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<u>BY EMAIL</u>

Louise L. Roseman
Director, Division of Reserve Bank Operations
and Payments Systems
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Docket No. R-1404 (Debit Card Interchange Fees and Routing)

Dear Ms. Roseman,

On behalf of the merchant community, the Merchants Payments Coalition (the "MPC") respectfully submits the following comments and proposal in response to the notice of proposed rulemaking published by the Federal Reserve Board ("Board") in the Federal Register on December 28, 2010. *Debit Card Interchange Fees and Routing*, 75 Fed. Reg. 81,722 (proposed Dec. 28, 2010) ("NPRM"). We are submitting these comments, which concern only the fraud prevention adjustment, in advance of our comments on the remainder of the NPRM.

The fraud prevention adjustment standards discussed below are drawn from the background and analysis in the Board's NPRM, and are consistent with Section 920 of the Electronic Fund Transfer Act ("Section 920"). Importantly, they would balance the interests of issuers and merchants to motivate the implementation of potentially paradigm-shifting fraud prevention technologies without prescribing a particular technology. Key aspects of these standards include:

- Each issuer, not the Board, would determine which "low fraud technologies" it wishes to pursue.
- An issuer would receive reimbursement – from merchants who choose to use an eligible "low fraud technology" – for that issuer's initial capital

investment necessary to implement the technology. The maximum per transaction reimbursement would be based upon statistics already calculated by the Board.

- Consistent with both the approach in effect in Canada and recent network proposals to merchants in the United States, as a trade-off for this reimbursement the issuer would be prohibited from imposing on merchants who choose to use the issuer's "low fraud technology" (i) fines or penalties related to any debit card information compromised by a data breach and (ii) any fraud loss costs associated with transactions using the "low fraud technology."[1]
- This approach would be easy to administer because, in lieu of requiring surveys and calculations regarding all merchants' costs, it simply would prohibit the imposition of certain fraud-related costs on merchants who choose to use the issuer's "low fraud technology."

This submission is intended to help facilitate the Board's compliance with the statutory deadline to prescribe fraud prevention adjustment regulations. We urge the Board to issue a supplemental NPRM as soon as possible containing draft regulations based upon these fraud prevention adjustment standards in order to meet that deadline.

I. Background

Section 920 requires the Board to prescribe regulations in final form for a fraud prevention adjustment by April 21, 2011. Section 920(a)(5). Specifically, any fraud prevention adjustment to a specific issuer's interchange transaction fee must be "reasonably necessary to make allowance for costs incurred by the issuer in preventing [debit card] fraud," take into account fraud-related costs (including chargebacks) absorbed by other parties, and require issuers to take effective steps to reduce fraud, "including through the development and implementation of cost-effective fraud prevention technologies." *Id.*

The Board has made substantial progress in the NPRM process (including data collection and analysis) to lay the groundwork necessary to establish regulations governing the fraud prevention and, given that backdrop, we believe regulations can be implemented within the statutory deadline. Important Board determinations that are relevant to the fraud prevention adjustment include:

- Defining fraud as "the use of a debit card (or information associated with a debit card) by a person, other than the cardholder, to obtain goods, services, or cash without authority for such use." NPRM at 81740.

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[1] In Canada, merchants that implemented EMV readers received protection against fraud-related chargebacks for all transactions including those completed with legacy magnetic stripe systems.

- Determining that signature debit transactions are substantially more fraud-prone than PIN debit transactions. NPRM at 81740-41.
- Determining that the cost of preventing fraud on signature debit transactions is almost 100% greater per transaction than the cost of preventing fraud with respect to PIN debit transactions.[2] *Id.* at 81741, note 75.
- Determining that PIN debit transactions have the lowest fraud rate of the authorization methods widely used in the United States. *Id.* at 81741.
- Determining that with PIN debit, due to the relatively high security of the transaction, issuers are willing to take almost complete responsibility for fraudulent transactions. *Id.* at 81741 (issuers reported that they bear "nearly all" – *i.e.*, 96% – of fraud associated with PIN debit).
- Determining that fraud prevention and data security activities cost issuers an average of 1.2 cents per PIN debit magnetic stripe transaction. *Id.* at 81741, note 75.
- Determining that the issuer's fraud losses should not be considered in setting the fraud prevention adjustment. *Id.* at 81742, note 79.

