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The Capital One-Discover Deal Increases Competition and Benefits Consumers

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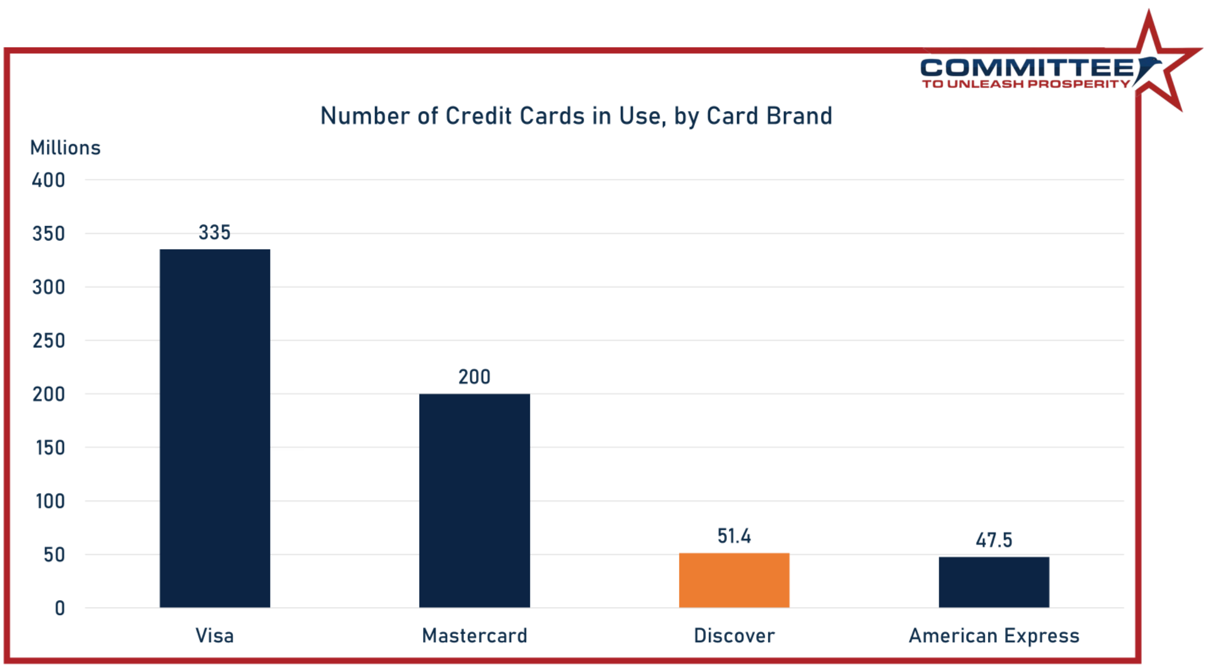
Executive Summary

This study examines the banking/credit card industry and finds that the likely economic effect of Capital One's acquisition of Discover will be to offer retailers and customers more choices and will insert added competition into an industry now dominated by two large players.

Today, Visa and Mastercard – with about 80% of the market that now processes more than $5 trillion of retail and online transactions. Visa and Mastercard are accepted almost everywhere, and they provide customer convenience, reward points, cash-back incentives, and so on, which shoppers love. But this study concludes that a third well-capitalized alternative - as Discover would become - would add a new positive competitive influence that could actually drive credit card swipe fees down. That's a result the Federal Trade Commission has long desired and has used its regulatory authority to try to pursue.

This study sees no evidence of adding more financial fire power to a distant third players in this industry. Discover currently controls just 8% of the market.

Question: how can a bank's acquisition of a company that controls less than 10% of the market be anti-competitive?



The Capital One-Discover deal promises to create a competitive threat to the banking leaders and credit card companies that have dominated the plastic card industry. This acquisition will likely lower fees, more generous rewards, and a better return for hundreds of thousands of Capital One and Discover shareholders.

