INDEPENDENT COMMUNITY BANKERS *of* AMERICA

Submitted via
http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm

September 30, 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 and RIN 7100–AD 63
Regulation II, Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

The Independent Community Bankers of America (ICBA)[1] is pleased to submit comments on the interim final rule issued by the Board of Governors of the Federal Reserve System (Federal Reserve) that revises Regulation II, Debit Card Interchange Fees and Routing to implement the fraud prevention adjustment provisions of Section 1075 (Durbin Amendment) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

ICBA has signed a separate joint industry comment letter with The Clearing House, the American Bankers Association, the Consumer Bankers Association, the Credit Union National Association, the Financial Services Roundtable, the Midsize Bank Coalition of America, the National Association of Federal Credit Unions and the National Bankers Association. The purpose of this submission is to explain the unique perspective of community banks and to provide recommendations based solely on that perspective.

[1] The Independent Community Bankers of America 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 they serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever changing marketplace.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold $1.2 trillion in assets, $960 billion in deposits, and $750 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

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Specifically, ICBA:

- Urges the Federal Reserve to significantly increase the adjustment amount from 1-cent to 4-5 cents (as explained in the industry letter). A 1-cent adjustment fails to consider the higher fraud prevention costs of community banks and other issuers with assets under $10 billion.
- Commends the Federal Reserve for adopting non-prescriptive fraud-prevention standards because technology-specific standards would limit incentives to develop new anti-fraud technologies.
- Commends the Federal Reserve for applying the adjustment uniformly to all forms of debit card transactions, thereby rejecting the argument that the adjustment be allowed only for PIN transactions.

Overview

The interim final rule, issued by the Federal Reserve along with the final Regulation II, Debit Card Interchange Fees and Routing, implements the fraud prevention adjustment provisions of Section 1075 which permit the Federal Reserve to make an adjustment to permissible interchange fees to account for an issuer's cost in "preventing fraud" related to debit card transactions.[2] An issuer must comply with the fraud prevention-related standards established by the Federal Reserve to receive the adjustment.

The Federal Reserve has adopted the interim final rule and has requested comment on provisions to allow issuers an adjustment of 1-cent to its interchange transaction fee cap if the issuer develops fraud prevention policies and procedures that are compliant with the prescribed fraud- prevention standards established by the Federal Reserve. The Federal Reserve could review the amount of the adjustment over time.

Rather than advocating a specific authentication method or fraud reduction technology, the Federal Reserve developed a framework in which the issuer must certify its eligibility to receive the fraud-prevention adjustment to its payment networks by demonstrating its ability to:

1. Identify and prevent fraudulent electronic debit transactions.
2. Monitor the reimbursements received for, and losses incurred from, fraudulent electronic debit transactions.
3. Respond promptly and appropriately to suspicious electronic debit transactions to limit the fraud losses.
4. Secure debit card and cardholder data.

[2] The fraud-prevention adjustment, as well as the interchange pricing providions, do not apply to financial institutions and their affiliates with assets less than $10 billion as of the end of the previous calendar year.

This interim final rule becomes effective on October 1, 2011; the same effective date as the interchange pricing provisions of Regulation II.

Community Banks and Debit Card Fraud

Community banks, most which have assets under $10 billion, are continuing to increase their spending to address payments fraud.[3] Community banks are investing in sophisticated fraud detection techniques such as behavioral analytics and neural networks to combat growing fraud losses. Many card processing platforms used by community bank issuers, such as ICBA Bancard, mandate the use of these costly technologies for their card issuers. The sophistication of these fraud-detection techniques increase their effectiveness, but at a significant expense, and can create a cost burden that is disproportionate to that of larger issuers.

This increase in spending comes at the same time that, as a result of Section 1075 of the Dodd-Frank Act and Regulation II, marketplace pressures will likely lower the interchange revenue of exempt issuers. The Federal Reserve's 1-cent adjustment is based on a single survey of non-exempt issuers, that is, issuers with assets of at least $10 billion. However, smaller issuers tend to have higher costs, including higher fraud prevention costs. This 1-cent adjustment will likely deny community bank issuers the ability to recover a substantial portion of their fraud prevention costs, particularly as marketplace dynamics, over time, reduce their interchange revenue as well.

ICBA Comments

<u>Non-Prescriptive Approach</u>

ICBA commends the Federal Reserve for adopting non-prescriptive fraud-prevention standards because technology-specific standards would limit incentives to develop new anti-fraud technologies. In substance, technology-specific standards would have limited the tools issuers use to prevent fraud, giving those seeking to perpetuate fraud an unfair opportunity to improve their technological capabilities. Additionally, a non-prescriptive approach allows 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 technologies.

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[3] 2011 ICBA Community Bank Payments Survey. Overall, 61 percent of community banks increased their deposit account spending in the past year to address payments fraud. Less than 2 percent of respondents decreased their resources to mitigate payments fraud.

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Uniform Application to PIN and Non PIN Transactions

ICBA also commends the Federal Reserve for applying the adjustment to all forms of debit card transactions, thereby rejecting the argument that the adjustment be allowed only for PIN transactions. Allowing an adjustment only for PIN authentication would have several negative consequences on the debit card system as a whole. This could possibly discourage the use of non-PIN transactions (which have certain advantages over PIN transactions such as the only means of transacting Internet and phone purchases), reduce available resources to fight fraud across all systems, and discourage 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.

Fraud Adjustment Amount

ICBA is deeply concerned about the unintended consequences of the 1-cent fraud adjustment on exempt issuers, with assets under $10 billion. While most community banks are exempted from this, marketplace pressures, over time, will decrease interchange revenue. Because smaller issuers have higher costs, including higher fraud prevention costs, the 1 cent adjustment will likely inhibit the ability of smaller issuers—to a greater extent than larger issuers—to recover a substantial portion of their fraud prevention costs, and could marginalize small issuers. This is a concern voiced by several Federal Reserve Governors. [4]

Fraud losses affect all card issuers, regardless of their size. In a June 2011 ICBA survey, nearly every community banker surveyed said his/her institution was impacted by debit card fraud.[5] Community bank issuers—not merchants or consumers—absorb the 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. 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.

[4] See, e.g., Statement of Governor Elizabeth A. Duke, Transcript of June 29, 2011("We received numerous comments expressing concern that the exemption would not be effective in practice. I agree with this 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. ("I share a lot of Governor Duke's concerns, particularly about the effectiveness of the exemptions applied").

[5] 2011 ICBA Community Bank Payments Survey. Ninety-five percent of community banks reported an associated monetary loss due to fraud from a customer's debit card last year (an increase of 28 percentage points from 2009). Ninety-two percent of community banks reissued a debit card last year as a result of fraud. Check fraud also faced a sharp increase, with 76 percent of community banks experiencing monetary losses due to check fraud (an increase of 20 percentage points from 2009).

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Accordingly, smaller institutions would suffer disproportionately from the adjustment amount at the 1 cent level as market dynamics move exempt and covered issuer rates closer which would be inconsistent with the small institution exemption anticipated by Section 1075. A higher adjustment amount would lessen this impact. ICBA recommends an adjustment amount of 4 to 5 cents, as explained in the industry letter.[6]

Again, ICBA appreciates the opportunity to comment on this important rulemaking. Please do not hesitate to contact me at viveca.ware@icba.org or (202) 659-8111 or L. Cary Whaley, Vice President, Payments and Technology Policy at cary.whaley@icba.org or (202) 821-4449 with any questions regarding our comments.

Sincerely,

/s/

Viveca Y. Ware
Senior Vice President, Regulatory Policy

[6] All Trades Comment Letter on Debit Card Interchange, page 16.