

ANTICOMPETITIVE REGULATION IN THE PAYMENT CARD INDUSTRY

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ABSTRACT

The payment card industry in the United States has come under increasing scrutiny in recent years. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 reflects a high-water mark of congressional influence for the industry, altering bankruptcy procedures largely for the benefit of card issuers. Since that point, Congress has turned repeatedly to rein in perceived abuses in the industry. The most substantial and direct response to the perception of abuse is the Credit Card Accountability Responsibility and Disclosure Act of 2009. That statute was focused directly on the card industry and outlawed a wide variety of industry practices. More recently, in § 1075 (the “Durbin Amendment”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress cut permissible interchange fees for debit card transactions to amounts that approximate the costs of processing those transactions; the Federal Reserve’s implementing regulation apparently will lead to a more than 50 percent decline in those fees.

So why is it at all noteworthy that Congress, in the course of reining in an industry targeted for excessive behavior, should require substantial changes in the industry’s operations? My hypothesis is a simple one. Both provisions make it more challenging to operate profitably in the payment card market. Because both provisions will pose greater challenges for smaller firms than they do for larger firms, both statutes will make it harder for smaller banks to compete in the payment card market. It may not be easy to evaluate the consequences of greater concentration in the industry. But it is clear that industry concentration is not what drove Congress to action: whatever else Congress was trying to do, it certainly was not trying to drive small banks from the payment card market

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I. THE CCA AND THE CREDIT CARD INDUSTRY

A) INFORMATION TECHNOLOGY AND CREDIT CARD LENDING

To understand the competitive structure of the credit card industry, *it is crucial to understand the shift in industry emphasis over the last few decades from finance to information technology.*

Specifically, I argue that the profitability of firms in the industry—the growth and decline of their market shares, the success of their new products, and their vulnerability to competitors—depends much less on the cost of funds or any measure of care or “prudence” in underwriting than it does on the technological sophistication with which the firms design and manage their interactions with their customers. To explain this point, I start with a brief summary of the business of credit card issuers and how it has developed over time.

1. The Proliferation and Specialization of Credit Card Products

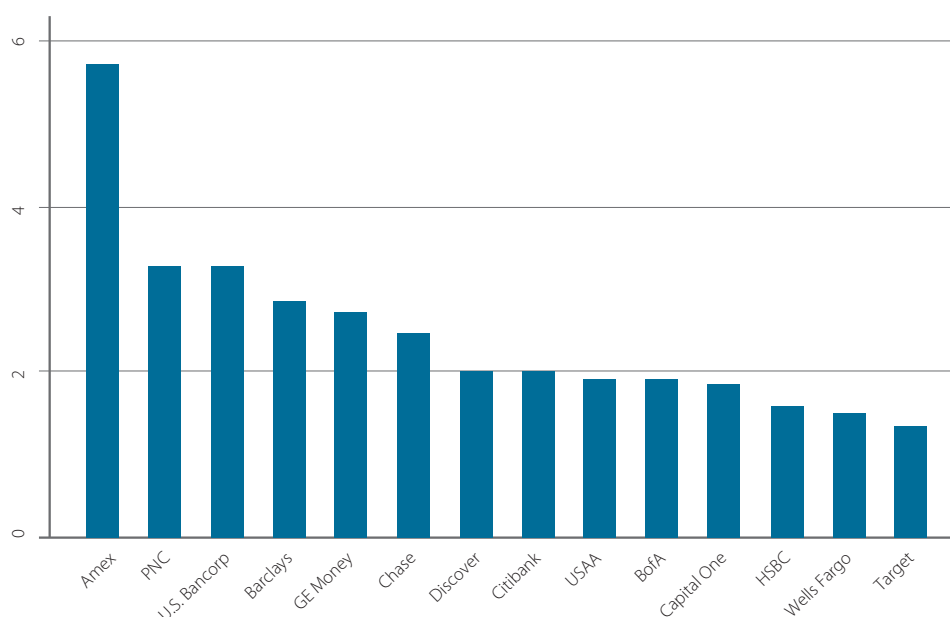
As recently as twenty years ago, the business of credit card issuing was a relatively simple one, with a more or less standard interest rate of 18 percent and three broad classes of potential customers: transactors, revolvers, and those too risky to receive cards.

Essentially, the goal of credit card issuers in those early days was to maximize the share of revolvers and minimize the share of transactors, while keeping chargeoffs at a relatively low level by excluding the risky. Even at that level of simplicity, the product was a risky one, as many issuers lost money, largely because of rampant fraud on the part of cardholders.⁵ But during the intervening years, the market has changed in several important ways, primarily because

advances in information technology have improved the ability of credit card issuers to distinguish among their customers and thus segment their product offerings.

Most importantly, issuers now offer a wide variety of products, which can be placed along a spectrum from transactor-based to revolver-based. As Figure 1 shows, the ratio of purchase volume to outstanding receivables differs remarkably even among the largest issuers. Some issuers, most notably American Express, focus primarily on transactors; with a transaction volume almost six times the size of its receivables, it stands apart from all of the other substantial issuers. Issuers of that product try to earn interchange fees that exceed the cost of funds, transaction costs, and any chargeoffs. Thus, those issuers attempt to maximize the number of cardholders that use their cards frequently for high-value purchases. The products directed to those customers are likely to include substantial affinity rewards and low interest rates.⁶

