The Durbin Amendment: Impact Analysis

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SPECIAL REPORT

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Abstract: The modern electronic payments industry has evolved in its complexity, value, and importance to consumers, financial institutions, merchants, and networks over the course of the past forty years. Electronic payment forms are a vital component of the financial services market and any steps taken to direct or control the systems under which these payment schemes operate should be approached with great care and consideration of the wide-ranging impact to a complex financial eco-system.

In view of the proposed Durbin Amendment, which attempts to apply a regulatory framework around debit card payment acceptance at the point of sale, Mercator Advisory Group has developed this analysis as a means of assessing the potential impact of this amendment on the electronic payments industry as well as proposing what we would consider to be reasonable next steps out of a topic mired in well-intentioned hyperbole.

SUMMARY

As an independent industry analyst firm covering this industry, Mercator Advisory Group believes that likely outcomes, should this amendment be enacted, include:

1. The cost of financial services will rise for consumers across a wide range of economic levels.

2. The largest issuers will have less of an incentive to promote debit related products and services and will either shift activities toward credit-based services or will cover their costs differently by fee-based approaches to debit accounts.

3. The smaller financial institutions, though exempt from portions of the amendment, are unlikely to escape undamaged. This is evident as wide government mandated pricing discrepancies between large players whose fees are price-controlled and smaller exempt issuers would be difficult to sustain from a network perspective. This problem is recognized in major public statements by smaller issuers expressing concern over the loss of their customers to those institutions mandated to charge artificially low rates. Examples of the concerns of smaller institutions include the following press releases: "Consumer choice imperiled by interchange amendment: CUNA/ICBA" (5/28/2010), and "NAFCU to CUs: Keep up interchange fight " (5/28/2010)

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4. State and federal agencies that have recently migrated public benefit payments from paper checks to prepaid card programs are growing increasingly alarmed at the impact this legislation would have on these programs and their ability to continue supporting them without additional funding sources.

5. Merchant benefits may not be as robust as anticipated. While direct debit interchange costs may be lower (depending on the current rates which vary widely), merchants may see a shift in consumer usage toward credit products, a decline in average ticket size as fewer cardholders opt for debit in an environment with lower promotional activities, or more transactions taking place in less efficient forms such as cash and paper checks.

In summary, it is our opinion that caution is warranted before any regulation of this type is enacted. It is evident by the numerous calls for additional consideration being made by state agencies, credit union advocacy groups, industry experts, and independent analysts that further study is warranted and justified. Once a thorough impact analysis is complete, both regulators and industry stakeholders can proceed together to create a more valuable and highly efficient system and to protect the U.S. financial services market from the unintended and costly risk present in this amendment.

DISCUSSION

The ramifications of the proposed amendment are not surprising given the faulty assumptions that form the foundation for the regulation. In the following section, we will identify the major assumptions contained in the Durbin Amendment and offer our analysis as to why these assumptions may be incorrect. We consider these assumptions to be problematic at the least and further, hold the potential for creating legislation which will permanently harm the U.S. payments market:

- The amendment falsely assumes that debit cards and checks are a functionally equivalent, or similar, payment scheme which implies that a common cost structure exists under which these forms of payment are processed.
- Proponents of the amendment incorrectly assert that small financial institutions are protected from harm.
- The amendment also appears to assume, contrary to prevailing evidence, that regulation of payment schemes operating in the U.S. economy will improve market conditions and benefit consumers.
- Proponents of the amendment incorrectly assume that imposing price controls would not have broad, sweeping unintended consequences for key stakeholders.
- The amendment incorrectly assumes that all debit card value chains are the same and so failed to identify that prepaid cards, which run under the debit scheme, will cost more for both government and low/moderate income (LMI) citizens.

