

Testimony of

David W. Kemper

on behalf of the

American Bankers Association

and the

Consumer Bankers Association

Before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

United States House of Representatives



Testimony of David W. Kemper
On behalf of the
American Bankers Association
and the
Consumer Bankers Association
before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
United States House of Representatives
February 17, 2011

Chairwoman Capito, Ranking Member Maloney, and members of the Subcommittee, my name is David Kemper, Chairman and Chief Executive Officer, Commerce Bancshares. I am pleased to represent Commerce Bank, the American Bankers Association and the Consumer Bankers Association at this hearing today.¹ Thank you for the opportunity to provide the Subcommittee with the banking industry's perspectives on the serious implications and negative consequences of the Durbin Amendment and the proposed Federal Reserve rule implementing it.

Commerce is a mid-sized, "main street" bank founded in Kansas City in 1865. Our strong Midwestern culture and engaged workforce of 5,000 serves our customers from 214 branches in five states – Missouri, Kansas, Illinois, Oklahoma and Colorado. We use a super-community banking model, which allows us to balance small bank customer service and deep market knowledge with large bank product offerings and pricing.

Commerce Bank is counted among the best capitalized banks in the country and we did not contribute to the economic crisis by originating *any* sub-prime products. Commerce Bank is only one of three banks in the country to hold Moody's highest bank financial strength rating. And last year, we were honored by Congressman Emanuel Cleaver and former Financial Services Committee Chairman Barney Frank on the floor of the House for ranking third in Forbes Magazine's list of America's Best Banks. Chairman Frank flew to Kansas City and

¹The **American Bankers Association** (ABA) represents banks of all sizes and charters and is the voice of the nation's \$13 trillion banking industry and its two million employees.

The **Consumer Bankers Association** (CBA) is the only national financial trade group focused exclusively on the retail banking industry as it strives to fulfill the financial needs of the American consumer.

presented us with a framed page from the Congressional Record recognizing Commerce's achievement.

The Durbin amendment and the Federal Reserve's proposed rule to implement it will cause great harm to consumers, and to financial institutions of all sizes and their ability to revitalize local economies. There are four key points that I would like to make today:

➤ ***Consumers will be severely affected by the price-controls of the Fed's proposal***

The government-mandated price control elements in the Federal Reserve's proposed rule will severely affect consumers everywhere, causing new consumer fees, including checking account fees, and pushing low-income customers out of the banking system. Debit cards have been widely embraced by both consumers and merchants in this country. They are faster at checkout, accepted worldwide, and provide a payment guarantee for the merchant **and** protect the consumer from fraud. Debit cards reduce the need for cash and check-writing and the cost of handling this paper. The Durbin Amendment moves the payment system backwards, taking a highly efficient debit card system where costs are shared by all who benefit to one where merchants are largely excluded from contributing and, instead, are presented with a multi-billion dollar windfall.

➤ ***Price-controls will mean a loss on every debit card account***

The proposed rule dictates that my bank – and financial institutions throughout the country – **must** lose money on every debit card transaction we process *unless* we charge consumers more. Artificial price controls are bad enough in a free market economy. Dictating that we may recover substantially less than the cost of providing the debit card service, while also restricting us from obtaining a reasonable return on capital, is bad policy and a recipe for serious problems.

➤ ***The small-bank exemption will not work in practice***

The exemption for small banks added to the Durbin Amendment will ultimately be ineffective. Every community banker that I speak with strongly believes they will be severely impacted by the interchange price controls imposed on larger banks. The economics are simple: market share will always flow to the lowest priced product, even

if those lower prices are mandated. The result for small banks is either a loss of market share, a loss of revenue that supports low-cost accounts and other valuable services, or both.

➤ ***A policy decision of such importance deserves more thorough consideration***

The process by which the Congress addressed this important issue was deeply flawed. The amendment was added on the Senate Floor as a last minute addition to the Dodd-Frank legislation. It was never the subject of any hearings in either the House or Senate, never voted on by this or any other standing Committee of the House or Senate, and never subject to informed debate. Completely missing was any thoughtful consideration of the impact on consumers, banks, and the economy. As such, the result is a deeply flawed measure that must be revisited.

Commerce Bank, and indeed the banking industry, supported many of the key principles embodied in the Dodd Frank Act – we are all for sound banks, strong capital and consumer transparency. However, the Durbin Amendment had nothing to do with these principles. It has never received the necessary consideration for something so important and with such far reaching consequences. It will devastate retail bank profitability, stifle innovation, lower productivity in our economy and force a number of our customers out of the protection of the banking system.