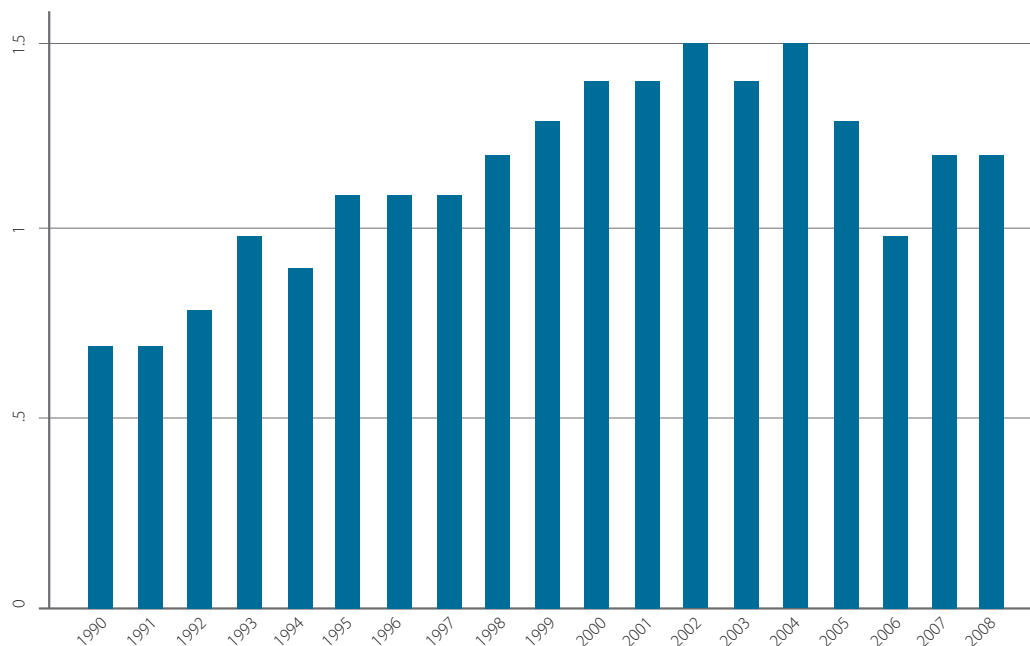
Figure 1: Turnover Rates of Major Credit Card Issuers



Source: Author's calculations from Nilson Report.

Figure shows ratio of expenditures on cards during 2010 to receivables at end of 2010.

Figure 2: Late and Overlimit Fees (1990-2008)



Source: Cards Profitability Survey.
Figure shows ratio of late and overlimit fees to annual expenditures on cards.

In contrast, a revolver-based product focuses primarily on revenues from interest and late or overlimit fees. Putting American Express to the side, most of the other large issuers emphasize a revolver-based model; as Figure One shows, Chase, Bank of America, Citibank, Capitol One, and Discover all have purchase volumes about twice their outstanding receivables. That product is less likely to have an annual fee and much more likely to have a high interest rate. The central task for the issuer of that product is to identify and attract customers who will carry substantial balances, without repaying them in full each month, and without defaulting (at least before they have paid on the balances for a period long enough to amortize the card issuer's investment in the customer). That model also depends, at least in part, on late and overlimit fees.⁷

Figure 2 traces the development of that model. Several points are salutary. First, it documents the doubling of the rate of those fees during the 1990s, as issuers swarmed to the model. After a peak lasting until about 2004, however, the level of those fees began to decline. A number of possible explanations are apparent. The first is simply that consumers began to avoid these fees by altering their conduct to avoid late and overlimit transactions; as the fees became more common, consumers learned of their costs and used greater efforts to ensure that they did not accidentally charge beyond

their credit limit or pay their bills late. To the extent late and overlimit fees resulted from accidental errors, rather than liquidity constraints, this would make sense. A broader, and not entirely unrelated, explanation is that more sophisticated contracting structures developed to increase interest revenues unrelated to the interest rate – double-cycle billing, minimum finance charges, and the like. As sophisticated issuers introduced those product attributes, the pressure to generate revenues from late and overlimit fees diminished, and their share of industry revenues similarly declined.⁸

One additional trend of importance, along a spectrum distinct from the transactor/revolver distinction, is the rise of affinity and rewards products. Because there is a cognizable cost to acquire and maintain each credit card account, all issuers focus on ensuring that those to whom they issue their cards use them as frequently as possible. Industry executives designing products frequently emphasize their desire that their cards will be “top of the wallet.” The more the cards are used, the more profitable the issuer's operations. Because issuers cannot compete on acceptance (in the United States there is, with the exception of Discover, little variation in acceptance among the major brands), affinity and rewards cards play a particular role in the competition for “top of the wallet status.” Traditionally, specialized monoline issuers like MBNA dominated that business,

but through acquisitions, that business has for the most part fallen into the hands of Bank of America and JPMorgan Chase.

The combination of those trends produces a mind-boggling potential for variation in product design. Driven both by consolidation (as the larger issuers acquire the portfolios of smaller issuers) and by market pressures, most of the large issuers now have large suites of products, including dozens of distinct credit card products, all targeting particular niches along the spectrum from transactors to revolvers, and particular pockets of affinity (specified sports teams, universities, social causes, and the like). For example, as of the fall of 2011, Bank of America displayed 72 distinct credit card products at its Web site. Although other issuers can't compete with that diversity, the number of distinct products at other major issuers is still impressive: U.S. Bank's web site advertises 29 different cards, CitiBank's 27, Chase's 20, and Capitol One's 14. Even once-stodgy American Express advertises 22 different products (15 of which are credit cards and 7 of which are charge cards).

2. Proprietary Predictive Models

The complexity and heterogeneity of modern credit card products presents numerous challenges to businesses that attempt to issue them profitably. For one thing, the issuance of cards involves a substantial expenditure—the process of sending solicitations, responding to applications, and issuing cards—that will produce no revenues at all unless the cardholder in fact begins to use the card for purchases. And if the cardholder maintains an unpaid balance, the consequent lending is rife with risks that are unusual for the typical bank lender. Unlike the lender on a home or a car, the lender has no collateral. The lender has no control over the uses to which the money is put. The debt is to be repaid over an extended period of time, on a payment schedule for the most part selected by the customer.

Thus, a successful credit card lender must have expertise at surveying the potential customers available to it;

predicting which ones are likely to use the cards, whether they are likely to default, and how long it is likely to be before they default; and managing accounts

capably in light of those projections. There is a great deal of room for increased (or decreased) profitability based on the level of sophistication applied to those activities.

