NAFCU

National Association of Federal Credit Unions

Testimony of

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On Behalf of

The National Association of Federal Credit Unions

"The Effect of Dodd-Frank on Small Financial Institutions and Small Businesses"

Before the

House Financial Services Subcommittee on Financial Institutions and Consumer Credit

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Introduction

Good afternoon, Chairman Capito, Ranking Member Maloney and Members of the Subcommittee. My name is John Buckley and I am testifying this afternoon on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the President and CEO of Gerber Federal Credit Union in Fremont, Michigan. Gerber FCU has more than 13,400 members with assets totaling $114 million. With two branches in Fremont, one in Newaygo, Michigan, and one in Fort Smith, Arkansas, we strive to improve the well-being of our member-owners each and every day.

NAFCU is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU member credit unions collectively account for approximately 64 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to discuss the profound impact that regulatory restructuring under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* [P.L. 111-203] is having, and will continue to have, on credit unions.

Historically, credit unions have served a unique function in the delivery of essential financial services to American consumers. Established by an Act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom may otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need – a niche that credit unions fill today for more than 92 million Americans.

Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While over 75 years have passed since the Federal Credit Union Act (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain wholly committed to providing their members with efficient, low-cost, personal financial service; and,

- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

Credit unions are not banks. The nation's approximately 7,400 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. Furthermore, unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions have grown steadily in membership and assets, but in relative terms, they make up a small portion of the financial services marketplace. Federally insured credit unions had approximately $884.7 billion in assets as of year-end 2009. By contrast, institutions insured by the Federal Deposit Insurance Corporation (FDIC) held $13.1 trillion in assets. The average size of a federal credit union is $107.4 million compared with $1.725 billion for banks. Over 2,800 credit unions have less than $10 million in assets. The credit union share of total household financial assets is also relatively small, just 1.5 percent as of December 2009.

Size has no bearing on a credit union's structure or adherence to the credit union philosophy of service to members and the community. While credit unions may have grown, their relative size is still small compared to banks.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the Credit Union Membership Access Act (CUMAA – P.L. 105-219) a little over a decade ago. In the "findings" section of that law, Congress declared that, "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means … [and it] continue[s] to fulfill this public purpose."

While the lending practices of many other financial institutions led to the nation's subprime mortgage debacle, data collected under the Home Mortgage Disclosure Act (HMDA) illustrates the value of credit unions to their communities. The difference between credit unions and banks is highlighted when one examines the 2007 HMDA data for loans to applicants with household incomes under $40,000. According to the pre-collapse 2007 HMDA data, banks had a significantly higher percentage of mortgage purchase loans (14.7 percent) charging at least 3 percent higher than the comparable Treasury yield for all low-income applicants with household income under $40,000. Credit unions, on the other hand, had only 3.7 percent of their loans in that category. To be clear, credit unions and other community based financial institutions were not the root cause of the housing and financial crises. As the Subcommittee is aware, this point was recently reiterated by the co-chairmen of the congressionally established Financial Crisis Inquiry Commission during testimony before the House Financial Services Committee on February 16, 2011.

Credit unions have always been some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital. There are many consumer protections already built into the Federal Credit Union Act, such as the only federal usury ceiling on financial institutions and the prohibition on prepayment penalties that other institutions have often used to bait and trap consumers into high cost products.

Despite the fact that credit unions are already heavily regulated, were not the cause of the financial crisis, and actually helped blunt the crisis by continuing to lend to credit worthy consumers during difficult times, they are still firmly within the regulatory reach of several provisions contained in the Dodd-Frank Act. The additional requirements in Dodd-Frank have created an overwhelming number of new compliance burdens, which will take credit unions considerable time, effort, and resources to resolve.

We applaud recent efforts by the Obama Administration and the House of Representatives to tackle excessive regulations that hamper the ability of an industry to create jobs and aid in the economic recovery. With a slew of new regulation emerging from the Dodd-Frank Act, such relief from unnecessary or outdated regulation is needed now more than ever by credit unions.

Regulatory Reform and Debit Interchange

Section 1075 of the *Dodd-Frank Act*, as prescribed by an amendment offered by Senator Richard Durbin, requiring the Federal Reserve to establish standards for determining whether a debit interchange fee is "reasonable and proportional" to the actual cost incurred by the issuer or payment card network with respect to the transaction is disastrous for the credit union industry and the 92 million members they serve. NAFCU strongly opposed Senator Durbin's amendment which, in the eleventh hour, was changed on the Senate floor to include a toothless handwritten exemption for financial institutions under $10 billion in assets.

Just two weeks ago while testifying in front of the Senate Committee on Banking, Housing, & Urban Affairs about the proposed debit interchange rule issued by the Federal Reserve, Chairman Ben Bernanke expressed the very real possibility that the small issuer exemption "will not be effective in the marketplace." Chairman Bernanke pointed to two factors to support this assessment – first, that merchants will reject more expensive cards from smaller institutions, and second, that networks will not be willing to differentiate the interchange fee for issuers of different sizes. These comments only reaffirm the validity of arguments that NAFCU member credit unions have been making since the Durbin amendment was first proposed and then inserted into the Dodd-Frank Act.

NAFCU strongly opposes the Federal Reserve's proposed rule that, with price caps for debit interchange, doesn't fairly compensate issuers for the costs involved in processing debit card transactions [see appendix A for a copy of NAFCU's letter to the Federal Reserve outlining these comments]. First, there should have been more consideration given to fraud losses and data security concerns when drafting this proposed regulation. Credit unions have suffered steep losses in recent years due to the direct and indirect costs of data breaches. Credit unions are forced to charge-off fraud losses and incur additional expenses in making their members whole again, much of which stem from the failure of merchants to protect sensitive financial information about their customers.

Such costs include, but are not limited to, the re-issuance of new cards, creation of new personal identification numbers, and fraud insurance. These were <u>not</u> factored into the Federal Reserve's proposal.

Several other significant costs associated with maintaining a debit card portfolio were also ignored. Network fees, licensing fees, personnel training, regulatory compliance, and the technology needed to operate a debit card program all add up to real money and become a serious burden for small financial institutions.

The Federal Reserve only surveyed issuers with more than $10 billion in assets during the rulemaking process because the Durbin amendment "exempted" smaller institutions. Thus the proposed cap of 7 – 12 cents only accounts for the costs of large issuers who have greater economies of scale, and further disadvantaged smaller credit unions like mine. On the one hand, small issuers will likely ultimately receive the lower, capped interchange rate. However, on the other hand, that rate will be twice as difficult for small issuers to manage because the fee is based not on their own costs but on costs of larger, more complex institutions with better economies of scale. Consequently, the small issuer exemption, which singled out issuers with less than $10 billion in assets for protection, will instead create the perverse effect of providing a significant competitive advantage to large issuers.

Congress and the Federal Reserve have interjected themselves into a free market system between two industries that works successfully for the American public. The government has clearly picked winners - mega-retailers who stand to gain billions of dollars while automatically transferring risk to financial institutions with each swipe of a debit card. The government has also picked losers - credit unions, community based financial institutions and the millions of Americans that they provide financial services to everyday. NAFCU-member credit unions have indicated that the implementation of the proposed rule threatens a 35 basis point hit on a credit union's bottom line.

