

Financial Effects of the Senate Interchange Amendment On Consumers and Credit Union Debit Programs

CUNA Policy Analysis - June 4, 2010

On May 26th 2010, CUNA began collecting information on the revenues and costs associated with credit union debit programs in an effort to measure the financial impact of the Senate Interchange Amendment¹. Due to time constraints the survey was not sent to a random sample, but instead was sent directly to members of the CUNA CFO Council via the group's listserv.

As of June 3rd, 2010, we received 93 responses representing 1.8% of all debit-offering credit unions. Responding credit unions hold \$84 billion in total assets, serve 7.4 million members, and report a total of 4.6 million debit cards. Respondents thus represent 9.5% of total assets and 8.4% of total members at all debit-offering credit unions.

Survey respondents reported a total of 733 million transactions in 2009. Of these, 56% were signature debit transactions and 44% were PIN debit transactions. They also reported a total of \$231 million in interchange revenue for 2009.

Effect on Consumers

Survey results reveal, as shown in the table below, that consumers are likely to pay a steep price if the Senate Interchange Amendment becomes law.

First, credit unions, like all debit card issuers, would undoubtedly act to replace revenue losses described below that would arise from the Senate Interchange Amendment's price controls. The most likely way this would be done is through the imposition of card fees. The survey results show that with a 50% reduction of debit interchange, credit unions would need to impose an annual fee of approximately \$25 to each cardholder, or a per transaction fee of about 15 cents, or some combination of the two (for example, \$12.5 per cardholder and 7.5 cents per transaction). At a 75% reduction of interchange, the stand-alone annual fee would need to be about \$40, or the stand-alone per transaction fee would need to be approximately 25 cents.

Also, we find little reason to believe that merchants would pass interchange savings through to consumers. Our survey of credit unions of course did not address this issue, but given the substantial resources they've used to try to eliminate interchange, it is reasonable to infer that merchants have no intention whatsoever in passing savings on to consumers.

| Credit Union Debit Program Financial Overview | | | |
|---|-------------------------|--------------------------|--------------------------|
| Per-Card, Per-Year Medians | | | |
| | Reported 2009 Actual | 50% Revenue Reduction | 75% Revenue Reduction |
| Interchange Revenue | \$53 | \$27 | \$13 |
| Direct Debit Card Expenses* | \$38 | \$38 | \$38 |
| Net Income** | \$12 | -\$12 | -\$24 |
| % w/negative net income | 20% | 83% | 99% |
| % w/net income \$0-\$5 | 9% | 17% | 1% |
| Approximate annual per-card fee to offset revenue reduction | | \$25 | \$40 |
| * Expenses defined as network and processing expenses including settlement, billing and data processing; fraud; negative balance; cost of plastics including reissuance costs; insurance; and staff expense. ** Net income is not equal to the difference between revenue and expense in this table because the values reported here are medians. | | | |

¹ The Senate Interchange Amendment was added to the Reform bill without any impact study, hearing or debate.

Effect on Credit Unions

Survey results reveal that for most credit unions debit interchange currently covers somewhat more than the direct costs of providing debit services but is not disproportionate given their expenses and potential costs such as those relating to fraud.² In fact, for one in five credit unions, debit interchange is not sufficient to cover all the direct costs of offering debit, and for another one in ten credit unions, interchange income provides only a small cushion above costs.

Going forward, we believe that the Senate Interchange Amendment would cause a reduction of debit interchange revenue to credit unions in the range of 50% to 75%. Others have suggested a reduction as high as 90%, which we believe is possible, but not likely. It is impossible to accurately determine the ultimate effects of the amendment on interchange revenue because of the host of intended and unintended consequences the amendment would have, working through the complicated interplay among cardholders, issuers, networks and merchants. All would be reacting to a new reality. However, we believe our assumption of a 50% to 75% reduction in debit interchange revenue to credit unions is reasonable based on the following:

- There is nothing in the amendment that requires networks to maintain separate debit interchange rates for small and large issuers.
- Even if the networks were to maintain separate debit interchange rates for small and large issuers, networks would have an incentive to minimize the spread between the two rates to make the brand more acceptable to merchants.
- The enhanced discounting ability afforded to merchants in the bill would reduce transaction volume for smaller institutions.
- Merchants would have an incentive to subtly steer customers to use debit cards from larger issuers.
- The previous two factors would either reduce transaction volume at smaller issuers such as credit unions, or eventually lead to a reduction in the debit interchange rate at smaller issuers to a rate very close to the rate for larger issuers.

As shown on the previous page an assumed 50% decline in revenue would cause an estimated 83% of credit unions to lose money on their debit card program. And for another one in six credit unions, interchange income would provide only a small cushion above costs.

An assumed 75% decline in revenue would mean that for virtually every U.S. credit union debit interchange would not be sufficient to cover all the direct costs of offering debit.

The bottom-line effects are substantial. Extrapolating from our sample we estimate that total credit union debit interchange revenue was approximately \$2.5 billion in 2009. Last year, total net income in all credit unions was approximately \$1.6 billion but without debit interchange credit unions would have lost nearly \$1 billion in 2009.³

² Not included in the costs are research and development, and the potential for major fraud events not covered by insurance, such as card re-issuance following a data breach. Also not included is an allocation of overhead.

³ In a “normal” year for credit unions, net income is approximately 90 basis points (bp) of average assets. That earnings rate would have amounted to a total net income of \$7.8 billion if 2009 were a “normal” year. Therefore, in “normal” times debit interchange would represent about a third (32%) of credit union net income, or 29 basis points of average assets. Assuming a 50% reduction in debit interchange income, credit union net income in normal times would be reduced from 90 bp to 75 bp. A 75% reduction of debit interchange would reduce net income in “normal” times to around 68 bp.