The difficulties issuers faced in the early days of the credit card industry arose directly from the primitive information technology then available to the issuers and networks. Thus, it was a bold development in the early years of the 1970s when Visa for the first time could introduce electronic processing to clear transactions among the various credit card companies—something that now is a simple and routine matter.

For the most part today, what distinguishes those who are successful and profitable from their competitors is skill at collecting, manipulating, and analyzing information. The historical example of Provident is conspicuous. At one time, it was a major player in the subprime market, but its inability to understand the risks inherent in its portfolio led to unsustainably high levels of chargeoffs, which eventually forced it to withdraw from that sector.

Issuers do not simply guess what customers will do with the cards that are offered or issued to them. Nor, like mortgage lenders, do they rely on third-party scoring systems (like Fair Isaacs) that are readily available to all in the industry. Rather, at all points along the lifecycle of each account (from the universe of potential customers through the group of existing customers at any given time), issuers access and gather immense databases, which they analyze in an effort to understand the likely patterns of use and risk associated with each customer profile. The more information issuers can use in their models, the better those models can predict future card use and the risks associated with each individual.

The better models predict future use and chargeoff risks, the better the issuer's ability to acquire (and retain) profitable customers and to avoid (or shed) unprofitable customers. The benefits drop straight to the issuer's bottom line. Models that more precisely and accurately predict the likelihood and timing of chargeoffs will allow the issuer to design a more profitable mix of product solicitations and to manage existing accounts in ways that attract or repel customers that are less (or more) likely to generate chargeoffs. Together, those will allow the issuer to keep lower reserves against future chargeoffs. Lower chargeoffs and lower reserve requirements lead directly to increased profitability.

Improving predictive models benefits issuers at several stages of the life cycle of a particular customer. First, the issuer with a better model of consumer behavior will be able to do a better job of targeting solicitations to the customers. The process of sending solicitations is extremely expensive, largely because the response rate has fallen significantly even as the number of solicitations has increased: CitiBank alone sent more than 350 million solicitations in the third quarter of 2011, expending about a quarter of a billion dollars.⁹ The goal of each solicitation is to get as high a response rate as possible from the most desirable group of customers.

Thus, a solicitation can fail either because too few people respond, or because the group that responds is a surprisingly unprofitable group of customers. Given the amount of money at stake, it should be no surprise that the issuers sending such a blizzard of solicitations invest heavily in technology to predict and improve the responses they receive.

Improved predictive models also benefit issuers when they set the terms of the cards that are issued when cardholders respond to the solicitation. As individual cardholders respond to a single solicitation, issuers allocate different terms (interest rates, grace periods, credit limits) based on the issuers' assessment of the likely future behavior of the responding customers. Again, issuers can err by issuing too few cards (and thus losing desirable customers to other issuers) or by issuing too many cards (and thus issuing cards that are under-used or lead to chargeoffs).

Perhaps the most important use of these kinds of predictive models involves the ongoing management of existing cardholder accounts. Relying on those models, issuers use predictions about future cardholder behavior to make instantaneous and precisely targeted decisions about such things as increases or decreases in credit limits, alterations in interest rates, and responses to overlimit transactions or late payments. For example, sophisticated issuers customarily use predictive tools widely for such purposes as updating credit limits, issuing balance transfer offers, setting prices, and identifying likely future chargeoffs.

In sum, although it is an exaggeration to say that lending expertise is no longer important in the credit card industry, it is just as true that lending expertise and caution standing alone are not enough to compete successfully.

B) THE CCA AND CREDIT CARD LENDING

Against that backdrop, it is useful to consider the CCA. For present purposes, the principal substantive provisions of the CCA fall into two categories. The first category includes prohibitions on conduct reasonably characterized as sharp dealing, by which I mean contractual attributes and business practices that are substantially more costly to the customer than any efficiency or cost saving they might produce for the issuer. In this category, for example, I would include the prohibition on double-cycle billing,¹⁰ the requirement that cardholders opt in to over-the-limit fees,¹¹ the rules requiring prompt crediting of payments,¹² and the strict limits on "fee harvester" cards.¹³

None of those provisions should substantially affect competition among the major players in the credit card industry by which I mean, loosely speaking, the large issuers identified in Figure 1, who increasingly control the market for credit card lending. In some cases, including fee harvesting, the provisions outlaw activity in which none of those issuers ever engaged.¹⁴ In others, they outlaw arguably fraudulent behavior that was already within the control of federal regulators, such as unreasonable limitations on crediting payments.¹⁵ In still others, they outlaw contract terms that major issuers had already stopped using before Congress enacted the CCA, like the practice of double-cycle billing.¹⁶

Those provisions probably are beneficial, because they outlaw conduct that serves no useful purpose. But they will not individually or collectively have any important affect on the way in which issuers design products and compete against each other.

The limitations on interest-rate increases in § 101 of the CCA (adding § 171 to the Truth in Lending Act¹⁷) stand out as qualitatively different. Among other things, that statute generally prohibited "retroactive" interest rate increases: interest rate increases that apply to funds already borrowed from the lender.

The only exception is for a variable interest rate that changes because of an index, rather than the borrower's individual characteristics or because of a failure of the borrower to make required minimum payments on the card account. This requires a major shift in business practices, amounting to a fundamental recasting of the basics of credit card underwriting.

Even with the predictions of future behavior drawn from their sophisticated modeling, credit card issuers traditionally have relied on product attributes that let them respond in real time to shifts in the perceived riskiness of their customer base. This is at least in part because so many of the adverse events that increase the riskiness of a particular customer are random events that have so little to do with an individual's past history that even the best modeling can do little to predict them. Thus, credit card issuers traditionally have reserved in their contracts the ability to increase interest rates on individual customers at any time or from time to time, for almost any reason that motivates the issuer to think this prudent.¹⁸

It always was common, of course, to increase interest rates in response to a failure of the borrower to make the required payments on the credit card account. But many lenders used "universal default" provisions, under which they increased interest rates on a credit card whenever they learned (through credit bureaus and the like) of a default by their customer on any other account: so the credit card interest rate went up, even if the cardholder was keeping that account current, solely because of a default on an electric bill.

