A First Data White Paper

The Path to Compliance: Selecting Another PIN Debit Network

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Introduction

The Durbin amendment (Section 1075) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA) is causing tremendous upheaval in the electronic payments industry. The law calls for the U.S. Federal Reserve Board (FRB) to develop regulatory provisions that affect debit interchange rates, debit network processing, and merchant payment acceptance options. These dramatic changes will impact the business of every issuer of debit cards.[1]

In December 2010, the FRB announced proposed rules to implement Section 1075 of the DFA and solicited comments from card issuers, networks, merchants, processors, consumer advocates and others. In March 2011, the FRB announced that it plans to issue final regulations on debit interchange fees, network exclusivity and merchant routing by July 21, 2011. Once the final rules are issued, financial institutions (FIs) and others in the payments industry may only have a few months to comply with certain aspects of the regulations.

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Over the last few years, the payments industry has not been able to escape the increased government intervention that has affected many sectors of the U.S. economy. Accordingly, now is the time for banks and credit unions to start planning for how to adapt to the changes—whatever they ultimately may be. By being proactive, executives can position their companies advantageously relative to the inevitable changes.

Specifically, FIs need to plan for the Durbin provision and the pending FRB regulations related to the prohibition on debit network exclusivity and routing restrictions. Designed to give merchants a choice of networks over which a debit card transaction may be routed, this provision requires issuers to participate in at least two unaffiliated debit access networks. The FRB is considering two options for this requirement:
(A) requiring all card issuers, regardless of asset size, to participate in two unaffiliated debit access networks; or (B) requiring all card issuers, regardless of asset size, to participate in two debit networks per authorization method (e.g. two unaffiliated signature debit networks and two unaffiliated PIN debit networks). Either way, many FIs will need to select at least one (and possibly more) additional network to work with.

The purpose of this paper is to help FIs understand the impact of non-exclusivity and to provide them with information on how to choose an alternative PIN debit network, if necessary. And because the government will soon be setting debit interchange rates, the criteria behind selecting a PIN debit network will henceforth be based less on the highest revenue potential a network can deliver for the lowest cost, and more on the best overall value that can be realized over the life of the partnership. This value is defined by a variety of benefits the network can provide, including acceptance, integrity, consistency, innovation and relationships.

Financial institutions should be aware that there are important strategic benefits to picking an additional network—irrespective of the pending regulations. Now is the time for issuers of all sizes to form strategic partnerships with organizations that provide a greater breadth of options and deeper value propositions—especially when the future regulatory environment is highly uncertain.

[1] Although the Durbin amendment includes an exemption for financial institutions with less than $10 billion in assets from regulation of debit interchange fees, these companies must comply with the law's provisions concerning prohibition on network exclusivity and routing restrictions.

The impact of non-exclusivity

Governor Sarah Bloom Raskin, who serves on the Board of Governors of the Federal Reserve System, explains the Durbin amendment provision that requires the FRB to prescribe rules related to the routing of debit card transactions:

> *"First, the Board must adopt rules that prohibit issuers and payment card networks from restricting the number of networks on which a debit card transaction may be processed to fewer than two unaffiliated networks. Second, the Board must adopt rules that prohibit issuers and networks from inhibiting the ability of merchants to route debit card transactions over any network that may process such transactions. Together, these provisions appear designed to give merchants a choice of networks over which a debit card transaction may be routed. The statute applies these provisions to all issuers, including the small issuers and government-administered payment and other prepaid programs that are exempt from the interchange fee standards."*[2]

As a result, FIs that today have an exclusive relationship with a debit payment network will be required to add at least one other unaffiliated network in order to provide choice to the merchants. As of this writing, the FRB is considering public comment on both alternatives and a final decision could come with the final regulations on debit interchange fee restrictions, which is to be no later than April 21, 2011. If alternative (A) described on the previous page is chosen, the FRB has proposed an effective date of October 1, 2011. If alternative (B) is chosen, the FRB has proposed an effective date of January 1, 2013.

While it is not clear today which alternative the FRB will choose, or what the final implementation date will be, what is certain is that many card issuers need to start evaluating their options and decide which additional network or networks they will add to their payment processing capabilities to ensure they are participating in at least two unaffiliated debit networks. Separately, the FRB has also proposed that merchant control of electronic debit transaction routing would be limited to only those payment networks enabled on the debit card by the FI.

Why act now?

There is a strong case for FIs to be proactive in their decision-making to keep ahead of the regulatory curve and the competition. The benefits of acting now include the ability to:

- Become knowledgeable and gain confidence about key network benefits
- Realize first-mover advantages and position to capture new opportunities
- Plan and develop a cardholder communication strategy
- Stage network implementation process to avoid queues
- Schedule and implement any necessary branding changes
- Receive advanced training on customer portal and other key systems

In addition to the proposed regulations providing an incentive for FIs to consider expanding their network partnerships, other compelling reasons to take prompt action include:

- Adding diversity to network routing choices
- Developing partnerships with innovative parties that will deliver the desired payment network features and functionality of the future
- Proactively addressing the market forces driving the proposed regulations.

[2] Statement by Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives, February 17, 2011

"Value" is the new top consideration for selecting a PIN debit network partner

In the past, card issuers partnered with the network(s) and promoted authentication methods that simply allowed them to generate the most interchange income. The FRB's regulatory interpretation of the Durbin amendment seems to neutralize that selection criterion because the agency has proposed that both PIN and signature debit interchange rates would be set at the same lower level. Now FIs need to look for long-term value in a network that goes beyond signature or PIN debit interchange revenue. Network value will be redefined in terms of how well the network can lower costs, help the FI reduce fraud, position the issuer with merchants, and prepare for future form factors and value-added services.

