Wal-Mart Decision Illustrates Merchants' New Debit Power

■ BY JEFFREY I. SHINDER and MATTHEW L. CANTOR

On Feb. 1 the payments industry crossed an important Rubicon when Wal-Mart Stores Inc., the nation's largest retailer, stopped accepting MasterCard debit transactions.

Although clearly the most important development stemming from the merchant class action against Visa and MasterCard, Wal-Mart's decision is merely one of many moves and countermoves that are reshaping the debit market.

Unlike in the past, one cannot merely assume that Visa and MasterCard — collectives that are owned and controlled by virtually all of the major banks in the United States — will continue to exercise their dominance over merchants. As competition emerges in this industry, the associations, their member banks, the PIN debit networks, and merchants are all trying to position themselves for the post-settlement world.

BACKGROUND

All payment networks must solve a "chicken and egg" puzzle. Simply put, a new payment network must simultaneously attract both merchants and cardholders. But this poses the following problem: How does a network entice merchants to accept a card that is not carried by many cardholders, and how does a network persuade cardholders to use a card that is not accepted by many merchants?

Put differently, a payment network must simultaneously satisfy demand for card network services for distinct but intertwined groups: merchants and cardholders.

Once a network gains momentum, positive effects kick in. The more merchants accept a particular payment card, the more utility it has for cardholders. By the same token, the more cardholders use a particular card, the more merchants will be willing to accept it.

Visa and MasterCard solved the problem by tying their debit cards to their dominant credit cards. Their "honor all cards" rules forced merchants that accepted Visa and MasterCard credit cards to also accept Visa and MasterCard debit cards (at credit card-style prices).

Merchants, who balked at the idea of accepting debit cards without the right to negotiation, sued. Following seven years of litigation, and after the merchants won a good portion of their case at summary judgment, the parties settled, setting the stage for competition in debit payments.

THE FUTURE OF DEBIT

While the settlements conferred enormous compensatory relief on the class (including $3.05 billion over 10 years and an estimated $846 million of mandated interchange reductions last year), the crown jewel was the elimination of the "honor all cards" rules. On Jan. 1, for the first time since the inception of offline debit, merchants could decline Visa and MasterCard offline debit products without jeopardizing their ability to accept Visa and MasterCard credit products.

Before the rules were rescinded, the associations dictated debit fees, and merchants that depended on credit cards had no bargaining leverage. Visa and MasterCard continually raised their credit and debit interchange rates without fear of merchants' dropping either product.

Now that Wal-Mart and other merchants can choose whether to accept Visa and MasterCard debit products, what will happen to debit pricing?

Previously, Visa and MasterCard did not set different prices for individual merchants. All merchants or, in some cases, entire merchant categories (such as supermarkets) paid the same price for debit and credit transactions. Wal-Mart paid the same interchange rates that mom-and-pop stores did for debit transactions. (Until Aug. 1, when the interim debit rates under the MasterCard settlement went into effect, MasterCard priced debit and credit identically.)

Because large merchants carry more economic weight than small ones, Visa and MasterCard have started offering lower debit (and credit) fees to large merchants. To avoid MasterCard's fate, Visa apparently has agreed to lower the fees Wal-Mart pays. This strategy is designed to maintain ubiquitous acceptance of Visa's debit products by enticing a few large merchants to keep accepting them. By maintaining ubiquity with large merchants, Visa hopes smaller merchants will feel enormous pressure to accept debit at higher prices.

MasterCard is probably facing hard negotiations with other merchants, who likely have been emboldened by Wal-Mart's decision. Against this backdrop, MasterCard may have to offer substantially lower rates, at least to the merchants with PIN pads, to avoid a decline in its acceptance base.

Whatever happens, the pricing associated with Visa and MasterCard offline debit products ultimately will be driven by competition and the network effects associated with the cards. If numerous merchants drop Visa and/or MasterCard debit because of pricing or quality considerations, the networks likely will reduce their debit interchange fees to keep their acceptance base. If the networks drop their offline debit rates, issuers may start promoting the cheaper and more efficient online debit products.

This explains why Visa is making large cash payments to banks for Interlink exclusivity agreements for online debit. Visa hopes these deals will put a floor on debit pricing and position Visa to dominate the market, if or when online debit emerges as the leading form of debit.

MERCHANT DECISIONS

As one would expect, and as demonstrated by Wal-Mart's decision to drop MasterCard debit, merchants are beginning to exercise their newfound leverage over the associations. This is especially true of merchants that already accept PIN debit.

Absent a cardholder penalty (ranging from 25 cents to $1.50) or a rewards program that "steers" the consumer to offline debit, many consumers would enter their PIN at the point of sale if asked to do so.

Unfortunately, before the settlements merchants could not cost-effectively steer customers, because, among other reasons, they could not identify when they were receiving Visa and MasterCard debit transactions.

That will change. All Visa and MasterCard debit cards will be reissued over the next three years so they will be visually and electronically distinguishable from credit cards. For the first time, all Visa and MasterCard debit cards will have a common identifier — the word "Debit" on the face — that will allow merchants and clerks to consistently and easily identify the cards.

Large merchants are recognizing that installing PIN pads vastly increases their leverage over the associations as they negotiate debit acceptance.

BANK DECISIONS

As merchants exercise their new rights, banks must decide which debit product they will issue and promote. Most issuers were loyal to Visa and MasterCard's offline products, because of the lure of high interchange, which the "honor all cards" rules forced merchants to pay.

Because of the higher interchange associated with debit transactions, many banks "reissued" ATM cards — which originally bore only the marks of the lower-cost PIN debit networks — to include Visa and MasterCard acceptance marks. Banks flooded the market with tens of millions of Visa and MasterCard debit cards, and many cardholders that previously made PIN-based transactions instead made Visa and MasterCard debit transactions, especially when they were steered by issuers to do so.

Under the umbrella created by the "honor all cards" rules, these practices greatly increased merchant debit costs.

These bank practices may change. Banks will decide whether to push offline or online debit, and over which networks, by gauging the likely overall profitability of alternative strategies. Some are betting that, because Visa has over 100 million debit cards in the market, most merchants will be locked into accepting these cards (for fear of losing customers), even if Visa pricing remains similar to pre-settlement levels. Others are saying Visa and MasterCard will drop their base debit fees, since over a million merchants have installed PIN pads and will be able to more easily steer debit transactions.

Others expect that, as Wal-Mart's decision to drop MasterCard debit demonstrates, merchants will have much greater bargaining leverage with MasterCard than with Visa, because of MasterCard's much smaller debit cardholder base. MasterCard apparently shares those fears. It recently took the extraordinary step of suing Visa over its settlement service fee, which MasterCard fears will compel Visa debit issuers to remain with Visa, confining MasterCard to its secondary and weak position in the debit market.

In the post-settlement world, one thing is clear. Not only will large merchants be able to exploit pricing concessions from the associations for continuing to accept debit, but they will be able to use their newfound leverage against the networks.

In the last few months Visa has paid banks such as Wells Fargo and Wachovia large bounties for the de facto exclusive issuance of Visa's signature debit and Interlink PIN debit products. Visa did this to cement its power in the debit market. If this trend continues, it may become dominant in online debit at the precise time the debit market moves to that product.

The future direction of debit remains unclear. As competition begins to flourish, Visa's dominance in the market may or may not survive. But, as Wal-Mart's decision debit shows, one thing is certain — merchants will have a say in the outcome.

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