Introduction

Nearly 80% of Americans have at least one credit card,[1] making the purchase of goods and services as simple as a swipe or a tap. In total over 1.1 billion credit cards are currently in circulation.[2] The widespread use of credit cards is hardly a mystery considering that beyond the convenience and fraud protections of credit cards, American consumers pocket almost $300 billion per year in rewards.[3] These credit card benefits are offset by an interchange fee that credit companies charge retailers and stores. The fees are set by competitive forces among many credit card companies vying for business. The more competition, the lower the fees and the higher the rewards. Now consumers stand to benefit from even more competition in this market, via the proposed merger of a major issuing bank with a relatively small – for now – payment network.

In mid-February, Capital One announced its purchase of Discover Financial Services. Capital One's $35.3 billion all-stock offer to buy Discover, represents the largest acquisition in the credit card market since Bank of America purchased MBNA in 2005.[4] By total assets, this deal would combine the ninth and twenty-seventh largest U.S. financial institutions, placing the combined company at sixth in the country. Despite the fact that the company would hold less than a fifth of the assets held by industry leader JP Morgan Chase, politicians on both sides of the political aisle have decried the deal as an increase in market concentration that will hurt consumers.

The politically motivated opposition to this deal is wrong on the economics. Contrary to what the opponents of this deal may claim, the Capital One-Discover merger would increase competition in the credit card market, to the great benefit of American consumers.

1 https://www.atlantafed.org/-/media/documents/research/publications/policy-hub/2022/07/11/10--payment-card-adoption-and-payment-choice.pdf

2 https://www.forbes.com/advisor/credit-cards/credit-card-statistics/#sources_section

3 https://6bca062c-65b7-49d4-bdb3-a0f61135aa80.filesusr.com/ugd/5ac508_bdc147419d6f4c5ab79d36595c243534.pdf

4 https://www.reuters.com/markets/deals/biggest-deals-credit-card-sector-globally-2024-02-20/

Political Opposition

As soon as Capital One announced the acquisition, criticism from both sides of the political aisle rained down on the deal. Senator Elizabeth Warren (D-MA) and twelve other members of Congress issued a letter to the Federal Reserve and the Office of the Comptroller of the Currency (OCC), urging them to block the deal on the grounds that this deal would "combine two of the largest credit card issuers in the United States into a 'colossus' that would leave the industry with fewer competitors overall and ease pressure on companies to attract customers with favorable terms." They further stated that left it would "cause higher prices and more fees, lower deposit rates, less access to credit, bank branch closures, and job cuts."[5]

Such claims against large corporations have come to be expected from Congressional liberals who are ideologically hostile to successful businesses, so it is even more alarming to hear similar sentiments echoed by conservative lawmakers who we expect to know better. Senator Josh Hawley (R-MO) sent a letter to Assistant Attorney General Jonathan Kanter claiming that the Capital One-Discover deal "...is destructive corporate consolidation at its starkest. If consummated, this merger will create a new juggernaut in the credit card market, with unprecedented powers to extort American consumers. That cannot be allowed to happen."[6]

Both Senator Warren and Senator Hawley's letters build on President Biden's 2021 executive order on Promoting Competition in the American Economy, an order which directed regulatory bodies including the DOJ, the Federal Reserve, the FDIC, and the OCC to "adopt a plan… for the revitalization of merger oversight" among financial institutions. In response, these regulatory bodies have ratched up the breadth and detail of the metrics used to evaluate mergers. Specifically, Assistant Attorney General Jonathan Kanter, announced that the DOJ would create new metrics to evaluate the "many ways in which competition manifests itself in a particular banking market – including through fees, interest rates, branch locations, product variety, network effects, interoperability, and customer service." These and other similar regulatory crackdowns promise to further delay the completion of the Capital One-Discover merger.

The CEO of the largest US bank took a different view. Jamie Dimon, CEO of JPMorgan Chase, when asked about the merger, replied, "companies should be allowed to innovate and grow and merge and try to challenge things. . . . It's good for competition. I think they should allow some of these smaller banks to merge. If that's how they think they can best compete with JP Morgan, you should let them. It may not work in every case. But you should not pre-determine that. You should let the market determine that."

The combined Capitol One-Discover may or may not be able to compete successfully against JP Morgan – but it will certainly have a greater capacity to do so than the two companies had pre-merger. And there is obviously no excess in market concentration here.

