IBC
International Bancshares Corporation

September 20, 2011

Via email: regs.comments@federalreserve.gov

Board of Governors of the Federal Reserve System
20th and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. R-1404; RIN 7100-AD63; Comments to Interim Final Rule Regarding Fraud Prevention Adjustments to Interchange Transaction Fees ("Proposal") by the Board of Governors of the Federal Reserve System ("FRB")

Ladies and Gentlemen:

The following comments are submitted on behalf of International Bancshares Corporation ("IBC"), a multi-bank financial holding company headquartered in Laredo, Texas. IBC maintains over 278 facilities and more than 440 ATMs, which serve 107 communities in Texas and Oklahoma. IBC is the largest Hispanic-owned financial holding company in the continental United States with over $12.2 billion in assets. IBC is a publicly-traded holding company. We appreciate the opportunity to comment on the FRB's Proposal.

Proposal

On July 20, 2011, the FRB published the Proposal, an interim final rule, providing that if an issuer meets standards set forth by the FRB, it may receive or charge a fraud prevention adjustment of no more than 1 cent per transaction to any interchange transaction fee it receives or charges in accordance with 12 C.F.R. Section 235.3.[1] The Proposal becomes effective on October 1, 2011. The FRB indicated that the 1 cent fraud adjustment corresponds to the amount of fraud prevention costs that were not already included in the base interchange fee.

To be eligible to receive the fraud prevention adjustment, an issuer must develop and implement policies and procedures reasonably designed to: (1) Identify and prevent fraudulent electronic debit transactions; (2) monitor the incidence of, reimbursements received for, and losses incurred from fraudulent electronic debit transactions; (3) respond appropriately to suspicious electronic debit transactions so as to limit the fraud losses that may occur and prevent the occurrence of future fraudulent electronic debit transactions; and (4) secure debit card and cardholder data. An issuer must review its fraud prevention policies and procedures at least annually, and update them as necessary to address changes in the prevalence and nature of fraudulent electronic debit transactions and the available methods of detecting, preventing, and mitigating fraud. Finally, the issuer must certify, on an annual basis, its compliance with the FRB's standards to the payment card networks in which the issuer participates.

[1] The 1 cent adjustment is addition to the ad valorem fraud-loss recovery of five basis points allowed under the FRB's final interchange fee rule.

Generally

Fraud prevention costs are sizeable and, in fact, fraud prevention efforts are the reason actual losses on debit card transactions are not larger and have been limited to the extent they have been. It is imperative that adequate allowances for fraud prevention costs be an integral part of the interchange fee rule. This will both compensate institutions for such costs and incentivize investments in efforts that protect consumers, enhance security, and maintain market confidence in the payments system. Financial institutions, not merchants, shoulder the cost of fraud that occurs with debit cards. During the year 2010, IBC incurred almost $2 million dollars in fraud losses. Income received from the new interchange fee cap will be further reduced by these fraud losses, which according to industry trends, will continue to increase each year.

We believe that these fraud losses are driven in large part by the very liberal unauthorized transfers liability provisions of Regulation E (12 C.F.R. Section 205.6) which permit consumers to avoid liability in many circumstances, including circumstances when the consumer is negligent in facilitating unauthorized use or dilatory in reporting unauthorized transfers to financial institutions. We note that the FRB's Official Staff Interpretation to Section 205.6(b) expressly provides that consumer negligence cannot be used as the basis for imposing greater liability on a consumer than is permissible under Regulation E and permits extension of the time limits specified in the rule, in certain circumstances, for consumers to report unauthorized transfers to financial institutions. These practices greatly increase a financial institution's fraud losses, and are counterproductive.

Under the FRB's final interchange cap rule, merchants, who already are liable for only a small portion of fraud, will pay less to issuing banks in interchange fees, which financial institutions currently use to help offset the cost of fraud. When accepting checks, merchants have to incur the cost of using funds verification systems. However, when accepting debit cards, merchants are provided a fast, safe, and secure method to obtain guaranteed funds from consumers without having to incur additional costs on fraud prevention or funds verification systems. The FRB's final interchange cap rule will result in a huge windfall benefit for merchants, including large retailers. Merchants should not be allowed to receive all of the benefits of the debit card system without any accountability or financial responsibility. The FRB's final interchange cap rule does nothing to assist consumers. Instead, they redistribute business earnings from financial institutions that incur the costs to issue debit cards, intermediate debit card transactions, carry the fraud risks, and float the consumers' purchases to merchants who will gain additional profits on the sale of goods and services. We believe this is grossly unfair. In light of the FRB's final interchange cap rule, greatly reducing interchange fee revenue for financial institutions, merchants, not financial institutions, should be liable for the fraud losses resulting from debit card transactions. After all, fraud losses should be a cost of doing business for merchants. Additionally, effective means to limit customer fraud should be sought, rather than putting the burden on the financial institutions. Merchants should be required to take reasonable steps to safe guard the debit system. The best way to guarantee that responsibility is to place the fraud burden squarely on the merchant, the one who has the best opportunity to prevent the fraud.

