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Testimony of
Frank Michael
President and CEO
Allied Credit Union

On behalf of the Credit Union National Association

Before the
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit

Hearing on

"Understanding the Federal Reserve's Proposed Rule on Interchange Fees:
Implications and Consequences of the Durbin Amendment"

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Chairman Capito, Ranking Member Maloney, Members of the Subcommittee, thank you very much for the opportunity to testify at today's hearing. Credit unions appreciate your having called this hearing today on the most significant regulatory issue facing the 95% of credit union members who belong to credit unions that offer debit card services. We believe it would not have been necessary for us to be here today if the Durbin Amendment to the Dodd-Frank Act (Section 1075 of the Act) had been reviewed and considered by any Congressional standing committee prior to its passage.

My name is Frank Michael, and I am President and Chief Executive Officer of Allied Credit Union[1] in Stockton, California. I am testifying today on behalf of the Credit Union National Association (CUNA)[2], and I am Chairman of CUNA's Small Credit Union Committee.

Allied Credit union is not Bank of America. We're not Visa. We're not 7-11. We're small. And we strive to fulfill our mission to serve our members every day. Our members find value in conducting their financial services with us, and one of the things that our members want is convenient access to their checking account. Today, that means the ability to use a debit card.

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[1] Allied Credit Union is a federally insured state chartered credit union headquartered in Stockton, California, with 2,300 members and total assets of approximately $18 million. Allied Credit Union issues approximately 1,100 debits cards.

[2] CUNA is the largest credit union advocacy organization in the United States, representing approximately 90% of America's 7,700 state and federally chartered credit unions and their 93 million credit union members.

As discussed below, Section 1075 will make it more expensive for my members to access their checking account, and I know that this is **not** what Congress intended because Congress included an exemption for institutions like Allied Credit Union.

My testimony focuses on six areas:

1. The benefit that the payment system brings to all parties – consumers, merchants and financial institutions;
2. The flaws of the statute and the Federal Reserve Board's (the "Board") proposed implementing regulation;
3. How the proposed implementing regulation renders the statutory small issuer exemption essentially meaningless;
4. The routing and exclusivity provisions which represent an unreasonable and costly burden on credit unions and will drive interchange revenue down for issuers of all size;
5. The impact that the Board's debit interchange proposal will have on credit unions like the one that I run; and,
6. The statutory and regulatory remedies we believe are necessary to prevent these regulations from having a devastating impact on consumers.

The Benefit of Interchange to All Parties

The interchange fee is just one part of what is referred to as the "merchant discount fee," which has been described by the Government Accountability Office (GAO) in the following manner:

> The majority of the costs associated with accepting cards are the "merchant discount fees" paid to the banks that merchants use to process their transactions. Generally, for each Visa or MasterCard transaction, a portion of the merchant discount fee is paid from the merchant's bank—called the acquiring bank—to the bank that issued the card. **This portion, called the interchange fee, reimburses card issuers for a portion of the costs they incur in providing card services.**[3] [Emphasis Added]

Interchange is an agreed upon condition of accepting debit cards. Payment of interchange is the responsibility of the merchant and the merchant's bank (the acquiring bank). Card issuers, like

[3]Government Accountability Office. "Credit and Debit Cards: Federal Entities Are Taking Actions to Limit Their Interchange Fees, but Additional Revenue Collection Cost Savings May Exist." GAO-08-558. May 15, 2008. 1.

my credit union, who assume the risks of guaranteeing payment, fraud, and the costs of supporting a debit card program, receive interchange as compensation for those costs and the significant benefits that accrue to merchants for accepting debit cards.

