



Navigating Uncertainty: Post Durbin Debit Issuing

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Executive Summary

In the next 12 to 24 months, debit industry participants will face a level of uncertainty unlike any other.

At the forefront, the Federal Reserve published Regulation II, Debit Card Interchange Fees and Routing. This rule implements the Durbin Amendment, setting forth regulations that will affect all debit issuing institutions regardless of size, strategy, or operational strength.

Most notably, non-exempt issuers (those with assets greater than \$10 billion) will face a steep reduction in interchange revenue; however **all issuers** will face uncertainty surrounding interchange structures and routing arrangements. Issuers with exclusive brand and network agreements will be required to add an unaffiliated debit network(s) and are in the process of evaluating participation dynamics. Additionally, non-exempt issuers may have to implement additional fraud measures to earn the 1¢ fraud premium and renegotiate contracts to ensure compliance.

In order to maintain a profitable debit card business, issuers will need to re-evaluate strategies and apply operational and business changes to compete effectively in a post-Durbin environment.

Since the rules were first announced, several non-exempt issuers have eliminated debit rewards programs, altered DDA structures, and introduced new customer fees, although the effectiveness of these tactics is still unknown. Alternative, more customer-friendly, tactics available include: integrating debit processing, employing effective debit segmentation, enhancing products through innovation, and optimizing fraud strategies.

An integrated or “Single Pipe” debit processing strategy, characterized by one highly robust processor connection for all debit, prepaid, and EFT processing, can help issuers navigate uncertain debit markets. The model provides increased flexibility by allowing issuers to change network participation with limited disruption and implementation costs. Additionally, back office functions are simplified, the ability to segment portfolios and launch new products is enhanced, and fraud monitoring is more robust. The result is a debit operating model that delivers superior functionality and operates consistently, regardless of network routing dynamics.

More savvy issuers will employ additional tactics to mitigate market challenges. Portfolio segmentation provides issuers with increased insight into customer behaviors enabling the ability to match the right product to the right consumer. Providing enhanced products such as mobile functionality, for bill payment, remote purchases, and person-to-person uses will soon be table-stakes for debit issuers. Lastly, developing optimal fraud strategies will improve the bottom line.

The following paper provides a summary of Regulation II and tactics issuers can employ to remain flexible and agile — attributes necessary to achieve strategic objectives and to weather market uncertainty.

Durbin Amendment Overview

This section summarizes Regulation II, the Federal Reserve rule which implements the Durbin Amendment, section 1075 of the Dodd-Frank Wall Street Reform Act. With final regulations effective beginning October 1 of this year, industry participants face unprecedented uncertainty. While some provisions affect “exempt” issuers (those with assets less than \$10 billion) differently than “non-exempt” issuers (those with assets above \$10 billion), understanding the regulation is essential for all stakeholders.

The regulations include five key components:

Section 235.3: Interchange Transaction Fees

Affects: Non-Exempt Issuers

Regulation II mandates an interchange transaction fee cap composed of a base fee of 21¢ and an *ad valorem* component of 5 basis points (bps) of the transaction’s value. In this provision, the Federal Reserve broadened its earlier definition of allowable issuer costs and added the *ad valorem* component which takes into account a portion of the fraud losses incurred by the issuer in order to provide incentives for both issuers and merchants to take steps to reduce fraud. First Annapolis Consulting estimates that non-exempt issuers will experience a 48% reduction in interchange revenue (36% reduction for the industry in total), resulting in a \$7 billion reduction in merchant interchange expense (see appendix for a breakdown of interchange fees by merchant category).

