PREPARING FOR THE NEW NORMAL IN YOUR CARD NETWORK AGREEMENTS

SRM ACADEMY REPORT

US banks and credit unions can expect to spend more quality time with their payment network providers in 2020 and beyond. A disproportionate number of card agreements will be up for renewal in the coming months, and these long-term contracts, some lasting as long as a decade, set the terms for the greater part of most financial institutions' costs and non-interest revenue streams.

History seems to repeat itself in some ways; many of these expiring agreements were entered into during the aftermath of the 2008 financial crisis, when the full impact of the Durbin Amendment and the outlook for consumer spending and credit remained unclear. Despite similar conditions in recent news, the payments world looks quite different today compared to when those agreements were last signed.

Card network providers will soon begin calling both existing and prospective customers, offering renewal terms and/or special offers to win bank and credit union business. In addition to considering how things have changed in payments over the last decade, it is now more important than ever that these renewal and financial terms be considered carefully - very carefully.

Conducting a successful card brand renegotiation is an extended exercise, requiring 12-18 months of lead time and significant internal effort. With millions of dollars at stake, investing in extensive due diligence should be obvious. However, there are still many financial institutions who enter into these negotiations with limited visibility or manpower of how costs and revenue streams set by these vital payments agreements are interconnected, leaving a considerable amount of potential bottom- and top-line gains on the table.

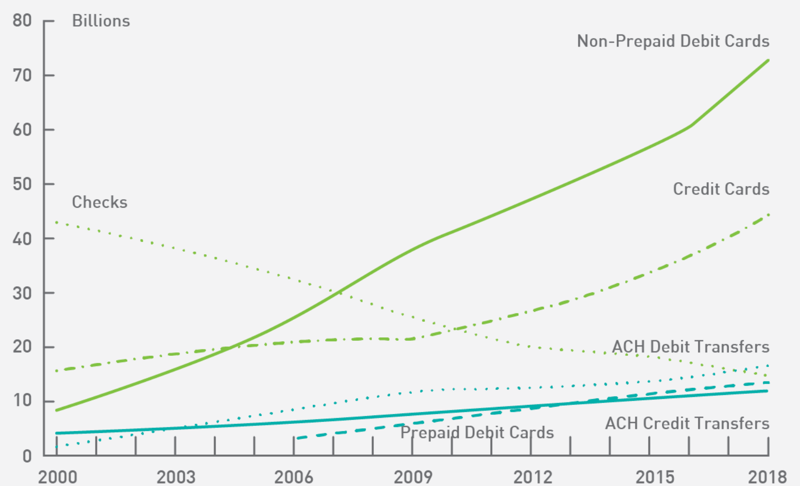
This report outlines key considerations to understand and review before entering (or extending) a card program agreement: an overview of interchange data and dynamics; ongoing changes in the payments industry landscape; strategies to maximize card programs within a given set of terms; and factors unique to each credit union and bank that should play a deciding role.

NOT ALL SWIPES ARE CREATED EQUAL

Fundamentally, card-issuing institutions earn revenue from both their credit and debit programs on a combined per transaction and percent-of-value basis. The concepts addressed in this report apply to both debit and credit card programs, but we will focus on debit since we anticipate a surge in debit volumes for the remainder of 2020 and beyond, as witnessed after the 2008 financial crisis.

Despite the Durbin Amendment implemented shortly thereafter, which reduced interchange revenues for institutions across the board, debit interchange revenue is still one of the top two non-interest areas of income for financial institutions - especially when the associated costs are effectively managed.

The Fed reported $2.75 trillion in debit transactions in 2018, growing at 8% annually. As for the number of transactions, according to the most recent US Fed payments study, there were nearly twice as many debit card transactions performed as credit - 86.4 billion vs. 44.7 billion. Credit still accounts for 56% of the value transacted, but the gap is narrowing.



Source: Federal Reserve Payments Study 2019

Recognition and loyalty are also factors with debit. Consumers are very aware that most banks and credit unions are directly tied to their accounts. When asked what debit card they used, the average person's response includes their financial institution's name. What's more, for debit transactions, debit economics typically drive vendor and brand affiliation decisions.

On this note, one of the few bright spots of the Durbin Amendment for card issuers was the requirement for the Federal Reserve (Regulation II) to publish an annual report of interchange rates. This report provides banks and credit unions with a credible source of information from which to make better informed decisions.