Merchants benefit greatly as a result of the interchange fees they pay. Merchants receive guaranteed and expedited payment when a debit card is presented and accepted. Further, a consumer's use of a payment card – whether it is a credit card or a debit card – eliminates the risks that merchants would otherwise have to assume if the transaction were paid for with cash (theft risk, handling and security costs) or a check (bounce risk, which includes non-payment and collection expenses). Merchants also may benefit from "streamlined accounting, reduced credit risk, faster check-out and increased purchase amounts compared to checks or cash."[4]

On the other side of the market, the card issuer – my credit union – assumes all of the risk and guarantees the merchant will receive payment. In the process, the consumer receives a very important service: an efficient, convenient, seamless, and universally-accepted transaction. That very consumer service redounds to the benefit of merchants. The easier it is for a consumer to access his or her funds at the point of sale, the more likely he or she is to spend them on the goods or services the merchant is offering. There is tremendous benefit and value attached to the debit card, as evidenced by the significant increase in its acceptance by merchants and its use by consumers over the last decade.

Between merchants and card issuers, merchants are the primary beneficiaries of debit cards. This is why the merchant-paid interchange model developed in the first place. Accordingly, it is only fair that if merchants receive benefits from debit cards payments that they should have to pay the costs of the provision of debit card services. Under Section 1075, however, the Board would set the price of debit card services below cost, forcing financial institutions such as credit unions and community banks to lose money on each transaction; thereby subsidizing payment services for merchants. Whatever real or perceived problems may exist with the current interchange system, forcing credit unions—and by extension, their members—to subsidize big retailers like Wal-Mart, Home Depot, and 7-11, cannot possibly be the right solution. Indeed,

[4]Adam J. Levitin. "Interchange Regulation: Implications for Credit Unions." Filene Research Institute. 6.

big retailers will be the primary beneficiary of any reduction in interchange, since a recent study found that approximately 80% of all debit card volume is conducted at only 1.5% of merchants.[5]

The Statute and the Proposed Rule Are Flawed

Despite the good intentions of its framers and consumer proponents, Section 1075 will disrupt the debit interchange market that has benefited merchants, card issuers—like my credit union—and consumers—like my members. Section 1075 adds a new Section 920 to the Electronic Fund Transfer Act (EFTA), which requires the Board to set standards for assessing whether debit interchange transaction fees are "reasonable and proportional" to the issuers' costs associated with a debit card transaction and to issue regulations on debit card transaction routing.

When considering the costs incurred by the issuer, Congress directed the Board to distinguish between the incremental costs incurred by the issuer as a result of authorization, clearance, or settlement of a particular electronic debit transaction (which the Board is permitted to consider when issuing its rule) and other operational costs incurred by the issuer which are not specific to a particular electronic debit transaction but which are essential to the operation of a debit card program. The Board is also permitted to make an adjustment to the interchange transaction fees for fraud prevention costs.

Unfortunately, the Board's interpretation of the statute is that Congress directed the Board to disregard many of the most significant costs associated with operating a debit card program. As a result, the Board has proposed a debit interchange rate that is well below the cost of operating a debit card program. The Board's proposed rule changes the nature of the debit interchange fee from a proportional rate based on the amount of the transaction to a hard per transaction cap that does not distinguish between the type of debit transaction (PIN or Signature) or take into consideration the risk assumed by the card-issuing credit union or bank for accepting the transaction. To make matters worse, the Board has selectively chosen to exclude clearly permissible incremental costs associated with authorizing clearing and settling a transaction. These costs include, at minimum, network fees and adjustments for fraud prevention costs.

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[5]Peter Schroeder. "Financial industry hits back on debit card fees," The Hill. February 16, 2011.

At its most basic level, the Board's rule tells financial institutions that seek to meet the debit card demands of their customers that if they want to do this business, they must do so under a set of government imposed restrictions that require them to do it for less than it costs them to operate the program. Even for not-for-profit credit unions, the idea of the government requiring the operation of a program at a loss is abhorrent; it flies in the face of safety and soundness and certainly is not reasonable and proportional to credit unions' cost of providing debit card programs.

While we urge Congress generally to repeal the Section 1075 or delay its implementation, in the alternative, we urge Congress to amend Section 1075 to direct the Board to consider all costs incurred in the operation of debit card programs by all issuers, even those which were exempt from the regulation.