Recent NAFCU surveys of our membership found that nearly 65% of responding credit unions are considering eliminating free checking to help mitigate lost revenue from the debit interchange rule and 67% are considering imposing annual or monthly fees on debit cardholders. Implementation of this rule could also lead to lower dividends and higher costs of credit, as 52% of respondents may consider reducing rates on deposit accounts and 25% will consider increasing rates on loans. Furthermore, it may lead to job losses, as nearly 19% of responding credit unions will consider reducing staff at their credit unions and nearly 21% will consider closing existing branches or postponing plans to open new ones if the capped rate becomes the default rate for all issuers.

At Gerber Federal Credit Union, we estimate we will lose $210,000 annually under the proposed Federal Reserve rule. Because credit unions are unable to raise revenue elsewhere, it is a foregone conclusion that this lost income will come directly out of our members' pockets. In addition, drastically lowering capital at each credit union with a debit card portfolio will increase risk to the credit union system as a whole. In short, I am appalled that our members will shoulder tremendous financial burden and still be on the hook for fraud loss while large retailers receive a giant windfall at the hands of the government. It is also worth noting that, under the law, retailers have no obligation to lower prices for consumers.

Today, on behalf of credit unions and their 92 million members, I am asking Congress to take action to stop the Federal Reserve's proposed rule from going into effect this July. This debit interchange amendment was not studied in a single Congressional hearing before its enactment and deserves serious consideration by Congress and its members to avoid unintended consequences for small financial institutions and consumers everywhere.

Regulatory Reform and the Consumer Financial Protection Bureau

While debit interchange is the industry's immediate primary concern, the creation of the new Consumer Financial Protection Bureau (CFPB) is also potentially problematic as the Bureau will have rule writing authority over credit unions of all size. Additionally, the CFPB was granted examination and enforcement authority for credit unions with over $10 billion in assets. NAFCU has consistently opposed efforts to include credit unions, regardless of size, under this new regulatory scheme.

While we were pleased to see the Financial Stability Oversight Council (FSOC) granted some "veto" ability over some proposed CFPB rules if they are deemed to create safety and soundness concerns, we would urge Congress to strengthen the ability of the FSOC to act in this capacity to "veto" proposed rules that may go too far.

NAFCU has long recognized the need for additional consumer protection in the financial services arena. From the moment the Obama Administration released its white paper in June 2009 calling for the creation of a CFPB like entity, NAFCU supported additional regulation for bad actors on Wall Street. NAFCU also supported the NCUA's establishment of an office dedicated for consumer protection. Given that credit unions were not part of the shadow banking system that helped lead to the financial crisis, it's perplexing that they were ultimately placed under the jurisdiction of the CFPB.

With new information about the focus of the CFPB surfacing, it appears that credit unions will likely face a new set of regulatory hurdles regarding credit card portfolios, in mortgage disclosure procedures under the Truth in Lending Act, and many other areas. I cannot emphasize enough how burdensome and expensive unnecessary compliance costs can be to credit unions. At Gerber FCU employees already spend countless hours updating disclosure booklets and Web sites, retrofitting facilities for new regulations, and constantly rewriting documents to comply with the never ending changes to regulations. The time and costs spent on this compliance burden are resources lost that could be used to help members purchase a new car or start a new small business.

The Dodd-Frank Act included a section (Section 1100G) that says it must evaluate as part of its regulatory flexibility analysis the impact that its actions have on "small entities" (which includes "small organizations"). We believe the credit unions meet the definition of a "small organization" as defined in Title 5, Section 601 of the U.S. Code as "any not-for-profit enterprise which is independently owned and operated and is not dominant in its field…" We would urge Congress to make sure that the CFPB abides by this Congressionally-mandated standard, and does not try to narrow the definition of "small entity" in order to strengthen its authority over credit unions.

Moving forward, NAFCU believes that the CFPB must have a Senate confirmed director before it becomes an official stand alone federal agency on July 21, 2011. Lawmakers, their constituents, and every entity under the CFPB deserve a fair and open process in which candidates that may head the new agency are properly vetted. After Senate confirmation, the new director should routinely testify before Congress about the CFPB's work. This will be especially important in the agency's infancy while credit unions and others adjust to a new regulatory framework, and the credit union prudential regulator, the NCUA, works to ensure that new protection plans don't create unintended safety and soundness concerns.

Additional Credit Union Concerns Stemming from Dodd-Frank

NAFCU member credit unions have several other concerns they would like to express to the committee as the Dodd-Frank Act is implemented across the board. We would urge Congress to take action to make the following additional changes to the act:

- Transition Time: Credit unions are already dealing with a multitude of new legislative regulatory requirements. The additional requirements imposed by Dodd-Frank have created an overwhelming number of new compliance burdens, which will take credit unions considerable time and effort to resolve. A slightly longer period for full implementation of Dodd-Frank—up to 24 months for some areas—would help alleviate some of these burdens and give credit unions more time to comply.

- Inflation Adjustment: An important omission in Dodd-Frank is the indexing for inflation of all monetary thresholds in the bill annually. This is important to keep the intent of the legislation intact over time. $10 billion in assets today will not be the equivalent of $10 billion in assets next year, and NAFCU is concerned that more and more institutions will find themselves crossing this arbitrary line and becoming subject to new and unintended requirements.

- Interest on Lawyers Trust Accounts (IOLTA): To the extent the FDIC is required to fully insure IOLTA accounts, it is essential for the NCUA's share insurance fund to be treated identically in order to maintain parity between the two federal insurance programs. Congress passed a change to the Dodd-Frank law late last year to clarify the FDIC's ability in this area, but failed to provide parity to credit unions in its last minute action. We urge Congress to take action to correct this failure and ensure continued parity. IOLTA accounts often contain funds from many clients, some of whom may have funds in excess of the standard $250,000 share insurance limit. IOLTA funds are constantly withdrawn and replenished with new funds from existing and new clients. Accordingly, it is impractical to require attorneys to establish multiple IOLTAs in different credit unions to ensure full share insurance coverage.

- Unified Mortgage Loan Disclosure: Although Dodd-Frank calls for a joint HUD-RESPA rule concerning mortgage loan disclosures, the bill provides an important exception—it leaves the CFPB with the final say on whether a new rule is needed. A combined disclosure rule is critical to avoiding some of the confusion and overlap that currently exists during the mortgage loan transaction process, easing the compliance burden on financial institutions and reducing confusion for borrowers.

- Definition of "Remittance Transfer": NAFCU also remains concerned that the overly broad definition of a "remittance transfer" in the bill imposes new disclosure requirements on all international electronic transfer of funds services, and not just transmissions of money from immigrants in the U.S. to their families abroad—which are in fact conventional remittances. The new regulatory and disclosure requirements would impose significant compliance obstacles for non-remittance services, and we ask that the definition be narrowed accordingly.