Exhibit 1: Interchange Cap based on Allowable Costs

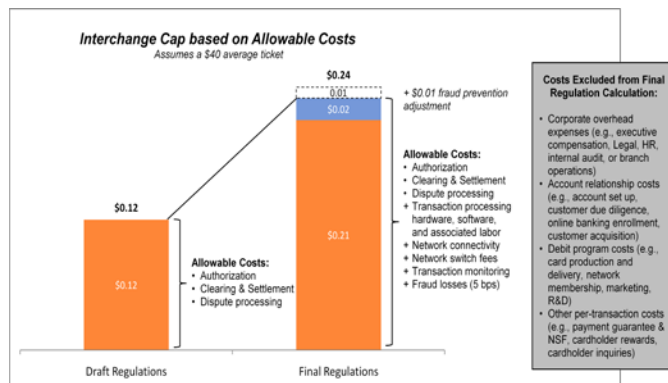
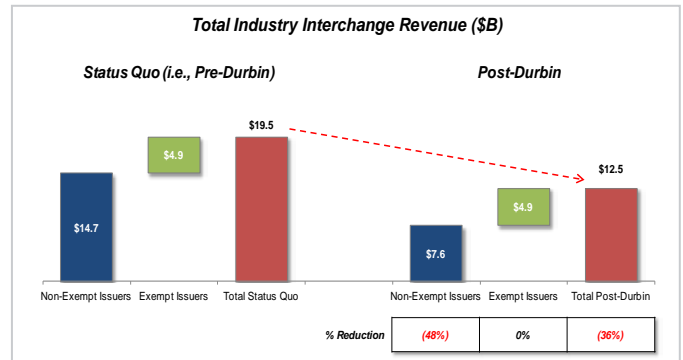


Exhibit 2: Total Industry Interchange Revenue (\$B)¹



¹Notes: Analysis assumes that networks maintain current interchange rates for exempt issuers which represent an estimated 28% of volume. Analysis includes small business debit. Analysis excludes prepaid. Analysis uses Status Quo interchange rates of 1.53% signature and \$0.23 PIN. Interchange rates for post-Durbin are \$0.21 plus an *ad valorem* 5 bps fee plus the 1¢ fraud adjustment. Based on 2011 transaction and purchase volumes. Source: First Annapolis Consulting analysis.

Section 235.4: Fraud Prevention Adjustment

Affects: Non-Exempt Issuers

In conjunction with publishing Regulation II, the Federal Reserve adopted an interim final rule allowing a fraud-prevention adjustment of 1¢ per transaction conditioned upon the issuer adopting effective fraud prevention policies. An issuer will be considered compliant by implementing policies and procedures designed to:

- Identify and prevent fraudulent electronic debit transactions (EDT);
- Monitor the incidence of, reimbursements received for, and losses incurred from fraudulent EDT;
- Respond appropriately to suspicious EDT so as to limit the fraud losses that may occur and prevent the occurrence of future fraudulent EDT; and,
- Secure debit card and cardholder data.

Section 235.6: Prohibition on Circumvention or Evasion

Affects: Non-Exempt Issuers

Section 235.6 of Regulation II prohibits the total amount of compensation provided by a network to an issuer in a calendar year, in the form of per transaction rebates or other incentives, from exceeding the total amount of fees paid by the issuer to the network. This prohibition is intended to prevent networks from circumventing the interchange fee standards by channeling merchant fees to issuers.

The calculation of Net Compensation excludes interchange fees, membership fees, and switch fees, but includes signing bonuses (pro-rated over the contract term) and any other incentives. Incentives for services not directly related to network participation (e.g., debit processing, credit card services) are not included in the amount of compensation. Existing agreements will not be grandfathered and will be subject to the prohibition on net compensation.

Section 235.7: Network Non-Exclusivity

Affects: All Issuers

Regulation II stipulates that no issuer shall restrict the number of payment card networks on which an EDT may be processed to less than two unaffiliated networks (e.g., one signature network and one unaffiliated PIN network, two unaffiliated PIN or signature debit networks).

Further, the regulation also details prohibited and allowable arrangements under the network exclusivity rule. Regulation II:

- Prohibits arrangements that limit an issuer's ability to contract with other networks.
- Prohibits networks from specifying other networks that may or may not be enabled on the card.
- Prohibits network rules that allow only one network's brand to appear on the card.
- Does not require that debit cards display a brand or mark of each network enabled.

- Allows an issuer to include affiliated networks as long as at least two networks enabled are unaffiliated.
- Requires all debit form factors to comply.
- Networks may offer payments or other incentives to merchants or acquirers to influence their routing choices.