The Proposed Rule Renders the Small Issuer Exemption Essentially Meaningless

Congress exempted issuers with less than $10 billion in total assets from the rate-setting part of the rule.[6] Simply being exempt from the language of the regulation does not guarantee that credit unions with under $10 billion in assets are unaffected by the regulation. We are deeply concerned that the carve-out may be rendered essentially meaningless by the Board's proposed rule. If this proposed regulation is implemented, it will adversely affect all financial institutions that offer debit cards, as well as their members or customers who use debit cards. That simply cannot be the result that Congress intended when this law was enacted and as evidenced by the statements of the provision's sponsor, Senator Richard Durbin.

There is extraordinarily little legislative history regarding Section 1075, as Congress held no hearings on the specific provisions of the amendment, and which was subject to only a very brief debate in the United States Senate. In the scant legislative history, however, Senator Durbin, stated of the small issuer exemption:

> "…the requirement that debit fees be reasonable does not apply to debit cards issued by institutions with assets under $10 billion. This means that Visa and MasterCard **can**

[6]This exemption currently covers all but three credit unions: Pentagon Federal Credit Union, Navy Federal Credit Union, and State Employees Credit Union of North Carolina.

> continue to set the same debit interchange rates that they do today for small banks and credit unions. **<u>Those institutions would not lose any interchange revenue that they currently receive</u>**."[7] [Emphasis added].

Unfortunately, under the Board's proposal, this will almost certainly not be the case, for two reasons. First, it is uncertain whether—and for how long—the various payment networks will be willing and/or able to maintain separate pricing schemes for small and large institutions (the so-called "two-tier system"), because there is no requirement for them to do so. Second, even if the payment card networks operate a two-tiered system, with the passage of time, market forces, including the routing and exclusivity provisions which apply to all issuers, will cause convergence of prices between the two tiers. Absent enforcement by the Board of the small issuer exemption intended by Congress, the exemption is meaningless.

Approximately 80% of debit transactions involve cards issued by institutions with assets over $10 billion.[8] Therefore, the debit card networks will likely devote most of their attention to serving the providers of the vast majority of their business. Indeed, large financial institutions frequently receive individually negotiated volume based "incentives" from the networks in addition to interchange fees. The current pricing mechanism was no doubt designed to meet the needs of larger institutions and grow network volumes. Once larger institutions no longer benefit from that structure, it is far from certain that the networks will continue to devote the resources necessary to continue to maintain the complex, existing structure. It is also possible that larger institutions would prefer that the debit interchange system not provide a competitive advantage to smaller institutions by paying higher interchange rates than the large issuers receive. Networks are likely to be sensitive to the small number of issuers who drive the majority of their volume. Therefore, the long-term future availability of a two-tiered structure is far from certain.

Even if a two-tiered system were maintained, merchants would have a clear preference for the lower fee debit cards issued by large institutions. They would therefore have a significant incentive to induce consumers to present cards from larger institutions. An extremely important

[7] http://durbin.senate.gov/issues/leg_wallstreet_swipe.cfm
[8] Mercator Advisory Group. "The Durbin Amendment Impact Analysis." Maynard MA: June 7, 2010. 7.

feature of the convenience of a debit card from the consumer's point of view is its seamless acceptability. Even subtle steering techniques to lower cost may create substantial consumer concerns, especially to avoid the embarrassment of having a card rejected in front of other customers. Consumers will want their small-issuer cards to be just as accessible as large-issuer cards, which may require lowering the fees on small-issuer cards. In addition, the routing and exclusivity provisions will tend to push interchange fees downward.[9] The result of these pressures will be the convergence of interchange fees toward the capped rate to be set by the Federal Reserve. The amount of convergence may not be large initially, but over time it is likely to be substantial, if not complete.

Board staff acknowledged this result in the December 16th meeting of the Board of Governors:

> Both the statute and our proposed rule permit, but do not require, the networks to establish higher interchange fees for the exempt issuers than for the covered issuers. The networks may decide that it's simply too costly or too complicated to maintain two separate interchange fee schedules and they may therefore say that everybody is going to operate on the same interchange fee scheduled which complies with our standards. In that case, obviously, the exempt issuers would face a similar reduction in their interchange fees, as would the covered issuer.[10]

By not including a mechanism to require the payment card networks to operate a two-tier system and by not enforcing the current pricing mechanism for small issuers, the Board has not undertaken its responsibility to protect small issuers from being adversely affected by its proposal. This is a severe misinterpretation of the small issuer exemption, which renders the exemption and intended protection for small issuers essentially meaningless. In fact, the Board's proposal with respect to the small issuer exemption (or rather, the lack thereof) reflects the exact opposite of what the plain language of the law provides and what Congress clearly intended.