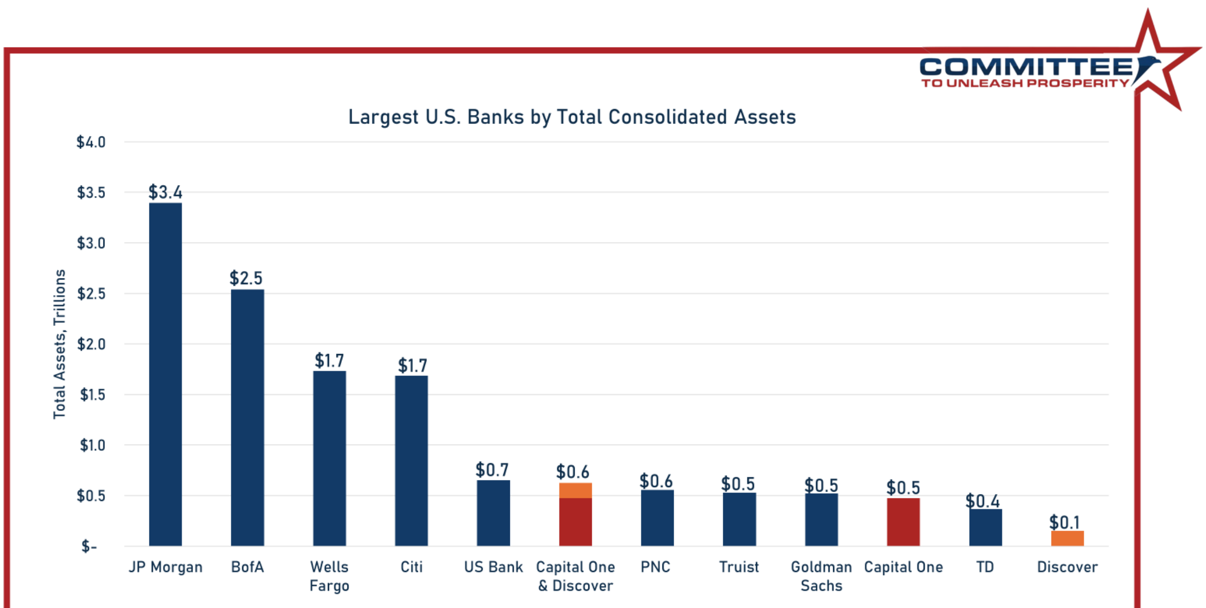
5 https://www.warren.senate.gov/imo/media/doc/2024.02.25%20Capital%20One%20Letter1.pdf

6 https://www.hawley.senate.gov/sites/default/files/2024-02/Hawley-Letter-to-Kanter-re-Capital-One-Discover-Merger.pdf

Increasing Market Competition and Consumer Benefits

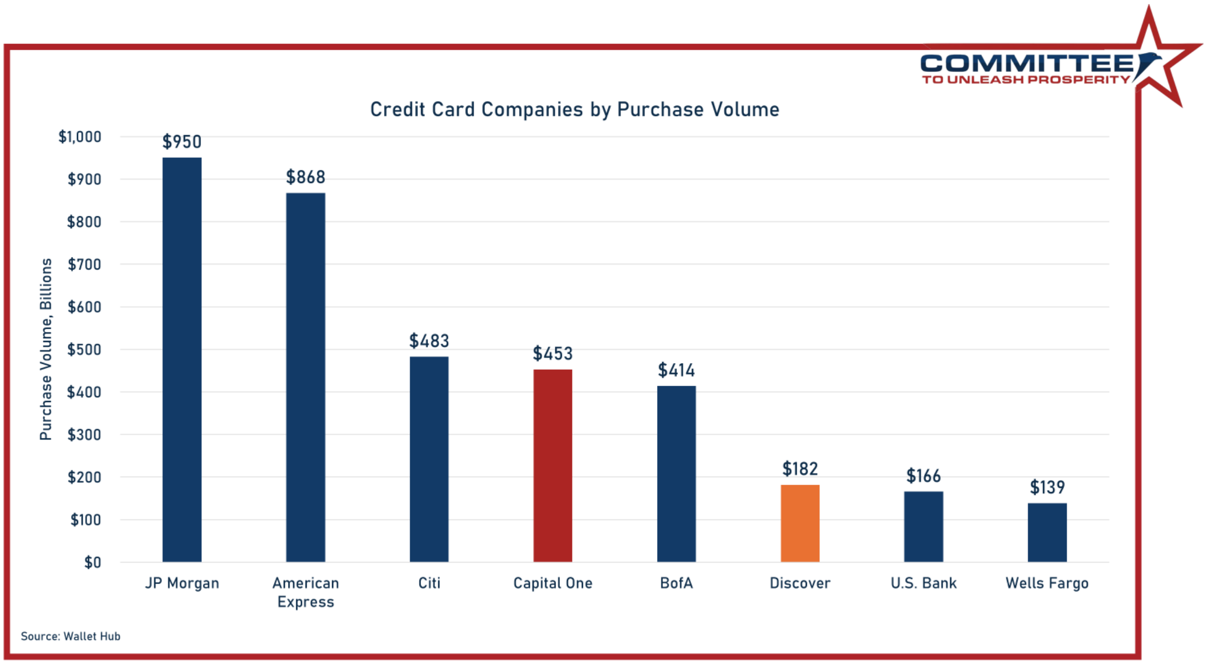
All available evidence indicates that the Capital One-Discover deal promises to create a competitive threat to the banking leaders and credit card companies that have dominated the plastic card industry. This acquisition will likely lead to lower fees and increased rewards for consumers.