Section 235.5: Exemptions

Affects: All Issuers

Regulation II provides for three categories of exemptions from the interchange transaction fees limits only: Small issuers (i.e., less than \$10 billion in assets); government administered programs; and certain general purpose reloadable (GPR) prepaid cards.

Small Issuers²

In general, small issuers are excluded from the provisions of Regulation II, specifically, Sections 235.3 (interchange transaction fee), 235.4 (fraud prevention adjustment), and 235.6 (prohibition on circumvention or evasion). This exemption applies to an interchange transaction fee received or charged by an issuer with respect to an EDT if the issuer holds the account that is debited and the issuer, together with its affiliates, has worldwide banking and non-banking assets, other than trust assets under management, of less than \$10B as of the end of the previous calendar year. Although the fraud-prevention adjustment of 1¢ per transaction does not apply, small issuers still have strong incentives to implement strategies to reduce fraud.

Government Administered Programs

Interchange rates for government programs will be determined by the payment card networks and may or may not be aligned with debit issuer interchange rates. The exemption applies to in-house programs, programs outsourced to a third-party, and programs that are not government-funded. Finally, the debit card may only be used to transfer or debit funds or other assets pursuant to the government program. This final provision will negatively affect the utility and marketability of certain FSA and HSA cards.

General Purpose Reloadable (GPR) Cards

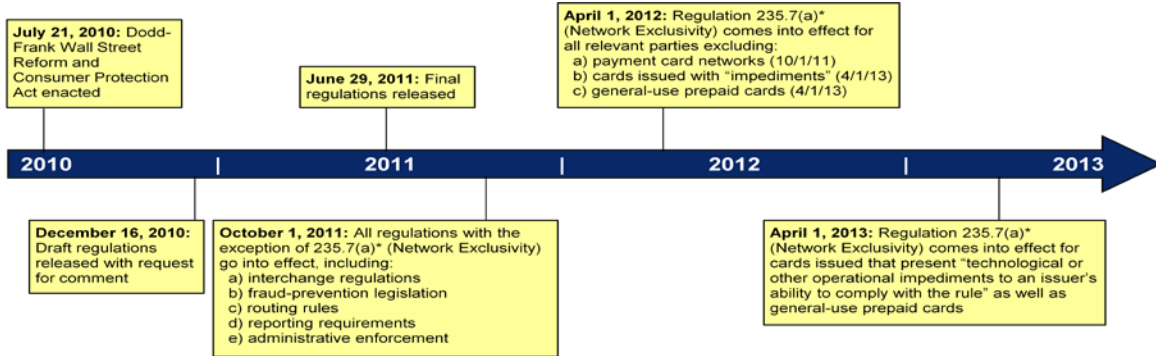
The final Federal Reserve regulations narrowed considerably the scope of the GPR exemption. Generally, the regulations limit the opportunities for issuers to use GPR products as DDA replacements in an attempt to earn exempt interchange. First, prepaid programs with omnibus account structures are exempt; programs in which the underlying funds are attributed to separate individual accounts are not. Prepaid cards in which funds may be accessed by any method other than the card are not exempt. For example, limited use of convenience checks and online bill payment are likely not allowed for exempt GPR programs. Finally, issuers, program managers, and/or retailers can not promote an exempt card as a gift card at any time.

² Small Issuer Exception Qualification: The Board will publish annually lists of institutions above and below the small issuer exemption threshold, which may be used to determine whether an issuer qualifies for the small issuer exemption.

Effective Dates

The first set of final regulations will become effective beginning October 1, 2011, followed by two additional effective dates of April 1, 2012 and April 1, 2013.