Even more aggressively, some lenders took the opportunity of repricing interest rates before the cardholder defaulted on any payment, solely because of a shift in attributes that, in the judgment of the lender, increased the borrower's risk profile.¹⁹

This is related to the practice, central to the revolving-credit business model, of issuing cards on the expectation that cardholders will build balances on them relatively quickly and then pay them off slowly, over a long number of years.²⁰ The balance-transfer method of acquiring customers epitomizes this: instead of waiting for your own customers to charge up their balances, you acquire customers that have already built up balances on the cards of other issuers, gambling that if you do your underwriting properly they will take so long to pay off the balances that you will profit even after paying whatever enticement you offered to acquire them.

The market-oriented premise of this regime is that if the issuer increases the rate excessively, the cardholder can avoid the excessive charges by repaying the credit card lender. By hypothesis, the cardholder would simply shift its outstanding balance to any other lender willing to lend at a lower rate; if the cardholder is borrowing at

any given time from the lender offering the lowest rate, then the cardholder has little about which to complain.

That market-oriented perspective overlooks a great deal of the reality that confronts the borrower. Most obviously, the borrower's ability to repay the lender is likely to be most limited at the moment the lender raises interest rates: if interest rates are raised when the borrower experiences financial distress, the borrower likely will find it hard to repay its credit card lender out of ready cash or to find a new lender willing to lend at a modest rate.

At the same time, by increasing the interest rate on the outstanding credit card debt, the lender increases the borrower's financial distress by increasing the borrower's monthly obligations.

Thus, whatever its premise, in practice the real-time interest-rate adjustment is likely to complicate the borrower's efforts to respond to financial distress, if not tip the borrower over the edge entirely.

Seen against that business model, the prohibition on retroactive interest rate increases is a major challenge. If credit card lenders cannot shift interest rates in response to changes in the borrower's risk profile as they occur, the lender instead must set an interest rate before advancing funds to the borrower in the first instance—a rate which must be adequate to compensate for all anticipated shifts in riskiness that can be foreseen as likely to occur before the debt will be repaid.

This is particularly complicated for borrowers that are likely to build up a substantial balance early in their relationship and then carry that balance for many years into the future, slowly making payments on it but not completely paying off the balance.

For those customers, the interest rate established at the beginning of the relationship, when the lender has little or no experience of the borrower's repayment behavior, will be the interest rate that must stick with the account for what well might be an extended time period. It is easy to see that this increases by an order of magnitude the difficulty of the underwriting and risk-modeling task that faces the credit card lender. It is safe to say that only the most sophisticated of credit card lenders will have adjusted to that challenge without difficulty.

C) CONCENTRATION IN THE CREDIT CARD INDUSTRY

The natural question to ask is why anybody should be concerned that Congress has made the task of credit card underwriting harder. After all, the avowed purpose of the CCA was to rein in the industry, and making the task harder should lower the profits of those lenders and thus lower the absolute or relative amount of that lending in the economy. If credit card lending imposes a negative external cost on society, then anything that lessens credit card lending is beneficial.²¹

The truth, I believe, is considerably more complex. The central problem is the industrial organization of the credit card industry, which is fissured not only along the lines of differing strategies of credit card lending as discussed in Part I, *supra*, but also into lending and non-lending sectors. Thus, although there are several thousand general-purpose credit card issuers, the number of significant debt issuers is much smaller.

As of 2010, the share of receivables held by the top ten issuers (those that appear in Figure 1) was about 87 percent; the top four issuers alone (JPMorgan Chase, Bank of America, CitiBank, and American Express) held 60 percent.²²

The heavy concentration of credit card lending in such a small group of issuers is not a coincidence. The profits from “ordinary” credit card issuance, reliant on interchange fees, involve many of the typical attributes of expertise broadly distributed throughout the banking industry: building customer loyalty, attraction to the bank’s brand, and the like.

Thus, it is much easier for “ordinary” banks to compete in the business of having their customers use their credit cards for ordinary day-to-day transactions. This is especially true when the credit cards are issued as one part of a broader relationship, and thus need not generate significant profit on a standalone basis. It is much harder, though, for the reasons discussed, *supra* Part I, and *infra* Part II, to issue credit card debt profitably.

Thus, the rapidly increasing sophistication of that business brought on by the use of information technology in the last two decades has made it increasingly hard for smaller issuers to compete, steadily driving them from that business and driving lending portfolios ineluctably into the hands of the largest and most technologically sophisticated issuers.

Seen through that lens, *the dead weight dropped on the industry by § 171 has a different meaning: it is yet another challenge to the “ordinary” banks trying to compete* against the few largest technologically sophisticated credit card lenders. For the largest banks, § 171 should pose a challenge, but not an insuperable one, as they presumably have been able to modify their products to predict future repayment behaviors relatively well. For smaller banks, however, with less cutting-edge modeling expertise, this should accelerate their move out of the lending market.

To be sure, those banks could invest in the modeling technology necessary to price their products as effectively as the large banks, but for several reasons this is likely to be quite difficult. The most obvious is that because their portfolios are smaller, they will have a smaller asset base over which to amortize the costs of their investment.

This problem is exacerbated by the rapid segmentation of products, *infra* Section I.A.1.

Where the portfolios of the larger issuers can be split into dozens of separate pieces, each with separate underwriting and pricing criteria, yet still large enough for effective modeling, the much smaller portfolios of the smaller issuers make it quite difficult for them to compete in specific segments.