- CFPB Document Access: While Dodd-Frank excludes financial institutions with $10 billion or less in assets from the examination authority of the CFPB, the new agency is provided with unlimited access to financial reports concerning covered persons issued by other regulators. Since the reports are drafted by federal agencies as part of their examination procedures, access by the CFPB to the reports essentially amounts to an examination in itself, even for those institutions with assets of $10 billion or less. NAFCU does not believe that this is the result Congress was seeking to achieve, and asks that this broad language be narrowed appropriately.

- Appraiser Independence: Section 1472 of the Act imposes mandatory reporting requirements on credit unions and other lenders who believe an appraiser is behaving unethically or violating applicable codes and laws, with heavy monetary penalties for failure to comply. These provisions would impose a significant burden on each credit union to essentially serve as a watchdog for appraisers violating their own professional practices, and should therefore be optional. If reporting continues to be compulsory, NAFCU asks that Congress amend the severe penalties of up to $10,000 or $20,000 per day which we believe to be excessive.

In addition, there are a number of issues arising from previous legislation that the Committee has not yet had the chance to address and resolve as needed. We ask that the

Committee take advantage of any opportunity to ease regulatory burdens from the Dodd-Frank Act to also attend to the following matters of high importance for credit unions:

- Risk-Based Capital: We ask that Congress amend current law to make all credit unions subject to risk-based capital standards, and direct the National Credit Union Administration (NCUA) to consider risk standards comparable to those of FDIC-insured institutions when drafting risk-based requirements for credit unions. Credit unions need this flexibility to determine their own risk and ability to lend. NAFCU supports amending the Federal Credit Union Act (FCUA) to permit the inclusion of certain uninsured capital instruments in a credit union's net worth. NAFCU strongly believes in the mutual model for credit unions and believes that all capital, including alternative capital, should come from membership, or in very limited circumstances, the NCUA. This change will enable credit unions to keep their mutuality, yet better manage their net worth levels under varying economic conditions.

- Member Business Loans: Credit unions have a 12.25% asset cap on their business lending, with loans of $50,000 or less exempt from this cap. Passed in 1998, this arbitrary threshold is severely outdated, and has not increased with inflation and economic fluctuations. We believe that this asset cap should be raised to at least 27.5%. At the very least, we ask that this *de minimis* exclusion be increased to exempt loans under $100,000, to allow credit unions to continue to lend to small business owners in dire need of credit during this difficult economic time.

- E-SIGN Act Requirements: Passed in 2000, the E-SIGN Act requires financial institutions to receive consumer consent *electronically* before e-statements can be selected. Credit unions cannot accept their members' consent to receive e-statements over the phone or in person, but must instead send them back to their computers to confirm electronically, inevitably dissuading them from doing so along the way. This outdated provision is a burden for financial institutions and a nuisance for consumers, and should be stricken.

- SAFE Act Definition of "Loan Originator": The S.A.F.E. Mortgage Licensing Act of 2008 required financial institutions to register any "loan originator." While the intent was to record commissioned originators that perform underwriting, regulators have interpreted the definition very broadly to include any employee accepting a loan application, and even call center staff. NAFCU asks that Congress narrow the meaning of what it means to "take" an application and to "offer" or "negotiate" terms, which would help prevent credit unions from going through a burdensome process to unnecessarily register individuals not involved in underwriting loans.

- Community Charter Conversions: In cases where a common-bond federal credit union (such as an employee group) wishes to convert to a community credit union charter, there may be groups within the credit union's existing membership located outside of the new charter's geographic boundaries that wish to remain members of the credit union. Most recently, this resulted in a federal credit union serving the military overseas having to divest itself of the overseas bases that it served, a result not desired by either the credit union or the Department of Defense. NAFCU asks that Congress amend the FCUA to give NCUA the power to determine whether an existing member group can continue to remain within the credit union's field of membership once it is outside of the new community. This is of particular concern to Gerber FCU, for while we serve Gerber employees and others in West Michigan, we also serve Gerber plant employees in Fort Smith, Arkansas. If we were ever to become a community-charter in Michigan, we would be forced to cut services to those Gerber employees in Arkansas.

- Credit Union Governance: the FCUA currently requires a two thirds vote to expel a member who is disruptive to the operations of the credit union, at a special meeting at which the member in question himself has the right to vote. NAFCU does not believe that this is in line with good governance practices, and asks that the FCUA be amended to provide federal credit union boards flexibility to expel members based on just cause (such as harassment or safety concerns).

- <u>SEC Broker-Dealer Exemption</u>: while the Gramm-Leach-Bliley Act allows for an exemption for banks from broker-dealer and investment adviser registration requirements with the SEC, no similar exception for credit unions is included, even though federal credit unions are permitted to engage in securities-related activities under the FCUA as regulated by NCUA. We ask that credit unions be treated similar to banks under these securities laws. This would ensure they are not dissuaded from providing services that consumers demand, thereby putting their members at a disadvantage.

<u>Conclusion</u>

In conclusion, the ink is barely dry and credit unions are already being negatively affected by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* [P.L. 111-203]. Congress must act to stop the Federal Reserve from moving forward with proposed debit interchange regulations. This is an issue of fairness and each stakeholder, including the consumer, deserves to have the debit interchange system studied by Congress before additional action takes place.

With respect to the Consumer Financial Protection Bureau, credit unions remain at a loss as to why they have been placed under a new regulatory regime to begin with. That being said, however, credit unions and their members welcome having an ongoing dialogue with Congress on possible changes as the new agency becomes functional.

Finally, NAFCU urges Congress to enact a series of additional "fixes" to the *Dodd-Frank* legislation to help relieve the new regulatory burdens on credit unions.

I thank you for the opportunity to appear before you today on behalf of NAFCU and would welcome any questions that you may have.

Appendix A

NAFCU comment letter to the Federal Reserve on proposed debit interchange rule [2/22/2011].

NAFCU
National Association
of Federal Credit Unions
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NAFCU | Your Direct Connection to Education, Advocacy & Advancement

February 22, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551

RE: Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the nation's federal credit unions, I am writing to express NAFCU's concerns with the Board of Governors of the Federal Reserve System's ("Board") proposed rule on debit card interchange fees. NAFCU is deeply concerned about the impact the proposed price caps will have on the entire financial services industry, including debit card issuers with less than $10 billion in assets. The proposed rule makes plain that the supposed small issuer exemption is illusory and will do little, if anything, to protect smaller issuers in the long term.

NAFCU strongly opposes the proposed rule and recommends the Board reconsider its determination to implement price caps for debit card interchange fees. Our concerns with the price caps, the fraud adjustment and the network exclusivity and routing provisions are explained in detail below. Additionally, nothing in the proposed rule indicates that the Board met its obligations under the Electronic Fund Transfer Act ("EFTA") to consult with other federal financial regulators, or to consider the impact of Board regulations on financial institutions, consumers and others who use debit cards.[1] Finally, the proposal completely ignores the small issuer exemption for institutions with less than $10 billion in assets.

I. <u>Debit Interchange Fee Caps</u>

NAFCU does not believe the Board has met its statutory obligation to establish reasonable standards for determining whether an interchange fee is "reasonable and proportional" as required by § 1075[2] of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] The Board's two proposed caps would greatly harm credit unions and significantly hamper their ability to provide low-cost alternative financial services. Accordingly, we do not support either of the two proposed alternative price caps.

