Advisors Plus®
Value Delivered

Editorial Perspective:
The EMV Era: Three Key Considerations for Managing Your Payments Portfolio as Chip Cards Gain Traction

The EMV Era: Three Key Considerations for Managing Your Payments Portfolio as Chip Cards Gain Traction

by Norm Patrick

This article originally appeared online in *CUES Management* in the December 2015 issue and is reprinted in its entirety here.

Effective October 1, 2015, the long-anticipated EMV fraud liability shift rules went into practice, meaning issuers no longer assume all fraud losses. Put simply, if fraud occurs on an EMV (chip) card, and the merchant does not process it as such, the issuer may have an opportunity to pass along the fraud loss to that merchant.

Although the liability shift date has already arrived, issuers and merchants alike are still in progress with their chip card implementation efforts. Consumers continue to receive replacement EMV cards in the mail and get accustomed to using them at the same time merchants are installing and activating EMV-enabled payment terminals at points of sale.

The implementation of EMV is just one example of how the world of card payments has continued to grow and evolve for credit unions. Over the past few years, the degree of change has intensified and the market has become increasingly complex. Despite a turbulent economic cycle, new regulations, advances in technology and new market players, the payments market continues to be an area of new opportunity for credit unions.

At the same time, existing card payments products continue to drive significant CU earnings and some of that payments revenue is at risk. For example, debit card programs are currently contributing on average approximately 20 percent to 40 percent of a credit union's annual non-interest income. With continued downstream impacts from regulatory changes involving debit card interchange, networks and overdrafts, there is a fair amount of risk inherent in this significant chunk of revenue.

As we head into 2016, payments owners will need to be cognizant of and deal with the risks to debit card programs because of changes in how the networks and the merchants process transactions. In addition, we expect to see the Federal Reserve take steps to increase interest rates, which could carry some degree of interest rate risk for credit unions that hold significant non-variable rate credit card assets.

Also, the mobile wallets arena is expected to further unfold in 2016. Three wallets—Apple Pay, Samsung Pay and Android Pay—are now in place, while others, such as ChasePay and the merchant-focused CurrentC, are expected to make an appearance in the market over the next year.

Debit Regs

Debit cards are experiencing impact from regulations already implemented, as well as potential new regulations coming down the pike.

As a requirement of Dodd Frank's "Durbin Amendment," the Federal Reserve implemented Regulation II in October 2011. The rule was intended to enforce key provisions of Durbin to place a reasonable and proportional cap on debit card interchange rates specific to financial institutions over $10 billion in assets. Additionally, **the** rule enforced a provision banning network exclusivity that now requires all debit issuers, regardless of size, to utilize two or more unaffiliated payment networks for merchants to choose from at the point of sale.

Since many of the largest debit card issuers at the time were under network-exclusive arrangements with either Visa or MasterCard, the implementation of Regulation II required many issuers to enable one or more additional PIN-based networks. The ban on network exclusivity caused a migration of PIN-based point-of-sale transactions from Visa's Interlink and MasterCard's Maestro to other networks, such as STAR, Pulse and NYCE.

Along the path, as competition among the PIN-based networks intensified, some PIN-based networks enacted rule changes to give some merchants the ability to accept debit transactions under a set dollar threshold (often $25) without a PIN and to route such transactions over those particular PIN-based networks.

When this occurs, the cardholder is generally unaware of exactly which network the transaction is being routed to and whether it will be considered a signature-based or PIN-based transaction. The cardholder is typically under the impression that the transaction has routed to either Visa or MasterCard since no PIN was required of the cardholder at the time of the transaction.

For credit unions that are exempt from the interchange rate caps imposed by Durbin, a significant number of transactions have found their way from higher-revenue-generating signature-based to lower-revenue-generating PIN-based networks. Since cardholders are generally unaware of what network such transactions are processed over, those who are members of credit unions that offer either the incentive of rewards on signature-based transactions or a per-transaction fee for PIN-based transactions may notice a decrease in points earned or an increase in fees assessed — along with some frustration.

With all the complexity in place with debit card networks, we recommend that credit unions take a proactive approach in managing their debit networks. Credit unions should work with each network deployed to understand both current and future fee structures, interchange support for Durbin-exempt financial institutions, as well as network product development plans. Regularly evaluate providers to determine which debit network options make the most sense and how many networks are required to meet members' needs.

Credit and Rising Rates

2016 is widely expected to be the year the Fed begins tightening credit through a series of interest rate hikes. For the last seven years, the Fed has left its benchmark Fed Funds Target Rate at near zero. As the Fed increases the Fed Funds Target, loan-funding costs for credit unions are also expected to increase.