The Routing and Exclusivity Provisions Represent an Unreasonable and Costly Regulatory Burden on Credit Unions and Also Will Undermine the Small Issuer Exemption.

Under Section 920(b) of the EFTA, the Board is directed to write rules to provide that an issuer or payment card network cannot restrict the number of payment card networks on which an

[9] Levitin. 35.
[10] Federal Reserve Board of Governors. December 16, 2010. http://www.youtube.com/FedReserveBoard#p/u/1/IaJqZMfqXNY at 31:35.

electronic debit transaction may be processed to just one network or two affiliated networks. The Board is also required to write rules that allow the merchant to direct the routing of debit transactions over any network that is authorized to process the transaction. These proposed provisions would apply to all issuers, not just those with assets of $10 billion and above.

The Board proposes two alternatives to fulfill the prohibition on exclusive arrangements. Alternative *A* would require an issuer to provide debit cards that could be processed on one of two unaffiliated networks, such as one PIN debit network and one unaffiliated signature debit network. A card could also be authorized to be processed on two unaffiliated PIN networks or two unaffiliated signature networks.

Alternative *B* would require a credit union to issue debit cards that could be processed on at least two unaffiliated PIN networks and also on at least two unaffiliated signature networks. Although, even the Federal Reserve has indicated this is technically infeasible at this time.

The first part of Section 1075 intentionally carved out small credit unions and banks in recognition of the importance of interchange to these institutions. However, by giving merchants the final authority to decide how to route each debit transaction – regardless of size -- these institutions and programs will be denied interchange revenue as merchants send transactions to the lower cost networks. So, on the one hand, the interchange provision recognizes the importance of interchange to small financial institutions, and on the other hand it then severely compromises the carve-out by giving merchants the power to route transactions to networks that effectively lower their revenue.

While the uncertainty regarding these provisions extends to large and small issuers, the implications of these provisions may be even greater for small issuers. During the Board's meeting on December 16, 2010 Board staff stated:

> If the networks do decide to establish two separate interchange fee schedules and allow higher interchange fees for the small issuer, it is possible that merchants would discriminate against those issuers by declining to accept their cards because there are higher fees associated with accepting those cards…The merchant routing provisions

> would tend to put downward pressure on interchange fees, in general, because now the merchants can steer transactions toward lower cost networks.[11]

While CUNA shares these concerns generally, we do not think the Board is excused in any way from implementing the exemption for small issuers. The first step toward ensuring small issuers receive the protection that Congress intended is for the Board to implement the exemption.

However, in recognition of the fact that Board has acknowledged the routing and exclusivity provisions may be particularly problematic for small issuers, and may undermine the protection Congress provided, we urge the Board to make changes in these provisions.

The Impact of the Debit Interchange Rule on Credit Unions and Their Members

What does Section 1075 mean to credit unions, and specifically to Allied Credit Union, and our members? It does not require an MBA to realize that if a regulation requires a credit union to operate a program below cost—or if market forces drive the price of a product lower than the cost of offering the product—the credit union is going to lose money. The proposed interchange regulation will significantly reduce the amount of debit interchange income credit unions earn, despite the exemption and Congressional pledges to the contrary. The only real question is how much.

At one extreme, through some combination of an ineffective dual pricing system or merchant steering in favor of large issuer cards, credit unions' interchange fees could converge on the rate set for very large institutions, or 7 to 12 cents per transaction. In that case, even at the higher 12 cent level, based on 2010 estimated volumes, credit unions would find their net income reduced by $1.6 billion. That would represent approximately 17 basis points (bp) of average assets and would amount to a third of credit unions' recent net income of around 50 bp.