Should the Board decide to finalize a rule with one of the two proposed alternative price caps for debit interchange, NAFCU would select the higher cap of twelve cents per transaction.

[1] 15 U.S.C. § 1693b(a)(1)-(2) (2010).
[2] Codified as § 920 of the Electronic Funds Transfer Act.
[3] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

While the twelve cent cap is the less harmful of the two alternatives, in the strongest terms possible, we do not believe either the seven cent option or the twelve cent option are appropriate.

A. The two Price Cap Alternatives

The higher twelve cent alternative is preferable for two primary reasons. First, the flat twelve cent cap would be much easier to administer for issuers, the networks and the Board than the more complex alternative permitting an interchange fee between seven and twelve cents based on the issuer's costs. More importantly, the twelve cent fee would better - though still not accurately - reflect some of the actual costs of operating a debit card system.

The twelve cent cap, although it is undesirable and unreasonably low, better reflects the actual costs of debit card issuers. The statute prohibits certain costs from consideration and the Board chose not to consider other costs that were within its discretion to include. Specifically, § 920 directs the Board to consider the incremental costs involved in authorizing, clearing and settling a particular debit transaction, but directs the Board not to consider other costs, "which are not specific to a particular electronic debit transaction…."[4] These two buckets, however, do not represent the entire universe of costs associated with operating a debit card portfolio. The Board, considered and ultimately rejected including other allowable costs that, in its view, would be permitted under § 920(a).[5] Given that the statute prohibits consideration of some costs and the Board chose not to consider other costs that were permissible, the proposed interchange fees are, unquestionably, based on a relatively small percentage of the total costs required to operate a debit card portfolio. Consequently, the higher of the two alternative fees is clearly the more reasonable approach.

B. Neither of the two Proposed Interchange Transaction Fees are Appropriate.

Neither the seven cent fee, nor the 12 cent fee is appropriate, and neither fairly compensates issuers for the costs involved in processing debit card transactions. First, the Board should not have proposed a rule implementing price caps. Second, even if imposing a price cap is a reasonable interpretation of the statute, the Board's proposed fee is unreasonably low. Third, even the higher of the two proposed fees is so low that it raises constitutional issues under the Takings Clause of the Fifth Amendment.

1. The Statute Does Not Require the Board to Implement Price Caps.

Congress did not direct the Board to impose price caps for debit card interchange fees. The interchange amendment only requires the Board "to establish standards for assessing whether the amount of any interchange transaction fee…is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[6] Nowhere does the statute require the Board to impose price caps. Indeed, requiring the Board only to establish standards for assessing

[4] § 920(a)(4)(B).
[5] Debit Card interchange Fees and Routing, 75 Fed. Reg. 81,722, 81,734-35 (proposed Dec. 28, 2010) (to be codified at 12 C.F.R. pt. 235).
[6] § 920(a)(3)(A).

interchange fees is distinctly different than directing the Board to impose hard price caps. Imposing hard price caps to meet the statutory requirement of establishing standards is not only unreasonable but also beyond the Board's authority.

The Board's proposal here is inconsistent with previous rules that interpret very similar terms. In 2009, Congress passed the Credit Card Accountability Responsibility and Disclosure Act (the "CARD Act")[7], directing the Board to "establish standards for assessing whether the amount of any" credit card penalty fee "is reasonable and proportional to the omission or violation to which the fee or charge relates."[8] The Board responded by implementing a safe harbor as required by the statute, but also created a flexible standard, authorizing credit card issuers to charge a higher fee based on the costs associated with the violation.[9] The CARD Act and § 920 of the EFTA employ virtually identical wording, yet the Board's CARD Act rule provides flexibility whereas the interchange proposal would affect a strict and unreasonably low cap on the fee in question.

The distinction between what Congress required and what the Board proposed is particularly confusing given that price caps are a tool used only sparingly by the U.S. Government. The Government imposed price caps on a number of goods during World War II, culminating in the Emergency Price Control Act of 1942. That legislation was "in the interest of the national defense and security and necessary to the effective prosecution of the present war,"[10] More recently, price caps were used to combat escalating energy prices. In 2001, the Federal Energy Regulatory Commission (FERC) imposed price caps, throughout several parts of the Western United States. FERC acted in order to minimize power outages that were affecting residents living in California.[11] Further, when imposing price caps, FERC had already determined "that the market structures and rules for wholesale sales of electric energy in California were seriously flawed and that these structures and rules...have caused, and continue to have the potential to cause, unjust and unreasonable rates for short-term energy under certain conditions."[12] Importantly, the statutory scheme provided FERC considerable authority to regulate rates.[13] The two examples above and the proposed debit interchange price caps could not be more disparate.

The Emergency Price Control Act was passed in order to ensure the Government could prosecute the Second World War. The Act also granted the administration wide latitude to stabilize prices, prevent speculation, profiteering, hoarding and manipulation and to protect individuals with limited income.[14] In the much more recent context of the energy shortage,

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[7] Pub. L. No. 11-24, 123 Stat. 1734 (2009).
[8] 15 U.S.C. § 1665d(b).
[9] Truth in Lending, 75 Fed. Reg. 37,526, 37,526-27 (June 29, 2010) (to be codified at 12 C.F.R. pt. 226).
[10] *Yakus v. U.S.*, 321 U.S. 414, 420 (1944) (quoting the purpose of the Act).
[11] *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services*, 95 FERC ¶ 61,115 (2001 (April 26 Order).
[12] *Id.*
[13] 16 U.S.C. § 824d et seq. (the statute (1) requires public utilities to provide regular rate schedules and contracts that may affect the rates; (2) provides FERC specific authority to approve rate changes and temporarily suspend rate changes at its discretion; and (3) authorizes FERC, in examining rates, to review whether utilities are efficiently using resources).
[14] *Yakus v. U.S.*, 321 U.S. at 420 (quoting the purposes of the Act).

FERC acted only after U.S. residents had already experienced power outages, a much more significant concern than merchants being unhappy with the price paid for accepting debit cards. Further, FERC had already determined that the market was not functioning. Finally, the statutory scheme provides FERC clear authority to closely oversee rates. Utilities are required to submit proposed rate increases to FERC. The Commission then has the authority to suspend operation of the proposed rate increases subject to a hearing where the Commission determines whether the higher rates are appropriate.[15]

Debit card interchange fees are not of the same significance as the national defense or access to electricity. The Board has not determined that the market is not functioning, and the statutory scheme provides the Board considerably less authority than FERC possesses in regards to regulating utility rates and prices. Certainly, these two examples are not dispositive of the issue. Nonetheless, national defense and ensuring access to an important public utility in a malfunctioning market are prototypical examples that arguably warrant using a tool as extreme as price caps. It does not follow that capping debit interchange fees is necessary in a market involving multiple networks, thousands of issuers and millions of U.S. consumers. Price caps are a tool seldom used because economists agree that they often do not work and, instead create new, unintended consequences.[16] Had Congress wished the Board to employ this extraordinary measure, it could - and presumably would - have clearly said as much. Given that the statute does not explicitly require price caps and that there are no extenuating circumstances that might warrant employing such a powerful tool, the Board should not implement the proposed debit card interchange fee cap.

