

# REVENUE CREATION AND COST RECOVERY POST DURBIN: THE PATH FORWARD FOR RETAIL BANKING

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## Where Investment and Innovation will be in the 'Post' Durbin Environment

In the past, U.S. market retail banking investment has been primarily focused on the revenue-generating side of the equation (e.g., rewards platforms and programs). However, due to the impact of the Durbin Amendment, future retail banking investments will be significantly more difficult to fund and primarily driven by three objectives:

1. Improve operational efficiency
2. Shift to an enterprise-wide view of consumer relationships and away from individual product silo analysis
3. Realize incremental fee revenue and build deposits through segmented offerings of products and services currently in the marketplace

These assumptions are based on a combination of MasterCard Advisors' U.S. market insight, experience in low-interchange markets across the globe, and analysis of ongoing issuer responses to regulatory shifts.

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## INTRODUCTION

The implementation of the Durbin Amendment will generate substantial change in the way retail banks regard their demand deposit account (DDA) and debit card businesses.

The amendment imposes a cap on debit card interchange, "composed of a base component of 21 cents and an *ad valorem* component of five basis points to reflect a portion of fraud losses."<sup>1</sup> There is little disagreement that the Durbin Amendment will have a significant negative impact on the financial performance of retail banks. At the end of the process it is estimated that banks will realize a deficit of \$22 billion in fee revenues over the next two years.<sup>2</sup> It is also estimated that, as a result of the cap on interchange, approximately 5% of current bank customers will be "pushed out" into the use of check-cashing stores and other nonbank financial services.<sup>3</sup> The loss is compounded by the impacts to revenue that many banks face with the implementation of the Reg E changes relating to overdrafts.<sup>4</sup>

ABSTRACT

**Prior to the Durbin Amendment, banks funded the majority of rewards programs from interchange fees. These fees came to about \$3.7 million per 100,000 rewards card users annually, according to Aite Group.**

For issuers in the U.S. to remain competitive despite this series of regulatory challenges, they must continue to invest and foster evolution in their products and service strategies. As observed in other low-interchange markets, despite the lack of a compelling standalone business case, issuers have still found a role for debit in the overall payments mix of the transaction account, disregarding the isolated financial impact of debit products. This paper will explore where banks will make those investments, including the strategies and tactics that are available to them to offset the revenue loss.

The way banks manage their P&L may be changed forever as the Durbin Amendment drives banks to shift focus from primarily being on the revenue side to a more balanced approach encompassing both revenue and cost. MasterCard's view is that this change in focus represents an opportunity not only to ensure bottom-line results, but also to deliver better customer experience and value, leading to greater customer loyalty. In other words, Durbin will force debit issuers to redefine and refocus their efforts as they work to maximize efficiency and gain an enterprise-level understanding of customers and relationships in order to survive.

#### • REACTIONS TO THE DURBIN AMENDMENT ARE WELL UNDER WAY

Many banks initiated their responses to Durbin as soon as, and in some cases even prior to, the release of the Fed proposal in December 2010.<sup>5</sup> These responses were geared toward recouping the anticipated significant revenue loss. Clearly, IT and operational structures not designed for rapid change are part of the reason for these lead times, but regulatory disclosure rules and, most importantly, effective management of customer relationships also play a significant role. The time required to make significant changes was recently evidenced with the implementation of the Reg E requirements. Although they went into effect in July 2010, MasterCard Advisors analysis indicates that banks were still responding to the impact of their implementation during the first quarter of this year.

Besides increases in core banking fees and the introduction of charges for previously free services, such as debit cards and DDAs, there has been a severe curtailing of debit rewards programs, with a number of issuers reducing or eliminating debit rewards altogether.<sup>6</sup>

#### • INVESTMENT IN THE RETAIL BANKING SPACE WILL SHIFT DRAMATICALLY IN FOCUS

Advisors' view is that, despite the enormous difficulties, banks will continue to invest in payments in an effort to compete for deposits, the core of any retail bank business. While these efforts will be significantly more challenging in the face of new regulation, banks will eventually find that they need ways to differentiate themselves from competitors. Although there may indeed be significant long-term change to products, operating rules, and procedures (PIN-only cards, daily or dollar amount transaction caps) on a wholesale basis,

banks will likely adopt the middle-ground position once they understand the negative impact these draconian responses have on consumers' larger banking relationships (e.g., account attrition).

