

Fed Rule on Debit Interchange: Partial Relief at Best



BY LEE KYRIACOU AND JIM BRAMLETT

In the quest to improve branch productivity, sustainable new arrangements can only be achieved through joint adaptations by banks and their customers.

In late June the Federal Reserve Board published a surprisingly favorable final rule on debit card interchange rates, compared with the draconian cap in its December proposal. But while this more moderate interpretation of the Durbin Amendment was gladly received in the banking industry, it would be a serious error for institutions to simply relax and return to business as usual.

Although the Fed's final "Regulation II" shaved an anticipated debit interchange revenue shortfall from more than \$10 billion to less than \$5 billion, the financial impact still is substantial. When it is combined with other regulatory changes affecting credit card charges and checking overdraft coverage, banks are still looking at more than a \$30 billion annual revenue loss in their payments business, exclusive of other factors such as tight margins. That figure could grow even higher with likely future regulation from the newly-formed Bureau of Consumer Financial Protection (CFPB).

Faced with a great revenue shortfall, banks need to step back and take a sober look at retail payments, a pivotal line of business including credit and debit cards, and the demand deposit account. Challenges include boosting volume and sifting the mix of consumer electronic payments; redefining products and business models; taking out infrastructure cost; and expanding core customer relationships.

Along with pursuing their individual competitive agendas, banks must collectively prepare for further challenges to their payments franchises. Emboldened merchants, for example, likely will lobby Congress to extend interchange caps to credit cards as well. Merchants have also gained new abilities to steer consumer payment choice with discounts, and to choose network routing as well, giving them increasing bargaining power with issuers and networks.

Banks also need to anticipate accelerating developments in technology, as well as strategic moves by the traditional card payment networks that are no longer owned by banks. They also must contend with the proliferating innovation by non-banks, which continue to forge new opportunities in payments even as banks struggle with the erosion of their accustomed revenue model.

LOOKING AHEAD

As institutions look to the future of debit, they must prepare for a world where their former flagship product, Signature Debit, no longer generates a superlative revenue stream. While PIN Debit probably will come into wider

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usage, that will not restore sagging debit economics, exerting even more pressure on banks to recast checking and retail payments.

PIN Dominates Signature. An average \$40 purchase previously generated Signature Debit about 60 cents of interchange revenue per transaction for issuing banks, or 150 basis points. After the Durbin cap, it will generate no more than 24 cents per transaction, or about 60 basis points, on a par with PIN Debit.

Without a higher interchange rate, Signature Debit has lost its luster for issuing banks, which are already backpedaling in promoting this product. We expect to see Signature Debit usage fade over the long term, ultimately limited to special uses such as online, small ticket and overseas transactions.

Meanwhile PIN Debit is poised to grow. The trend that saw every forms of debit growing at approximately 10% annually will shift, with PIN growth decreasing to the low teens at the expense of Signature’s drop to mid to high single digits.

One advantage of this shift is improved security. Banks will have a lower fraud risk with this form of debit; merchants have reduced fraud/chargeback exposure; and consumers have a stronger sense of protection.

In local markets, PIN pads will proliferate well beyond the counters of larger merchants. Online secure PIN solutions will take hold as well. The shift toward PIN Debit also sets the stage for the U.S. introduction of EMV, the global standard for authenticating credit and debit

card transactions. This arrangement combines integrated circuit cards, or “chip cards,” with PIN, for use at the merchant point of sale and at automated teller machines. EMV stands for Europay, MasterCard and Visa.

Higher Debit Growth. Compared with other options, the debit card will become an even more attractive and viable solution across a wider range of retail payments due to the Fed’s ruling. Interchange-conscious merchants now will see all debit cards (PIN or Signature) as being more than two-thirds less expensive than credit cards. And banks will still want to emphasize debit over other methods of accessing the consumer Demand Deposit Account, given that checking and ACH payments offer no direct transaction revenue.

In terms of consumer usage at the point of sale, debit cards will begin taking additional share from credit cards, ACH, checks and cash, raising the overall debit growth rate by two to three percentage points for several years.

Overall debit growth will include usage for low-value payments (current interchange doesn’t reach anywhere near the 24-cent cap); online payments (expect to see accelerated innovation in secure online PIN pads) and specialty areas such as health care, where debit can now compete on price with checks and ACH. Prepaid applications will continue growing, but as a niche business, and likely will not emerge as a broadly superior alternative to debit payments from a demand deposit account.

Debit Cost Reduction. Debit card

rewards programs were the first casualties even before the final Fed ruling, given that they add to bank costs and are not a major driver of customer preference for debit. Banks generally will continue to drop debit rewards. In other cases, rewards program will be broadened to include deposits, DDA activity and overall bank relationships. Fraud cost reduction will push banks toward PIN Debit. Banks will apply heavy pressure on payments networks to reduce their fees and they will look for opportunities to streamline their own internal infrastructure costs.