A clear indication of the pro-competitive nature of this deal can be found in market response to the announcement of the deal. At the close of the first trading day following the announcement of the deal on February 19, 2024, Discover's stock price jumped 12.6%, as investors showed their enthusiasm at the prospect of receiving a 26.6% premium on the current value of their shares of Discover. Visa and Mastercard, the two companies that process the overwhelming majority of credit card transactions saw a 1.2% and 3.5% decline, respectively. This decline denotes the fact that as market leaders, they stand to lose the most from an alternative credit card network such as the one that Capital One will gain with the purchase of Discover. Finally, and perhaps most notably, Capital One saw only a negligible 0.1% gain in the value of its stock. Based on this market response, it is hard to believe that investors are buying into the idea that Capital One stands to gain any excess market power or profits through this deal. If they did, there would be a rush of buying that would drive up the price of Capital One. It would seem that Wall Street isn't buying into the fearmongering from the halls of Congress.



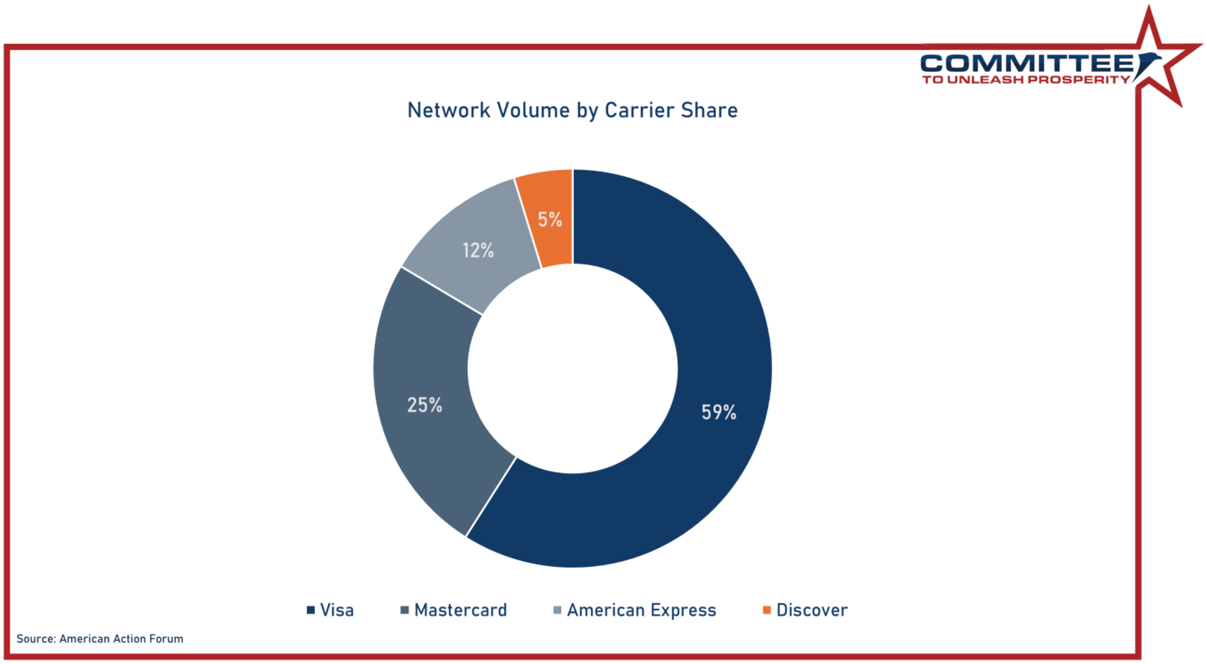
Source: Federal Reserve Statistical Release, Dec. 31. 2023