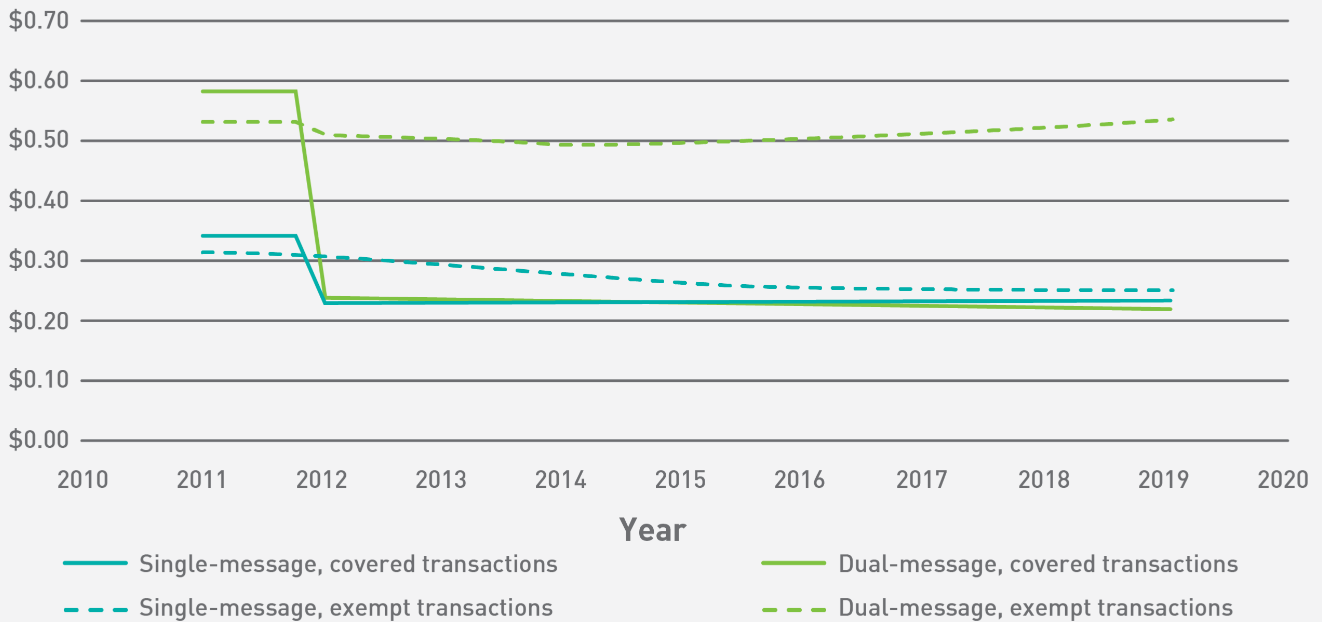
Remember, technically, the Durbin Amendment covers only banks and credit unions with more than $10 billion in assets, capping their permitted interchange rates. The FDIC & NCUA report that there are approximately 130 such institutions in the US, including 7 credit unions, contributing 63%of debit volume. The same sources estimate this leaves roughly 10,000 smaller financial institutions exempt from the Amendment's restrictions. However, despite their exempt status, market forces have caused reduced interchange rates for these community and regional institutions too.

What's more, even minor rate differences between network providers add up to meaningful P&L impact. Many small community banks and credit unions generate more than 300,000 monthly debit transactions. A mere $0.04 difference per transaction in the interchange terms negotiated can translate to an annual $150,000 lift – enough to fund additional FTEs or a critical strategic initiative. With proper preparation and expertise, the numbers only increase from there.

A quick review of the Fed Reg II tables referenced earlier makes clear that one size does not fit all in the debit card world. The Fed reports interchange fees for 15 US networks, segmented by covered and exempt FIs as well as by single-message (typically PIN) and dual-message (typically signature) transactions. Note that beginning with 2018 data, Visa PAVD - a PIN-authenticated transaction type running across dual-message rails – is now also broken out.

Though the Durbin Amendment shifted control of debit routing decisions into the hands of the merchant initiating the transaction, this does not mean card issuers have zero influence over the process. From the selection of a brand partner through the choice of a required "back of card" second routing option, and extending into customer education programs and marketing promotions, decisions can be informed by a gaining a firm understanding of the Fed's debit interchange data.

AVERAGE DEBIT CARD INTERCHANGE FEE, 2011 - 2019



Source: U.S. Federal Reserve Regulation II Debit Interchange Fees and Routing

For a broader perspective, let's take a step back and consider how the Fed's 2018 transaction data compares to its snapshot from 2012.

