



July 28, 2010

Louise Roseman
Director
Division of Reserve Bank Operations and Payment Systems
Board of Governors of the Federal Reserve
20th and Constitution, NW
Washington, DC 20551

Dear Ms. Roseman:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents federal credit unions (FCU), I am writing regarding the interchange fee provisions included in the regulatory reform legislation which require the Federal Reserve to set debit interchange fees at a level that is “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” As the Federal Reserve moves forward in drafting regulations, we encourage the Board to exercise as much flexibility as possible, within the confines of the statute, as any interchange fee price cap will cause operational concerns for NAFCU’s membership.

The interchange fee provisions do include an exemption for institutions with less than \$10 billion in assets. However, the legislation also affects a massive, interconnected network of card companies, issuers, merchants and consumers. Simply put, the changes necessary to allow the system to continue to function cannot be made in isolation.

Currently, the smallest credit union and the largest bank in the world receive the same interchange fee when their respective customer uses their debit card. It is this equal footing that has allowed credit unions to compete in this market. Absent a carefully considered implementation plan, interchange fee price caps have the potential to destroy this equal footing by segregating large institutions from small institutions.

The interchange fee provisions dictate what costs the Board may consider in determining what constitutes a “reasonable and proportional” interchange fee. Specifically, the legislation authorizes the Board to consider “the incremental cost incurred” in the “authorization, clearance or settlement of a particular electronic debit transaction...” By contrast, the Board may not consider costs that “are not specific to a particular electronic debit transaction...” The legislation, however, does not define

which costs should fall into the former category and which would fall into the latter. Accordingly, NAFCU encourages the Board to use its authority to define the incremental costs involved in the authorization, clearance or settlement of a particular transaction to ensure it encompass all of the actual costs associated with processing debit card transactions.

This can best be accomplished by examining the authorization, clearance or settlement costs of particular *types* of electronic debit transactions. Congress could not have intended the Board to consider only the incremental cost of a single, individual transaction when determining “reasonable and proportional” fees for a system that requires billions of dollars worth of infrastructure to function. This is true for a number of reasons. First, the incremental cost difference between processing one transaction and the next, in a system that processes billions of transactions annually will in all cases be next to nothing and will certainly not be enough to support the current electronic payment system. Next, given the various different types of interchange transactions – online, in person, at an automated machine, such as a gas pump – and the differing costs that accompany different types of transactions, it would be impossible to settle on a single fee that applies to all types of transactions. Additionally, the legislation impacts all institutions with more than \$10 billion in assets that issue debit cards, regardless of corporate structure or other distinguishing characteristics. This is an extremely broad category of affected institutions. Given that an incremental cost analysis would not be helpful, as a practical matter, it would be useful to instead organize the issue by examining it in a way which is familiar. In this case, breaking down the costs and the ultimate fee that may be charged, can best be accomplished by examining the authorization clearance and settlement charges for different types of transactions.

By examining transactions by type, the Board will be better able to evaluate the true costs associated with the authorization, clearance or settlement of debit transactions. For example, the costs associated with fraud losses, fraud insurance, fraud resolution and anti-fraud measures cannot be assigned to any one particular transaction. However, if transactions are categorized; for example online purchases, as opposed to purchases where the card is present, or purchases where a pin is required as opposed to purchases where only a signature is required; certain fraud trends become easy to identify (In the above examples online purchases and purchases requiring only a signature have, relatively speaking, higher instances of fraud.). By categorizing transactions in this manner and identifying trends, the Board will be better able to accurately determine the full cost of processing different debit transactions. To this end, NAFCU encourages the Board to consider the following costs as it moves forward with its mandate to set price caps for debit card interchange fee rates.

First, institutions must comply with extensive card network eligibility and application requirements (which are generally several hundred pages long), including:

- Paying applicable network licensing fees, charges and assessments;
- Significant data security controls and procedures;

- Meaningful, ongoing monitoring and review of card systems;
- Compliance with strict licensing requirements;
- Ongoing compliance with anti-money laundering programs; and
- Financial audits and exams at the discretion of the card networks.

