Point of View:

Are Changes Ahead for Debit Interchange? Helping Your Credit Union Be Aware and Prepared

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Summary of Recent Regulation II Litigation

Following the passage of the Durbin Amendment in 2010, changes to the debit card business landscape under Federal Reserve Regulation II (which outlined the provisions to enforce Durbin) have presented challenges, not only to credit unions, but to all of the key stakeholders in the card business.

Regulation II, which capped interchange rates for financial institutions over $10 billion in assets and mandated network non-exclusivity for all financial institutions, has been unpopular from the start—so much so, that it took exactly one month after Regulation II was implemented for a consortium of big box retailers, food marketers, convenience stores and individual merchants to file a major lawsuit against the Fed seeking to strike down Regulation II. The plaintiffs argued that Regulation II was unlawful on the grounds that its language contained key discrepancies between Durbin's statutory language and the Fed's regulatory interpretation.

In a 58-page opinion handed down in late July 2013, Judge Richard J. Leon of the District Court for the District of Columbia ruled on behalf of the merchant plaintiffs, calling Regulation II "fundamentally deficient and unlawful." With that ruling, Judge Leon essentially ruled that Regulation II must be re-written to bring its language into compliance with the Durbin Amendment, which remains law.

What, if any, impact will changes to Regulation II have on credit unions?

For the time being, very little has changed, since the Federal Reserve has appealed the District Court verdict and both parties have agreed that Judge Leon should stay his verdict (thus keeping the existing provisions of Regulation II in place) until the appeal is heard and final decisions are handed down.

In a related action, Judge Leon has also scheduled a hearing for September 16, 2013 for preliminary arguments pertaining to whether merchants should be awarded "damages" (i.e., reimbursed) for "overcharges" during the time period Regulation II was in force, which promises to become the next round of a protracted legal battle between merchants and card issuers.

For credit unions, however, the potential that Regulation II will be rewritten in some fashion makes this an ideal time to focus on understanding how provisions might change, what specific actions credit unions can take to be aware and prepared, and how Advisors **Plus** can help. This POV will address the questions:

1. How have the existing provisions of Regulation II impacted credit unions?
2. What actions can credit unions take now to prepare?

3. What can credit unions do to mitigate risks that might occur with the adoption of new Federal Reserve regulations?
4. Are there any potential opportunities that a rewritten version of Regulation II might present?

1. How have the existing provisions of Regulation II impacted credit unions?

Caps to interchange rates have proven profoundly unpopular since their inception. This is true for financial institutions, of course, but it is also remarkable to realize how little consumers have benefited from the intent of the Durbin legislation. Given credit unions' mission to serve community and member needs with transparency and without raising fees, it has proven particularly difficult for credit unions to be locked into a position where they have had to choose between cutting member services and cutting margins.

According to the Electronic Payments Coalition, the National Retail Federation estimates that merchants are saving approximately $18 million on a daily basis and "consumers are hard-pressed to see the results in their pocketbooks." Yet, that hasn't stopped merchants from being unhappy as well, since they have generally felt that the Federal Reserve ultimately set their regulated interchange rates too high.

Figure 1 below summarizes the service dissatisfactions and declines experienced across the board by all constituencies. (Credit unions are considered exempt FIs.)

Figure 1: Not Big Fans – A Look at Four Key Stakeholders Post-Durbin

Non-Exempt FIs (> $10 Billion Assets)	Exempt FIs (< $10 Billion Assets)	Consumers	Merchants
• 50%+ reduction in SIG interchange • 30%+ reduction in PIN interchange • Prohibition of exclusive network arrangements	• Interchange reduction of 5-10% on average • Future uncertainty • Prohibition of exclusive network arrangements	• Large banks discontinue free checking and debit rewards programs • No direct evidence of lower merchant prices	• The Federal Reserve set interchange rates too high • The Fed should have required 2+ networks for each type of transaction – SIG and PIN, rather than 2+ networks on the card

For credit unions in particular, where all but the four largest credit unions (BECU, Navy Federal, PenFed and North Carolina's SECU[1]) are exempt from the interchange caps imposed by Regulation II, the industry has been plagued by a slow erosion of interchange rates. While the decrease in rates has not

[1] CU Times

been as extreme as seen with non-exempt issuers, the financial impact has nevertheless been significant because what might be a rounding error for a money center bank can become a sizeable hit to a credit union debit portfolio. Take a credit union with $500 million in annual sales volume from its debit portfolio, for example: A single basis point drop in the interchange rate would result in a loss of $50,000 in annual revenue. A small change in the interchange rate? Yes. Small change? Not to a typical credit union's bottom line!

As Figures 2 and 3 below indicate, there was also a strong carryover effect between significant reductions in debit interchange rates (upwards of 50% on signature-based transactions) experienced by the non-exempt FIs over $10 billion and a "trickle down" to the smaller exempt credit unions and community banks. Not only did exempt institutions face the same pattern of interchange declines as the larger institutions (though to a lesser degree); they were also subject to legislative uncertainty in both the SIG and PIN network markets.

Figure 2: Non-Exempt FI Rates Pre- and Post-Regulation II

Category	1Q-3Q 2011	4Q/2011	2012	% Change
SIG POS Networks	1.54%	0.63%	0.64%	-58.4%
PIN POS Networks	0.84%	0.55%	0.58%	-30.9%

Source: Federal Reserve Bank

Figure 3: Exempt FI Rates Pre- and Post-Regulation II

Category	1Q-3Q 2011	4Q/2011	2012	% Change
SIG POS Networks	1.48%	1.43%	1.40%	-5.4%
PIN POS Networks	0.75%	0.72%	0.69%	-8.0%

Source: Federal Reserve Bank

2. What actions can credit unions take now to prepare?

We are advising our credit union clients that interchange will continue to be a contentious—and fluid—subject, even for credit unions as exempt issuers with assets under $10 billion. **Credit unions need to focus on potential implications of re-written Regulation II in two areas:**

- **Interchange implications:**
  There are two important "ifs" regarding interchange:

  1. If the Federal Reserve is unsuccessful in the appellate process, causing the interchange bar to be lowered even further for non-exempt issuers, it is reasonably certain that some degree of decrease in interchange rates will find its way to exempt issuers.