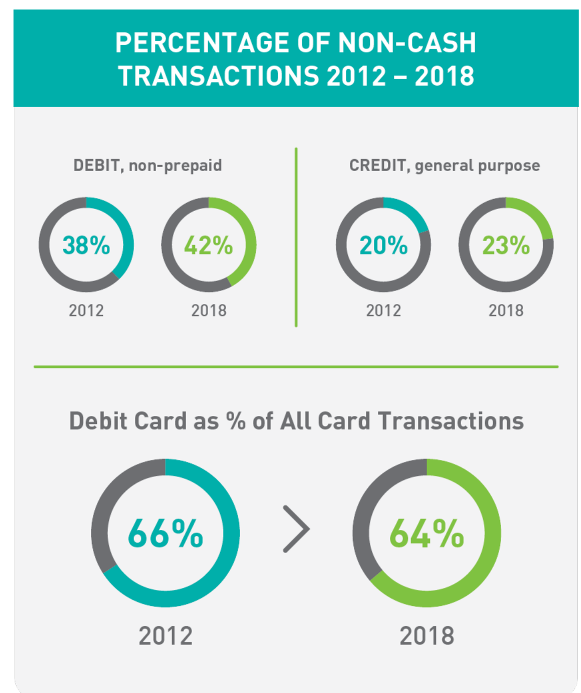
Aggregate debit card transaction volumes are 53%higher than just six years ago, while the average transaction value has barely changed. Market interchange rates have moved somewhat – both on an industry average basis and through volume tiers built into each contract – but it's safe to assume there is more interchange revenue at stake today than in 2012. In addition, there is a continuing shift in the Signature/PIN mix, though this will not appear in Fed data until later in 2020. This will be important, as PIN/POS processor contract terms can both amplify or detract from revenues gained in card network negotiations.

Along with the growing number of transactions, consider the following material changes in the payments industry since 2012:

EMV: In the US, chip cards and chip-enabled terminals took hold years after similar transitions in Europe and Asia. Cardholders were reconditioned to insert instead of swipe, and analysts fretted over potential long queues at the checkout line stemming from confusion on both sides of the register as well as extended data transmission times. Most of these fears proved unfounded – the conversion is not yet complete, but a solid majority of in-person card payments are now conducted via chip compared to an insignificant fraction as recently as 2015.

THE MAINSTREAMING OF E-COMMERCE: The concept of "two-day shipping" was not coined by Amazon, but the program it built around it – Amazon Prime – has had a considerable impact on the growth of ecommerce. According to the 2019 Fed report, the value of remote purchases made with general purpose cards has pulled even with the value of in-person card purchases. To be clear, in-person transactions still comprised nearly three-quarters of the total count, and the remote category also includes items like mail/phone order and recurring bill payments. Still, e-commerce represents the largest and fastest growing source of remote card activity – and given recent social distancing norms, this trend can only be expected to accelerate.

MOBILE PAYMENTS – NEW NORMAL, SAME AS OLD, ONLY MORE: With the new normal, more goods are being purchased via e-commerce than ever before, accelerating as consumers increasingly reached for their smartphones and tablets when shopping for goods and services. According to the IMARC Group, mobile payments were expected to grow from an annual total transaction value of $881 billion to $3.081 trillion from 2019 to 2024. Perhaps even more impressive is the fact that research suggests mobile devices now influence 56% of every dollar spent as consumers use them to research purchases before they buy. Post-pandemic, the growth of mobile payments will become even steeper - with brick and mortar payments declining faster than previously.



Source: Federal Reserve Payments Study 2019

It would be naive to think these changes have fully played out. In the latest Fed payments study, general purpose debit and credit card volumes grew by 8.7% and 9.7%, respectively – remarkable numbers for products that already enjoy substantial installed bases. Even allowing for some moderation, this implies volumes will be 60-70% higher in six years' time. For those preparing to renew terms with a card network, this means negotiating price tiers should account for this trend and be inclusive of headroom and volume discounts over the life of the contract.