Looking at total assets, the claim that this deal represents any serious market consolidation becomes untenable. Capital One is the ninth largest U.S. bank and Discover the twenty seventh largest. But even their combined assets of approximately $600 billion represent less than a quarter of Bank of America's, which sits at number two with $2.5 trillion in holdings and less than a fifth of the largest bank in the country. JP Morgan Chase, and its total assets of $3.4 trillion.



Comparing top U.S. credit card companies on the basis of purchase volume paints a similar picture. The market is largely dominated by JP Morgan with $950 billion and by American Express at $868 billion in annual purchases. Notably, the third ranking competitor, Citi Bank, has just over half of the purchase volume of JP Morgan, with $483 billion in annual purchase volume. Capital One sits at fourth with $453 billion and Discover at a distant sixth with $182 billion. Their combined purchase volume would bring them up to $635 billion in annual purchases, putting Capital One ahead of Citi Bank, but still well behind industry leaders JP Morgan and American Express.

The combined purchase volume of Capital One and Discover would provide a legitimate third competitor to the dominant position of JP Morgan and American Express. This would only benefit consumers as Capital One would offer lower rates and better rewards to attract more card users, drive increased purchase volume, and take an increased market share from its more dominant competitors. In turn JP Morgan and American Express would be incentivized to offer more attractive rates and rewards to their customers to defend their position in the market.



Perhaps the most pro-competitive aspect of the proposed merger is the potential creation of a vertically integrated payment network to rival the position of Visa and Mastercard. In 2023, Mastercard and Visa processed approximately 84% of all transactions on their networks.[7] American Express followed distantly with 12% and Discover processed a mere 5% of all transactions on its private network. Although only 5% of transactions were processed through Discover's network last year, it would be an invaluable resource to Capital One to have one of the four main transaction networks. At the moment, Capital One processes about 58% of its transactions through Mastercard and the remaining 42% through Visa.[8] Although Capital One plans to only switch a portion of its transactions from Visa and Mastercard to Discover's network, it could eventually move most or even all of its transactions, threatening $351 billion of Mastercards transactions and $255 billion of Visa's.

7 https://www.americanactionforum.org/insight/capital-ones-acquisition-of-discover-could-inject-competition-into-payments-market/

8 https://www.cnn.com/2024/02/20/economy/capital-one-discover-credit-card/index.html

Payment Network	Interchange Fee Range
Visa	1.15% - 3.15%
Mastercard	1.15% - 3.15%
American Express	1.10% - 3.15%
Discover	1.10% - 2.40%

Source: Helcim (2023); Mastercard (2023); Visa (2023).

Currently, 130 million merchants are connected to Visa's network and another 100 million to Mastercard's. Discover carries only 70 million merchant locations. In order to expand its market share and eventually transfer all of its transactions to Discover's network, Capital One will need to entice merchants to choose its newly acquired network over those of Visa and Mastercard. Discover already boasts the lowest swipe fees of the four transaction networks.[9] With Capital One's financial resources and large customer base, accepting payments on the Discover network would become much more appealing to merchants. This would give merchants more leverage to negotiate lower swipe fees and potentially pass on those cost savings to consumers.

