September 30, 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: Interim Rule on Debit Card Fraud Prevention Adjustment, Docket No. R-1404

Dear Ms. Johnson:

Through this letter, every major bank and credit union trade association[1] writes to express general support for the concepts of the interim rule issued by the Board of Governors of the Federal Reserve System (the "Federal Reserve") (the "Interim Rule"[2]) to implement the fraud prevention adjustment provisions of Section 1075 (the "Durbin Amendment") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[3] We believe, however, that the amount of the adjustment should be considerably higher.

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1 A description of the associations joining this letter is attached as Appendix A.

2 Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,478 (July 20, 2011) (to be codified at 12 C.F.R. pt. 235).

3 Codified as Section 920 of the Electronic Fund Transfers Act ("EFTA"), 15 U.S.C. 1693o-2.

## EXECUTIVE SUMMARY

As we noted in our February 22, 2011 comment letter on the Federal Reserve's proposed rule for the general regulation of debit card interchange fees,[4] debit card transactions have become the most popular non-cash means of purchasing goods and services in the United States.[5] The remarkable growth of the use of debit cards is due to the simple fact that they represent one of the most effective and innovative consumer banking products of recent decades, bringing to merchants, consumers, and financial institutions very substantial benefits beyond cash or checks.

Of particular relevance to this letter, one of the most important benefits of debit cards to merchants and consumers is that *issuers*—not merchants or consumers—absorb the substantial majority of fraud losses through (i) guaranteed payments to merchants for properly authorized in-person transactions and (ii) zero liability for consumers if their cards are lost or stolen or if the transaction is disputed.[6] By doing so, issuers allow consumers to use debit cards (and allow merchants to accept them) without general risk of incurring losses due to fraud.

The difference between debit cards and checks in this regard is striking, as described in detail in our joint and separate letters addressing the Federal Reserve's proposed interchange rule.[7] In contrast to debit card transactions, paying banks may

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4 Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (proposed Dec. 28, 2010) ("Proposed Rule").

5 February 22, 2011 All-Trades' Comment Letter at 2-4.

6 Typically, an issuer absorbs the fraud loss related to a debit card transaction for which the merchant has properly followed the basic security procedures outlined in the agreement governing the relationship between the merchant and the relevant debit card network. In contrast, the merchant typically absorbs the fraud loss when it has not properly followed those procedures. Because merchants have been better at meeting those requirements when accepting a PIN transaction rather than a signature transaction, issuers absorb a much higher percentage of fraud losses related to PIN than related to signature. *See* 76 Fed. Reg. 43,481 (noting that "[i]ssuers and payment card networks reported that nearly all the fraud losses associated with PIN debit card transactions (96 percent) were borne by issuers. In contrast, reported fraud losses were distributed much more evenly between issuers and merchants for signature debit card transactions"). Likewise, because it is harder to verify a card-not-present transaction (*e.g.*, telephone and internet transactions), than a card-present transaction, merchants typically bear a much higher percentage of fraud losses for card-not-present transactions. *See id.* (noting that approximately three quarters of the percentage of fraud losses are related to the much smaller universe of card-not-present transactions).

7 *See, e.g.*, February 22, 2011 All-Trades' Comment Letter at 34-39; February 22, 2011 American Bankers Association Comment Letter at 5-11; February 22, 2011 Consumer Bankers Association Comment Letter at 12-14; February 22, 2011 Independent Community Bankers of America Comment Letter at 27; February 22, 2011 National Association of Federal Credit Unions Comment Letter at 4-5.

return checks to merchants for many reasons, and so merchants have *no guarantee* of payment when they accept a check. Merchants thus bear most of the fraud losses associated with checks. Consequently, to minimize check fraud losses, merchants purchase costly check verification and check guarantee services from third parties that range from 1.15% to 2% of the check's value.[8] The Nilson Report states that merchants paid 8 cents per check for verification services and an additional .92 basis points of check value for guarantee services.[9]

The benefits of fraud protection that issuers provide to merchants and customers come at substantial cost. In 2009 alone, issuers absorbed approximately $830.8 million in actual fraud losses related to debit card transactions.[10] Moreover, losses for issuers and merchants alike undoubtedly were reduced by the substantial investments that issuers made to deter fraudulent transactions from occurring in the first place: in 2010, issuers incurred over $680 million in fraud prevention costs.[11] And everyone—merchants, consumers, and issuers—benefits from fraud prevention and lower fraud losses.

Recognizing the importance and value to all parties of encouraging issuers to invest in fraud prevention, Section 920(a)(5) of the Durbin Amendment authorizes the Federal Reserve to adjust the general interchange fee provisions set forth in Sections 920(a)(2) and (3) upward so that issuers recover their fraud prevention costs.

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8 *See* Professor Christopher M. James, *Comments on the Federal Reserve Board's Debit Card Interchange Fees and Routing Proposal* at 11, in February 22, 2011 MasterCard WorldWide Comment Letter at Appendix B (citing JAVELIN STRATEGY & RESEARCH, 2009 LEXISNEXIS TRUE COST OF FRAUD STUDY 58).

