

Debit Legislation: Rethinking Retail Payments Strategy

BY JIM BRAMLETT, LEE KYRIACOU AND HANK ISRAEL

Banks already have been pushed into uncertain territory by recent federal regulation of checking overdraft and legislation on credit card fees. Now they face another major challenge and mandate for change from the “Durbin Amendment” to the recently enacted financial reform package, which complicates the picture for debit interchange fees, particularly for the more lucrative Signature Debit.

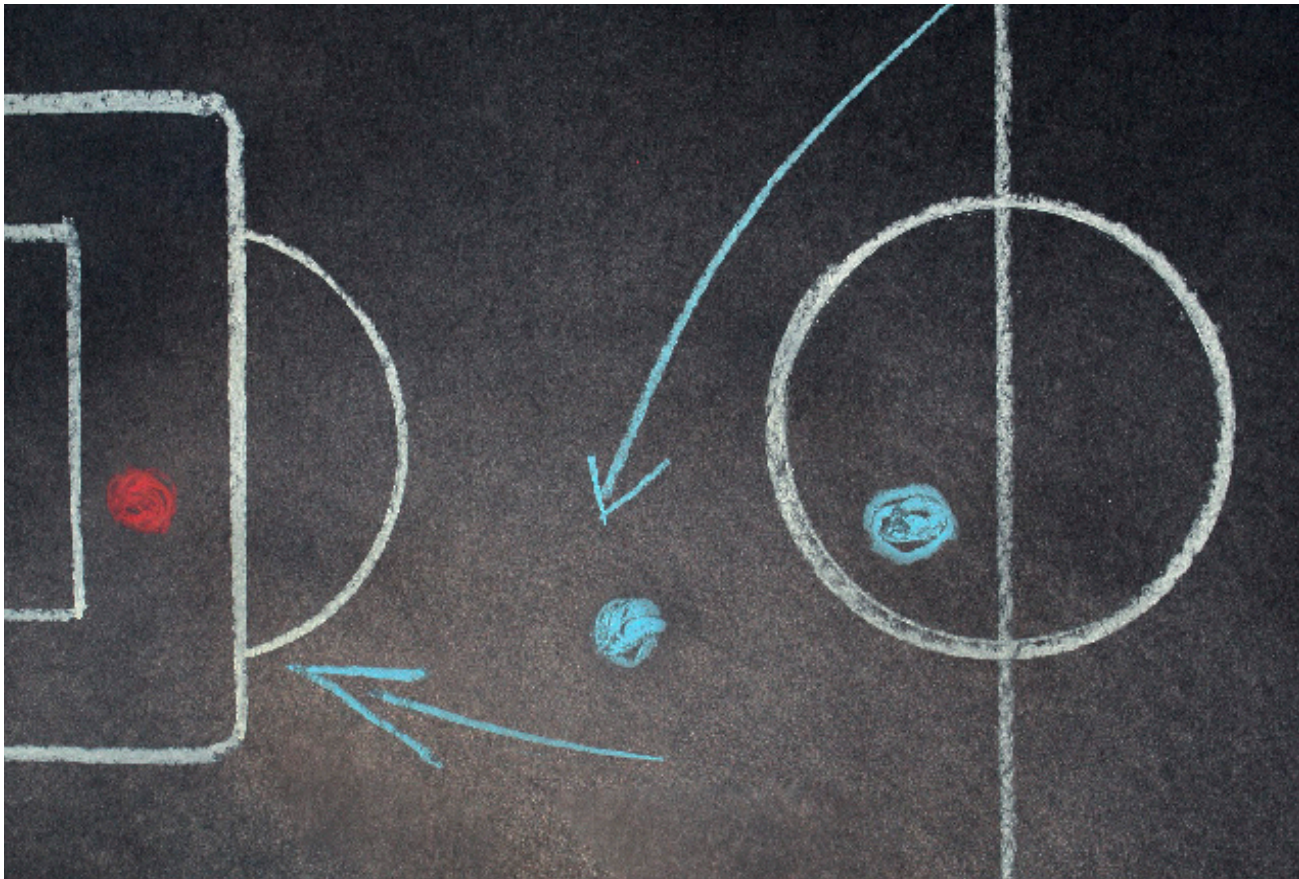
Even under the best-case scenario, we estimate that banks will suffer a roughly 35% curtailment in debit interchange fee revenues — a loss of roughly \$5 billion annually — under a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act that empowers the Federal Reserve to regulate debit interchange rates. And the damage could easily slip to the worst-case scenario, entailing a roughly 70% interchange reduction for a loss of roughly \$10 billion annually. This is on top of an estimated \$12 billion to \$20 billion annual shortfall stemming from new restrictions on checking overdraft fees.