Further, although more surprises are inevitable in the coming years, here are two events that should be firmly on your radar:

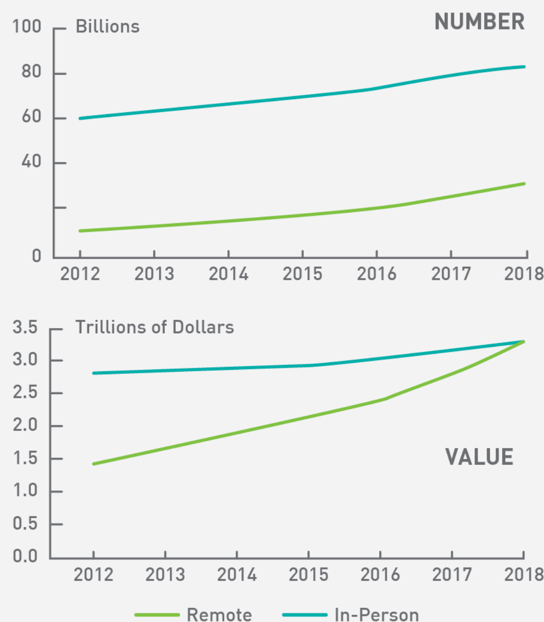
CONTACTLESS CARD ROLLOUTS: Contactless payments is another area in which the US lags well behind other geographies, but many factors are converging to drive more use. Transportation – e.g., the recent move of major transit hubs like New York's Penn Station to contactless-enabled turnstiles – has made the use of this type of card more familiar. Though most cardholders know the "insert card" drill through the introduction of EMV, contactless transactions are much faster. There is no need to stand focusing on the point-of-sale device screen awaiting the command to "remove card." With contactless cards, you "tap and go." Contactless cards could even drive more adoption of digital wallets, though, those can require first unlocking the phone. Removing a contactless card and waving it over the device can be much more convenient - and more hygienic (now a non-trivial consumer concern).

8-DIGIT BINS: It's estimated that by 2022 the inventory of 6-digit Bank Information Numbers (BINs) will be depleted, necessitating the conversion to 8-digit identifiers. This will involve phasing in cards with new identifier numbers as the cards expire. For those managing the institution's card network relationships, this event could serve as an opportunity to revisit proposals from competing brands.

MAKING THE MOST OF YOUR PORTFOLIO

The growth trends discussed above are based on aggregate industry data. Naturally, some institutions will perform above these averages and some below, for logical reasons –geography, demographics, or strategic focus. If an institution regularly falls short of the peer growth described by Federal Reserve data for no apparent reason, the most expedient answer may be to analyze the data for common and actionable root causes.

Although card interchange is often the first or second largest source of non-interest income, it's surprising how many institutions do not actively manage this line item – particularly those with less than $5 billion in assets. Card program optimization, especially with debit portfolios, offers an oft-overlooked chance to cultivate gains and deepen relationships with customers and members - at no cost



Source: Federal Reserve Payments Study 2019

to either. If an institution is seeing growth at or above peer levels outlined by the Fed data, it's worth looking at why with an expert familiar with conducting these kinds of analyses.

Also consider the PAU principle (Penetration, Activation, Utilization), which SRM card experts have found to be an effective construct for both debit and credit program optimization. Basically, each of these areas boils down to a few key metrics, with supporting tactics to support improved performance.

When it comes to card penetration, many FIs believe an average of 0.9 cards per account holder is acceptable. Depending on demographics and other factors, however, further analysis may show 1.5 to be attainable.

Activation rates – measuring cards used to transact in the past 30 to 90 days – should be in the 65-80% range, with campaigns implemented to spur activity. The first six months of card ownership is particularly critical for establishing behavior, with three consecutive months of usage for a given activity serving as a good benchmark.

Utilization, the level of dollar throughput, can be influenced via analyzing data and creating incentives based on observed established consumer spending patterns.

You can find more on these PAU tips here. Subscribe to SRM's blog The Bottom Line for additional insights and payments analyses in the coming months.

PREPARING FOR YOUR NEXT CARD NEGOTIATION

When preparing your institution for its next card network negotiation, the two most important foundational steps are to *start early* and *be proactive.* These agreements rarely include an auto-renewal provision, so expect outreach well ahead of expiration from both the incumbent and the challenger(s). Be wary of pre-emptive offers; they are often designed to capitalize on an imbalance of information.