Exhibit 3: Regulation Effective Dates



Uncertain Issuing Environment

The final Durbin Regulations have several practical implications for industry participants and will affect exempt and non-exempt debit issuing institutions differently. Irrespective of size, all issuers will face an uncertain landscape, increasing the importance of **flexibility** and **agility** with respect to contract structure, processing environment, and network configuration / participation. At a high level:

- Non-exempt Issuers will face a steep reduction in interchange revenue. The impact on issuers with less than \$10 billion in assets is less clear, as networks have introduced interchange schedules for exempt and non-exempt issuers; however, it is unclear how market forces will affect dual interchange schedules.
- With signature and PIN interchange rates equivalent, non-exempt issuers who do not thoroughly consider other factors may attempt to shift portfolio spend to PIN in an attempt to reduce fraud losses.
- Non-exempt Issuers with contractual arrangements that do not pass the Net Compensation test (i.e., incentives that exceed the total amount of fees paid by the issuer to the network) will have to renegotiate or restructure contracts.
- Issuers required to add an unaffiliated debit networks will have six additional months (until April 1, 2012) to identify and implement the optimal partner(s). Current network and issuer processor relationship will affect the extent to which this is a burden on issuers. If an issuer's current processor is well-positioned to act as a flexible network provider, implementation and compliance cost and effort will be greatly reduced.
- Prepaid as a DDA alternative is less viable as allowable functionality is significantly diminished in the final regulations (e.g., prepaid cards in which funds may be accessed by any method other than the card are not exempt). As an alternative, debit issuers may look to promote non-Durbin regulated payment types (e.g., credit and charge).
- Merchants are likely to route transactions over the least-cost network option. It is unclear whether networks will negotiate deals with merchants or acquirers to influence their routing choices.

Overall, the combination of economic reshuffling, network non-exclusivity and merchant routing provisions will require operational and business changes on behalf of **both exempt and non-exempt** issuers to remain profitable. Issuers will face significant uncertainty over the next 12 – 24 months as provisions take effect and those who position themselves to be agile and flexible will be able to better navigate industry developments.

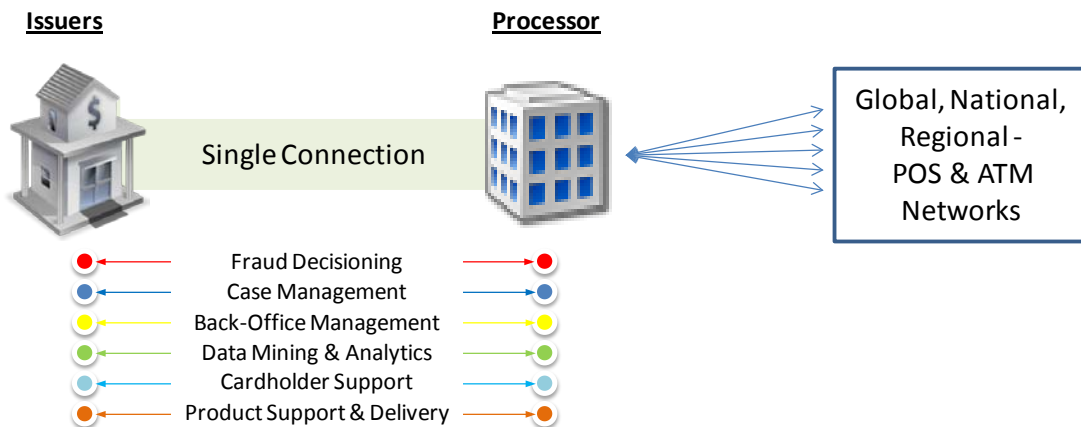
Integrated Debit Processing using a “Single Pipe” Solution

A “Single Pipe” strategy allows issuers to aggregate multiple debit processing services, specifically signature debit, PIN debit, and prepaid, through a single processor interface in order to improve efficiency and ensure consistency and robustness in service delivery. The approach provides issuers the flexibility to change network participation with limited disruption and implementation costs, a strategic advantage in an uncertain and evolving market. Additionally, the approach positions issuers to make use of portfolio segmentation, enhance products through innovation, and improve fraud strategies.

This section highlights the structure and advantages of a “Single Pipe” debit processing strategy issuers should consider as a means to position themselves optimally to mitigate significant portions of lost interchange revenue, achieve strategic objectives, and maintain debit portfolio profitability in a post-Durbin environment.

