

Testimony of

Robert Oeler

On Behalf of the

AMERICAN BANKERS ASSOCIATION

Before the

Subcommittee on Investigations and Oversight

Of the

Committee on Small Business

United States House of Representatives



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Chairman Altmire, Ranking Member Fallin, and members of the Subcommittee, my name is Robert Oeler. I am President and CEO of Dollar Bank, a \$5.7 billion Federal Savings Bank that has served Western Pennsylvania and Northeastern Ohio since 1855. Dollar Bank is the largest traditional mutual savings bank in the United States. Our focus, like that of my fellow bankers throughout the country, is to build and maintain long-term relationships with customers, many of which are small businesses. I am proud to say that we have maintained an “Outstanding” CRA rating since 1994 and we work hard every day to meet the credit needs of our community.

I am pleased to be here today on behalf of the American Bankers Association (ABA). The American Bankers Association represents banks of all sizes and charters and is the voice for the nation’s \$13 trillion banking industry and its two million employees.

I appreciate the opportunity to testify on the impact of interchange fees on small businesses. I know that the first reaction for many who see the title of this hearing is the impact that interchange has on small “retailers,” but the interchange system and the impact of any changes to it affect *all* small businesses – including *small banks*. While some might think the banking industry is composed of only large global banks, the vast majority of banks in our country are community banks – small businesses in their own right. In fact, over 3,200 banks (41 percent) and 6,100 credit unions (81 percent) have fewer than 30 employees. Given the

important role that community banks – my bank included – play in funding small businesses nationwide, hearings like this that explore the impact of changing interchange fees are extremely important.

When merchants choose to accept payment cards, they pay a small fee (for example, a \$10 debit transaction would cost the merchant less than 10 cents in interchange) for the many benefits that come with accepting electronic payments. Debit cards increase foot traffic and thus increase merchant sales, lower wait times for customers at the cash register, provide immediate payment for the merchant while generally transferring the risk of fraud to the bank, and reduce the costs and risk of managing cash, among other benefits. These interchange fees have been an integral component of the system for decades and are an essential but modest cost to pay to support a system that works 24/7, 365 days a year almost anywhere in the world. It is now under attack by the retail community for the costs associated with it, with no regard for the benefits of accepting payments by debit or credit cards.

The most recent attack by retailers involves the Dodd-Frank Act and the so-called “Durbin Amendment” which was added to the bill on the Senate Floor – without any hearings investigating its significant ramifications. It directs the Federal Reserve to dictate the pricing of interchange on debit cards (among other things). The Federal Reserve must limit interchange fees on debit transactions to those that are reasonable and proportional to the “incremental” cost related to *each* transaction. No one really knows what “incremental” means in the amendment but the ABA expects that the merchant community will argue that it should not include the large costs of the entire system, including the overhead, maintenance, investments in new software, research and development that continue to make this system highly efficient and accurate. In fact, the Durbin Amendment seeks to explicitly restrict consideration of these other important costs and does not even allow for a reasonable return on investment.

Such uneconomic pricing will wreak havoc on our bank's ability to offer reasonably-priced products both to consumers and to small businesses in my community, as the costs of offering debit cards will not disappear. Interchange income today helps banks and credit unions offset some of the costs of providing the checking accounts that fund debit card transactions. As an example, Dollar Bank handles about 16 million debit card transactions each year, or about 1.3 million per month. We had net debit interchange revenue of less than 1 percent of sales. In 2009, debit card interchange revenue was \$4.6 million, based on total card sales volume of \$600 million on 140,000 debit cards. That amounts to \$32.85 per card or less than \$3 per month. This revenue is important, but does not cover our costs of maintaining a transaction account which run between \$12 and \$15 per month. For the industry, the cost of opening an account runs between \$150 and \$200, and the yearly cost of maintaining an account typical runs between \$150 and \$300. Thus, providing over 300 million transaction accounts comes at a considerable expense for banks.

Without this income, it becomes very difficult for many banks to continue to offer low and no-cost checking for our customers. The loss of revenue will, for example, impact the ability of banks to provide basic banking accounts which will impact low-income people that utilize such accounts for access to the banking system.