A small issuer with a portfolio a fraction the size of the ones held by JPMorgan Chase and Bank of America will find it much more difficult to obtain enough customers in any particular segment to compete effectively against the precisely targeted products of those issuers. They will have many fewer customers in any particular segment, and thus much less information on which to form predictions about the likely use and repayment behavior of those customers if they do issue a competitive card. If they respond to the uncertainty by higher pricing, then almost by definition their products will not be competitive.

It is, then, difficult to see how the smaller issuers can hope, in the longer run, to compete on card product definition and management standing alone. They must, if they are to remain in the market, compete on a “whole relationship” basis.

II. THE DURBIN AMENDMENT AND THE DEBIT CARD INDUSTRY

A) THE ROLE OF DEBIT CARDS IN BANK ACCOUNT RELATIONSHIPS

Although their use at the point of sale is functionally similar to that of credit cards, the role of debit cards in financial services is completely different. Credit card markets are dominated by large national (and multinational) banks that hold gigantic portfolios unrelated to their deposit structures. Thus, the largest portfolios are constructed, for the most part, of customers that have no depositary relationship with the issuer, and often no relationship beyond the card at all.²³

The rise of securitized financing played a major role in weakening the link to deposits, because it provided what seemed to be a low-cost and reliable source of funding that allowed banks like MBNA, Provident, and Capitol One to issue credit card loans in sizes that far exceeded the deposit base that was the traditional source of funds for credit card lending. Even now, with Capitol One the only remaining major credit card lender without a nationally significant deposit base, large-scale funding of credit card loans through securitized financing leaves the tie between deposits and credit card lending thin at best.²⁴

The situation with debit cards is quite different. Debit cards are almost universally issued by a bank with which the cardholder has a deposit-account relationship.²⁵ Thus, debit cards and their pricing are an integral part of a larger relationship. This has several ramifications for the industry's structure. For one thing, because debit card issuance loosely parallels deposit collection, the debit card industry is much less concentrated than the credit card industry. For example, the top four debit card issuers (by purchase volume) control only 39 percent of the market; the top ten, less than half the market.²⁶

Second, revenues from debit cards interact much more broadly with the account relationship; their "subsidy" is not internal to the product as it is for credit cards. Thus, debit card interchange fees essentially have funded free or low-cost checking accounts. Generally speaking, revenues from debit card interchange fees, in the range of fifty cents per transaction since settlement of the Visa and MasterCard antitrust litigation²⁷ in the early years of

the century, have provided revenues that offset the costs of checking account services, especially for customers with relatively low average balances. Among other things, this has facilitated broader penetration of mainstream checking account services to low- and middle-income populations.²⁸

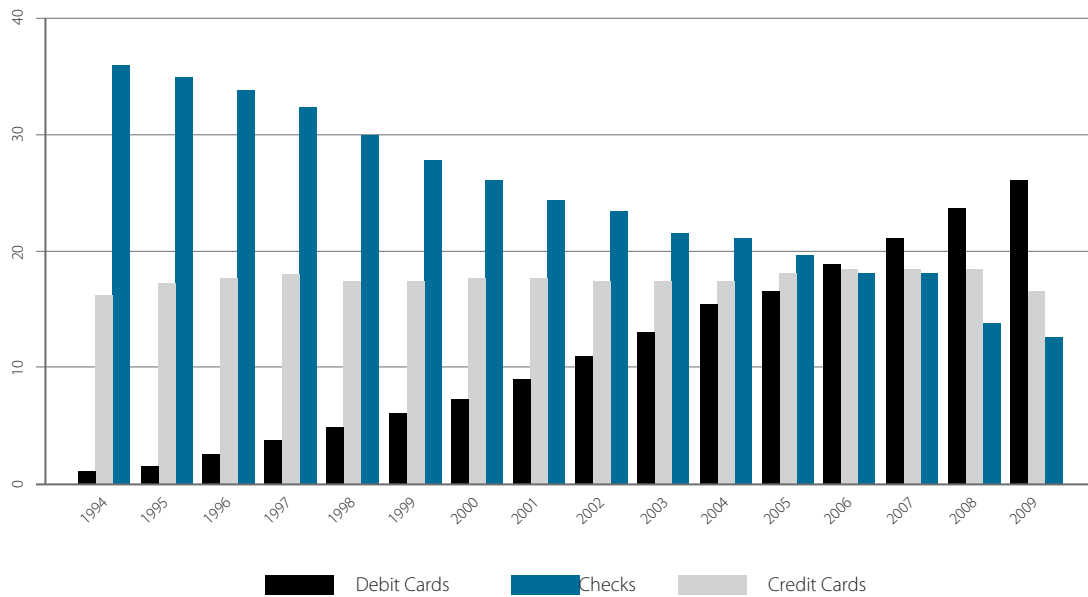
The price structure reflects the reality that debit cards, like credit cards, are a two-sided product. Thus, the manager of the relevant network must coordinate prices and terms for two distinct groups of users, managing those terms and prices to maximize the value to be derived from use of the product.

For credit cards, relatively high interchange revenues (charges imposed by the networks on the merchants) traditionally have facilitated quite generous terms for cardholders, including extensive rewards programs, which have fostered rapidly growing card usage. The parallel for debit cards has been interchange charges on merchants at levels sufficiently high to provide resources that facilitate broad provision of relatively low-cost bank accounts as a benefit to the cardholder side.²⁹

Although merchants understandably have opposed cost structures in which they bear the brunt of expenses, the product borne from those cost structures has been undeniably successful.

As Figure 3 illustrates, debit card usage (as a share of consumer payment transactions) has increased from about 1 percent in 1994 to more than 25 percent in 2009, surpassing both credit cards and checks. Much of that growth has come at the expense of declining check use. Because checks are a paper-based payment system with high transaction costs, the shift to an electronically cleared system like debit cards presents a clear social benefit.³⁰ To the extent debit card growth also comes at the expense of credit card use, as seems to be the case since 2007, there is a parallel social gain to the extent that routine debit card use limits the unreflective borrowing associated with routine credit card use.³¹

Figure 3: Check, Credit Card, and Debit Card Transaction Shares (1994-2009)



Source: Author's calculations from Nilson Report.
Figure shows ratio of expenditures on cards during 2010 to receivables at end of 2010.

