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Director
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Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

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Re: Fraud adjustment and fraud prevention standard provisions of Section 1075 of the Dodd Frank Act related to debit card interchange fees.

We appreciate the challenge to the Federal Reserve Board (“Board”) in implementing the Section 1075 of the Dodd Frank Act that requires the Board to prescribe regulations ensuring that the amount of any interchange transaction fee be “reasonable and proportional to the costs” incurred by the issuer,¹ given the complexity of the card system, the shortcomings of the statute, and the goal, which we share, of not disrupting a popular, convenient, reliable, and efficient payment system that is so critical to commerce. We also recognize that it is unlikely that any solution will be completely satisfactory, given the limited time and practical constrictions.

We offer our suggestions on creating a workable regulation that will meet the goal of minimizing fraud and preserving customers’ convenience and their reliance and confidence in the debit card. The regulation would:

- (1) Include as simple a fraud adjustment calculation as possible;
- (2) Preserve as much as possible the incentive to prevent fraud and invest in new fraud prevention solutions; and
- (3) Avoid locking in particular technologies or solutions and allow flexibility in fraud prevention solutions to maximize fraud prevention results.

¹ Section 1075 of the Dodd Frank Act (“Act”) requires the Federal Reserve Board (“Board”) to prescribe regulations ensuring the amount of any interchange transaction fee be “reasonable and proportional to the costs” incurred by the issuer. Section 1075(a)(5) provides that the Board may allow for an adjustment to the interchange fee permitted “if such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to the electronic transactions involving that issuer; and the issuer complies with the fraud-related standards established by the Board. . .” Factors the Board must consider include “the fraud prevention and data security costs expended by each party involved in the electronic debit transaction” and “the costs of fraudulent transactions absorbed by each party involved. . .”

To accomplish these objectives, we strongly encourage the Board to include in the interchange fee a fraud adjustment, as contemplated by Congress, and to avoid locking in or endorsing a particular fraud prevention technique or solution. Accordingly, we suggest that the Board total the actual fraud losses, related dispute costs, and fraud prevention costs and allow the payment card networks to allocate that total to debit card transactions based on the networks' own fraud related factors, such as those envisioned by the Act. In addition, we suggest that the regulation adopt a general fraud prevention standard, with examples to illustrate, rather than designate or favor particular fraud prevention techniques or technology that may be or quickly become ineffective or obsolete.

1. *The regulation should include a fraud adjustment factor in the debit card interchange fee.*

We believe that it is critical that the interchange fee incorporate the fraud adjustment contemplated by Congress in order to:

- Encourage effective and cost-efficient fraud prevention solutions so that fraud is minimized and discouraged; and
- Ensure that consumers and merchants continue to have access to a popular, reliable, and convenient payment option that facilitates commerce.

Failure to compensate debit card issuers for fraud losses, the cost of resolving disputes, and fraud prevention costs could have significant unintended consequences. For example, if debit card issuers cannot recover sufficient revenue through interchange and the fraud adjustment to justify robust fraud prevention efforts, it could create unnecessary pressures on debit card issuers (and networks) to shift additional debit fraud and/or other losses directly to merchants. This simply cannot be the merchants' preferred outcome. Furthermore, merchants' efforts to mitigate losses associated with their acceptance of debit cards could have unintended consequences on debit cardholders if merchants alter their willingness to accept debit cards in the manner they do today. It stands to reason that the ounce of prevention is worth more to the merchants than the pound of cure.

Merchants should compensate issuers for the costs related to the issuers' fraud losses and dispute and fraud prevention costs because they reap significant benefits: they suffer fewer losses from fraud; they avoid the time-consuming processes associated with other payment options; and their customers have confidence in the reliability and convenience of the debit card system so are more comfortable proceeding with the purchase. If issuers are not adequately compensated and consequently the guarantee of payment is reduced or eliminated, both merchants and consumers will suffer.

Actual fraud losses and dispute resolutions costs. Issuers should be compensated for actual debit card fraud losses as well as the cost of resolving disputes with bank customers. In effect, under the debit card system, the risk of loss due to an uncollectible payment as well as the burdens of trying to minimize those losses are shifted from the merchant to the issuer. Unlike

checks, for example, which may be returned to the merchant and cause the merchant a loss, card present transactions generally come with a guarantee that the merchant will be paid if the merchant has followed the required procedures. Debit cards also allow merchants to avoid following procedures such as check verification procedures which slow the transaction and inconvenience customers. Even cash presents potential fraud issues because it may be stolen (by employees or others). In contrast, the debit card transactions are processed electronically, so are not susceptible to that type of loss to the merchant.

In essence, without the network payment guarantee, merchants would suffer 100% of the losses and dispute costs related to fraud. Therefore, any losses they have avoided should be reflected in the fraud adjustment as compensation for the issuers who now suffer the loss.