Taken together, these two developments would seem to crush the checking industry, a bedrock line of business for banks. Yet banks stand to lose even more if they go into extreme defensive mode. In a tight market, a high priority is nurturing customer relationships, and a robust payments interaction is critical to this effort.

To re-establish the economic foundation of the checking business, there are three interrelated courses of action that retail banks should be working on now:

- The first is to create new configurations of payments accounts, adding features and niche services that will either lower the cost to serve or justify new categories of fees.
- The second is to explore alternative payments solutions, including new types of credit card plays; pre-paid account solutions; and mobile payment capabilities.
- The third is to flesh out the customer relationship dimension of checking strategy, including new types of conditional free checking offers; analytically based relationship pricing; recasting debit rewards programs; and exploring new hybrid product concepts.

Combined with new distribution arrangements that will help lower the cost to serve, these three avenues will help to usher banks into a healthy new era of checking and payments competition, with far less reliance on outsized fee revenues from a minority of customers. From that perspective, the erosion of debit interchange fees simply accelerates the



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course that banks should already be on today. In proceeding, however, it is critical to understand the new economics of debit and the role that merchants will play in shaping the market.

THE ROLE OF SIGNATURE DEBIT

Retail banks have grown increasingly reliant on the interchange revenues generated by debit card transactions. Total debit card interchange reached an estimated \$14 billion in 2009, more than six times the total from 10 years earlier, reflecting the ascendancy of debit into a major U.S. payments vehicle (Figure 1). This year debit transactions will account for roughly one-fifth of U.S. retail payments dollar volume.

Of particular significance is the fact that Signature Debit offers a higher interchange rate to issuing banks. In round numbers, banks earn \$1.50 on a Signature Debit transaction

worth \$100, compared with only 60¢ on PIN Debit. Signature Debit accounts for roughly 75%-80% of total debit interchange revenue for U.S. banks, further underscoring its recent economic importance. In turn, many banks have built their payments growth strategies around the higher Signature interchange rate, incentivizing cardholders to sign for a debit transaction even when a PIN terminal is available.

Merchants, on the other hand, have encouraged customers to enter their PIN numbers for debit transactions, eager to secure a PIN interchange rate that is 60% lower than for Signature. The financial reform law now introduces a significant tilt in the balance of power between merchants and banks, probably signaling an end to the era of Signature Debit as a major standalone revenue growth and profit engine for banks. Specifically, the amendment:

- Enables merchants to discount products and services

based on the type of payment media, effectively overriding contractual restrictions in merchant agreements that traditionally prohibited them from doing so.

- Empowers the Federal Reserve to set debit interchange rates on the basis of pass-along cost (with the potential to seriously undercut or even eliminate the banking profit margin). Rates will be based on the established cost of transaction authorization, clearing and settlement (This provision does not apply to credit and prepaid cards, and it excludes debit issuers with less than \$10 billion of assets).

These provisions will create a new competitive landscape for all players in retail payments. Retail banks will need an in-depth understanding of the new terrain to make their way in the post-Durbin market for checking and payments.

IMPLICATIONS FOR THE FED

The mandate to develop a universal pricing scheme for debit card issuers with more than \$10 billion in assets presents the Fed with several challenges:

Which costs? The legislation requires that debit interchange rates be based on “incremental” cost of authorization, clearing and settlement, and that it should exclude costs “which are not specific to a particular electronic debit transaction.”

Even with these requirements, the definition of cost should not overlook the many shared activities and expenses that increase in banks as debit card activity grows. This includes, for example, write-offs from fraud and charge-offs, and the operational costs associated with limiting them, as well as customer servicing costs related to transactional activity (e.g., transaction inquiries and dispute resolution via the phone and website, and in the branches). Debit represents roughly 50% of the monthly payment transaction volume related to the consumer checking account. In turn, an “assigned” debit interchange rate should reflect a similar proportion of the ongoing processing costs associated with providing checking services.