It is a simple fact that for any business to remain viable, revenue has to exceed costs. New restrictions created by Congress will severely reduce expected income from interchange fees and threaten other sources of revenue. This will force every bank to rethink the features of transaction accounts they offer and how to cover the significant costs of providing these valuable services. As a direct result of Congressional and regulatory actions, in many cases, free checking will be a thing of the past.

Moreover, the loss of interchange revenue will impact the ability of all types of banks to make loans. However, this will be even more pronounced for Dollar Bank, since we are a mutual. The only way we can raise capital is through retained earnings. If we lose interchange income, it means that we will be unable to make as many loans in our community. The consequences are significant, since \$1 worth of capital supports up to \$10 in lending. If we see a 50 percent reduction in net interchange revenue, it would decrease our net income by \$1.4 million in *after-tax* income. This loss of income, and in turn loss of capital, means that our overall lending could be reduced by up to \$14 million. To put this in context, based on our average small business loan of \$70,000, this means **200 fewer small business loans that we could make each year.**

New price controls on interchange will also affect the pricing on all types of prepaid card programs, including government benefits programs and payroll card programs that depend upon interchange as a revenue source for the provision of such services. Congressional efforts to shield such programs simply will not work as the reduction in overall revenue affects the entire system. In short, the Dodd-Frank Act merely shifts the costs from merchants to banks and their customers. While big-box retailers may benefit and see their profits increase, ultimately it is debit card holders that will end up paying the costs for these convenient methods for making everyday payments.

Congress recognized that setting price controls on interchange fees will have a significant negative impact on roughly 16,000 small banks and credit unions. Congress *attempted* to remedy this problem by providing an exemption to the price controls for these institutions. While this idea sounds good, it does nothing to protect small banks. The reality will be that the price controls imposed on the largest banks will force smaller banks to adopt the same price or risk losing business to the largest banks. Market share will always flow to the lowest priced

product, even if those lower prices are mandated. The result for small banks is either a loss of market share, a loss of revenue that supports free transactions and other valuable services, or both. Most importantly, consumers will suffer, including low-income consumers relying on low-cost banking accounts that may no longer be available, or available at a much higher price.

While I realize that the ink is barely dry on the Dodd-Frank Act, the negative consequences for banks and bank customers – and indeed, the impact on the general economy – stemming from the restrictions on interchange revenue are so great that Congress should revisit and repeal this provision. Moreover, further restrictions on interchange income from credit card transactions should be vehemently opposed, as the magnitude of the negative impact on credit availability and job creation would be large and would further retard the economic recovery.

There are three points we would like to make today:

- Price controls on interchange will have far-reaching effects on the business of banking that will limit the ability of banks to serve their local communities.
- Price setting of interchange fees shifts costs from merchants to cardholders in spite of the significant benefits that merchants already receive from card acceptance.
- Congress should repeal the Durbin price control provisions, and avoid taking further steps which would cause more damage to consumers, small businesses, and local communities.

I. Price Controls on Interchange Will Have Far-Reaching Effects on the Business of Banking That Will Limit the Ability of Banks to Serve Their Local Communities

Demand deposits are the central product offered by all banks – large and small. Debit card access (which is now practically universal) allows smaller banks to provide identical global transaction services that large banks provide, and the large scale network infrastructure costs required to build and maintain debit card systems are borne by all involved. For example, there are significant costs in providing transaction accounts to customers of the bank. Interchange income helps to offset *some* of those cost of providing demand deposit services, *costs which far exceed the revenue per account from interchange income*. Debit interchange income has become a reliable and stable source of revenue for small banks even through this current economic cycle.

As I explain below, with mandated price controls for large banks on debit card transactions, small banks will inevitably be forced to lower their fees to retain acceptance and not lose market share. Without the ability to offer debit cards on reasonable terms, small banks would be unable to compete. The loss of revenue would be very difficult for smaller banks to make up. One likely result of decreased interchange income may be increased fees for transaction accounts.

To the extent that small banks cannot make up the loss of revenue through pricing changes, it means that banks will have to adjust in other ways, including cutting expenses and jobs. The loss of income also means that banks will have fewer retained earnings to build capital. This is a problem for any bank, but it is a severe problem for banks like mine that are mutually chartered. As I mentioned earlier, it could mean a reduction of up to \$14 million per year or 200 small business loans per year. For the industry as a whole, a 50 percent loss of interchange income would mean that *lending could fall by as much as \$74 billion*.

