American Express and non-traditional closed loop network providers of "electronic debit

[26] Carlton, Dennis and Jeffrey Perloff. 2000. *Modern Industrial Organization.* Addison-Wesley, at 694-5; Viscusi *et al* (*see* footnote 14, *supra*) at 549; Willig, Robert and William Baumol. 1987. "Railroad Deregulation: Using Competition as a Guide," *Regulation,* Volume 11, at 28-36.
[27] *See* supra note 15.

transactions." Any exemption received by non-traditional providers with regard to "interchange" regulation should also apply to American Express. Especially where, as here, the traditional and non-traditional three-party networks are (1) small players among the providers of products potentially regulated under the Durbin Amendment and (2) subject to vigorous competition in that space, asymmetric regulation of just one such network would tilt and distort innovation and marketplace evolution. It would be potentially anticompetitive to impose regulation that could inhibit American Express's ability to innovate, while permitting others that are similarly situated to take advantage of such opportunities and constricting American Express's competitive response. For example, if another three-party network were to develop an offering that is compelling to consumers and/or merchants, but is economically suboptimal or impractical if subject to a regulated interchange fee, it would be anticompetitive effectively to prevent the regulated three-party network from competing with the other unregulated provider. Thus, three-party networks should be treated symmetrically.

American Express needs to compete with other three-party networks (especially fast-growing networks such as PayPal).[28] I understand that this is especially true in the context of rapidly growing mobile and on-line payments. Confining regulations would restrict the ability of American Express to compete with other non-traditional three-party networks, and, for the reasons explained above, American Express faces a higher risk of regulatory error than four-party networks. The competitive effectiveness of American Express would be further weakened if it were subject to regulation while non-traditional three-party networks were free of regulation.

V. Concluding Remarks

The Board has recognized that three-party networks differ from four-party networks in ways that materially affect the implementation of the Durbin Amendment.[29] Indeed, the economics of the two types of networks are sufficiently different that regulating interchange fees in the context of three-party networks via the use of regulatory formulae is not feasible, and any

[28] With respect to PayPal, I understand that in addition to utilizing traditional payment card networks and the existing financial infrastructure of bank accounts to support its users' choice of funding transactions, PayPal also allows its users to fund electronic debit transactions through existing PayPal balance accounts that PayPal issues, manages and administers for its users. According to its parent eBay's 2010 10-K filing, PayPal balance transactions represent 17% of total payments volume on PayPal. If the Board determines that American Express should be regulated under the Durbin Amendment, then this facet of PayPal's business should be subject to regulation to the same extent.
[29] 75 Fed. Reg. at 81,727.

attempt to do so would likely harm the innovative efforts of American Express in its prepaid card business while harming the merchants and consumers who benefit from such cards today. Given the risks associated with confining formulaic regulation, and given also that the American Express prepaid card volume is insignificant relative to the volume of general purpose debit cards as well as prepaid cards, regulatory forbearance would be consistent with the policy objectives of the Durbin Amendment. In any event, any regulation should treat symmetrically American Express and other non-traditional closed loop, three-party network providers of "electronic debit transactions."

Robert Willig

Date: February 22, 2011 Robert Willig