Even if net income recovers to pre-recession levels, the lost interchange income would represent about a fifth of total net income. Absent any alternate price or fee increases by credit unions, such a reduction in income would lower capital at debit card issuing credit unions by 10% after six years. For those credit unions currently under regulatory Prompt Corrective Action (PCA)

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[11] Federal Reserve Board of Governors. December 16, 2010.
http://www.youtube.com/FedReserveBoard#p/u/1/IaJqZMfqXNY at 32:20

restrictions due to low capitalization levels, or close to PCA thresholds, such a reduction of net income would seriously impair their ability to restore capital, since earnings retention is the only source of credit union capital.[12]

Even if we conservatively estimate that after the passage of a few years the effect of the debit interchange regulation is only half the reduction to be experienced by larger institutions, the effect would still be substantial. At 2010 volumes, net income would fall by about $800 million or 9 bp. As a proportion of total net income, the loss would be almost 20% at current net income rates, and almost 10% if and when net income reaches pre-recession levels.

However, that is not where the story ends, certainly not for credit unions. The harmful effects of this law and regulation will not just be the loss of revenue to financial institutions, but the inevitable result will be its adverse impact on consumers.

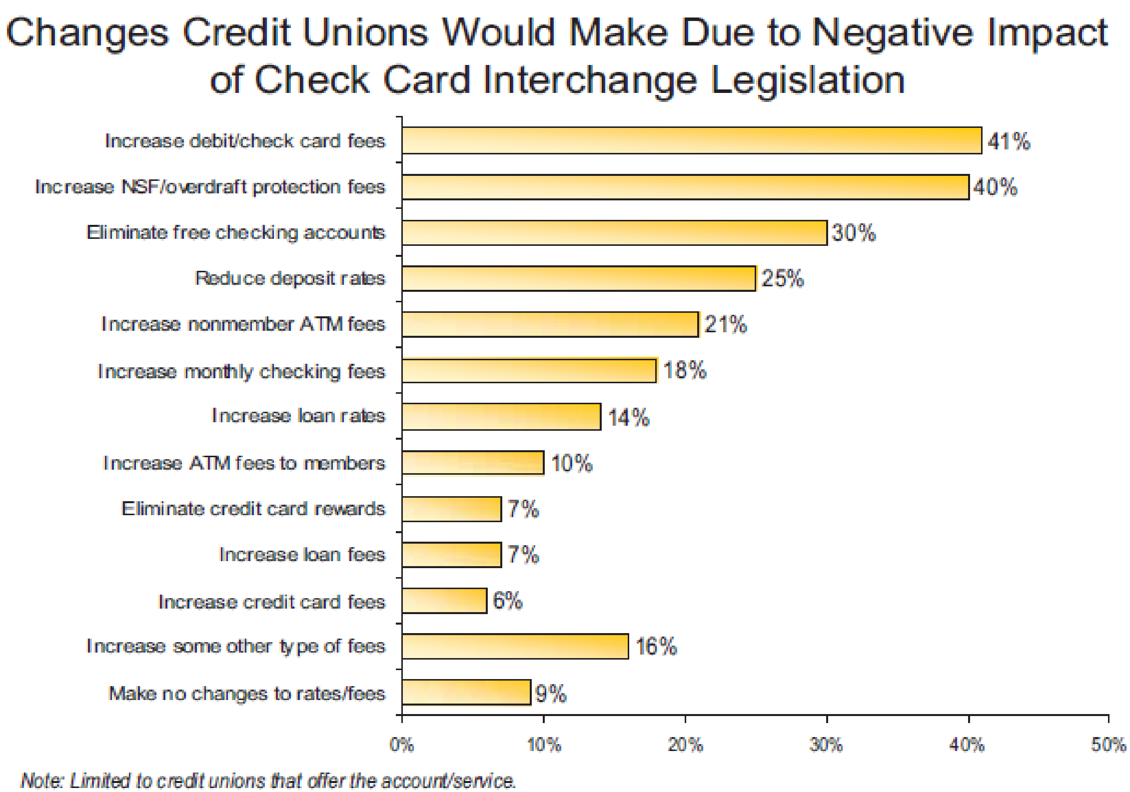
If credit unions experience the significant reduction in debit interchange revenue that is expected as a result of this rule, the National Credit Union Administration (NCUA), which oversees the National Credit Union Share Insurance Fund, will nonetheless expect credit unions to maintain current net income levels and replace the lost revenue. This means that credit unions will have to take steps to cover their losses to ensure that they continue to operate in a safe and sound manner.

