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THE DURBIN AMENDMENT

A First Analysis of the Draft Rules

Abstract: The wait was over for thousands of observers who logged in to the Federal Reserve Board webcast on Thursday, December 16th where Chairman Bernanke and the rest of the Board listened to and questioned the Federal Reserve Bank staff's initial interpretation of the Durbin Amendment. At 163 pages long, it will take more than a few days to analyze these draft rules, but here's our first take on the potential market impact.

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Who Could Have Gessed?

The complexity of the modern electronic payments industry was on full display in Washington as the Federal Reserve Bank staff awkwardly attempted to explain to the Federal Reserve Board how they arrived at the draft rules for new section 920 of the Electronic Fund Transfer Act (EFTA Sec. 920). This group had the unenviable job doing what would be the equivalent of becoming an expert in an entirely new language in a few months. There's no Rosetta Stone for the payments industry and a glance through the meetings leading up to the rule-writing indicates the willingness of the Fed to consider a wide range of viewpoints. But, even a group of very smart individuals can only learn so much, so fast.

At the end of the day, the FRB relied on the letter of the law and made a narrow interpretation of a narrow statute with the result that a majority of debit card issuers are going to be operating their programs on a revenue model that has been slashed by 75% or even more. On the opposite end of the transaction, many merchants are going to see their operating costs improved; some dramatically. In between lays a confusing mix of market opportunities and competitive challenges, along with a long, long list of questions yet to be answered.

In this Viewpoint, we are going to separate the strategic and tactical as we try to initially unravel the draft rules in our attempt to make sense of the task ahead. Therefore, first we will discuss some of what we believe are the more important strategic implications of these rules and then offer some organization around the startlingly long list of rules, approaches, terms, and definitions on which the FRB has asked for commentary.

Strategic Implications

Impact to Retail Banking Fee Structures

Perhaps the biggest shock from last week is the fact that the FRB has established both a maximum debit card transaction interchange fee and set the fee at a level somewhere between \$0.07 and \$0.12 per transaction regardless of authorization type. Putting aside the extreme fee reduction, the fact that both signature and PIN debit transactions will be indistinguishable to issuers from a revenue opportunity, and the sharp difference in fraud between these two debit forms indicated by the Fed's survey analysis, may mark the beginning of the United States migration to a PIN-only debit market. Since signature debit transactions are the venue of Visa and MasterCard, we may see an even more aggressive push by these networks to capture issuer debit processing and portfolio servicing volume through their Visa DPS and MasterCard IPS businesses as a means of protecting their issuer base and mitigating potential network fee loss.

As one can see, this economic shift cannot be looked at in a vacuum, but has to be placed within the context of the entire range of changes taking place within the financial institution industry. For example, there was already an expectation that debit card interchange fees were going to be impacted in some material way and many of the largest issuers were introducing new checking account fee structures in response to the anticipated change, notwithstanding the earlier modifications to overdraft fee regulations. What was not known, until last week, was

the extent to which the FRB was going to ensure that issuers exempt from these regulations (those with assets under \$10B) would be protected within the construct of the final legislative rules.

Now we know that it will be up to the card networks to determine how, or even if, they are able to “exempt” this issuer segment, which is further complicated by the fact that these same networks don’t yet know which interchange fee structure is going to be put into place. The result of all this uncertainty is that the retail banking industry will likely transition much more quickly across a broader financial institution base towards a for-fee checking account business model. In a variety of instances throughout the draft rules, the FRB writes that financial institutions have other avenues to recoup expenses through account-based fees as they defend their interpretation of what constitutes the cost of authorizing, processing, and settling an (i.e., a single) electronic debit transaction. The implication is clear that a cost shift is going to take place from merchants to consumers.

This extreme interchange revenue cut will most certainly give some issuers pause to consider their internal economics, and we may also see a strong shift to outsourcing more processing and portfolio servicing as issuers search for means of maintaining their product equilibrium in the market. We are not of the opinion that there will be a wholesale flight out of the debit card issuing market, but rather that the industry will reform itself around co-processing, outsourcing, and cost-shifting strategies for the near future.

