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BY EMAIL

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 (RIN No. 7100 AD 63) - Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

On behalf of the merchant community, the Merchants Payments Coalition (the "MPC")[1] respectfully submits the following comments concerning the interim final rule that the Board of Governors of the Federal Reserve System (the "Board") issued pursuant to Section 920(a)(5) of the Electronic Fund Transfer Act (the "Act") concerning the fraud prevention adjustment. *See Regulation II - Debit Card Interchange Fees and Routing*, 76 Fed. Reg. 43,478 (proposed Jul. 20, 2011).

A. KEY PRINCIPLES

(i) The Fraud Prevention Adjustment Should Be Configured to Enhance Incentives to Effectively Reduce Fraud

It is important to understand the history and rationale behind the Durbin Amendment fraud prevention adjustment provision. Issuers are best positioned to reduce fraud in the payment card system, yet they have not taken effective steps to reduce fraud because they have pushed the costs of fraud onto other parties (through interchange fees and other anticompetitive

[1] The MPC is a group of retailers, supermarkets, drug stores, convenience stores, fuel stations, online merchants and other businesses that are fighting against excessive credit and debit card fees and for a more competitive and transparent card system that works better for consumers and merchants alike. The MPC's member associations collectively represent about 2.7 million stores with approximately 50 million employees.

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practices related to chargebacks and PCI compliance).[2] To date, issuer incentives have been distorted and counterproductive for fraud prevention. The Durbin Amendment seeks to create correct incentives for issuers to invest in real fraud prevention methods. The Act is written to reward issuers that objectively reduce fraud, and prevent issuers that do not take effective steps to reduce fraud from shifting costs onto other parties. Toward that end, the Act states that standards must "require issuers to take *effective* steps to reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions …." Section 920(a)(5)(A)(ii)(II) (emphasis added).

Issuers' paramount ability to address fraud is clear. Issuers choose the authentication method that is used for debit card transactions as well as the underwriting decisions that influence which customers qualify for the various debit products. Moreover, issuers are able to track cardholder and account behaviors and spending trends on a given debit card or account across multiple merchants, and they have access to and often provide their customers with numerous financial products that could be used to enable them to identify suspicious transactions.[3] Most economists would advocate that the cost of preventing fraud should be borne by the party best positioned to address it.[4] Under the current model, however, merchants that are much less well positioned to address fraud[5] bear a disproportionate share of the costs.

Further, rewarding issuers with positive interchange for fraud has chilled their incentive to combat fraud. This is evidenced by the longstanding decision of U.S. issuers to push signature debit over the more secure and efficient PIN debit product. In addition, the distorted incentives of issuers and networks are reflected in the fact that, in contrast to virtually all other OECD countries, the U.S. is still entirely dependent on the highly insecure magnetic stripe system.[6]

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[2] The Act recognizes that, until now, issuer incentives have been backward. It requires the Board to consider in its rulemaking "the extent to which interchange transaction fees have in the past reduced or increased incentives for parties involved in electronic debit transactions to reduce fraud on such transactions." *See* Section 920(a)(5)(B)(ii)(VI).

[3] *See* Report of Stephen Craig Mott, Oct. 29, 2010 ("Mott Report") at ¶ 64.

[4] *See* Report of Steven C. Salop, Oct. 27, 2010 ("Salop Report") at ¶ 130. The Mott Report and Salop Report were submitted to the Board in October 2010 along with earlier comments made by the MPC, and are available at http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf.

[5] The PCI DSS rules reinforce merchants' inability to effectively screen against fraud. These rules strictly prohibit merchants from storing any debit (or credit) card account information except as tokenized and/or encrypted. As a result, merchants cannot easily maintain or check databases of suspicious cards that may be associated with fraudulent activity. Issuers are not similarly restricted, and this is another reason why they are much better positioned than merchants to combat fraud. *See* Mott Report at ¶ 64.

[6] *See, e.g.*, Bob Sullivan, "The Magnetic Stripe: Why it is Hard for Americans to Say Good-Bye – In the US, clinging to old-fashioned payment methods is more than just a bad habit," European Payments Council Newsletter, Apr. 21, 2011, available at http://www.europeanpaymentscouncil.eu/article.cfm?articles_uuid=69346069-B2B6-B1FB-993888C5B3F3FBEC.

