Testimony of

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on Behalf of

The National Association of Federal Credit Unions

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Introduction

My name is John Blum and I am submitting this testimony on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the Vice President of Operations for Chartway Federal Credit Union, headquartered in Virginia Beach, Virginia. Chartway FCU was founded in 1959 by seven civilian employees of Norfolk Naval Air Base. Since then, Chartway has grown substantially and we now have more than $1.2 billion in assets and operate 49 branch locations in 9 states. Chartway serves 160,000 members and provides financial services to our members across the globe.

For the past six years my responsibilities at Chartway FCU have included the operational performance of our credit and debit card portfolios, including card issuance, card activation, transaction authorization and processing, reversals, as well as funds verification, settlement, fraud/compromise analysis and fraud protection of member funds. Prior to joining Chartway, I spent ten years in senior management positions for two big box retailers; The Home Depot and Haynes Furniture, preceded by thirteen years as an officer in the United States Army.

I am testifying today on behalf of NAFCU, the only national organization exclusively representing the interests of the nation's federally chartered credit unions. The organization is comprised of member-owned financial institutions representing approximately 30 million individual credit union members. NAFCU–member credit unions collectively account for approximately 55 percent of the assets of all federally insured credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding credit card interchange fees.

The electronic payments system has proven to be one of the most important advances in the financial services marketplace in the last century. The system is tremendously beneficial to consumers, as well as merchants.

Consumers can travel the globe without worrying about having access to cash or exchange currency. Everything from a trip to the supermarket or gas station is made simpler and more convenient thanks to credit and debit cards.

The system has been equally beneficial for merchants. Retailers reap tremendous benefits in the form of increased sales, reduced costs for overhead such as accounting for, and transporting cash, substantially fewer fraud losses and ***immediate*** payment for goods and services. Indeed, credit and debit card sales helped Wal-Mart ring up more than $375 billion in sales last year. It is also instructive to note that Exxon-Mobil, Chevron and ConocoPhilips were the first, seventh and eighth most profitable companies in 2007 according to Forbes Magazine. Based on the profits of the largest gasoline manufacturers, perhaps gas station operators should look to cut costs by negotiating a cheaper wholesale price for gasoline rather than advocating for price controls on interchange fees. Further, the explosion in internet commerce would have been virtually impossible absent the electronic payment system. In 2007, the Census Bureau estimated there was $136.4 billion in online sales.

The proof of the system's success lies in its popularity among consumers and merchants. Last year, there were more than 40 billion electronic payment transactions. Plastic is quickly growing more and more popular with consumers. Likewise, more and more merchants are also signing on to use the Visa and MasterCard networks. The system is working exceedingly well. Introducing price controls into the electronic payments system is unnecessary and potentially very harmful.

H.R. 5546 directs the three judge interchange panel it would create to "establish rates and terms that most closely represent the rates and terms that would be negotiated in a hypothetical perfectly competitive marketplace for access to an electronic payment system between a willing buyer with no market power and a willing seller with no market power." Given the clear, concise precision of the language, it is clear that this is, indeed, a price control bill.

With that in mind, this testimony focuses on the benefits of the current system specific to the credit union industry and NAFCU's concerns regarding how H.R. 5546 would affect the industry. I conclude with a brief response to some of the most common – and in my mind inaccurate – complaints about the current fee structure.

<u>The Importance of Interchange to the Credit Union Industry</u>

The electronic payment system and the interchange fee structure that supports the system are incredibly important to the credit union industry. The electronic payment system is integral in allowing credit unions to compete with the largest financial institutions. Credit and debit products are important tools in developing and fostering relationships with our members. Finally, interchange fee revenue helps cover the cost of maintaining the system; a cost which, contrary to merchants' arguments, is not negligible.

The current structure allows credit unions to compete with even the largest national banks. Credit union members who use a debit or credit card issued by their credit union know their card is substantially the same as what they would receive at Citibank, Wells Fargo or any of the other industry giants. Given the ubiquity of plastic cards, it is vital that credit unions and other small financial institutions continue to be able to compete in this important market.