The outspoken critics of the Capital One-Discover deal overlook the current market dynamics of the financial industry that would make this deal a huge win for American consumers, but they are all too quick to point out that this deal would make Capital One the largest credit card issuer and the largest holder of credit card debt. These claims are far from the objective evidence they are touted to be. It is true that Capital One's purchase of Discover would make it the largest U.S. credit card lender, holding around 24% of all outstanding U.S. credit card loans. It would hold approximately $257 billion in credit card loans, surpassing JP Morgan that sits just over $200 billion.[10] The merger would also add 75 million Discover credit cards in circulation to Capital One's 106 million issued cards.[11]

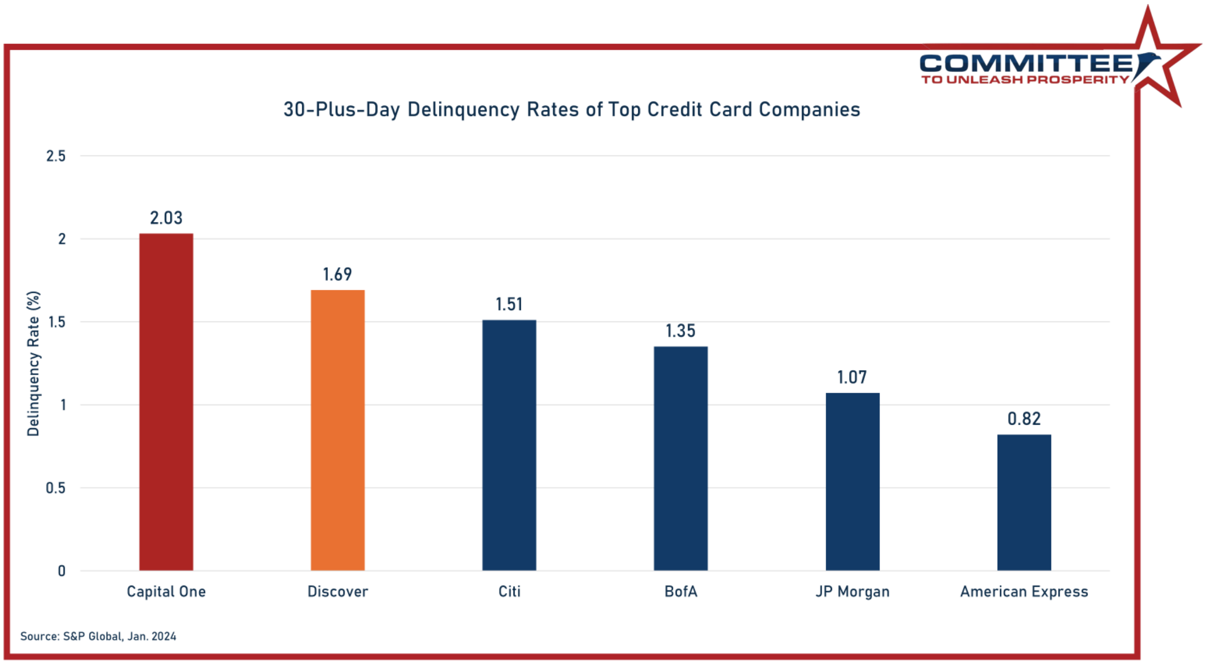
These statistics in isolation, however, fail to include important contextual information. By acquiring Discover, Capital One may surpass its competitors in the number of credit cards issued and credit card loans held, but

9 https://www.fool.com/the-ascent/research/average-credit-card-processing-fees-costs-america/

10 "Initial Thoughts on Potential COF/DFS Deal," Piper Sandler, Feb. 19, 2024

11 https://www.forbes.com/advisor/credit-cards/credit-card-statistics/#:~:text=Largest%20Credit%20Card%20Issuers,-By%20far%2C%20Chase&text=This%20is%20substantially%20higher%20the,106%20million%20cards%20in%20circulation.

this means that Capital One is offering credit to a wide range of both high and low income borrowers and taking on the risk of those loans. Cardholders and the debt they accumulate are only assets if they make their payments. They are a liability if the cardholders don't. Credit card debt is fundamentally an unsecured loan with the lending company taking on the full risk of the debt.