In order to maintain compliance with respect to Durbin, participation in a second non-affiliated debit network must also be established and supported via a connection through the issuer processor. As Exhibit 4 illustrates, the key attribute of the model is a single point of connectivity allowing for increased flexibility and agility in regards to network participation in the new multi-network environment.

Exhibit 4: Single Pipe Operating Model



In a debit processing environment employing multiple vendors and network connections — the alternative to a “Single Pipe” solution — an issuer will experience infrastructure, people, and process duplication, thereby increasing expense and/or reducing efficiency. This inefficiency can manifest itself in many ways. First, different connections often use proprietary message formats, with unique transaction data elements, unique files and file transmission methods and ancillary services content. Additionally, multiple circuits, routers, firewalls, and data warehouses must be maintained, contributing to a complicated and costly infrastructure and IT maintenance and support environment. Similarly, issuers must support multiple settlement and reconciliation

processes, multiple dispute and chargeback policies, and potentially multiple fraud strategies. These issues are not always transparent to customers, as multiple processor and network connections can potentially lead to inconsistent customer experience for alternative transaction types (e.g., I get mobile alerts on some of my debit transactions but not others). The end result is an inefficient and more expensive debit issuing business model.

In a post-Durbin environment, an integrated or “Single Pipe” debit processing strategy allows an issuer to avoid these inefficiencies. The complex infrastructure and IT architecture of a multiple vendor strategy is eliminated, substantially reducing hardware, software, and support expenditures. The single connectivity allows for participation in multiple EFT networks while minimizing the burdens of interface management, network mandates and enhancements, and implementation of network-based innovations. Strategically, issuers will also be able to change network participation with limited disruption and implementation costs, a valuable feature in today’s dynamic debit network environment. For example, an issuer implementing a second unaffiliated network will avoid costs associated with a new network interface by leveraging its processor as the provider; furthermore, the issuer can quickly change network participation if its corresponding selection becomes suboptimal from a routing perspective.

A “Single Pipe” solution also enhances back office efficiency. First, issuers will benefit from a single interface and point of settlement for all debit networks, resulting in fewer data transmissions, less variation, and simplified reporting and reconciliation. Chargeback and dispute processing is also simplified as analysts can use one back-office data tool across all networks. Enhancements in fraud administration and detection may also be observed as one fraud management system can be used for all networks and transaction types. Further, issuers will only need to create one set of fraud rules to deploy across their entire card base. Employing one consolidated fraud case management system further reduces variation and simplifies the research and filing process. From a detection standpoint, combining processor and network capabilities (e.g., Visa Advanced Authorization) provides issuers the ability to use two tools, resulting in lower fraud losses. The architecture also provides an enhanced view of consumer behavior enabling more holistic fraud detection. Additionally, aggregating all debit networks through a common processor allows issuers to perform highly-effective common-point-of-compromise analysis to determine quickly the source of a fraud compromise and identify affected cardholders.

Consolidated data mining and analytics is critical to issuers in an uncertain environment and a “Single Pipe” strategy may lessen or alleviate the need for substantial in-house data mining/analytics investments or at a minimum, lessen the integration expenses that flow from fragmented processing. The structure also provides an issuer with the ability to view all accounts and activity across all debit and prepaid networks, providing issuers with enhanced ability to segment, target, plan, and track revenue growth strategies and payment portfolios.

From a strategic standpoint, having discrete, easily measurable third-party vendor costs attributable to debit card transaction processing is advantageous to issuers. The Federal Reserve plans to gather information from covered issuers regarding their costs every two years and costs associated with an integrated solution will be easy to report and defend.

While an integrated debit processing strategy offers substantial benefits, it also presents issuers with certain risks. Selecting the appropriate partner is imperative as the strategy concentrates vendor risk. To mitigate these risks, issuers must carefully consider the extent to which their processor supports their needs in terms of agility, flexibility, commitment to innovation, and alignment with and support of the issuer’s goals related to customer service and long-term profitability.

