



# Assessing the Shockwaves from Capital One's Plan to Purchase Discover



**Capital One just announced a definitive agreement to buy Discover Financial Services for \$35.3 billion in an all-stock deal representing a 26.6% premium to Discover's Feb. 16 closing price of \$110.49.**

The acquisition "is a singular opportunity to bring together two very successful companies with complementary capabilities and franchises, and to build a payments network that can compete with the largest payments networks and payments companies," Capital One CEO Richard Fairbank said in a press release for the deal.

Undoubtedly, Capital One-Discover will be a formidable player in payments, and banking more broadly, and reshape the competitive dynamics for card issuers, financial institutions, and networks. The acquisition will have far-reaching implications for market constituents, potential regulatory actions, and competitor responses that will alter the payments landscape. It will be intriguing to watch this unfold over the next few years.

While Capital One and Discover provided great summary information during an investor call tied to the announcement, numerous questions still exist given the recency of the news and initial market reactions.

**Below are major themes and considerations based on SRM's initial perspective of the deal.**

- 1. Capital One-Discover Will Be a Card Issuing Force:** While Discover's value as a viable third-party network can and will be debated, the network's value to Capital One cannot be overstated, especially given the current competitive and regulatory environment. As Fairbank noted, Discover "has created one of the rarest assets in the payment space, a global payment network at scale."

On their own, Capital One and Discover are the nation's fourth- and sixth-largest credit card issuers, ranked by purchase volume, while the combined company will be the third-largest issuer post-closing, according to *The Nilson Report*. While size and scale have always been an important aspect of credit card issuing, the ancillary benefits of owning a network asset are even more noteworthy.

Capital One will have inherent cost advantages compared to competing bank issuers, evidenced by the company's

anticipated \$1.2 billion in modeled network synergies. Furthermore, owning a network will enable Capital One to directly engage merchants and generate revenue that does not require capital reserves or carry typical credit risk.

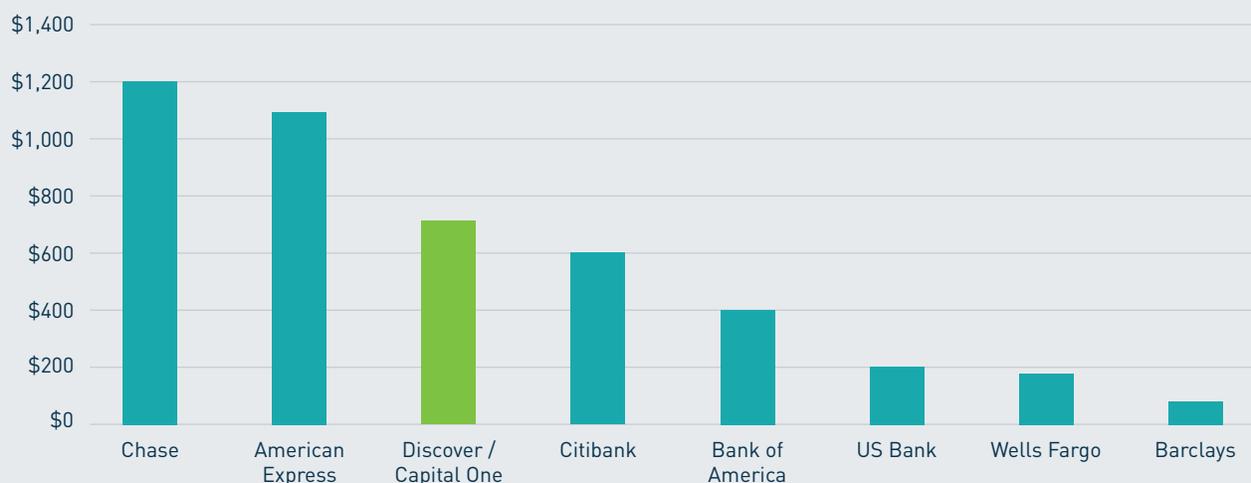
"What we're trying to do over time is build merchant relationships and show merchants how we can help generate more sales, which is exactly how Capital One Shopping works," Fairbank said. "By going direct through the network, we can build even deeper merchant relationships and provide customized value."

Less mentioned, but potentially the greatest advantage of the network to Capital One, is how it complies with debit regulations. Specifically, three-party systems as defined in Reg II (where the network is the card issuer) are not considered "payment card networks" and the Durbin Amendment's regulations are specific to debit cards that participate in payment card networks. As such, Reg II would not apply to Capital One debit cards if they are issued on the Discover network. SRM estimates that the annual incremental interchange revenue Capital One may secure could be more than \$350 million based on the difference between exempt and non-exempt effective rates. It could be even higher because the dual-unaffiliated network requirement would not apply to such cards.