Any kind of issuer-funded debit rewards program has to be highly suspect under the proposed revenue model. Some issuers will be able to reformulate their programs around broader relationship services beyond the DDA, others will turn to more merchant-funded relationships, and some will simply sunset their existing debit reward programs (as Chase announced in November). We would look to cash back-based programs to take the most immediate hit, as these are generally the most expensive programs to operate, but issuers will be hard-pressed to explain this to consumers, as they are also the most popular programs.

Impact to Network Relationships: Issuer

The other main component of the Durbin Amendment has to do with network relationships, specifically issuer network participation and merchant routing rules. Putting aside the fact that under the proposed rules, there would be no economic differentiation between a signature and PIN network, the industry is being asked to comment on two alternative proposals:

1. **Two Unaffiliated Networks** – A debit card must operate on two unaffiliated networks without consideration of the authorization method chosen by the cardholder (i.e., one network for signature, one for PIN).
2. **Two Unaffiliated Networks by Authorization Method** – A debit card must operate on two unaffiliated networks for each authorization method (i.e., two networks for signature, two for PIN).

At a minimum then, debit card issuers who are in exclusive, one-brand relationships will be changing one of their affiliations since this component of the amendment has no exemptions. Networks have been both discrete and bold in their market strategies to date, but this should help them take the gloves off and begin to compete in earnest for issuers.

However, since interchange fees will be flattened, they will have to compete on value, and those networks that have made investments in infrastructure to support more flexible programs (including such things as managed MFDN rewards), better reporting, fraud control, and operating efficiencies should be able to quickly take a more leveraged position. At the end of the day however, there will be great pressure on networks to control their non-interchange fee structures. In addition, the FRB has also asked if network fees should be considered one of the cost components included in an interchange fee standard calculation, however, it would appear unlikely that these fees would be included if for no other reason than they would fly in the face of the intention of the amendment by asking merchants to pay the cost of issuer network fees and their own network fees for each transaction.

This downward pressure on cost will also funnel into debit processing markets, affecting such organizations as FIS, Jack Henry, Fiserv, First Data, Visa DPS, and MasterCard IPS, all of whom will be called upon by their issuers to keep costs down and services up. In addition, processors will now be required to be certified on more than one network or on a wider range of networks as issuers are required to seek out new partners. Scale will become even more important in this new market landscape which may drive additional M&A activity. However, scale and operational efficiencies are not sustainable growth strategies, which will have to come from a combination of more deeply penetrated electronic payments and innovative new payment schemes.

Impact to Network Relationships: Acquirer

Acquirers who service the small end of the merchant market, those that operate under bundled discount programs, could end up with an interesting set of problems to solve. Depending on how the interchange structure is defined, they may be faced with making significant changes to their systems in order to accommodate issuer-level fee calculations. On the other hand, they will also find themselves with an increase in capital that may or may not be passed on to their processing clients.

Merchants have won the right to route debit transactions to the least cost network, but in the same way that only the largest merchants will definitely benefit from lower interchange fees, only the largest merchants will accrue benefits from this rule as well. Acquirers who do not offer flexibility around network routing and operate under default or preferred network relationships (for smaller merchants) will also have to consider the benefits of multiple relationships that enable least cost routing under the new regulations.

The largest merchants, who own their own processing, are the ones that stand to win the most from this legislation – placing small merchants at a further cost disadvantage. These are the companies that can establish direct relationships with networks and for a time, will most certainly leverage this into the most favorable contractual terms they're able to negotiate. This new leverage and the sharp reduction in cost of debit payments

will offer a windfall to some merchants and it will be interesting to track their capital investments and margin structures versus their consumer-facing discount strategies as these new regulations begin to take effect.

Therefore, the network industry in the United States is preparing for an extremely challenging business problem which puts them between issuers and acquirers/merchants, both of which are focused on cost reduction, increased services, and better overall terms.

