Cornerstone ADVISORS

Future Harm From New Credit Card Regulations

Six Ways the Credit Card Competition Act Will Negatively Impact Consumers and Financial Institutions

Glenn Grossman
Director of Research | Cornerstone Advisors

COMMISSIONED BY | America's Credit Unions | American Association of Credit Union Leagues

Table of Contents

Introduction

The Credit Card Competition Act of 2023 (CCCA) was introduced in Congress in June 2023 with sponsors claiming that fees charged for offering and servicing credit cards are too high. According to the office of Sen. Dick Durbin (D-Ill.), these "fees keep going up." This claim is contrary to data collected between 2016 and 2021, where the estimated weighted average credit card interchange rate did not change.[1]

The CCCA has the potential to financially harm credit card issuers, consumers and merchants. This report demonstrates six ways the CCCA will negatively affect all parties involved in this debate, including those the bill sponsors indicate would benefit if the proposed legislation is passed and implemented.

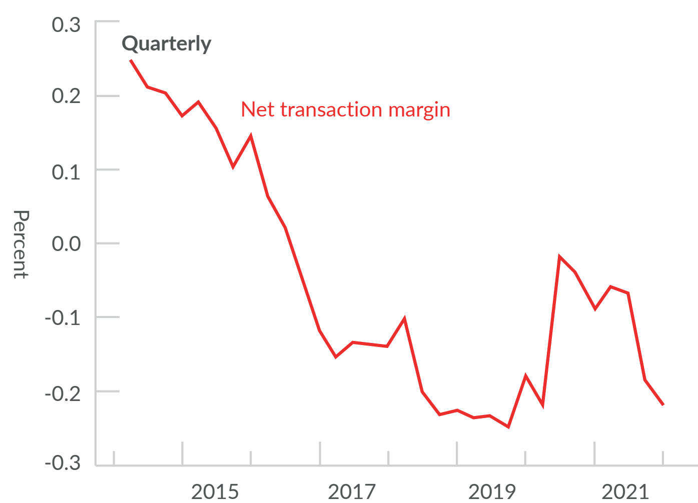
1. Reduced Revenue for Card Issuers

The CCCA will require dual routing for credit card transactions for issuers greater than $100 billion in assets. The total cost to process a credit card transaction for a merchant is the merchant discount rate (MDR), which comprises three elements: 1) interchange fee; 2) network assessment fee; and 3) merchant processing fee or markup. Under the CCCA, the interchange fee would be reduced as Visa and Mastercard adjust pricing to ensure payment volume is conducted on their networks.

$100 Merchant Transaction	
Current State Interchange	Future State Interchange / Exempt Issuers
1.60% x $100 = $1.60	1.28% x $100 = $1.28
Assumption: Network assessment and the markup are unchanged under CCCA. 1.6% is comparable to a Tier 1 supermarket for credit transactions. Exempt issuers experienced about a 20% reduction in debit card interchange in the years following the implementation of Reg II.	

A reduction in interchange will further challenge the economics of providing credit card programs. According to the Federal Reserve Board, the net transaction margin has been negative since 2016, reflecting that the expenses exceed the revenue brought in from credit card interchange (Figure 1).

Figure 1: Transactional Margin of Credit Cards



Source: Federal Reserve Board

The exempt issuers could face unintended consequences of lower interchange. An alternative scenario is one in which issuers under $100 billion do not see interchange reductions but surcharging is applied by identifying the BIN numbers of lower asset issuers and passing a higher cost to the consumer.

