First Data’s debit network has unrealized potential

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Payments behemoth First Data has punched below its weight for more than a decade.

It’s a portfolio of payment processing and network assets and the sum should be greater than the parts. Like processors FIS, Fiserv, and Vantiv, it has a debit network. Because of its merchant reach and card-issuer processing relationships, it touches many payments from end to end.

First Data therefore has greater potential to wrap additional value around its Star network and "on-us" payments, enhancing cardholder and merchant value and thereby its growth prospects and transaction economics.

While FIS’s NYCE network is national, FIS lacks First Data’s millions of merchants. Fiserv too lacks merchants. Its Accel network is intended to enhance Fiserv’s relationships with core-banking-processing clients. Vantiv has merchants and processes for small and midsized banks’ debit cards, but its network Jeanie is tier-three.

First Data acquired Star in 2004. Notwithstanding the promise, the network has disappointed and seemed almost an afterthought lost among larger card-issuer and merchant-processing businesses.

In 2002 Star had 56% share of US PIN debit payments and touched 67.4% of ATM transactions. The second and third largest PIN debit networks were Visa and NYCE with 14% and 10.3% share respectively.

Concerned that the combination of Star and NYCE, in which First Data was majority shareholder, would have too much market power, the U.S. Department of Justice forced First Data to divest NYCE before giving the acquisition a greenlight. While negotiating with the DOJ Star lost Wells Fargo and Wachovia to Visa, harbingering losses to come.

The thesis that a network would strengthen the processing giant’s value proposition for banks and merchants, and in turn its relationships with banks and merchants would strengthen the network, was eminently plausible. But It hasn’t panned out yet. Star continued bleeding PIN debit share principally to Visa. In 2016 Visa’s debit network processed 10.3 times as many transactions as Star in the US. MasterCard’s processed 4.1 times as many.

Banks and merchants treat Star as a payment utility. Its brand has little value. Large banks don’t put it on their debit cards. While small banks frequently still affix the Star bug to the back of the card, neither cardholders nor merchants look for it.

Banks typically align with one signature debit network Visa or Mastercard, with both the bank’s and network’s brand on the front of the card, and enable at least one but often multiple PIN debit networks. Historically, signature debit networks used the same delivery systems, acceptance network and business model as credit cards, similarly earning licensing and processing fees.

In contrast, PIN debit systems evolved from ATM networks. Processing or “switch” fees drive their revenue. And, like other traditional PIN debit networks Star rides in the slipstream of Visa’s and Mastercard’s brands. Networks with brands have better transaction yields.

Over the last decade and a half Star’s fees have eroded, like other PIN debit networks. In 2001 Star made an average of 11.8 cents per debit and ATM transaction. Today it makes roughly 4 to 4.25 cents per debit transaction. Large issuers squeeze its fees.

With merchant acquirers and merchants Star sets fees in Visa’s and Mastercard’s shadows. From stronger positions, since their IPOs Mastercard and Visa have relentlessly ratcheted up credit-and-debit network fees, particularly on the acceptance side of the network.

Star charges merchants a “fixed” $12 annual fee. Visa charges merchants a fixed fee tiered to volume and number of locations ranging from zero for casual merchants with less than $200 payment volume per month to $40,000. Visa’s variable signature debit fees are roughly 220% greater than Star’s. Its variable PINdebit fees however are only slightly higher than Star’s.

The processing behemoth needs to resuscitate its network’s brand or create a new one, no mean task. Competitive table stakes are changing. The cut and dried distinction between signature and PIN networks is breaking down. Networks must support a range of authentication means across all channels.

First Data acquired Acculynk to support PIN debit online. And it’s starting to compete to rout signature transactions when it’s enabled on a Visa or Mastercard-branded card.

Historically issuing banks set network preferences and a significant percent gave Visa debit exclusivity. The Dodd-Frank Act’s Durbin Amendment upended this competitive structure. Debit is debit, whether with a brand, licensing fees, or authenticated by a signature, a PIN or neither. Debit cards must be enabled on at least two different networks and merchants’ not banks’ routing choice reigns. The law’s intent was to drive networks’ merchant fees to zero.

Roughly 72% of debit cards are Visa signature debit cards enabled on one or more other typically PIN networks. Visa uses its dominant position to compete for signature, PIN, and no-cardholder-authentication-debit routing. Roughly 28% of debit cards are also Mastercard enabled on at least one additional network. Markets work. Large merchants have exercised choice with PIN-authenticated payments, putting pressure on variable fees.

For signature authenticated payments, until recently merchants have had no choice. Neither Mastercard nor Visa competed for the other’s signature-authorized debit routing when they were both enabled on a card.

The network routing the transaction captures the economics from the merchant and issuing bank. As networks’ marginal costs are zero, it’s a slippery slope. Star can win share by undercutting Mastercard’s and Visa’s fees but the networks can respond in kind. On this new battlefield it’s only surprising Discover’s Pulse and NYCE haven’t fired a salvo.

However, for First Data the more appealing play would be to deliver services around Star and other on-us payments, increasing value for the issuing bank, cardholder and merchant, a trifecta, for which it could increase fees.

Running promotional campaigns on behalf of merchants, funded by merchants, harnessing issuer and merchant data to drive incremental sales ought to be a winner. Synchrony and Citi Retail for which first Data processes do this on behalf of their private-label clients. Cardlytics runs open-loop-card promotional campaigns for banks and retailers. Chase is attempting something similar where it’s the merchant processor and card issuer, over ChaseNet.

It could also attach a retail-credit product, perhaps underwritten and kept on the balance sheet of Synchrony or Citi Retail, with a fee or participation paid to the issuing bank.

The network brand ought to convey the promise of the full range of authentication at the physical point of sale and in electronic and mobile commerce, rich custom retailer-funded promotional campaigns, and perhaps retail credit. And it should be on the “card” in leather and digital wallets.

If the payments Gargantua can revivify Star it would boost its issuer and merchant processing businesses.

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