By Dan Toughey, *President, TouchNet Information Systems, Inc.*

For the college business office, Oct. 1, 2011, ushered in a change in the regulatory environment that is literally worth millions.

On that date, a federal law – the Dodd-Frank Wall Street Reform and Consumer Protection Act – went into effect. The law, popularly known as the "Durbin Amendment," mandated the Federal Reserve to set reasonable and proportional interchange fees for debit card transactions. The result is a steep reduction in the fees that banks collect from merchants (including colleges) who accept debit cards as payment.

Potential savings for higher education amount to tens or even hundreds of thousands of dollars per campus; nationwide, they're easily in the millions.

However, the law is silent on who gets the money that used to go to the banks. It is left up to merchants, and the various payment card industry middlemen and service providers they work with, to sort out the details on their own.

As a result, millions of dollars that used to be paid to banks is now on the table, literally up for grabs.

In the following pages, TouchNet Information Systems will provide a detailed analysis of the new law and its implications, and describe the steps college business offices need to take to claim their fair share of these huge potential savings.

Debit Basics

Chances are, your campus processes a huge volume of financial transactions via payment cards – Visa, MasterCard, American Express, Discover and others – and it is not uncommon for half of that card volume to be debit, not credit, transactions.

With regard to risk, there really is no difference to the college, or any merchant, whether the transaction is credit- or debit-based. The merchant is guaranteed payment by the bank or other financial institution that issued the card. It is that guarantee that makes merchants so willing to accept payment cards.

For the card issuer, it is a very different story. Every time an individual makes a credit card purchase, they are taking out a small loan from the bank. The bank is risking capital by covering that purchase until the cardholder pays the bill. The fee that merchants pay to banks to participate in their card networks isn't pure profit; it also helps cover the bank's risk of not being paid by the cardholder.

From a risk perspective, a debit card transaction is very different. A debit card draws from money the cardholder already has on deposit in the bank. Covering that purchase presents virtually no risk to the bank. Potential fraud is the only real source of risk, and while fraud is a problem, it hardly begins to rise to the dollar level of unpaid credit card debt.

That difference in risk exposure is at the heart of the regulatory issue that resulted in passage of the Durbin Amendment. The law directed the Federal Reserve to develop and enforce new limits on the per-transaction fees banks charge for debit card use. The justification for the change was that debit card fees do not have to cover unpaid debt risk the way credit card fees must.

As reasonable as that change sounds, this one was a long time coming.

The Interchange War

Within the financial services industry, the debit card fee is known as the Interchange Fee. The passage of the Durbin Amendment was the culmination of a decade-long battle between merchants and banks over how those fees would be set, and who would be in charge of regulating them.

The battle was fought at the highest levels of American commerce, and while virtually every merchant and financial institution in the country had a stake in the outcome, it was the biggest players who were the most vocal and involved in the fight – leading some observers to describe the conflict, half-jokingly, as "Wal-Mart vs. Bank of America."

Before Durbin, there were two different categories of debit card interchange fees, based on two forms of debit transactions: signature debit, and PIN debit.

PIN debit requires the cardholder to provide a Personal Identification Number before a transaction is processed, just like an ATM transaction. That adds an extra layer of fraud protection, reducing bank risk even further. Given that extra level of protection, the interchange rates in effect prior to Oct. 1 were generally lower and often capped.

Signature debit is like a credit card transaction. Without the need for a PIN, the risk of fraud is higher. Signature debit interchange fees were not capped and banks set them at whatever point they thought was justified – and acceptable to customers.

As debit card usage grew steadily, however, interchange fees came to represent a large and growing revenue source for banks. To drive more signature debit revenue, more and more banks began converting their debit cards to credit card look-alikes stamped with a VISA or MasterCard logo, rather than the individual bank-specific debit cards that used to dominate.

The idea was to promote greater use of signature debit. "Use it just like a

credit card," was the common marketing theme. While the fraud risk was higher, so was the revenue from the interchange fees – paid by the merchant, not the cardholder. That's how "credit or debit" became as common as "paper or plastic" as a checkout-line question, even though the question itself was inaccurate. It was all debit; the banks just convinced people to refer to signature debit as "credit." Eventually, debit cards grew to become the largest non-cash form of payment in the country.