Capping interchange fees, however, would ultimately provide an advantage to large financial institutions at the expense of credit unions and other small financial services providers. The average size of a federal credit union, for example, is $81.7 million, compared with $1.4779 billion for banks. Over 3,600 credit unions have less than $10 million in assets. The credit union share of total household financial assets is also relatively small, just 1.1 percent as of September 2007. Given Chartway's relatively modest gross profit per transaction, coupled with our customer base – which is smaller than typical commercial banks – we will find it more difficult than larger institutions to offset the losses from a cap on interchange fees. By comparison, large banks with economies of scale, and large credit and debit card portfolios would be able to internalize the loss much easier as a simple consequence of the fact that they have more customers.

Further, credit unions also have a number of restrictions on the businesses they can engage in, as well as stricter capital requirements. Consequently, credit unions have fewer avenues to offset any losses created by a cap on interchange fee income.

This issue is particularly troubling as H.R. 5546 clearly states that the three judge panel will set a ***single rate that is operative for all institutions*** and merchants using the respective payment systems. The legislation directs judges to "consider the costs necessary to provide and access an electronic payment system for processing credit and/or debit card transactions as well as a normal rate of return" when determining prices. Credit unions, being much smaller than banks, and lacking economies of scale, have a higher per transaction cost for processing card payments. However, credit unions make up a very small percentage of the financial services market. Consequently, in determining the one rate for the entire system, the three judge panel might – indeed the panel could arguably be compelled to – set the rate based on the cost for larger institutions as they process significantly more transactions. Smaller institutions consequently, will receive the lower, capped fee even as their actual costs are higher. Ironically, it is some of these larger institutions that other Committees in Congress are examining for questionable credit card practices that harm consumers. Certainly many credit unions will be able to continue operating their portfolio even with a capped fee. Just as certainly, however, some credit unions will either exit the plastic card market and/or merge with larger credit unions. Given the consolidation from 20,000 credit unions to the approximately 8,900 that exist today, any measure that will lead to further consolidation should be carefully considered.

Further, it is important for Chartway FCU – and all other credit unions – as a brand, to have our members carrying our cards in their wallet. In today's financial services marketplace, it is not uncommon for a consumer to have their primary checking account at one institution, a credit card from another institution, a mortgage from a third and money market or retirement account somewhere else. Indeed, there is no limit to the combinations available today for consumers who wish to shop for their financial service products. By providing these most fundamental products, we help build our relationship

with our members so that we can continue to serve them when they are looking for other financial services.

If interchange fee income is capped, it is doubly painful for credit unions and other small financial institutions. First, it will be more difficult to provide our members a credit or debit card without increasing costs elsewhere. Second, if the institution finds it no longer can offer these products they will lose an incredibly important relationship building tool. In this day and age, it would be literally impossible for a credit union to grow and continue operating if it cannot offer its members this most basic product.

For many financial institutions, interchange fee income is not the huge income generating engine that the merchants make it out to be. In 2007, Chartway processed over 14 million transactions for more than 43,000 credit card users and 85,000 debit card holders. On average, Chartway made 24 cents on each transaction it processed last year. This interchange fee income is vital in allowing Chartway to offer credit and debit card services to our members.

In order to understand the importance of interchange fees, it is critical to also understand the costs associated with maintaining the system. Simply put, the 24 cents per transaction that Chartway made in 2007 is not pure profit. Merchants argue interchange fees should be going down to reflect the smaller per transaction cost of clearing a payment. However, simply clearing a payment through the system is only one of a number of costs associated with issuing credit and debit cards and processing payments. First, the system does not simply run itself. Chartway FCU employs 11 people internally for debit card support, and a large service provider externally for credit card support to ensure our debit and credit card portfolio is operating smoothly and that our members are satisfied with their service.

