National Credit Union Administration

Office of the Chairman

April 29, 2011

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Bernanke:

This letter furthers the comments of the National Credit Union Administration (NCUA) on the Federal Reserve Board's proposed rule on interchange fees. NCUA collected data in March and recently completed a review of the direct costs and income related to debit card transactions for credit unions of different sizes. This analysis substantiates NCUA's prior concerns about the rulemaking. In order to protect the safety and soundness of smaller credit unions and to ensure that the members of smaller credit unions may continue to have access to debit card services, NCUA urges the Federal Reserve Board to modify the proposed rule either to provide meaningful exemptions for smaller card issuers related to network exclusivity and merchant routing or to address NCUA's concerns through some other means.

Background on Interchange Fee Rulemaking

Congress incorporated the Durbin Amendment into the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This provision requires the Federal Reserve Board to issue regulations to ensure that interchange fees charged to merchants for electronic debit transactions are "reasonable and proportional" to the cost of processing such transactions. The proposed rule would set this cap at 12 cents per transaction for all institutions with assets exceeding $10 billion.

As required by the Dodd-Frank Act, NCUA has previously participated in the interagency consultation process to assist the Federal Reserve Board in developing the rule to implement the Durbin Amendment effectively. During these discussions, NCUA has advocated for the development of a final rule with meaningful exemptions for smaller card issuers related to network exclusivity and merchant routing. Excepting smaller issuers from the network exclusivity and merchant routing rules would be consistent with the congressional exemption from the interchange fee rulemaking.

In an earlier comment letter, NCUA has observed that 59 percent of federally insured credit unions offering debit card services have assets of less than $50 million. NCUA has also maintained that the proposed rule's prohibitions against network exclusivity and merchant routing restrictions could significantly increase the fixed and variable costs for these small

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institutions, resulting in an inability to remain competitive with larger debit card issuers. Unless changed, the proposed rule could also negatively affect the members of small credit unions by cutting off access to debit cards or unnecessarily increasing the costs of obtaining debit card services.

Methodology for NCUA's Analysis

In order to examine the potential effects of the proposed rule on interchange fee limits and to expand upon the Federal Reserve Board's prior survey of large financial institutions offering debit card services, NCUA canvassed credit unions undergoing on-site examinations during the first two weeks of March. During this exercise, NCUA staff reviewed the interchange contracts and data of individual credit unions.

In completing this exercise, NCUA sought to collect data on the direct costs and income related debit card transactions for credit unions of different sizes. NCUA also gathered information on the types of vendor relationships credit unions use for debit products. The review does not incorporate data related to indirect costs like labor, facilities, equipment and other overhead costs related to operating a debit card program. In completing this analysis, NCUA staff also excluded outliers, reporting errors, and incomplete data when such information appeared to skew the analysis and outcomes. As a result, the final data set for NCUA's review includes 296 credit unions.

Results of NCUA's Review

NCUA staff has now compiled, scrubbed and analyzed this data. The results of the sweep analysis are found in the enclosed table. In brief, the review confirms NCUA's position about the need for the Federal Reserve Board to adopt meaningful exemptions for smaller card issuers.

Among other things, the sweep analysis reveals that the direct costs of providing debit card services are progressively higher for smaller credit unions. Direct costs per transaction do not fall below the proposed cap until credit unions reach $100 million to $500 million in assets. Median direct, per transaction costs for credit unions with $10 million or less in assets came in at 31 cents per transaction. For credit unions between $50 million and $100 million in assets, the median cost falls to 19 cents per transaction. For both groups, however, the median direct interchange costs significantly exceed the maximums allowed under the proposed rule on interchange fees. Additionally, the analysis likely underestimates costs for debit card transactions, as NCUA could not easily segregate PIN/ATM and signature transactions in the information obtained during the brief canvassing effort.

The NCUA staff review also finds that credit unions, especially smaller ones, often use a third party to access debit card payment networks. Because the networks may include a processor that only offers the large institution cap rate fee -- such as MasterCard which has previously signaled that it may not operate a dual system -- the proposed rule seems likely to result in market forces shifting income for credit unions under $10 billion to the large institution cap level of compensation. In other words, without exemptions for network exclusivity and merchant routing, credit unions belonging to a gateway with multiple networks may find themselves subject to the large institution cap.

The analysis further reveals that the smaller the credit union the more likely it was that the institution lost money on member debit card transactions. In fact, a large number of credit unions currently incur direct costs in excess of interchange fee income. The inability of small credit unions to achieve the economies of scale necessary to offer debit card services seems the likely factor in contributing to such losses on provided services. As a credit union increases in asset size, the analysis additionally finds that the median direct cost per card transaction drops.

In closing, NCUA again urges the Federal Reserve Board to modify the proposed rule on interchange fees to take into consideration the unique circumstances of smaller credit unions. NCUA also looks forward to continuing to cooperate with the Federal Reserve Board on the interchange fee rulemaking. Please feel free to contact me or to have your staff contact NCUA staff about any questions that you may have about NCUA's analysis.

Sincerely,

Debbie Matz

Debbie Matz
Chairman

Encl: Preliminary Results Identified in NCUA's March 2011 Sampling of Credit Unions' Direct Interchange Costs and Income

Copy to: Board Member Gigi Hyland
Board Member Michael E. Fryzel

Preliminary Results Identified in NCUA's March 2011 Sampling of Credit Unions' Direct Interchange Costs and Income[1]

	$10 million and under	$10 million to $50 million	$50 million to $100 million	$100 million to $500 million	$500 million to $1 billion	Greater than $1 billion
Number of Institutions	44	130	41	61	6	14
Median Assets of Credit Union	$6,771,898	$18,412,315	$57,915,518	$215,448,726	$640,945,662	$1,605,749,118
Median Number of Share Draft Accounts	325	1,055	3,413	10,382	32,499	84,964
Median Number of Debit/ATM Cards	285	946	2,520	7,454	32,500	82,784
Median Total of Card Transactions Per Month	3,185	5,068	31,633	96,590	170,270	336,778
Median Transactions Per Card Per Month	9	9	12	11	7	11
Median Direct Cost Per Card Transaction[2]	$0.31	$0.21	$0.19	$0.08	$0.10	$0.02
Median Gross Income Per Card Transaction	$0.31	$0.27	$0.29	$0.27	$0.45	$0.38
Number of Credit Unions with Net Positive Interchange income[3]	21	74	25	48	5	14
Number of Credit Unions with Net Negative Interchange Income[4]	23	56	16	13	1	0

[1] Transaction analysis includes both PIN/ATM and signature transactions due to the inability to segregate activity on credit union reports. In order to gain a consistent picture, NCUA measured total card activity from a direct cost and income perspective. Actual debit-only activity could result in a slightly higher net cost per transaction.

[2] Direct cost equals all direct fees (fixed and variable) reported by a credit union broken into monthly apportions and divided by the total reported monthly card transactions.

[3] Positive income from debit card transactions means the credit union's total network card services income exceeds total network card services direct costs.

[4] Negative income from debit card transactions means the credit union's total network card services direct costs exceed total network card services income.