  2. If the Federal Reserve rules are rewritten and continue to lack explicit provisions to "lock-in" interchange rates for exempt issuers, market forces will continue to erode those rates for exempt financial institutions such as credit unions.

- **Network exclusivity implications:**
  Recent news and commentary has been laser focused on the interchange implications, while not much attention has been paid to the network exclusivity issue, which impacts all debit card issuers regardless of asset size. However, network exclusivity may be the more important of the two issues for two reasons:

  1. The District Court ruling has indicated that the Federal Reserve will need to require two or more networks for each *type* of debit transaction, rather than two or more networks for each debit *card*. Since this will affect every player—exempt and non-exempt alike—it makes a great deal of sense for credit unions to be thinking about their networks and preparing now.

  2. This issue is actually something that credit unions have the power to control right now and should be optimizing independent of regulation. If the Federal Reserve is unsuccessful in its appeal and is required to rewrite Regulation II, merchants will be able to decide whether to route signature-based transactions to MasterCard, Visa, Discover, etc. in addition to the similar decisions they currently make on PIN-based transactions. Refer to Figure 4, following page, for further information. This change in rulemaking will indeed cause angst for issuers in terms of operations and costs, and implementation of EMV for debit in the United States will face even more challenges than those being experienced today. It will become vital for credit unions to have access to the network configuration and processing expertise required to compete effectively on the same playing field as the much larger players, and there is no reason why credit unions should not take steps today to optimize their network configurations for efficiency and cost effectiveness.

Figure 4: Summary of Changes to Debit Network Exclusivity Rules and Their Implications		
Pre-Regulation II (Prior to April 2012)	**Post-Regulation II** (After April 2012)	**July 2013 District Court Ruling** (Timing TBD)
• Network participation was open – issuers could deploy as little or as many networks they felt were needed • Exclusive network agreements were permissible	• Regulation II requires that all issuers must have two or more unaffiliated networks enabled on their debit cards • Issuers added networks as necessary to comply • Visa further enabled their PIN Authenticated Visa Debit (PAVD) functionality • MasterCard required their debit issuers to enable their Maestro PIN network	• Court rules that Regulation II did not correctly apply the Durbin statutory language requiring two or more network options for each *transaction type*. • If Regulation II is changed as such, issuers would need to enable multiple unaffiliated signature-based networks in addition to multiple unaffiliated PIN-based networks • Potential Examples: ▪ A current Visa and STAR issuer could add MasterCard and PULSE to comply ▪ A current MasterCard and NYCE issuer could add Discover and STAR to comply

3. What can credit unions do to mitigate risks that might occur with the adoption of new Federal Reserve regulations?

- **Stay in-tune with developments on these issues.** Over the coming months, Advisors **Plus** encourages credit unions to keep abreast of developments on these issues related to debit card interchange and network routing and we stand ready to help. Consider appointing a senior "point person" within your credit union to stay on top of these issues and keep your executive team and Board of Directors updated as legal proceedings and events progress.

  One reason Advisors **Plus** wanted to publish this POV was to reassure the credit union community that we are watching Regulation II developments closely and stand ready to interpret future actions on behalf of the credit union community. "Fed watching" normally means something quite different, but in this case, we will be watching every aspect of Durbin and Regulation II and staying in touch through our Advisors **Plus** website, Twitter (@PSCUAdvisorPlus) and our parent company, PSCU's communications network.

- **Reserve for fee income risk in your 2014 budget.** As mentioned earlier, even a reduction to interchange by one basis point can amount to a great deal of fee income. To that end, we suggest that as your management team evaluates and quantifies your credit union's forward financial risks, you consider building a reserve for interchange risk into your 2014 operating budget.

4. Are there any potential opportunities that a rewritten version of Regulation II might present?

Potential changes to the interchange landscape may not be cause for wild optimism but there could be potential opportunities for credit unions to position themselves favorably versus banks going forward:

- **Recognize and be ready for the confusion your credit union members may experience, and capitalize on the opportunity to re-educate them.** Durbin was the consumer price revolution that never happened and many individual and small business consumers—including your members—report feeling betrayed. Make your credit union the exception to that feeling by consistently delivering transparency, value and great service to your members year in and year out. When the big banks cut back on service and your credit union is there with better offers at lower prices the market unrest fostered by further interchange erosion could be an outstanding opportunity to underscore that case.

- **Evaluate and optimize the network configuration of your debit card program.** With the added flexibility merchants have today to route debit transactions to the networks that offer the lowest rates of interchange, it is important to evaluate your network participation. There was a time when credit unions had more control over transaction routing and when having a large number of networks available on a debit card was necessary due to limited network reach.

  However, times have changed and most networks have grown and/or merged with other networks to develop a national reach. As a rule of thumb, less is now generally better. Advisors **Plus** can help you carefully evaluate the financials of your network options and optimize your network participation to help you balance the best value for your credit union with the highest level of service for your members.

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For More Information

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

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

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. Our average Net Promoter Score in 2012 was 84 as measured by client surveys.

The Advisors **Plus** team partners 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.

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.**