Another significant cost associated with the system is fraud losses. In 2006, there was over $1.1 billion in plastic card fraud losses. In nearly all situations, it is the financial institution that covers those losses. Federal law caps the amount that can be charged to a

consumer if his or her account is fraudulently accessed. Further, Chartway, like most other financial institutions will reimburse members in full for any fraudulent transactions made on their account. On average, Chartway spends nearly $425,000 a year to cover fraud losses and insurance for fraud. Further, this number would be considerably higher, if Chartway had not made an aggressive effort to seek reimbursement for fraud losses.

Importantly the figures above only capture actual fraud losses. There are a number of other costs associated with each instance of fraud, which are not captured by the statistics; nor are they covered by our insurance policy. Employee time must be spent contacting and working with members to resolve problems. Accounts may need to be shut down entirely and new account numbers issued. New plastic cards may need to be printed. In extreme cases, such as with the TJ Maxx data breach, financial institutions may find themselves issuing thousands of new cards and setting up call centers to respond to customer concerns. Interchange fees help offset all of these substantial – and growing – costs.

My colleagues and I in the financial services industry find it particularly troublesome that merchants are seeking to reduce interchange fee income even as we suffer more and more fraud losses at the hands of thieves who access information through poorly protected merchant databases.

In addition, it is important to note that debit cards and some credit card accounts generate little income outside of interchange. Debit cards, for example, have no cost for Chartway's members. Credit cards obviously generate income in the form of interest. However, that interest rate is calculated to reflect the risk of nonpayment or late payment, it does not include the costs of maintaining the account. Further, at Chartway 34% of our active credit card accounts are paid in full at the end of every month. Consequently, for these members, Chartway does not receive any interest income. In fact, quite the opposite, Chartway is essentially providing these customers a short term unsecured loan at no interest. Interchange fees help cover the costs of these products.

This proposal, however well intentioned, would be potentially disastrous for the credit union industry, particularly for smaller credit unions. Credit unions are not-for-profit institutions. Our industry operates on thinner margins, with less income, a smaller customer base and fewer total assets than traditional banks. As not-for-profit institutions, the income that is generated from interchange is reinvested in higher yields for our members, lower interest rates on loans and superior customer service. If fees are set at an artificially low price, it will be smaller institutions that suffer while large banks will be able to internalize the loss in income, and will likely end up with new customers that small institutions no longer can serve. That is not to say the credit union industry will cease to exist if interchange fees are capped. However, price caps will, undoubtedly, have an effect on the industry. Just as certainly, those effects will be felt most directly by the smallest members of our industry.

Common Misconceptions about the Interchange System.

Next, there are several fundamental misconceptions about the interchange fee system that need to be addressed. It is impossible to grasp the consequences of H.R. 5546 without a firm understanding of the system's structure. Merchants have benefited from the system's complexity by making arguments that those well versed with the intricacies of the system know to be untrue. With that in mind, I would like to address a few of the most common arguments regarding the current interchange fee structure.

First, the interchange fee is not a hidden tax or fee on consumers. Just like the cost of labor, electricity, rent or insurance; interchange fees are a cost of doing business. Further, interchange is a cost that retailers can and do pass on to their customers in the final price of the goods and services they sell.

Next, retailers do not pay the interchange fee. Retailers pay a separate fee known as the merchant discount fee. This distinction is vital in understanding the debate regarding interchange fees. The interchange fee is the fee that a merchant's bank pays an issuing institution, such as Chartway FCU, to process a transaction. The merchant, in turn, pays its bank the merchant discount fee on each transaction. The interchange fee is one

component in the merchant discount fee that the merchant pays. This distinction is significant for two reasons.

First, the merchant discount fee – the fee the merchant actually pays – is negotiable. Merchants can and do negotiate with their bank for a lower merchant discount fee. Further, merchants are free to choose a new bank altogether if they can find a better rate elsewhere.

