Intrepid Ventures

Impact of the "Compromise" Durbin Interchange Amendment on the Card Payments Industry: Who Would Be Hurt? Who Would Gain?

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* View's expressed are strictly the author's.

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Setting the Stage

- The merchant lobby has waged a long and relentless campaign on multiple fronts for regulation of card-payment-networks interchange.
- On May 6th by a vote of 64 to 33 Senate Majority Whip Dick Durbin's interchange amendment was attached to the "Restoring American Financial Stability Act."
- It would have a profound impact on the card payment industry.
- On June 10th Senate Banking Committee Chairman Chris Dodd and House Financial Services Chairman Barney Frank said they expected the Durbin interchange amendment to survive the conference committee reconciliation of the House and Senate financial system regulatory overhaul bills, though they allowed it might be modified.
- Whether the Durbin amendment is dropped, which seems unlikely, or passed in a weakened form along the lines of Durbin's June 21st compromise language for the Conference Committee, which seems likely, should be determined this week, or next.

What the Durbin amendment would do

- Permit merchants to differentially discount different payment types (e.g. cash or debit), but not to discriminate between issuers or networks.
- Allow merchants to refuse payment cards for purchases below $10
- Ability to restrict card use for small transactions not likely to have a significant impact. Networks could mitigate by reducing fixed fees
  - Some but not most merchants would discount for cash and debit and/or restrict card use for small transactions.
  - At the pos discounts and restrictions would at least modestly steer purchases to cash and debit use in lieu of credit.
- Merchants could pick on which network to rout a debit transactions. They would have to have at a choice between at least two nonaffiliated networks for **each transaction**. Historically cardholder and issuer choice determined the network. Going forward the interplay of issuer network alignments and merchant preferences would rule.

What the Durbin amendment would do

- Impose punitive price controls on debit and prepay interchange
- Require debit and prepay interchange fees be reasonable and proportional to actual incremental processing costs incurred by the issuer. Fraud prevention costs could also be recovered. All other costs expressly excluded from consideration. Fed charged with defining within 9 months.
- However, transactions from (1) issuers with under $10 billion in assets, (2) federal, state and local government benefit cards and (3) reloadable consumer prepay cards, would be exempt.
- Fed also charged with ensuring the networks don’t create synthetic interchange by increasing acquirer fees and reducing fees and/or increasing rebates for issuers.
- Bill would take effect 12 months from enactment.

Visa has dominant signature and the leading pin debit market share in the US. Its debit interchange fees are illustrative of what's at stake

Visa Signature-Debit Interchange

Fee Program	Visa Check Card
CPS/Supermarket Debit—Performance Threshold[1] I	0.62% + $0.13 ($0.35 Cap)
CPS/Supermarket Debit—Performance Threshold[1] II	0.81% + $0.13 ($0.35 Cap)
CPS/Supermarket Debit—Performance Threshold[1] III	0.92% + $0.15 ($0.35 Cap)
CPS/Supermarket Debit—All Other	0.95% + $0.20 ($0.35 Cap)
Check Card II Supermarket	$0.25
CPS/Retail Debit—Performance Threshold[1] I	0.62% + $0.13
CPS/Retail Debit—Performance Threshold[1] II	0.81% + $0.13
CPS/Retail Debit—Performance Threshold[1] III	0.92% + $0.15
CPS/Retail Debit—All Other	0.95% + $0.20
CPS/Automated Fuel Dispenser, Debit	0.75% + $0.17 ($0.95 Cap)
CPS/Service Station, Debit	0.75% + $0.17 ($0.95 Cap)
CPS/Small Ticket, Debit	1.55% + $0.04
CPS/Retail 2, Debit	0.80% + $0.25
CPS/Debt Repayment	0.35% + $0.50
CPS/Utility	$0.75
CPS/Debit Tax Payment	$2.50
CPS/Retail Key Entry, Debit	1.60% + $0.15
CPS/Card Not Present, Debit	1.60% + $0.15
CPS/e-Commerce Basic, Debit	1.60% + $0.15
CPS/e-Commerce Preferred Retail, Debit	1.55% + $0.15
CPS/e-Commerce Preferred Hotel and Car Rental, Debit	1.36% + $0.15
CPS/e-Commerce Preferred Passenger Transport, Debit	1.60% + $0.15
CPS/Hotel and Car Rental Card Present, Debit	1.36% + $0.15
CPS/Hotel and Car Rental Card Not Present, Debit	1.36% + $0.15
CPS/Passenger Transport, Debit	1.60% + $0.15
CPS/Restaurant, Debit	1.19% + $0.10
CPS/Account Funding, Debit	1.75% + $0.20
Check Card II	0.55% + $0.10
Electronic Interchange Reimbursement Fee, Debit[2]	1.75% + $0.20
Standard Interchange Reimbursement Fee, Debit	1.90% + $0.25