2. The Board's Cost Calculation is Unreasonably Low.

Even if it is appropriate for the Board to set hard price caps, the cap should not have been set at a level so low that it fails to cover all of the costs associated with operating a debit card portfolio. First, the Board chose not to consider several legitimate costs associated with issuing debit cards. Then, after discounting several costs from the fee structure, the Board set the rate at a level that fails to compensate issuers even for the small number of costs the Board did include in the fee structure.

The Board, somewhat inexplicably, determined to consider only a very small range of costs in proposing the two potential interchange fees. To be clear, the Board did explain that in determining to include only costs associated with authorization, clearance and settlement, it examined the similarities and differences between debit cards and checks and chose not consider "costs that a payor's bank in a check transaction would not recoup through fees from the payee's bank."[17] However, the Board's rationale for allowable costs taken together with its cost

[15] 16 U.S.C. § 824d(d), (e).
[16] Hugh Rockoff, Price Controls, The Concise Encyclopedia of Economics, *available at* http://www.econlib.org/library/Enc/PriceControls.html (stating, "Despite the frequent use of price controls…economists are generally opposed to them, except perhaps for very brief periods during emergencies. In a survey published in 1992, 76.3 percent of the economists surveyed agreed with the statement: 'A ceiling on rents reduces the quality and quantity of housing available.' A further 16.6 percent agreed with qualifications, and only 6.5 percent disagreed. The results were similar when the economists were asked about general controls.").
[17] 75 Fed. Reg. at 81,735.

measurement, do not lead to a reasonable result. In examining the similarities and differences between checks and debit card transactions, the Board made virtually no mention of the benefits that debit cards provide merchants vis-à-vis checks - such as prompt, guaranteed payment - or the considerable capital invested by the networks and issuers to ensure the debit card system functions properly. The Board failed to include network switch fees, despite the fact that issuers are required to pay a switch fee on each debit transaction.[18] The Board also chose not to include other costs such as customer service costs.[19] Tellingly, the Board acknowledges that its cost measurement does not include fixed costs that are specific to debit card transactions.[20] It simply cannot be that a reasonable interchange fee is one which, by the Board's own estimation, does not include several of the costs *absolutely necessary* to operate a debit card program.

The problem created by the decision not to consider several permissible costs is compounded by the Board's interpretation of what constitutes a "reasonable and proportional" interchange fee. The Board interpreted "reasonable and proportional" to mean "equal to" the allowed costs. This interpretation ignores a bedrock principle of statutory construction; namely that each word matters.[21] Had Congress intended for the Board to set the interchange rate at a level "equal to" the costs, it could have easily used those words. While the phrase "reasonable and proportional" is clearly ambiguous, the Board's interpretation is not a reasonable reading of the term.

The Board's determination of allowable costs and its cost measurement result in allowable costs that are far below the actual per transaction cost. Further, the Board's interpretation of "reasonable and proportional" is itself unreasonable, and ignores fundamental rules of statutory construction. It simply is not reasonable to set the fee at a level that fails to adequately reflect actual costs and then, fails again, to compensate issuers for even the limited number of costs the Board did consider.

It is with the above thoughts in mind that NAFCU recommends that the Board allow recovery through interchange of other costs. Specifically, the following costs should be included by the Board in establishing standards for determining what constitutes a "reasonable and proportional" debit interchange fee.

- Network switch fees;
- Data security controls and procedures;
- Ongoing maintenance, monitoring, review and technical upgrades of card systems;
- Hardware;
- Software;
- Personnel;

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[18] *Id.* at 81,735.
[19] *Id.*
[20] *Id.* at 81,736.
[21] *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) quoting *Duncan v. Walker*, 533 U. S. 167, 174 (2001) ("It is 'a cardinal principle of statutory construction' that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.'").

- Qualifying members for a card through ChexSystems or similar providers;
- Card issuance costs, such as producing, mailing and activating new debit cards;
- Creating a PIN number and mailing separate confirmation of the PIN;
- Bank Identification Number (BIN) management costs;
- Administrative and production activities related to processing transactions, including authorization, settlement and posting to cardholder accounts;
- Error resolution services;
- Insurance premiums;
- Insurance deductibles;
- Fraud and risk management tools; and
- Processing claims, including fraud and non-fraud disputes, chargebacks and copy retrieval requests.

To the extent that the Board determines any of the costs related to fraud should not be included in the fraud adjustment, NAFCU urges the Board to instead include those costs in the base interchange fee.

Including all or some of these costs in the debit card interchange fee will more accurately represent the actual cost incurred by issuers in processing debit card transactions. Further, most if not all of these costs arguably fall within the scope of costs which the Board, in the proposal, indicated would be permissible, but which it ultimately chose not to include.

3. <u>The Proposed Cap is so Low that it risks violating the Takings Clause of the Fifth Amendment.</u>

The Board's proposed price cap raises serious constitutional concerns under the Fifth Amendment's Takings Clause. The Fifth Amendment guarantees that no person will be deprived of property without due process.[22] The U.S. Supreme Court has interpreted the clause to protect private companies against price caps that do not guarantee a fair and reasonable return.[23] By the Board's own estimation the proposed debit card interchange rate of 12 cents fails to cover the allowed costs of twenty percent of covered issuers.[24] Further, the Board also acknowledged that the proposed rate fails to include all costs associated with processing debit card transactions.[25] On the face of the regulation, the more reasonable proposal still (1) fails to consider all of the costs associated with operating a debit card program; and (2) fails, even after ignoring several costs, to fairly compensate twenty percent of issuers for the cost of processing a transaction.

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[22] U.S. CONST. amend. V.

[23] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (holding that government imposed rates must be sufficient to provide "enough revenue not only for operating expenses but also for the capital costs of the business.").

[24] 75 Fed. Reg. at 81,737.

[25] *Id.* at 81,734 (stating, "After considering several options for the costs that may be taken into account in setting interchange transaction fees ('allowable costs') the Board" limited such costs "to those associated with authorization, clearing and settlement of a transaction." *Id.* at 81,736. The Board also acknowledged the rate does "*not* consider costs that are common to all debit card transactions and could never be attributed to any *particular* transaction (i.e., fixed costs), even if those costs are specific to debit card transactions as a whole." *Id. at 81,737.*) (emphasis in original).

Meanwhile, the lower of the two proposed rates would fail to cover the allowable costs, much less the actual costs, for a full fifty percent of debit card issuers.

The Board's reasoning is deficient for five different reasons. First, the differences between public utilities and debit card issuers, referenced by the Board, strengthen the argument that issuers are entitled to a fair and reasonable return. Second, the fair and reasonable return rule has been applied in cases that did not involve public utilities. Third, the Board ignores its obligation to avoid creating constitutional issues. Fourth the Board ignores precedent that a company cannot be forced to carry out part of its operation at a loss. Fifth, even absent the four above issues, the ultimate result of the proposal will be increased costs to consumers and thus there will be little, if any, actual benefit.

