



# The Great Canadian Debit Debate

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**Is the reason Canadians use debit cards more than their American counterparts the Visa/MasterCard rules in the U.S. that tied signature-based debit cards to credit card acceptance? In this commentary, two of the lawyers who led the merchant class-action lawsuit against the card associations say tying hurt U.S. debit.**

**W**ith its recently published report about debit in Canada, Dove Consulting has brought into focus one of the lingering questions remaining in the aftermath of the merchant lawsuit against Visa and MasterCard. That is, would personal identification number-based debit have been as successful in the United States as it has been in Canada if the associations had not used their "honor-all-cards" (HAC) rules to tie debit to credit card acceptance?

While the Dove report does a good job of discussing some of the main differences between the two debit systems, it doesn't really confront this central question head-on. The report, therefore, is of limited utility in evaluating how the Canadian experience sheds

light on the even more fundamental questions that remain post-lawsuit; namely, which debit products in the U.S. will prevail, and at what price?

## The Differences

There is little disagreement as to how the Canadian and U.S. debit systems currently compare. In Canada, PIN debit accounts for roughly 100% of all debit transactions while in the United States it accounts for well less than half. In Canada, PIN debit is accepted at a significantly greater proportion and much broader array of merchants than it is in the U.S. In Canada, debit usage has far surpassed check usage while in the U.S. check usage, though slipping, still dominates. In Canada, debit transactions have zero interchange while in

the U.S., both PIN and signature-based debit transactions have been subject to ever-increasing credit card-styled interchange rates. And in Canada, per-capita debit usage greatly exceeds debit usage in the U.S. (PIN and signature debit combined), despite the significant head start the U.S. had in debit.

By virtually any measure, most will agree that debit, and particularly PIN debit, in Canada has been a much greater success than in the U.S. Where there is disagreement is how we got there.

On the consumer side, there are no relevant differences in payment behavior that would explain the gulf. The populations are equally affluent. The use of plastic is equally prevalent. Consumers in both countries typically use credit for higher-ticket purchases and purchases for which they prefer or need to "pay later." And, they use debit principally as a "pay now" replacement for cash and checks.

On the banking and merchant sides, the strategic incentives to implement and promote point-of-sale debit also have been the same. Banks in both countries looked to debit as a means to reduce the risk in the payments system, reduce the volume of checks and associated check-processing costs, leverage the success of automated teller machines, build and retain customer accounts, and increase revenues through larger account balances and the increased opportunity for cross-selling financial services. Likewise, mer-



cash rebates—for which only signature debit transactions qualified and PIN debit was excluded or even vilified (e.g., Kansas City, Mo.-based Commerce Bank's "Skip the PIN, Sign and Win!"). And they sent their cardholders steering materials directing them to always sign for their debit purchases or press the "credit" button at the merchant terminal. Cincinnati-based Fifth Third Bancorp, the fourth-largest debit card issuer, went so far as to affix a "do not input your PIN" sticker on the face of many of its cards.

The perverse incentives created by the HAC tying rules forced the regional networks to respond the only way they could to regain the attention of banks—raise their prices. The pressure to raise their interchange fees was exacerbated by Visa's use of its PIN-based Interlink POS network (and Visa Check II) as a lever to elevate PIN debit pricing. Over the past decade, PIN debit pricing has increased by well more than 2,000%!

The combination of suppressed transaction flow and heavy price hikes significantly reduced the incentives of merchants to make the capital expenditures necessary to accept PIN debit. This further cemented signature debit's dominance in the U.S. The result of this HAC rule-driven spiral: higher prices, lower debit volumes, and the ascendancy of an inferior debit product.

### **What Happens Now?**

None of this happened in Canada because the associations did not use HAC rules to tie debit to credit. The Canadian banks recognized the clear superiority of PIN over signature debit. And, they recognized that interchange was not necessary to support a business case for issuing and promoting debit. Dove's suggestion that PIN debit and at-par pricing prevailed in Canada because of industry concentration, government regulation, or network architecture is way off the mark. Market forces dictated the outcome in Canada. And they would have done the same in the U.S. had the market not been distorted by the HAC tying rules.

So, where does U.S. debit go from here now that the merchants have succeeded in abolishing the tying rules? Two things seem likely. One, pricing for both PIN debit and signature debit will converge. And two, PIN debit will

soon overtake, and eventually eliminate, signature debit.

Pricing for signature debit has already dropped markedly. The settlements in the merchant lawsuit mandated temporary interchange reductions of roughly one-third. While the associations' published rates have crept up from there, the published rates do not account for the many private deals that the associations are no doubt negotiating with the larger merchants to ensure their continued acceptance of signature debit. Nor do these rates account for the new-found but largely untapped power that all merchants have, big and small, to just say no to signature debit.

This merchant power will likely fuel over the next year or two a cat-and-mouse game between merchants and the associations that ultimately will determine whether interchange climbs to its pre-settlement levels and beyond, or tumbles in the opposite direction.

With its recent decision to drop MasterCard debit, Wal-Mart Stores Inc. has delivered the opening salvo in this simmering tug-of-war. Other merchants may be similarly poised to follow, either through flat-out rejection of signature debit, or by using their vastly improved ability to steer their customers towards PIN debit. This dynamic will drive more and more merchants to accept PIN debit, and put increasing pressure on the associations to lower signature debit fees. As merchants flex their muscles with signature debit, they likely will start doing the same with PIN debit.

This merchant power also will likely facilitate the inevitable disappearance of signature debit altogether. Once the pricing gap between PIN and signature debit sufficiently narrows, and PIN debit becomes commonplace at those merchants where consumers most like to use their debit cards, as it is in Canada, banks will have no motivation to favor the more costly, less efficient debit product. Then, signature debit won't be worth supporting at all.

### **Conclusions**

As to the great Canadian debit debate, it was never really about which debit system is truly better. The high numbers for Canadian debit transactions readily answer that one. So do the low numbers for Canadian paper check transactions. By aligning the interests

of banks, merchants, and consumers with a single preferred product, Canada has maximized the efficiency of its debit system redounding to the benefit of all participants.

The U.S. system, in contrast, has been significantly hobbled because of the HAC tying rules which have misaligned the interests of banks, merchants, and consumers. The result has been less debit and more paper checks.

Unfortunately, the Dove study avoids getting into any of this. By merely focusing on certain structural differences between the two debit systems, the Dove study fails to tackle what's really behind the tremendous success of PIN debit in Canada. This has allowed apologists for high interchange and signature debit to use the study to bolster their view that the U.S. debit system is just fine the way it is. Even worse, it has given them fodder to falsely suggest that the U.S. system is actually better for consumers because it is cheaper for them, \$4.3 billion cheaper to be exact (Dove's calculation of per-transaction debit fees Canadian consumers paid last year).

### **Consumer Costs**

This finding of supposed cost savings ignores the massive interchange overcharges that all U.S. consumers, not just debit consumers, have had to shoulder (and continue to do so) in the form of higher prices and reduced services. It ignores the consumer costs associated with the U.S. banking system's relative failure to displace paper checks with debit transactions. It ignores the PIN debit penalty fees that, up until recently, banks had been imposing with ever-greater abandon.

It largely ignores the Canadian system of bundled pricing for bank-account services under which the majority of consumers do not pay per-transaction debit fees. And, it ignores the greater costs of fraud and dislocation to which many consumers have been subjected due to the prevalence of signature debit.

But most of all, it highlights the failure of the Dove study to recognize the central teaching of the Canadian debit experience—that a low-price, PIN debit system is superior for all participants, and now that the HAC tying rules are gone, that system has a fighting chance of emerging in the U.S. ■