The middle ground can be achieved through segmentation. Rather than allowing retail financial services to stagnate, banks can use solutions that exist in the market to deliver value for customers. Retail banks will have to target payments solutions delivery and value provision efforts to tightly defined customer segments, while working to mitigate risk more selectively. There is no one-size-fits-all approach. Relationship management and segmentation immediately enable an effective move to a retail bank profitability view, looking at the whole payments wallet, rather than product silos, as the engine for revenue and income.

Banks will have to work to retain disappointed customers who have just seen the cost of their accounts rise while paradoxically noting service erosion. At the same time, the strict regulatory environment will promote fierce competition and slimmer margins, forcing banks to streamline their operational processes in order to be more efficient and competitive, and to differentiate in order to survive and grow share. This progression has been observed in a number of other markets in which providers already operate in a low-interchange environment. For example, in Australia, "free checking" is becoming the norm following adoption by National Australia Bank in 2009<sup>7</sup>; *PayPass* technology is also gaining traction, even in the debit space, as banks compete to gain share.<sup>8</sup>

In many international markets where there is little or no interchange, banks have redoubled efforts to drive profitability through targeted marketing in specific opportunity pools. One particular example is the management and promotion of cross-border transactions (both card present and card not present). These efforts can drive revenue and also reduce associated levels of fraud, which will prove critical as the world continually becomes more of a borderless marketplace.

- **PROCESS EFFICIENCY WILL BE MANDATED BY THE NEW REGULATION**

Banks have historically focused on creating additional revenue drivers with the confidence that the cost of payment processing would be covered by interchange revenue. This focus is not sustainable in the coming regulatory environment, which introduces a minimum hurdle of efficiency (or a maximum marginal cost) that banks must meet in order to gain any profit or even break even on incremental transactions.

The Durbin Amendment is effectively compelling financial institutions to adopt a holistic approach aimed at understanding the bottom-line value of every transaction and finding ways to maximize profitability. Operational efficiency will be driven by a reduction in costs across all processes involved in managing a debit portfolio: from customer service to policies, from fraud management to chargeback management and authorizations improvement.

Movement to industry standard technology and practices, streamlined fraud strategies, improved fraud operational efficiency, improved authorization results, and decreased levels of customer impact can be the expected result if properly implemented. To achieve this while minimizing customer impact, a highly segmented customer approach to policies and procedures across the debit card business will be required.

Fraud, for instance, must be addressed from both a strategic and a tactical level throughout the entire fraud lifecycle, using an optimal construct of technology, people, policy, and process associated with portfolio profitability. Banks must undertake a delicate balancing act of assessing the costs and benefits of fraud reduction in the context of satisfying customers, increasing approvals, and improving share of wallet.

Chargebacks will require debit issuers to have a tighter handle on the holistic chargeback processing costs for the various transaction types in exchange for making sounder low-dollar write-off decisions. Banks may look at bundling certain merchant category codes with the same chargeback reason code in an effort to generate processing cost savings. For example, in Canada, a savings of \$21.28 on average per transaction was realized.<sup>9</sup>

