Managing the Debit Cost Challenge in a Changing Payments Landscape

A First Data Perspective

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Overview

In spite of all the changes in the banking industry, the current account has remained central to managing the retail client relationship. While it can be accessed by a range of payment instruments, the debit card has become by far the most common.

Control of the current account has become a major battleground due to its importance as the account into which salary or benefit payments are made. While bank revenues from fee-based products such as life insurance or consumer loans may be very clear, debit card economics until recently have been very opaque. Many banks, however, now need to have a much clearer focus on the cost base of their debit card programmes. Ensuring the economic viability of debit card programmes is now a major priority for banks everywhere.

Given the fundamental changes taking place, particularly in the European payments market, this is a crucial development. The introduction of the Single Euro Payments Area (SEPA) on 1 January 2008 is leading to much greater transparency in - and questioning of - the real cost of running debit programmes while putting traditional debit business models at risk. Within Europe, SEPA is opening up new opportunities to both increase revenues and reduce costs through regulatory challenge of existing debit economics and the demand for interoperability of card payments across Europe.

One of the major challenges facing debit card issuers is the growing cost of compliance. This is just one of several trends impacting debit card economics. Others include:

→ European banks are reviewing their approach to debit in light of regulatory and commercial changes

→ Banks in the Middle East, Asia-Pacific and Latin America are seeing huge increases in debit card issuing and transaction volumes

→ Debit issuing is becoming increasingly internationalised, driven by the expansion of multinational banks

→ Debit will maintain its key role as the major current account access instrument, but differentiation will become a major market requirement

→ Driving economies of scale, reducing compliance costs and increasing cost efficiencies will be critical success factors

→ Standardisation will become the norm to ensure cross-border interoperability, while product innovation and differentiation will be key to maintaining customer loyalty

→ Processing flexibility and the ability to issue cards of more than one payment scheme will be a major advantage for banks looking to build significant market share

→ Creative channel management into the current account will become increasingly important, with mobile phones and other delivery channels adding convenience to the service.

In this report First Data highlights the major trends in European debit. We have spoken to senior executives in European banks to get their opinion on the major opportunities and challenges in the debit market. Several leading payment consulting firms have also shared insight with us on the potential for debit in Europe and beyond.

First Data hopes that this report will open up debate on the future direction of debit and how to make the most of the opportunities to reduce costs in this critical product area.

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Introduction - The Importance of Debit

Debit cards are now easily the most popular card payment product in Europe and elsewhere. They account for the vast majority of bankcard transactions across Europe today and debit usage is now growing faster than credit in almost all markets around the globe. It has become the most important access instrument to the current account and is therefore seen as the key to the retail banking relationship.

The explosive growth of debit cards, and in particular its usage for retail purchases, is happening because it benefits all stakeholders - cardholders, merchants and banks, as well as the wider economy.

Cardholders tend to see debit cards as more convenient than cheques and a more secure way of paying for day-to-day transactions. As a result, debit is the natural replacement for cash transactions - a long-term trend boosting debit card growth.

Merchants prefer debit because it is generally much cheaper to accept than credit payments due to lower interchange fees and reduced fraud risk. This is a trend being encouraged further by European regulators currently challenging the level of card payment fees. These fees are expected to decrease under SEPA since their level today is viewed by many as unacceptably high and structurally inconsistent.

Revenue on debit is mainly generated in three ways: card fees; interchange and earnings from interest on overdrafts.

Debit is a 'must have' utility product for cardholders so that they can access funds in their current account. However, banks are finding that, as card numbers and usage increases, the total cost of debit processing grows. This growing cost base can no longer be offset to the same degree by interchange fees (falling) or card fees (unacceptable in most markets).

There is also scope for debit cards to grow beyond their traditional role, as internet and mobile payments become more established, providing further opportunities to generate revenues. Opportunities to expand the usage of debit cards in new payment environments increase the likelihood that a higher proportion of debit cards are activated and used regularly.

While outsourcing of debit processing itself is not the driver of debit profitability, it has a key role to play in enabling banks to implement new technologies cost effectively and to leverage the full potential of increasing debit revenues.