9 *See id.* (citing 953 THE NILSON REPORT, July 2010; Notice, p. 28). Debit cards offer more effective fraud protection to merchants than do checks: despite the higher use of debit cards, 52% of the brick-and-mortar store transactions that are not authorized are linked to checks. *See id.* (citing JAVELIN STRATEGY & RESEARCH, 2009 LEXISNEXIS TRUE COST OF FRAUD STUDY 34); *see also id.* (noting that 34% of all fraudulent transactions at both brick-and-mortar and online stores involved checks and only 8% involved debit cards) (citing JAVELIN STRATEGY & RESEARCH, 2009 LEXISNEXIS TRUE COST OF FRAUD STUDY 54).

10 *See* 76 Fed. Reg. at 43,480-81.

11 This number was calculated by multiplying (i) the fraud prevention costs in 2010 of "covered" issuers (*i.e.*, issuers with at least $10 billion in assets) of 1.8 cents per transaction, as estimated by the Federal Reserve, *see* 76 Fed. Reg. at 43,481, by (ii) the 37.7 billion transactions conducted by all issuers in 2010, *see* 75 Fed. Reg. 81,725. As will be discussed, the Federal Reserve's estimate of 1.8 cents per transaction is based on the median covered issuers' cost, and does not include (i) the cost of covered issuers' response to customer inquiries concerning fraudulent or potentially fraudulent transactions, (ii) the cost of covered issuers' development and implementation of new technologies and systems, and (ii) *any* of the fraud prevention costs of supposedly "exempt" issuers (*i.e.*, issuers with under $10 billion in assets).

To qualify for this adjustment, Section 920(a)(5) requires an issuer to take certain steps concerning fraud prevention as set forth in regulations by the Federal Reserve.

In the Interim Rule, the Federal Reserve has chosen to implement Section 920(a)(5) by allowing a covered issuer to receive an adjustment of no more than 1 cent per transaction (regardless of the form of the transaction) if it follows certain non-prescriptive fraud prevention guidelines. The 1 cent amount is based on the median covered issuer's fraud prevention costs, and applies to all covered issuers regardless of their actual fraud prevention costs.

We believe that the Interim Rule correctly requires issuers who wish to receive a fraud prevention adjustment to meet flexible, non-prescriptive fraud prevention standards, as opposed to the alternative set forth in the Proposed Rule of mandating that issuers use certain specific fraud prevention technologies selected by the Federal Reserve. The multiple advantages of the proposed flexible, non-prescriptive standards include: (i) enabling issuers to utilize the most effective methods of preventing fraud, (ii) allowing them to develop and implement new methods and technology to combat fraud on the existing and future debit card authentication and clearance systems, and (iii) giving them the ability and flexibility to adapt quickly to new methods that criminals use to commit fraud. Moreover, by not forcing the entire industry to use identical or similar types of fraud prevention technologies, the flexible, non-prescriptive standards will make it more difficult for criminals to devastate the entire debit card system by focusing on and exploiting common vulnerabilities in one or two types of technologies.

We also believe that the Interim Rule properly applies the adjustment to all forms of debit card transactions, thereby rejecting the argument that the adjustment be allowed only for PIN due to PIN's supposedly lower incidence of fraud losses as compared to signature transactions. Indeed, the belief that signature transactions have higher fraud losses than PIN transactions—regardless of who absorbs the losses—is highly questionable. Debit card account numbers and PINs often are compromised in the merchant environment, and fraudsters then use that compromised information to withdraw cash from automatic teller machines ("ATMs").[12] Bank of America relates that thirty percent of losses from all PIN transactions (including point of sale and at ATMs) are due to merchant data breaches which, when extrapolated out using aggregate industry loss numbers, amount to approximately $500 million in claims and $50 million in operating expense across the industry annually. Accordingly, fraud losses related to PIN transactions and to ATM transactions cannot be viewed independently, as the Board has done in the Interim Rule.[13] Even issuers' losses from fraudulent ATM transactions

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[12] There have been several recent high-profile instances in which customer card numbers and PINs were compromised at the point of sale, but all losses occurred from fraudsters withdrawing money from cardholder accounts. *See, e.g.*, Gregory Karp and Amy Alderman, *Thieves swipe PINs at store checkouts, raid bank accounts*, Chicago Trib., May 6, 2011.

[13] 76 Fed. Reg. 43,480 n.13.

alone can be very significant: Chase's ATM fraud losses are three times its losses from PIN transactions.[14] Accordingly, when taking this holistic view, debit card fraud losses related to PIN and signature transactions are more comparable; and, therefore, separate PIN and signature fraud prevention cost adjustments are not warranted.

Even if PIN-related fraud losses could be shown to be higher than signature-related fraud losses, allowing an upward adjustment only for PIN authentication would have several negative effects on the debit card system as a whole. These disadvantages include discouraging the use of non-PIN transactions (which have certain advantages over PIN transactions and are the only means of transacting internet and phone sales), reducing available resources to fight fraud across all systems, and discouraging issuers from investing in emerging, and potentially superior, methods of fighting fraud and securing customer data. In effect, a PIN-only adjustment would tend to incentivize issuers to freeze fraud prevention technology at the level available in 2011.

Finally, however, the 1 cent amount is insufficient to cover the true costs that issuers bear for fraud prevention for several reasons.

- *First*, without explanation, the Interim Rule bases the 1 cent adjustment amount on what the Federal Reserve calculates to be the *median* fraud prevention costs of covered issuers,[15] rather than the fraud prevention costs of issuers at the *80th percentile*, which is the percentile the Federal Reserve used in the Final Rule to determine the general debit interchange fee caps.[16] By using median costs, the Interim Rule fails to adequately compensate issuers who do not have the economies of scale of the largest volume processors and would deny half of all covered issuers the ability to recoup crucial fraud prevention costs that they incur above 1 cent per transaction.