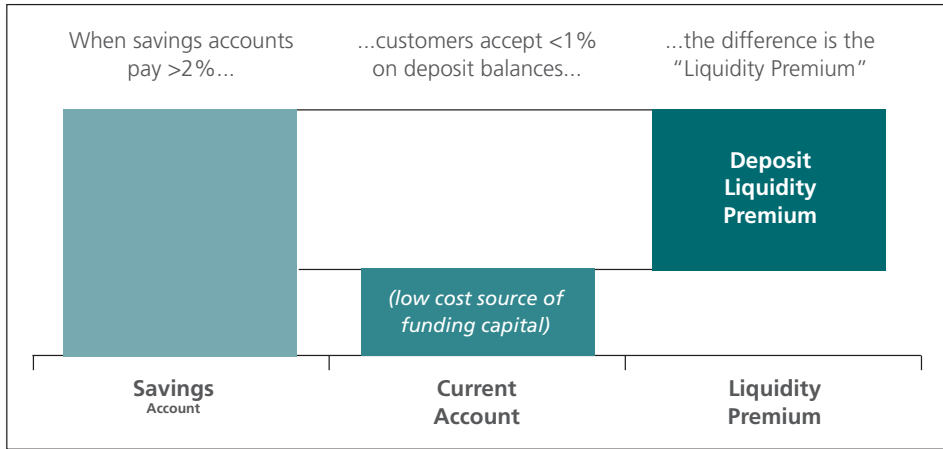
- **PRODUCT EVOLUTION WILL MOVE FORWARD AT THE ENTERPRISE LEVEL**

Enormous additional pressure in the debit space will require banks to move to an enterprise-wide payments view aimed at integrating debit within the payments mix of the DDA, and DDA payments within the context of the consumer's overall wallet. The move will enable banks to better justify and understand the impact of a given investment, while capturing a greater share of the customer's wallet.

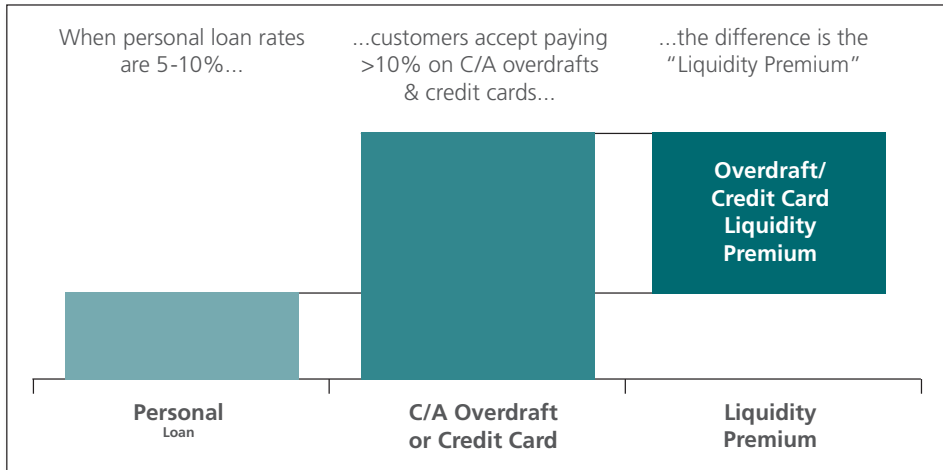
Banks that actively manage payments behavior across all market segments to optimize customer and enterprise profitability will be positioned to enjoy superior returns and market valuations over the credit cycle. The difference between what banks pay to hold deposits and the premium consumers are willing to pay for security and liquidity comprises a major portion of bank revenue generation. The value proposition banks present consumers is precisely the banks' ability to combine payments functionality with their deposit and lending services. This value, the liquidity premium, can be measured by comparing the rates customers are willing to forego (for their deposits) in return for payment functionality (including access to cash).

**In an effort to maximize the average transaction profitability level, JPMorgan Chase, one of the nation's largest banks, is considering capping debit card transactions at either \$50 or \$100. This cap would apply even if a debit card transaction was run as a signature, rather than a PIN, transaction.<sup>10</sup>**

**DEBIT CARDS CAN BE AS PROFITABLE AS CREDIT CARDS IF SEEN IN THE CONTEXT OF A CUSTOMER'S OVERALL RELATIONSHIP WITH THE ISSUING BANK.**



- When customers use a debit card they experience fast and easy access to their money as well as convenience and control when paying.
- In exchange for these benefits the bank gains the Deposits Liquidity Premium.



- When customers use a credit card they experience flexible, fast and easy access to a line of credit, float and better cash management options.
- In exchange for these benefits the bank gains the Credit Card Liquidity Premium.

Source: MasterCard Advisors Analysis

The pressure that regulators are putting on profits is effectively moving banks to focus on customer relationship profitability metrics rather than discrete products to create a more sustainable business model.