In addition, the Board outlined two possible approaches to the fraud prevention adjustment regulations in the NPRM. The Board's discussion of these approaches highlights several important policy considerations that should influence the content of the fraud adjustment rulemaking, including that: (1) the regulations have the potential to spur paradigm-shifting technologies; (2) any such technology should reduce fraud in a cost-effective manner; (3) the Board should avoid prescribing specific technologies that an issuer should use; (4) the fraud adjustment should be issuer-specific to spur issuer competition to provide cardholders the most secure platform for debit transactions; and (5) issuers could be reimbursed for their initial fraud prevention costs (net of costs absorbed by other parties, especially merchants) up to a cap.

In short, the background and analysis undertaken by the Board with respect to the fraud prevention adjustment is similar to that undertaken in the NPRM regarding the other regulations mandated by Section 920. As with those regulations, the Board can meet the statutory deadline for prescribing final fraud prevention adjustment regulations based upon its work to date.

II. Proposed Fraud Adjustment Standards

The following standards are drawn from and marry the best aspects of both approaches discussed in the NPRM. Importantly, they are manageable from an

[2] This metric corroborates our position that it makes no sense to reward debit issuers for investments that are necessitated by the fraud that is abetted by the insecure signature debit networks. That the vast majority of signature debit transactions could be completed more securely and cost-effectively with PIN debit, as is the case in Canada, only makes this conclusion more apparent.

administrative perspective and would encourage the implementation of a paradigm shift without prescribing the technology to accomplish that objective.[3]

Coupled with the specificity of Section 920(a)(5), the Board's analysis and conceptual development of the fraud prevention adjustment detailed in the NPRM logically suggest regulations based upon the following standards:

- Eligibility. An issuer would be eligible for a fraud prevention adjustment if that issuer implements a "low fraud technology" that both significantly reduces fraud and is cost effective. To be eligible, the fraud prevention technology must meet the following criteria:
  - Debit card fraud losses on a transaction value basis with the "low fraud technology" are materially lower (*e.g.*, at least 10%) than the industry-wide PIN debit transaction fraud losses (calculated by the Board to be 3.5 basis points).
  - The costs of implementing such a "low fraud technology" are less than the amount of fraud losses eliminated by its use (*i.e.*, the benefits exceed the costs).
- Calculation of the fraud prevention adjustment. An issuer that satisfies the eligibility requirements may receive a fraud prevention adjustment:
  - Up to 1.2 cents per transaction for all transactions that use the eligible "low fraud technology," depending upon the reduction in average fraud loss per transaction. Specifically, the issuer would qualify for a fraud prevention adjustment equal to 1.2 cents times the percentage by which the issuer's "low fraud technology" reduces its debit card fraud losses on a transaction value basis below the industry-wide debit card fraud losses as determined by the Board. For example, if debit card fraud losses are 67% lower on a transaction value basis with the "low fraud technology" than the Board-determined industry norm for PIN debit transactions, then the issuer would qualify for a fraud prevention adjustment of 0.8 cents (67% of 1.2 cents).[4]
  - Up to lifetime cap for eligible "low fraud technology." The lifetime cap for the aggregate amount of fraud prevention adjustment received by the issuer is the amount of the issuer's initial total capital investment specifically and necessarily incurred to implement that "low fraud technology."[5] If that technology applies to other (*i.e.*, non-

[3] The standard also could spur investment in fraud prevention technologies for PIN debit.

[4] The Board may want to take into account the disproportionate impact this adjustment could have on low dollar transactions.

[5] The Board should limit any fraud prevention adjustment to the initial round of necessary investments by an issuer in a new fraud prevention technology (exclusive of any subsidy or other payments the issuer chooses to make to merchants). Thus, to cite one example, if issuers must reissue cards with the new

debit) payment card transactions, then the fraud adjustment shall be limited to the portion of the capital investment that can be attributed to the issuer's debit program based on the proportion of its payment card volumes that are debit as opposed to other payment card types.