Whose costs? Historically, the interchange rate for a specific product and type of transaction has been the same for all banks participating in the network. But the unit cost of transactions varies across banks, based on institution-specific factors such as operational effectiveness, outsourcing policies and procure-

ment practices, and operating scale. A bank with 25 million debit cardholders has a huge efficiency advantage over a bank with 500,000 cardholders. Outsourcing of transaction processing to third parties only narrows the efficiency gap, moreover, and certainly does not eliminate it.

If the Fed sets a uniform interchange rate based on some version of “average” cost, it will introduce a competitive tilt. Larger, more efficient banks will realize a profit margin while smaller, less efficient banks will be unable to cover their costs. Given the artificial carve-out of banks with less than \$10 billion in assets, we estimate that banks between \$10 billion and \$40 billion in assets will be the most disadvantaged by uniform interchange rates.

Alternatively, interchange rates could be differentiated not just based on whether a bank is above or below the \$10 billion threshold, but also based on the individual cost profile of the bank. This approach would add enormous complexity to the interchange system, however, and would, in effect, reward banks that are less efficient.

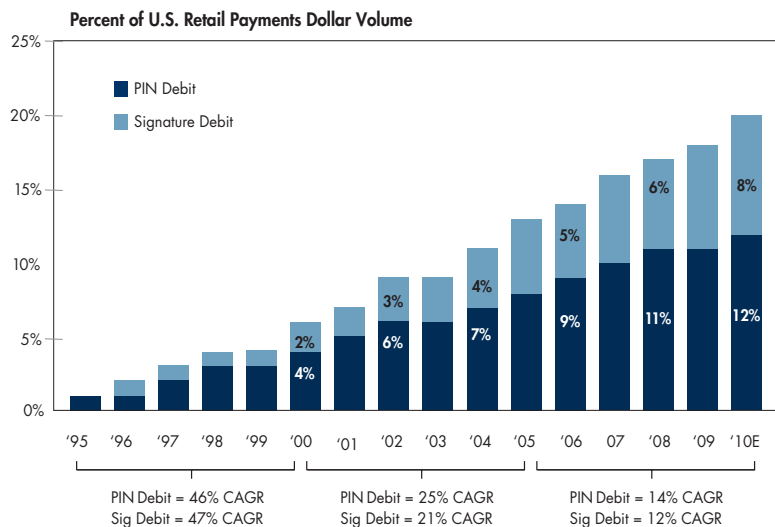
MERCHANT INFLUENCE AT THE POINT OF SALE

As merchants gain the ability to selectively discount payment methods, steering customers to lower-cost payment vehicles, they will face new choices and potential opportunities.

There is more than meets the eye in merchants’ newfound ability to discount by payment method. On the one hand,

Debit’s Growth to Payments Prominence (Fig. 1)

Debit accounts for one fifth of the dollar volume of U.S. retail payments, but recent legislation has clouded the picture for growth and interchange revenue.



Source: Novantas, LLC

“As the incentive to discount between PIN and Signature Debit disappears, merchant discounting would then morph into a merchant tool to move customers away from credit card payments, which continue to command the highest interchange rate.”

merchants can now elect to pass along to consumers the savings from lower-cost payment methods, including PIN Debit, cash, checks, and ACH/point-of-purchase transactions. And some will immediately seize upon this newly-sanctioned means for influencing customer payments. There is a definite overseas precedent, including in Australia and other markets where debit interchange rules have been modernized.

On the other hand, many other merchants likely will proceed quite cautiously in their experimentations with discount by type of payment media. After all, not all businesses have the same motivations or considerations to address.

Consider the local grocery stores, which likely already pay among the lowest interchange rates because of the lower ticket price and risk of their transactions. Modestly discounting PIN, say, by 0.25%, likely will be greeted by indifference from customers, whereas higher discounts may require a financial offset in the form of higher shelf prices that are uncompetitive. Similarly, discounting cash, check, and POP may lower direct transaction costs, but the net benefit is lowered by cash slippage and collection costs on returns.

Other broad categories of merchants, such as liquor stores and bars that pay relatively higher interchange rates, have a greater opportunity for discounting. But they also need payment authorization services, typically more firmly tied to Signature Debit, to reduce transaction risk (Try taking a check from a bar patron at midnight).

While it is easy to see how PIN (from a process point of view) would work at the liquor store, it is not clear how well it would work with current card payment terminals at the bar — currently authorization and settlement are tied together, and the tip would need to be handled separately. Moreover, the discount would need to be material to encourage significantly higher PIN debit usage among patrons.