Small businesses and their customers – already struggling in this difficult economic environment – cannot afford to face further restrictions in credit. A recent study looks at the importance of credit – particularly credit cards – in funding small businesses. Prepared for the American Bankers Association by Keybridge Research, LLC, the study found that there was a 36 percent expansion of business credit card use in the five-year period from 2003 to 2008 which *is associated with the creation of approximately 1.6 million jobs, and the creation of \$289 billion in output and \$142 billion in value-added*. Based on data available through the Federal Reserve, the research concludes that small businesses that use business credit cards experience faster employment growth. Importantly, the opposite is also true – when small businesses have restricted access to credit, they experience a corresponding drop in hiring. In short, any unreimbursed reduction in bank revenue from interchange reduces banks’ ability to provide services, including offering credit to small businesses. This is a subtle, but very important, impact that gets lost in the debate.

But small businesses will not be the only ones who feel the impact of decreased interchange revenue. This revenue allows banks to offer products of great value to lower income consumers. Indeed, for many such consumers these products are the only way that they can access the payments system, other than using cash. Basic checking accounts, with low minimum balance requirements, are often tied to the use of debit cards, with interchange revenue carrying much of the cost of these accounts.

Moreover, more companies are now using payroll cards to pay their workers, particularly attractive to lower income employees. Many government benefit programs run off of reloadable cards. Despite the fact that Congress attempted to exempt prepaid card programs from the price-setting mandates of the Durbin Amendment, all of these programs will be impacted, as the vast majority of debit card interchange revenue that supports these very programs will be

substantially reduced. You cannot eliminate the vast majority of revenue supporting such programs and not expect them to be greatly affected. Without adequate interchange revenue, all these products will have to be repriced if not eliminated, with consumers and government agencies picking up more of the costs.

II. Price Setting of Interchange Fees Shifts Costs from Merchants to Card Holders in Spite of the Significant Benefits that Merchants Already Receive from Card Acceptance

Merchants receive considerable benefits from debit cards, so they should be willing to pay for the service, as is the case with all their other services. Instead, they have asked Congress to intervene through a government-mandated price cap that will not even come close to covering the cost of the service. The result will be higher costs for consumers and government programs, and the degrading of popular and safe consumer products.

Consider some of the many benefits provided by payment cards of all kinds. *They provide the passkey to new sales channels in the 21st century.* Payment card acceptance gives business owners access to the broadest possible customer base. It allows merchants to sell a greater volume of products in less time and at a lower cost. Payment cards are particularly helpful to smaller merchants because they give them access to a larger pool of customers that helps them compete with large chain stores at both the store front level and on the Internet. In fact, e-commerce would have been impossible without the support of the electronic payments systems. Whether online or in person, card transactions generate millions of customers and billions of dollars in sales for merchants every year.

Sophisticated payment card systems *provide merchants huge benefits compared with cash or checks.* They allow retail merchants to instantly confirm that a customer has sufficient

funds to make a purchase with his payment card and to have that payment transferred electronically from the customer's bank to the merchant's account. The greater the use by both consumers and merchants, the more valuable the network is to all parties. It is no wonder that even retail businesses that deal in small dollar sales, such as fast food restaurants and coffee shops, are accepting card payment services. The firms had a *choice* to make regarding how best to increase sales and enhance the customers' need for convenient and fast service. The businesses have realized the significant value of the service and made an economic decision that it is in their best interest to be a part of the system.

The price controls will also chill innovation and discourage payment system improvements. It is simple economics. Banks, like any business in a free market, must make a return on their investment. As with any business, for a bank to be successful in the long-term, revenue has to exceed expenses, and the opportunity of reward for improvements needs to be available. Indeed, in a free market, the bank as well as the merchant are expected to make a return. This return encourages imagination, innovation, and investment. Under the new price control law, banks are not permitted to make a return on their investment. As envisioned by the merchants, banks will not even be permitted to cover their costs.