Tactic: Employing Debit Portfolio Segmentation

Portfolio segmentation — the process of analyzing patterns of cardholder behavior and actively managing groups of customers exhibiting similar behaviors — is a key tactic for issuers to effectively manage uncertainty around debit portfolio profitability.

Using data analytics or statistical programs to query debit cardholder transactional activity, issuers are not only able to gain a holistic view of portfolio metrics such as penetration, activation, and usage, but also insight into the specific factors and dynamics influencing debit cardholder behavior.

Exhibit 5: Portfolio Segmentation Example

Elevate	<ul style="list-style-type: none"> Target accountholders who consistently use issuer’s debit card, but do not keep the card ‘top of wallet’.
Expand	<ul style="list-style-type: none"> Target accountholders that exhibit narrow debit usage (i.e., limit use to small set of MCCs) and encourage broader card usage.
Re-engage	<ul style="list-style-type: none"> Within the portfolio there is a material set of customers with a history of debit use who haven’t transacted recently. There is an opportunity to re-engage these accounts.
Migrate	<ul style="list-style-type: none"> Target accountholders who frequently use the ATM and write checks but infrequently use POS debit.
Cross-Sell	<ul style="list-style-type: none"> Certain accountholders may be targets for conversion to a alternative payment product, credit, charge and / or prepaid card offering
Dormant or Debit Inactive	<ul style="list-style-type: none"> Do not reissue card after expiration

Segmentation can also be utilized to track interchange revenue and fraud costs at the transaction and cardholder levels. The result is the increased insight necessary to customize communication and messaging to maintain, engage, cross sell, or even cut ties with groups of customers based on desired outcomes. Exhibit 5 provides an example of actionable items an issuer may undertake to increase revenue or reduce cost as a result of debit portfolio segmentation and analysis.

In a post-Durbin environment, having the capability to analyze cardholder behavior and target customers with the appropriate product will be essential. Most issuers have a subset of debit cardholders who exhibit behavior more suitable for a credit or prepaid product; moving them into the correct product is often more profitable.

Furthermore, some customers may be unprofitable and cutting ties with those customers may be beneficial to the overall profitability of a debit card portfolio. An issuer may select a policy to not reissue cardholders in this segment at expiration, thereby reducing reissuance costs, marketing costs, and account on file processing fees while eliminating any potential fraud on the card account.

Given the importance of portfolio segmentation, a “Single Pipe” strategy provides issuers with the ability to change networks without compromising or needlessly complicating their ability to segment effectively. However, optimal implementation requires a processor with advanced analytics capabilities that work effectively in a multi-network environment.

Tactic: Enhancing Products through Innovation

After using portfolio segmentation to identify key customer groups, issuers may define product innovations tailored to business goals and segmentation dynamics. Although the timing, range, and extent of product innovations vary widely, mobile banking, payments, and commerce must figure into every issuer’s plans.

The delivery of a consumer-facing mobile service that supports all phone types and allows a consumer to view account information and receive alerts for their accounts and cards through a single application/service will be a required capability for issuers hoping to achieve competitive parity; however only a few processors have the capabilities to support those capabilities. Importantly, as the rapid evolution of mobile services continues, these required capabilities will soon include mobile payments and commerce, bill payment, remote purchases, and person-to-person uses. Continual investment and ongoing to commitment to innovation will be critical for keeping pace.

Similarly, the post-Durbin environment will increasingly place a premium on core product differentiation along dimensions other than price. Developing, packaging, and bundling payments products and services will become a critical element of every successful issuer’s strategy in the emerging direct consumer-paid environment. Some of these offerings may include specialty prepaid spending products attached to debit cards, and non-revolving credit cards. Importantly, issuers must convey clearly the value of these bundles to their customers, and respond nimbly to changes in consumer preference.

Tactic: Fraud Reduction Strategies

In its analysis of issuer and network surveys, the Federal Reserve discussed the nature, type and occurrence of fraud in EDTs, noting that industry-wide fraud losses to all parties of debit (including prepaid) card transactions were approximately \$1.34B in 2009. These figures suggest that all issuers have a significant opportunity to reduce fraud-related expenses regardless of a fraud-prevention adjustment of 1¢ per transaction received by non-exempt issuers. Best in class issuers will look to re-evaluate fraud strategies to optimize performance and value.