- Prohibitions. An issuer shall not receive a fraud prevention adjustment if it or a network on its behalf:
  - Imposes costs on merchants for fraud losses that are directly or indirectly related to a transaction using this "low fraud technology." Thus, issuers and networks operating on their behalf will not be able to impose on merchants any fraud loss costs (*e.g.*, via chargebacks or fees) related to transactions using the "low fraud technology."[6]
  - Imposes on merchants who choose to use the issuer's "low fraud technology" any PCI DSS (or similar) fines or penalties related to any debit card information compromised by a data breach.
  - Requires merchants to use the "low fraud technology," directly or indirectly through any network rule or policy, or through other third party, or by condition, penalty, or otherwise.[7]
  - Discriminates between or among merchants with respect to the amount of the per-transaction fraud prevention adjustment.
- Required application. Before receiving a fraud prevention adjustment for an eligible "low fraud technology," an issuer must apply to the Board by providing data to verify:
  - That debit card fraud losses on a transaction value basis with the "low fraud technology" are materially lower (*e.g.*, at least 10%) than the industry-wide PIN debit transaction fraud losses (calculated by the Board to be 3.5 basis points).[8]

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technology on the card, then they can claim an adjustment for that initial investment but not for any subsequent reissuance cycles that issuers would implement in the normal course of business.

[6] Since merchants will be getting chargeback protection only with respect to transactions made with the "low fraud technology," the Board should consider crafting an anti-circumvention rule that prevents the networks from imposing additional chargebacks on merchants for legacy systems, particularly signature debit, to help subsidize the issuers' new technology. Given that there likely will be a transition period during which legacy systems will continue to be used along with the "low fraud technology," this is a significant risk to merchants. One possible way to address this would be to prohibit an issuer receiving a fraud prevention adjustment from imposing costs on merchants for more than the current percentage of fraud losses merchants bear for signature debit and/or PIN debit.

[7] Nothing, however, would prevent an issuer from providing merchants subsidies or other payments (*e.g.*, to offset the costs of new terminals that merchants may need to install) to incent merchants to use the "low fraud technology."

[8] The Board could consider evidence both from foreign jurisdictions and from similarly-situated issuers in the U.S. to assess the efficacy of a particular technology. That could accelerate the time frame in which the regulation could be utilized by issuers. Moreover, if a network develops a "low fraud technology" for

- That the costs of implementing this "low fraud technology" are less than the amount of fraud losses eliminated by use of the technology.
- The amount of the issuer's total capital investment necessarily incurred to implement the eligible "low fraud technology."[9]

- Verification procedure. Before verifying an application received from an issuer, the Board must:
  - Receive the application (including supporting data) from the issuer in writing.
  - Make the entire application publicly available and request comments.
  - Accept comments regarding the application from the public for at least 30 days.
  - Take into consideration the public comments in determining whether or not to accept the issuer's application.

III. Discussion

We believe that in addition to reducing fraud – which benefits consumers as well as issuers and merchants – this approach addresses most of the questions that the Board raised in the NPRM. To configure the adjustment to motivate paradigm-shifting approaches to fraud, it should be limited to fraud prevention technologies that are materially superior to the low fraud experienced with PIN debit. By making eligible only technologies that reduce fraud below the low levels associated with PIN debit, the Board could implement a paradigm-shifting approach without selecting particular technologies. That way, the market can make those decisions and the Board can avoid unduly influencing the process by picking the technologies that will be favored by the standard. In addition, under this approach, networks or individual issuers could compete on the basis of the fraud prevention systems or technologies they implement and they will control the timing and content of their applications for an adjustment. Lastly, this approach is administratively straightforward because, in lieu of requiring surveys and calculations regarding all merchants' costs, it simply prohibits the imposition of certain fraud-related costs on merchants who choose to use the issuer's "low fraud technology."

Under this approach, issuers would be incented to implement paradigm-shifting fraud prevention technology. If debit card interchange for covered issuers is reduced substantially, as it should be under the statute, and if the regulations eliminate the discrepancy between signature and PIN debit interchange rates, issuers' incentives to use

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deployment by issuers, the network could proffer verification to the Board regarding fraud prevention and, if this verification was accepted, it would obviate the need for separate verification of fraud reduction by issuers implementing that technology.