Therefore, the American Bankers Association and the Consumer Bankers Association, and the thousands of banking institutions we represent, respectfully request that the Congress take immediate action to stop the proposed Federal Reserve interchange rule from being implemented.

In the remainder of my testimony I would like to expand on the above points.

Mandating Prices Below Cost is a Recipe for Serious Problems

Under the current Federal Reserve’s proposal, it is estimated that banks will be penalized \$14 billion in revenue, a number equivalent to 16 percent of last year’s industry pre-tax profits. In essence, this amounts to a government mandated revenue transfer from banks to merchants. It may be worthwhile to note that last year, according to SEC filings; *the largest retailers enjoyed*

a return on equity at an average of 19 percent, almost three times the financial returns in the banking industry.

It is important to understand the economics of the banking business and the real impact revenue reductions have on our ability to serve consumers and our local communities. It is quite clear that the significant cuts in interchange fees envisioned by the Federal Reserve's proposed rule will lead to a direct harm to consumers, be it in the form of higher costs, lost services, or a smaller banking industry able to serve local needs. And, as explained later, this has an exponential effect on economic growth, as every dollar lost means as much as ten times that amount cannot be loaned to small businesses, manufactures and others.

It is a simple fact that for any business to remain viable, revenue has to exceed costs. If the Federal Reserve's interchange proposal is allowed to move forward, banks will likely see a 70 percent to 85 percent cut in debit card revenues. This means that the income earned on the service will be ***significantly*** less than it costs a bank to provide it.

To illustrate, it costs Commerce Bank about \$230 per year to maintain a consumer checking account, including branch costs, administrative, data processing, and issuing statements among other costs. Our overall profit margin for that checking account is 13 percent, or about \$35. The Federal Reserve's proposal would cut our debit card revenues by about 85 percent, or \$62 per account. This means that our profit on a typical checking account goes from \$35 to a ***negative*** \$27 and would leave our bank in the unfortunate position of losing money, on average, for each account. Our experience is no different than large and small banks around this country.

Durbin Interchange Price Controls Will Severely Impact Consumers Who Use Debit Cards

The debit card is one of the most successful and widely accepted products we have ever offered. The reality is that checking accounts have become debit accounts. This is because consumers enjoy the convenience of a seamless worldwide payments system available 24 hours a day, seven days a week, 365 days a year, coupled with a near complete protection from fraud. The evidence of how much consumers rely on their debit cards is startling. Our debit card users on average perform 26 debit card transactions a month compared to writing 5 checks.

Local communities also benefit with these added services, and merchants see operating efficiencies and higher sales generating from the confidence consumers have in our highly functioning payments system.

The Federal Reserve's proposed rule, however, will cause such a significant decline in revenue that banks will be forced to seek ways of making up that revenue. For example, without interchange revenue, many banks will be forced to begin charging higher fees on what previously were low and no-cost checking for our customers. Thus, as a direct result of the Federal Reserve rule, in many cases, free checking may very well be a thing of the past. It also may result in new or higher debit card fees and other account-related fees and even not issuing debit cards to some individuals.

As the cost of using a debit card shifts from the merchants to customers, some individuals will not be able or willing to pay the higher cost even though they value the use, safety and convenience of using their debit card to buy goods and services. For example, the loss of revenue will hurt the ability of banks to provide basic banking accounts that enable low-income people to access to the banking system. These individuals may well be forced out of the mainstream banking system, and will end up with more expensive and less regulated check cashers and other non-bank financial service providers.

The loss of revenue and the need to absorb the costs of providing debit card services may have to come by dramatically reducing other bank expenses, such as closing branches, laying off employees, or limiting other services that customers have come to expect. The bottom line is the cost of providing customers with debit cards does not disappear with the Durbin Amendment. It has to be covered somehow and that ultimately means higher costs and even less access to debit cards for consumers, and reduced services and even employment opportunities in community banks.

Interchange Price Controls Will Limit Banks' Ability to Serve Local Communities

If net income is reduced, so is capital growth as most community-based banks raise capital through retained earnings. This means that there are fewer resources to make job-producing small business loans in our community. In short, community banks and the customers they serve will be greatly harmed. The consequences are significant, since \$1 worth of capital supports up to \$10 in lending. Just to illustrate, for the industry as a whole, a 70 percent loss of interchange income would mean that lending could fall by as much as \$100 billion each year.