- *Second,* the 1 cent amount does not include the important fraud prevention costs that issuers incur in responding to customer inquiries about fraudulent or potentially fraudulent activity related to their debit cards. These inquiries are often crucial starting points to detecting and preventing fraudulent activity.

- *Third*, the 1 cent amount does not include any costs incurred by issuers for adopting and utilizing new fraud prevention technology and systems, such as issuing new cards that contain superior fraud prevention technology.

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14 *See* February 11, 2011 JPMorgan Chase & Co. Comment Letter at 13.

15 76 Fed. Reg. at 43,481-83.

16 76 Fed. Reg. at 43,422.

- *Fourth*, to compound all the above deficiencies in calculating the fraud prevention adjustment, the 1 cent amount fails to consider at all the higher fraud prevention costs of issuers with assets under $10 billion, despite acknowledgement by Board members that these "exempt" issuers likely will be subject, as a practical matter, to the same limits on interchange fees that the Federal Reserve imposes directly by law on non-exempt issuers.[17]

We believe that when these flaws in the Interim Rule's calculation of the fraud prevention adjustment amount are rectified, the appropriate amount would be at least 4 to 5 cents per transaction. We also note that these flaws are magnified by the fact that, although the Federal Reserve will review the appropriate amount of the fraud prevention adjustment every two years,[18] any future adjustment the Federal Reserve makes to this amount will be inherently prospective, and thereby fail to capture prior lost costs. The Federal Reserve has not put forward a plan to compensate issuers for any higher fraud prevention costs (*i.e.*, above 1 cent per transaction) that actually occur during that two-year period. At a minimum, we urge the Federal Reserve to survey carefully issuers' fraud prevention costs and reconsider, with appropriate frequency, the formulation for the fraud prevention adjustment amount.

## DISCUSSION

### I. Description of the Durbin Amendment's Provision on Fraud Adjustment

In addition to the Durbin Amendment's provisions on the general allowable amounts of debit interchange fees, it provides for "an adjustment to the fee amount received or charged by an issuer [for an electronic debit card transaction] if (i) such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer; and (ii) the issuer complies with the fraud-related standards established by the Board . . . ".[19]

The Durbin Amendment further provides significant flexibility as to the "standards established by the Board" through requiring that issuers take "effective steps to reduce the occurrence of, and costs from, fraud in relation to electronic debit

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17 The 1 cent proposed adjustment for fraud prevention only modestly alleviates the Final Rule's almost 50% reduction in general debit interchange fees. *See* Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43,394 (July 20, 2010) (to be codified at 12 C.F.R. pt. 235) ("Final Rule"). Although we firmly believe that the Final Rule's 50% price cap reduction on debit interchange fees was considerably greater than what the Durbin Amendment permits, we acknowledge and appreciate the significant work that the Federal Reserve and its Staff undertook to improve the Final Rule from the Proposed Rule.

18 76 Fed. Reg. at 43,458.

19 § 920(a)(5).

transactions, including through the development and implementation of cost-effective fraud prevention technology".[20] The Durbin Amendment does, however, require the Federal Reserve to "take[] into account any fraud-related reimbursements (including amounts from charge-backs) received from consumers, merchants, or payment card networks in relation to electronic debit transactions involving the issuer".[21]

In considering the amount of the adjustment and the standards an issuer must meet to receive it, the Durbin Amendment requires the Federal Reserve to consider:

> "(I) the nature, type, and occurrence of fraud in electronic debit transactions;
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> (II) the extent to which the occurrence of fraud depends on whether authorization in an electronic debit transaction is based on signature, PIN, or other means;
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> (III) the available and economical means by which fraud on electronic debit transactions may be reduced;
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> (IV) the fraud prevention and data security costs expended by each party involved in electronic debit transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers and payment card networks);
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> (V) the costs of fraudulent transactions absorbed by each party involved in such transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers and payment card networks);
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> (VI) 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; and
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> (VII) such other factors as the Board considers appropriate".[22]

## II. Description of the Interim Rule

Under the Interim Rule, an issuer may receive an upward adjustment for fraud prevention of no more than 1 cent above the amount of interchange fees it receives for each debit card transaction, provided that the issuer previously has certified to the network on which the transaction is carried that the issuer complies with the following,

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20 § 920(a)(5)(A)(ii)(II).

21 § 920(a)(5)(A)(ii)(I).

22 § 920(a)(5)(B)(ii).

non-prescriptive fraud prevention standards. *First*, the issuer must certify that it has "[d]evelop[ed] and implement[ed] policies and procedures reasonably designed to: (i) Identify and prevent fraudulent electronic debit transactions; (ii) [m]onitor the incidence of, reimbursements received for, and losses incurred from fraudulent electronic debit transactions; (iii) [r]espond 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 (iv) [s]ecure debit card and cardholder data".[23] *Second*, the issuer must certify that it "[r]eview[s] its fraud-prevention policies and procedures at least annually, and update[s] them as necessary to address changes in prevalence and nature of fraudulent electronic debit transactions and available methods of detecting, preventing, and mitigating fraud".[24]

The Non-Prescriptive Standards

In the Proposed Rule, the Federal Reserve sought comments on two alternative standards that an issuer would have to meet in order to qualify for a fraud prevention adjustment. Alternative A was a "technology-specific approach" through which "the Board would identify paradigm-shifting technologies that would reduce debit card fraud in a cost-effective manner". Alternative B was a "non-prescriptive approach [that] would entail a more general set of standards that an issuer must meet to be eligible to receive an adjustment for fraud-prevention costs".