Non-Prescriptive Approach

In the Proposal, the FRB expressly requests comment on a non-prescriptive approach for the fraud-prevention adjustment. We strongly recommend the non-prescriptive approach and strongly oppose any cap on recovery of fraud prevention costs. The key goals of the fraud adjustment should be:

1. to formulate as a simple a calculation as possible;

2. to preserve as much as possible the incentive to prevent fraud and invest in new fraud prevention solutions; and

3. to avoid locking in particular technologies or solutions and allow flexibility in fraud prevention solutions to maximize fraud prevention results.

It is in everyone's best interest – bank customers, merchants, banks, the payment networks, and regulators – to minimize payment system fraud and employ effective fraud prevention solutions. Fraud and fraud prevention solutions are ever-changing and quickly become obsolete as criminals learn to circumvent them. Accordingly, it is critical that the regulation ensure that issuers are compensated fairly for fraud prevention costs to encourage the use and development of effective fraud prevention measures, not freeze prevention solutions, or handicap banks in responding to the latest fraud event or scam by locking in a particular technology or technique. Encouraging investment in and supporting fraud prevention through compensation means less fraud, which benefits all parties.

A general rule such as the "non-prescriptive approach," gives issuers flexibility in determining fraud prevention techniques without dictating particular techniques or technology that often quickly become obsolete. Under this approach, it would not be necessary to measure the general value of any particular fraud prevention technique across all institutions. Rather, it recognizes that a single technique or technology may not be the optimal solution for all issuers or circumstances, a critical aspect of effective fraud prevention. Moreover, it recognizes that to fight fraud, issuers have to be flexible, fast, and imaginative. In contrast, a government-prescribed solution would be more likely to be lagging and ineffective for many institutions. Indeed, the process for determining which solutions qualify for the fraud adjustment would alone compromise the government-prescribed solution by giving criminals advance notice so they may more quickly learn how to circumvent them. It is not clear how the FRB, which has no direct role in preventing debit card fraud, would be able to identify and judge better the effectiveness and appropriateness of a particular fraud prevention solution than institutions driven by their own self interest, which includes losses, customer relations, reputation, and competition, to find the best solution for their institution and their customers. We note that a non-prescriptive approach is similar to the approach found in other regulations, including those implementing the data protection provisions of the Gramm Leach Bliley Act (Section 501(b)), and the Fair Credit Reporting Act's Identity Theft Red Flag provisions (Section 615(e)).

We also strongly object to a cap on recovery of fraud prevention costs. An artificial cap will only discourage vital investment in fraud prevention to the detriment of all parties, including bank customers.

"Fraud" or "Fraudulent Electronic Debit Transaction"

In the Proposal, the FRB expressly requests comment on whether the rule should include a definition of "fraud" or "fraudulent electronic debit transaction," and if so, what would be an appropriate definition. Fraud and fraud prevention solutions are ever-changing and quickly become obsolete as criminals learn to circumvent them. Accordingly, we urge the FRB not to adopt a definition of "fraud" or "fraudulent electronic debit transaction."

Customer Rewards Programs

In the Proposal, the FRB also expressly requests comment on whether an issuer's policies and procedures should require an issuer to assess whether its customer rewards or similar programs provide inappropriate incentives to use an authentication method that is demonstrably less effective in preventing fraud. We strongly urge the FRB not to mandate such a practice. The FRB's interchange fee rule already places significant regulatory and financial burdens on financial institutions. An additional, unnecessary, and burdensome requirement, will not benefit consumers or financial institutions. Furthermore, it is very likely that the FRB's interchange fee rule, and its resulting revenue loss for financial institutions, will cause many institutions to eliminate customer rewards programs. Thus, a significant decrease in customer rewards programs will likely occur negating any need to engage in the unnecessary and unbeneficial practice of assessing whether an institution's customer rewards or similar programs provide inappropriate incentives to use an authentication method that is demonstrably less effective in preventing fraud. Additionally, we believe that merchants and their employees frequently discourage customers from utilizing their PINs when engaging in debit card transactions because of delays caused by PIN transactions versus credit transactions. This practice facilitates fraudulent transactions. Unfortunately, Regulation E makes no allowances in favor of financial institutions relating to debit card transactions involving unauthorized use. It seems only reasonable that Regulation E should place the burden for paying these fraud losses on merchants who either discourage PIN based transactions or fail to request customer identification on debit card transactions treated as credit card transactions. After all, financial institutions did not facilitate these fraudulent activities and, therefore, should not be held culpable.

Certification

As previously noted, the Proposal requires an issuer to certify to its payment card networks that its fraud prevention standards comply with the FRB's standards. Issuers that are eligible for the adjustment should certify their compliance annually to each payment card network in which the issuer participates that allows issuers to receive or charge a fraud-prevention adjustment to their interchange transaction fee. In the Proposal, the FRB expressly requests comment on whether the rule should establish a consistent certification process and reporting period for an issuer to

certify to a payment card network that the issuer meets the FRB's fraud prevention standards and is eligible to receive or charge the fraud-prevention adjustment. We believe that the form of annual certification process is best left for each payment card network to determine and this business decision need not be mandated by the FRB. We note that the Proposal's Preamble states that, "The Board expects that these payment card networks will develop their own processes for identifying issuers eligible for this adjustment."

Thank you for your consideration.

Respectfully,

Dennis E. Nixon
President