Unlike the big banks, which can recover lost revenue by reducing shareholder profits, credit unions have but one choice -- to pass the costs on to our members. Credit union members will lose as a result of these rules when credit unions are forced to reduce dividends, recover fees from members for debit related or other services, or refrain from offering checking account services if they do not already do so. The choices facing the boards of directors and management of credit unions are relatively straightforward and carry a consistent theme: charge more to consumers for services or reduce the services offered to consumers. Either way it is a bad deal for consumers.

[12]By law – not regulation, as is the case for other insured depositories – credit unions must maintain a 7% net worth (or leverage) ratio in order to be considered "well capitalized." The law also specifies that only retained earnings constitute net worth for credit unions. If credit unions fall below the 6% adequately capitalized threshold, a variety of sanctions apply. (See Section 216 of the Federal Credit Union Act.)

According to CUNA's 2010-2011 Fee Survey, 91% of credit unions offering debit cards anticipate making some sort of change to their rates, fees, and/or services as a result of the negative impact of the regulation. The most common changes credit unions anticipate making will be to introduce or increase debit card fees and to increase nonsufficient funds (NSF)/overdraft protection fees. About 40% of credit unions cite these potential changes as shown in the following graphic. Beyond this, 25% to 30% of credit unions say they might eliminate free checking accounts and/or lower deposit rates as a result of the regulation.[13]

If the exemption for small issuers proved completely ineffective, the Board's proposed 12 cent fixed fee could require credit unions to impose an annual fee in the range of $35-$55 per debit card, a fee in the range of 25 – 35 cents per transaction, or some combination of the two in order to maintain pre-reform revenue. These would be new fees to our members.



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[13]Credit Union National Association. "Credit Union Fees Survey For Strategic Planning 2010-2011." Washington DC: 2010. 4-4.

Remedies

We recognize that the proposal under discussion today is subject to an open comment period. However, the timeline for finalization and implementation is very short, and the consequences are potentially devastating for small financial institutions and consumers. There are problems with the rule that the Board can and should address, but there are also significant statutory problems that Congress needs to fix.

We urge Congress to **stop, study and start over**.

Enacting a significant moratorium against implementation of the Board's interchange rule will provide Congress the necessary time to study the impact of this proposal; time which neither the House nor the Senate were afforded when this measure was hastily approved last year.

Congress should direct the Treasury Department, in consultation with the NCUA, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, to thoroughly analyze the impact of debit interchange regulation on (1) consumers, (2) debit card issuers of all size, (3) the safety and soundness of depository institutions, and (4) future debit card innovation.

Congress should then direct the Board to start its rulemaking process over again, taking into consideration the results of the Treasury study, and the operational impact of the regulation on all issuers; and to set standards for a rate which is reasonable and proportional to the full costs and risks of the transaction.

Conclusion

The consequences of this rule, and the statutory provisions it seeks to implement, have not been adequately or fully considered by the Board. However, credit unions strongly believe that the Board's rule in its current form would cause harm to the small issuers Congress intended to protect, and to consumers that use debit cards issued by credit unions and banks of all sizes. It is important for Congress and the Board to get this right. Otherwise, consumers face higher costs for financial services with no assurance that any savings will be passed on by the merchants. We urge Congress and the Board to stop, study and start over.

Chairwoman Capito, Ranking Member Maloney, Members of the Subcommittee, thank you very much for the opportunity to testify at today's hearing. I am pleased to answer any questions you may have.

[redacted]

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
FRANK MICHAEL	ALLIED CREDIT UNION CREDIT UNION NATIONAL ASSOCIATION
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered yes to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.