To summarise, debit is important to banks for three main reasons. First, it offers significant opportunity to rationalise retail bank services, replacing cash transactions and reducing related operational costs.

Secondly, current debit economics are being heavily challenged under SEPA as well as by other changes, such as the requirement for interoperability regardless of the different formats in Europe. This puts the current debit business model and related revenue sources at risk.

Finally, debit offers the opportunity to secure future card revenues by moving from a utility product to a value-added product. The only way to achieve this is through product enhancements, combining debit with additional services and banking business lines (e.g. loyalty programmes). In this way, debit can act as a catalyst for product innovation, allowing access to new markets and customer segments.

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Market Trends and Issues

The debit card market is becoming much more volatile after a ten-year period of relative stability:

- → Card interchange is under attack from both national and multinational regulators, with debit card interchange being at the greatest risk
- → Products available in the market are changing, with international card schemes introducing new debit products and at least one new European debit card scheme in active development
- → Technical standards for cards are changing, resulting from the SEPA initiative; EMV is now mandated. Interoperability based on common standards is replacing national propriety standards
- → Many of the national debit card schemes are evaluating whether they have a future role in a more unified European payments landscape.

Banks and advisory firms interviewed for this report identified four top trends and issues:

1 Optimising programme economics

Although most banks do not regard debit card as a true P & L because it is seen as an access channel to the current account, the economics of debit are becoming increasingly important.

As debit card programmes become ever larger, competitive alternatives and compliance costs continue to grow. Therefore, there is increasing focus on understanding and optimising programme economics. For most banks it is no longer acceptable to position the debit card as an undifferentiated utility with no detailed operating economics.

While most of the costs on debit can be identified, there are currently major revenue and cost challenges for issuers. On the revenue side, debit card interchange is falling as a result of regulatory pressure. With the implementation of SEPA, the charging of cross-border fees within the Eurozone is no longer permissible. Meanwhile, on the cost side, the migration to EMV in several countries is a major cost burden and there is now a realisation that the cost of remaining compliant with the international schemes is much higher than traditionally assumed. These cost pressures are forcing many banks to reconsider their debit processing models.

Consequently, banks are increasingly looking for solutions creating cost synergies in the back-office by sharing tools for both credit and debit card programmes (e.g. fraud, data management and customer service facilities).

2 The brand decision

Unlike the credit card market where the Visa/ MasterCard duality has become the norm, banks have traditionally chosen a debit card offering from only one of the international payment schemes. However this situation has now started to change.

Banks increasingly want to issue products of more than one debit scheme in this large and growing market and to have the flexibility to switch between brands as they wish. This is particularly important as the brands may have different success in handling the regulatory attack on interchange. As a result, the ability to issue more than one brand - and to switch brands to take advantage of better interchange or scheme incentives - is seen as increasingly important. But this flexibility must not result in additional costs for banks.

As the structure of the European debit market changes, with at least one new debit scheme being developed, more banks will decide to issue at least two debit card brands. For banks operating in multiple markets, it is unlikely that a single brand approach will deliver optimal results.

3 Product specification

Banks are starting to look at how they can develop a superior debit card offering, moving from a commodity to a value-added product. The objective is to offer a better debit card proposition through added-value services (e.g. insurance and other cardholder benefits). This represents an opportunity for banks to create additional and/or new revenue streams on debit through the increasing number of creative loyalty programmes, similar to those offered by many credit card programmes. A growing number of non-traditional players are running pilots around ‘decoupled debit cards’, where a self-registered off-host card is used at the POS to access the cardholder’s bank account.

4 Multiple market issuance

SEPA brings the promise of a fully open European market with banks able to issue standardised debit card products in multiple markets. However, this process will take many years to be completed and multi-country banks are urgently seeking ways to achieve maximum product consistency and cost-efficiencies between markets in advance of the SEPA end-state.

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The Debit Cost Challenge

Banks are facing a range of costs challenges, driven by the introduction of new regulations which fundamentally change the market (e.g. SEPA and the European Union's Payment Services Directive) and compliance. Revenues are being impacted by falling interchange rates and the difficulty of charging debit card fees in many markets.