Tools available in a “Single Pipe” solution should be robust and include (i) a single tool that allows for fraud rules to be created and quickly deployed and (ii) a single interface providing consolidated fraud decisioning and case management. The result is a consistent application of fraud management across networks and products. Additionally, other tactics issuers should consider include cost-efficient PIN fraud scoring and enabling the ability to treat different cardholders and transactions differently without creating inconsistency and confusion for the cardholder.

Issuers will also want to align with processors with robust point of compromise tools, gaining the ability to perform highly-effective common-point-of-compromise analysis on-demand to quickly determine the source of a fraud compromise and identify affected cardholders.

Conclusions

Although fallout from the Durbin Amendment will likely take months, if not years, to play out, industry participants face near term changes that drastically alter the debit issuing environment:

- Non-exempt issuers will face a 48% annualized interchange reduction compared to current levels.
- Issuers without two unaffiliated networks will need to assess their debit network participation to identify the optimal partner(s).
- Many non-exempt issuers will have to renegotiate contracts and others will have to implement additional fraud measures to earn the 1¢ fraud premium.
- Additionally, **all participants** face uncertainty surrounding interchange structures and routing arrangements.

The implementation of the Durbin regulations presents issuers an opportunity to evaluate the strengths, weaknesses, opportunities, and threats in their current business model.

To mitigate the risk of making urgent decisions in a new and uncertain environment, issuers should develop strategies and business efficiencies to remain agile and maintain profitability; tactics for consideration include:

1. Integrated debit processing using a “Single Pipe”. The model lowers integration costs, allows issuers to more easily and effectively adopt new services and participate in new networks, outsource as desired, and leverage a processor’s assets and scale in responding to marketplace changes. The result is high-performance debit products and support capabilities that operate consistently regardless of network routing dynamics.
2. Implement portfolio segmentation to distinguish high and low value clients and match the right product to the right consumer.
3. Product innovation, such as offering a best in class mobile offering; specialty prepaid spending products attached to debit cards, and non-revolving credit cards as appropriate.
4. Deploying optimal fraud strategies that have the potential to significantly reduce fraud expense.

It’s clear that strategies to grow debit volume for issuers that manage costs effectively remain viable. Issuers who remain flexible and agile while actively responding to and strengthening their consumer value proposition during this time of uncertainty will be the clear winners moving forward.