Finally, the general incentives for merchants to offer discounts for preferred payment types will change over time. Once interchange rates are reduced under Fed guidelines, the cost of Signature Debit will certainly fall, and quite probably PIN Debit rates will fall as well. At that point, as the incentive to discount between PIN and Signature Debit disappears, merchant discounting would then morph into a merchant tool to move customers away from credit card payments, which continue to command the highest interchange rate (thus far untouched by new legislation or regulation).

The point is that within a rational merchant base, there will be great variations in the degree to which newfound discount abilities will prove feasible. Alert banks will take time to study the various categories of merchants to stay abreast of likely evolutions of discount structures as the debit interchange rate environment changes.

MERCHANT PAYMENTS STRATEGY

Large merchants and merchant groups will likely leverage the law to negotiate more favorable interchange rates with card associations as a trade-off to steering. For many merchants, this path will be easier and represents a larger potential savings, allowing them to save on transaction fees without necessarily passing along savings to the consumer.

If this negotiation approach advances, it will likely lead to significant pressure on credit card interchange rates — as opposed to merchants attempting to steer customer transactions with significant discounts for PIN debit.

In any case, the reduction of interchange rates will likely increase the pace of innovation in payment solutions for merchants, creating a large opportunity for merchant acquirers to support the development of new payment solutions. The successful players will likely provide more than just a lower cost of payments as they additionally focus on generating new categories of value to both merchants and consumers.

Payment options have long been used by merchants to build customer relationships and loyalty. But the disconnect has been that high interchange rates have been used to fund loyalty to card issuers and banks, rather than to the merchants who are footing the bill in the first place. In the new world, rather than making anonymous contributions to customer loyalty on behalf of banks, merchants could reinvest their savings in robust and consistent loyalty programs centered on purchases within their own brand families.

Loyalty cards pre-encoded with a customer's checking account number for ACH debits offer a simple example of such a program. A more ambitious version would harness such mechanisms to create a merchant coalition loyalty program. This arrangement potentially provides consumers with far greater relevance and value than any one merchant could offer, and it allows participating merchants to leverage brand equity across the coalition, cross-marketing to each others' loyal customer base.

Merchant acquirers can facilitate such programs by offering the right combination of data and access devices to support analytically driven rewards programs, and tailoring the content and complexity of the information offering to the size and sophistication of the participating merchants.

In this way, payments innovations can provide significant value to merchants with recurring, day-to-day transactions — grocery stores, pharmacies, etc. — well beyond the direct savings in cost. Indeed, even the major categories of merchants who historically have voiced vigorous objections to interchange rates that are forced upon them may turn around and voluntarily pay fees to participate in an effective customer loyalty program.

RETAIL BANKERS AND DEBIT ISSUERS

If there were clear losers in the debit card interchange legislation, that regrettable distinction goes to retail banks, especially those that built payments growth strategies around the higher interchange rate of Signature Debit.

Best-case scenario. If Signature Debit interchange merely falls to the current levels of PIN Debit as a percentage of purchase volume, the first order revenue impact will be an

industry-wide loss of roughly \$5 billion annually, or roughly 35% of total debit interchange revenue. From a larger perspective, this shortfall represents roughly 9% of estimated total 2009 checking account fee revenue.

Worst-case scenario. Most estimates of Fed-driven debit interchange reductions are considerably more aggressive, particularly if the cost of PIN Debit is also determined to be well below the current posted interchange rates. In that case, the total reduction in annual debit interchange revenue could easily double, cutting as deep as 70% — or as much as \$10 billion annually.

While the revenue impact of reduced interchange is not at the same magnitude as the recent restrictions on overdraft fees (\$12 billion to \$20 billion annually), the marginal impact will be even more acutely felt, hitting banks at a time when they already have seen up to 35% of annual checking fee revenues evaporate under Reg E.

