

The Impact of Regulatory Compliance on the Card Industry

The current regulatory landscape for the card industry, the costs and opportunities of compliance, and the impact on the stakeholders



People matter, results count.

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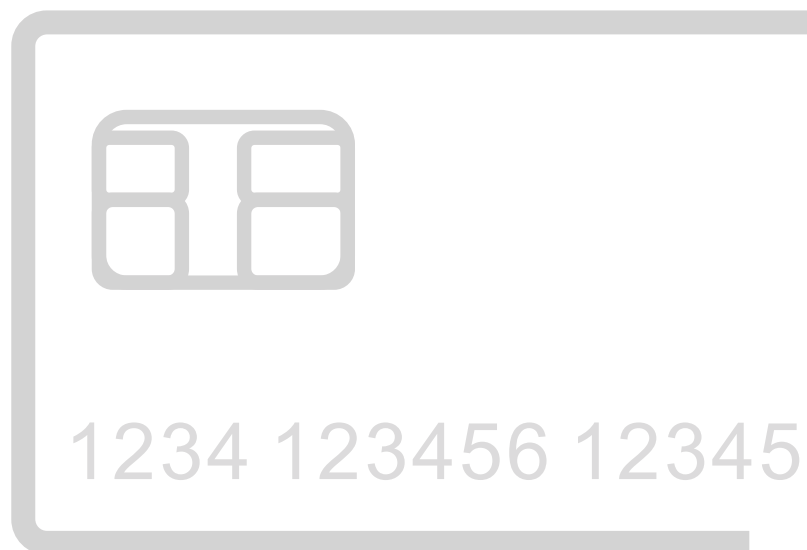
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1. Highlights

Cards continue to remain the primary non-cash payment instrument, accounting for 40% of the global market share in 2010¹. Along with the rise in card usage, demand for privacy, security, convenience, and transaction speed has also grown. This has led to an increased focus on regulations aimed at achieving these goals.

Consumer protection, fraud prevention, and standardization are the major drivers for regulations in the card industry. Regulations such as the Durbin Amendment, Unfair and Deceptive Acts and Practices (UDAP), and the Credit Card Accountability Responsibility and Disclosure (CARD) Act originated in the U.S. with consumer protection as their primary goal. European regulatory authorities focused mostly on standardization and fraud prevention by creating standards such as Europay MasterCard Visa (EMV) and SEPA Cards Framework (SCF). Countries such as China, India, Singapore, and Malaysia have initiated their own domestic payment networks which are likely to challenge the global networks. *For a list and description of relevant regulations and standards, see the Appendix at the end of this document.*

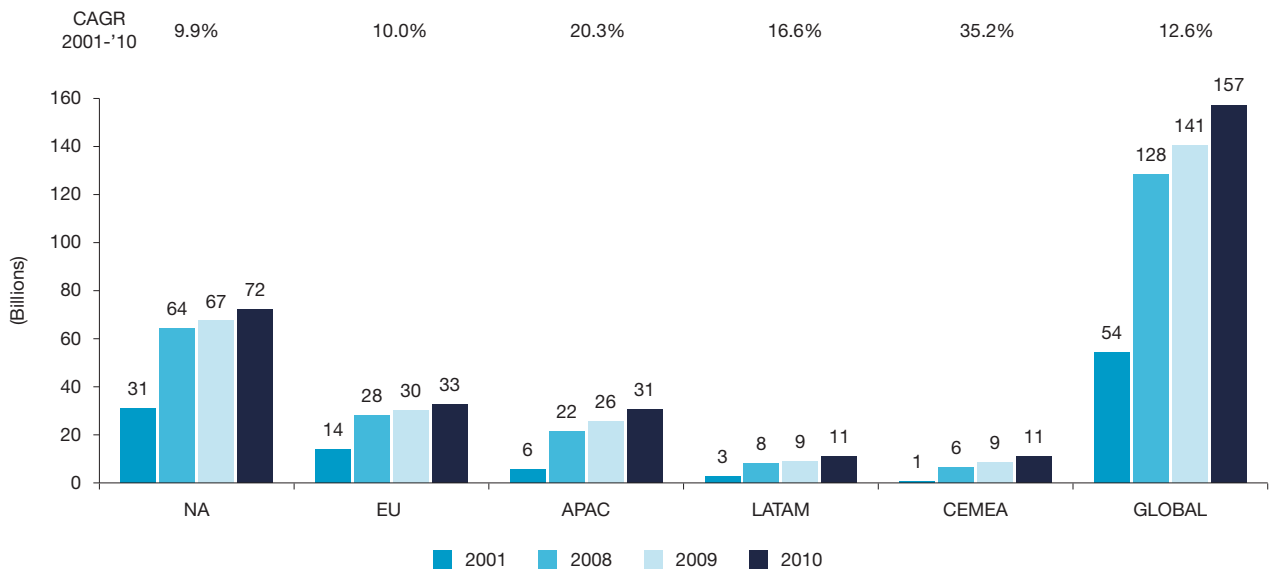
Adherence to regulations in the cards industry is likely to have an impact on all stakeholders. Payment card networks will need to invest heavily in infrastructure upgrades in order to be compliant with the latest updates of security standards such as the Payment Card Industry Data Security Standard (PCI DSS). Regulations such as the Durbin Amendment, the CARD Act, and UDAP are having a negative impact on revenues of most issuers and networks, forcing them to alter their business models in order to survive and grow. Some regulations such as the Durbin Amendment would have a more direct and severe affect on banks, while other regulations such as SEPA Cards Framework (SCF) might indirectly benefit the growth of non-banks.