Assumption: Debit cards and checks are essentially the same payment scheme…

Using the same premise, would one assume that the cost to produce a bicycle is the same as an automobile since they are both transportation? Or, the cost to build a cottage is the same as a mansion since they are both houses? This generalization is perhaps the most troublesome of the amendment, since it serves to lump together very different forms of payment schemes:

- Debit cards (signature): Designed to be used without requiring a personal PIN. These transactions are processed on the Visa, MasterCard, and Discover credit networks, where payment authorizations require a second process to settle, potentially leaving transactions pending for hours or even days.

- Debit cards (PIN): Designed to require that a personal PIN number be used in the authorization process. These transactions are processed on any number of Electronic Funds Transfer (EFT) systems, including Interlink (VISA), Star (First Data), NYCE (FIS), and Pulse (Discover) among others where the transaction is authorized and settled immediately (i.e., good money).
- Prepaid cards: Designed to access a pre-funded account typically held by a third party that uses a signature debit process for access to funds (see section following for a further discussion of prepaid cards).

Additionally, this amendment fails to identify if it intends to include small business debit cards, American Express or Discover prepaid cards, or electronic checks.

From consumer and merchant perspectives, a debit card and a check are two widely different payment forms and the December 2009 study published by the Federal Reserve Bank of Boston examining the trends in consumer payment preferences is illustrative of this fact. In this study, the consumers surveyed were asked about the most important characteristics of the payment methods available to them. In the table to the right, we show that these ratings indicate not only the value consumers place on debit cards vs. checks, but also the value that merchants gain from accepting debit cards.

Characteristic	**Debit Card**	**Check**
Very Easy to Use	48.4%	14.5%
Very Fast	34.6%	6.7%
Almost Always Accepted	47.9%	19.3%
Very Low Cost	33.2%	22.8%
Very High Control	23.0%	11.4%

Therefore, as a high-functioning form of payment, the benefits debit cards offer consumers and merchants far outstrip any benefits associated with checks (and even cash). The electronic payments and financial services industry (including issuers and merchants) have been continually investing in making these products more convenient, safer, and more desirable for decades. For example, debit cards provide consumers strong protections against liability when a card is lost or stolen (e.g., federal law and network “zero liability” policies), offer easy access to cash at ATMs and points of sale, provide accessible record-keeping and transaction efficiencies, and safety advantages over carrying significant sums of cash.

Debit cards offer merchants guaranteed payment, proven increased sales (i.e., “ticket lift”), lower labor costs (e.g., significantly reduced tender time at check out and deposit preparation time), as well as the reduction or elimination of bad check costs (e.g., fraud and costs associated with check verification and guarantee services). Additionally, debit cards enhance merchant’s capabilities to create comprehensive e-commerce and telephone sales and bill payment strategies. In sum, the function and benefits of debit card transactions for both consumers and merchants are far superior to those involving checks.

Assumption:… and implies a common cost structure exists under which theses forms of payment are processed.

Referring to the list of affected (and potentially affected) debit payment forms we outlined previously (signature, PIN, prepaid), the false assumption in this amendment is that all of these payment forms are equivalent in their functionality and value chain. Further, this premise also implies that a reasonable and customary cost structure can be determined across a wide variety of issuing and processing entities, including approximately 105 large issuers, 3 card networks, and 11 EFT networks notwithstanding the myriad number of debit card management systems and banking/credit union core processing systems.

Comparative studies of payment scheme economics have been undertaken in both the United States and other countries. For example, the Federal Reserve Bank of Chicago writes in their 2008 analysis of the economics of payments cards that, "To date, there is still little consensus—either among policymakers or economic theorists—on what constitutes an efficient fee structure for card-based payments."

Constricting the analysis of debit card interchange fees to cost components disregards the fact that the electronic payments market is an economy and as such, operates as a set of inter-related production and consumption activities. Therefore, changing one element will result in changing all elements, since it is unlikely to protect or isolate individual schemes or stakeholders in the modern electronic payment's market. Unintended consequences may result as participants in this economic fabric take actions driven by self interest.

Assumption: Small financial institutions are being protected from harm.