To retain existing deposits, or even attract new ones, banks should redirect their focus at the continued movement into mobile and low-value payments. *PayPass* and NFC technology adoption could help issuers migrate payments from costly cash transactions (about 91% of the total cost of cash for European banks<sup>11</sup>) to more efficient payment methods. In fact, the fixed interchange per transaction will make the displacement of low-value cash transactions even more appealing to banks, as the fixed fee will generate a higher-percentage interchange fee on lower-value ticket sizes.

- **PRODUCT EVOLUTION WILL BE DRIVEN BY A CONVERGENCE OF CUSTOMER DEMAND FOR BETTER MONETARY VALUE AND REGULATORY PRESSURE**

The need for differentiation between banks is evident, particularly in an environment in which issuers are driven to compete fiercely for the revenue necessary to sustain operations. A strong set of value-added fee-based services will prove necessary for banks trying to remain competitive in the future, as these services allow banks to simultaneously drive incremental fee revenue and better meet target customer needs. While the creation of new debit products may no longer be practical, solutions that have already been developed and exist in the market can provide differentiation as they are offered by banks and adopted by consumers.

**Banks can no longer focus on building value propositions that adequately provide revenue across all segments; this is no longer a viable strategy in the majority of cases. Promotion and marketing of existing payments solution products across the whole customer base will no longer be feasible.**

Banks can no longer focus on building value propositions that adequately provide revenue across all segments; this is no longer a viable strategy in the majority of cases. Promotion and marketing of existing payments solution products across the whole customer base will no longer be feasible. Moving forward, banks will need to operate with particular segmentation strategies in mind, not only to deliver value to consumers and provide issuer revenue, but also to deploy existing differentiated products and services to attract and retain consumers.

For example, in the UK in May 2011, NatWest launched a current account acquisition campaign offering 2% cashback on debit card transactions for the first six months from new account opening up to £125 GBP. The conditions to achieve the rebate are account engagement behaviors: £1,000 is credited to the account each month, and rebates are linked to debit usage at a rate higher than average for the UK. The rewards program has specific restrictions; it does not apply to ATM withdrawals, branch counter withdrawals or cashback, money transfers, gambling transactions, or electronic cash transfers. In this manner, the rewards are specifically provided for value-enhancing transactions for NatWest, while excluding value-destroying behavior.<sup>12</sup> This marketing effort is financially sound in the context of the entire DDA, as well as for the overall banking relationship it helps create.

Highlighting this point further, in June 2011 Emirates NBD became the first bank in the Middle East to offer its debit cardholders the opportunity to make online transactions.<sup>13</sup> Based on the finding that 29% of UAE consumers would like to use the same top-of-wallet card used for everyday transactions when they shop online, the bank found a way to maximize debit card profitability even in a zero domestic interchange environment.<sup>14</sup> The profits were realized largely due to the rise in DDA deposits and the resulting liquidity premium that banks were able to collect.

## IMMEDIATE PATH FORWARD

In the short term, because of the lag time it will take for banks to implement their near-term revenue replacement decisions, investment in debit may indeed come to a standstill. However, in the background, what we believe is also happening is the real work on the future, as banks begin to redefine and refocus efforts to optimize P&L management in the harsh “new normal.” This shift is occurring in two distinct categories: process efficiency and product evolution.

The Durbin Amendment does not make a debit card less important but less profitable. As it still remains every customer’s access tool to the checking account, understanding the combined debit card and account usage patterns will still be important in identifying the type of relationship—primary, secondary, or even dormant; it will still represent the main gateway to understanding product cross-hold; and it will still constitute the starting point in developing cross-selling strategies aimed at increasing depth, length, and profitability of any customer’s relationship. Success in the coming regulatory environment will require shifting to an enterprise-level view of customers and operating based on the insights provided by a view across individual product silos.

Competition among retail banks will be fierce as the Durbin Amendment creates pressure on profitability. Evolving to perform effectively in this new environment will be critical for retail banks as they redefine and refocus investments to continue to compete despite the regulatory challenges they face.

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## ENDNOTES

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