Fraud prevention costs, including research and development. In addition to compensation for fraud losses, it is essential to minimize debit card fraud that the interchange fee include a fraud adjustment component to compensate issuers for their actual fraud prevention costs as well as their fraud prevention research and development costs.

It is in everyone's best interest – bank customers, merchants, banks, the payment networks, and policy makers – to minimize payment system fraud and employ effective fraud prevention solutions. It is axiomatic that fraud and fraud prevention solutions are ever-changing and quickly become obsolete as criminals learn to circumvent them. Accordingly, it is critical that the regulation ensure that issuers are compensated for fraud prevention costs in order to:

(1) encourage the use of effective fraud prevention measures;

(2) encourage innovation and improvement of fraud prevention solutions; and

(3) not freeze fraud prevention solutions, chill advancements, or handicap banks in responding to the latest fraud event or scam by locking in a particular technology or technique.

Simply put, encouraging investment in and supporting fraud prevention through compensation means less fraud, which benefits all parties.

We note that including a fraud adjustment for fraud losses and fraud prevention costs in the fraud adjustment will not encourage or tempt issuers to use or retain ineffective solutions or act without regard to whether a loss is incurred. They have strong incentives to prevent fraud in a cost efficient manner even if they receive a general allotment in the interchange fee for fraud prevention costs: (1) the fraud adjustment will not be based on individual issuers' fraud prevention expenses, so the cost-effectiveness (return on investment) of their individual fraud prevention solutions will continue to be measured against their bottom line, and (2) fraud adversely impacts their customer relationship, customers' trust and confidence in the bank, and the banks' reputation.

- 2. The regulation should spread the total costs of issuers' fraud losses and fraud prevention costs, including research and development costs, over all transactions and have the payment networks determine how that total cost is allocated based on fraud factors.***

While not perfect, this approach is simple. Actual fraud and related dispute costs and fraud prevention costs are added up to calculate a fraud adjustment to compensate issuers for those costs. The networks would determine allocation based on various factors that they already consider, such as whether is an online or offline transaction and whether it is a card not present or card present transaction. It not only allows recovery of fraud costs, it also allows more timely and accurate adjustments based on factors that actually influence fraud losses, and it allows adjustments in response to the inevitable changing fraud schemes.

Incorporating into the fraud adjustment fraud losses and fraud prevention costs and simply spreading that total in the adjustment factor for all transactions will not always produce a perfectly equitable result. For example, the data, especially as it has never been collected, may be faulty and the data will always be lagging. In addition, it is possible that an issuer who spends relatively little on fraud prevention might also suffer relatively lower losses and therefore will be compensated less than an issuer who suffers higher losses and spends more on fraud prevention. However, we believe that in general those who spend more on fraud prevention efforts (including research and development) will generally have lower losses and certainly lower than they would otherwise. Accordingly, the fraud losses and fraud prevention expenses will to some degree balance each other out in the fraud adjustment.

3. The regulation should not specify fraud prevention techniques, but should instead adopt a more general approach as it has in other fraud related rules.

With regard to the provision of Section 1075(a)(5) of the Dodd Frank Act requiring that the Board issues standards related to fraud prevention, we suggest that the Board adopt the approach found in other regulations such as those implementing the Gramm Leach Bliley Act 501(b)² and the Fair Credit Reporting Act Identify Theft Red Flag provision³ and create a general fraud prevention standard and provide examples. This approach gives issuers flexibility in determining fraud prevention techniques without dictating particular techniques or technology that often quickly become obsolete. Under this approach, it would not be necessary to measure the value of any particular fraud prevention technique or incorporate that value into the fraud adjustment. It also recognizes that a single technique or technology may not be the optimal solution for all issuers or circumstances. For example, in the event of a data breach, some issuers may conclude that their neural networks are sufficiently robust to detect fraudulent activity, and it is not necessary to inconvenience customers with new debit cards and debit card numbers. Others may determine that card replacement is necessary.

² Section 501 of the Gramm Leach Bliley Act requires the banking agencies to establish appropriate standards for financial institutions relating to administrative, technical, and physical safeguards for customer records and information. In implementing this provision, the banking agencies adopted guidelines that provide general direction without mandating specific actions or solutions.

³ Section 615(e) of the Fair Credit Reporting Act requires federal agencies to develop identify theft prevention guidelines and regulations. The implementing regulation provides a requirement that covered institutions adopt an identify theft prevention program designed to identify, detect, and respond to relevant identify theft red flags, but does not include specific red flags or fraud prevention solutions. Rather, the accompanying guidelines provide factors that institutions should “consider.” The supplement to the guidelines lists examples of red flags.

The proposed solution is not perfect or exact. However, it is simpler, easier to implement, and more flexible than alternatives.

We are happy to provide additional comments or suggestions.

Regards,

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