Debit’s New Normal: How the Industry is Responding to Rapid Change

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2013 Debit Issuer Study

Definitive review of the U.S. debit card industry

- Objective fact base on debit issuer performance and outlook
- Eighth installment
- 64 large banks, credit unions and community banks participated, representing:
  - 140 million debit cards
  - 78,000 ATMs
  - 21 billion transactions in 2012 (about 45% of U.S. debit transactions)
- Study participants distributed by issuer type, geography and debit network affiliation
  - Also segmented into regulated (≥$10 BN in assets) and exempt (<$10 BN in assets)

Debit performance metrics

- Comprehensive fact base
- Current performance, trends, projections
- Best-in-class issuers

Plans and outlook

- Responses to Regulation II
- Developments in prepaid, EMV, mobile
- Outlook and views on opportunities and challenges
The “New Normal”…

<table>
<thead>
<tr>
<th>Lower interchange, even for exempt issuers</th>
<th>Strong performance, weak projections</th>
<th>Lower fraud loss rates</th>
<th>Declining interest in debit rewards</th>
</tr>
</thead>
<tbody>
<tr>
<td>– Rates have stabilized at cap for regulated issuers</td>
<td>– PAU metrics have improved</td>
<td>– Heightened attention to managing fraud and reducing losses</td>
<td>– Regulated issuers have abandoned rewards</td>
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<tr>
<td>– Some deterioration for exempt FIs</td>
<td>– 2013 growth projections are much lower than 2012</td>
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<td>– Exempt issuers see programs as tool for differentiation</td>
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<tr>
<td>– Various issuer responses</td>
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<td>– Growing interest in merchant offers</td>
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... and the “New Uncertainty” – Judge Leon’s ruling
Interchange Rates Decline

Consumer signature
$ per transaction (bps)

- Regulated:
  - Pre-Reg II: $0.52 (144)
  - 2012: $0.23 (67)

- Exempt:
  - Pre-Reg II: $0.47 (143)
  - 2012: $0.45 (131)

Average Ticket: $35

Consumer PIN
$ per transaction (bps)

- Regulated:
  - Pre-Reg II: $0.32 (72)
  - 2012: $0.23 (57)

- Exempt:
  - Pre-Reg II: $0.33 (85)
  - 2012: $0.31 (79)

Average Ticket: $41
Annual Interchange Revenue

Average gross interchange revenue per active consumer card per year
Regulated vs. exempt issuers

Transaction mix  | Interchange rate ($ per transaction)  | Blended interchange rate ($ per transaction)  | Monthly txns per active card  | Months per year  | Gross interchange revenue per active consumer card
--- | --- | --- | --- | --- | ---
Regulated  | 37% | $0.23  |  |  | $54
  | 63% | $0.23  |  |  |  
Exempt  | 38% | $0.31  |  |  | $96
  | 62% | $0.45  |  |  |  

Note: Numbers may not add up as shown in chart due to rounding
Responses to Changes in Economics

- Cut operating costs
- Reduce fraud
- New DDA structure/requirements
- Rewards program redesign (or elimination)
- Organizational changes
- Added new or raised fees
- Promote PIN
- Migrate to other payment products
Issuers’ Responses to Reg II

Initiatives taken following Reg II
% of issuers

- Cut costs: 77% Regulated FI, 36% Exempt FI
- Reduce fraud: 77% Regulated FI, 42% Exempt FI
- Changed product structure: 73% Regulated FI, 21% Exempt FI
- Cut rewards: 58% Regulated FI, 21% Exempt FI
- Organizational change (size/structure): 35% Regulated FI, 3% Exempt FI
- New/Raised fees: 31% Regulated FI, 11% Exempt FI
- Promote PIN: 31% Regulated FI, 5% Exempt FI
- Encourage other payment products: 19% Regulated FI, 5% Exempt FI
- Cross-sell: 12% Regulated FI, 3% Exempt FI

