Digital Payments Issuers Face Regulatory Risk

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Now that we have discussed the role merchant acquirers play in the global payments ecosystem, which offers access to a truly enormous addressable market, we'd like to move on to issuers—the banks that issue credit and debit cards and the issuer processors that are either internal functions within banks or are banks' external partners.

By assuming credit risk, banks that issue credit cards, as well as debit cards, justify earning the largest portion of the merchant discount rate (MDR), which refers to the difference between what the consumer spends and what the merchant ultimately receives, net of the payments providers' fees.

But issuers also must deal with greater regulatory risk and increasing cybersecurity threats.

What Issuers Do

Issuers are the banking entities that extend credit to cardholders and house the checking accounts that fund debit cards.

Related entities, issuer processors, handle incoming requests from the networks, connecting to the bank that approves (or declines) the transaction and sends that decision back to the network.

Some banks handle processing in-house, but there is a strong trend toward outsourcing the processing work. The processing business is fairly commoditized, highly scalable, and lower-risk, so banks are increasingly turning to third parties to handle their processing as it lowers the bank's operating expenses.

How Issuers Add Value

The interchange fee represents the largest share of the MDR because issuers accept consumer credit risk.

In the United States, issuers use a portion of the fee to support generous loyalty/incentive programs. The EU limits interchange fees (credit interchange fees are capped at 30 bps, debit interchange fees at 20 bps), so loyalty programs are far less robust in Europe.

A recent trend has seen issuer processors merge with merchant acquirers, which serve as the initial gatekeepers in a digital transaction, allowing the merchant to accept various forms of noncash payments from consumers. That is because the data obtained at both ends can allow the provider to improve acceptance rates for online transactions and reduce fraud risk.

Risks

Because the interchange fee is the largest portion of the MDR, it is natural to assume that it could attract the most scrutiny and pressure from regulators looking to clamp down on the fees consumers pay. Issuer banks in the United States and elsewhere could face regulatory action to reduce fees, such as the cap on interchange fees imposed by EU regulators.

Separately, hacking and financial penalties associated with violations of consumers' data privacy rights, including the EU General Data Protection Regulation (GDPR), are an ongoing concern.

Banks must also think about how to fend off potential disruption from technology companies that are looking to move into banking. In March 2019, Apple introduced its credit card and in November 2019, *The Wall Street Journal* reported that Google plans to launch checking accounts.[1]

How do Digital Wallets Affect the Payments Value Chain?

While Apple Pay, Google Pay, and other digital wallets are garnering much attention, their ultimate impact on the payments value chain is questionable.

Digital wallets, which enable fast, convenient purchases by storing various payment methods on a mobile phone, can be funded with a credit card or debit card, or by linking directly to a bank account. Most digital wallets use the existing global payments infrastructure, and the additional convenience and security for consumers are likely to drive more noncash volume, which is a positive for networks and merchant acquirers.

From the issuer's perspective, digital wallets take a cut from the interchange fee, but the overall impact is likely to be minimal. This is especially true considering how slow consumer adoption of digital wallets has proved to be in developed markets.

Tech giants are investing significantly to promote their digital wallets in developed markets, but the primary business reason is to collect and sell data about customer purchasing patterns or combine the digital wallet with other services to further integrate the consumer into the company's ecosystem.

Digital wallets don't have a clearly defined path to profitability, and many of the largest players in the space are still trying to determine what their revenue model should be.

In emerging markets, where there is less of a tradition of using credit cards, digital wallets could play an important role in accelerating the conversion to noncash transactions. This is especially true in India, where the government-supported, real-time, account-to-account payment infrastructure is particularly well-suited for digital wallets. Consumers in developing countries also use digital wallets to receive funds from friends and family outside of the country.

Outlook

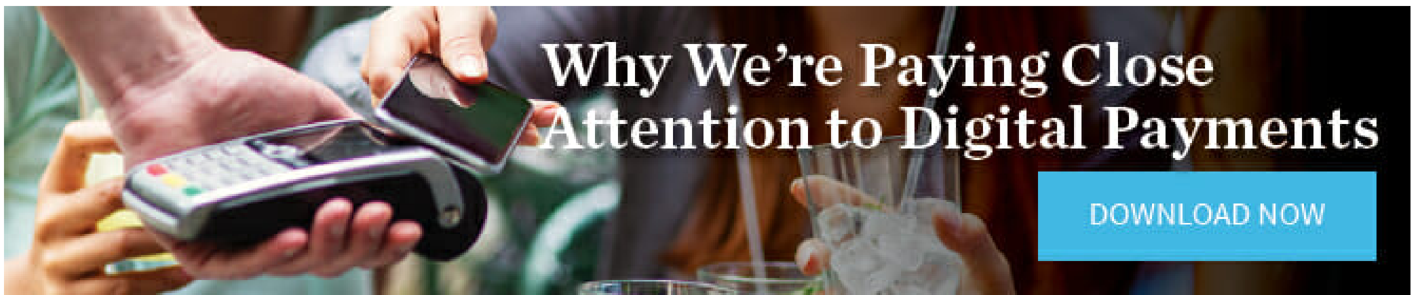
With less opportunity for differentiation and lower growth in mature markets, scale is key to issuer processors. These firms typically enjoy low- to high-single-digit growth that is relatively low risk.

Although the growth story is not as dramatic as some other segments, the trend among banks to outsource noncore functions is a tailwind for issuer processors. Much of the large-scale M&A in the U.S. payments industry has come from merchant acquirers combining with issuer processors.

Customer data is a key driver of this trend, as merchant acquirers are looking to support their e-commerce business by combining their data with that of issuer processors to create a more robust offering that can improve acceptance rates for online transactions.

Next Up

Now that we've discussed merchant acquirers and issuers, there is one more part of the global payments ecosystem to discuss: networks.



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Part 5: More Competition for Merchant Acquirers

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Part 7: Networks: The Rails That Connect Digital Payments

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[1] *The Wall Street Journal*. "Next in Google's Quest for Consumer Dominance: Banking." November 13, 2019.

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