Merchants want all the benefits of accepting card payments, but they do not want to pay their fair share to receive those benefits. Instead, merchants want Congress to dictate market prices and shift the cost of doing business onto consumers. While merchants say that they will lower their prices to pass on the savings to consumers, no reasonable person expects that to happen nor did Congress mandate that such a result occur. The experience in Australia, which imposed price controls on interchange fees, proved just the opposite: retailers pocketed the savings in cost for themselves to boost their own profits with no evidence that consumers

received any savings from lower retail prices. Moreover, consumers saw higher interest rates, less access to credit, and fewer rewards for card use as a result.

III. Congress Should Repeal the Durbin Interchange Price Control Provisions, and Avoid Taking Further Steps that Would Cause More Damage to Consumers, Small Businesses, and Local Communities

The regulation of interchange fees, as included in the Dodd-Frank Act, will have a great negative impact on roughly 16,000 small banks and credit unions and the customers they serve. Quite simply, the price controls in this Act should be repealed. The retailers will say that small banks and credit unions are protected because the legislation exempts small depository institutions from the Federal Reserve Board's interchange rate setting. There is no community banker that believes such an exemption will work in practice. As with any price controls, there are inevitable unintended consequences, market distortions, and higher costs for others, including consumers.

For example, the exemption will not work for the following reasons:

➤ ***Merchants Will Discourage the Use of Higher Priced Small Bank Debit Card Transactions***

It is entirely possible under the regulations issued pursuant to the Durbin Amendment that the mandated price of interchange will be nominal. Even though the legislation has language that tries to prevent it, there will be enormous incentives for merchants to steer customers away from using debit cards issued by small banks. The differential may just be too large between the very low rate that large bank debit card issuers must accept and the current rate that small banks charge. Large retailers will provide additional rewards to customers that use large bank cards through their special offers related to overall

purchases at their stores. Merchants will see significant reductions in costs (and concomitant increases in profits) if they drive business away from higher-cost debit card alternatives to lower-cost ones.

➤ ***Competition and Network Rules Would Force Convergence of Small Bank Pricing with Large Bank Mandated Rates***

In order to preserve some market share of debit transactions and to compete for card acceptance by merchants, smaller banks will have to lower rates to similar levels mandated for large banks. These competitive forces do not disappear with the exemption from the price controls. In fact, large card issuers will actively work to compensate for the significant loss of interchange revenue, and they have the resources to provide various incentives to drive customers to their products.

Importantly, the combination of these two factors will, over time, cause a significant volume of customers to migrate out of small banks to larger competitors. This would drain important sources of liquidity from smaller competitors as these debit card accounts (tied to checking accounts) move to larger competitors. Such a shift would impair community banks' ability to provide reasonably priced banking services to local communities. The bottom line is that the so-called exemption will not work in practice. The result is that interchange income, so important for small banks to be able to offer competitive transaction accounts for their customers, will decline drastically.

Simply put, the interchange amendment will have serious consequences for community banks, and the exemption provides no relief. Ultimately, prices will converge to the mandated

rate, and community banks and their customers will end up bearing this significant cost. For this reason, the interchange provisions of the Dodd-Frank Act should be repealed.

One additional note of caution: Congress should avoid further price controls or detrimental changes in the area of interchange fees, such as a restriction on the use of credit card interchange fees. As demonstrated above, government price setting of business-to-business transactions hurts the ability of local banks to service their communities. It hurts everyday consumers and our ability to serve local businesses. It affects banks in low-income communities looking to provide low-cost banking services to the underprivileged. And it stifles innovation in a system that has supported the development of electronic bill payment, the online retail market, and the promotion of enormous operational efficiencies for small businesses.

Conclusion

The result of the new law mandating the government price controls on interchange fees will be higher costs for consumers and for government programs, and the degrading of popular and safe consumer products. Merchants receive considerable benefits from debit cards. Debit cards increase foot traffic, lower wait times for customers, provide immediate credit for the merchant, and reduce the hassles and risks of managing cash, among other benefits. Therefore, merchants should be willing to pay for the benefits, as is the case with all their other services and operating costs they must absorb. Instead, they have received a great assistance through a government-mandated price cap that will not even come close to covering the cost of the service. Congress should repeal the interchange fee restrictions mandated by the Dodd-Frank Act.