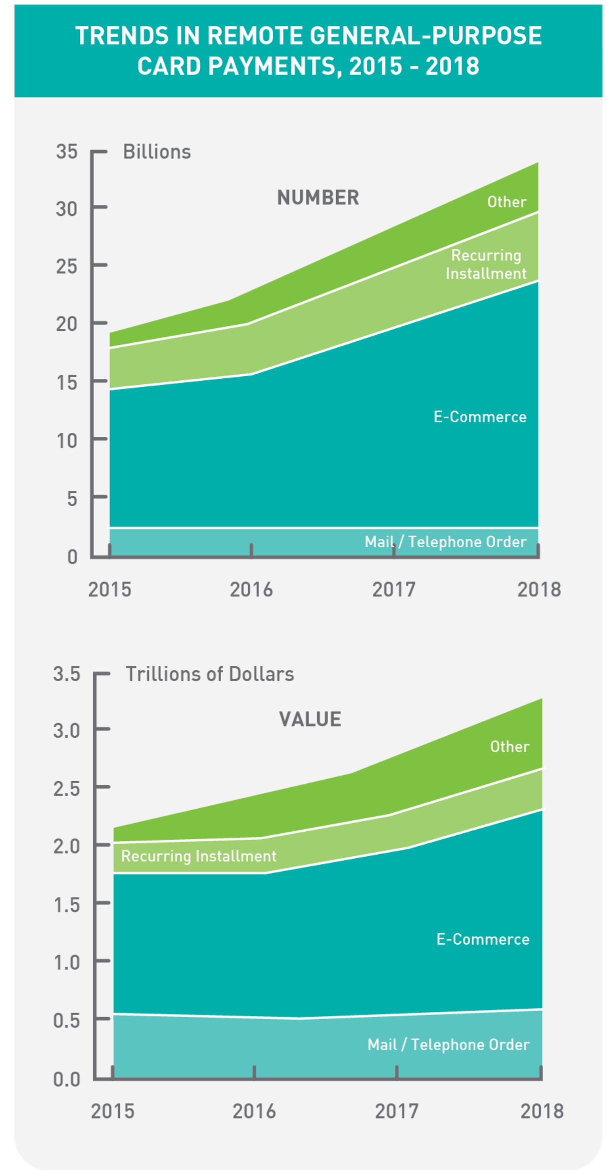
Card network representatives have various types of incentive programs at their disposal, both to spur the closing of a deal and to drive win/win results in the long run. If unaware of their availability, banks and credit unions are unlikely to ask for them. In such cases, the support of a qualified domain expert can easily pay for itself in the form of direct, bottom-line results. To put it into perspective, the difference of a few basis points in interchange rates can add up to millions over the life of a long-term contract.

Card agreements are also built to anticipate growth, but what if your institution grows faster than the overall market – whether through acquisition or organically? Mechanisms should be put in place to reward exceptional performance. Again, there are proven ways to accomplish this goal, though it takes specific knowledge of the acceptable approaches.

CONCLUSION

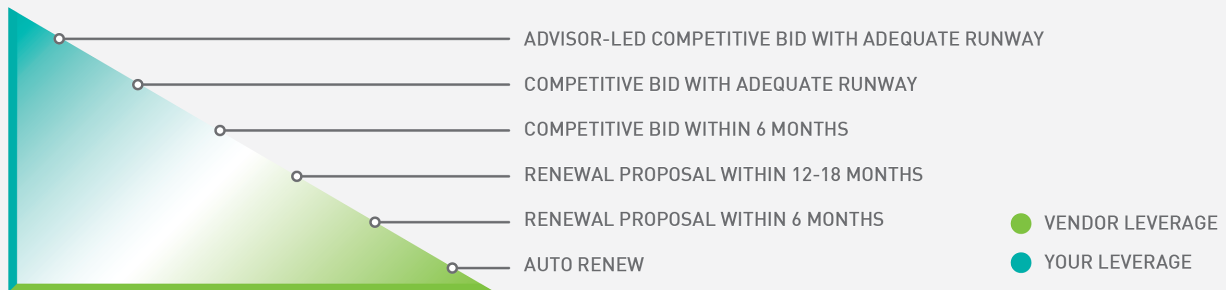
There is little reason for a bank or credit union representative to remain intimately familiar with the changes of market pricing during a long-term contract. Conversely, card network representatives are dealing with dozens - if not hundreds - of institutions on a regular basis and understand precisely what the market will bear.

However, the window of opportunity for a bank or credit union to negotiate a card brand agreement only comes around roughly once every 7 to 10 years. It's essential to make the most of that window so that by 2025, when the payments landscape has again changed dramatically, management doesn't look back in hindsight and lament mismatched terms and missed revenue.



Source: Federal Reserve Payments Study 2019

STARTING THE EVALUATION PROCESS EARLY PROVIDES NUMEROUS BENEFITS



Source: SRM Academy – 8 Rules of Engagement for Vendor Negotiation Strategy, February 2020