2. Introduction

The payment card industry has witnessed a robust, double-digit growth rate in the past decade. Card usage in developed regions such as North America and the European Union (EU) has grown at a rate of around 10%, whereas in developing regions such as APAC² and CEMEA³, the growth rate has been above 20%, primarily due to improvement in payment infrastructures.⁴ North America and the EU remain the most mature cards markets, accounting for more than two-thirds of the global payment card transactions.

Exhibit 1: Total Cards Transaction Volume Across Major Geographies (billions), 2001–'10



Note: Cards indicate usage of credit cards and debit cards only
 Source: Capgemini Analysis, 2012; *World Payment Report 2012*, Capgemini, RBS, EFMA

The card industry needs to balance this growth with better risk management techniques while introducing new products, moving to new countries, or cross-selling related products in order to satisfy the ever increasing customer demand for data privacy, convenience, and transaction speeds.

This growth in the card industry has been accompanied by an increase in card fraud, loss of confidential financial data, aggressive marketing practices and complex billing procedures by card companies, and different standards for different card networks.

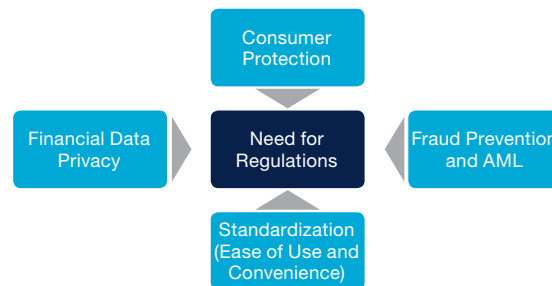
To counter these risks, the industry as a whole has been forced to adopt several stringent regulations, which impacts all the major stakeholders.

² APAC denotes countries in the Asia-Pacific region
³ CEMEA denotes countries in Central Europe, Middle East, and Africa
⁴ *World Payment Report 2012*, Capgemini, RBS, Efma

3. Drivers for Regulations in the Card industry

Consumer protection, fraud prevention, and anti-money laundering (AML), standardization, and maintaining financial data privacy have been the major drivers behind the majority of the current regulations in the card industry.

Exhibit 2: Key Drivers for Regulations in the Payment Card Industry



Source: Capgemini Analysis, 2012

3.1. Consumer Protection

Regulatory authorities, particularly in the U.S., are concerned about consumer protection and have passed several regulations such as the Credit Card Accountability Responsibility and Disclosure (CARD) Act and Unfair and Deceptive Acts and Practices (UDAP). These regulations are designed to protect consumers from irregularities in the card issuing, billing, and settlement phases. Several other countries such as Australia and Canada have also made regulations restricting the amount of interchange fees charged by issuers. These fees were considered to be high and placed a burden on merchants and customers.

Aggressive marketing practices

Some card issuers employ aggressive marketing practices such as sending unsolicited cards, issuing cards to underage customers with no repayment capabilities, and actively seeking out potential customers by inundating them with mails and mobile calls. These kinds of aggressive practices upset customers and often result in loan defaults. To address these concerns and prevent such practices, regulations such as the CARD act and UDAP were formed in the U.S.

Higher fee burden on merchants and customers

Merchants have often felt that the fees charged by card networks in the form of interchange fee or merchant discount were disproportionate to the costs incurred by issuers and other ecosystem players. As a result, merchants sometimes pass on these higher costs to customers, which could adversely affect their card usage frequency. Also, certain issuers charged extremely high fees for violations such as late payments. In order to curb these high fees, several countries such as Australia, Canada, and the U.S. have passed regulations limiting the fees charged by issuers.

Lack of transparency in terms and conditions

Unusual terms and conditions such as certain late payment penalties or the validity of pre-paid cards are sometimes provided in small print, making it difficult for consumers to understand. On occasions, the payment allocation structure employed by some card organizations lacks transparency. For example, card companies sometimes do not apply a significant portion of the payments made by customers to the balance with the greater interest rate. Regulations such as UDAP and the Gramm Leach Bliley Act (GLBA) financial privacy rule have been formed to increase transparency and protect customer interests. In addition, the Consumer Finance Protected Board was created as part of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, charged with making credit prices and risks more transparent so consumers can more easily compare credit card and loan products.

3.2. Fraud Prevention and Anti Money Laundering

There has been a rise in the number of fraudulent card transactions in the past few years and the value of fraudulent card transactions has grown at a rate faster than the increase in the value of card transactions.