Here is a look at the new value propositions for selecting a PIN debit network:

Acceptance

More than ever, FIs need to consider a network's value to merchants. In the post-Durbin landscape, merchants will be a newly empowered driving force in payments processing. Surely every issuer wants to ensure its cardholders have a good experience at the point of sale (POS), and that includes broad acceptance of its card. Thus, an FI should partner with a PIN debit network that can demonstrate superior merchant acceptance throughout the country.

Broad merchant acceptance is also important when the FI wants to encourage consumers to adopt new form factors and technologies. For example, some issuers are deploying the new one-time card number fraud mitigation technology known as STAR CertiFlash®. This technology requires contactless readers at the POS. Because the STAR network and First Data have extensive relationships in the merchant community, STAR is able to encourage merchants' atcceptance of the CertiFlash contactless technology, which in turn makes it easier for issuers to rollout this fraud mitigation solution—as well as mobile payment technologies and other contactless form factors.

Due to lower processing and fraud costs associated with PIN, another factor to consider is how well a network partner is able to grow acceptance of an issuer's card, especially in areas where, historically, PIN acceptance has not been prevalent. The ability to use a debit card safely instead of cash or a check is important to the consumer, and some networks have been more successful than others in expanding debit card acceptance among merchants.

Operational Capacity

Approximately 35 percent of all noncash payments in the U.S. are handled via debit card today—more than any other payment type. What's more, debit card payments have grown more than any other form of noncash payment over the past decade, increasing from about 8 billion payments in 2000 to almost 38 billion payments in 2009.[3]

With more of this kind of growth likely to shift towards PIN, it's important that FIs consider the system integrity of any new debit network partner. In addition, once the prohibition of network exclusivity becomes effective, there will be considerable movement of payments from affiliated to unaffiliated PIN debit networks. The new network partner must be able to handle the influx and volume of transactions from a processing and settlement perspective, as well as from a support perspective.

[3] The 2010 Federal Reserve Payments Study, December 2010

Fraud Mitigation and Risk Reduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act gives the FRB the authority to make adjustments to debit interchange rates for fraud-mitigation costs incurred by an issuer. However, it is not clear what approach the FRB will take to enable such adjustments. Nevertheless, FIs should look for a network partner that has innovative yet cost effective fraud mitigation and risk reduction solutions that can help drive fraud out of the payments value chain: within the card, the merchant process, the issuing process, and the transaction. Such solutions can reduce an FI's costs and liabilities and provide a boost to the bottom line.

Future Proofing

The payments landscape is changing in other ways that are not a direct effect of the Durbin amendment. For example, the migration from magnetic stripe to contactless and potentially to chip and PIN; the broader acceptance of mobile payments; the increase of card-not-present payments for eCommerce; the emergence of peer-to-peer (P2P) payment services. There is significant innovation underway in the financial services industry—and FIs need to be developing strategies and making plans on how to deploy these emerging technologies and solutions as they become available. A component of any "future proofing" strategy should include choosing a debit network partner that is positioned to build and deploy new solutions in the future.

Relationships

One outcome of the Durbin amendment is that merchants will now be able to choose the network routing for debit card transaction processing—a choice they have never had before. Accordingly, FIs may find that this makes it advantageous to consider selecting a network partner that already has deep relationships on both the issuing and acquiring sides of the payments value chain.

Conclusion

The Federal Reserve Board's final rules are yet to be determined, but one thing is fairly certain: many financial institutions will need to choose a new or additional PIN debit network partner to comply with the forthcoming regulations. While it is not yet known which network non-exclusivity alternative the FRB will choose, or what the final implementation date will be, card issuers should start evaluating their options and determine which additional network or networks they will add to their payment processing capabilities to ensure they are in compliance.

The traditional approach of choosing a debit network solution based solely on interchange revenue potential will no longer be valid. Instead, FIs must choose their network partner(s) based on long-term value, opportunities for growth, and a strategic business advantage. Important considerations include:

- Acceptance
- Operational Capacity
- Fraud Mitigation and Risk Reduction
- Future Proofing
- Relationships

The proposed regulations are an important reason for FIs to consider expanding their network partnerships; however, savvy FIs understand the strategic benefits of taking action irrespective of regulatory mandates to maximize the diversity of their networks, prepare for the future and better address the needs of the market and their cardholders.

Not only should FIs carefully consider all of the strategic implications of selecting additional debit network partners—they should act quickly in order to mitigate risks and capitalize on potential first-mover advantages in the altered payments landscape.

Payment Solutions for Maximum Performance

The STAR Network is an integral part of First Data Corporation's breadth of payment solutions. First Data makes payment transactions secure, fast and easy for merchants, financial institutions and their customers. Whether the choice of payment is by debit or credit card, gift card, check or mobile phone, online or at the checkout counter, First Data takes every opportunity to go beyond the transaction.

About the Author

Kevin Barry is general manager for First Data Corporation's STAR® Network. Barry joined First Data in 2009 with more than 20 years of experience in the financial services industry, including time as vice president and director of retail products and research at Commerce Bancorp. In that role, he oversaw product management for retail deposit products, debit cards and marketing research. He previously served on Visa's Debit Product Executive Council, PLUS Network Executive Council and Visa DPS Product Advisory Group.

Most recently, Barry was senior vice president and director of marketing at Republic First Bancorp. He also has worked at FirstTrust Savings Bank, Corestates Financial (Wachovia) and the Federal Reserve Bank.

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