The Board seemingly dismissed the requirement for a fair and reasonable return, distinguishing that precedent because it applies, according to the Board, only to public utilities.[26] This distinction is all the more unusual, given that the statutory langue in *Hope Natural Gas*, which the Board discusses, requires a "just and reasonable" rate[27] that is very similar to the "reasonable and proportional" fee required by § 920. Nonetheless, the Board states the similarities between § 920 and the public utility cases are limited and that, consequently, the Court's precedent in *Hope Natural Gas* is of little significance in this context. Specifically, the Board distinguished public utilities from debit card issuers because the former are required to provide services while the latter are not, and because debit card issuers presumably have sources, besides interchange fees, which can be used to earn revenue and pay for the costs of operation.[28]

The distinction between public utilities and debit card issuers, however, actually supports the argument for a constitutionally guaranteed fair and reasonable return in this context. Transmitting and selling power is "affected with a public interest" and thus subject to robust federal oversight to protect that interest.[29] Given the importance of ensuring the nation has reliable, affordable access to energy, the government has a much more significant interest in regulating the market and ensuring power can be distributed even if the returns on the investment are extremely small. The debit card system is important, but certainly not as vital as the power grid. Accordingly, there is significantly less rationale for the government imposing price caps that fail to even cover the costs of operating the system. Further, the primary parties in the energy market are the companies that produce and distribute energy and the consumers who use it. By contrast, the primary parties affected by interchange fees are card issuers and the merchants, ranging from simple and small proprietorships to large and complex multinational companies, which pay the interchange fees. Certainly, the merchants that pay for the benefit of accepting debit cards do not require the same sort of protection - in the form of government price caps - as individual citizens that wish to have reliable, affordable access to power. In conclusion, the Board's distinction between public utilities and debit card issuers strengthens the argument that debit card issuers are entitled to a fair and reasonable return on their investment.

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[26] *Id.* at 81,733, n. 44.
[27] 16 U.S.C. 824d(a).
[28] *See* n. 22.
[29] 16 U.S.C. § 824(a).

Next, the Board seems to indicate that the fair and reasonable return test is not applicable here because it has been applied only in the context of public utilities.[30] However, the test has been applied by the courts in several other contexts. Specifically, some version of the rule has been applied to railroads, insurance companies, and landlords.[31] Thus, the distinction made by the Board misses the point entirely. Regardless of whether debit card issuers are public utilities, they are still entitled to a fair and reasonable return. This seems particularly true given the similarities in the statutory language at issue here and in *Hope Natural Gas*.

Next, the Board should reconsider the interchange rate because it raises serious constitutional issues, which should be avoided if possible. This principle was articulated by the Supreme Court, when it ruled that "[w]hen the validity of an act of the Congress is drawn in question, and even if a serious doubt of constitutionality is raised, it is a cardinal principle that this Court will first ascertain whether a construction of the statute is fairly possible by which the question may be avoided."[32] The proposed rate cap does raise serious Constitutional issues as there is significant case law for the proposition that companies are constitutionally entitled to a return on their investment.[33] Further, the Board itself acknowledges that the proposed interchange fee rate does not include all costs associated with operating a debit card program and that the rate is not sufficient to cover costs for twenty percent of issuers, even when considering the relatively small number of "allowed costs."[34] Accordingly, the Board should revise its proposal to either eliminate the proposed price caps altogether or to set the interchange fee at a level that is not so low that it prohibits issuers from earning a return on their investment.

The Board, in stating that issuers may compensate for the decreased interchange revenue by charging more elsewhere ignores Supreme Court precedent to the contrary. In a case involving state rate-setting authority, the Court found that the state of North Dakota could not, "set apart a commodity or a special class of traffic and impose upon it any rate it pleases, provided only that the return for the entire intrastate business is adequate."[35] In much the same way, the Board cannot require debit card issuers to operate a debit card program at a loss simply because it is possible that issuers could make up that lost income in another line of business. Much more recently, the Sixth Circuit held the same, finding, "although the plaintiffs have other unregulated income streams, they are not required to subsidize their regulated services with income from...unregulated services."[36] It is simply not enough to say that debit card issuers may be able to recover their costs through charging other customers or by increasing revenue in other lines of business.

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[30] *See* n. 22.

[31] *B. & O.R. Co. v. United States*, 345 U.S. 146, 150 (1953) (finding "so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates...."); *New Jersey Ass'n of Health Plans v. Farmer*, 777 A.2d 385, 395 (N.J. Super. Ct. 2000) (finding a rate that does not provide a fair and reasonable return would raise serious constitutional issues.) (quoting *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 350 A.2d 1 (1975)); and *Morgan v. City of Chino*, 9 Cal. Rptr. 3d 784, 788-789 (Cal. Ct. App. 2004) (finding price controls may not "deprive investors of a fair return on their investment.").

[32] *Crowell v. Benson*, 285 U.S. 22, 62(1932) (favorably citing six other cases that stand for the same proposition).

[33] *See n. 22.*

[34] 75 Fed. Reg. at 81,737.

[35] *Northern Pacific Ry. Co. v. North Dakota*, 236 U.S. 585, 600 (1915).

[36] *Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 594 (6th Cir. 2001).

Finally, if institutions are forced to offset the losses on their debit card programs elsewhere, the most logical solution is to begin charging customers for checking accounts generally and for using debit cards specifically. Alternatively, issuers may reduce the service and overall support provided to debit card users. Proponents of debit card price caps have argued those increased costs would be offset by lower prices for consumer goods. However, the Government Accounting Office (GAO) reported that officials in Australia, which did cap interchange prices, stated there is no "conclusive evidence" that merchants' savings were passed on to consumers in the form of lower prices.[37] Consequently, the proposed rule is seemingly at odds with the intent of the Electronic Fund Transfer Act, which states its "primary objective" is the provision of individual consumer rights.[38] Instead, this rule will lead to consumers paying fees for a previously free service without any guarantee of a corresponding drop in prices.

In conclusion, the Board should reconsider its decision to implement price caps for debit card interchange fees. Price caps are not required by the statute and the Board's decision to implement price caps will create constitutional issues where none existed previously. If the Board is intent on implementing price caps, however, the fee should include all costs associated with operating debit card programs that are not explicitly prohibited by § 920. NAFCU opposes any price cap for debit card interchange fees, nonetheless, increasing the fee to more accurately reflect the true costs associated with operating a debit card program would, at the least, improve the proposed rule.

II. Fraud Adjustment

NAFCU is also concerned with the proposal as it relates to the fraud adjustment. NAFCU supports the non-prescriptive approach for the fraud adjustment. Moreover, the Board should implement a fraud adjustment when it approves its final rule on interchange fees. NAFCU understands that more research on this issue may be useful; nonetheless, it is imperative that issuers receive the fraud adjustment in tandem with any capped interchange fee.