Exhibit 3: Total Cards Transaction Volume (€ trillions) vs. Cards Fraud Volume (€ billions), 2006–2009



Source: Capgemini Analysis, 2012; Capgemini World Payments Report 2011, Capgemini, RBS, EFMA; Money Laundering using new Payment Methods, October 2010

Fraudsters are using increasingly sophisticated techniques such as card cloning⁵ to replicate the cards of unsuspecting customers and allow the run-up of large bills on these cloned cards. The chances of fraud can also be high during electronic or mobile payments, where the card is not physically present (CNP transactions).

⁵ Card cloning is a technique which is employed by fraudsters to replicate the data present in a customer's card to another duplicate card, which can then be used without the customer's knowledge

Another source of concern has been the usage of payment cards for money laundering and other illegal activities. For example, General Purpose open-loop prepaid cards issued in one country without extensive customer identification can be used in cross-border trade, making them easy avenues for money laundering activities which often aid terrorism, drugs, and other illegal activities.

Therefore, several standards such as Payment Card Industry Data Security Standards (PCI-DSS) have been established and Know Your Customer (KYC) and Anti-Money Laundering (AML) rules have been formed by Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Office of Foreign Assets Control (OFAC) forcing adherence to those standards to curb fraudulent transactions and prevent money laundering.

3.3. Standardization

Lack of uniform standards across different card networks and organizations can lead to limitations in card usage. Differences in standards can also increase the financial burden on merchants since they need to invest in different hardware based on the different card standards.

Use of common standards can provide a consistent customer experience across locations and channels, and other benefits such as increased options for consumers and merchants in choosing an issuer and network.

Standards such as the SEPA cards framework (SCF) and EMV are being implemented with a focus on providing global interoperability and compatibility across various networks.

3.4. Customer Data Privacy

On a regular basis, Financial Services Institutions in the card industry deal with a large amount of personal and confidential customer information, including bank account numbers, credit card and debit card data, and other personal information. Financial institutions across the world have often become the targets of data breaches due to the perceived value of the underlying data.

There have been some very high profile data breaches in financial firms in the last few years, which compromised millions of data records held by these institutions and led to irreparable financial and reputational damage. In March 2012, a global credit and debit card processor disclosed that it was hit by a data breach, potentially exposing around 1.5 million MasterCard and Visa customer data records and resulting in heightened concerns about credit and debit card security.

Data security standards and data privacy regulations therefore have to be strong due to the high risk of potential financial and reputational loss associated with data breaches.

To capitalize on emerging growth opportunities, firms need to be flexible in sharing confidential customer data among different departments and third parties. However, all involved parties would still have to adhere to the regulations.

The key to growth lies in the delicate balance between data sharing flexibility and data privacy.

4. Regulatory Compliance: Burden or Opportunity

4.1. Cost of Compliance

Regulatory compliance places a lot of strain on both the top and bottom lines of financial institutions in the card industry. Payment Service Providers (PSPs), especially banks, are feeling intense pressure as regulations impact one another and continuously evolve. The regulatory landscape requires constant monitoring and attention. Some of the specific costs of compliance include:

Increased Infrastructure Costs

Investment in infrastructure to achieve regulatory compliance is a significant cost which is likely to affect all stakeholders. Card issuers, associations, merchants, and acquirers will have to invest in advanced infrastructure in order to adhere to the regulatory standards set by the authorities. In 2010 alone, Visa and Master Card spent around \$500 million on upgrading their infrastructure to meet the latest regulatory standards.⁶

Revenue Loss

Some of the regulations aimed at consumer protection such as the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, force card companies to reduce their fees or alter their fee structure, thereby creating a dent in the top line of several firms. Other regulations such as UDAP or CARD Act prevent issuers from aggressively seeking out new customers or launching new products, which limits the sources of revenue.

Reduced Flexibility

To capitalize on growth opportunities, Financial Services Institutions in card industry need to be flexible in sharing confidential customer information with other departments or third-parties such as outsourcing firms. However, an increase in regulations with regards to data privacy could prevent firms from being flexible enough and limit their growth potential.

Increase in Competition

The cards networks industry has primarily been an oligopolistic market, marked by the presence of few large players such as Visa and MasterCard who control the majority of the market share. Certain regulations have been formed which either directly or indirectly impact this small group while providing an uplift to smaller firms and new entrants. This could decrease the clout of the large institutions and lead to increased competition, which could reduce the scale of operations for them and push their costs upwards.

⁶ Cost of Compliance, Wall street journal article, <http://online.wsj.com/article/SB119228427431745878.html>

4.2. Overview of Opportunities Arising Out of Regulatory Compliance

Despite the high cost of compliance, there are inherent opportunities arising out of regulatory compliance.

Opportunity for New Entrants and Ancillary Industries

Some of the regulations are aimed at reducing the oligopolistic nature of the card industry. For example, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 makes it mandatory for each issuer / network to participate in at least two unaffiliated debit card networks for card processing. These regulations might favor smaller players, thereby giving them an opportunity to compete with much larger opponents despite the huge variance in their scale of operations.

As a result of these regulations, existing firms could decide to focus solely on their core services, and outsource non-core functions, which could provide an opportunity for new entrants.