STRATEGIC CHALLENGE

The retail banking challenge extends far beyond the particulars of the post-Durbin debit card business. Instead of isolated plans for individual payment and deposit products, banks will need integrated strategies to reposition for the future. Deliberations regarding the future of debit should be folded into a larger context that includes:

Revenue Model. Previously, the main sources of bank retail payments revenue have been deposit spreads, penalty fees and interchange. As regulation drastically reduces penalties and transaction fees, banks must move to bifurcated retail DDA offers that are either deposit-based (higher balance minimums with higher yields) or payments-based (requiring high debit card usage and/or modest monthly fees).

Infrastructure Rationalization. Due to \$30 billion in regulatory hits, the current retail banking cost structure is unsupportable, especially if current low interest rates continue. Banks must

aggressively adopt new branch network models and accelerate customer migration to low-cost digital channels.

Relationship Banking. Unfocused customer acquisition strategies and single-product silos are also much less sustainable. Banks must redouble their focus on core customers and develop much deeper retail bank relationships based on their expected lifetime customer values. Product silos that have traditionally been scattered across alternative payment types must learn to collaborate to provide more integrated “cash management” solutions that provide customers with liquidity from both sides of the balance sheet.

Many consumers who have used debit cards to overdraw their retail accounts may have larger household cash management needs, such as standby financing arrangements for contingency expenses. Financing is also an important need for more affluent customers. They often turn elsewhere for their periodic liquidity needs, but banks can offer sweep accounts that tap idle deposit balances or lines of credit, possibly secured by home equity. Cash management is the foundation of “relationship banking” for both mass market and mass affluent customer segments.

Merchant-Friendly Innovation. Even in the face of revenue pressures, banks will need to keep up with proliferating innovation, much of it from non-banks, to maintain their core payments franchise.

For example, merchant-funded rewards programs will get a closer look. Although early ventures have not yet achieved market penetration, new approaches are being actively explored. Some will take advantage of new mobile commerce platforms linked to payments, where banks could forge partnerships with the

likes of Google or ISIS (the mobile payment network joint venture formed by AT&T, T-Mobile and Verizon), or with other entrants that have yet to show their hand.

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Another innovation is PayPal’s person-to-person (P2P) payments feature which they offer as part of an “electronic wallet.” P2P creates a superior value proposition for merchants who account for the majority of PayPal’s revenue. As PayPal has evolved beyond its niche in online auctions and is now poised to move to the physical point of sale, it is time for banks to respond — they can do far better.

Banks will need to elevate P2P payments to a priority and work to ensure its success. They must also recognize that merchant relationships are a strategic asset in this war, and extend those same payments to the point of sale, finding innovative new ways to work with merchants for mutual benefit.

Collaborative Action. In order to succeed with payments innovations that transcend traditional boundaries, banks need to strengthen the coordination of their internal organizational silos; collaborate among themselves to create meaningful network effects; and partner with unfamiliar non-bank players having different agendas and cultures.

Along with their individual

competitive agendas, banks must also address the collective industry challenges posed by new non-bank players and networks. Against these very powerful new entrants, even the largest banks will need to compete in tandem in specific areas of payments innovation. They will need to operate more holistically across more traditional lines of business. The situation will also require banks to be more proactive and unified in both advocacy as well as education in order to protect and promote industry interests.

MARKET CONTEXT

As banks regroup after this latest regulatory blow to checking and retail payments, it is critical to stay abreast of all of the constituencies in an evolving marketplace, including customers, merchants, regulators and non-bank players.

Perhaps understandably, bankers find it powerfully tempting to view the world through a thick internal lens, with products, activities and profits driving their deliberations. It is so very easy to drift off course with this mind-set in a fast-changing market, however, which is being reshaped primarily by external developments.

The primary motivation in debit is the merchant community, which was the driving force in persuading legislators to enact the Durbin Amendment. Merchants will continue pressing for regulatory action to address the far bigger annual bill they incur for credit card interchange fees, currently at about \$40 billion, or roughly 200 basis points of corresponding purchase value at the point of sale, among the highest in the world.

We expect merchants to begin pushing for legislation that will let them impose surcharges for the use of credit cards. This would be much



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more effective in steering consumers to debit cards than the newfound merchant ability to offer purchase discounts for debit usage (as permitted by the Durbin Amendment).

Such recommendations, which introduce “market” factors through price transparency, are more likely to gain a hearing with regulators who were ambivalent about legislation that required them to impose price controls. Other regulatory interventions such as these are expected as the provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act are implemented and the CFPB forms its agenda.

Just as importantly, banks should expect non-bank payments innovators

to continue bringing new technologies, new propositions, and new business models to market. As banks struggle with the erosion of their traditionally lucrative approach to retail payments, these new players continue to attract investment. While many will fail, others will adapt and discover new approaches. Banks can emulate the newcomers, partner with them, or neutralize their advantages, but they will not be able to ignore them.

During the last year since the passage of Dodd–Frank, the threat to debit interchange has caught the attention of bankers everywhere. However, the Fed’s implementation of the Durbin Amendment will not bring this chapter to a close. The

world of debit cards and consumer payments has been thrust into a period of rapid change that will continue for some time to come.

Now is the chance for leaders to frame the final results of Reg II appropriately, and get to work. There are strong possibilities for competitive tilting as alert banks more quickly adapt to a changed environment, compounding the revenue threat for players that attempt a return to business as usual.

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