B) THE DURBIN AMENDMENT AND DEBIT CARD ISSUANCE

The Durbin Amendment to Dodd-Frank strikes at the heart of that system, requiring a drop in debit card interchange fees to a cost-justified level. Specifically (as codified in the Truth in Lending Act ("TILA")),³² the Durbin Amendment requires the Federal Reserve to define a cap on interchange fees that is "reasonable and proportional to" the issuer's costs.³³ Also, in an effort to bolster downward pressure on network-level interchange pricing, the statute requires that each card have "bugs" from at least two non-affiliated networks, so that a merchant has two different ways to process each transaction.³⁴

To implement the statute, the Board of Governors of the Federal Reserve, exercising authority delegated to it by the Durbin Amendment, originally proposed a fee cap of 12 cents per transaction, a stark drop from preexisting market levels averaging about 50 cents.

In response to voluminous comments on its proposed rule, the Federal Reserve ultimately adopted a final rule³⁵ that sets a cap of 21 cents plus .05 percent of the transaction amount, amounting to approximately 24 cents per transaction.³⁶ As compared to preexisting market levels, this amounts to a revenue drop of about 50 percent.³⁷

C) CONCENTRATION IN DEBIT CARD ISSUANCE

As a matter of economic theory, the Durbin Amendment is profoundly wrong-headed. It is premised on the notion that lack of competition in the debit card industry has led to an unnaturally elevated price that banks collusively charge to merchants for the debit card product.

But there is no reason to expect a priori that a network in a fully competitive environment would set a price on either side that bears any predictable relation to the costs of providing services to that side.

Thus, the acknowledged fact that existing interchange fees are, for many banks, higher than the costs of processing debit card transactions proves nothing at all about the efficiency of the market or the "correct" debit interchange price. The relevant question is whether the networks are setting prices that maximize growth of their network. The rapid uptake in debit cards in recent years (summarized, supra Figure 3) suggests that they are.

To put it bluntly, economic theory suggests no reason to think that shifting to a cost-justified level of fees for debit card interchange will improve the efficiency of the affected markets.

To be sure, the statute rejects that understanding of the debit card market and proceeds on the supposition that existing prices reflect improper price-fixing by the major networks. Even on that basis, however, there is great reason to expect that the statute will have a substantial adverse effect on market structure.

On its face, the statute bears evidence of Congress's intention to protect small issuers. Specifically, cards issued by small issuers (those with less than \$10 billion of assets) are exempted from the price-level restrictions imposed by TILA § 920(a).³⁸ For several reasons, however, it is likely that the statute will disadvantage the smaller institutions singled out for protection by the small-issuer exemption.

The first and practical reason is that networks have little or no incentive to establish separate, higher price levels for their smallest and least influential issuers. As discussed above, networks that control two-sided products like debit cards thrive by coordinating the prices and terms on the two sides of the network so as to maximize the growth of the network.

Among other things, they must attract transactions to their network and they can do that only by attracting issuers that issue large volumes of cards. The basic problem this creates is that networks that establish special elevated pricing for small issuers will offend their most important issuers, the large issuers on whose cards the overwhelming majority of debit card transactions occur.

*Thus, the most likely response of large networks is to adopt fee structures that minimize the revenue advantages of small issuers over large issuers.*³⁹

The second is the ability of the merchant to steer customers away from high-cost cards. For one thing, the Durbin Amendment allows merchants to control routing, to select whatever network they prefer from the networks on a card, and small issuers are not exempt from that provision.⁴⁰

Furthermore, although the Durbin Amendment does prohibit merchants from discriminating on the basis of an issuer's identity,⁴¹ it does not prohibit them from discriminating on the basis of price.

Accordingly, it appears that merchants could lawfully refuse to accept small-issuer cards on any network that allows small issuers to collect substantially greater interchange fees than the Durbin Amendment caps for large issuers.

The third reason that the Durbin Amendment is likely to affect small issuers particularly harshly relates to the cost structure of the industry. Before promulgating Regulation II, the Federal Reserve collected data from issuers on their cost structures.

The data show substantial economies of scale in the costs of debit card processing. For the largest issuers, average variable costs appear to be less than four cents per debit card transaction; for those issuers, Regulation II leaves approximately twenty cents per transaction to subsidize other account services.

This is, to be sure, much less than what they had before the Durbin Amendment, but it is a substantial continuing revenue stream. For most small issuers, by contrast, average variable costs appear to exceed twenty-five cents per transaction.⁴²

Thus, for those issuers, transactions processed at the cap would be processed at a loss; not only would this eliminate the subsidy of other services entirely, it would require a flow of funds from other sources to debit-card processing. For those institutions, then, maintaining revenues substantially above the Regulation II cap is not only attractive, it is crucial to the existing business model. Because continuation of those revenue levels is unlikely, small issuers face daunting challenges in the years to come.

III. ROOTING OUT COMPETITION

So what does this mean? Let us suppose I am correct in my conjecture that the CCA and the Durbin Amendment will exacerbate the market push driving relatively small banks from the payment card industry. What adverse effects can we attribute to this? The first and obvious one is lessening competition.

Although it is easy to suggest that competition between Visa and MasterCard has rarely been aggressive, competition at the bank level traditionally has been vigorous.

For credit card issuance, thousands of issuers produce a blizzard of television advertisements and billions of annual solicitations sent by mail. For the basic business of consumer banking, the medium is different—the local billboard supplementing nationwide television advertising campaigns—but the market for consumer banking accounts traditionally has been relatively robust.⁴³

Yet as the number of effective players falls ever lower, *the point is coming (if it is not already here) when there are few issuers competing for the business of any particular consumer.*

This is particularly salient in the credit card sector given the trend toward segmentation, which allows larger issuers to provide products that can compete nationally for smaller and smaller groups of precisely defined customers.

