

## PayPal Unlikely to Escape Durbin Pain

American Banker | Wednesday, March 2, 2011

By Eric Grover

Dark clouds are on the horizon for the card payments industry. Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (aka the Durbin interchange amendment) mandates price controls on debit card networks' interchange fees and may upend how debit networks compete by permitting merchants to pick transaction routing. Large issuers such as Bank of America, Wells Fargo, JPMorgan Chase & Co. and U.S. Bancorp stand to lose \$14 billion in interchange revenue. Traditional retail debit card networks, in particular the market leader Visa, will be jarred.

Competing alternative payment systems will also be affected.

With 94 million accounts and payments volume growing at 28% per year the e-commerce phenom PayPal has been on a tear. Robert Swan, eBay's chief financial officer, said the Durbin amendment would be neutral to positive for PayPal, and dismissed suggestions it could be regulated by the Federal Reserve as a card payment network. As the words "debit card" and "payment card network" are used in common parlance, Swan would be right and PayPal and other alternative electronic payment systems wouldn't be covered directly.

The legislation will nonetheless impact PayPal.

The company's card funding costs will fall. Mandated debit interchange cuts will reduce acceptance fees funding accounts backstopped by debit cards. Credit card funding costs will fall too. Credit card acceptance fees are set relative to competing payment systems including debit. An 80%-90% drop in debit interchange will spur networks to cut credit card interchange, though by less than the debit reduction.

In the same vein, to stay competitive with prevailing payment card discount rates PayPal's merchant fees will come down, hurting its top line.

Many PayPal accounts are funded by automated clearing house transfers. To offset lost interchange revenue, in addition to hammering consumers

with new fees, it's possible retail banks will raise ACH fees, increasing PayPal's ACH funding costs.

But lo on top of this mixture of positive and negative impacts on its business, under the Dodd-Frank Act PayPal is almost certainly a payment card network and therefore directly regulated.

The card is only a form factor holding a payment account key(s).

Debit cards and payment card networks are expansively defined under Dodd-Frank. A PayPal account is "a code or device" issued by PayPal to debit "an asset account" — funds at PayPal or a demand deposit account backstopping a PayPal account, authorized by "other means" — a password rather than a signature or a PIN.

A PayPal account is therefore a debit card for purposes of the Durbin amendment. It is also a card payment network providing "proprietary services, infrastructure and software that route information and data to conduct debit card transactions ... authorization, clearing and settlement" directly, and indirectly.

Merchants use PayPal to accept debit card payments. The ban on network exclusivity and new debit routing rules should consequently cover PayPal along with traditional retail card payment networks, and PayPal the issuer and network would have to offer merchants a second alternate network to process PayPal debit transactions.

As a still largely closed network, PayPal acts as issuer, payment card network and acquirer. Some of the fees PayPal charges merchants are de facto interchange fees for PayPal issuance and should therefore be covered by Dodd-Frank's debit interchange price controls. If debit interchange is capped at 7 to 12 cents per transaction, hundreds of millions of dollars of imputed PayPal interchange could be eliminated. To avoid government price controls, PayPal would likely reverse its previous practice and start encouraging users to fund accounts with credit cards rather than DDAs.

PayPal is starting to open up its network, partnering with Bling Nation, First Data's Star, Fidelity National Information Services and others to extend its reach. It may soon have cause to introduce explicit interchange, which for debit transactions would be capped.

The Durbin amendment purposefully casts a wider, more harmful net, than has been commonly assumed.

Eric Grover is a partner at Intrepid Ventures in Minden, Nevada.