Meanwhile, merchants started to ask some pointed questions of their own: about the justification for those high fees they were paying for debit transactions. Both sides sought changes in the law from Congress to better serve their competing interests.

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In the end, Wal-Mart prevailed over Bank of America. The Durbin Amendment became law. Interchange fees came down. And the fee difference between signature and PIN debit has been eliminated; both now follow the same formula.

Banks are now scrambling for ways to make up the lost revenue from interchange. Don't be surprised if the same banks that for years urged customers to pay with signature debit now change their tune and start promoting credit card purchases instead.

Cents-per vs. Per-cents

The key to the impact of Durbin is that the interchange fee for debit card transactions has been changed in a truly fundamental way.

Under the old system, the fee for each transaction was based on a percentage of the transaction amount. Buying a fancy coffee yielded a few pennies for the bank, but buying a flat-screen TV generated more than $10 in fees for the bank.

Again, as a credit card transaction, such a discrepancy makes sense from a risk perspective. But if you're just

looking at the actual cost of processing the transaction, the amount doesn't matter.

The new Durbin rules reflect this. The new formula is complex, but the biggest piece of the interchange fee is now a flat rate of 21 cents per transaction. There still will be a percentage fee applied as well, to account for fraud risk, but it is much lower than before: .05 percent, or five cents on a $100 transaction.

According to the Federal Reserve, the average debit card transaction is $38. Under the new fee structure, which goes into effect Oct. 1, the bank's fee for that transaction will drop from 45 cents to 24 cents.

But the real impact will be felt on higher-amount transactions. Under the old fee structure, a $1,000 transaction – such as a partial tuition payment – would cost a college $10; under the new rules, that drops to 72 cents. That's a savings factor of greater than 90 percent.

$1,000 Tuition Transaction	Before Durbin	After Durbin
Interchange for card issuer (1%)	$10	$.72
Card processor fees (20 bps)	$2	$2
Total discount fees	$12	$2.72

(example for illustration purposes)

This is why this development is so significant for colleges. They tend to generate a large number of high-dollar-amount transactions: tuition payments, season tickets for football, a semester's worth of books at the bookstore.

Potential savings for higher education amount to tens or even hundreds of thousands of dollars per campus; nationwide, they're easily in the millions.

There are additional complications. Banks with less than $10 billion in assets are exempt from the new rules. Most debit cards in the U.S., however, are issued by banks that are covered by the new rules. Most colleges that distribute debit cards to their students, on the other hand, do so in partnership with banks that are under the $10 billion threshold.

Some forms of prepaid debit cards are also exempt.

Man in the Middle

So, Durbin is on the books, the bank fees are capped, and all is right with the world. Just sit back and count the money?

Not so fast.

Colleges do not generally pay interchange fees directly to banks. Instead, they hire a third-party processor to act as an intermediary; the third party's job is to process the transactions and route them to the many, many different issuing banks that provide the cards that students, alumni and guests use to make on-campus purchases.

These merchant service providers, or MSPs, collect the interchange from the colleges and pass it on to the various banks. They also charge a fee to cover their costs and run a profitable business. Those fees, combined, are referred to as the Discount Fee, which is what colleges and other merchants pay; interchange is the single biggest piece, by far, of the overall cost of the MSP.

In most cases, the business relationship between the MSP and the merchant (or college) is covered by a contract. The discount fee specified in that contract is not legally affected by the Durbin Amendment. The merchant service provider is therefore legally entitled to reap a windfall from the changes. It can continue to charge the merchant or college the same rate as before, pay a much smaller cut to the bank, and keep the difference.

“With more than half of VISA transactions now being debit rather than credit, schools can give convenience fee arrangements another look.”

What You Need to Do

Step one for colleges is to take a long, hard look at their merchant service contract. Many such contracts have an opt-out or buyout provision; if so, schools need to exercise their opportunity to opt out of the current deal and renegotiate their agreements. Even if there is a financial penalty involved, the savings potential is such that in many cases the penalty is well worth it.

