Capital One’s acquisition of Discover will disrupt Durbin’s straitjacketed debit market

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Debating the impact: Capital One's acquisition of Discover

‘Capital One's acquisition of Discover will disrupt Durbin's straitjacketed debit market’. ***Eric Grover, Intrepid Ventures***

Despite US politicians and activists rallying against Capital One’s proposed acquisition of Discover, Eric Grover from Intrepid Ventures believes the acquisition would be highly competitive and beneficial for consumers.

Capital One is acquiring Discover for USD 35 billion in an all-stock deal. The combination will increase payment network, debit card, and retail banking competition, and has the potential to massively disrupt Senator Durbin’s straitjacketed debit market.

Nevertheless, a host of politicians and activists oppose the deal. Progressive heartthrob Senator Elizabeth Warren hyperbolically railed against the deal declaring ‘the merger…threatens our financial stability, reduces competition, and would increase fees and credit costs for American families’. She demanded regulators block the merger. National Community Reinvestment Coalition CEO Jesse Van Tol too wants the deal blocked, charging Capital One does deals that don’t benefit consumers and that it ‘poses massive antitrust concerns, given the vertical integration of Capital One’s credit card lending with Discover’s credit card network’.

The owners and management of public and private companies should be free to engage in M&A to maximise their businesses’ competitiveness and value unless there is persuasive evidence it would harm consumers. The combination of Capital One and Discover will benefit not harm consumers.

The contention a bigger credit and debit card issuer, and retail bank, and payment network, would threaten financial stability is risible. Credit cards and payments businesses have never caused a financial crisis in the US and no credible scenario under which they might have been posited.

Contrary to Warren's contention, the deal would reduce fees American families pay and increase card benefits they receive.

The US debit market has been shackled by interchange price controls since 2011, imposed by Senator Durbin's eponymous Durbin Amendment, which was part of the 2010 Dodd-Frank Act. Interchange fees fund issuer innovation, a slew of cardholder benefits and rewards, and free debit cards and retail banking. It's the principal revenue source for neobanks.

Additionally, from 2012 the Durbin Amendment required issuers to enable at least two networks on each debit card between which merchants or merchant processors on their behalf could choose to route transactions. Politically sympathetic banks with under USD 10 billion in assets are exempt from the debit-interchange price cap.

The Fed was tasked with implementing Congress's debit-interchange price controls and network-routing-choice mandate.

Congress stipulated that the debit-interchange price cap be reasonable and proportional to issuers' incremental processing costs. It was intended to be punitive. Because debit-issuer processing costs have declined roughly 50%, the Fed proposes reducing the debit-interchange cap by 28% from the ceiling established in 2011.

Today Capital One's Mastercard-branded debit cards are subject to the price cap and routing-choice mandate. By converting its debit portfolio to its own networks Discover and Pulse, Capital One will no longer 'route' debit transactions to independent debit networks. It will, therefore, be exempt from the Durbin Amendment - a boon for Capital One and its customers.

Capital One debit cards will earn interchange revenue roughly 300% higher than the Fed's proposed debit-interchange ceiling. That will give it a huge interchange-revenue advantage over retail-banking Goliaths like Bank of America, Chase, and Wells Fargo, which are shackled by niggardly price controls. Capital One will be able to offer consumers superior value - fee-free retail banking and compelling debit rewards. That's decidedly pro-consumer.

Thousands of community banks and credit unions also earn market debit-interchange fees. But lacking Capital One's enormous resources, reach, and marketing and product prowess, they've struggled to take share. However, a handful of community banks issue debit cards and share market interchange with partners with the reach, resources, and brands to win debit share. Rightly fearing the threat these programs pose, large banks unsuccessfully lobbied the Fed to deny them market interchange.

Capital One will also earn revenue from debit-network fees merchants pay, which will be paid to Discover and Pulse rather than to third-party debit networks like Mastercard and Visa. And, Capital One won’t pay issuer network fees on its debit cards to third-party debit networks.

So, with better economic fundamentals, Capital One will win retail banking and debit share, and millions of consumers will profit.

Capital One’s credit network opportunity will be tougher to realise.

Discover’s long been a weak number four in the US general-purpose credit card network, behind Visa, Mastercard, and American Express, and a very weak global payment network. Its credit card network will benefit from the portion of Capital One’s Mastercard and Visa credit card portfolio migrated to Discover. Bigger payment networks are stronger.

The proposed settlement of a longstanding merchant antitrust suit against Mastercard and Visa may also help a heftier Discover credit network. Mastercard and Visa have agreed to cut credit interchange by 7 basis points making them less attractive for issuers like BofA, Chase, Citi, US Bank, and Wells Fargo. This provides an opening for Discover to be added as the 4th credit card network by major US banks.

The challenge to strengthen the Discover network abroad is worth undertaking but daunting.

Critics worry the combination will be America's largest credit card issuer by outstandings and number three in purchase volume. Notwithstanding somewhat greater concentration, the US credit card market will remain fiercely competitive.

There are a mind-boggling 4 thousand credit card issuers in the US. With the top ten issuers accounting for 83% of loans in 2022, it's more concentrated than the debit card market, but nonetheless hypercompetitive. Critics' unexamined charge that the combination of Capital One and Discover could offer inferior credit cards and not lose share to mega-issuers like American Express, Chase, Citi, BofA, Wells Fargo, US Bank, and Barclays, and thousands of smaller issuers, is risible.

Of course, if you define a market narrowly enough, you can always conjure an antitrust problem. Critics of the deal further assert the combination will make the subprime credit card market even more concentrated and, therefore, would harm underserved consumers. Subprime credit cards would still be competitive. They could be more competitive.

Many critics are disingenuous since they relentlessly advocate making it more difficult and less attractive for the credit card industry to serve riskier consumers. The 2009 Card Act effectively capped credit card administrative fees at 25% of credit lines. The absolutist CFPB has proposed slashing credit card lates fees to USD 8, which would cost the industry USD 10 billion. Populist Senator Josh Hawley proposes capping credit card interest rates at 18%. Price controls slashing credit card revenue make it more difficult if not impossible, to serve riskier consumers. The crusade against credit card fees reduces access. Those who profess to want more subprime credit card competition should press to rollback credit card price controls making it more attractive for issuers to serve subprime consumers.

The financial services and payments industry as a matter of principle should oppose regulators blocking it. However, it’s likely some management at Mastercard, Visa, Bank of America, Chase, and Wells Fargo will shed crocodile tears if regulators block the deal because the combination of Capital One and Discover would be a more formidable competitor.

The Capital One/Discover combination would intensify debit, DDA, and payment-network competition. It would pressure payment networks and bank competitors to up their game. And, it would highlight that value creation and innovation migrate to less-regulated domains.

It might also force large banks and debit networks to put their political shoulders behind repealing the value-suffocating Durbin Amendment.

Most importantly, the combination of Capital One and Discover would deliver additional value to millions of consumers.

About Eric Grover

Eric Grover is the Principal at Intrepid Ventures, providing corporate development and strategy consulting to financial services, payment network, and processing businesses, principally in North America and Europe. He's a payment thought leader with a comprehensive understanding of the global payment network and processing space, including each stage in the payments value chain: credit, debit and prepay issuing, issuer processing, payment networks, and merchant acquiring and processing. His prior experience includes Visa International, GE Consumer Finance, BofA, NationsBank, Transamerica, and serving as a director on Nordstroms credit card A/R subsidiary’s board.