Editorial Perspective:

Debit Interchange 2.0: Is Your Credit Union Optimized and Ready?

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It has been a tumultuous time for credit unions in the debit arena since Federal Reserve Regulation II spelled out the Durbin Amendment's new play book in October 2011. Now, almost exactly two years later, the debit landscape may be changing again. Judge Richard J. Leon of the U.S. District Court has issued a strongly-worded 58-page decision striking down Regulation II as unlawful, and right now all that is keeping it on the books are an appeal by the Fed and all parties' mutual agreement to stay Judge Leon's original verdict pending the appellate court's decision.

As the appellate court prepares to consider the Fed's appeal, what timeline lies ahead for credit unions, and even more important, what can credit unions do to understand and prepare for the challenges they will face in a new post-Regulation II world? Although a precise answer to the first question requires a crystal ball, Advisors **Plus** believes that by working now to formulate proactive risk management and network optimization strategies, credit unions can largely indemnify themselves against future debit interchange rewrite worries.

Regulation II: From Bad to Worse

Looking back, Regulation II, the key provisions of which capped interchange rates for financial institutions over $10 billion in assets and required all financial institutions regardless of size to use two unrelated networks in processing debit transactions, alienated nearly every constituency from the beginning:

- During the Fed's formal comment period prior to the release of its now-current Final Rule, it received over 11,500 letters regarding Regulation II.
- Within one month of Regulation II's release, the group of merchants that would ultimately prevail in Judge Leon's courtroom had filed its lawsuit, arguing that Regulation II was unlawful based on key discrepancies between the original Durbin statute and the language of Regulation II.
- Consumers, the original intended beneficiaries of the Durbin statute, were doubly betrayed as there is lack of evidence that merchants passed along their interchange cost savings and Big Banks eliminated free checking and debit rewards programs.

Credit Unions: Not Exempt from Big Bank Contempt

It didn't take long for credit unions to join the list of Regulation II casualties as well. As financial institutions under $10 billion in assets, their "exemption" from Regulation II interchange provisions turned out to be a double-edged sword. As interchange rates declined in the marketplace as a whole, credit union rates declined as well, but without the well-defined enforcement provisions afforded to the larger institutions. This no-win scenario negatively impacted non-interest income, squeezed margins and made stable pricing an ongoing challenge.

Fed Watching: An Action Plan for Your Credit Union

Regardless of the appellate court outcome, the Advisors **Plus** debit consulting team believes that the credit unions best positioned for the post-Regulation II climate are those that plan conservatively with effective risk mitigation measures while seeking out the best ways to shine versus their bank competition. Successful credit unions should think Aikido, the stealth Japanese art that channels an attacker's own force against him rather than Karate which might look dramatic but could only serve to attract unwelcome scrutiny.

Specifically, we recommend two key strategies to turn your credit union into a Fed-watching "ninja" while waiting for the appellate court's direction to become clear:

1. **Reserve for potential reductions to non-interest income:** Remember that credit unions remain extremely vulnerable to even a small drop in interchange rates. What might be a drop in the bucket to a Big Bank could have a major effect on a credit union's bottom line. Now is an excellent time for your credit union to undertake a complete debit portfolio review aimed at establishing a baseline understanding of exactly where your credit union's leverage is in reducing expenses and filling revenue gaps as the downward pressure on interchange rates continues.

2. **Optimize network profitability and reduce processing costs:** The glaring media attention on interchange rates has obscured the issue of network exclusivity itself, which actually impacts all debit card issuers, regardless of asset size. The District Court ruling clarifies that two or more networks will be required for each type of debit transaction, versus two or more networks for each debit card. In other words, we may potentially see a future environment that would require both Visa and MasterCard to be deployed on a debit program in addition to multiple PIN-based networks.

That means that if the district court verdict is upheld, merchants will be able to decide where to route signature-based transactions, similar to the decisions they currently make on PIN-based transactions. We can be certain that merchants will continue to seek out least-cost routing alternatives, which makes it extremely important for credit unions to maximize their network efficiencies.

- **More networks aren't better:** Some credit unions continue to support multiple regional PIN networks on the issuing side, but fragmented or redundant network coverage is unnecessary and expensive. Now that most large networks have near nationwide coverage and merchants and not credit unions control the transaction routing decisions it's time to eliminate network redundancies and take the savings straight to the bottom line.

- **Eliminate split processing.** Just as merchants are seeking least-cost transaction alternatives, so, too, should credit unions. Some credit unions continue to use so-called split processing, e.g., processing SIG POS with one vendor and PIN POS/ATM transactions/ATM terminal processing with others. It is much more efficient in terms of cost, settlement and reporting for a credit union to consolidate all of its processing with a good single provider.

Your Members Are Your Greatest Assets

No matter what challenges Regulation II—past, present or future—may create for debit, it is important for credit union managers to remember that their commitment to member satisfaction in the form of high-quality, low-cost products, transparency and consumer education will always confer an advantage. As Big Banks and merchants continue to wage the "battle of the basis points," we believe that credit unions stand the best chance of leveling the debit interchange playing field by siding with the member to redefine the game.

For More Information

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About Advisors Plus Consulting Services Debit and Checking Consulting

Advisors **Plus** takes a comprehensive approach to reviewing debit and checking portfolios and making strategic recommendations. Our Consulting Services Debit and Checking Consulting is one-of-a-kind in the credit union industry, with no other competitor offering the type of insight and intellectual capital that Advisors **Plus** delivers.

The Advisors **Plus** team begins each engagement by partnering with a credit union for an uncommonly thorough review process. Because Advisors **Plus** offers a complete analysis of debit P&L and the role that debit and checking play within the entire business model, the majority of Advisors **Plus** clients re-engage our Debit and Checking Consulting team annually to revisit the review and provide updated results and recommendations.

In 2012, our average Net Promoter Score in 2012 was 84 as measured by client surveys.

About Advisors Plus

Advisors **Plus** was established in 2005 to provide consulting and marketing services to credit unions. Our range of services covers the key areas of strategy, credit cards, debit and checking, marketing, contact center, operations, and branch sales.

The experienced consultants at Advisors **Plus** work with a credit union's staff through the entire process from project analysis to implementation and management. Our goal is to ensure that each credit union client achieves sustainable business growth, exceptional member experiences and operational efficiencies.

As of December 31, 2012, Advisors **Plus** has superior NPS Scores of: 79 – Credit; 84 – Debit and Checking; 91 – Contact Center. For more information, please visit **AdvisorsPlus.com.**