Visa Pin-Debit Interchange

Fee Program	Interlink
Qualified Supermarket—Performance Threshold* I	$0.20
Qualified Supermarket—Performance Threshold* II	$0.25
Qualified Supermarket—Performance Threshold* III	$0.29
Qualified Supermarket—All Other	0.95% + $0.20 ($0.35 Cap)
Eligible Retail Merchant—Performance Threshold* I	0.50% + $0.10 ($0.60 Cap)
Eligible Retail Merchant—Performance Threshold* II	0.60% + $0.13 ($0.70 Cap)
Eligible Retail Merchant—Performance Threshold* III	0.75% + $0.15 ($0.80 Cap)
Fuel Transactions	0.75% + $0.17 ($0.95 Cap)
All Other Retail Transactions	0.95% + $0.20
International Interlink Standard	0.75%
Quasi-Cash	2.30% + $0.10

Interchange

- Real incremental debit-issuer* processing costs are close to zero.
- Signature debit fraud costs run 7 to 8 basis points and pin-debit ~ 1 basis point.
- But fraud prevention costs are the relevant number. They're more elastic – arguably 6 to 7 basis points.
- Regulated debit and prepay interchange would be a di minimis fee, probably 90% lower than current levels. No incremental-processing cost basis for ad valorem fees. For fraud prevention costs, maybe.
- Various analysts' comparisons to what the EC Competition Directorate and RBA did aren't particularly relevant. While European and Australian regulators also took a cost-recovery approach, they considered fully-allocated and nonprocessing costs.
- Merchants selecting networks transaction by transaction would put downward pressure on regulated and unregulated interchange.
- Credit-card interchange likely to be pulled down, somewhat. Similarly, Amex acceptance fees and interchange would decline.

*For issuers buying processing from third-party processors, pennies.

Network fees

- Network fees would not be directly affected.
- However,
  - Network issuer fees would likely come under increased pressure from large debit issuers faced with a dramatic interchange reduction. They're currently relatively small compared with interchange. That would no longer be the case.
  - Network pricing power with acquirers would be curbed. What is and isn't synthetic interchange is an elastic and debatable concept. The merchant lobby will push taking an expansive view of synthetic interchange.
  - Merchants' selecting which network to rout debit transactions over would put strong downward pressure on network acquirer fees and interchange.
  - Networks could at least initially boost issuer signature-debit fees.

Direct and indirect impacts across the card payments value chain

Card issuers

- US issuers earn ~ $14 to $15 billion per year in debit and prepay interchange fees. Interchange provides the lion’s share of revenue for debit cards and for many prepay cards.
- Large card issuers have a majority of debit share, and have been gaining share at the expense of thousands of small community banks and credit unions.
- Only two of the top thirty debit and prepay issuers (Meta and Bancorp) have less than $10 billion in assets.
- Large issuers would offset lost interchange revenue by raising and introducing new debit cardholder fees.
- Consequently, reduced debit issuance and transaction growth.
- Issuers would have to align with at least two signature debit and two pin debit networks.* If the issuer restricted its cards to a single pin and a single signature network then whatever the cardholder’s choice, the merchant would have a single network over which the transaction could be processed.