2. Minimal Pass-Through Savings to Customers

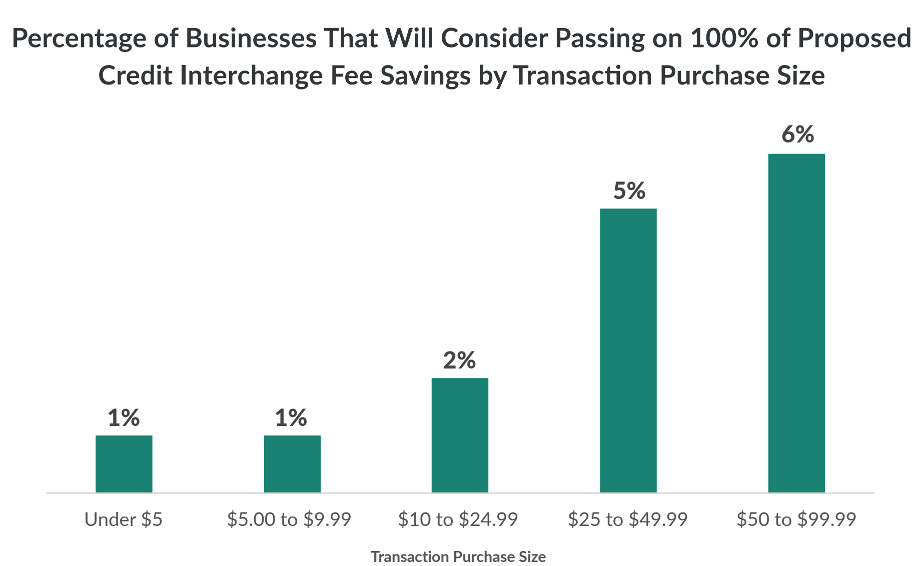
Bill sponsors say the CCCA is intended to "keep fees in check," but there are no requirements for a merchant to pass on savings to consumers. According to a study by the Richmond Federal Reserve, only 1.2% of merchants reduced their prices following the passage of the Durbin Amendment, when debit fees were cut nearly in half.[2] What merchants pay is the MDR, which includes interchange, the payment network assessment and the merchant acquirer fee.

$100 Merchant Transaction & MDR	
Current State MDR	Future State MDR
2.19% x $100 = $2.19	1.89% x $100 = $1.89
Assumption: The average MDR is 2.19% in 2022.[3] The impact of CCCA could bring a 30 basis point reduction in the overall MDR to 1.89%.	

Larger retailers have the ability to negotiate pricing in a cost-plus agreement, which may result in a lower MDR for certain credit card types. Retailers have little incentive to pass through savings that amount to pennies for individual items. Considering the average credit card transaction was $68 in 2022, a 30-bps reduction would generate 20 cents. This is hardly noticeable with inflation increasing the costs of everyday items.[4]

Small businesses typically pay one all-inclusive rate for all credit cards in contrast to large retailers with negotiated rates by interchange category. Even if small businesses received some savings on their MDR, very few would pass on the savings to their customers (Figure 2).

Figure 2: Small and Medium-Size Businesses Pass-Through of Credit Card Savings



Source: Cornerstone Advisors survey of 1,009 small to medium-size business owners and executives, March 2023

