DEBIT KARD TACTICAL CHANGES

by Steve Brown

When we say we are bullish on community banking for the future, we would like to give you another concrete example. Back in October, it leaked that the Fed was going to place a cap on debit card interchange fees at about 60% the level of where they are today. Last week we got word that several major banks (Wells Fargo, Bank of America and Chase) will discontinue their reward debit card programs next year as a result. While these have been popular programs, without the current level of fees, large banks can no longer profitably support the cost of reward points. As such, many large banks will seek to curtail debit card costs.

The impact on the industry is several-fold. Considering that the average interchange fee is approximately 1.79%, this means that the industry could stand to lose about $5B annually, assuming 2009 debit card volumes. Fortunately, the limit on interchange fees only pertains to banks over $10B in asset size and excludes prepaid cards. Both factors could play to the advantage of community banks.

Originally, legislators intended to provide financial relief to consumers and merchants by capping the cost at a more "reasonable level." Theoretically, the interchange regulation and encouragement of cash spending will lower merchant costs and result in trickle-down consumer savings (thereby stimulating purchasing and providing aid to the reeling economy). In reality, however, we doubt the limitation will have much long-run impact. Consumers will either not receive any benefit (the Australian Fed tried something similar to little effect) or banks will find ways to mitigate its impact (like limiting debit card rewards). As such, the impact on profitability and the economy is most likely negligible. That said, we do see a shift of product focus that might play particularly well for our community bank clients.

For retail-oriented community banks, management can expect several changes. First, community banks should increase resources to marketing debit transactions and debit rewards programs, as competition is now less and marketshare can be gained. Debit reward cards always rank high in focus groups for generating satisfaction and community banks can now better take advantage of this fact. Second, community banks should make a decision on how they feel about prepaid cards, since we look for that to be an initiative at major banks. If your bank is focused on the mass market, our recommendation is to embrace prepaid cards, as your bank can ride the coattails of major banks promoting the product. To this point, last week's announcement of the 20-something, VIP-focused "Kardashian Kard," (card graphic above) while seemingly pathetic in its appeal, is an important trend to watch both for the affinity and for the potential fee generating ability. On the more mainstream side, Capital One and other major banks, offer a traditional prepaid card that look to increase promotion to take advantage of the uncapped interchange fee structure. If your bank has more of a high net worth focus, then positioning your bank against prepaid cards (pointing out the high fees for example), could win you additional goodwill, press and community support.

Finally, as a secondary impact, we expect to see the continuation of higher monthly fees and/or higher balance requirements on some accounts at larger banks to compensate for these capped fees and loss of revenue. This also plays well, as community banks can choose to increase their fees or market a lower fee product and gain marketshare.

By late next year, we expect product-oriented community banks to take advantage of these changes and increase profitability as a result. If your bank has a significant retail component, we recommend convening a working group to figure out how to best position your bank to take maximum advantage of this shift in the product marketplace.

BANK NEWS

Predictions

A report from Meredith Whitney Advisory Group estimates nearly 5,000 bank branches will be closed over the next year and half, as loan growth and fee revenue drop. From 2Q09 to 2Q10, the total number of bank branches in the US declined by 1,035.

Less Risk Redux

We ran a news story on the 18th that indicated concern over CRE is easing off some as companies have been able to refinance a chunk of debt coming due in the next 4Ys. A reader was quick to point out, however, that while research by JPMorgan projects "investor uncertainty with respect to collateral quality will begin to abate," they "do not expect fundamentals to firmly bottom until sometime toward the middle of 2011." Adding to the overhang, over the next 7Ys an estimated $500B of fixed-rate CMBS collateral is scheduled to mature, so pressure on the sector will remain.