The Fed Proposal Misses Significant Important Costs of Running the Debit Card System

The interchange amendment sets price controls by directing the Federal Reserve to establish standards for assessing whether the transaction fee paid by merchants to card issuers to use the debit card payment network is “reasonable and proportional” to cost. While this could be viewed more consistently with long-standing legislative and judicial precedents to recover costs and have a reasonable return on investment, the fact is that it is being interpreted very narrowly. As bad as the Durbin Amendment is, the Federal Reserve has made things worse by proposing an extremely restrictive rule that sets caps that do not account for important costs related to ensuring the reliability and security of the vast debit card system that customers enjoy today. The Durbin Amendment even permitted the Federal Reserve to explicitly consider fraud, which the agency acknowledged as important but stated it did not have the time to fully consider it.

Specifically, the Federal Reserve did not include a number of costs related to a transaction, such as: fraud losses; fraud prevention costs; fees banks pay networks to process transactions; costs of handling customer inquiries about the transaction and other customer services; card production and issuance costs; the cost of periodic statements required by Federal Reserve Board Regulation E (and other various costs of federal laws that we must comply with); capital costs for development, improvement, and expansion of the infrastructure to handle volume growth; staff time; and a reasonable rate of return, among others.

Covering just some variable costs and ignoring all the other costs of providing the product will certainly lead to disaster for any business. It is a false premise that in a fixed-cost business, a business could price at variable cost and survive. In the long-run, price needs to cover both variable and fixed costs. No business in the world can survive if it only covers variable costs.

The Federal Reserve Proposal Fails to Compensate Issuers for Fraud Expenses

A primary shortcoming of the Federal Reserve’s proposal is it fails to compensate issuers for their fraud losses or fraud prevention costs, even though the Durbin Amendment clearly requires that fraud *prevention* costs be included in this rule, and certainly permits *actual* fraud losses to be included as well. Under card network rules, if a merchant obtains authorization for an in-person debit card transaction and there is fraud – which often stems from data breaches at

the retailer – *my bank ends up covering the fraud losses, not the retailer.*² It is also the case that for some community banks, the annual fraud losses alone can wipe out all the revenue from interchange for that year. If I lose most of the interchange fee, the primary source of revenue from debit card use, how can I cover my related fraud risks, losses, and fraud prevention costs?

Because of their liability for fraud, card issuers have invested billions in fraud prevention. This includes, for example, neural networks that detect and stop unusual activity that suggests fraud, constant upgrades of card security features and systems, and working with law enforcement to capture and prosecute criminals. And these efforts are never ending. Fraud is dynamic. Eventually, the criminals figure out how to circumvent fraud filters, so issuers must stay one step ahead of the criminals and anticipate the next scam through additional investments, research, and imagination. My staff works 24 hours a day, 7 days a week, 365 days a year to thwart the attacks on our part of the payment system. We discover fraud before the consumer does in over 7 out of 10 fraud cases. We stand between the crooks and our consumers every single day and we offered our customers a zero liability guarantee long before the networks offered it nationwide. We believe we deserve to be compensated for this service.

As noted, current interchange fees help to pay for this investment in fraud prevention and the issuers' fraud losses. The Federal Reserve's proposed rule, however, fails to make any adjustment for these factors.³ Failure to compensate issuers for fraud losses and fraud prevention will have a significant impact on fraud and change the dynamic of the card system and consumers' experience. Without interchange fees, there is less bank incentive and fewer resources to spend on fraud prevention. Even now we are hesitating over the release of a new fraud-fighting process as we prepare for the profound reduction in revenue that the amendment will impose. Will we be compensated for our investment? It appears not.

Investment in fraud prevention is also an investment in protecting the confidence that consumers have in the payment system. If we are forced to forgo investment opportunities to fight fraud because we cannot be adequately compensated, everyone suffers: banks, consumers, merchants and the economy.

² Section 7.0, *Visa International Operating Regulations Core Principles*: "Issuers are financially responsible for transactions that are accepted by the merchant as defined in the Visa Operating Regulations, and properly processed by the acquirer."

³ The Durbin Amendment directed the Federal Reserve to consider, as part of its rulemaking, fraud prevention costs. While the Federal Reserve has indicated its intention to do so, it has not done so in the proposed rule and has indicated it will not likely be able to do so by the July 21st effective date for the final rule. We view this as a glaring omission. We would likewise note that the Fed has declined to include actual fraud losses as part of its calculations.