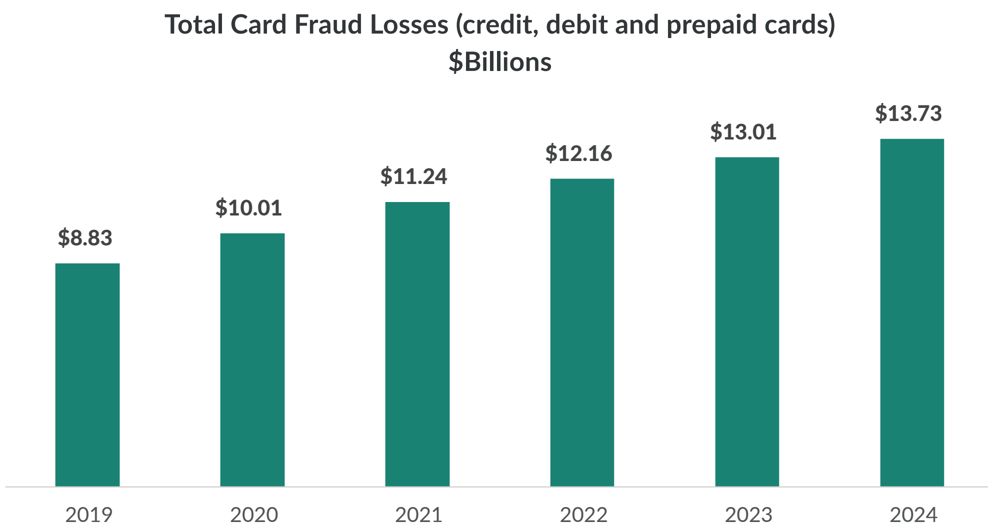
3. Increased Cost of Fraud to Issuers

Visa, Mastercard, American Express and Discover credit cards issued in the U.S. generated $5.451 trillion in purchase volume in 2022.[5] All credit card issuers route transactions from their credit cards through their networks, enabling them to monitor fraud with a single view of cardholders' activity. Card processing with multiple payment networks will create a fragmented fraud detection system where today the card networks provide a holistic, global payment system with a single view of the accountholder and global fraud trends.

Fraud per $100 of Payment Volume	
Current State Fraud Costs	Future State Fraud Costs
10.57 cents per $100	21.14 cents per $100
Assumption: Fraud costs represented 10.57 cents per $100 in payment volume in 2021.[6] Issuers today assume ~50% of dispute costs on credit cards. Issuers could hold 100% of fraud costs from new networks in the future.	

The ability to identify fraud requires a vigilant and ongoing investment by payment networks. Fraud losses under the current payment processing model are expected to grow (Figure 3). Introducing additional payment networks will make the task of fraud identification harder and increase the overall cost of fraud to issuers.

Figure 3: Projected Total Fraud Costs for All Card Payments



Source: Insider Intelligence[7]

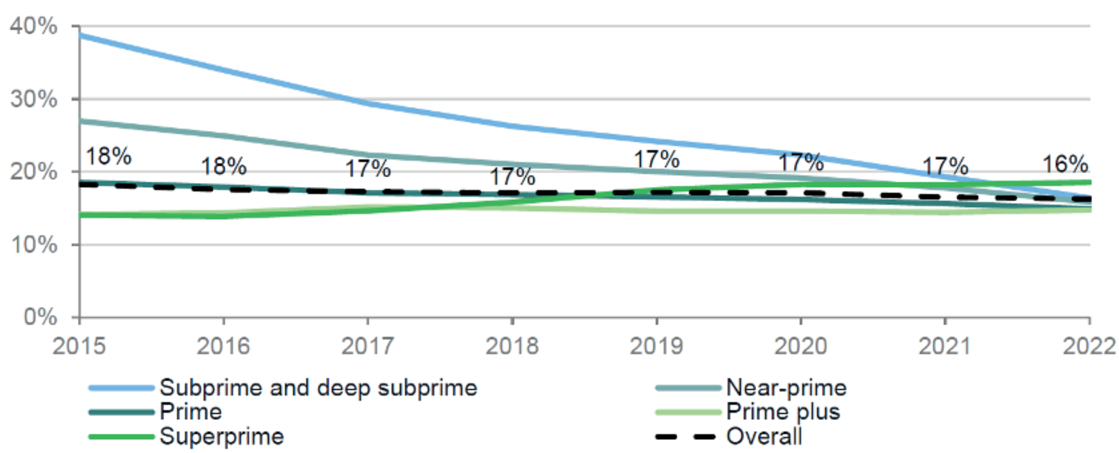
4. Increased Annual Fees for Customers

The presence of annual fees for a credit card varies depending on the card type and the credit rating of the customer. The prevalence of an annual fee has declined from 18.3% in 2015 to 16.3% in 2022 (Figure 4), representing 122 million accounts out of the more than 753 million total credit card accounts in the market.[8] The majority of these accounts reside with issuers over $100 billion in assets. According to the Nilson Report, the seven largest issuers generated 76.1% of the payment volume in the United States.[9]

