ForeSight

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A More Competitive Debit Network Battlefield

The global and EFT debit networks are pulling out all the stops to protect, defend, and expand their respective market share.

Savvy merchants are deploying smart routing to reduce processing fees to maximum effect, and issuers are working to limit the negative impact of that action on their debit card income. Networks are deploying new products and creative pricing in the no man's land between issuers and acquirers. And the overturn of the Durbin Amendment would turn the tide of the battle in an instant.

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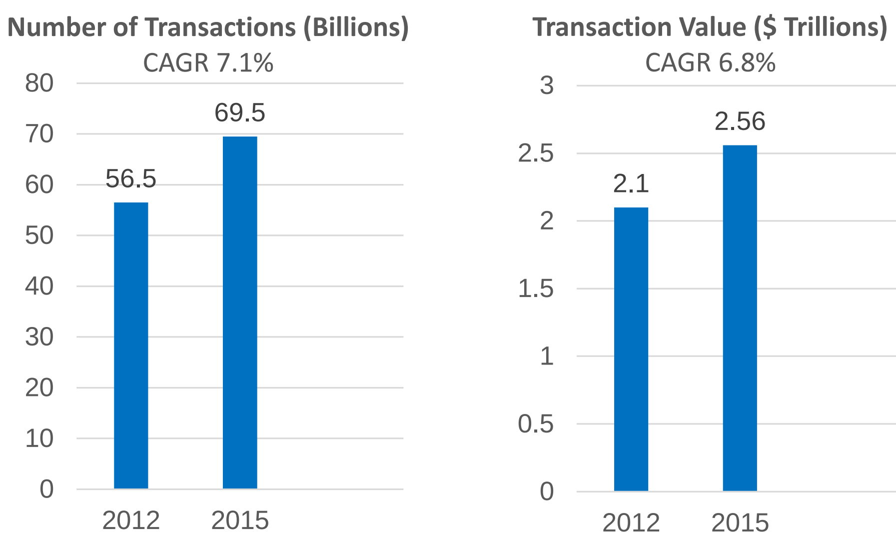
Introduction

From the looks of things, bank-issued, network-branded debit cards are having a good run. Although a mature product, debit continues to see reliable year-over-year transaction growth. Summary data from the 2016 Federal Reserve Payments study reveals that transactions and dollar volumes grew in the high single digits for three years from 2012 to 2015, as shown in Figure 1.

Figure 1: U.S. Debit Card Growth, 2012–2015



Source: The Federal Reserve Payment Study, 2016

This solid growth belies the tumult that is occurring behind the data. Three parties of the four-party payment system—issuers, merchants, and acquirers—are engaged in a battle to control volumes, costs, and revenues, while the fourth party—the cardholders—is standing confused at the point of sale not sure whether to swipe, dip, or waive their card or phone and whether or not they will need to remember a personal identification number. The unknown future of regulations governing debit and the emergence of financial technology (fintech) upstarts leave the outcome even more uncertain as the fight takes place in-store, over mobile phones, and online. This Mercator Advisory Group ForeSight document reveals which parties are gaining the upper hand and how - overturning - the Durbin Amendment of the Dodd-Frank Wall Street Reform and Consumer Protection Act may reverse the current industry direction and send winners to retreat positions.

Taking Sides

Merchants

Merchants, out of necessity, are becoming better informed about the importance and role that payments play in their business. A complex shift in the types of fraud involving payment cards, the confusing and sometimes contentious rollout of EMV technology, including a challenge over debit EMV rules, as well as the introduction of mobile payments of all varieties have forced merchants to extend resources not to their core business but to the devices and software that are needed to safely accept whatever sort of payment mechanism a customer may want to use. Merchants have learned well from the experience and are savvier about where and how to direct payment transactions to optimize the outcome. This is not necessarily the least expensive route.

Merchants are "smart routing" or optimizing their payment acceptance not just to consider what networks are available on a card but also to take into consideration transaction risk and throughput at the checkout line. During the seconds it takes for a consumer to pay for goods, a merchant using smart routing is processing data points that will lead to a decision regarding transaction type and cardholder verification method (CVM). This type of rules-based decisioning capability has already been deployed by large merchants whose IT specialists can code business rules to affect the outcome. This capability is winding its way downstream as merchant processors begin to deploy this type of technology for smaller merchants. In a matter of seconds, a merchant must choose among the following transaction types at the point of sale (POS):

Dual-Message Debit Transaction. A debit card transaction in which the data streams for authorization and clearing are two separate events. Dual-message debit transactions usually require a signature as the cardholder verification method, but that requirement can be waived by the merchant or in some cases a personal identification number (PIN) can be requested.