Debit v. Cash/Checks – the Enormous Benefits of Guaranteed Payment

Sophisticated payment card systems ***provide merchants and businesses huge benefits compared with cash or checks***. They allow retail merchants and businesses to instantly confirm that the account and card are valid and the customer has sufficient funds in the account to make a debit card purchase.

In contrast, checks may be returned for any reason – insufficient funds in the account, account closed or nonexistent, counterfeit check, stop payment by the customer – and the business is on the hook for the loss. If the merchant wants to avoid that loss he can refuse to accept checks or he can agree to pay a check guarantee fee similar to, and in many cases higher, than interchange. For that reason, most retailers do not want to take checks, restaurants are a good example, and have seen their profits increase by accepting debit cards rather than checks.

Debit cards also allow the payment to transfer electronically from the customer's bank to the business's account for their almost immediate use without the merchant leaving the store. In contrast, most merchants have to drive to the bank to deposit checks and in some cases may also have to wait for the checks to clear to use the money from checks. Of course, debit cards also speed up the check-out, leading to more sales for the business, and saving time for both the merchant and the customer.

Debit cards also have huge advantages over cash, which can be lost or stolen, for both businesses and consumers. Cash has to be counted, recounted, sorted, transported, and protected. Thus, cash has the largest transaction costs of any payment instrument, and is one of the reasons why some businesses no longer accept cash (e.g., some airlines now accept only cards for in-flight food and beverages purchases). Also, customers' purchases are not limited to the amount of cash in their wallet. Businesses sell more, and customers do not have to carry large amounts of cash which can make them targets for criminals.

It is also important to keep in mind that cash and checks are not free to businesses. Businesses pay banks directly or indirectly for check deposits and services through their general account agreement with the bank. They pay for the cost of delivering checks to the bank, either electronically or physically and for their employee's time in accepting checks. They pay their employees and banks for the costs of handling, managing, and protecting cash, as described above.

The following table provides details on the relative social marginal costs of different payment instruments when considering *all the parties* that are involved in the transaction: the merchant, consumer, bank, and the central bank (which clears final payment).⁴ These numbers show quite dramatically that debit card acceptance – including the interchange fee – is still the lowest cost.

Payment Type	Social Marginal Cost
Cash	\$2.66
Non-verifiable Check	\$1.40
Verifiable Check	\$1.08
Credit	\$1.22
Signature Debit	\$1.01
PIN Debit	\$1.08

It is also important to point out that merchants and businesses can simply provide *discounts* to customers for non-card transactions such as cash and checks.⁵ This way, consumers decide whether they want to pay extra for the convenience of paying with cards or receive the discount for other types of payments. Some gas stations have done just this. It allows the merchant to recoup the interchange fee if they believe that providing that discount option is in their financial interest. *Any business that believes that the cost of accepting checks and cash is less expensive for them than debit cards, can – under current rules – provide incentives for customers to use those payment options.*

⁴ *The Economics of a Cashless Society: An Analysis of the Costs and Benefits of Payment Instruments.* Daniel D. Garcia Swartz, Robert W. Hahn, and Anne Layne-Farrar, AEI-Brookings Joint Center for Regulatory Studies, September 2004.

⁵ “Merchants may steer customers to an alternative method of payment such as providing discounts for cash, but may not do so in a confusing manner that denies consumer choice.” (Section 6.0 *Visa International Operating Regulations Core Principles.*) “The Merchant may request or encourage a Cardholder to use a means of payment other than a Visa Card.” (*Visa International Operating Regulations*, 15 October 2010 p.406. “A U.S. Merchant may offer a non-monetary benefit to a Cardholder as an inducement for the Cardholder to use a means of payment other than a Visa Card. A merchant may offer a monetary benefit in the form of a discount, as provided in “Discount Offer – U.S. Region,” as an inducement for the Cardholder to use a means of payment other than a Visa Card.” (*Visa International Operating Regulations*, 15 October 2010, p. 407.)

Interchange Price Controls Moves the Payment System Backwards

Every participant in the debit interchange system—every issuer, network, merchant, and consumer—has entered into the system *voluntarily*. And more and more join every day. The acceptance of the system demonstrates dramatically just how important this system is to all participants. It is no wonder that even retail businesses that deal in small dollar sales, such as fast food restaurants and coffee shops, are accepting card payment services. These businesses had a *choice* to make regarding how best to increase sales and enhance the customers' need for convenient and fast service. They have realized the significant value of the service and made an economic decision that it is in their best interest to be a part of the system.