*If however the Fed takes the view that in the case where the merchant has a pin pad the cardholder in selecting signature or pin has restricted the transaction to a single network and in the case where the merchant doesn’t have a pin pad it is the merchant who has restricted the transaction to a single network then issuers aligning with a single signature and a single pin-debit would be compliant, and the impact on network and issuer economics more modest.

Card issuers

- With rich interchange, generally no annual fees and generous rewards, credit cards would become relatively much more attractive for issuers and cardholders.

  ⇨ Spend would shift from debit to credit.
- Notwithstanding Visa's hard-to-credit statement to the contrary, a two-tier interchange system would prevail.
- Small unregulated card issuers' interchange would be less affected, but nonetheless subject to pressure from merchants' picking which debit network to rout transactions over. They could offer free debit cards/free checking and debit rewards and would therefore start to take share from larger issuers.

⇨ Large issuers will take a major hit. Smaller issuers will gain share albeit with thinner economics

Card-issuer processors

- Card issuer processors such as Fidelity, Fiserv, First Data, Total Systems and Visa would be indirectly affected. Several countervailing effects.
- Reduced debit and prepay transaction growth and therefore revenue from large issuers.
- Additional pressure on transaction processing fees from large issuers
- An increase in transactions from small issuers paying rack prices.
- Shift from debit to credit would boost Fidelity, First Data and Tsys

⇨ Mixed impact.

Card payment networks

- The “compromise” Durbin amendment isn’t positive for the networks but it is less bad.
- Debit and prepay card payment networks such as Visa, First Data’s Star, MasterCard, Discover’s Pulse, Fidelity’s NYCE and Fiserv’s Accel would be directly and indirectly impacted.
- Networks, particularly Visa and MasterCard have enjoyed enormous pricing power on the acquiring side of the network. The share of network economics acquirers pay has been increasing. This would come to an end for debit.
- Fed oversight to prevent synthetic interchange will reduce networks’ ability to increase acquirer fees on debit and prepay transactions.
- More importantly, merchants shopping each signature and pin debit transaction for the least expensive network would put downward pressure on network fees and interchange.

Card payment networks

- Ban on exclusive debit cards a significant negative for Visa which will lose pin and signature debit share and pricing on share it retains. Star, NYCE, Accel, Pulse and MasterCard may gain share but with thinner economics.
- On the other side of the network, having lost interchange issuers would put additional pressure on network fees.
- Reduced debit growth a negative
- Shift to credit a plus
- Small issuer share gains a significant plus.
- Reloadable consumer prepay exemption a plus.

⇨ Network economics will deteriorate

Merchant acquirers and processors

- Merchant acquirers and processors such as First Data, Elavon, Fifth Third, Global Payments and Heartland would be least impacted by Durbin’s price controls
- Reduced debit and prepay transaction growth would reduce merchant acquirer and processor revenue.
- This would be offset by increased credit spend and debit and prepay spend from small issuers.
- Additionally, some acquirers wouldn’t pass on 100% of interchange fee reductions to small merchants.
- Elimination or curbing of ad valorem debit interchange fees for most transactions might put pressure on acquirers’ ad valorem signature debit pricing.

⇨ Modest impact

Unintended consequences

- A boost in credit over debit spend
- Banks aggressively promoting hybrid credit/debit cards
- An increase in cash usage
- Debit share gains by small issuers whose products would be more expensive for merchants and cheaper for cardholders.
- Possibility of negative interchange or negative synthetic interchange for debit.

What's next in the legislative and regulatory assault on the card payments industry?

- If a card-payment-network regulatory edifice is established – no matter how weak, Durbin and the merchant lobby will look to expand its scope, and inevitably seek price controls for credit interchange fees in 2011.
- Once the Fed is given authority to regulate interchange and oversee network fees, slow but inevitable regulatory scope creep will ensue.
- If Durbin's interchange amendment is dropped or if only the provision permitting retailers to differentially discount different payment systems and to reject payment cards for small and/or large transactions is kept, partisans of interchange regulation will continue their campaign at the Federal and state levels.

Q&A