This demonstrates that high interchange diminishes incentives to innovate in fraud prevention technology.[7]

The Board, unfortunately, did not take into consideration these points in configuring the interim final rule regarding the fraud adjustment. Instead of correcting the misaligned incentives created by interchange (and the PCI and chargeback systems), the Board has elected to reward issuers for fraud losses via the base interchange rate, and then compound that error by providing them a guaranteed 1-cent windfall through the fraud prevention adjustment. And it has done so without providing merchants any protection against escalating PCI DSS costs, fines, or other fraud-related costs.

(ii) A Paradigm-Shifting Approach Can Be Implemented Without Mandating Specific Technologies

Before more specifically addressing the various reasons why the interim final rule does not satisfy the requirements of the Act, it is worth revisiting the MPC's proposal to the Board regarding the fraud adjustment.[8] In the Notice of Proposed Rulemaking, the Board questioned whether the final rules should endorse a paradigm-shifting approach and, if so, whether that necessitated the Board choosing a particular technology. In the alternative, the Board requested comment on a best practices-type approach to the fraud adjustment.

In our comments, the MPC strongly endorsed a paradigm-shifting approach by coming forward with a fully developed proposal that did not involve the choice of a particular technology, as we believe that such choices are best left to the market. Our proposal took into account the following critical policy considerations: (1) the fraud adjustment rule should be designed 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; (4) the fraud adjustment should be issuer-specific to motivate issuer competition to provide the greatest security to cardholders; and (5) issuers should receive, at most, a limited reimbursement for their initial fraud prevention costs (net of costs absorbed by other parties, especially merchants) up to

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[7] Lest there be any doubt as to the correlation between high interchange and the perpetuation of the fraud-prone magnetic stripe system, it is dispelled by a comparison of interchange rates in the U.S. and the rates (including in many cases at-par structures) that prevail in the rest of the world. For example, according to data collected by economist, Dennis W. Carlton, "in seven of the eight countries with the highest debit card usage per capita there is no interchange fee." Those countries include Canada, New Zealand, Iceland, Norway, Finland, Denmark, and the Netherlands. *See* Dennis W. Carlton, "Externalities in Payment Card Networks: Theory and Evidence, Commentary," The Changing Retail Payments Landscape: What Role for Central Banks, proceedings of a conference held at the Federal Reserve Bank of Kansas City, November 9-10, 2009, pp. 129-130 and Chart 1, available at http://kcfed.org/publicat/pscp/2009/PDF/Carlton.pdf.

[8] *See* January 20, 2011 Letter from the MPC to Louise L. Roseman, Director, Division of Reserve Bank Operations and Payments Systems, Board of Governors of the Federal Reserve System, available at http://www.federalreserve.gov/SECRS/2011/February/20110203/R-1404/R-1404_012011_61804_561400767649_1.pdf.

a cap. These principles are consistent with the law, which requires issuers to take effective steps to reduce fraud, including through the development of new cost-effective technologies, and requires any fraud adjustment amount to be offset by costs to other parties.

Based on these principles and the law's requirements, the MPC proposed that issuers be eligible for a fraud adjustment if the technology they implement reduces fraud to levels that are materially below the very low fraud experienced with PIN debit, and if the costs of implementing such technology are less than the cost of fraud eliminated by its use.[9] We also proposed that issuers must apply to the Board to receive the adjustment and document their eligibility by providing data to verify that the technology in question is actually reducing fraud to the requisite levels and doing so in a manner that is cost-effective. Whether the Board adopts this specific proposal or one that is generally consistent with its overarching principles — requiring material reductions in fraud while leaving the manner of implementation to the market — the Board must follow the law. The final fraud adjustment rule must satisfy the Act's core requirements that any adjustment must be (i) "reasonably necessary;" (ii) based on actual issuer costs; (iii) reflect actual fraud reductions that outweigh the costs incurred; and (iv) take into account costs of other parties to the transaction. The Board's interim final rule fails to satisfy the law's requirements in several respects.