To illustrate, we know a hair salon owner located just a few blocks from our St. Louis headquarters who recently came to this conclusion. The owner tells us that he began accepting debit cards last year because he knows that his customers prefer them. He feels that his business has grown because he has begun to accept debit and now he doesn't need to worry about any delays in check clearance and the headache of returned checks. He sees debit interchange as just another cost of doing business for which the benefits exceed the cost.

Every participant must bear the large-scale network infrastructure costs required to build, maintain, and protect debit card services. Yet now, merchants want all the benefits of accepting card payments, but they do not want to pay their fair share to receive those benefits. ***It is the big-box retailers in this country that stand to receive a large windfall profit, as only a very small percent of merchants will receive the vast majority of benefit from this change.***

Instead, merchants want the government to fix prices and shift the cost of doing business off their books. While merchants say that they will lower their prices and pass on the savings to consumers, no reasonable person expects that they will be lowering the price of a soda or bag of chips. Congress did not mandate that such a result occur.

Moreover, rather than encouraging the continuing development of the interchange system and the use of debit cards, the Federal Reserve's Proposed Rule would take a fully functioning market and disrupt it by imposing a hard price cap on all debit interchange fees of no more than 7-12 cents. The severity of the cuts under this rule will discourage issuers from investing in the security, innovation, improvement, and maintenance of the debit interchange payment system, because those issuers are unlikely to recoup the costs of such investments, let alone make any return on capital. Accordingly, the natural result of the Federal Reserve's price controls will be

the gradual degradation of the reliability and confidence in the payment system (including system failures and security breaches).

The concern about the Durbin Amendment goes far beyond the impact on my bank, my customers, and the economy. It sets a dangerous precedent, suggesting that financial institutions may be subject to future, unknowable price controls on other financial products and services, undermining important free-market principles. We have always accepted the operational, reputational, and financial risk associated with developing new products and services and making them available to millions of consumers. Now financial institutions risk losing their investments of billions of dollars into improvements of existing products and services, and the creation of new ones, through government price controls. Why would any business invest in an innovative product knowing the government *ex post facto* will interfere and completely dismantle its free-market business model by imposing price controls? The Durbin Amendment serves as a strong disincentive for innovation and investment by financial institutions in other emerging payment systems and financial products and services. In the end, it is the American public who suffers.

Interchange Price Controls Provide No Effective Protection for Small Banks

The retailers will say that small banks and credit unions are protected because the legislation exempts small depository institutions from the Federal Reserve Board's interchange rate setting. Community bankers do not believe that such an exemption will work in practice. It is simply unsustainable for two firms to offer the same product at radically different prices. As with any price controls, there are inevitable unintended consequences, market distortions, and higher costs for others, including consumers.

Under the Federal Reserve rule, the differential between the very low fee that large bank debit card issuers will have to accept and the current fee that small banks receive is so large that there are enormous incentives for merchants to steer customers away from using debit cards issued by small banks. Large retailers will provide additional rewards and perks to customers that use large bank cards. Merchants will see significant reductions in costs if they drive business away from higher-cost debit card alternatives to lower-cost ones. The economics are simple: market share will always flow to the lowest priced product, even if those lower prices

are mandated. The result for small banks is either a loss of market share, a loss of revenue that supports low-cost transactions and other valuable services, or both.

It is likely that merchants will begin a new campaign to have price controls put in across the board on debit cards and on credit cards as well. Such efforts will only magnify the severe unintended consequences of the price controls on debit cards if the Federal Reserve rule goes forward.

Conclusion

The Durbin Amendment was passed as a *last minute* addition to the Dodd-Frank legislation on the Senate Floor. This was done *without any Congressional hearings* on the amendment. It was done without any consideration for the consequences on consumers or community-based institutions like mine. And it was done without any consideration of the economic impact on communities like mine and those of other banks around our country.

This flawed process and the quick adoption of this amendment will lead to significant unintended consequences if not addressed. It will have profound adverse consequences on consumers (particularly low-income Americans), the banking system (particularly the nation's smaller banks and credit unions), and the United States payments system and economy as a whole.

On behalf of all the member banks of both the ABA and CBA, I urge you to immediately take all necessary congressional action to stop the Federal Reserve from implementing the proposed interchange rule.