In choosing to issue the flexible, non-prescriptive standards listed above, rather than technology-specific standards, the Federal Reserve emphasized that "the dynamic nature of the debit card fraud environment requires standards that permit issuers to determine themselves the best methods to detect, prevent, and mitigate fraud losses for the size and scope of their debit card program and to respond to frequent changes in fraud patterns. Standards that incorporate a technology-specific approach do not provide sufficient flexibility to issuers to design and adapt policies and procedures that best meet a particular issuer's needs and that would most effectively reduce fraud losses for all parties to a transaction".[25] The Federal Reserve also noted the specific concern "that fraudsters may use [any list of fraud prevention technologies mandated by the Federal Reserve] as a way to focus their efforts to compromise card and cardholder data is material".[26]

The General Application of the Upward Adjustment

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23 76 Fed. Reg. at 43,487.

24 *Id.*

25 *Id.* at 43,484.

26 *Id.*

In the Proposed Rule, the Federal Reserve sought comments on whether a fraud prevention adjustment should apply to all types of debit interchange transactions or just to PIN transactions. In the Interim Rule, the Federal Reserve applied the adjustment to all forms of debit card transactions, noting that "limiting an adjustment to authentication methods available today, or a subset of those methods, may not allow flexibility for issuers to develop other methods of authentication that may be more effective than today's alternatives and may not require a PIN".[27] The Federal Reserve further noted that limiting the adjustment to PIN transactions might "reduce the incentives for issuers to improve fraud-prevention techniques for systems that, for a variety of reasons, experience higher fraud rates".[28]

The Amount of the Fraud Prevention Adjustment

In considering the amount of an allowable fraud adjustment, the Federal Reserve concluded that the Durbin Amendment's provision that such an amount be "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer" did not require (i) "a direct connection between the fraud-prevention adjustment and actual issuer costs" or (ii) "that each (or any) issuer fully recovers its fraud-prevention costs".[29] Rather, the Federal Reserve determined that the provision required only that it "give[] consideration to those costs, and allow[] a reasonable recovery of those costs based on the considerations in Section 920(a)(5)(B)(ii) described above" and other considerations that the Federal Reserve deems relevant.[30]

Using this logic, the Federal Reserve determined that it would allow an adjustment equal to the *median* per transaction fraud prevention cost of covered issuers, because the median amount "provides some issuers with recovery of all of these costs and other issuers with recovery of some of these costs", "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".[31] The Federal Reserve did not explain why it chose to use the median of issuers' costs of fraud prevention, in contrast of its choice to use the 80th percentile of

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27 *Id.* at 43,483.

28 *Id.*

29 *Id.* at 43,482.

30 *Id.*

31 *Id.* at 43,483.

issuers' costs when determining the general debit card interchange fee restrictions issued in the Final Rule.[32]

The Federal Reserve then looked to the responses to its survey on issuers' debit interchange costs that it sent to issuers who are explicitly covered by the Durbin Amendment, *i.e.*, issuers with at least $10 billion in assets. The Federal Reserve then excluded, without comment, (i) the costs issuers incur in responding to customer inquiries concerning fraudulent or potentially fraudulent activity linked to their cards, and (ii) costs issuers incur in developing and implementing new fraud prevention technology and systems.

After excluding these costs, the Federal Reserve determined that "[t]he median amount spent by issuers on all reported fraud-prevention activities was approximately 1.8 cents per transaction".[33] The Federal Reserve then (i) subtracted the .7 cent median per-transaction cost for monitoring activity, because that amount already was included in the 21 cents per transaction general debit interchange fee cap in the Final Rule, and (ii) rounded down from 1.1 cents to 1 cent.

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[32] *Id.*; 76 Fed. Reg. at 43,422.

[33] *Id.* at 43,481.

## III. The Interim Rule Is a Minimum Start Toward Implementing the Durbin Amendment's Provisions on Fraud Adjustment.

### A. In general, the Interim Rule's Approach Properly Implements a Fraud Adjustment.

As the Interim Rule notes, even with issuers investing substantial amounts in fraud prevention, fraud losses are substantial—approximately $1.34 billion per year[34]—and criminals are continually attempting new ways of attacking the debit interchange system.[35] It is axiomatic that if issuer investment in fraud prevention is reduced, the types of "at risk" transactions will increase—and therefore fraudulent transactions and fraud losses will increase. Moreover, increased fraud will cause reputational harm to the debit card interchange system as a whole, potentially leading consumers, merchants, and issuers to lose confidence in the debit card system. The net result: fewer sales and higher fraud losses for issuers and merchants and increased inconvenience for consumers, with no corresponding consumer benefit.

Despite the strong need for fraud prevention, unless issuers believe that they can recoup their costs in the debit card system as a whole, they will be reluctant to invest substantial resources in fraud prevention. But, as the Federal Reserve itself acknowledges, the Final Rule caps debit interchange fees at below an issuer's average total costs per transaction, and thus will require many issuers, among other things, to begin charging for previously free or low-cost banking services in order to offset some of their losses on each debit card transaction. The fraud adjustment marginally helps alleviate the heavy burden the Final Rule places on issuers by enabling issuers to recoup at least partial payment for the critical investments they make in fraud prevention.