The “new normal” – Lower interchange
Key Performance Metrics

Penetration

- 2011: 76%
- 2012: 77%

Activation²

- 2011: 66%
- 2012: 68%

Usage

- Txns/active card/month
- 2011: 18.3
- 2012: 19.4

Signature Transactions

% of all txns

- 2011: 67%
- 2012: 64%

Ticket Size³

- 2011: $38
- 2012: $37

Annual Spend

$/active card/year

- 2011: $8,326
- 2012: $8,753

1. Consumer cards
2. Based on definition “used for any transaction in last 30 days”
3. Blend of PIN and signature

The “new normal” – Strong performance, weak projections
Transaction Growth Projections

2012 Actual Growth

14% PIN
6% Signature

Projected 2013 Growth

8% PIN
4% Signature

Historical growth expectations
% growth over previous year

2007: 18% PIN, 16% Signature
2008: 12% PIN, 13% Signature
2009: 7% PIN, 7% Signature
2010: 9% PIN, 8% Signature
2011: 7% PIN, 7% Signature
2012: 15% PIN, 8% Signature
2013: 8% PIN, 4% Signature

The “new normal” – Strong performance, weak projections
Debit Fraud Losses

Debit net fraud losses
$ per transaction (bps)

- Large Banks: $0.021 (5.4) Signature, $0.003 (0.7) PIN
- Credit Unions: $0.015 (4.5) Signature, $0.001 (0.3) PIN
- Community Banks: $0.017 (4.8) Signature, $0.001 (0.2) PIN
- Overall: $0.020 (5.4) Signature, $0.003 (0.7) PIN

The “new normal” – Lower fraud loss rates
## Debit Rewards Programs

**Rewards program incidence**

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>51%</td>
<td>53%</td>
<td>58%</td>
<td>56%</td>
<td>37%</td>
<td>32%</td>
</tr>
</tbody>
</table>

- **2010**
  - Regulated: 67%
  - Exempt: 46%
  - 2010: 37%
  - 2011: 24%
  - 2012: 44%

The “new normal” – Declining interest in debit rewards.
Rewards Landscape Shift

Debit Rewards Offerings
% of issuers that offer rewards

1. Includes co-brand, charity/school donation and fuel perks programs
The “New Uncertainty”

**Background**

- In Nov 2011, a group of merchant associations and certain merchants sued the Fed arguing that it incorrectly implemented Reg II.
- On July 31, 2013, U.S. District Judge Richard Leon issued a 58-page decision and ruled that the Federal Reserve Board “has clearly disregarded Congress’s statutory intent by inappropriately inflating all debit card transaction fees by billions of dollars and failing to provide merchants with multiple unaffiliated networks for each debit card transaction.”
- Judge proposed that Reg II be replaced by a new rule that is consistent with Congress’s directive.

**Elements of decision**

- **Interchange**: The ruling says that the Fed should only consider the incremental authorization, clearing and settlement (ACS) costs of a particular debit transaction when setting interchange (for regulated issuers)
  - In its proposed rules, the Fed indicated that incremental ACS costs were $0.07–$0.12 per transaction
  - Judge Leon also introduced the possibility of issuers refunding merchants for over-charging on interchange
- **Network exclusivity**: The ruling says that “Congress intended for each transaction to be routed over at least two competing networks for each authorization method.”
- **Timing**: The Fed is appealing the Judge’s ruling and requested a stay on the ruling in the interim. Merchants have requested an interim rule within
**Scenarios to Consider**

**Possible results of Fed’s appeal**

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
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<tbody>
<tr>
<td>Fed loses appeal on interchange</td>
<td>Regulated interchange declines</td>
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<table>
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<tr>
<th>3</th>
<th>4</th>
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<tbody>
<tr>
<td>Fed wins appeal on interchange</td>
<td>Status quo</td>
</tr>
</tbody>
</table>

- Fed wins appeal on network participation
- Fed loses appeal on network participation
Interchange Decline Scenarios (1 and 2)

Regulated Issuers

- Tough to make meaningful changes in costs (following actions already taken)
- Need to identify additional sources of revenue, e.g.:
  - Higher monthly fees for DDAs
  - Higher minimum balance requirements for DDAs
  - Ancillary fees (ATM fees, card replacement fees, etc.)