The ability to offer consumers debit card access to consumer demand deposit accounts (DDAs) has been a key competitive capability for community banks and credit unions. Debit card access has arguably been a significant success factor in motivating a broad economic range of consumers to establish checking account relationships, with over 9 out of 10 consumers holding a checking account in 2009. Debit cards have allowed community financial institutions to offer “big bank” global transaction services to their retail customers, without having to build large scale internal operations to enable the capability. Without this ability, community financial institutions would be hard pressed to compete for customers with the big banks.

By intention, the amendment attempts to limit the impact of interchange regulation by exempting the roughly 7,800 banks and 8,200 credit unions under $10 billion in total assets from interchange rates set by the Federal Reserve. This scenario contemplates a theoretical two-tier interchange regime, with the top 100 bank tier likely mandated to receive lower interchange from merchant transactions, and a second tier for community institutions which would possibly retain traditional and likely higher merchant interchange rates.

While the apparent desire to shield smaller institutions from reduced interchange revenues may be politically attractive, the actual outcome of this plan will be different than its intention.

- **Establishing and sustaining a two-tiered structure would be unlikely**. Under a two-tiered structure small institutions would charge market-based interchange fees while the larger banks responsible for approximately 80% of debit transactions would be limited to a much lower government-controlled rate. It is not clear why any of the large banks, which are essential to achieving the scale necessary for a nationwide or global network, would continue to sustain a system that provides such a dramatic advantage to thousands of its competitors. A potential outcome is that card networks find it necessary to implement a single interchange schedule based on the Federal Reserve’s ruling in order to best preserve the integrity and value proposition of their debit and credit systems.

- **Merchants would impose higher costs on consumers who pay with the more expensive cards issued by exempt banks and credit unions**. Under the amendment, merchants would be free to offer lower or reduced prices to consumers who pay using cards issued by large banks with set rates. Should the interchange differential between the two tiers be significant enough, merchants would have a strong motivation to "steer" consumers away from using their community bank or credit union cards. Large merchants have been very successful in incorporating technology into their point of sale systems to steer consumers to use sometimes cheaper PIN debit transactions instead of signature transactions based on card ("BIN") numbers today; such systems could easily be engineered to identify cards from more expensive small issuers and to prompt consumers to use some other tender type at the store checkout.
- **Merchants may decline more expensive cards from small issuers.** Enforcing card acceptance rules has met with very limited success. If it is tacitly assumed by the legislation that the card networks would be able to police their 4+ million merchant locations to enforce their existing "honor all cards" rules for debit cards and protect classes of issuers from discrimination, it should be noted that the networks have had limited success in enforcing existing merchant card acceptance rules such as those prohibiting minimum transaction sizes. Even absent the sophisticated steering technologies mentioned above, it would not be difficult for a merchant to broadly identify large national banks from small local ones, should they be so motivated – and the likely large cost differential between cards issued by large and small issuers could provide that motivation.

> *Through some combination of these dynamics, community financial institutions' debit interchange income would likely be reduced, along with that of large institutions.*

Debit interchange income has become a closely watched, reliable income source for community banks that has been relatively stable through varying economic cycles. Declines in this income would surely need to be replaced from other sources, such as account-based or debit transaction-based fees charged to checking account holders. For consumers at the margin, new fees could suppress their use of debit cards or even checking accounts.

Assumption: Expanding regulatory oversight into the multiple payment schemes operating in the U.S. economy will improve market conditions and benefit consumers.

Earlier discussions concerning card interchange have recognized the complexities in this marketplace and the difficulties of fee reduction in this marketplace. The GAO study issued in November of 2009, entitled “Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges” (GAO-10-45) found that each option considered for reducing interchange “presents challenges for implementation”.

The U.S. financial services market has created an electronic payments industry that offers proven benefits to each of its stakeholders. New innovations such as mobile banking and payment technologies, internet-based services, identity-verification services, merchant based loyalty solutions, and other areas require continued innovation and investment in network operations, risk management, and merchant and consumer education which necessitates funding across all of the industry’s operating entities.