Annual Fee Prevalence	
Current State Annual Fees	Future State Annual Fees
16.3% of credit cards with an annual fee Fee range: $53 to $129 per year	Additive range of fee increases: $5 to $20 annually
Assumption: A reduction in interchange for issuers could result in annual fees increasing by 20%. Fee increases would vary by issuer and card product.[10]	

Issuers may seek to close revenue gaps from the CCCA with higher or new annual fees. The prevalence of annual fees has dropped by 22% since 2015 for subprime account holders. The CCCA could reverse this progress and make unsecured credit more expensive for these individuals (Figure 4).

Figure 4: Prevalence of An Annual Fee by Account Holder Credit Rating



Source: Consumer Financial Protection Bureau[11]

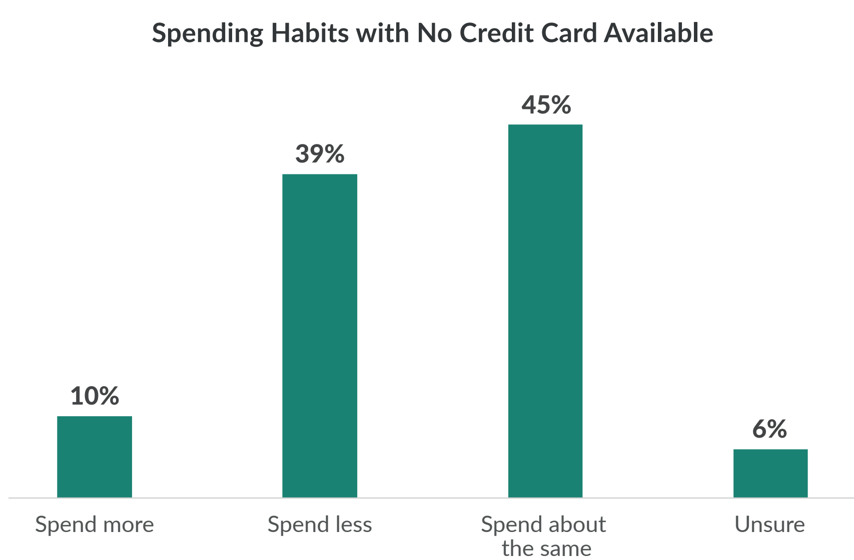
5. Reduced Revenue for Merchants

During the past decade, the average credit line has gradually increased by 17% to an average credit limit of $26,069 for all cardholders. Consumers' use of their credit limits has been stable the past 10 years, sitting at 20.7% for all accountholders in 2022.[12] The CCCA, if enacted, has the potential to alter utilization and available credit limits as issuers seek to reduce expenses through tighter credit policies that will result in lower credit limits, thus reduced purchasing capabilities at the merchants these Americans choose to shop with.

Utilization and Spending	
Current State Utilization / Credit Limit	Future State Utilization / Credit Limit
Prime cardholders: 46.3% / $21,178 Subprime cardholders: 75% / $6,482	Prime cardholders: 40.7% / $19,060 Subprime cardholders: 56.2% / $5,833
Assumption: 10% of consumers spend more when they have access to credit cards. Removal of rewards from the CCCA could drop utilization. Credit limits lowered by 10%.	

Retailers have benefited from the growth of unsecured credit, and consumers spend more resulting in increased revenues for retailers.[13] More than $5.7 trillion in payments were processed on credit cards in 2022 with merchants.[14] With approximately 40% of point-of-sale transactions conducted on credit cards, a reduction in credit limits or availability is bad news for retailer revenue.[15] Merchants may incur an unintended and negative side effect from a post-CCCA of lower revenue from decreased spending when credit is not available or reduced (Figure 5).

Figure 5: If you did not have a credit card, how would that affect your spending habits?