Regulatory compliance could also open up new opportunities for ancillary industries. Auditing firms which specialize in ensuring compliance or IT firms which provide comprehensive, compliance-related IT solutions could benefit from the new regulatory environment.

Early Compliance Leading to Increased Customer Preference

Issuers, acquirers, and networks that adhere to regulatory standards sooner than their competitors will have an early advantage. Customers and merchants might prefer to use their products and services because of their ability to offer higher security and better service quality.

Increased Choice of Products and Services for Customers Due to Innovation and Standardization

While regulation is often synonymous with constraint, some regulations often enable innovation either directly or indirectly. Increasingly complex market conditions caused by regulations might force the industry to embrace greater innovation. The current situation could be seen as an opportunity to innovate and introduce the next generation of card products, services, and operations. Banks are using regulations as an opportunity to pursue and take customer-centricity to a new level. They are being drawn further into customer-driven, value-added innovation, an area in which non-banks have been more successful historically.

Certain regulatory standards such as EMV and SEPA Cards framework might lead to uniform standards across different geographies, networks, and phases of the card payment life-cycle. Customers would then be able to use a card or select the network of their choice due to this uniformity.

Long Term Cost Reduction

Harmonization and standardization of card payments is likely to ease the burden on different stakeholders, due to the possibility of lower hardware and transaction processing costs. Regulations forcing adherence to standards could bring down operating costs in the long run.

Increased competition arising out of these regulations could force firms to tighten their spending and improve their operational efficiency, leading to reduced costs.

Inorganic Growth Opportunities (Mergers & Acquisitions)

As a result of stringent regulations, several card companies which have seen a drop in their profits are assessing their future course of action and some might decide to exit altogether. This would provide an opportunity for other firms to grow inorganically, either through mergers or acquisitions, potentially leading to increased scale of operations.

4.3. Cost of Non-Compliance

Non-compliance to regulations could prove to be costly for firms in the card industry in a number of ways:

Heavy Penalties

Non-compliance to global regulatory standards such as Payment Card Industry Data Security Standards (PCI-DSS) could result in heavy fines. If any merchant is found to be non-compliant to PCI-DSS, they could be fined to the tune of \$5000 - \$500,000 per violation.⁷ In other instances, the payment brands may, at their discretion, fine an acquiring bank up to \$100,000 per month for compliance violations. The banks are most likely to pass these fines downstream until it eventually hits the merchant. Furthermore, banks are also likely to terminate their relationship with merchants or increase transaction fees. Firms could also be forced to compensate customers in case of data breaches arising out of non-compliance to security standards.

Risk of Lawsuits and Reputation Loss

Any kind of data breaches could result in massive reputational losses for firms, leading to a dip in customer confidence that is likely to be detrimental for business. Card companies could also face the risk of lawsuits for non-compliance to regulations related to consumer protection or security.

Loss of Business to Competition

Non-compliance or delay in adherence to regulations is likely to result in business losses to competition, as firms that invest up front in compliance could grab an early advantage. Customers may prefer those firms due to increased security and improved services. However, in some cases, a wait-and-see approach might be beneficial as firms learn from how others are coping with regulatory compliance and plan it better. In such scenarios, firms would need to make a trade-off between loss of business to competition and a well-planned compliance structure which could lower costs.

On the whole, the high cost of non-compliance should hasten the journey of all stakeholders in the card industry towards timely regulatory compliance.