The consequences of such a decline of competition, at least under classic economic theory, are simple: an increase in price and a fall in supply. It is safe to assume that neither Congress nor the federal competition regulators (the Department of Justice and the Federal Trade Commission) would applaud a conspicuous decline in competition in such an important industry. Indeed, the Durbin Amendment was enacted on the stated premise that small issuers would be protected.

For several reasons, however, I doubt this simplistic take on the competitive impact of these statutes is adequate. On the one hand, it is easy to argue after the recent economic meltdown that unbridled competition by financial institutions is itself socially harmful. What we have seen in the last decade is the specter of financial institutions substantially unconstrained by regulators, driven by cutthroat competition into lending that was so plainly imprudent as to drive the world financial system to the brink of collapse.

Commentators can speculate and argue about what particular piece of the system led to such an exuberance of irrationally imprudent lending. Was it the existence of deposit insurance and related regulatory institutions that left banks too little concerned about the effects of imprudent lending?⁴⁴

Was it the markets that allowed (or even encouraged) banks to make loans based on insupportable valuations by making it so easy for them to transfer the risks of nonpayment to others?⁴⁵

Was it the relative asymmetry of institutions that made it easy to withdraw home equity during times of rising prices but left no similar exit strategy for times of falling prices?⁴⁶ Or was it the failure of financial analysts to understand the nature of the risks created by the financial instruments into which these loans were packaged?⁴⁷

Whatever the reason for the problem was, it is clear that unbridled competition exacerbated the problems into which they have driven our economy. Accordingly, we should acknowledge at least one beneficial side effect to reforms that undermine vigorous competition in financial markets: they lessen the risks we all face from destructive competition in those markets.

On the other hand, a look at the particular actors affected here tells a less sanguine story of the aggregate effects of these statutes. In both cases, they accelerate shifts away from an older, more relational style of financial services toward a more information- and product-centered model based in technocratic norms.

Thus, if I am right in thinking that the CCA is effectively driving the smaller, more relational issuers from the lending sector of the credit-card industry, the market response will not be limited to a decline in competition about price. It also includes a broader eradication of a model of banking in which the bank sees a credit card as one of a suite of products issued to a particular customer, out of which the bank needs to profit in aggregate.

Because this model involves less of the highly aggressive lending characteristic of the largest, most information-intensive lending experts, it probably has less of the adverse social costs that go with that lending. If the only issuers with competitive significance are the very largest and most technologically focused lenders, we should be concerned about the potential for a shift to

a market in which all credit card lending is conducted at the harsh edge of riskiness that maximizes the adverse social cost of the product.

The Durbin Amendment's effects are likely parallel. By putting inordinate pressure on the cost structures of community banks and credit unions,

the statute is likely to accelerate the shift toward the large money-center institutions

and away from the smaller, more fragmented localized financial institutions. This seems particularly perverse, given the role money-center institutions played in the recent crisis and given the unique role the smaller institutions play in funneling capital to small businesses and employers remote from national financial centers.

It would be easy to view these statutes through a simple public-choice model as yet two more examples of the continuing political power of the largest financial institutions.⁴⁸ To me, however, it makes more sense to emphasize the particular perversity that the CCA and the Durbin Amendment share: a failure to recognize the links between product design and market structure. The central flaw in the CCA is its failure to recognize the relation between interest-rate flexibility and the ability of smaller banks to manage credit card lending effectively.

The central weakness of the Durbin Amendment is its misunderstanding of the relation between interchange fee levels and the cost structure of small institutions.

Given Congress's stated intention to protect small institutions in Durbin, I find it more accurate to view the statutes as example of ineptitude – poor craft in policymaking – than venality in intentionally favoring the interests of the largest institutions. I leave it to the reader to judge which perspective bodes better for the future of financial regulation.

1 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (2005).

2 Ronald Mann, *Bankruptcy Reform and the Sweat Box of Credit Card Debt*, 2007 U. ILL. L. REV. 345.

3 The Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. 111-24, 123 Stat. 1734-1766 (2010).

4 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

5 LEWIS MANDELL, *THE CREDIT CARD INDUSTRY: A HISTORY* (MacMillan Publishing Company 1990); Timothy Wolters, "Carry your credit in your pocket": the early history of the credit card at Bank of America and Chase Manhattan, 1 ENTERPRISE & SOC'Y 315 (2000).

6 Ronald Mann, *Patterns of Credit Card Use Among Low- and Moderate-Income Households*, in *INSUFFICIENT FUNDS: SAVINGS, ASSETS, CREDIT, AND BANKING AMONG LOW-INCOME HOUSEHOLDS* (Rebecca M. Blank & Michael S. Barr eds., 2009).

7 Mann, *supra* note 2; Mann, *supra* note 6.

8 Mann, *supra* note 6.

9 Suzanne Kapner, *Debit or Credit? Citi Places Its Bet*, WALL ST. J., Sept. 20, 2001, at C1.

10 CCA § 102(a), codified at TILA § 127(j).

11 CCA § 102(a), codified at TILA § 127(k).

12 CCA § 104, codified at TILA § 164.

13 CCA § 105, codified at TILA § 127(n).

14 As defined in TILA § 127(n), "fee harvesting cards" assess fees at issuance that exceed 25 percent of the card's credit limit. Although it is not easy to obtain data about all products issued by large issuers, I have never observed such a product from a large issuer. The majority of those products were issued by relatively small issuers such as CompuCredit (the object of a major FDIC enforcement action that terminated its role in the industry), First Premier Bank, First National Bank of Pierre, First Bank of Delaware, and Applied Bank. See National Consumer Law Center, *Fee-Harvesters: Low-Credit, High-Cost Cards Bleed Consumers* (2007).