Impact to Product Portfolios

Included in these rules is also the determination of what constitutes a regulated debit card account. In this definition are business debit cards and any prepaid card program that utilizes individual accounts. At a time in the market when small business debit card programs were just starting to gain momentum, this inclusion may impact investment plans for the foreseeable future. One must remember that debit cards are still more efficient to process than checks, but minimal revenue streams should serve to commoditize the small business debit market. We would expect that issuers, who are able, will instead turn their attention to small business credit programs, perhaps offering straight revolving cards or charge cards in place of debit cards.

The real bright spot from a payment product perspective may very well be GPR (general purpose reloadable) cards. Exempted from interchange fee regulation, this product segment should realize a boost coming from two main delivery channels: traditional financial institutions that can rationalize these products as a more efficient means of serving less profitable customers and non-traditional financial services companies, or solution providers that will capture consumers who voluntarily or otherwise, exit traditional banking relationships.

These rules do have a potentially very wet blanket to throw over the festivities however, and that is the network routing rules. As written, these rules appear to fail to offer prepaid cards any exemptions from the network exclusivity and routing restrictions, except those prepaid products that implement selective authorization (Mercator terms these Restricted Authorization Networks) to restrict usage to a single merchant or a few participating merchants, as long as these cards do not display a network bug.

As a result, as currently written, it would seem that all network branded gift cards and general purpose prepaid products must comply with whichever network exclusivity and routing restriction proposal (as identified above) is adopted. The market for network branded gift cards would certainly be significantly impacted by a requirement to add a PIN network to the card that enables ATM access to funds – which by one interpretation of the rules is required under both proposed alternatives.

The Prepaid Financial Services segment would also experience increased costs if required to add more networks to existing products, however these costs can be offset by increasing fees paid by the consumers and since these costs would be incurred by all suppliers, the competitive playing field would remain neutral.

Impact to Three Party/Alternative Networks

The current draft rules are calling for a wide range of commentary around three party and alternative networks. The FRB is not certain whether to include or not include these entities in the legislation including:

- Decoupled debit cards – other than to say that the financial institution issuing these cards would be the regulated entity, not the brand issuer.
- Deferred debit or credit-lite cards – including hybrid accounts and accounts where transactions are only debited once a month.
- Three Party Networks – such as American Express and Discover.
- Alternative Networks – such as PayPal, which also leaves open the question of networks such as Bling, Cimbale, Dwolla, Isis or any number of other recent market entrants.

Further, this inquiry drives the question around what constitutes a payment network, which is also addressed in the draft rules in the form of commentary requested by the FRB as to how to differentiate between these networks for regulatory purposes. As written the FRB appears inclined to include any mobile device that is used to access funds in an account, regardless of network affiliation – including no network affiliation. It is unclear how this would impact the growth of new mobile payments networks that would presumably need to support the same network exclusivity and routing restrictions – which seems impossible when they are the first to execute such a network.

The alternative payment network market in the U.S. may find itself in an oddly inverted position once the rules that impact them are defined. If it turns out they are a regulated network, then some will collapse under the weight of their much higher operational cost structure and lack of scale. Larger organizations will now have to compete squarely on value alongside their legacy cousins and have less revenue to draw from. If they are not regulated, those with strong revenue sharing models for issuers should find a bigger welcome mat laid out for them, but merchants may shy away in favor of very low cost debit transactions – especially if the industry can crack open the online debit market. And of course, until the Fed defines exactly what a regulated payment network is, there's no telling which alternative solutions will be impacted other than to say that it appears the Fed has excluded "pure" ACH transactions from the definition of a debit card. This exclusion would seem to protect payment schemes such as Secure Vault Payment, NOCA, or Moneta, but does not protect payment schemes dependent on ACH to settle transactions, like PayPal and Bling.

Fraud Rules

Noticeably absent in our commentary here and in the draft rules is any clarity around how to incorporate some kind of fraud standard into interchange fee regulations. Clearly the FRB realized that this is perhaps the most complicated issue of all and as a result, there are pages of questions around how best to address this component of the Durbin Amendment. For purposes of this Viewpoint, we will also leave fraud to this side and address that issue in more depth in later documents.