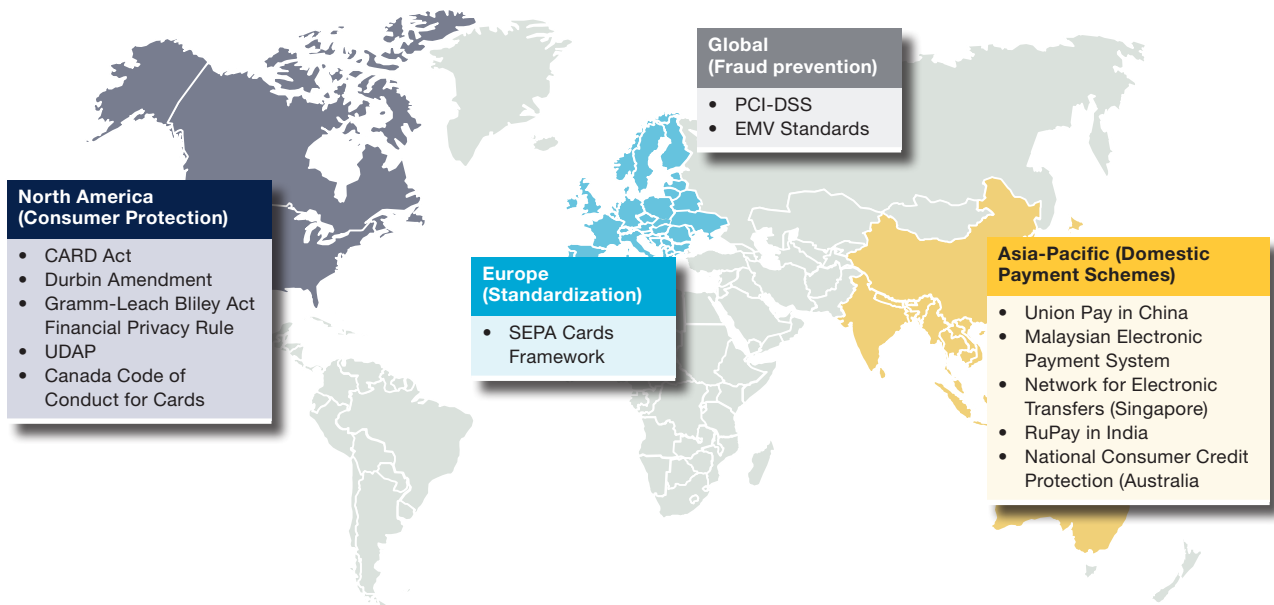
⁷ pci.complianceguide.org

5. The Impact of Major Regulations on Stakeholders

Several major regulations or standards have been formed in recent years to address consumer protection, data privacy, and fraud prevention. The regulations are both local, addressing concerns specific to a region or geography, and global as well.

In addition to regulations and regulatory standards, there are certain domestic payment schemes that are being promoted by the regulatory authorities of those countries which impact the stakeholders.

Exhibit 4: Origin of Regulations or Standards and Primary Objective of the Region



Note: Country boundaries on diagram are approximate and representative only
 Source: Capgemini Analysis, 2012; SEPA Cards Framework, EPC; www.emvco.com; www.ncpi.org; reform of wholesale payment systems, www.imf.org

Regulation continues to be both challenging and beneficial for the stakeholders in the card industry. Different regulations have different levels of impact on various stakeholders. It is however important for regulators and market players to look at all current regulations holistically, carefully gauging the impact of each regulation on the others, and the net effects.

While some regulations are likely to be favourable for some stakeholders, others might have a negative impact on their revenues by increasing costs or limiting revenue sources. Other regulations are likely to have both positive and negative impacts on the stakeholders. Exhibit 5 below gives an overview of the impact of these regulations on various stakeholders. These snapshots also indicate whether that particular regulation has a positive or negative impact and the level of the impact.

Exhibit 5: Impact of Regulations on Various Stakeholders

Regulation	Issuers	Card Associations	Acquirers/Processors	Merchants	Customers
Durbin Amendment					
CARD Act					
UDAAP					
GLBA Financial Privacy Rule					
Domestic Payment Schemes					
EMV Standards					
PCIDSS					
SEPA Cards Framework					

Positive Impact
 Negative Impact
 Both Positive and Negative Impact
 Very High Impact
 High Impact
 Medium Impact
 Low Impact
 Negligible
 Uncertain

Source: Capgemini Analysis, 2012

5.1. Global Regulations: Focus on Fraud Prevention and Standardization

Payment Card Industry Data Security Standard (PCI-DSS)

A regulatory standard for organizations handling cardholder information aimed at enhancing data card security and reducing credit card fraud. Validation of compliance is to be done annually and any non-compliance can lead to hefty fines. This standard impacts:

- **Issuers and Acquirers:** Issuers and acquirers will need to invest in infrastructure in order to adhere to PCI standards. These standards are updated at regular intervals, so issuers and acquirers will have to incur a recurring cost every time there is an upgrade in these standards.
- **Merchants:** The infrastructure investments requisite for PCI-compliance could be a significant burden for smaller merchants who do not enjoy economies of scale.
- **Consumers:** Customers would benefit from improved security, which could promote increased card usage.

Europay MasterCard Visa (EMV) Standard

EMV is a global standard for credit and debit payment cards based on chip card technology. The primary goal is to help facilitate global interoperability and compatibility of chip-based payment cards and acceptance devices. These standards were developed by Europay, MasterCard, and Visa, and ensure enhanced security and greater transaction speeds. This standard impacts:

- **Issuers:** Issuers will have to incur huge costs in manufacturing cards with appropriate chip technology. However, they might benefit from positive brand impact of being EMV-compliant as customers might perceive such issuers to be more innovative and prefer to go with them for providing better security.
- **Card Networks and Associations:** Card associations would have to incur heavy costs in order to be EMV-compliant. However, this could be beneficial in the long run since standardization could reduce processing costs.
- **Acquirers:** Acquirers are likely to face the highest technical impact since they need to implement a full data host environment. Acquirers who are EMV-compliant are better positioned to mitigate the risk of chargebacks under liability shift arrangements.
- **Merchants:** Merchant groups are perceived to be the stakeholders facing the most challenging impact because of issues such as retail staff training and conformance, in addition to setting up the entire data host environment.
- **Consumers:** Customers would benefit from enhanced security features by using EMV cards instead of magnetic stripe cards which are prone to fraud and data theft.