Additionally, the acquisition would be a significant hedge against the future passage of the Credit Card Competition Act ("CCCA"), at least in its present form. As currently drafted, the CCCA, which was introduced by Sens. Dick Durbin, D-Ill., and Roger Marshall, R-Kan., would require issuers with more than \$100 billion of assets to support two unaffiliated payment card networks, with one unaffiliated network not being Visa nor Mastercard, on their credit cards.

Similarly to Reg II, the current CCCA draft would exempt three-party systems, so Capital One would be exempted from the law if it began issuing credit cards on the Discover network. Issuing Discover credit cards will mitigate headwinds Capital One would potentially face, including significant capital investment to address technology and back-office implications and the potential for reduced interchange due to routing competition.

## 2023 Adjusted US Credit Card Purchase Volume by Network (\$B)



Source: *The Nilson Report – Issue 1249*

The inherent economic advantages of securing more revenue and mitigating expenses will enable Capital One to incrementally invest in its payments portfolio, and potentially retail banking portfolio, at a level that its competitors cannot. This should lead to more innovation, superior products and services, and card value propositions, including potentially debit rewards, which are not currently offered by most of the largest bank issuers. This will give Capital One a unique advantage to compete against the largest banks for traditional deposit products and cards. The acquisition likely enables Capital One to invest more in its retail footprint than many other banks.

- 2. Expanding the Discover Network:** While Discover has always been a formidable credit card issuer and has broadened its business to deposits and loans, its network has suffered from perceived acceptance gaps and the company has experienced limited success selling network services to banks and credit unions. Discover's front-of-card debit market share is not material, and the company's debit success has been centered around selling PULSE as a viable unaffiliated network option to Visa and Mastercard debit issuers.

Capital One's acquisition, if completed, has the potential to reshape the competitive dynamics in the debit network space. Fairbank indicated that Capital One would transition its proprietary card portfolios from Visa and Mastercard to Discover, with debit being one of the first initiatives it

would undertake. Capital One expects to add over 25 million cardholders and over \$175 billion in purchase volume to the Discover network by 2027.

Once complete, the Discover debit network will have the marquee client it has historically failed to attract. Capital One's debit business has over 7 million cards that generated almost \$60 billion in purchase volume last year, according to *The Nilson Report*. As debit issuers have long sought alternatives to Visa and Mastercard, Capital One's issuance of Discover debit, given increased scale coupled with the bank's strong data, technology, and marketing assets, seems to suggest that Discover debit may be a truly viable third option for issuers. The success of Discover's debit network will be highly dependent on its overall strategy, economic value-proposition for issuers and merchants, and whether banks and credit unions feel comfortable partnering with a competing bank issuer.

- 3. Mitigating Deposit Concerns:** An ancillary benefit to the Capital One acquisition is the \$84 billion in stable, largely insured consumer deposits on Discover's balance sheet. These deposits will enable Capital One to leverage a strengthened balance sheet to grow credit card receivables and loans given its existing capital requirements. It also signals to other regional issuers, that continue to aggressively defend and attempt to attract deposits, that acquiring deposits with M&A may be more expedient and cost-effective than relying on organic growth.