Source: America's Credit Unions: National survey of 2,524 Americans, August 2023

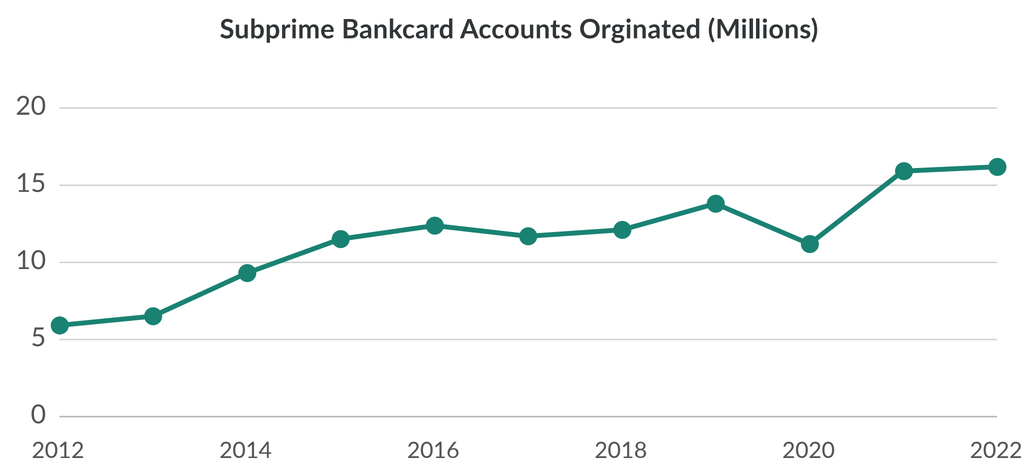
6. Limited Options for Unsecured Credit

Americans with limited access to credit have few options from banks and credit unions if credit card lending is restricted or in some cases eliminated. Three prominent alternative unsecured credit options are buy now pay later (BNPL), payday lending, and small-dollar loans. The CCCA will cause all issuers to examine their approval policies as they seek to manage expenses and possible losses. Americans with lower credit scores are more financially vulnerable and could be faced with account closures or the inability to obtain unsecured credit via a credit card as issuers tighten credit policies to ensure profitability.

Reduction in Approval of Credit for Financially Vulnerable Americans	
Current Approval Rates	Future Approval Rates
~18%-20% of subprime or lower credit score applicants are approved for credit cards	~15% of subprime or lower credit score applicants are approved for credit cards.
Assumption: 1.6 million subprime and lower credit Americans will be denied access to unsecured credit.[16]	

A more restrictive credit risk policy could force many Americans to seek higher-interest credit from payday lenders. While small-dollar loans are emerging from banks and credit unions, the take-up of these loans has been low as most financial institutions have requirements including an active checking account. According to Equifax, 16.2 million new accounts were orginated in 2022, which is 10.3 million more accounts than a decade earlier[17] (Figure 6). The CCCA has the potential to revert the progress of providing more credit to more Americans.

Figure 6: Subprime Bankcard Account Originations



Source: Equifax[17]

The availability of small-dollar loans from financial institutions remains low. Innovative programs such as the payday alternative loan (PAL) program offered by many credit unions have generated only $262 million in credit for the quarter ending September 2023, compared to $79 billion in credit card lending for the same period by credit unions.[18]

About the Author

Glenn Grossman | Director of Research

Backed by more than 30 years of leadership experience in data analytics, product management and product development in banking growth strategies and bank regulation, Glenn Grossman produces analytical studies aimed at delivering insights for innovation, growth and sustainable competitive advantage for financial institutions and fintech firms. Before joining Cornerstone Advisors, Grossman was a principal consultant and senior thought leader with FICO and the product leader for a start-up fintech payments firm. He started his career in the financial services industry managing product innovation and payment strategy at Bank of America. He also served as an economist with the U.S. Department of Labor–Bureau of Labor Statistics.