Even if your contract doesn’t include such a provision, you can still negotiate from a position of strength. The college business office should tell the merchant service provider you know the rulebook has changed and the provider’s fees have dropped dramatically. You say you want a new deal that reflects the new reality, or the provider’s chances of renewing the deal when it expires are nil. Odds are the provider will be willing to deal.

Second, insist on a plan that passes the actual charge from the bank directly to the college – with an additional fee on top to cover the service provider’s expenses. That is known as a “cost plus interchange” formula.

As you negotiate, make sure the new agreement unbundles credit and debit card transactions. In the past, contracts often called for a flat-rate fee to cover all transactions, both credit and debit. Such deals are no longer in your favor.

How Convenient

Another important side effect of the Durbin changes is that convenience-fee-based credit card payment systems are now back on the table. Up to now, some campuses have declined to participate in convenience-fee systems, despite the substantial cost savings they offer, because many schools felt VISA’s convenience fee rules were unworkable for higher education purposes.

Campus merchants typically pay a fee of about 2 to 2.5 percent of the transaction amount for accepting credit cards – again, to cover the financial risk of the loan. A convenience fee vendor acts as the college's agent, accepting the payment and charging the fee back to the student. Georgia Tech, for example, estimates that it saves about $1.7 million a year in fees by using a convenience fee vendor.

Other schools, however, did not want to deal with the hassle of having to tell students and their families, "Sorry, we can't accept VISA." Now, under Durbin rules, the schools can accept VISA debit card payments at a significantly reduced cost.

With more than half of VISA transactions now being debit rather than credit, schools can give convenience fee arrangements another look. "We can accept VISA *debit* cards" is a much easier sell.

The Technology Factor

Given the now-significant gap between the costs of credit card transactions vs. debit card transactions, schools should seriously consider offering a discount for using debit cards for large-amount transactions. For example, a $1,000 tuition payment can be reduced to $995 if made with a debit card or paper check instead of a credit card. Even with the discount, the school will come out ahead on the fee difference.

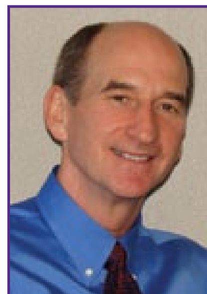
In fact, colleges can benefit from channeling as many transactions as possible to debit rather than credit. Business office technology can play an important role in that process.

It's also possible that banks may start to offer an even lower interchange rate for PIN debit over signature debit, or offer PIN-based incentives in other ways, now that higher-risk signature debit can no longer be used as a cash cow. Under the new rules, you now have the power to decide how you want each debit transaction processed. You'll want to make sure all your debit transactions are processed in the lowest-priced format; there are business-office software packages that enable you to ensure that all debit transactions – from tuition payments to bookstore purchases – are processed the way you want them for maximum savings.

The best business software packages can recognize that a payment card is a debit card, rather than a credit card, and prompt the customer to enter a PIN. We may also see a move to PIN-based online transactions, so you'll want to be working with a technology partner that is fast and flexible enough to react to changes and allow you to leverage the opportunities that arise.

There are other ways that highly capable and flexible software platforms can help cut costs in Durbin's wake. Routing PIN debit transactions through competing communications networks is just one example. VISA used to require merchants to use their internal network; now, under Durbin, that's not allowed, and competition may drive that cost down as well. The catch is that the college's software has to be intelligent enough to route each transaction through the lowest-cost system available.

At TouchNet, we're committed to being your partner and helping you navigate these important changes. Contact us if you find any of this confusing or if you want assistance in reviewing your merchant agreement(s). Here's a special e-mail address to use: debit-watch@touchnet.com.



About the Author

Dan Toughey, president of TouchNet Information Systems, Inc. (www.touchnet.com) since 1989, has guided the company to market-leader status in automated commerce management solutions for higher education. A graduate of Augsburg College in Minneapolis, Minn., he formerly worked for leading firms in the financial services industry.

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