A non-prescriptive approach is superior to a technology-specific approach. A prescriptive approach would stifle innovation in an area that *must* respond quickly and dynamically to new threats. Some basic anti-fraud technologies change little over time. Other technologies, however, are a result of a never-ending chess match pitting issuers, networks and consumers against increasingly sophisticated criminals. Many of the anti-fraud technologies in place today are a direct response to complex new criminal attempts to commit fraud. A prescriptive approach would discourage issuers, networks and third parties from developing sophisticated new technologies to combat fraud. Issuers obviously have an interest in any cost-effective anti-fraud technology; nonetheless a requirement that the Board formally approve any new technology would certainly factor into an issuer's calculus when determining whether to move forward. Moreover, third party vendors that currently develop anti-fraud programs but

[37] U.S. GOVERNMENT ACCOUNTING OFFICE, *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, But Options for Reducing Fees Pose Challenges* (2009), *available at* http://www.gao.gov/new.items/dl045.pdf.
[38] 15 U.S.C. § 1693(b).

which lack issuers' vested interest in combating fraud may reasonably determine that their resources will be put to better use developing products that do not require government approval. The Board stated that it "would identify the paradigm shifting technology(ies) that would reduce debit card fraud in a cost effective manner" and approve an adjustment for those technologies.[39] However, a prescriptive approach would undoubtedly result in significantly fewer paradigm shifting technologies. Further, the proposal seemingly ignores other technologies that may not have as dramatic an impact but that still successfully combat fraud in a cost-effective manner.

If the Board ultimately chooses a non-prescriptive approach, NAFCU recommends the framework that it implements for examining anti-fraud measures be as flexible as possible for all of the reasons discussed above. If the Board adopts a rigid approach it will have a direct, negative impact on innovation in an area that demands constant change.

The Board should permit issuers to recoup the entire cost of any anti-fraud measures, rather than simply a percentage of the costs. As the Board indicated, issuers bear the majority of the costs associated with fraud losses.[40] However, direct fraud losses are only a small portion of the overall costs associated with combating fraud. First, issuers already spend a considerable amount of money on anti-fraud technology. Issuers pay insurance premiums to minimize out of pocket expenses when fraud occurs. Issuers devote a considerable amount of time and money towards responding to instances of fraud, including employee time dealing with the customer, processing claims, chargebacks and copy retrieval requests, and card and PIN reissuance costs. At least some of these costs appear not to be included in the Board's discussion of the fraud related losses borne by issuers and merchants.[41] These costs, however, are substantial. Moreover, the networks' liberal payment policy benefits merchants who are guaranteed payment in most cases where they follow network rules. Finally, given that the proposed interchange fee cap does not cover all allowable costs, let alone fixed costs, the fraud adjustment is the most logical avenue for ensuring issuers' have the ability to cover their fraud related costs.

The Board indicated it does not plan to implement a fraud adjustment at the same time that it finalizes its interchange fee rule.[42] This planned approach is unnecessary and also contrary to the clear direction of § 920 which instructs the Board to implement standards for assessing the interchange fee and the fraud adjustment within nine months after passage of the Dodd-Frank Act.[43] Accordingly, the Board should adopt a fraud adjustment fee if or when it adopts a final regulation implementing the "reasonable and proportional" requirement.

The Board may implement a fraud adjustment fee with the information it currently has at its disposal. The interchange survey was distributed to all issuers directly affected by the rule as well as networks and merchant acquirers.[44] The information included in the survey was, presumably, sufficient to guide the Board in setting an interchange fee cap. Consequently, it seems unusual that the Board does not have enough information to set the fraud adjustment.

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[39] 75 Fed. Reg. at 81,742.
[40] *Id.* at 81,741.
[41] *Id.*
[42] *Id.* at 81,740.
[43] § 920(a)(3)(A), (a)(5)(B).
[44] 75 Fed. Reg. at 81,724.

While NAFCU understands the Board's desire to properly calculate the adjustment, there is nothing in the statute that prevents the Board from implementing an interim fraud adjustment fee that it can increase or decrease upon further study.

More importantly, the Board's decision to implement an interchange fee cap and the fraud adjustment independent of each other is in clear disregard of the statutory mandate, already discussed above, that both rates be finalized by the Board within nine months after passage of the Dodd-Frank Act. Under the familiar *Chevron* analysis, courts defer to agency interpretations of a statute provided (1) the statute is ambiguous or silent to the issue and (2) the agency's interpretation is reasonable.[45] Here, the Board's interpretation would not even satisfy the first prong of *Chevron*. The intent of Congress is not ambiguous. Quite the opposite, Congress could not have been any clearer in its instruction to the Board to set both an interchange fee rate and a fraud adjustment within nine months after passage of the Dodd-Frank Act. The subsection describing the fraud adjustment immediately follows the subsection dealing with the interchange fee itself and is every bit as detailed. Assuming Congress really did intend for the Board to implement price caps based on an admittedly small universe of total costs, it stands to reason that Congress, at the very least, intended for those caps to be implemented hand-in-hand with the fraud adjustment. Indeed, Congress thought the fraud adjustment was so important that it is the sole cost explicitly referenced in the entire amendment.

The Board acknowledges the proposed interchange fee does not consider several costs associated with processing debit card transactions. The Board also acknowledges that even within the smaller universe of "allowed costs" several issuers directly impacted by the rule will be unable to recoup their own costs on each transaction. Given the low interchange fee the Board proposed, the considerable information the Board already has regarding fraud costs, and Congress' clear directive to implement the interchange fee and fraud adjustment simultaneously, the Board should adopt a fraud adjustment fee at the same time that it adopts a final rule on the base interchange fee.

III. Network Exclusivity and Routing Restrictions

NAFCU is equally concerned with the routing and network exclusivity provisions which will affect all debit card issuers regardless of size. NAFCU supports Alternative A, which would require that debit cards have the capability to route transactions over two unaffiliated networks. This option is superior to Alternative B, requiring four unaffiliated networks, because of technical concerns and the cost that would be associated with Alternative B.

Alternative B is currently not technologically feasible. Under this alternative, debit cards must have the capability to process transactions over two unaffiliated signature networks and two unaffiliated personal identification number (PIN) networks. However, debit card transactions currently cannot be processed over multiple signature networks. Further, the Board acknowledged that it may be unfeasible to develop such technology in the "near term."[46] Alternative A is feasible, though still potentially costly. Further, nothing in the statute can be

[45] *Chevron U.S.A. v. NRDC*, 467 U.S. 837, 842–843.
[46] 75 Fed. Reg. at 81,749.

interpreted to require Alternative B. It would be unreasonable for the Board to mandate technology that does not yet exist. This is particularly true when nothing in the statute can be read as requiring such a mandate.

Alternative A will be significantly less costly. Understandably, the cost to the industry is not the Board's primary concern; nonetheless, mandating four unaffiliated networks on each debit card would be extremely costly. The Board itself said,

> "enabling multiple signature debit networks on a debit card could require the replacement or reprogramming of millions of merchant terminals as well as substantial changes to software and hardware for networks, issuers, acquirers, and processors in order to build the necessary systems capability to support multiple signature debit networks for a particular debit card transaction."[47]

While closely related to the feasibility concerns mentioned above, these sorts of wholesale changes to transaction routing will be extremely expensive for all parties involved. The capital costs required by the networks to build these systems will obviously be recouped by higher fees levied on issuers and others that use the system, which brings into question whether there will be any real benefit. Moreover, issuers will have significantly higher reoccurring expenses if they are required to provide debit cards capable of routing transactions over four networks, as opposed to one or two, as is often the case today. Issuers also have legitimate business reasons for limiting transactions to one or two networks, such as simplifying the processing system and consequently minimizing costs. Requiring debit cards to carry four networks will complicate the process and also add new costs. The Board should adopt Alternative A as Alternative B is currently not feasible and by the Board's own estimation would only be feasible at some future date and only at *considerable* expense.