### B. The Interim Rule's Flexible, Non-Prescriptive Standards Are Superior to Technology Specific Standards.

The Interim Rule properly applies flexible, non-prescriptive standards for issuers to recoup fraud prevention costs instead of the more restrictive technology-specific approach outlined in the Proposed Rule. The non-prescriptive approach is highly superior to the technology-specific approach for a number of reasons.

*First*, the non-prescriptive approach enables issuers to determine the appropriate technologies and procedures to implement effective fraud prevention programs, as opposed to requiring the Federal Reserve to identify specific paradigm-shifting technologies and then issue blanket "one-size-fits-all" rules for issuer compliance. Issuers have considerable experience developing, testing, implementing

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[34] *Id.* at 43,480.

[35] *Id.* at 43,484.

and adjusting fraud prevention technologies to meet day-to-day market demands, whereas the Federal Reserve lacks such direct experience with debit transaction activity. In addition, individual issuers, rather than the Federal Reserve, are in the best position to determine which technologies and practices are commercially feasible for their own business practices and internal corporate structures.

*Second*, the non-prescriptive approach allows for issuers to invest in a wide range of technologies and practices, including promising next-generation fraud prevention technologies, instead of confining their efforts to those specified by the Federal Reserve. By allowing issuers continuously to adopt new approaches to fraud prevention, the Interim Rule will allow for constant innovation in the fraud prevention marketplace instead of arbitrary (and, potentially, mistaken) selection of technology winners and losers, with the corresponding possibility of stifling private sector efforts to adopt new breakthrough technologies. There is, of course, the possibility that an individual issuer, as well as the Federal Reserve, will fail to select the best technology, but only the latter error has systemic implications. The non-prescriptive approach provided in the Interim Rule also supports issuer investments in non-technology-based fraud prevention activities such as increased staffing levels and employee training, which can be equally critical to the success of fraud prevention activities.

*Third*, by allowing issuers to continue to invest in and implement a wide range of technologies, the Interim Rule will ensure that criminals are unable to direct their efforts toward a prescribed set of technologies identified by the Federal Reserve. Under a technology-specific approach, necessarily made public in the rulemaking process, criminals would be given a window into issuers' fraud prevention practices, thereby receiving potentially valuable insight on how they should best target their criminal activity. The Interim Rule's market-based approach continues to allow issuers to shift to new technologies and take the steps necessary to react immediately to fraud, thereby protecting consumers and the integrity of the debit transaction system.

*Fourth*, the Interim Rule correctly identifies the disproportionate cost to issuers for fraudulent debit transaction activity and does not seek to limit unfairly recovery of the fraud prevention adjustment based on actual reductions in fraud losses. As the Federal Reserve correctly observes in the Interim Rule, factors other than issuer fraud prevention activity affect the occurrence of fraud.[36] Issuers should not be subject to reduced fraud prevention adjustment costs due to factors outside their control, including merchant data breaches or third-party processing failures.

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[36] *See Id.* at 43,484.

### C. The Interim Rule Correctly Applies the Upward Adjustment to All Types of Debit Card Transactions.

The Interim Rule properly applies the upward adjustment to all types of debit card transactions. The only basis for applying the adjustment to PIN transactions but not to current forms of non-PIN transactions (or other, not yet developed forms of transactions) is the questionable argument that PIN transactions have a lower incidence of fraud,[37] and thus the Interim Rule should use the fraud adjustment to encourage issuers to steer consumers away from non-PIN transactions and towards PIN transactions when using their debit cards. This argument suffers from several flaws.[38]

*First*, to the extent that non-PIN transactions can be associated with higher levels of fraud losses, it is largely due to the fact that they are the exclusive means of transacting card-not-present sales, such as sales over the telephone and the internet.[39] Such sales are increasingly crucial to the U.S. economy, and any fraud prevention adjustment should be based on the sound public policy of allowing issuers to recoup the fraud prevention costs they incur for the growing number of debit card transactions taking place over the internet and telephone.

*Second*, and related, because issuers have strong financial and reputational incentives to reduce fraud while simultaneously not losing money,[40] limiting the fraud prevention adjustment to PIN transactions would pressure issuers to reduce the availability of signature and other non-PIN authentication to their customers. Any such artificial shift away from non-PIN authentication could dramatically reduce consumer choice: currently 59% of all debit card transactions, including 100% of debit card transactions over the internet, are non-PIN transactions.[41] Indeed, many consumers and merchants prefer in-person transactions without a PIN, as signature transactions are faster (especially for small dollar transactions where merchants can choose not to require a signature) and do not require the customers to expose their PINs to the merchants.

*Third*, any fraud prevention adjustment policy that causes an artificial increase in PIN transaction volume creates an incentive for criminals to shift their attention and efforts from fraudulently using debit cards to make purchases to illegally obtaining PINs.

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37 *See supra* at 4-5.

38 If merchants believe that such "steering" is desirable, they can, of course, accomplish this directly without asking the Board to implement an arbitrary distinction.

39 76 Fed. Reg. at 43,480-81.

40 *Id.* at 43,481.

41 75 Fed. Reg. at 81,725 n.19; 76 Fed. Reg. at 43,480-81.

If they are used more widely, PINs will be easier to get and would constitute more attractive target for criminals, especially as PINs allow criminals to gain access to cardholder accounts and therefore cash, a more usable commodity than merchandise.