5.2. Regulations in the U.S.: Focus on Consumer Protection

Durbin Amendment (U.S. Dodd-Frank Act)

The Durbin Amendment establishes the standards for determining whether an interchange fee charged by an issuer for a debit card transaction is proportional to the issuer's cost. It recommends that the interchange fee be reduced. Another recommendation is that each issuer or network must participate in at least two unaffiliated debit card networks. This regulation impacts:

- **Issuers:** Due to the reduction of interchange fees proposed by the Durbin Amendment, banks stand to lose around \$12 billion a year⁸, prompting them to increase other customer charges on debit cards or reduce existing benefits to offset a part of this loss. The requirement that each issuer must participate in at least two unaffiliated debit card networks might force the larger banks to focus more on credit card services, rather than provide an advantage to their competitors.
- **Card Networks / Associations:** Debit card networks might be forced to share any losses with banks, resulting in lower profits for the networks. The regulation that each network must participate in at least two unaffiliated debit card networks might force the network to follow the issuers and focus more on credit card services.
- **Merchants:** The Durbin Amendment is going to lower the burden on merchants since they will now pay lower fees. However, an indirect impact on customer spending patterns or payment modes could affect the merchants adversely.

8 <http://www.forbes.com/sites/halahtouryalai/2012/03/29/here-are-the-banks-that-lost-the-most-under-the-durbin-amendment/>

- **Consumers:** Though consumer protection was the major reason behind enforcement of this regulation, it is not yet certain if the merchants are passing on the benefits of a reduced interchange fee to the customers. Customers might be faced with reduced benefits like removal of loyalty points or increased fees on debit card usage as the issuers try to offset their losses, which could result in consumers favoring other means of payment. Large banks such as Wells Fargo, Chase, and Bank of America charge a monthly fee if the checking account falls below \$1500 and some of these banks have also stopped issuing debit reward cards. Creation of consumer financial protection bureau (CFPB) is however a beneficial outcome as a result of this regulation.

Credit Card Accountability Responsibility and Disclosure (CARD) Act

The aim was to establish fair and transparent practices relating to extension of credit under an open-end consumer credit plan. The CARD act aims to protect consumers from arbitrary interest rate increases, misleading terms, and excessive fees. This regulation impacts:

- **Issuers:** The CARD Act is likely to have a significant impact on issuers who relied heavily on interest income, penalty fees and targeted less credit-worthy customers. This might cause the issuers to focus on premium segment or devise their strategies or products accordingly. CARD Act has outlawed four key abusive practices such as universal default, double cycle billing, due date changes, grade periods, and overlimit fees. This might cause some issuers to re-think about their presence in the credit card business.
- **Card Networks / Associations:** With the issuers limiting credit access to less credit-worthy customers, this might result in a lower number of cards and lower transactions which could potentially reduce the overall revenue of the networks.
- **Consumers:** This regulation may insulate customers from higher interest rates and likely prevent a potential reduction in their credit scores for late payments. The regulation is also likely to aid customers who fall back on some payments and provide them additional time to pay the credit card bills. This act protects customers from arbitrary interest rate increases, and prevents penalization of card holders who pay on time. This provides the right to customers to set limits on their credit. However, it might adversely affect customers with low credit scores by limiting the amount of credit available to them.

Unfair and Deceptive Acts and Practices (UDAP)

The purpose of the UDAP act is to assist consumers in battling fraud in the market place and to provide the regulatory agency with the authority to prevent unfair, deceptive, and abusive acts. Different states and countries have different statutes of the UDAP act, with some statutes offering more protection than others. This regulation impacts:

- **Issuers:** The UDAP Act is likely to force issuers to simplify their products and services, limiting the entry of new and complex products. This will prevent issuers from charging excessive fees or following aggressive marketing practices, thereby causing a reduction in revenue and limiting the sources of revenue.
- **Consumers:** Since this act aims to simplify products and services, it is likely to provide transparency to end users on the terms and conditions of using a debit or credit card. Customers will be relieved from the varying charging models and aggressive marketing practices previously employed by card issuers.

Gramm-Leach-Bliley Act (GLBA – Financial Privacy Rule)

Under the financial privacy rule of the GLBA act, financial institutions must provide their clients a privacy notice prior to starting a business relationship with them. The notice must clearly explain what information the company gathers about the client, where this information is shared, and how the company safeguards that information. The notice provides them with an opportunity to opt out of their loyalty and reward programs, ensuring data privacy. This regulation impacts:

- **Issuers:** This act restricts issuers from using private customer information to cross-sell products and services, limiting their revenue sources.
- **Consumers:** This act helps provide better clarity to end users on how financial institutions plan to use their personal financial information. Customers can then take a well-informed decision on either opting out or going ahead with the product or service.

5.3. Regulations in Europe: Focus on Standardization

SEPA Cards Framework (SCF)

The European Payments Council's SEPA Card Framework (SCF) enables a consistent customer experience when making or accepting euro payments and cash withdrawals across the Euro area. The SCF outlines high level principles and rules, that when implemented by the card industry, aim to deliver a consistent user experience to cardholders and merchants throughout markets that have adopted SEPA. This standard impacts:

- **Issuers:** Issuers might face increased competition resulting in reduced electronic payment revenues. However, according to a study by the European Payment Council (EPC)⁹, issuers could benefit to the tune of \$500 million annually from 2016 due to reduction in costs as a result of synchronization and standardization.
- **Card Networks / Associations:** Visa and MasterCard volumes and revenues might increase if national debit schemes begin to disappear.
- **Acquirers:** SEPA POS standards would reduce terminal costs and acquirer rental revenues. Acquirers and payment processors could join new card schemes and exploit new market opportunities.
- **Merchants:** With the SEPA Cards Framework fully operational, merchants might witness an increase in sales since customers from across the border would also be able to use the cards issued in their home country for purchases. Lower cost of settlement could enable merchants to deliver greater rewards on loyalty cards.
- **Consumers:** Customers would have the option of making a choice based on value considerations alone if they wish to adopt a particular card product or brand, fully supported by technical interoperability and with a pan-European presence. Cardholders would expect the same level of ease and convenience, and the same terms and conditions while using their cards anywhere in Europe.