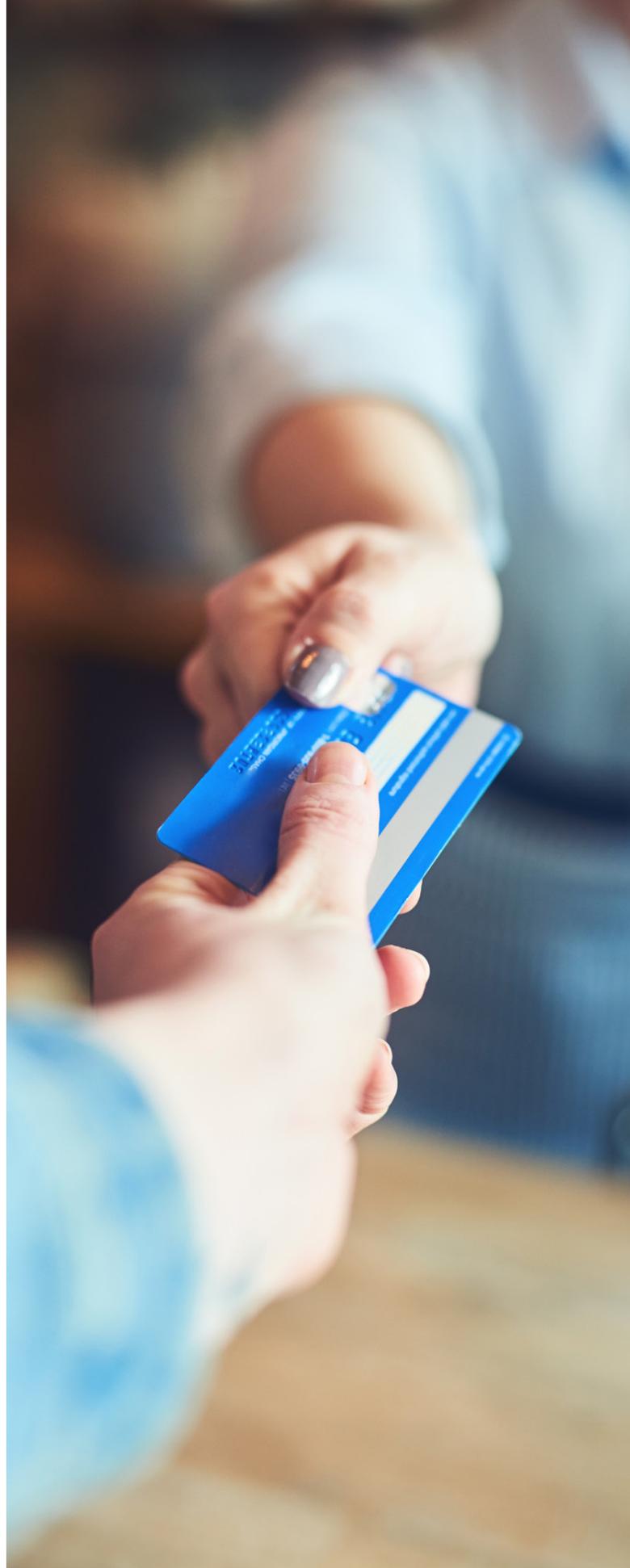
Previous transformative acquisitions in the payments and banking space led to a wave of similar deals as competitors reacted quickly to remain competitive. Fiserv's acquisition of First Data led to subsequent payment processor consolidation, while the merger of BB&T and SunTrust spurred considerable regional banking consolidation. However, the likelihood of any of Capital One's competitors following suit with a major acquisition seems improbable as the remaining network assets (e.g., Visa, Mastercard, and American Express) are materially larger and the hurdles to develop a network asset organically seem too high. Yet, it's almost certain Capital One's acquisition will prompt a response from the largest banks and networks (for example, the implementation of unique issuer and network relationships/offerings such as ChaseNet may increase). It will likely make it more difficult for community banks and credit unions to compete, especially in the cards business.

**One uncertainty is the probability that this acquisition withstands regulatory review.** This is a significant transaction that will reshape the payments and banking landscape and activists in all branches of government will likely want to weigh in. Rep. Maxine Waters, D-Calif., has already voiced strong opposition to the deal, while Durbin has yet to weigh in. Given the Justice Department's recent history of extending reviews of bank acquisitions, or in some cases, attempting to block such acquisitions (e.g., Visa's attempted acquisition of Plaid), all parties should be prepared for a lengthy process.

## The Bottom Line

Capital One-Discover, if approved and completed, will significantly shake up the banking and payments industries. Many large financial institutions will be at a significant disadvantage competing for retail customers' deposit and payments accounts. Many financial institutions were caught off-guard by the deal and are likely scrambling to develop their responses. Smaller issuers are going to lose some of the relative benefits of holding less than \$10 billion of assets as it relates to competing directly against Capital One.

SRM will continue to track this critical acquisition this year, including the regulatory approval process and its impact on pending legislation and regulation. Contact us if you have any questions about the deal and its broader implications on your business strategy.



## About the Authors



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Myron Schwarcz is Chief Product Officer at SRM and has more than 20 years of experience in the financial services industry advising leading financial institutions, card issuers, merchant acquirers, payment processors, software providers, and other entities. Major initiatives under his management include new business launches, vendor selections, contract negotiations, and business strategy development.

Myron has extensive consulting expertise. He has advised clients in North America, South America, and Western Europe in matters involving market entry, portfolio growth, business transformation, platform evaluations, and contract negotiations. His work in this area spans all aspects of business advisory, including evaluating strategic options, financial analysis, market analysis, vendor selections, and implementation support. Myron has supported many business evaluations related to both consumer and commercial banking.

Prior to SRM, Myron managed the Strategic Sourcing practice at First Annapolis Consulting, now an Accenture Company. He holds an MBA from Georgetown University, an MS in Information Systems from Drexel University, and a BS in business from the University of Delaware.



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**SENIOR DIRECTOR** 

Andrew Gordon is Senior Director of Project Management at SRM. Gordon has more than 15 years of experience in the financial services industry advising leading national and regional banks, community banks, credit unions, card issuers, payment processors, and other entities with payment strategy and strategic sourcing initiatives. Gordon's primary focus is vendor evaluation and selection, contract negotiation, and payment strategy development.

*Myron Schwarcz, Chief Product Officer, and Andrew Gordon, Senior Director of Project Management, have extensive experience in the banking industry, advising leading financial institutions on their strategic initiatives.*

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