15 The most well-known incident involved Provident Bank, which was the subject of a 2000 consent decree under the Federal Trade Commission Act requiring it to pay approximately \$300 million to the OCC. See David Leonhardt, *Credit Card Issuer Will Repay Millions to Some Customers*, N.Y. TIMES, June 29, 2000, at A1.

16 At least in part, issuers stopped those practices in anticipation of their likely prohibition by Congress. But a large part of the cessation also involved the phenomenon of "term cycling," in which issuers routinely change the terms of their card agreements as consumers learn how to avoid the costs of more familiar adverse terms. See Mann, *supra* note 2.

17 Truth in Lending Act, 15 U.S.C. §§ 1601-1665 (1968).

18 Ronald Mann, *Contracting for Credit*, 104 MICH. L. REV. 899 (2005).

- 19 Although I am unaware of data about the prevalence of this phenomenon, conversations with industry professionals convince me that it was quite common in the portfolios of large issuers, especially those with exposure in the “prime” market to five- and six-figure credit lines likely to be repaid over long periods of time (during which the cardholder’s riskiness and the issuer’s tolerance for risk both might change substantially).
- 20 Mann, *supra* note 2.
- 21 See ROBERT D. MANNING, CREDIT CARD NATION: THE CONSEQUENCES OF AMERICA’S ADDICTION TO CREDIT (2001); RONALD MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS AROUND THE WORLD (2007).
- 22 THE NILSON REPORT 966 (Feb. 2011).
- 23 DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING (2nd ed. 2004).
- 24 Although that market obviously slowed with the economic downturn, most of the largest issuers have successfully securitized credit card receivables in 2011.
- 25 The only exception is a trivial number of “decoupled” debit cards, generally issued by nondepository banks. Capitol One pioneered the only general-purpose decoupled debit card in 2007, but stopped issuing it after a one-year trial, so that at the present time there is no substantial portfolio of decoupled debit cards.
- 26 THE NILSON REPORT 971 (May 2011).
- 27 *In re Visa Check/MasterMoney Antitrust Litigation*, No. CV-96-5238 (E.D.N.Y. Apr. 1, 2003).
- 28 David S. Evans, Robert E. Litan, & Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board’s Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses* (Feb. 22, 2011) (unpublished, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1769887).
- 29 Evans & Schmalensee, *supra* note 23; DAVID S. EVANS & RICHARD SCHMALENSEE, CATALYST CODE: THE STRATEGIES BEHIND THE WORLD’S MOST DYNAMIC COMPANIES (2007); Evans, Litan & Schmalensee, *supra* note 28.
- 30 Mann, *supra* note 21.
- 31 Ronald Mann, *Adopting, Using, and Discarding Paper and Electronic Payment Instruments: Variation by Age and Race* (Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 11-2, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1862169; Mann, *supra* note 21.
- 32 TILA, *supra* note 17.
- 33 TILA § 920(a)(2).
- 34 TILA § 920(b).
- 35 Regulation II, 12 C.F.R. pt. 235 (2011).
- 36 Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43394 (July 20, 2011) (describing interim rule and justifying shift to final rule).
- 37 Evans, Litan & Schmalensee, *supra* note 28.
- 38 TILA § 920(a)(6).
- 39 Although it is far too soon to see how this will play out in practice, as I write it appears that none of the major networks have yet implemented fee schedules that advantage small issuers over large issuers. Indeed, perversely enough, it appears that Visa and MasterCard’s new schedules will increase fees on small-ticket transactions for large issuers (up to the regulatory maximum, which is higher than the previous market level fees for those transactions), leaving small issuers with **lower** revenues for those transactions. See Digital Transactions News, *Applying the Durbin Maximum, Visa and MasterCard Could Squash Small Tickets*, Sept. 27, 2011, <http://digitaltransactions.net/news/story/3217>. If it seems strange that the Durbin fee cap actually raised rates for small-ticket transactions, the key is in the way the rate is defined. Market-set rates traditionally have had a substantial variable component, increasing with the size of the transaction. The Regulation II rate, by contrast, is almost entirely fixed. Thus, although the overall effect of Regulation II is to cut rates by about 50 percent, the Regulation II cap is above the preexisting market rate for small-ticket transactions.
- 40 TILA § 920(b)(1)(B).

- 41 TILA § 920(b)(4).
- 42 Letter from Independent Community Bankers of America, to Jennifer J. Johnson, Sec'y of the Board of Governors of the Federal Reserve System (Feb. 22, 2011) (on file with author), *available at* www.icba.org/files/ICBASites/PDFs/cl022211a.pdf.
- 43 Evans, Litan & Schmalensee, *supra* note 28 (presenting industry concentration data for retail banking in large SMSAs).
- 44 DANIEL IMMERGLUCK, *FORECLOSED: HIGH-RISK LENDING, DEREGULATION, AND THE UNDERMINING OF AMERICA'S MORTGAGE MARKET* (2009).
- 45 ROBERT J. SHILLER, *THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT* (2008).
- 46 Amir Khandani, Andrew W. Lo, & Robert C. Merton, *Systemic Risk and the Refinancing Ratchet Effect* (MIT Sloan Research Paper No. 4750-09, Harvard Business School Finance Working Paper No. 1472892, Sept. 15, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1472892.
- 47 Donald MacKenzie, *The Credit Crisis as a Problem in the Sociology of Knowledge*, 116(6) *AM. J. SOC.* 1778 (May 2011); GILLIAN TETT, *FOOL'S GOLD: THE INSIDE STORY OF J.P. MORGAN AND HOW WALL ST. GREED CORRUPTED ITS BOLD DREAM AND CREATED A FINANCIAL CATASTROPHE* (reprint ed., 2010).
- 48 See DAVID A. SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2010) (arguing that the entirety of Dodd-Frank reflects a similar failure to grapple with the social costs of financial centralization, and that the statute inevitably will lead to increased power by the largest financial institutions).