Commentary Requested

As we indicated throughout this Viewpoint, the FRB has left many questions unanswered in their quest to provide the industry with initial guidance around these topics before the end of the year. Whether another few weeks would have made a difference or not is now irrelevant and the commentary they've requested throughout the draft rules will serve to inform them as they consider their final rule-making. Organizations have until February 22, 2011 to deliver their comments. Here are the main questions under consideration:

- Interchange fees set by issuer using a combination safe harbor/cap structure.
- Interchange fees set for all issuers using a cap structure only.
 - a. Is there another interchange fee structure they should consider?
 - b. The FRB has established a fee structure based on the average cost of one transaction; could an alternative structure exist where the fee is calculated against an average of either all issuers transactions or all transaction activity within a network?
 - i. If so, what would be the permissible amount of fee variation between issuers or transactions?
 - ii. Should there be both a safe harbor and a cap?
 - iii. Should this vary by authorization type?
 - c. Should there be different interchange fee standards for debit cards and prepaid cards?
- Is it necessary for issuers to report interchange fee revenue to networks in order to set issuer-specific interchange fees?

- a. Does the FRB need to include a rule to specify the data reporting that is required?
 - b. The FRB has defined March 31 as a the date for the issuers to report their data to the networks – is this a good date for that reporting to occur?
- Allow for two unaffiliated networks (at card level)
 - Allow for two unaffiliated networks (at authorization type level)
 - Is an ATM card a debit card, and are ATM networks payment networks?
 - What is the definition of a payment network and which, if any of these networks should be included?
 - a. Three party networks (where network acts as issuer and acquirer)
 - b. Alternative payment networks
 - c. ATM networks
 - How are the following card types defined, as regulated debit card or non-regulated debit card?
 - a. Decoupled debit
 - b. Deferred debit
 - c. Credit-lite (hybrid)
 - d. Unaffiliated, non-network branded GPR cards (i.e., mall cards)
 - What are the circumstances where an agent of issuers should be considered the issuer?
 - What are allowable costs?
 - a. Which costs other than authorization, clearing, and settlement?
 - b. Network fees
 - c. Should they allow only authorization costs since this is the only cost element unique to debit cards as compared to checks?
 - d. Any fixed costs

- e. Costs limited to marginal costs and if so, how are marginal costs measured?
 - f. What are the correct criteria for determining what constitutes an allowable cost?
 - g. Does the FRB need to better clarify allowable costs?
- Commentary has been asked on all terms and definitions included in the draft rules as well as if there are any additional questions the FRB should be asking that they have not included.

One can only consider that not every interested party will address each of these questions teed up for commentary by the FRB. However, this list is the strongest indicator of just how difficult a task this analysis has been for the Fed. The length of the commentary period – a full 68 calendar days – also signals their willingness, perhaps even eagerness, to be educated by the expected avalanche of opinions they will be looking at and listening to in the weeks to come.

Finally, what becomes of existing contractual relationships that extend beyond any implementation dates defined by the FRB? Do these contracts become null and void or will there be an allowable transition period built into the new rules? All questions for the legal analyst community to answer.

Enough for Now

As events unfold and we are able to take a more focused and measured view of the proposed legislation, we will be issuing additional Viewpoints on this topic that will be more product and industry-focused. We believe that this analysis supports our previous views that the danger in the Durbin Amendment was that the original, traditional debit card industry would be commoditized, and that the retail banking business model in the United States would be forever changed. Unfortunately, this appears to be the case.

It is certainly possible that merchants will pass some savings onto consumers in the form of targeted discounts, and it is most likely that they will attempt to steer consumers towards debit as their very lowest cost form of payment. As we've indicated in previous work, alternative debit networks will have to compete on value unless they themselves come under the regulators thumb, and it is now apparent that they will be competing against very low cost debit options. The uncertainty around that issue alone may serve to delay investments in alternative networks at least until the final rules that address the definition of a regulated payment network are issued.

Merchants are pleased with the outcome, but not all merchants will benefit, and with new power comes new challenges. Merchant POS systems are not changed at will, issuer-level interchange is still a real possibility, and consumers may clamor for some benefit from the battle won on their backs.

In one of our earliest pieces on the Durbin Amendment, we wrote about merchants “punching a hole in the universe”. Now that the Federal Reserve has stepped through it, the hard work has begun.



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