There are some strong forces for change in the European payments market, which are having a big impact on debit card economics. They include:

→ Cost reduction and re-engineering in some of Europe's biggest banks

→ The need for owners of non-SEPA compliant payment processing systems to either invest in making them SEPA compliant or, if not, to find suitable alternatives in-house or with other processors

→ The increasing internationalisation of major European retail banks and their search for economies of scale across multiple markets

→ Mid-sized banks want, but cannot achieve, the same processing and cost efficiencies as the big banks

→ More banks want to issue more than one debit brand without increasing associated costs

→ Ongoing EMV migration in several countries is increasing the cost base of banks' debit card businesses, although also reducing fraud levels as EMV cards are introduced.

Banks that issue cards of the international card scheme brands have to comply with a range of quarterly IT updates and other requirements, while members of national card schemes face the added challenge of deciding whether or not to invest in making their national scheme compliant with the SEPA Cards Framework (SCF).

According to consultants AT Kearney, allocating in-house processing costs is difficult when debit processing is not carried out by a separate unit and the infrastructure is typically part of the current account operations and systems. AT Kearney also notes that identifying per-transaction costs can be even more challenging for banks as many debit cards carry more than one brand and originate transactions that are switched through different processing infrastructures with different costs.

One of the biggest compliance challenges is SEPA. This is driving standardisation as it breaks down national economic, IT and regulatory barriers to entry.

Among the key impacts of SEPA are:

→ There will be an increasing migration to products that are compliant with the SEPA Cards Framework (SCF)

→ Cost reductions have to be driven through economies of scale, either within markets or cross-border

→ Banks with retail operations in multiple markets will find it easier to issue debit products in different countries, presuming that current interoperability hurdles, such as managing the different proprietary processing formats and standards in the various markets, are solved efficiently. For those banks that wish to enter new markets through greenfield operations (e.g. direct banks) or through acquisition, standardisation will make this an easier and less expensive move

→ For those banks that outsource card processing, additional synergies will be gained by processing debit and credit transactions on the same platform, sharing the same back-office facilities and services.

SEPA brings the prospect of cross-border debit issuing much closer for a larger number of banks. Fully-open markets should mean that standardised debit products can easily be issued, assuming the bank has the local infrastructure to support them.

Given the high compliance burdens, the high cost and the slow pace of innovation and other technical challenges, outsourcing can be an efficient way for banks to rationalise their debit operations and get a clear view of the costs involved.

EMV migration - mandated under SEPA - will be an additional cost for banks in markets that have not yet fully moved to chip and PIN technology.

"The big cost issue for us on debit is the migration to EMV," said Grigoris Politis of the cards and consumer banking products support division at Alpha Bank in Greece. "This will affect us from the cost side as it will make the cards more expensive to produce. However chip technology will allow us to reduce fraud losses, helping us to recover much of this investment. Other than that, I don't think initially (in the next two to three years) SEPA will have much of an impact."

At present, less than 50 European banks have a cross-border retail banking presence. This is most certainly a direct consequence of the existing national market structures in Europe as well as the technical challenge of managing different formats and standards in these markets.

As SEPA opens debit card markets and drives interoperability, the standardisation process will allow banks in the mid-term to start issuing cross-border without the hurdles they experience today. This process is expected to create a richer and more economic service proposition to the consumer.

Banks' current debit cost challenges are also exacerbated by the fact that many of them process debit transactions on legacy systems, making it more costly and technically difficult to innovate in product development and to drive economies of scale.

"Many debit portfolios are run on legacy infrastructures which are not very cost-efficient," notes AT Kearney. "The case to migrate to more capable card management systems comes from the need to introduce a more differentiated debit product offering with value-added services that allow for new revenue sources, so it is less of a cost motivation than the option to innovate and differentiate."

Given the high compliance burdens, the high cost and the slow pace of innovation and other technical challenges, outsourcing can be an efficient way for banks to rationalise their debit operations and get a clear view of the costs involved. The actual cost becomes a very transparent number on a third party processor's invoice, which can be tracked and worked towards delivering real value over the lifetime of the contract.