/glenn-grossman-5a86762

crnrstone.com/our-team/glenn-grossman/

About Cornerstone Advisors

After more than 20 years in this business, Cornerstone Advisors knows the financial services industry inside and out. We know that when banks and credit unions improve their strategies, technologies and operations, improved financial performance naturally follows. Because we live by the philosophy that you can't improve what you don't measure, we help financial institutions use laser-focused measurement to develop more meaningful business strategies, make smarter technology decisions and strategically reengineer critical processes.

480.423.2030 info@crnrstone.com crnrstone.com /cornerstoneadvisors @CstoneAdvisors

About America's Credit Unions

America's Credit Unions brings together the power of credit unions into one national organization representing all not-for-profit credit unions and their nearly 140 million consumer members. The Credit Union National Association (CUNA) and National Association of Federally Insured Credit Unions (NAFCU) legally combined Jan. 1, 2024. America's Credit Unions delivers strong advocacy, resources and services to protect, empower and advance credit unions and the people they serve.

800.356.9655 americascreditunions.org /americascreditunions

About American Association of Credit Union Leagues

AACUL is the national association for the state and regional credit union leagues/associations throughout the United States. AACUL's mission is to cultivate the success of individual leagues as well as the collective League System by supporting league efforts to advocate, communicate, collaborate and influence policy on behalf of credit unions nationwide. We partner with America's Credit Unions to foster the League System relationship and the prosperity of the credit union movement.

800.356.9655 aacul.com /aacul @AACUL

Endnotes

[1] No Change in Interchange Rates: https://www.digitaltransactions.net/merchants-cost-burden-for-card-acceptance-has-long-been-flat-a-card-industry-group-argues/

[2] Richmond Federal Reserve Study: https://www.richmondfed.org/publications/research/economic_quarterly/2014/q3/wang

[3] MDR: https://electronicpaymentscoalition.org/resources/the-electronic-payments-coalition-epc-released-its-2023-q1-data-dashboard-highlighting-the-emerging-trends-within-the-credit-and-debit-markets/

[4] Diary of Consumer Payment Choice https://www.atlantafed.org/-/media/documents/banking/consumer-payments/survey-diary-consumer-payment-choice/2022/sdcpc_2022_report.pdf

[5] Nilson Report 1241: https://nilsonreport.com/newsletters/1241/

[6] Nilson Report 1232: https://nilsonreport.com/newsletters/1232/

[7] Fraud Losses: https://www.insiderintelligence.com/content/spotlight-us-card-payment-fraud-losses-forecast-2022

[8] CFPB Consumer Credit Card Market: https://www.consumerfinance.gov/data-research/research-reports/the-consumer-credit-card-market/

[9] Nilson Report 1236: https://nilsonreport.com/newsletters/1236/

[10] https://files.consumerfinance.gov/f/documents/bcfp_data-point_credit-card-revolvers.pdf

[11] 2023 Credit Card Report: https://files.consumerfinance.gov/f/documents/cfpb_consumer-credit-card-market-report_2023.pdf

[12] 2023 Credit Card Report: https://files.consumerfinance.gov/f/documents/cfpb_consumer-credit-card-market-report_2023.pdf

[13] Consumer Spending and Credit Cards: https://www.nerdwallet.com/article/credit-cards/credit-cards-make-you-spend-more

[14] https://nilsonreport.com/articles/merchant-processing-fees-in-the-united-states-2022/

[15] Credit Card Usage in Stores: https://www.fisglobal.com/en/-/media/fisglobal/files/campaigns/global-payments-report/FIS_TheGlobalPaymentsReport2023_May_2023.pdf

[16] Credit Score Levels: https://www.consumerfinance.gov/data-research/consumer-credit-trends/student-loans/borrower-risk-profiles

[17] Bankcard Origination Risk: https://assets.equifax.com/marketing/US/assets/EFX_OriginationCreditTrends_202310.pdf

[18] https://ncua.gov/files/publications/analysis/quarterly-data-summary-2023-Q3.pdf

Cornerstone ADVISORS

Have questions regarding this report?

Glenn Grossman
Director of Research | Cornerstone Advisors

ggrossman@crnrstone.com