*Fourth*, because 59% of all debit card transactions are authenticated through non-PIN means,[42] limiting the adjustment to only PIN transactions would deny issuers recovery on the majority of their fraud prevention costs and potentially reduce their effectiveness as resources shift to PIN transactions. Because much of the fraud prevention technology and systems in which issuers invest helps prevent fraud for both PIN and non-PIN transactions, limiting the adjustment to PIN transactions only would actually harm the security of PIN transactions overall.

*Fifth*, if confining the adjustment to PIN transactions causes issuers to discourage or eliminate the use of non-PIN debit, then the 5.2 million merchant locations that currently do not accept PIN transactions—roughly 75% of merchant locations that accept any form of debit card payments[43]—would need to install PIN terminals in their stores if they wish to continue to accept debit cards at all.

*Sixth*, limiting the fraud prevention adjustment to PIN transactions would discourage issuers from investing in emerging and potentially more effective forms of authentication besides signature or PIN, such as those that rely on biometrics.

D. The Board Should Revise the One Cent Amount Upwards to Account For Various Factors Not Accounted for in the Interim Rule.

Although we generally support the Interim Rule, it should be amended in final form to take into account the full costs of fraud prevention. The 1 cent amount in the Interim Rule does not cover the true costs of fraud prevention and risks stifling innovation and diminishing the provision of fraud prevention services over time.

*First*, in deriving the fraud prevention adjustment from the *median* amount spent by surveyed issuers on fraud prevention,[44] the Federal Reserve tacitly acknowledges that more than half the issuers surveyed already spend more than 1 cent per transaction on fraud prevention (excluding monitoring). Using the median costs to determine the fraud prevention adjustment amount is in direct contrast to the Federal Reserve's use of the 80th percentile of issuer costs when determining the general debit interchange fee cap set forth in the Final Rule, and the Interim Rule provides no

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42 75 Fed. Reg. at 81,725 n.19.

43 75 Fed. Reg. at 81,723, 81,725.

44 *See supra*, p. 3; *see also* Federal Reserve, *2009 Interchange Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions* (June 2011), at 30.

explanation for this deviation. There are, however, significant reasons to set the adjustment amount at the 80th percentile. As an initial matter, the Durbin Amendment authorizes the Federal Reserve to allow for a fraud adjustment if "such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer".[45] As the Federal Reserve has acknowledged the importance of issuer investment in fraud prevention, but has not made any determination that fraud prevention costs above the median issuer amount are not "reasonably necessary", there is no basis for denying over half the covered issuers an adjustment commensurate with their true fraud prevention costs. An adjustment tied to the 80th percentile would allow a much greater number of issuers to recoup their fraud prevention costs and thus be more in line with the statute.

Moreover, as a practical matter, a fraud adjustment price cap at the median level is simply inconsistent with the goal of fostering an innovative and secure payment system; in a dynamic marketplace—one in which fraud schemes continuously evolve—issuers must constantly invest in new strategies and technologies to protect themselves, merchants, and consumers. Issuers have a natural financial incentive to institute the most efficient and cost effective means of preventing fraud, but the proposed 1 cent adjustment amount threatens to skew issuers towards spending less on fraud prevention. For issuers that believe that the optimal amount of fraud prevention costs is more than 1 cent per transaction, the Interim Rule, when set at the median level, constitutes a factor against investing more than 1 cent per transaction, and, consequently, risks greater fraud losses going forward.

According to the Federal Reserve, issuers' fraud prevention costs at the 80th percentile are 3.5 cents per transaction (which is 2.3 cents per transaction when excluding the 1.2 cents per transaction monitoring costs at the 80th percentile, which already are included in the general debit interchange fee cap), as opposed to the median fraud prevention costs of 1.8 cents per transaction (which is 1.1 cents per transaction when excluding the .7 cents per transaction monitoring fees at the median).[46] It is the 3.5 cents per transaction amount that is the proper starting place for the adjustment.

*Second*, in reaching the 1 cent per transaction amount, the Interim Rule does not consider the key fraud prevention cost that issuers incur when responding to customer inquiries concerning fraudulent or potentially fraudulent activity related to their debit cards. These inquiries often constitute the starting point to uncovering actual fraud (including compromised card numbers and PINS) and stopping the criminals at issue

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45 § 920(a)(5).

46 *2009 Interchange Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions*, Board of Governors of the Federal Reserve System (June 2011) at Table 13.

from committing even further fraud. Indeed, the Federal Reserve has recognized specifically the importance to fraud prevention and fraud loss of cardholders inquiring about and reporting fraudulent and potentially fraudulent activity linked to their cards; the Federal Reserve regulations provide for increases in a cardholder's liability for fraudulent losses related to the card if the cardholder is dilatory in reporting stolen debit cards.[47]

According to the Federal Reserve, the median issuer's customer inquiry cost is 3 cents per transaction; the cost at the 80th percentile of issuers is 6 cents per transaction.[48] The Federal Reserve should endeavor to determine the portion of these costs that are related to fraud and fraud prevention and add that portion to the fraud prevention adjustment amount. Even if only one-sixth to one-third of cardholder inquiries relate to fraud prevention, this would add 1 to 2 cents (at the 80th percentile level) to the adjustment amount.

*Third*, the 1 cent amount does not include the costs that issuers incur for new and superior fraud prevention technologies and systems. For example, issuers incur significant costs for issuing new cards that are designed specifically to reduce the opportunity for criminals to commit fraud.