B. CONFLICTS BETWEEN THE INTERIM FINAL RULE AND THE LAW

According to the Act, the Board may permit a fraud prevention adjustment to the base interchange rate only if one is "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud." Section 920(a)(5)(A)(i). The Act, however, limits the Board's discretion to permit a fraud prevention adjustment to situations in which an individual issuer makes investments in fraud prevention systems that *reduce* fraud and do so in a way that is cost-effective. *See* Section 920(a)(5)(A)(ii)(II) (Standards must "require issuers to take effective steps to reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions, including through the development and implementation of cost-effective fraud prevention technology."). The Act also requires that any fraud prevention adjustment for issuers be offset by costs to other parties in the payments system (including chargebacks to merchants). Section 920(a)(5)(A)(ii)(I). The interim final rule does not comply with these requirements, and therefore must be revised.

(i) The Interim Final Rule Conflicts with the Act by Failing to Require that Fraud Prevention Efforts be Effective and Cost-Effective

Rather than require the implementation of "effective steps" and "cost-effective" technology, the interim final rule provides an unearned windfall to covered issuers by weakly

[9] The MPC proposed an adjustment of up to 1.2 cents per transaction for qualifying issuers that would be paid to issuers until their initial capital expenditures are covered. While we reiterate the principles behind the proposal, as the 1.2-cent threshold is based on a flawed survey, that figure could be revised once the survey is done properly.

requiring them to check a few boxes before qualifying for a 1-cent fraud adjustment. Specifically, to qualify for an adjustment, an issuer is only required to "develop and implement policies and procedures reasonably designed to (1) [i]dentify 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." 76 Fed. Reg. at 43484 (Section V.C.3 (Section 235.4(b)—Adoption of Non-Prescriptive Standards – Develop and Implement Policies and Procedures)). None of these standards require the issuer to demonstrate that it has made any investments at all and, if it has, that they are actually reducing fraud.[10]

In evaluating the efficacy of the Board's approach, it is worth noting that industry commentators have concluded that virtually all, if not all, covered issuers can certify compliance with these standards without making any changes to their systems. The Board's approach also does not require any showing of reduced fraud or that any fraud reduction actually outweighs the costs to all parties in the payments system. As stated recently by a payments consultant:

> All debit card issuers have rudimentary fraud-prevention practices in place through their [Payment Card Industry Data Security Standard] requirements and card-network participation, so there is no reason to believe any issuer won't qualify for the one-cent adjustment.[11]

That issuers can qualify without making any additional investments at all and without any demonstration that their systems actually are effective in reducing fraud is clearly contrary to the Act. Moreover, given the persistence of fraud in the system and the fact that issuers often avoid taking necessary steps to reduce fraud, the fact that even "rudimentary" systems can qualify for the adjustment is troubling from a policy perspective. Given that the Board had an opportunity to use the adjustment to motivate paradigm-shifting change, this result is especially unfortunate.

[10] The Board curiously critiqued this requirement by noting that, in some cases, the origins of fraud may be outside the control of the issuer and that, therefore, issuers should not be required to show that their fraud prevention systems actually reduce fraud. We see several issues with this analysis. As an initial matter, while some fraud may be caused by other participants in the payments system, issuers are well positioned to take steps to reduce most fraud, and requiring them to demonstrate such fraud reduction makes sense from a policy perspective. Second, as noted, the statute requires that fraud prevention technology be cost-effective to qualify. While this standard may raise administrative burdens, which we acknowledge and address below, it cannot be ignored in the final rule.

[11] Statement of Beth Robertson, Director of Payments Research for Javelin Strategy & Research (Kate Fitzgerald, "Fed's Fraud Allowance May Not Cover Debit Issuers' Costs," *American Banker*, Aug. 1, 2011).

(ii) The Interim Final Rule Conflicts with the Act by Failing to Take Into Account Merchant and Consumer Costs

According to the Act, any fraud prevention adjustment set by the Board must reflect merchants' and consumers' fraud loss and fraud prevention costs. *See* Section 920(a)(5)(A)(ii)(I) ("standards shall … take[] into account any fraud-related reimbursements (including amounts from charge-backs) received from … merchants"); *see also* Section 920(a)(5)(B)(ii)(IV) (in crafting a fraud prevention standard, "the Board shall consider … the fraud prevention and data security costs expended by each party involved in electronic debit transactions (including consumers … [and] retailers)"). As set forth more fully in the Mott Report, merchants in particular bear substantial fraud costs, including fraud prevention and data security costs, which, when PCI DSS costs are taken into account, likely exceed the costs incurred by the issuers. These costs include the following:

- PCI DSS costs ($10 billion to date and escalating)
- Chargeback costs (likely more than $2 billion over the last three years)
- Fraud prevention costs
- Lost transactions

Mott Report at ¶ 63. Contrary to the law's mandate, the interim final rule does not account for these costs. Instead, the fraud adjustment amount is based solely on the fraud prevention costs that were reported by a limited number of issuers in the issuer survey. *See* 76 Fed. Reg. at 43482-83 (Section V.B.2 (Section 235.4(a) Adjustment Amount – Interim Final Rule)) (calculating 1-cent adjustment by deducting 0.7 cents from median issuers' 1.8 cent costs as reported in the survey). In short, the Board failed to adhere to the Act's requirements and, due to this failure, the Board should revisit its approach to the fraud adjustment.[12]

(iii) The Interim Final Rule Conflicts with the Act by Failing to Require That Specific Issuers' Costs Be Utilized for the Adjustment

The Act requires that any fraud adjustment be based on the fraud prevention expenditures of specific issuers. As such, the Board's conclusion that "[t]he phrasing 'reasonably necessary to make allowance for' fraud-prevention costs does not require a direct connection between the fraud-prevention adjustment and actual issuer costs" is incorrect. *See* 76 Fed. Reg. at 43482

[12] The Board cannot justify this approach by citing the administrative burdens associated with surveying merchants regarding such costs. A fraud adjustment rule can be configured that implicitly accounts for these costs. For example, the Board could account for merchant fraud loss or fraud prevention costs by prohibiting issuers from imposing on merchants any fraud loss costs (*e.g.*, chargebacks and fees) that are directly or indirectly related to transactions that qualify for the adjustment. The Board also could prohibit issuers or networks from imposing on merchants PCI DSS (or similar) costs, fines or penalties related to transactions that qualify for the adjustment. These approaches would not impose any administrative burden on the Board and would protect merchants from paying a windfall fraud adjustment to issuers and, at the same time, from facing networks and issuers raising fees and penalties associated with chargebacks or PCI DSS.

(Section V.B.2 (Section 235.4(a) Adjustment Amount – Interim Final Rule)). In fact, the very clause that the Board cited refers to "costs incurred by the issuer," leaving no ambiguity whatsoever that specific issuer costs must be used for this adjustment. The Act also stipulates that "the issuer" must comply with standards and that such standards must reflect the costs incurred by that bank. *See* Sections 920(a)(5)(A) and 920(a)(5)(B)(ii)(IV) and (V). Moreover, this conclusion is reinforced by the fact that, under the Act, the adjustment must be based on the issuer "tak[ing] effective steps to reduce the occurrence of, and costs from, fraud ... through the development and implementation of *cost-effective* fraud prevention technology." Section 920(a)(5)(A)(ii)(II) (emphasis added). Simply put, unless the adjustment is based on issuer-specific performance — involving both fraud reductions and costs — the requirement that the adjustment reflect cost-effective investments is negated.

Based on the clear language of the Act, the Board erred in its interpretation that actual issuer costs underpinning the adjustment are unnecessary. Further, the Board relied on a deeply flawed set of survey results to calculate median fraud prevention costs for "representative" issuers. While we will address the problems with the survey in more detail below, because the Act does not permit the use of representative issuers, the survey should never have been used in the first place for this purpose.

(iv) The Interim Final Rule Relies on a Statistically Flawed Survey

The Board's adoption of an interim final rule that will be set at issuer survey respondents' median fraud prevention costs, minus transaction monitoring costs, is a further reason why the interim final rule should not be implemented. As an initial matter, despite repeated questions raised by merchants regarding the survey mechanics and results, the Board did not reveal key details about the survey until the release of its final rule.[13] Merchants, for example, expressed concerns about the potential for substantial non-response bias as well as the need for an independent verification of the results by the Board.[14] No such verification was done, calling

[13] The first time that the Board revealed key details about the survey was not until June 2011 when it released the document entitled *2009 Interchange Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions*, available at http://www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf.