PIN-Authenticated Visa Debit (PAVD). PAVD is a transaction type that operates using Visa's dual-message processing network and a PIN, should the *merchant* request it. A merchant selling valuable good like electronics or jewelry who wants an additional level of cardholder verification may utilize this transaction type. Around the time PAVD was launched, Visa encouraged its adoption through the announcement of an incentive called Fixed

Related Concerns

If you find this piece of interest and would like to explore this issue further, possible proprietary project work could be done to examine questions like these:

What is the best way to develop a strategic plan for debit cards within your organization?

How can you as an issuer select the optimal network affiliations for your debit cards?

What considerations should you take into account to maximize your organization's debit card income?

What are the likely impacts of the U.S. Faster Payments initiative on the network debit?

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Acquirer Network Fee (FANF). FANF offers merchants a fixed monthly fee and lower per-transaction fees, incenting merchants to send as much of their transaction volume as possible to Visa to maximize their incentive.

Single-Message Debit Transaction. A debit card transaction in which the data sent from a merchant's terminals includes all the information necessary for authentication and clearing all in a single event. These transactions are still commonly referred to as "PIN debit" transactions even though personal identification numbers are not always required to execute a transaction.

PINless Debit Transaction. PINless debit, a single-message debit transaction that doesn't require a PIN, was first rolled out by the electronic funds transfer (EFT) debit networks to support the use of debit for online bill payments. The transaction type is now available for all online transaction types as well as lower-value purchases conducted in stores.

The routing freedom that merchants have is a hard-won right and continues to be a point of contention to this day. Large merchants that were optimizing their routing without input from debit card cardholders ran afoul of network rules. Visa asserted, through the use of multi-million-dollar fines, that merchants could not determine transaction type and CVM on their own but were required to allow consumers to choose. This particular battle came down to interpretations of federal regulations and network rules. Unable to find common ground, Kroger, Walmart, and Home Depot filed lawsuits in 2016 against Visa (and in the case of Home Depot also against MasterCard).

On November 2, 2016, direction changed again. Based on a carefully worded question posed to the Federal Reserve Board of Governors, the Board issued a statement making it clear that merchants in fact *do* have full control regarding where debit transactions are routed given the networks associated with a consumer's card and no input from the consumer is needed.[i] The 160-word paragraph has many industry implications: Merchants and merchant processors can go full steam ahead to optimize their routing, the lawsuits with the global networks now have another wrinkle to contend with, issuers will see more transactions routed through the EFT debit networks, which can mean less interchange income, and consumers are in a game of POS roulette, not knowing how their transactions will proceed, if a given transaction will impact their debit rewards points, and which verification method, if any, will be required of them.

Issuers

For issuers, the influential debit card events of the last several years have meant less interchange income and greater expense. The cost of converting cards from magnetic stripe to EMV chip technology was a very visible, multi-billion-dollar expense that financial institutions incurred. A subtler but still significant change was the need to include two unaffiliated networks as required by the Durbin Amendment. Where issuers in the past could send all transactions through one of the global networks with a Visa/Interlink or MasterCard /Maestro combination to encompass both PIN and signature transaction types, now another vendor relationship was required, which often included the addition of an EFT debit network (Accel, NYCE, PULSE, STAR, and others).

The addition of the EFT debit networks on debit cards and the routing freedom for merchants meant more transactions were directed at the EFT debit networks, returning less interchange to issuers. For larger issuers, which represent 65% of total debit transactions and are covered by the Durbin Amendment's interchange rate caps, the difference between the global network interchange and the EFT debit network rates exists, but it is minimal. The Federal Reserve Board of Governor's 2015 Interchange Fee Income report calculated that both global and EFT debit networks were returning approximately $0.23 in interchange revenue per average transaction. With interchange for covered institutions at par, these issuers are focused on reevaluating their network contracts to look for cost saving and incentives. Exempt issuers still enjoy full interchange on global debit network transactions, providing $0.51 per average transaction, but merchants' routing decisions are decreasing the number of transactions that will earn the higher interchange level.[ii] Both covered and exempt issuers find .their revenues are further affected by negotiated rates that are offered to the largest merchants. Outside of any regulatory action, networks looking to gather as much transaction volume as possible will offer rates that are below the Durbin interchange caps to these largest of the large merchants. So regardless of an issuer's asset size, the issuer may see lower returns on 30–40% on its debit card portfolio transactions than were seen before the Federal Reserve's pronouncement.

Issuers are also experiencing new expenses as a result of a shift in fraud. Since debit issuers trailed credit issuers in the migration to EMV chip cards, counterfeit card fraud and the ensuing fraud losses shifted from credit cards to debit cards, the weaker link in the card ecosystem. At the same time, transactions are shifting from in-person to digital channels. This has required issuers to begin investing in more sophisticated authentication capabilities to recognize card-not- present fraudulent transactions in online and mobile environments. Fraud is also showing up with PINless debit transactions routed through the EFT debit networks. Many issuers are assuming that transactions coming through the EFT debit network pipes are PIN verified, but at the merchant's option, many are not and more fraud losses result. Issuers are beginning to apply the same risk tools typically employed with MasterCard and Visa signature transactions to PINless debit transactions. Some are taking the drastic measure of simply declining altogether any EFT debit transactions without a PIN.