In 2010, during the period of low interest rates, provisions of the CARD Act were put into practice, limiting a credit card issuer's ability to increase the interest rate on existing revolving balances. From an interest rate risk perspective, this regulatory change could prove problematic for CUs with significant non-variable-rate credit card assets on their balance sheets in a rising rate environment.

The CARD Act requires that when an interest rate is increased on a non-variable account, cardholders be given 45-day written notice of the rate increase, which would only apply to new purchases, with existing balances being protected and remaining at the rate in place prior to the change.

CUs should evaluate their credit card product line regularly and implement changes to keep the products competitive and to make modifications to manage risk. CUs currently offering non-variable products are encouraged to evaluate and determine if a set of variable rate credit card products would be a better fit.

Mobile Wallets

Over the past several years, we have witnessed very interesting developments in the area of mobile wallets. The clear leader in this space has been the Starbucks mobile app.

During 2015, Starbucks announced that its closed loop mobile payments app had over 13 million users generating over seven million transactions a week. This mobile app accounts for over 16 percent of total spend at Starbucks locations.

The wild success of the Starbucks mobile app has helped fuel the aspirations of other players seeking to bring their own mobile payments solutions to the mainstream market. This was a tough challenge for the early group of solutions, such as Google Wallet and Softcard (formerly known as Isis) in getting traction. Then, with huge fanfare and anticipation, Apple launched Apple Pay in 2014 and has seen limited success given the hardware requirement of iPhone 6 and higher, as well as NFC technology at point-of-sale terminals, which continues to be fairly limited.

In September, we observed the launch of two new wallets—Android Pay (formerly Google Wallet and Softcard) and Samsung Pay, initially involving certain issuers and merchants.

With three solutions now in the market covering a wide array of hardware types and mobile operating systems, it will be interesting to see how and if these take off. Of particular interest is Android Pay, which is available on a wide range of phones running the Android operating system, as compared to Apple Pay and Samsung Pay, which are based on specific hardware.

CUs need to stay on top of developments in the mobile wallet space and offer some — if not all — of the current solutions when they are made available. At this point, we have not observed a dominant mobile wallet outside of the Starbucks app. However, it is important that credit unions develop both business and operational experience in offering these types of solutions, in addition to showing the market that credit unions stack up very well against larger banks in terms of technology offerings.

As we move into 2016, we expect to see other players enter into the mobile wallet market. CurrentC**,** the merchant-driven, ACH-based wallet solution, will likely be wrapping up testing in certain markets and prepare for a wider-scale launch. This solution will need to be watched closely. Unlike other mobile wallets, CurrentC will be the first to utilize ACH to process transactions, potentially circumventing the traditional payments networks and interchange. However, there could be some changes to the processing model given the announcement of ChasePay's 2016 launch.

In addition, we expect to see more financial institutions such as Capital One getting into the mobile wallet game directly. It is too early to declare a winner, but it will certainly be fun to participate and see firsthand how the mobile wallet game plays out.

To make sense of all the complexity, manage the risks and capitalize on the opportunities in this space, it has become increasingly important that CUs take a more holistic and proactive approach to managing the payments function. A way to do that is to empower a highly visible senior manager with the responsibility to "own" payments at the CU.

This person would be responsible for the profit and loss of the CU's payments products, able to vet opportunities with new and emerging payments products and technology, and charged with managing risks to transactions and revenue that may emerge through additional legislation and emergence of new players in the marketplace.

For More Information

Norman C. Patrick, Jr.
Director, Debit & Checking Consulting
727.299.2523
npatrick@advisorsplus.com

Arnie Goldberg
Director, Business Development
727.299.2535
813.316.8036 mobile
agoldberg@advisorsplus.com

OR

Your PSCU Account Executive

About Advisors Plus

Advisors **Plus** serves as the consulting arm of PSCU, helping credit unions to meet their financial and business challenges and grow. The team provides practical, data-driven expertise in the areas of business strategy, credit cards, debit and checking, marketing growth campaigns, digital and branch channel engagement, and contact center and operations optimization.
With over 250 years of combined experience, Advisors **Plus** consultants partner with credit union management to provide actionable solutions for sustainable business growth, exceptional member experiences and measurable operational efficiencies. For more information, visit **AdvisorsPlus.com.**

About PSCU

Advisors **Plus** is an independent business unit of PSCU, the nation's leading credit union service organization (CUSO). Founded in 1977, PSCU is owned by over 800 Member-Owner credit unions representing 18.5 million credit, debit, prepaid, online bill payment, mobile and electronic banking accounts. 24/7/365 member support is delivered through call centers located throughout the United States that handle more than 18 million inquiries a year. For more information, visit **PSCU.com**.