9 SEPA – Can Banks Find New Opportunities for Growth and New Sources of Revenue? – PSE Consulting, Dec 2010

5.4. Regulations in the Asia-Pacific Region: Focus on Domestic Payment Networks

Regulations Favouring Domestic Payment Networks

Currently, fees and charges incurred by various stakeholders are higher for cards in international networks. As such, certain governments in markets like the Asia-Pacific region have passed regulations favoring domestic payment networks such as UnionPay in China and Rupay in India. The aim is a reduction in fees and charges, and financial inclusion of the unbanked population. These regulations impact:

- **Issuers:** Connecting with new domestic payment networks could provide opportunities for issuers and help them in reaching out to an untapped customer base.
- **Card Networks / Associations:** Domestic card schemes are likely to provide tough competition to global card networks. In countries like China, where regulations mandate the use of domestic card networks for payment processing, usage of cards belonging to these international networks is likely to diminish and could negatively impact their revenues.
- **Acquirers or Processors:** Acquirers could connect with domestic card networks, which could improve their opportunities and help bring in additional business.
- **Consumers:** Domestic payment networks allow governments to achieve their objectives of financial inclusion and providing the benefits of e-government to its citizens.

6. Regulatory Compliance Impact on Non-Banks

Most of these regulations have an impact, either directly or indirectly, on non-banks functioning in the card industry. In the field of payment cards, Non-banks have usually been able to bring in innovations and new technology perspectives, aided partially by a less stringent regulatory regime.

6.1. SEPA Cards Framework

SEPA regulations provide an opportunity for non-banks to increase their role in the card industry in Europe. The recently enabled Payment System Directive (PSD) has harmonized the payment process and thereby enabled the entry of several non-banks into this domain.

Restructuring and consolidation of the payment processing industry is likely to lead to the growth of payment instruments such as cards, whose processing models would rely more on third-party processors. These changes would allow non-bank front-end payment service providers to operate in a harmonized framework.

Banks might be forced to outsource parts of the payment process to non-banks through partnerships as they focus on migration and upgrading their payment processing infrastructure.

6.2. Capital Requirement Regulations: Basel III and Sarbanes-Oxley Act

Relatively less stringent capital requirements could aid non-banks in increased innovation. Banks have to adhere strictly to certain capital adequacy requirements due to regulations such as BASEL and the Sarbanes-Oxley Act. However non-banks are not restricted by these regulations since they mostly act as fund-transfer carriers and do not technically hold deposits.

Hence, non-banks have the freedom to invest more in innovation in their products and services, and could attract customers of banks by offering better value for their money.

6.3. Other Regulations

The impact of most other regulations has been similar on both banks and non-banks, however, non-banks still do not face the same level of stringency as banks. Hence non-banks are more likely to innovate further to increase their role within the card industry. Payment Services Act (2010) is promoting competition by allowing non-banks to provide funds transfer services that were previously restricted to banks.

6.4. The Future Role of Non-Banks in the Card industry

Non-banks have forayed into the domain of pre-paid cards, which were traditionally issued by banks. This foray provides an indication that non-banks are now looking for greater market share and role in the card industry, including holding deposits, and clearing and settlement. Going forward, this could bring them into the realm of greater regulatory focus.

7. The Way Forward: Possible Outcomes from Regulatory Impact



The regulations discussed above are shaping the future of the card industry. They are likely to determine the upcoming trends, which include the following.

Migration from Magnetic Cards to Chip-Based Cards (EMV)

In geographies such as Europe, smart cards (cards with chip technology) are replacing magnetic stripe cards as a result of adopting EMV standards, provided POS terminals have the infrastructure in place. In the U.S., the switch to smart cards has not been successful so far, owing to the reluctance on the part of the various stakeholders to invest in the requisite infrastructure necessary for EMV compliance. However, a recent push by Visa and MasterCard to embrace EMV standards is likely to change the scenario in the U.S. as well.

Cards As a Means of Financial Inclusion

Governments could start issuing pre-paid cards to millions of citizens with no bank accounts as a part of their e-government initiative to bring about financial inclusion. An example is the Rupay card, issued by National Payments Corporation of India (NPCI), which enables unbanked customers to transact with banks. Governments in several countries could promote or mandate the use of domestic payment networks to reach out to consumers (such as UnionPay in China).

