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September 28, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551

RE: Docket No. R–1404 and RIN No 7100 AD 63

Dear Ms. Johnson:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the nation's federal credit unions, am writing to provide NAFCU's comments on the Federal Reserve Board's (the Board) interim final rule on the fraud adjustment for debit card interchange fees. NAFCU supports the Board's decision to implement a non-prescriptive approach to the fraud adjustment. A prescriptive approach would strangle innovation and ultimately lead to less secure debit cards. NAFCU is generally supportive of the interim rule, and we appreciate the agency permitting a fraud adjustment. We do request that the Board consider increasing the fraud adjustment beyond the proposed one cent fee per transaction.

The one cent adjustment does not adequately capture all of the costs associated with fraud protection. First, at least some costs associated with customer inquiries should have been included in the fraud adjustment. Second, it is not clear if the Board included costs such as research and development, card activation, PIN Customization, merchant blocking and card authentication systems in the fraud adjustment. Third, given that the capped interchange rate will likely ultimately become the default rate, the Board should consider the fraud costs for institutions with less than $10 billion in assets. Fourth, the Board gave little reason for its decision to set the fraud adjustment at the median level reported by issuers, while setting the base interchange rate fee at the 80th percentile, as reported by issuers. Setting the fraud adjustment at the same level as the base interchange fee would more accurately reflect the costs of anti-fraud measures and would also be more reasonable.

The interim final rule does not include costs associated with card inquiries in the fraud adjustment. The cost also is not included in the base interchange fee. It would be appropriate to include at least some percentage of the costs associated with card inquiries in the fraud adjustment. Virtually every fraudulent transaction involves an inquiry or some sort of communication with the member whose debit card has been compromised. As such, the time and expense associated with fraud related card inquiries should be included in the fraud adjustment. In setting the fraud adjustment, the statue specifically instructs the Board to consider, among other things, "the available and economical means by which fraud on electronic debit transaction may be reduced" and "fraud prevention and data security costs expended by each party involved in the electronic debit transaction." Debit Card Interchange Fees and Routing, 76 Fed. Reg., 43,478, (proposed July 20, 2011) (to be codified at 12 C.F.R. pt. 235) (summarizing section 920 of the Electronic Fund Transfer Act (EFTA)). Certainly, responding to cardholder inquiries is an economical means to prevent fraud. Further, the time and expense associated with cardholder inquiries is a tangible and quantifiable cost associated with fraud prevention and data security. Both of these factors weigh in favor of including some percentage of the cost of cardholder inquiries in the fraud adjustment. Further, none of the other factors the statute requires the Board to consider weigh against inclusion of this cost. Answering and responding to cardholder inquiries regarding fraudulent charges is a fundamental component of any comprehensive anti-fraud program. As such, some percentage of the cost associated with cardholder inquiries should be included in the fraud adjustment.

Next, it is unclear from the interim final rule or the Board's study of interchange fee costs (Federal Reserve 2009 Interchange Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions (June 2011)) whether the Board included research and development, card activation systems, PIN Customization, merchant blocking, and card authentication systems in the fraud adjustment. Those costs are included in the section of the study that discusses fraud prevention costs; however, the study states that those costs "were all small when measured on a per-transaction basis, typically less than one-tenth of a cent each." *Id.* at 16. Consequently, it is unclear if the Board chose to disregard those costs because they are, relatively speaking, small. To the extent any of these costs were not included in the fraud adjustment, NAFCU would strenuously object. All of these costs are integral to a full and robust anti-fraud program and should be included in the fraud adjustment. Regardless, I would recommend that the final rule provide a more detailed analysis of the component costs that make up the fraud adjustment.

NAFCU also recommends that the Board consider the fraud protection costs of institutions with less than $10 billion in assets. NAFCU has discussed this issue with Board staff and is aware of the Board's position. To briefly summarize the issue, NAFCU – like much of the financial services industry – believes the capped rate will ultimately become the default rate for all card issuers, regardless of size. Accordingly, it is logical to base the capped rate on the actual costs for all card issuers. Although the Board stated that it will only survey institutions with more than $10 billion in assets (because the statute only explicitly applies to such institutions) nothing in the statute explicitly restricts the Board from also considering the costs of institutions with less than $10 billion in assets. Moreover, § 920 grants the Board discretion to consider those factors that it deems appropriate. Accordingly, we urge the Board to consider this option in the future. The Board, along with the rest of the industry, will be closely following the uncapped rate. If, as expected, the capped rate impacts the entire industry, resulting in smaller institutions earning increasingly lower rates, we are hopeful the Board will consider the costs of smaller institutions.