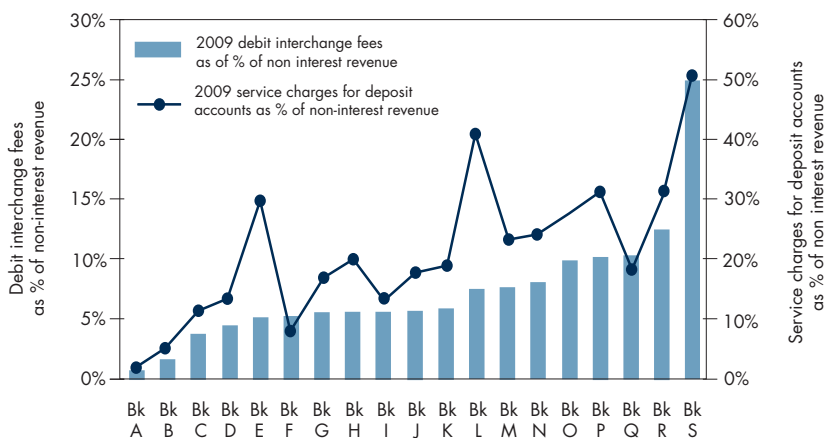
Indeed, the double-whammy on fees is concentrated with many of the same banks — i.e., banks that have the greatest exposure to debit interchange revenue also tend to be the ones most impacted by the recent regulation of overdraft fees (Figure 2). This in part reflects differences

in customer mix across banks, in that the impact of interchange reduction is often skewed toward many of the same customer segments most affected by the loss of overdraft revenues.

Even with the dramatic decline in checking account profitability, smart banks will be unwise to back away from developing active, engaged payments relationships with their customers. Payments activity is a core marker of an engaged payments “relationship,” and the evidence across multiple Novantas clients is that “relationship” customers will buy more, price-shop less, stay longer, and charge off less often than non-relationship customers. In turn, highly engaged checking customers rank significantly higher in lifetime relationship value. Obviously, maintaining payments relationships with core customers will remain a strategic pillar of retail banking.

A Double Whammy for Fee-Intensive Banks (Fig. 2)

Banks that rely on debit interchange fees tend to rely on checking overdraft fees, thus doubly exposed to the Durbin Amendment and Reg E.*



*Analysis of 19 major U.S. banks, based on payment volume data from The Nilson Report; interchange estimates from Novantas; and non-interest revenue data from bank call reports, as published by Highline Financial.

Source: Novantas, LLC

Post-Durbin Executive Agenda for Retail Banks (Fig. 3)

To thrive in what essentially will become a new market for checking and payments, winning retail bankers will aggressively pursue new payment priorities and craft new strategies to re-cast customer relationships.

New Payment Priorities

Prepaid Solutions as a more economical way to support payments-only relationships

Innovative Credit Card Plays integrated into the demand deposit account to recapture higher-spending customers

Merchant Partnerships to accelerate share shift from credit to debit

Relationship Strategies

New Checking Propositions such as “free-with” accounts

Relationship Pricing built on a solid analytical foundation

Hybrid Product Concepts such as the U.K.’s “offset accounts”

Recasting Debit Rewards by expanding programs beyond the debit card to relationship loyalty

Source: Novantas, LLC

generate the most interchange revenue. Rather, on top of Reg E, the impact of Durbin will be to further unmask the cross-subsidization of the many checking account-holders who do not generate enough revenue (through fees and/or spread) to cover their cost to serve.

Free checking in this traditional form as a standalone proposition is doomed. And yet, both research and experience show that customers will strongly resist fees for services they are accustomed to receiving for free.

Consequently, the erosion of interchange revenues will accelerate the course that banks should already be on today, seeking to create new configurations of payment accounts, adding features and niche services that will either lower the cost to serve or justify new classes of fees. The cost to provide each component feature of the checking account has to be carefully evaluated, and then features must be priced in a manner to encourage economically constructive account-holder behavior.

ALTERNATE PAYMENTS SOLUTIONS

Once the interchange incentive to promote Signature Debit evaporates, retail banks will become even more aggressive in their quest for new types of payments offerings that will meet the emerging needs of checking account clients (Figure 3). Not all of these will entail high-risk, breakthrough innovations.

Examples might include:

Aggressive credit card volume plays. The legislation oddly exempts credit cards from interchange legislation (at least for now). Large credit card issuers could therefore find an opportunity to make the credit card part of the transaction account proposition, to increase credit card volumes with their checking customers.

This could be done by integrating the two products into a single cash management solution, with integrated statements and online transactional information. For banks that feature a strong rewards platform for their credit cards, an integrated credit card/checking proposition could allow them to reclaim payments market share among affluent customers who have been lost to monoline card providers.

Prepaid account solutions. Prepaid accounts are also treated differently in the Dodd-Frank legislation (at least for now). Historically, prepaid accounts have often been narrowly viewed as a way to serve the “under-banked” segment. In fact, they could be repurposed and configured to provide a better, more cost-effective solution to a large segment of less profitable checking customers.