Exempt Issuers

- Likely further decline in interchange rates – especially if the Fed loses on network exclusivity
- Likely an advantage in the short-to-medium term in being able to offer more value
FIs will have to ensure the presence of at least two unaffiliated network routing options for both PIN and signature transactions.

Three potential options:
- 2 Signature + 2 PIN
- 2 Signature + 0 PIN
- 0 Signature + 2 PIN

If required, most FIs are likely to opt for “2+2”.
- But, it is unclear how FIs could enable two signature networks given current card technology.
- Opportunity for PIN networks to support PINless transactions
  - Faster and simpler for FIs.
Developments Adjacent to Debit

**Prepaid**
- 84% of issuers offer some type of prepaid card
- Gift cards are the most common, but issuer support is tepid
- Growing interest in GPR prepaid

**EMV**
- Issuers are in “wait-and-see” mode
- Even with 2015 liability shift, issuers struggle with business case
- Industry needs to reconcile EMV with Reg II

**Mobile Payments**
- Many view the shift to mobile as inevitable, with the primary question being when, not if
- Risk to FIs if their cardholders embrace a non-FI solution
GPR Prepaid Card Growth

Growth of GPR providers…

<table>
<thead>
<tr>
<th>Issuer</th>
<th># of active cards (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Green Dot</td>
<td>2010: 2.5, 2011: 3.0, 2012: 3.5</td>
</tr>
</tbody>
</table>

…attracting banks…

Issuers offering GPR prepaid

<table>
<thead>
<tr>
<th>Year</th>
<th>% of issuers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>14%</td>
</tr>
<tr>
<td>2011</td>
<td>19%</td>
</tr>
<tr>
<td>2012</td>
<td>36%</td>
</tr>
</tbody>
</table>

…with some high-profile product launches

Source: Green Dot and NetSpend 2012 Annual Reports
GPR Prepaid Strategies

**Supplement**
- For current customers, GPR prepaid cards can be used as a supplemental account
  - Travel
  - Internet spending
  - Mobile wallets
  - Children
- Under certain conditions, these will be exempt from the Reg II cap on interchange

**Expand**
- GPR can be offered to the unbanked/underbanked expanding the size of the FI’s addressable market
- Chase indicated that 30% of their Liquid cards are issued to never-banked/unbanked customers\(^1\)

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Prepaid Card Growth Expectations

Prepaid card growth projection
% growth over prior year

2012 Projections
- Gift card: 6%
- GPR prepaid card: -2%

2013 Projections
- Gift card: 26%
- GPR prepaid card: 55%

GPR Economics

- GPR prepaid economics are very different than for traditional debit
- Average balance: $100-$200
- Average profit per card per year: $15-$20
Plans for EMV Issuance

- In October 2015, all major networks plan to institute a fraud liability shift to the party with the lowest level of security.
- This is not a deadline for issuers.
- Many issuers expect these dates to be pushed out.

Half of issuers have no plans to move to EMV debit cards.
Benefits of EMV

Facilitate debit payments for international travelers

- EMV is the global payment card standard; some POS terminals no longer read magnetic stripe cards
- Some credit card issuers have begun issuing EMV cards to select international travelers
- However, only 23% of Americans travel abroad in any given year, with 36% indicating that they never leave the country.¹

Reduce fraud

- EMV cards are not as easily skimmed as magnetic stripe cards, which could reduce card-present fraud
- However, first/second party fraud and card-not-present fraud would not be impacted. Benefit also depends upon merchant deployment of EMV terminals
- For issuers, there are certain costs, but uncertain benefits
  - Difficult to make a business case to change

¹ International travel data from 2012 Oliver Wyman Survey of Consumer Finances
EMV and Reg II

Reg II requirements

1. Network participation
   All debit cards must participate in (at least) two unaffiliated debit networks

2. Merchant routing choice
   Merchants/acquirers can determine transaction routing (i.e., network routing rules are voided)

Current situation

- EMV Application IDs (AIDs) are designed to support one network application
- Current implementation of EMV does not facilitate choice
Debit Networks are Proposing Cooperation