Second, this simple fact that merchants do not pay the interchange fee is integral in understanding why merchants have limited ability to negotiate the fee. In this sense, the interchange fee is one of several costs associated with the final, retail product (the merchant discount fee). This system is no different from any other retail product. For example, consumers do not get to negotiate the price their local diner paid for the eggs in their omelet, even though being able to do so might result in a cheaper breakfast.

The current interchange fee structure is transparent for retailers. Merchants have argued that they do not know what the fees are for each card. A simple search on Google.com for "Visa interchange rates" or "MasterCard interchange rates" will yield information from Visa and MasterCard respectively on what the rate is for each kind of transaction. That said, the rates are complex and they vary depending on the type of card, the type of retailer, whether it is a pin or signature transaction and several other factors. However, to claim that merchants have no information regarding the cost of interchange is simply not true.

That retailers do not know the exact cost of interchange at the point of sale is a necessary consequence of the complexity of the system and the different options available. Further, it is important to keep in mind that merchants do not pay the interchange rate; they pay the merchant discount fee. In some cases, the merchant discount fee is a set percentage of the transaction. Consequently, even if a retailer does not know the price of interchange on a transaction, they do know the price they are actually paying to process the transaction.

Responding to the merchants' arguments has grown more and more daunting as their expressed concerns with the system change from day to day. The ever changing criticism of the system is indicative of the fact that there is nothing wrong with the system. Merchants want little more than a price control for this cost of business. Consequently they have draped this ultimate desire in whatever argument they find expedient or compelling at that particular point in time.

<u>Conclusion</u>

NAFCU strongly opposes H.R. 5546. If caps are imposed on interchange fees it will enrich merchants while harming credit unions and consumers.

The electronic payments system has proven incredibly beneficial to merchants. Retailers, however, want all of the benefits of the system, while at the same time they are asking Congress to simply cut their costs of doing business. As a businessman I certainly understand why retailers would like to cap their costs for processing transactions. However, as a businessman I am fundamentally opposed to the government dictating prices that should be paid between sophisticated parties negotiating in the free market. Further, as a consumer I am weary of the government interfering with a valued product that has been incredibly successful and that I use on a daily basis. Finally, lower interchange fees are not going to be translated into cheaper prices for consumers. Merchants will, almost certainly, pocket the difference with no actual benefit to their customers.

Further, if caps are imposed on interchange fees it will harm credit unions and other small financial institutions. As not-for-profit cooperatives, credit unions, particularly smaller credit unions, will suffer; finding it more difficult to continue offering credit and debit card services to their members. Large institutions meanwhile will be able to use their economies of scale to weather the decreases in revenue. Indeed, larger institutions will likely step in where smaller institutions once stood. While many credit unions will internalize the loss in revenue, smaller institutions will have to begin to consider merger

opportunities. In a market that has already seen considerable consolidation, Congress should carefully consider whether it wants to inadvertently encourage more mergers.

Finally, this proposal will harm consumers. If interchange fees are capped, consumers will almost certainly see no corresponding decrease in the price of the goods and services they purchase, but will likely face fewer options for obtaining credit. Credit unions have been good actors with their members in terms of credit card rates (federal credit unions have a usury ceiling of 18 percent). Driving credit unions out of this market could result in higher interest rates and more predatory practices.

Credit unions that remain in the credit card business will have to adjust to the loss in revenue by increasing interest rates, decreasing the yield on investment products, decreasing services or otherwise cutting costs. I understand that the merchants' arguments regarding the fees may sound persuasive in relation to industry giants such as Citibank or Wells Fargo. However, those industry giants are not the industry norm. Credit unions, being not-for-profit institutions, do not have the deep pockets of our for-profit colleagues. The institutions that comprise our industry cannot issue stock to raise capital. Further, the federal credit union charter imposes significant restrictions on what markets we can enter and what products we can offer. The loss in revenue that would occur if interchange fees were capped must be made up somewhere. Ultimately, those costs and those burdens will fall on consumers.