



Testimony of

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on Behalf of

The National Association of Federal Credit Unions

H.R. 2695, the “Credit Card Fair Fee Act of 2009”

Before the

House Judiciary Committee

United States House of Representatives

April 28, 2010

Introduction

My name is John Blum and I am testifying today 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 \$1.5 billion in assets and operate 55 branch locations in 10 states. Chartway serves over 200,000 members and provides financial services to our members across the globe.

For the past eight years, my responsibilities at Chartway FCU have included the operational performance of our credit and debit card portfolios. This includes 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 the approximately 55% 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 Payment System

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. There is a transfer of risk from the merchant to the financial institution. The financial institution assumes the risk of non-payment and fraudulent charges while the merchant receives their payment. 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, Royal Dutch Shell, Chevron, and BP were the first, third, fourth, and fifth most profitable companies in 2008, 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.

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. 2695, The Credit Card Fair Fee Act

H.R. 2695, the *Credit Card Fair Fee Act of 2009*, would give merchants an exemption from federal antitrust laws, allowing them to negotiate in an anti-competitive manner in order to shift their payment card acceptance costs to consumers, credit unions, community banks and other financial institutions. The focus of H.R. 2695 is to have the big players who reap the benefits from economies of scale do the negotiating, potentially leaving smaller entities behind. While we appreciate the recognition of credit unions and their ability to opt-out of the negotiated

settlement in the bill, we find this language potentially troublesome, as it could create a system where plastic cards from credit unions are viewed differently by merchants and consumers than those from other institutions. It is with these concerns in mind that we oppose the bill in its current form.

The Importance of Interchange to the Credit Union Industry

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, fostering and maintaining relationships with our members. Interchange fee revenue also helps cover the cost of maintaining the payment 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 critical that credit unions and other small financial institutions continue to be able to compete in this important market.

Capping or placing new restrictions on interchange fees, however, would ultimately provide an advantage to large financial institutions at the expense of credit unions and other small financial services providers. As of December 31, 2009, the average size of a federal credit union, for example, was \$102.4 million, compared with \$1.636 billion for banks. About 3,000 credit unions have less than \$10 million in assets. The credit union share of total household financial assets is also relatively small, at just 2 percent as of December 2009. Given Chartway's per transaction cost, coupled with our customer base – which is smaller than that of a typical commercial bank – 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 more easily, 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.

If merchants receive an antitrust exemption, they will be permitted to “negotiate” their costs in an anti-competitive and collusive manner, and they will likely be able to force agreements to pay an artificially low price for payment card acceptance. Merchants receive tremendous benefits from payment card acceptance, including a shift of credit risk to others, increased sales, the ability to transact with anyone anywhere in the world (including via Internet), and increased customer satisfaction. They should pay their fair share for these and other benefits. If merchants do not pay their fair share for payment card acceptance, those costs must be borne by someone else, such as consumers and credit unions. This will result in higher costs for payment cards, less availability of payment cards, and reduced benefits associated with payment cards.

Conversely, if credit unions and other small issuers opt-out of the negotiated rates, they may find an environment where their plastic cards may be overtly or covertly discouraged by merchants. This could create an environment where the plastic card in your wallet from Chartway FCU is no longer viewed the same as a plastic cards from Citibank or other large issuers. Credit unions and their 92 million members stand to be losers under this scenario.

Certainly many credit unions will be able to continue operating their portfolio even with a new limited 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 7,700 that exist today, any measure that will lead to further consolidation should be carefully considered.

Further, it is important for Chartway FCU, as a brand – as well as all other credit unions – to have our members carrying our cards in their wallets. 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 around for their financial service products. Credit unions are member-owned organizations that offer the financial products that their members want. Surveys have shown that credit union members value the service that they receive from their credit union. By offering fundamental products like plastic cards, we help build relationships with our members so that we can continue to serve them when they are looking for other financial services.

If interchange fee income is essentially capped, it will be doubly painful for credit unions. First, it will be more difficult to provide our members a credit or debit card. Credit unions are not-for-profit cooperatives, meaning that they cannot raise capital from the markets and have no stockholders. Instead, all of their capital comes from their members and it is returned to the institution and the members (in the form of lower rates, higher dividends, more services, etc.). Federal credit unions are the only financial institutions with a statutory usury ceiling limiting the rates that they charge members. Simply put, credit union members often receive better services and rates on their credit cards from their credit unions as compared to other types of institutions. Second, if credit unions had to drop or cut back their plastic card programs because of changes in the interchange system, credit union members would likely seek these products from other institutions that may be less consumer-focused.

The Australian example can be helpful in understanding the impact interchange fee limitations will have on merchants, financial institutions, and consumers. In 2003, Australia became one of the first countries in the world to impose artificial restraints on interchange fees and other card network transactions. Although merchants benefited from savings because of their lower service charges, the Reserve Bank of Australia itself found that there was no conclusive evidence these savings were passed on to consumers in the form of lower prices. Furthermore, to make up for the losses, card issuers in Australia were forced to reduce rewards and raise annual fees following the interchange fee cap, which in the end only resulted in a higher cost to consumers.

Chartway FCU and the Interchange System

For many financial institutions, interchange fee income is not the huge income generating engine that the merchants make it out to be. In 2009, Chartway processed over 15 million transactions

worth in excess of \$500 million dollars for more than 43,000 credit card users and 85,000 debit card holders. On average, Chartway made 15.8 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 15.8 cents per transaction that Chartway made in 2009 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 with fraud losses. In a recent report from Aite Group, U.S. card industry fraud losses for 2008 were estimated at \$8.6 billion. 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 over \$450,000 a year to cover fraud losses and insurance for fraud. This number would also 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. On top of this, the GAO has found

that financial institutions also assume the risk that a merchant will not deliver the goods or services promised at the time of purchase, as when a merchant becomes bankrupt. 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. If the Committee wants to help protect our nation's consumers with this legislation, you should add provisions holding those who fail to protect sensitive data responsible for the full costs of any losses that they may occur as a result.

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, and does not include the cost of maintaining the account. Further, 34% of our active credit card accounts at Chartway 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. This is not to say the credit union industry will cease to exist if interchange fees are capped; however, new interchange limits 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

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. 2695 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, gas, 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. Furthermore, any increased revenue merchants earn as a result of paying lower fees for card services is unlikely to result in lower prices for consumers. The Government Accountability Office (GAO) found in their report last November (GAO-10-45) that it is "unclear" if merchants would pass any additional savings on to consumers from new lower interchange rates. Unfortunately, merchants continue to mislead the public by trying to present interchange fees as a consumer issue. If the Committee is intent on moving this legislation forward, it should include provisions requiring merchants to pass any savings on to consumers.

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 already 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 and 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. It should be noted that many of the corporations advocating for the passage of H.R. 2695 are large, sophisticated entities with the tools and expertise necessary to understand the system.

The fact 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.

Conclusion

NAFCU strongly opposes H.R. 2695 in its current form. If mandatory negotiations force new caps on interchange fees, they will enrich merchants while harming credit unions and consumers. Additionally, if credit unions opt out of this new process, they may find themselves for the first time in a situation where their plastic cards are viewed disparagingly when their 92 million members try to use them at merchants.

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. As a consumer, however, I am weary of the government interfering with a valued product that has been incredibly successful and which I use on a daily basis. Finally, lower interchange fees are not going to be translated into cheaper prices for consumers. The one thing that is clear is that the passage of H.R. 2695 in its current form will hurt credit unions and their 92 million members.