Capital One Lights the Path Away from Interchange Price Controls

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Capital One is the trailblazer that larger banks like BofA, Chase, and Wells Fargo should follow to move their debit businesses to a freer market enabling enormous value creation for their customers and shareholders. With Capital One's $35 billion all-stock acquisition of Discover, it will own two national debit networks and thereby free itself from value-stifling debit-interchange price controls.

Interchange fees are the principal revenue source for debit cards and DDAs. They fund fee-free accounts, a range of benefits and rewards, and issuer and fintech innovation. They're neobanks' lifeblood.

The 2010 Dodd-Frank Act's "Durbin Amendment" subjects politically unsympathetic banks with over $10 billion in assets that "route" transactions over third-party debit networks like Mastercard and Visa, to punitive debit-interchange price controls. All banks using third-party debit networks are required to provide at least two unaffiliated networks on each

card for merchants to choose between. Lawmakers' idea was to force down merchants' debit-card-acceptance costs. But one has to consider the entire payment system end-to-end. The unacknowledged consequence was higher consumer fees for debit cards and DDAs, the elimination of benefits and rewards, and suffocating innovation.

Congress tasked the Fed with implementing its debit-interchange price controls. Under the Fed's proposed reduced cap, covered debit issuers would earn 17.7 cents in interchange on the average $50 transaction or 35.4 basis points.

In 2022, the average market debit-interchange fees for Discover, Mastercard, and Visa were 141, 137, and 143 basis points, respectively, which is 300% higher than the new proposed ceiling. Brand-neutered traditional pin-debit networks have lower interchange fees. Average market debit interchange fees for Accel, Jeanie, NYCE, Pulse, and Star in 2022 were 57, 44, 75, 74, and 49 basis points, respectively.

Banks unfettered by the cap would earn vastly more interchange revenue. Plus, banks owning their own debit network would earn roughly 16 basis points in network fees from merchants. On the cost side, they would save a few basis points in network-issuer fees currently paid to third-party networks. The economic lift would be compelling and

banks' shareholders and customers would be the chief beneficiaries.

J.P. Morgan Chase looked at acquiring Discover, but passed. Perhaps Chase wasn't interested in some of Discover's nonnetwork businesses.

In 2023, BofA, Wells Fargo, and Chase debit cardholders did $468.1 billion, $467.6 billion, and $467.3 billion of purchase volume, respectively. Capital One debit cardholders did considerably less – only $66.7 billion. By acquiring its own debit network, each of America's three largest retail banks, therefore, has an opportunity to realize incremental revenue and cost savings roughly seven times greater than the Capital One/Discover combination's gain.

Other than Mastercard and Visa, Discover has the best debit network in terms of acceptance and a trusted brand that a debit-issuing titan could acquire to free itself of the Durbin Amendment's shackles.

There are, however, other debit networks they could try to buy. Processors Fiserv and FIS own the Accel and Star debit networks, and the NYCE and Jeanie networks, respectively. Alternatively, banks might seek to buy and build out a smaller cooperative debit network such as Shazam or Co-op Pay.

The tier-two debit networks have interrelated weaknesses, all of which a BofA, Chase, or Wells Fargo could fix. Their brands are near worthless; they have weaker merchant acceptance than Discover, Mastercard, and Visa; they do little to incent incremental cardholder use; and they have lower interchange than the leading debit networks, making it more difficult to fund cardholder benefits.

In retail payments, brands convey the promise of acceptance and guaranteed payment. Tier-two debit networks ride in the slipstream of Visa's and Mastercard's brands. For instance, if Star's enabled on a Visa-branded debit card, its brand is rarely on the card. At best it's displayed with a small bug on the back of the card. When transactions are routed over Star, cardholders and merchants assume it's a Visa transaction.

BofA, Chase, and Wells Fargo have powerful, trusted brands. Using their brands on their networks' debit cards and as acceptance would strengthen the network. A stronger network brand begets greater acceptance, spend, and interchange revenue.

Traditional pin-debit networks Accel, Jeanie, NYCE, and Star don't enjoy ubiquitous acceptance in-person, much less online. Nevertheless, each of them has acceptance at most of the nation's largest retailers. Critically, banking giants

would boost their networks' acceptance, directly and through partners.

BofA, Chase, and Wells Fargo in a joint venture with Fiserv, have acquiring businesses that provide payment acceptance to merchants. They would use their own and third-party acquirers to expand their debit networks' acceptance and thereby their debit volume reaping market interchange revenue. Greater acceptance begets greater use and interchange revenue, and bolsters the brand.

Retail-bank colossi have the wherewithal to create rich reward-and-loyalty programs boosting use. Greater cardholder spend increases acceptance, enables higher interchange, and strengthens the brand.

And, broader acceptance, a brand consumers and merchants recognize and trust, and meaningful rewards and greater spend, enable higher interchange, which enables richer rewards. There are powerful flywheel effects.

Debit-issuing giants would only earn market interchange where their network is accepted. Elsewhere they'd be subject to Congress's interchange cap and have to support a second unaffiliated debit network. Initially banks with their own debit network would have to cobrand debit cards with

Discover, Mastercard, or Visa to ensure maximum acceptance, while investing to build acceptance parity.

While the U.S. debit-network market is the most competitive in the world, it's dominated by global payment networks Visa and Mastercard. Nonetheless, if several major debit issuers owned their own debit network, competition would intensify. It would drive a stake into the heart of the Durbin Amendment's manacled market. They'd slash or eliminate retail-banking and debit fees and offer consumers a rich buffet of rewards. That's pro-consumer. Being pro-consumer is a good growth strategy.

America's retail-banking behemoths don't have to continue to be straitjacketed by the Durbin Amendment. They haven't put their political shoulders behind repealing it. They owe their customers and shareholders more. Capital One is showing them there's another path to escape its restrictions and create value for customers and shareholders.

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