



Office of the President

September 28, 2011

Ms. 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; Debit Card Interchange
Fees and Routing

Dear Ms. Johnson:

Navy Federal Credit Union provides the following comments on the Federal Reserve Board's (Board) proposed provisions in Regulation II (Debit Card Interchange Fees and Routing) adopted in accordance with Section 920(a)(5) of the Electronic Fund Transfer Act (EFTA). Navy Federal is the nation's largest natural person credit union with \$44 billion in assets and 3.7 million members.

The Board has issued an interim final rule (Rule), which authorizes a fraud adjustment of one cent to the base of the debit card interchange fee. Thus, issuers eligible for the fraud adjustment would receive 22 cents for each transaction plus five basis points of the transaction. We support the Board for providing financial institutions with this fraud adjustment to regulated interchange transaction fees and believe the Board should permanently adopt an appropriate fraud adjustment. We believe this approach recognizes that financial institutions must continuously reinvest in fraud mitigation tools with the latest and most advanced technology.

We believe that the standards established by the Board under this Rule will likely set future expectations for fraud prevention by issuers in the payment card industry. As such we urge the Board to not only consider fraud on a per transaction basis (as the Rule is currently written) but on a fraud prevention basis tied to the actual card. Many emerging fraud prevention tools such as chip technology will require an investment not only in the card but in the new authorization applications that communicate with this new technology. If the adjustment is only calculated on a per transaction basis, then issuers would have no guarantee that the consumer will utilize the card enough times so that this expense would be covered. We believe the Board should be mindful of such investments by issuers and encourage their use by providing incentives such as a greater fraud adjustment amount to issuers who utilize this technology.

We believe that the Board should consider changes to the fraud adjustment moving forward. Specifically, we note that most fraud prevention programs are targeted at large dollar

transactions since the risk of losses for these transactions is most significant. Under the current fraud adjustment the 1 cent adjustment would apply to all transactions no matter the dollar amount. Accordingly, it would be more effective to price the fraud adjustment as an ad valorem expressed in basis points similar to the fraud loss component of the interchange transaction fee cap, rather than a fixed amount.

We believe the fraud adjustment the Board has provided will be unable to cover the fraud expenses incurred by issuers. We note that the fraud adjustment is calculated to cover the median fraud prevention cost, excluding transaction monitoring costs, while the interchange transaction fee cap was calculated to cover the 80th percentile issuer's average per-transaction cost. Neither the Debit Card Interchange Final Rule nor the Interim Final Rule on Debit Card Interchange Fee provides any explanation within the Rules themselves or within the Supplementary Information for this inconsistency. We believe in the future the fraud adjustment should be computed on this same 80th percentile basis as the interchange fee cap. As a result we believe the fraud adjustment rate should be set at the 80th percentile of the median issuer cost for all debit card related fraud prevention activities at approximately 3.1 cents¹.

This Rule implements a non-prescriptive approach on which the Board sought comment in December 2010. We applaud this approach however, caution the Board to be mindful of the ever changing landscape of fraud prevention. As financial institutions increase their fraud prevention tactics, criminals will find other ways to fraudulently acquire card data. The Rule as currently written requires the Board to gather information as necessary every two years and to approve new fee caps if appropriate. We support this biannual review by the Board and encourage the gathering and monitoring information so financial institutions can benefit through the Board's oversight of the fraud adjustment rate. Upon review of these changes, if it were to be found that policy or procedure requirements were in need of updating, then we urge the Board to increase the fraud adjustment rate so that issuers may better mitigate losses related to fraud prevention.

The interim final Rule does not include a definition of "fraud." We support adopting a broad definition of "fraud" which would remain silent on any specific authentication method that must be used. We believe this is necessary in order to prevent institutions from being limited to a particular method. First, if one method were to be used by the entire network, a weakness could be exploited, potentially resulting in breach of data and loss of funds. Using multiple methods provides enhanced protection. Second, if financial institutions are dictated to use only one certain method they may no longer strive to develop new ones. This could deter issuers from adopting emerging technologies. Lastly, financial institutions do not have the freedom to choose which authentication method is used at point of sale (POS). This decision can occur by the customer in choosing a payment method or by the merchant themselves. Merchants choose what authentication methods they want to adopt at their terminal. An example of this is PIN

¹ Debit Card Interchange Fees and Routing: Final Rule, 76 FR 43397 (July. 20, 2011).

transactions which are inherently more secure. Seventy-five percent of debit transactions cannot be conducted using a PIN because merchants have chosen not to install PIN capable terminals.

We believe when establishing the fraud adjustment amount, ATM fraud must be considered. Unfortunately when criminals capture a consumer's PIN, they prefer to use it at an ATM to get cash rather than at the POS. As a result of this Rule, we expect to see a decrease of fraud related to POS, however, we believe we will see an increase in fraud related to ATMs. The addition of a PIN network on cards that currently have Signature as the only authorization method will increase ATM fraud through added exposure of a cardholder's PIN. This fraud, while committed at an ATM, is directly tied to the theft of a PIN at a POS transaction. Adding ATM fraud to the adjustment amount is necessary for issuers to be compensated for fraud related to ATM transactions so that issuers may effectively mitigate risk.

Issuers must certify to their payment card network that its fraud-prevention standards comply with the Board's standards. The payment card networks have already integrated this into their process of when issuers certify whether they are exempt or non-exempt from the interchange Rule itself. We support this process however, it is not clear how the fraud prevention standards will be enforced in practice and what the network role in the process will be. We believe this clarification is necessary regarding the specifics of the certification requirement within the final Rule.

We appreciate the opportunity to provide comments on the Board's proposal to the EFTA. If you have any questions, please contact Charla Tompkins, Senior Policy Analyst, at (703) 206-2672.

Sincerely,



Cutler Dawson
President/CEO

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