[14] *See, e.g.*, February 22, 2011 Comment Letter from the MPC to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, at 9 n.15, available at http://www.federalreserve.gov/SECRS/2011/March/20110303/R-1404/R-1404_022211_67840_571559563177_1.pdf ("The decision of certain low-cost issuers not to respond to the surveys also could skew upward the Board's [authorization, clearance, and settlement] cost estimates."); August 20, 2010 Letter from the National Association of Convenience Stores (NACS) to Louise L. Roseman, Director, Division of Reserve Bank Operations and Payments Systems, Board of Governors of the Federal Reserve System, at 2-3, available at http://www.nacsonline.com/NACS/News/Daily/Documents/ND082710_LettertoFed.pdf ("In our view, the Federal Reserve will need the assistance of experts in order to [disaggregate costs provided by issuers in their surveys that are not specific to a particular debit transaction and, therefore, should not be considered], and properly analyze the data received. We urge that merchant-provided and independent experts be used for this purpose in order to provide as full a perspective as possible on the data collected.").

into question the underpinnings of both the final rule on interchange fee standards, which regrettably is based entirely on the survey, and the interim final rule regarding the fraud adjustment.

Further, the details of the survey – which were improperly withheld in December when the NPRM was published – reveal a construct that is so methodologically flawed that, if it were offered as expert opinion in Court, it would almost certainly be rejected by the Court as "junk science" under the *Daubert* standard.[15] While the Board claims to use the survey to estimate a "representative" issuer's costs, that claim is belied by the fact that only 15% of non-exempt issuers responded to the survey.[16] In fact, the Board failed to survey over 78% of the non-exempt issuers, further revealing the inherent flaws in its approach. Moreover, the extremely high standard deviations in the survey indicate that the statistical mean cannot be relied upon as being representative of issuer costs.

As discussed above, the law requires the Board to rely on issuer-specific costs, not median costs across the entire industry. The Board's failure to utilize a methodologically sound approach to identify "representative" issuer fraud prevention costs only compounds the rule's conflict with the Act's requirements.[17]

C. THE INTERIM FINAL RULE DOES NOT PROVIDE FOR AN EFFECTIVE CERTIFICATION OF COMPLIANCE

The interim final rule requires that issuers certify compliance to their payment card network providers. This approach is contrary to the requirements of the law. The Act requires that fraud actually be prevented. Certifying compliance with vague standards to card networks does not ensure that fraud will be prevented.

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[15] *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993).

[16] According to the Board, there are currently 601 non-exempt issuers. *See* Federal Reserve Board, "Interchange Fee Standards: Small Issuer Exemption," Data Revised as of Aug. 29, 2011, available at http://www.federalreserve.gov/paymentsystems/debitfees.htm (generally) and http://www.federalreserve.gov/paymentsystems/files/debitfees.xls (at "Not Exempt" tab). Of those 601 non-exempt issuers, the Board surveyed 131 (or 22% of total non-exempt issuers surveyed) and received 89 responses from those issuers (or 15% of total non-exempt issuers surveyed). *See* "2009 Interchange Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions," available at http://www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf (at 3).

[17] Given the problems associated with the Board's reliance on the survey, its discussion of the "cost discipline" introduced by the use of the median cannot withstand scrutiny. *See* 76 Fed. Reg. 43483 (Section V.B.2 (Section 235.4(a) Adjustment Amount – Interim Final Rule)) ("The Board believes that the median allowance helps to offset the costs of implementing activities that are effective at reducing fraud losses while placing cost discipline on issuers to ensure that those fraud- prevention activities are also cost effective and recognizing that fraud-prevention costs are incurred by both merchants and issuers.").

The Board or FTC must certify compliance with fraud prevention standards. This is a government function and, as such, cannot be delegated to the payment card networks which have demonstrated a history of violating the antitrust laws in order to maximize fees to their member banks.

D. CONCLUSION

Given the numerous flaws in the interim final rule and its complete failure to comply with the Act, we respectfully suggest that the Board replace the interim final rule with an approach, like our earlier proposal, which could dramatically reduce fraud over time to the benefit of consumers and all other shareholders in the system. To do that, we suggest that the Board set out a proposed fraud adjustment rule in a notice of proposed rulemaking that would give the industry time to respond. In the interim, the remaining rules can go into effect as we see no reason why any of them are dependent on the fraud adjustment rulemaking for their implementation. We urge the Board to adopt this course and, in the process, explore the opportunity to create a safer structure for all stakeholders in the debit payments system.

Sincerely,

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