Focus on Core Competencies and Outsourcing of Supporting Functions

Card companies may choose to focus solely on their core business functions and outsource supporting functions like payment processing to third-parties to be more efficient in their services. Card companies are likely to follow a business model where they would prefer revenues from services offered to premium and loyal customers rather than selling products to less credit-worthy customers. Card issuers could consider the option of clubbing deposit services along with credit cards to reduce charge-off rates, wherein, customers could utilize both savings account features of a debit card (when additional funds are deposited), and regular credit card features as well.

Consolidation in the Card industry

Financial firms in the card industry which relied on interest income and penalties for revenue growth have been hit hard by regulations. Several organizations could move out of the cards business, owing to their inability to operate on such thin margins. This could pave the way for consolidation where larger players would look for merger and acquisition opportunities to achieve economies of scale.

Lowered or Shared Spend on Innovation

As a result of regulations which have reduced the revenues of card companies and forced them to spend on security infrastructure, companies are likely to spend less on innovation, and more likely to collaborate with other stakeholders to share the innovation cost. Companies have the opportunity to introduce innovation in cost control, customer relationships, and flexibility, although it remains to be seen whether card companies would be willing to do so.

Emergence of Smaller Niche Players and Increasing Role of Non-Banks

Owing to the nature of their business, banks have to adhere to stricter regulatory norms such as Basel III and the Sarbanes–Oxley Act, with a potential impact on their cards segment as well. However, non-banks, unaffected by the guidelines regulating the banks, could be more innovative and flexible in their offerings, which could attract more customers. For example, Klarna is a Swedish firm which provides payment solutions for online storefronts by allowing customers to pay after the delivery of their goods. Dwolla is a U.S. firm offering an online and mobile payment network which charges a flat fee per transaction instead of a percentage.



8. Conclusion

The payment card industry is currently at crossroads regarding regulatory compliance. Compliance costs (IT infrastructure upgrade, reporting costs, limitations on fee models and products) are expected to put a lot of strain on profit margins of card companies. Firms would thus need to improve their operational efficiencies and make optimum use of their resources while at the same time being flexible and innovative in their offerings. The payment card industry is also likely to witness some consolidation as firms aim to improve their operations of scale.

These regulations, while facilitating the emergence of new players, also provide opportunities for existing firms in the form of inorganic growth and economies of scale. The industry is likely to be driven by how quickly, efficiently, and innovatively firms adhere to these regulations and bring out products and services which are cost efficient, easy to use, and secure.



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Appendix

Regulation / Standard	Brief Description
Durbin Amendment (US Dodd-Frank Act)	<ul style="list-style-type: none"> The Durbin amendment establishes the standards for determining whether an interchange fee charged by an issuer for a debit card transaction is proportional to the issuer's cost, and has recommended that the interchange fee be reduced. It has also recommended that each issuer / network must participate in at least two unaffiliated debit card networks.
Credit Card Accountability Responsibility and Disclosure Act (CARD)	<ul style="list-style-type: none"> The aim is to establish fair and transparent practices relating to extension of credit under an open end consumer credit plan. The CARD act aims to protect consumers from arbitrary interest rate increases, misleading terms, and excessive fees to bring about transparency.
Unfair, Deceptive or Abusive Acts and Practices Act (UDAP)	<ul style="list-style-type: none"> The purpose of the UDAP act is to assist consumers in battling fraud and to provide the regulatory agency with the authority to prevent unfair, deceptive and abusive acts. Different states and countries have different statutes of the UDAP act, with some statutes offering more protection than others.
Gramm-Leach-Bliley Act (GLBA) – Financial Privacy Rule (GLBA)	<ul style="list-style-type: none"> Under the financial privacy rule of the GLBA act, financial institutions must provide their clients a privacy notice, prior to starting the business with them, that explains what information the company gathers about the client, where this information is shared, and how the company safeguards that information, with an option to opt out of their loyalty and reward programs, ensuring data privacy.
Regulations favoring domestic payment networks	<ul style="list-style-type: none"> Currently, the fees / charges incurred by various stakeholders are higher for cards in international networks. As such, certain governments in markets like the Asia-Pacific region are planning to pass regulations such as UnionPay in China and Rupay in India, favoring new domestic payment card networks aimed at reducing those fees and also for financial inclusion of unbanked population.
EMV Standards	<ul style="list-style-type: none"> EMV is a global standard for credit and debit payment cards based on chip card technology whose primary goal is to help facilitate global interoperability and compatibility of chip-based payment cards and acceptance devices. These standards developed by Europay, MasterCard and Visa ensure enhanced security and greater transaction speed.
Payment Card Industry Data Security Standards (PCI-DSS)	<ul style="list-style-type: none"> A regulatory standard for organizations handling cardholder information aimed at enhanced data card security and reducing credit card fraud. Validation of compliance is to be done annually and any non-compliance on part of these organizations can lead to fines.
SEPA Cards Framework (SCF)	<ul style="list-style-type: none"> The European Payments Council's SEPA Card Framework (SCF), enables a consistent customer experience when making or accepting euro payments and cash withdrawals across the Euro area. The SCF outlines high level principles and rules that when implemented by the card industry, will deliver a consistent user experience to cardholders and merchants throughout SEPA.

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