*Fourth*, as fraud losses affect the entire industry, the fraud prevention adjustment should seek to cover the costs of *all* debit card issuers. Yet, the Federal Reserve's 1 cent adjustment is derived from a single annual survey of issuers specifically subject to regulations under the terms of Durbin Amendment, *i.e.*, issuers with assets of at least $10 billion. The Federal Reserve did not consider the fraud prevention costs of theoretically "exempt" issuers, despite the acknowledgement by its Governors that there is a strong likelihood that, because of marketplace pressure, issuers with under $10 billion in assets will be subject, as a practical matter, to the Final Rule's general cap on interchange fees and the Interim Rule's 1 cent adjustment.[49] Because smaller issuers

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47 *See, e.g.*, 12 C.F.R. 205.6(b) ("If the consumer notifies the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of $50 or the amount of unauthorized transfers that occur before notice to the financial institution", but "[i]f the consumer fails to notify the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of $500 or the sum of: (i) $50 or the amount of unauthorized transfers that occur within the two business days, whichever is less; and (ii) [t]he amount of unauthorized transfers that occur after the close of two business days and before notice to the institution, provided the institution establishes that these transfers would not have occurred had the consumer notified the institution within that two-day period").

48 *Id.* at Table 6.

49 *See, e.g.*, Statement of Governor Elizabeth A. Duke, Transcript of June 29, 2011 Hearing of the Board of Governors of the Federal Reserve at 14-15 ("We received numerous comments expressing concern that the exemption would not be effective in practice. I agree with this

(footnote continued . . .)

tend to have higher costs, including higher fraud prevention costs, the 1 cent adjustment likely will deny smaller issuers—to a greater extent than larger issuers—the ability to recover a substantial portion of their fraud prevention costs. To ensure that the "exempt" issuers do not suffer disproportionately from the 1 cent amount, the Federal Reserve should err on the side of a higher fraud adjustment in case of any doubt.

Accordingly, we believe the fraud prevention adjustment should be calculated as follows:

- Start with the total fraud prevention costs, as defined in the Interim Rule, of issuers at the 80th percentile (including transaction monitoring). This amount is 3.5 cents per transaction.

- Then add the appropriate amount—likely 1 or 2 cents per transaction—to cover (i) issuers' costs at the 80th percentile for cardholder inquiries that are related to fraudulent activities and fraud prevention, and (ii) issuers' costs at the 80th percentile for costs associated with new fraud prevention technologies and systems (such as the issuance of new debit cards designed to reduce fraud). This brings the amount of the adjustment to at least 4.5 to 5.5 cents per transaction.

- Then subtract the costs of transaction monitoring at the 80th percentile, as that cost already is included in the 21 cent per transaction debit interchange fee cap in the Final Rule. This brings the amount of the adjustment to 3.3 to 4.3 cents per transaction.

- Then add at least 1 cent per transaction to ensure adequate compensation for supposedly "exempt" issuers whose (likely higher) costs were not

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(. . . footnote continued)

concern. Indeed, when I asked about the exemption at our previous board meeting on this issue, the staff acknowledged that there was no way to know whether the exemption would be effective. The staff pointed out then and in the final rule that the statute and rule permit, but do not require the networks to establish higher interchange fees for exempt issuers than for covered issuers"); Statement of Governor Daniel K. Tarullo, *id.* at 17 ("I share a lot of Governor Duke's concerns, particularly about the effectiveness of the exemptions applied"); Testimony of Federal Reserve Board Chairman Ben S. Bernanke Transcript of Feb. 17, 2011 Hearing before the Senate Banking Committee at 16 ("I think this is something we are trying to better understand through the comments and through our outreach; we are not certain how effective that exemption will be. It is possible that because merchants will reject more expensive cards from smaller institutions or because networks will not be willing to differentiate the interchange fee for issuers of different sizes, it is possible that that exemption will not be effective in the marketplace. It is allowable, not a requirement. And so there is some risk that that exemption will not be effective and that the interchange fees available to the smaller institutions will be reduced to the same extent that we would see for larger banks").

considered in formulating the 1 cent amount. **This brings the proper amount of the adjustment to 4 to 5 cents per transaction, after downward rounding.**

| **Fraud Prevention Costs** | **Amount of Costs at 80th Percentile** |
|---|---|
| "Fraud Prevention Costs" (as defined by the Interim Rule) | 3.5 cents |
| Cardholder Inquiries Related to Fraud Prevention and New Technologies (such as the issuance of new cards designed to reduce fraud) | + 1 to 2 cents |
| Transaction Monitoring | - 1.2 cents |
| Exempt Issuer Costs | + 1 cent |
| Total | 4.3 to 5.3 cents |
| **Rounded Total** | **4 to 5 cents** |

It is also important to note that the current 1 cent adjustment amount acts as a disincentive for all issuers to develop and apply new technologies that require significant costs upfront but have the potential for substantial long-term reductions in fraud losses, because there is no guarantee that the Federal Reserve will later revise the adjustment amount or permit compensation for past expenditures. Indeed, even if fraud prevention costs rise sharply, issuers will not recoup any amount above 1 cent per transaction for the two-year time period before the Board conducts a new survey of issuer costs and potentially revises the fraud prevention amount to account for the increased costs.