Next, debit programs require considerable set up and maintenance costs, without which it would be impossible to process transactions. These costs include:

- Hardware;
- Software;
- Training personnel;
- Developing and implementing marketing programs for new debit card programs;
- Qualifying members for a card through ChexSystems or similar providers;
- Card issuance costs, such as producing, mailing and activating new debit cards;
- Creating a PIN number and mailing separate confirmation of the PIN; and
- Ongoing technical upgrades to improve service and combat fraud.

Further, there are a number of other routine operating costs that are absolutely necessary in order for the electronic debit system to function, such as:

- Administrative and production activities related to processing transactions, including authorization, settlement and posting to cardholder accounts;
- Customer service personnel to answer and resolve customer inquiries;
- Reissuing debit cards as they expire, or to replace lost or destroyed debit cards; and
- Regulatory compliance costs, including Gramm-Leach-Bliley and the Truth in Savings Act (TISA).

Finally, financial institutions pay a significant amount of money to resolve and combat fraud. In 2008, financial institutions paid an estimated \$8.6 billion just in fraud losses. However the actual cost of fraud is substantially larger than that figure. Card issuers also spend a considerable amount of money on fraud related losses, such as:

- Insurance premiums;
- Insurance deductibles;
- Paying transactions that exceed insurance coverage;
- Fraud management, which prevents and detects fraudulent behavior, including reviewing and monitoring account activity and investigating missing or fraudulent point-of-sale enabled debit cards;
- Processing claims, including both fraud and non-fraud disputes, chargebacks and copy retrieval requests (e.g., merchandise complaints, non-receipt of merchandise, fraud claims and duplicate posts);

- Card reissuance costs, such as producing and mailing new debit/credit cards for accounts that have been compromised; and
- Staff time dedicated to reversing fraudulent transactions, closing old accounts and opening new accounts.

Additionally, major data breaches, which are increasingly common, multiply exponentially all of the costs described above. For example, the Heartland data breach that was discovered in 2009 cost card issuing institutions millions of dollars in direct fraud and associated expenses.

Closely related to the point above regarding fraud, the Board should use the authority granted it under the Act to adjust the interchange fee to account for fraud costs. Financial institutions are spending an increasing amount of time and money dealing with fraud and its related costs. Moreover, in cases of widespread fraud, the breach virtually always originates at a merchant or processor and not with the financial institution that issued the card, receives the interchange fee and is ultimately liable for paying fraudulent transactions. Given that merchants benefit from guaranteed payment while simultaneously routinely failing to protect customers' personal information, it is only fair that interchange fees reflect the fraud costs for card issuers.

In addition, institutions are using increasingly sophisticated programs to identify fraud before transactions are approved. For example, one of NAFCU's member credit unions pays a vendor to search for patterns of fraud, for example purchases of a certain amount at a certain time at specific stores. Transactions that fit the parameters for likely fraud are denied. The vendor receives a monthly fee, plus a percentage of the savings the credit union realizes from denying fraudulent transactions. In return the credit union realizes a net savings in the form of lower fraud losses. Further, the arrangement guarantees that fewer than two percent of legitimate transactions will be denied. With the technology available today, combating fraud is a never ending process. Criminals continue to attack the system wherever it is vulnerable and inevitably some flaw will be discovered and exploited. Allowing an adjustment to the interchange fee to account for fraud costs helps provide an incentive to develop innovative new systems and technologies to combat fraud. Certainly, all financial institutions have an interest in combating fraud and protecting their own losses. Nonetheless, if interchange fees are capped at a level that only covers the incremental cost of processing a transaction, the market for these innovative systems will inevitably dry up and anti-fraud technology will stagnate.

In conclusion, the Board should consider all of the costs listed above, as they are absolutely necessary in order to authorize, clear and settle transactions. Even the most highly automated and complex financial institutions employ a significant number of so called "back room" personnel to oversee their debit card programs, identify problems, resolve customer complaints and ensure the system is operating as it should. Any interchange fee set by the Board should acknowledge these real and substantial costs.

Louise Roseman

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NAFCU appreciates this opportunity to share its concerns. Given the significance of this issue, I would also like to again request the opportunity to meet with you regarding this matter. Please have your office contact me or Dillon Shea, NAFCU's Associate Director of Regulatory Affairs, at dshea@nafcu.org or by telephone at 703-842-2212 and we will arrange accordingly.

Sincerely,

A handwritten signature in cursive script that reads "Carrie R. Hunt".

Carrie Hunt

Director of Regulatory Affairs