Opportunities to drive synergies

Rising compliance costs and the need to drive economies of scale are just two of the reasons why an increasing number of banks are looking to outsource debit. Associated reasons for an outsourcing model include:

→ The speed to market for innovation and new products can be improved enormously by a specialised vendor that can pull in ideas from projects delivered across the globe

→ The processing and related risks associated with entering into new markets, whether through cross-border issuing or other geographical growth plans, can be reduced with established processors that are already on the ground in those markets

→ Multiple schemes, languages, currencies and product types are typically all available for launch, out of established and proven platforms

→ Costly errors can be eradicated through access to up-to-date and best of breed management information. This gives insight to real-time transaction data and other key business metrics resulting in high data quality, accuracy and control

→ It becomes easier and less costly to link value-added services, such as data analytics, loyalty and fraud to debit where outsourcing companies offer the full value chain as part of their value proposition for debit and other business lines.

There are increasing demands from banks to get the best possible synergies from their processing infrastructure. One way to do this is by processing several products on the same platform, such as debit and credit cards.

Driving synergies through using centralised platforms enables banks to gain significant processing system and financial advantages. "The benefits [of centralised processing] are clearly one common platform, a common authorisation process, lower maintenance costs and the delivery of a common product and service to the customers. IT centralised processing and centralisation is more effective," said Peter Jones, managing director of PSE Consulting.

The overwhelming view from banks interviewed for this report was that there would be cost efficiencies if transactions for several products could be processed on one platform. This would also enable banks to organise their processing systems and structure more efficiently.

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First Data Perspective

There is a new dynamic to debit processing in Europe and many other markets around the globe. First Data has developed a comprehensive strategy to respond to these marketplace pressures and to provide a very relevant service to European banks. The First Data debit solution provides the following benefits:

Multi-brand and multi-country support

First Data supports all major debit card products, making it easy for a bank to offer multiple brands and to switch brands if this becomes necessary. This avoids too much reliance on one organisation and allows flexibility for banks, without requiring them to build connections to multiple schemes and then maintain ongoing compliance. The First Data solution can also provide services seamlessly in multiple markets for banks with international business.

Technical standards support

First Data supports EMV and all major European technical standards, enabling banks to avoid this investment. The First Data policy is to adopt and support all major new technical standards.

Modular service offering

The debit solution can be provided on a modular basis at a low cost so that banks can outsource selected elements of the debit card value chain without having to pay for a 100 percent solution on a 'take it or leave it' basis.

Back-office efficiency

First Data's debit solution includes optional services for fraud and risk control, management reporting, and exception item (chargeback) administration. These can be configured to create significant back-office savings for banks. If First Data is also being used for credit card processing, the savings are even larger.

Value-added support

Included in the First Data debit solution are optional components for loyalty programmes and data warehouse and analysis services, so that banks can exploit the marketing potential of using a processor for both debit and credit card transactions.

End-to-end transaction support

The Trionis processing network - resulting from First Data's joint venture with EUFISERV - can be used to create additional flexibility and service possibilities. Trionis supports bilateral and 'on us' switching between banks in the combined First Data/EUFISERV network.

Cost-effective outsourcing

As the complexity and cost of running debit card programmes increases, a growing number of banks are looking to maintain the management of current account systems in-house while outsourcing debit interfaces and card management. The First Data debit solution is highly cost-effective for banks and an ideal way to ensure that operational costs are both fully transparent and optimised.

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Summary

Many banks are reviewing their approach to debit in light of regulatory and commercial changes. In recent months, this review has been accelerated further by the global credit crunch and the critical importance of managing bank liquidity. The replacement of heavy IT investment plans with outsourcing alternatives can be a very attractive option for financial institutions.

Debit will maintain its key role as the major current account access instrument. However, driving economies of scale, reducing compliance costs and increasing cost efficiencies will be critical success factors. In a market where standardisation will become the norm, product innovation and differentiation will be key to maintaining customer loyalty. Finally, processing flexibility and the ability to issue cards of more than one payment scheme will be a major advantage for banks looking for market growth and expansion.

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