Finally, NAFCU disagrees with the Board's decision to set its fraud adjustment at the median level of issuers' costs. It would be more appropriate to set the fraud adjustment at the 80th percentile of issuers' costs, as was done with regard to the base interchange fee. As a preliminary matter, given the importance of protecting consumers' personal financial information, the increasing incidences of massive data breaches, and the costs associated with such breaches (which credit unions and banks must bear) setting the rate at the median level makes little sense. NAFCU understands that the Board attempted to set the adjustment at a level that encourages issuers to employ only the most cost effective procedures. However, there is no discussion in the interim final rule to illustrate that issuers reporting costs above the median level were not using cost-effective anti-fraud measures.

The lack of background to support setting the cap at the median level is all the more striking given the Board's thorough discussion of its decision to set the base interchange fee at the 80th percentile. In setting the base interchange fee, the Board explained that most institutions reported costs below the 80th percentile with a "scattered set of institutions" reporting significantly higher costs. Debit Card Interchange Fees and Routing, Fed. Reg. 43,394, 43,433 (July 20, 2011) (to be codified at 12 C.F.R. pt. 235). The Board went on to explain that for issuers with costs below the 80th percentile, the difference in costs is fairly small. "For example, among issuers whose costs are between the 20th and the 80th percentiles, the largest cost difference over a 5- percentile range of the distribution (*e.g.*, from the 60th to 65th percentile) is about 3 cents." *Id.* The Board, however, provides no similar supporting information to explain why the fraud adjustment should be set at the median level, instead of the 80th percentile.

The base interchange fee and the fraud adjustment are obviously closely related in that the two fees, taken together, help offset the costs of operating a debit card program. The base fee and the fraud adjustment were both set using information reported by the same debit card issuers. Further, the costs used to set the base fee were reported at the same time as the costs used to set the fraud adjustment. Yet, the Board chose to set the base fee at the 80th percentile, while setting the fraud adjustment at the median level of costs. The Board provided detailed analysis supporting its decision to set the base fee at the 80th percentile, but provided comparatively little support for its determination to set the fraud adjustment at the median level.

As the Board itself points out, combating fraud is a "cat and mouse" game, that requires card issuers to constantly adapt and react to ever more sophisticated criminal attacks. NAFCU is concerned that setting the fee too low will discourage issuers from developing new, innovative anti-fraud programs that require significant start-up costs. Given that the Board gave little reason for setting the fraud adjustment at the median level and given the potential unintended consequences the rule will have on innovation, NAFCU recommends the Board set the fraud adjustment at the 80th percentile.

Finally, NAFCU is appreciative of the Board's stated desire to closely monitor the base interchange fee and the fraud adjustment, as well as the long term implications for both small and large card issuers. Given the implications of the changes to the Electronic Fund Transfer Act (EFTA) for all issuers as well as consumers, it is appropriate to continue examining all of the costs and associated benefits of debit card programs.

NAFCU has thoughts on two specific questions the Board asked in the interim final rule. First, the Board asked whether issuers should be required to assess whether customer reward programs provide inappropriate incentives to use a particular authentication method. Second, the

Board asked whether it should establish a process to certify that issuers have met the relevant fraud prevention standards.

Issuers should not be required to assess whether its customer reward programs provide "inappropriate" incentives to encourage an authentication method that is less effective at preventing fraud. The interchange rule and the fraud adjustment already require substantial micromanagement by the Board of issuers' costs, operations and procedures. NAFCU would encourage limiting that micromanagement only to areas that are required by the statute. Further, it is unclear exactly what would constitute an "inappropriate" incentive. The Board would likely have a difficult time defining what constitutes an "inappropriate" incentive in any clear, concise manner. Consequently, such a rule would be difficult to comply with for issuers and likely difficult to enforce for the Board. Moreover, the benefits of any such rule are unlikely to outweigh the costs. For example, many merchants currently only offer customers signature authorization. It would be particularly wasteful for issuers to be required to assess any "inappropriate" incentives that it offers for signature authorization when, at a number of merchants, signature authorization is the only means available. For all these reasons, NAFCU opposes a requirement for card issuers to assess whether it offers "inappropriate" incentives for certain types of card authorization.

Next, NAFCU opposes any rule that would establish a certification process and reporting period for issuers to certify they are in compliance with the Board's fraud prevention standards. The card networks and card issuers already expend significant sums of money on fraud prevention. The card networks' user agreements grant the networks wide latitude to ensure compliance with the networks' fraud prevention standards. Further, card issuers already have an interest in ensuring their card programs are secure since they are responsible for the majority of fraud related losses. Requiring issuers to certify compliance is unnecessary and would be nothing more than a waste of time, money and resources for card issuers.

NAFCU appreciates the opportunity to comment on these issues. NAFCU also appreciates the Board's work on this complex issue. We strongly support the fraud adjustment, though we believe a higher figure would be more appropriate. Should you have any questions or concerns, please feel free to contact me or Dillon Shea, NAFCU's Regulatory Affairs Counsel, at 703-842-2212.

Sincerely,

Fred R. Becker Jr.
President/CEO