Mobile payment capabilities. The trend toward mobile payments is accelerating, with profound long-term implications for consumer payments strategy, and banks will want to be sure to stay abreast of that trend. But that is a wild and woolly world that will take time to sort itself out.

In the meantime, banks will want to seek simple, pragmatic solutions that solve basic customer needs. For example, the transition from checkbooks to debit cards left customers without the simple reassurance of always knowing the running balance in their check registers — contributing to mismanagement of their checking balances and/or growing stress and uncertainty.

Such lack of control compels customers to embrace throwback cash management solutions. For example, Novantas research shows a growing consumer practice of literally keeping hundreds — even thousands — of dollars in envelopes where nervous households can keep track of funds and curb the spending impulse.

That customers have to turn to such tricks in an informa-

tion-drenched world seems like a failure on the part of banks. As an example of an innovative response, simple, readily available communications technologies can turn the mobile phone into a real-time check register, fulfilling the information and control needs previously ignored in the evolution to electronic payments.

RELATIONSHIP STRATEGIES

Checking accounts will continue to be important as a relationship gateway product even when their standalone profitability evaporates. Relationship Value will provide a new lens for valuing debit card transactional activity, which in many cases will be greater than the direct revenue benefits of debit card interchange.

Targeted free checking. Banks that understand Customer Lifetime Value on a relationship basis will have a superior lens for setting the criteria for “free” checking accounts, and the insight needed to maximize Relationship Value beyond the checking account itself.

For example, the quest for checking portfolio profitability will lead the market to focus on checking propositions that are “free” to customers who meet specific conditions, offering the most attractive payment account terms to customers who drive profitable overall relationships.

Analytically-based relationship pricing. Historically, relationship pricing has been approached with good intentions and common sense — for example, a lower loan rate when the customer maintains a certain minimum savings balance. However, this approach often proves counterproductive when the lowest rates are offered to the least price sensitive customers, thereby forfeiting the full economic value of the customer relationship.

As the arms race for analytically driven, elasticity-based pricing strategies extends past individual products to take the full relationship into account, the next generation of Relationship Pricing strategies will require a full understanding of relationship impact.

Recasting of debit rewards programs. The debit card rewards programs that have proliferated in recent years have mostly been predicated on the higher interchange from Signature Debit. However, simply terminating such programs would be a mistake for deposit account providers. Rather, rewards programs must be quickly reconfigured to reflect the value of the entire relationship of the customer with the bank, including deposit and loan balances, high payment volumes and other profitable behaviors.

Hybrid product concepts. In place of stand-alone products that operate as independent accounts, banks will explore new

product concepts that tie the functionality of accounts across the relationship. Some may operate in a “lite” form, such as Bank of America’s Keep the Change program, stitching debit card transactional activity to savings accounts (although reduced interchange will surely alter the business case for this program, in particular the matching provisions).

“Strong” forms of hybrid product will also deserve new consideration. For example, offset mortgages — in which customers consolidate the balances of their mortgage, traditional current accounts, personal loans and their saving accounts into one account — are popular in the United Kingdom. Variants of such a concept, reflecting U.S. tax considerations, stand to offer a distinctive, relationship-consolidating proposition to customers who either already have significant savings, or who plan to save regularly.

LONG-TERM COST REDUCTION

While the triumvirate of account cross-subsidization flourished, most banks tolerated the high costs of gathering deposits. With two of those three now limited (and how far away are real interest rates for retail deposits?), banks will have to look extensively at the high fixed costs of deposit gathering, particularly with brick-and-mortar branches. Forward-thinking banks are already exploring new network models, for example, “thin networks” that provide a more cost-effective reach to selected segments.

The impending loss of debit interchange revenues offers a silver lining to the banks that move quickly and correctly in responding. While painful, it removes another of the unrealistic planks of deposit account revenue, and accelerates the demise of free checking. Those banks that restructure effectively around customer segments, desirable product bundles, smart pricing and rationalized cost structures will find new opportunities in retail consumer relationships.

Jim Bramlett is a Managing Director and Lee Kyriacou and Hank Israel are Directors in the New York office of Novantas, LLC, a management consultancy. Additional contributors are Gaurav Gupta, a Director in the New York office; Dale Johnson, a Principal in the Chicago office.