• Visa and MasterCard have offered to open up a common AID to other debit networks
  – In this way, an issuer could have a common US debit AID (and another for ATM and international usage)

• However, Visa and MasterCard’s approach is very restrictive
  – Visa’s AID is to have priority, the common AID is restricted for PIN tx only, and issuers must use Visa or MasterCard’s technology

• 10 debit network members, within the Secure Remote Payment Council (SRPc), are proposing that issuers should be able to use any EMV-certified technology, e.g. Visa VSDC, MasterCard M/Chip, Discover D-PAS
  – AIDs to be managed by a consortium of debit networks

• Judge Leon’s ruling adds further uncertainty about the best approach for the industry
  – Strengthens issuers’ belief that the liability shift will be delayed
Mobile Payments Could Be “Next Big Thing”
More FIs are Piloting Mobile Payments

Mobile payments pilot participation
% of issuers

- 2011: 9%
- 2012: 13%

Mobile share of debit in five years
% of issuers projecting

- 0%–4.99%: 7%
- 5%–9.99%: 26%
- 10%–14.99%: 26%
- >15%: 41%
- Total: 100%

% of debit transactions on mobile in five years
Consumer Adoption of Non-FI Solution Poses Risk

<table>
<thead>
<tr>
<th></th>
<th>Erosion of bank economics</th>
<th></th>
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<tbody>
<tr>
<td>1</td>
<td>• Lower revenue</td>
<td></td>
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<tr>
<td></td>
<td>– Mobile wallet routes transactions to a lower cost funding method</td>
<td></td>
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<tr>
<td></td>
<td>– Mobile wallet aggregates consumer purchases and batches transactions to the linked funding account</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Higher costs, particularly fraud</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Bank fees to the mobile wallet provider</td>
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<table>
<thead>
<tr>
<th>2</th>
<th>Customer relationship disintermediation</th>
<th></th>
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<tbody>
<tr>
<td></td>
<td>• Customer affinity may shift from bank/payment card provider to the phone/mobile wallet provider</td>
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<td></td>
<td>• Mobile wallet provider captures the data associated with customer purchases</td>
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<tr>
<td></td>
<td>• Wallet may be configured as the Merchant of Record, complicating fraud prevention and chargeback rights</td>
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</table>
Issuer Opportunities in 2013

Key opportunities
% of issuers

- Improving PAU: 85% (Regulated FI), 65% (Exempt FI)
- Merchant offers: 35% (Regulated FI), 19% (Exempt FI)
- Mobile payments: 31% (Regulated FI), 54% (Exempt FI)
- Improving customer relationship: 19% (Regulated FI), 5% (Exempt FI)
- New products/technology: 19% (Regulated FI), 14% (Exempt FI)
- Shifting to PIN: 15% (Regulated FI), 0% (Exempt FI)
- Bill payment: 12% (Regulated FI), 5% (Exempt FI)
- Customer acquisition: 12% (Regulated FI), 14% (Exempt FI)
- Issuer-funded rewards: 8% (Regulated FI), 35% (Exempt FI)
- Cost reduction: 4% (Regulated FI), 5% (Exempt FI)
- Instant issuance: 4% (Regulated FI), 8% (Exempt FI)

- Back-to-basics approach cited by many issuers
- Merchant offers emerged as a key opportunity
Issuer Challenges in 2013

Key challenges
% of issuers

- Regulatory/litigation pressure: 73% (Regulated FI), 89% (Exempt FI)
- Fraud: 58% (Regulated FI), 76% (Exempt FI)
- Emerging/alternative payments: 38% (Regulated FI), 19% (Exempt FI)
- Lack of growth: 31% (Regulated FI), 11% (Exempt FI)
- Interchange pressure: 27% (Regulated FI), 27% (Exempt FI)
- Macroeconomy/payroll tax: 23% (Regulated FI), 8% (Exempt FI)
- EMV: 19% (Regulated FI), 24% (Exempt FI)
- IT/cost management: 12% (Regulated FI), 11% (Exempt FI)

Several issuers cited lower-than-expected growth in 2013 year-to-date.
Questions?

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