Accordingly, we urge the Federal Reserve to revise upwards the 1 cent amount to ensure that it (i) covers all reasonable costs that issuers incur for fraud prevention at the 80th percentile, (ii) properly compensates *all* issuers, both covered and "exempt", for their costs, and (iii) insures the proper incentives for issuers to make investments in fraud prevention going forward.

*  *  *

Thank you for considering the views expressed in this letter. We appreciate the opportunity to share our views and would be pleased to discuss any of them further at your convenience. Please feel free to contact Paul Saltzman, President and General Counsel of The Clearing House Association (Paul.Saltzman@theclearinghouse.org, (212) 613-0138), Rob Hunter, Deputy General Counsel of The Clearing House Association (Rob.Hunter@theclearinghouse.org, (336) 769-5314), or Rodge Cohen of Sullivan & Cromwell LLP (Cohenhr@sullcrom.com, (212) 558-3534), who have been coordinating the participation in this letter of all the trade associations listed below.

Sincerely,

/s/
Frank Keating
President and CEO,
American Bankers Association

/s/
Paul Saltzman
President,
The Clearing House Association

/s/
James D. Aramanda
CEO,
The Clearing House Payments Company

/s/
Richard Hunt
President,
Consumer Bankers Association

/s/
Bill Cheney
CEO,
Credit Union National Association

/s/
Steve Bartlett
CEO,
Financial Services Roundtable

/s/

Camden R. Fine
President/CEO,
Independent Community Bankers of America

/s/

Russell Goldsmith
Chairman and CEO of City National Bank,
Chairman of the Midsize Bank Coalition of America

/s/

Fred R. Becker, Jr.
President/CEO
National Association of Federal Credit Unions

cc: Hon. Timothy F. Geithner
Chairman, Financial Stability Oversight Council and
Secretary, Department of the Treasury

Hon. Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System

Hon. Janet Yellen
Vice Chair
Board of Governors of the Federal Reserve System

Hon. Elizabeth Duke
Member
Board of Governors of the Federal Reserve System

Hon. Daniel Tarullo
Member
Board of Governors of the Federal Reserve System

Hon. Sarah Bloom Raskin
Member
Board of Governors of the Federal Reserve System

Hon. Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation

Mr. John Walsh
Acting Comptroller
Office of the Comptroller of the Currency

Hon. Debbie Matz
Chairman
National Credit Union Administration

Mr. William Haraf
Commissioner
California Department of Financial Institutions,
on behalf of the Conference of State Bank Supervisors

H. Rodgin Cohen, Esq.
Partner
Sullivan & Cromwell LLP

Michael M. Wiseman, Esq.
Partner
Sullivan & Cromwell LLP

## APPENDIX A

### The American Bankers Association

The American Bankers Association ("ABA") represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities. Learn more at www.aba.com.

### The Clearing House

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. The Clearing House Payments Company L.L.C. provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

### The Consumer Bankers Association

The Consumer Bankers Association ("CBA") is the only national financial trade group focused exclusively on retail banking and personal financial services—banking services geared toward consumers and small businesses. As the recognized voice on retail banking issues, CBA provides leadership, education, research, and federal representation on retail banking issues. CBA members include most of the nation's largest bank holding companies as well as regional and super-community banks that collectively hold two-thirds of the industry's total assets.

### The Credit Union National Association

The Credit Union National Association ("CUNA") is the largest credit union advocacy organization in the country, representing approximately 90 percent of our nation's nearly 7,300 state and federal credit unions, which serve about 92 million members. CUNA benefits its members by partnering with state credit union leagues to provide proactive legislative, regulatory, and legal representation, the latest information on credit union issues, economic reports, regulatory analyses and advocacy, compliance assistance, grassroots and political advocacy efforts, and education. Visit www.cuna.org for more information about CUNA.

**The Financial Services Roundtable**

The Financial Services Roundtable ("Roundtable") represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $74.6 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

**The Independent Community Bankers of America**

The Independent Community Bankers of America ("ICBA"), the nation's voice for community banks, represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold over $1 trillion in assets, $900 billion in deposits and $750 billion in loans to consumers, small businesses and the agricultural community. Visit ICBA at www.icba.org.

**Midsize Bank Coalition of America**

The Midsize Bank Coalition of America ("MBCA") is a group of 22 US banks formed for the purpose of providing the perspectives of midsize banks on financial regulatory reform to regulators and legislators. The 22 institutions that comprise the MBCA operate more than 3,300 branches in 41 states, Washington, D.C., and three U.S. territories. Our combined assets exceed $322 billion (ranging in size from $7 to $25 billion) and, together, we employ approximately 60,000 people. Member institutions hold nearly $241 billion in deposits and total loans of more than $195 billion.

**The National Association of Federal Credit Unions**

Founded in 1967, the National Association of Federal Credit Unions ("NAFCU") exclusively represents the interests of federal credit unions before the federal government. Membership in NAFCU is direct; no state or local leagues, chapters or affiliations stand between NAFCU members and its headquarters in Arlington, VA. NAFCU provides its members with representation, information, education, and assistance to meet the constant challenges that cooperative financial institutions face in today's economic environment. NAFCU represents nearly 800 federal credit unions, accounting for 63.9 percent of total FCU assets and 58 percent of all FCU member-owners. NAFCU represents many smaller credit unions with limited operations as well

as many of the largest and most sophisticated credit unions in the nation, including 82 out of the 100 largest FCUs. Learn more at www.nafcu.org.