In order to compete with more dominant lenders, Capital One and Discover hold the debt of riskier borrowers. This is evident in the payment delinquency rates of the top credit card lenders. As of January 2024, Capital One and Discover had the highest delinquency rates of all U.S. credit card lenders. At 2.03% Capital One has nearly double the payment delinquency rate of JP Morgan. And at 1.69%, Discover is double that of American Express. Contrary to what critics of the deal may say, accepting more borrowers and holding more debt is a competitive strategy that comes with risk along with benefit. And it is notably the less creditworthy borrowers that benefit from this approach.

Antitrust Regulation Reduces Competition

As an economic principle, markets remain competitive as long as there are low barriers to entry and competitors are permitted to innovate freely. It is the introduction of prohibitive regulation that makes a market susceptible to regulatory capture and the extraction of rents due to market concentration. Nobel prize winning economist, George Stigler, illustrated this fact in his seminal 1972 paper, "The Process of Economic Regulation." The financial industry is no exception to this principle. It is only the threat of antitrust regulation that keeps competitors out and allows dominant firms to maintain their commanding market position. So ironically, if the merger critics succeed in preventing Capital One and Discover from vigorously competing with the dominant firms such as JP Morgan, American Express, Visa, and Master they will allow them to maintain and even increase their position in the market to the detriment of American consumers.

Credit card interchange fees, or more accurately "swipe fees" in the context of three-party payments systems like Discover and American Express, have been a recent target of political ire. Last year a bipartisan group of congressmen led by Senator Dick Durbin (D-IL) introduced the Credit Card Competition Act[12] on the theory that Visa and Mastercard command oligopoly power in the credit card network market. This piece of government regulation would require that an alternative transaction network other than Visa and Mastercard be available on every card to process purchases.[13] The perceived threat of legislation like this passing and crippling the Visa and Mastercard business model, may provide a partial motivation for Capitol One to acquire its own payment network. This is ironic that many of the same politicians now seek to block the merger.

Ironically, the underlying logic of this legislation is that unless government regulation requires an alternative network to be provided to consumers, Visa and Mastercard will raise swipe fees unchecked. Now, through a free-market process, the Capital One-Discover merger promises to provide a strong alternative network without a mandate. But far from embracing this market solution to this claimed "market failure," lawmakers are trying to block the deal. The evident principle is that for lawmakers, the only acceptable solution to any problem is more regulation, even when the source of the problem is regulation.

12 https://www.durbin.senate.gov/imo/media/doc/The%20Credit%20Card%20Competition%20Act%20of%202023%20-%20one-pager.pdf

13 Economist Stephen Moore thoroughly explains the detrimental consequences of this legislation in the CTUP study, "The Durbin Credit Card Interchange Fee Caps Will Cost Consumers"https://committeetounleashprosperity.com/wp-content/uploads/2023/10/231030_CTUP_DurbinCreditCard.pdf

Conclusion

The Capital One-Discover merger presents a pivotal opportunity to drive increased competition in the financial industry, potentially bringing significant benefits to American consumers. Despite political opposition alleging concerns of market concentration, a closer examination reveals a robustly more competitive post-merger landscape.

Criticism from both sides of the political spectrum appears to be motivated by an ideological rejection of free market competition rather than a genuine economic concern. However, industry competitors have demonstrated unexpected support for the merger, recognizing its potential to foster innovation and drive better outcomes for consumers

The enthusiastic response from investors and the potential creation of a vertically integrated payment network signal promising shifts in the market that will benefit consumers. Moreover, the combination of Capital One and Discover's assets and market presence, while substantial, remains modest compared to industry giants like JP Morgan Chase, reinforcing the fact that this will result in increased competition rather than market consolidation.

The merger also offers a free market alternative to resolve political concerns regarding credit card interchange fees without price controls or mandates. By providing an alternative transaction network, the merger could mitigate the dominant position currently held by Visa and Mastercard, potentially leading to lower fees and improved benefits for consumers.

Ultimately, the opposition to the Capital One-Discover merger appears rooted more in political ideology than genuine concerns about market competitiveness. There is no economic or antitrust justification for the federal government to block this deal.

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