Appendix

Exhibit 6: Interchange Fee by Average Ticket³

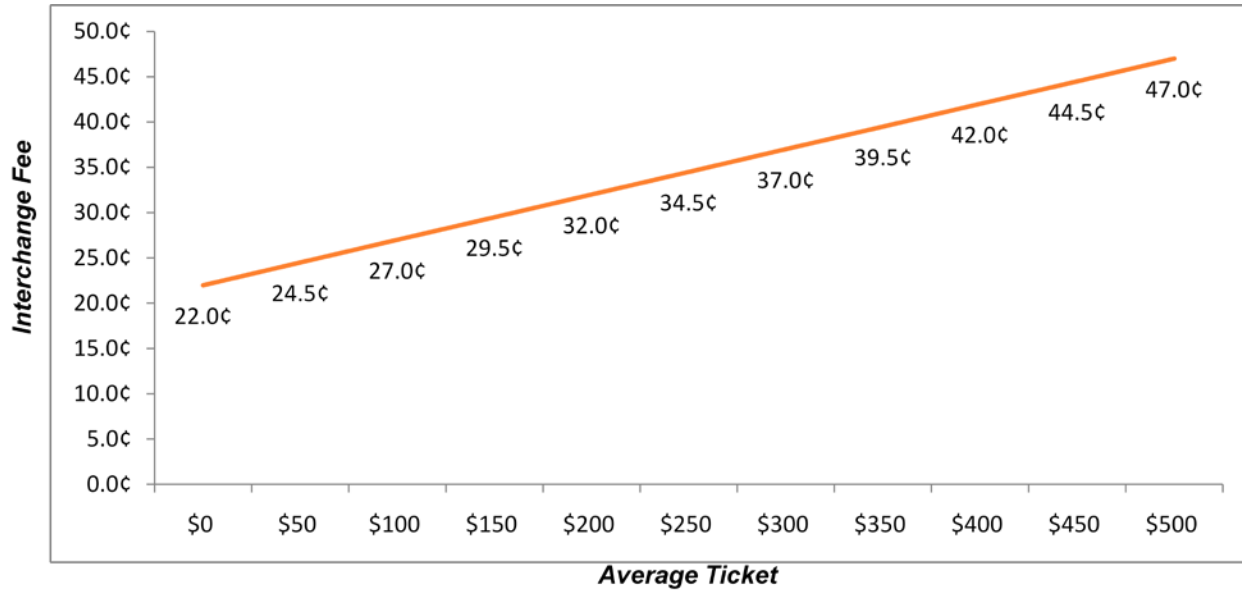
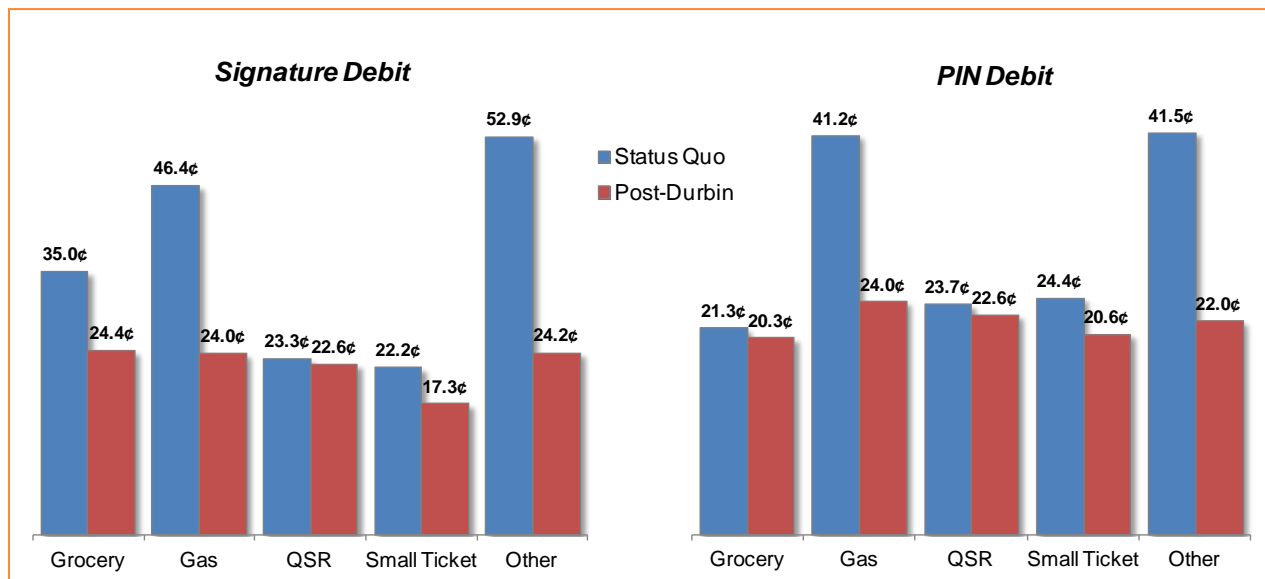


Exhibit 7: Average Interchange by MCC (consumer only)⁴



³ Note: Source: First Annapolis Consulting analysis. Analysis uses the \$0.21 cap plus the 5 bps ad valorem fee plus the 1c fraud adjustment to calculate the interchange fee.

⁴ Notes: Source: First Annapolis Consulting analysis. Analysis uses the average ticket for the various MCCs to calculate the average rate. Analysis assumes that networks do not raise status quo interchange rates for any MCC's that currently have lower rates. Includes fraud adjustment of 1c.

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An electronic copy of *Navigating Uncertainty: Post Durbin Debit Issuing* is available at Firstannapolis.com*

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