Networks

The global debit networks are looking to move on from the current mundane issues of card fees, interchange, and routing and to attract attention to new developments. The development of their digital enablement capabilities with tokenization services is an example. Currently all tokenized transactions, including mobile payment transactions, are going through the tokenization vaults operated by the global networks. As the internet of things (IoT) expands and we find that bots, cars, refrigerators and washing machines, etc. are conducting transactions, more activity will funnel through the global networks to token-secure the transactions.

It is possible for other organizations to compete, but there are steep barriers to entry. First, the standards for payment tokenization are created by EMVCo, an organization managed by the global networks, which puts it at odds to certify a competing organization. Alternatively, an upstart organization could enter the space and create a separate standard, but that would necessitate merchants, processors, and issuers all agreeing to the new standard. That would be a tall order given the sheer volume of participants and the effort required. The global networks have also set the current cost of tokenization services at $0.00. This gives an upstart little incentive to innovate with an alternative service.

The EFT debit networks in the meantime are expanding their debit product capabilities by introducing dual-message debit capabilities, where the authorization and clearing are separate transactions. This mirrors the capabilities of the global network signature transactions and allows competing with them head to head. PINless debit transactions are now available through the EFT debit networks, where previously transactions were only available with a PIN. PINless debit transactions are gaining volume at a rapid pace both digitally for online and mobile transactions as well as in-person to help merchants move customers quickly through their checkout lines.

Cardholders

Little of the recent activity in debit payments has been beneficial to the cardholders. They bear the implications of the decisions made by their card issuers, the merchants where they shop, and the card networks, as these entities determine what is in their own best interest to maximize revenues, reduce cost, or rein in fraud. The migration to EMV was confusing and frustrating to many consumers. The slower or perceived slower checkout times are still a point of conversation. The message that EMV provides improved security is well received, but debit cardholders rarely bear any financial responsibility for unauthorized transactions, so that effect is hardly noticed. The impact of transaction routing, now determined by merchants, can affect cardholders negatively however. Not only are they unsure which CVM will be required of them, but also they cannot select a transaction type that could reward them through their financial institutions' debit rewards program. Cardholders are also unable to select a transaction type that will allow them to avoid transaction fees that some financial institutions charge for certain debit card payments. The combination of regulatory requirements and protectionist activities by issuers, merchants, and acquirers has shamefully ignored the customer experience.

Conclusions: What Might Be Next

Following the election of Donald Trump as U.S. president, an expectation based on campaign promises has been created that financial regulations will be significantly scaled back and new regulations will be scarce. Although payments providers can only plan for the laws and regulations that currently exist, having an outline of how to react in the event of a regulatory overhaul may speed up reaction time in the event of any changes likely to have an impact on the payments environment.

The probability of regulatory changes notwithstanding, consider what might happen if some of the stipulations of the Durbin Amendment were to disappear. Consider what the market reaction would be if the interchange caps were to be removed and the requirement for two unaffiliated networks disappeared.

The networks would be hard pressed to raise interchange back to original market levels for those financial institutions with greater than $10 billion in assets. Merchants now experiencing lower interchange for years for most debit transactions or enjoying contracts with discounted, negotiated rates would revolt and quickly look to add or develop new payment solutions to circumvent the networks. With available products such as decoupled debit, which uses ACH rather than the card rails, the launch of same day ACH, and the potential of new faster payments capabilities, merchants have an abundant environment for integrating existing and developing new non-network payments. There is no shortage of fintech companies with which to partner to help incubate new payment methods. If debit card fee caps were to be removed, a likely outcome would be little change at all to existing interchange levels for the most common transaction types, but strategically placed interchange-based incentives could be used by merchants to encourage the adoption of new transaction types or to encourage new niche markets.

The release from the two unaffiliated network requirement would also have an impact on payments, but one that would play out over time. Issuers may want to reduce the number of networks they support, but the change to cards and systems that would be necessary would take time to accomplish. Since issuers will need the global reach of the MasterCard and Visa networks, a decision to reduce network partnerships would likely be detrimental to the EFT debit networks. The EFT debit networks would then likely protect their market share and offer incentives to protect their business, potentially starting a network bidding war that will advantage the financial institutions. If these changes do indeed play out, cardholders will once again not experience any noticeable benefits. This will simply be a new development and shifting direction in the ongoing battle for network payment transactions.

Endnotes

[i] https://www.federalreserve.gov/paymentsystems/regii-faqs.htm
[ii] https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm

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