[9] If that investment pertained to other forms of payment as well as debit, the portion of that capital investment should be attributed to the issuer's debit card program based on its relative payment volumes.

the higher-fraud signature debit authorization method will be reduced if not eliminated. That should put issuers' focus squarely on potential paradigm-shifting approaches given the high degree of security associated with PIN debit. Against that backdrop, issuers will be provided with an opportunity to recoup their initial capital investment through interchange in a way that is calibrated to peg the adjustment to the extent to which the new technologies actually reduce fraud below the relatively low fraud levels experienced with PIN debit. The prospect of being reimbursed by merchants for their entire initial capital investment in new technologies, while reaping the benefits of reduced fraud, should motivate issuers to invest in such improvements.[10]

This approach also is more generous to issuers than other approaches that the Board could propose under Section 920. That statutory provision calls for the Board not only to take into account the amounts of fraud-related costs such as chargebacks imposed on merchants prior to allowing any fraud prevention adjustment,[11] but also to reduce any such adjustment by the amounts merchants spend on fraud prevention and data security.[12] The standards discussed in this submission do not reduce an issuer's fraud prevention adjustment by those latter amounts in order to provide an even greater incentive for issuers to pursue and implement paradigm-shifting fraud reduction technologies. This is a significant concession given the billions of dollars that merchants spend to prevent fraud related to the magnetic stripe technologies currently used by issuers in the United States, but one that the MPC is willing to consider at this time in order to facilitate the Board meeting its statutory deadline and to benefit the system as a whole by reducing overall fraud.

Merchants also would be motivated to participate in this new technology. First, issuers would be prohibited from imposing on merchants any fraud loss costs (*e.g.*, chargebacks and fees) that are directly or indirectly related to transactions using this "low fraud technology." Second, issuers would be prohibited from imposing on merchants who choose to use the issuer's "low fraud technology" any PCI DSS (or similar) fines or penalties related to any debit card information compromised by a data breach.[13] This combination of liability shift and protection against fines for data breaches should encourage merchant adoption of new "low fraud technologies" that truly could make the payment system more secure. Moreover, because this approach gives merchants strong incentives to implement new paradigm-shifting technologies, it should include a strict

[10] If issuers bear as much fraud costs as they claim – 57% for signature debit and 96% for PIN debit transactions – and if fraud is as big a concern for them as they say, this approach should give them adequate incentives to invest in innovative fraud prevention techniques. NPRM at 81741.
[11] Which occurs under the proposed approach by prohibiting issuers from imposing any fraud loss costs (such as chargebacks) on merchants related to transactions using the low fraud technology.
[12] The statute also references fraud prevention and fraud loss costs imposed on consumers, but the former are not imposed and the latter (as noted by the Board in the NPRM) are "negligible." NPRM at 81741.
[13] This prohibition has the added benefit of preventing issuers from circumventing these standards by indirectly making merchants subsidize fraud losses related to "low fraud technologies" simply by increasing fines or penalties for data breach related to legacy technologies under the PCI DSS system that the issuers and networks created and continue to control.

prohibition against networks or issuers forcing merchants – including sole proprietorships and mom-and-pop stores – to implement a new "low fraud technology" that could conceivably require those merchants to absorb substantial terminalization and other costs.

For all of these reasons, regulations based upon this approach should lead to substantially reduced fraud that will benefit all parties, including consumers. Not only is it possible for the Board to meet all of its statutory deadlines under Section 920 by issuing a supplemental NPRM proposing draft regulation for the fraud prevention adjustment, but the Board already has completed much of the necessary analysis and conceptual development for these regulations in its original NPRM.

All final regulations promulgated pursuant to Section 920 are likely to be the subject of significant commentary and debate. The fact that regulations relating to the fraud prevention adjustment will be subjected to that degree of scrutiny, however, should not dissuade the Board from building on its own work to date to prescribe these regulations in final form by April 21, 2011.

Thank you and your team for your hard work preparing the NPRM issued in December. The MPC appreciates your efforts and your consideration of this initial comment regarding the fraud prevention adjustment. Please let us know if you would like to discuss any of these issues further.

Sincerely,

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Todd Anderson/mp
Todd Anderson