The modern payments industry is in a period of key product development and innovation. Networks forced to operate under an at par pricing model face a much more difficult challenge in their ability to create and support innovative, optimized products.

Since innovation in electronic payments is occurring at an ever-increasing rate both in the United States and globally, maintaining the United States’ position as a global market leader requires that continual investments be made in new features, benefits, and functionality. The debit card market, including both consumers and merchants, has benefitted from these investments, made possible in part by the current interchange system.

Based on other at par pricing models in operation in the United States and other regions of the world, it is likely that the Federal Reserve may not consider all costs associated with the successful operation of a payment scheme. Therefore, many of the processes providing high value to the industry, including risk management, security, loyalty programs, product development, and user education will suffer from lack of available investment capital.

Assumption: All debit card value chains are the same, including prepaid cards.

The vast majority of government disbursement programs, including Social Security, Unemployment, and State and federal Payroll Programs, are operated by banks that have assets well over the ten billion dollar carve-out in the Durbin Amendment. These banks include CitiBank, Comerica, JPMorganChase, and US Bank, which combined represent greater than 85% of all government prepaid programs that in 2009 disbursed more than $24 billion in benefits onto prepaid cards.

While the government agencies and issuing financial institutions rarely publish any financials regarding the operations of these prepaid programs, Mercator Advisory Group estimates that the income shortfall these government programs will suffer would be $146.5 million. Our calculation is derived by estimating the total number and size of payment transactions created by the $24+ billion disbursement and then comparing existing interchange revenue to interchange revenue that would be derived from half the existing PIN Debit Rates – one potential outcome of the Durbin Amendment.

In view of the restrictive directives to the Federal Reserve in the amendment, the shortfall actually could be much greater. But should these state and federal agencies experience an income shortfall anything near $146.5 million, it would have a serious impact on state and federal budgets already constrained by lower tax income and higher operating costs. This suggests that these agencies would either ask for additional funding from Congress to cover the shortfall, be forced to add or increase cardholder fees associated with using the cards, or return to printing and mailing paper checks. It should be noted that if disbursements revert back to checks, Low/Moderate Income recipients will be driven back into the arms of check cashing agencies that charge fees for cashing checks and fees for paying bills – both of which are free services associated with prepaid cards.

The Low/Moderate Income consumers will also be paying much more to use General Purpose Reloadable (GPR) prepaid cards they purchase at retail outlets if the card networks decide not to implement multi-tiered interchange to support the carve-out offered in Senator Durbin's amendment. LMI consumers purchase these GPR products at retail in order to receive their wages via direct deposit programs (in some cases such as WalMart, these programs are essentially mandated). Prepaid cardholders also benefit since these cards enable consumers to securely pay bills, establish savings, and enjoy the benefits of loyalty points – all without the cost, risk of rejection, or the inconvenience of applying for an account at a bank.

Attempts to fix this problem by exempting these card programs are unlikely to succeed. As noted above, it is difficult to sustain a network where some participants charge market prices while essential competitors are subjected to price controls. Moreover, if government prepaid cards are more expensive for merchants than other cards, discrimination against those cards at point of sale of the type noted above is likely to occur.

> *Increasingly, financial institutions have begun to implement "checkless checking accounts" to address the needs of the LMI consumer, but should interchange be removed, these LMI solutions, along with general purpose reloadable prepaid cards, will no longer deliver a strong value proposition, since the interchange fees that fund the programs will be gone and fees will need to be collected from the cardholder to compensate.*

Assumption: Price controls can be imposed without broad sweeping unintended consequences for key stakeholders. It is unnecessary to consider the larger impact of such changes to dependent stakeholders in the payment systems value chain.