IV. <u>The Board Failed to Meet its Obligations under EFTA.</u>

The Board did not satisfy its responsibilities under EFTA because it failed to consult with other federal financial regulators as required by the Act. Specifically, the EFTA states the Board "shall" consult with other federal financial regulators to ensure the continued evolution of the electronic banking system.[48] However, absolutely nothing in the proposed rule indicates the Board consulted with other agencies. Further, nothing on the Board's website disclosing meetings and communications regarding this rulemaking indicate any consultation with other regulators.[49] It is clear the Board did not carry out its statutory obligation to meet with other regulators regarding this rulemaking.

The Board failed to fully consider the economic impact, costs and benefits to financial institutions, and it also failed to consider the effect of the rule upon competition between small

[47] *Id.*
[48] 15 U.S.C. § 1693b(a)(1).
[49] The Federal Reserve, Regulatory Reform Communications with the Public, *available at* http://www.federalreserve.gov/newsevents/reform_interchange.htm

and large financial institutions as required by EFTA.[50] There is no indication that the Board conducted any thorough economic analysis of the costs and benefits to financial institutions and consumers, despite the rule's direct and indirect impact on every single debit card issuer in the nation as well as every debit card issuer.

Moreover, the Board refused to consider the likely impact of the rule on smaller institutions and the competitive consequences, as required by the Act. The Board's inattention to smaller institutions is particularly troubling given that both the EFTA and the interchange amendment, through the small issuer carve-out,[51] explicitly single out smaller institutions for protection. The Board refused to consider the likely consequences of the price caps on smaller institutions and failed to meet with smaller issuers on that matter. However, at the December 16 Board meeting, Federal Reserve staff acknowledged that the price caps may ultimately trickle down to all institutions, regardless of whether they qualify for the small issuer exception. The proposed rule fails to account for, much less implement the small issuer carve-out, which Congress clearly included in order to protect smaller issuers from the statute's pricing provisions.

The EFTA clearly requires the Board to consult with other regulators on rules promulgated pursuant to the Act. The EFTA specifically directs the Board to consider the impact of its rules on smaller institutions and the interchange amendment also explicitly directs the Board to take steps to protect smaller issuer from the rule's most onerous provisions. The Board, however, failed to meet any of these duties. The Board should postpone finalizing this rule until after it has carried out its statutory duty to consult other agencies and until such time that it has fully assessed the impact of the rule on small issuers.

V. Small Issuer Exemption

Finally, the Board's determination not to consider, much less implement, the small issuer exemption will create a perverse result where the small issuers that were singled out for protection under the statute will instead suffer the greatest harm. The statute intended for the Board to regulate rates only for issuers with more than $10 billion in assets. The Board's proposed interchange fee rates are, in turn, based on survey results from eighty-nine of the nation's largest debit card issuers.[52] However, as the entire financial services industry predicted, there is an increasing likelihood that the capped rates will ultimately become the industry standard. Consequently, small issuers will likely receive the lower interchange rate, even though that rate is based on results from the nation's largest issuers which, presumably, have a much lower per transaction cost.

Throughout the rulemaking process, the Board refused to consider the costs for small issuers. The Board's issuer survey was sent only to the 131 institutions that had more than $10 billion in assets.[53] No corresponding survey was conducted for issuers with less than $10 billion in assets. It is beyond question that the Board's proposed interchange rates are based solely on

[50] 15 U.S.C. § 1693b(a)(2).
[51] § 920(a)(6).
[52] 75 Fed. Reg. at 81,724-725.
[53] *Id.*

the results it gathered from institutions with more than $10 billion in assets.[54] The Board's determination to ignore the costs of smaller institutions is unreasonable in light of the fact that the Board simultaneously chose not to take steps to implement the small issuer exemption.

As discussed above, § 920 explicitly includes an exemption for small issuers with less than $10 billion in assets.[55] The intent of the exception was to ensure that small issuers would receive the same interchange rate they currently receive even if the Board's rulemaking impacted interchange rates for issuers with more than $10 billion in assets. The rule contains an exemption for small issuers from the lower interchange rates; however, there is no assurance that the exception will actually protect small issuers. That is to say, the card networks that set interchange fee rates are free, under the proposed rule, to set the interchange rate for small issuers at the same level that the Board requires for large issuers, thereby eviscerating the exception. During the debate on the Durbin amendment, NAFCU stated that the small issuer exemption was unworkable and would provide no protection. Consequently, I understand that the Board itself had no real option other than to execute a very flawed and unworkable provision. Nonetheless, that reality is of little solace to the credit unions and other small institutions that will suffer at the hands of a provision intended to protect them.

The Board's decision not to consider small issuers' costs, and the lack of any practical method for enforcing the small issuer exception create a result at clear odds with the intent § 920. On the one hand, small issuers will likely ultimately receive the lower, capped interchange rate. On the other hand, that rate will be twice as difficult for small issuers to manage because the fee is based not on their own costs but on costs of larger, more complex institutions with better economies of scale. Thus, the small issuer exception, which singled out issuers with less than $10 billion for protection will, instead, place small issuers at a significant competitive disadvantage, compared to large issuers. However rational the Board's individual decisions might appear when viewed in isolation; taken together they generate a completely irrational result.

VI. <u>Conclusion</u>

First and foremost, the Board's proposed price caps are unreasonably low, fail to consider all of the costs associated with operating a debit card program and raise serious constitutional concerns. The Board should revise its proposal and eliminate the price caps altogether in favor of a more generalized standard for assessing whether fees are reasonable and proportional. Alternatively, the Board should, at the very least, reconsider the "allowable costs" in order to ensure the interchange fee rates more accurately reflect the actual costs involved in operating a debit card program. Regarding the fraud adjustment, NAFCU supports the non-prescriptive approach as the alternative will undoubtedly stifle innovation in an area that thrives on dynamic and creative responses to an ever-changing threat. NAFCU prefers the Board's proposal to require only two unaffiliated networks on debit cards, though neither of the two options is desirable. As required by the EFTA, the Board should consult with other federal regulators, more thoroughly consider the consequences of this rule on small debit card issuers, and revise

[54] *Id.* at 81,724-726, 81,737-738
[55] § 920(a)(6).

the rule as necessary. Finally, the Board should reconsider the interchange fee as well as its decision to ignore the costs of small issuers when setting the fee. The logical consequence of the Board's rulemaking is a competitive disadvantage for small issuers, a result that Congress specifically sought to avoid.

NAFCU appreciates the opportunity to share our thoughts on the proposal. Should you have any questions or require additional information please call me or Carrie Hunt, NAFCU's General Counsel and Vice President of Regulatory Affairs at (703) 842-2234.

Sincerely,

Fred R. Becker, Jr.
President/CEO