- **Merchants empowered to set minimum and maximum transaction amounts** may act to increase consumer usage of cash and checks for pay-now purchasing, which are less efficient and therefore more costly to process, or will lose sales to merchants who chose not to set minimums and maximums.
- **An overall decrease in electronic payments** may lead debit card issuers to increase the cost of their products to recoup an interchange income shortfall, motivating consumers to choose other forms of payment including cash and paper checks.
- **Smaller financial institutions may be faced with higher operating costs** should their customers' debit card usage decline. Any decline in transaction volumes or debit user accounts will drive small banks' debit operations costs higher per account and per transaction, again making it likely that consumer end-user fees will need to be increased to pay for operations.
- **Other prepaid programs that will likely be impacted** include payroll cards, which depend on float and interchange fees to offset costs. Due to various laws, both state and federal, payroll cardholders typically do not pay upfront fees on the cards and despite the fact ATM access is costly to the issuer, cardholders always get some ATM access for free.

- **Consumers will pay more for financial services** as operating capital is removed from the market. This impact has been documented in other countries where debit card interchange is regulated. In these countries, consumers pay periodic account fees, checking account fees, transaction fees, and do not have access to beneficial loyalty programs or more innovative, convenient, and efficient payment services since available investment capital is more limited. We would expect these benefits, along with access to low or no cost basic checking accounts, to be severely impacted if not disappear altogether in the United States.
- **Severely limiting debit income** may result in an increased emphasis on credit. While fees will appear on checking accounts and debit cards to compensate for lost revenue, interest on credit advances remain far more lucrative and will continue to fund free access to electronic payments, offer significant rewards programs, and deliver other incentives consumers find compelling. By reducing debit interchange, debit cards will become invisible compared to credit offerings, both from financial institutions and from less regulated start-ups.
- **Merchant acquirers and merchant processors who experience a drop in payment transaction activity** will pass higher unit costs back to merchants in the form of non-transactional fees and will also not benefit from the opportunity to more rapidly expand access to newer forms of electronic payment types.
- **Implementing these changes on a rapid schedule** will require large investments of capital and human resources which will negatively impact market expansion during a fragile economic recovery.
- **Constraining financial services entities** that currently operate under federal regulatory oversight will expose the market to more loosely regulated financial services entities.

MEASURE TWICE, CUT ONCE

This analysis was not written in an attempt to discuss the broader issues present in the industry which led to the creation of the Durbin Amendment, issues which should be discussed, reviewed, and considered with care before any legislation is presented to Congress. Rather, it has been written as our analysis of the potential impact this specific amendment could have on the industry as a whole, which we believe would be serious and far reaching.

Further, it is the opinion of the Mercator Advisory Group that while well-intentioned, the proposed Durbin Amendment would ultimately not serve to protect an industry that has built one of the most efficient and secure payment markets in the world. Recently, the Chicago Federal Reserve Board wrote:

"Based on a panel of 12 European countries during the period 1987–99, Humphrey et al. (2006) conclude that a complete switch from paper-based payments to electronic payments could generate a total cost benefit close to 1 percent of the 12 nations' aggregate GDP."

In a recent article examining the case for *ad valorem* debit card fees, the Kansas City Federal Reserve wrote:

"…allowing card networks to charge ad valorem fees may actually product better results for consumer surplus and social welfare. Findings such as these suggest that policy markets should consider intervening in the debit card markets with caution."

We believe this bill is structured as a systemic approach to address a negotiated business-to-business arrangement operating within a complex marketplace. Such activities should not be entered into lightly, and a full justification of both why government involvement is needed and the effectiveness of such involvement are warranted. The regulation appears to largely view debit payments as though they were a 'public utility', failing to recognize the substantial innovations and competition occurring in this area surrounding fraud and security needs, risk assessment, timely settlement, guaranteed payment, and other social benefits.

In sum, Mercator Advisory Group finds the potential risks associated with the Durbin Amendment far outweigh the benefits the amendment promises to deliver. As such, we urge significantly broader research be conducted into the effect it could have on the entire debit ecosystem prior to passage, in order to avoid a prolonged period of market instability resulting in additional disruption from the inevitable corrections that will need to made to it in the future.