DOMESTIC
PAYMENT
SCHEMES
JURY **2018**

DOMESTIC PAYMENT SCHEMES

Building a bridge to the future

CONTENTS

FOREWORD AND ACKNOWLEDGEMENTS

This report is the fourth in a series of reports into domestic card schemes and switches that I have published since 2013; each one has drawn on the expert opinions of a panel of senior executives from domestic/regional payment organisations – the Domestic Payment Schemes Jury.

It has been prepared to coincide with the International Conference of Regional Card Organisations organised by EPCA in Madrid in October 2018.

We are currently at a fascinating but critical time for domestic payments schemes & infrastructures. The pace of change in the payments sector is clearly increasing. New technology is continually being developed, consumer behaviour is changing, and the regulatory environment is evolving. These factors combine to create new business models which may be driven by new market entrants or may be developed by existing players.

The domestic schemes & infrastructures can play a critical role in creating a bridge from the status quo to the payments world of the future. Their deep understanding of and connections into domestic markets and low-cost approach provides an excellent opportunity for them to be even more relevant in the future. But there are many players with competing visions of the future and the domestic organisations are going to have to evolve quickly to be the successful builders of the bridge to the future.

Experience has shown that the challenges faced by domestic schemes & infrastructures are similar around the world but necessarily the solution cocktail must be specific to each market. This means there are no right answers although certainly there are some wrong approaches that are highly likely to fail irrespective of location. The report is intended primarily to be an information resource for schemes and switches as they develop their strategies. But it is also a resource for regulators developing their regulatory approaches for domestic payments as they will also have a critical role in shaping the future payments environment.

The Jury research was carried out with nationally focussed card payment schemes and switches over a 6-week period from July to September 2018.

Grateful thanks are due to Andrew Veitch for helping to develop the research topics and to Lizzy Chenery for organising the questionnaire and producing the report. Most of all I wish to thank the senior executives from the 36 participating organisations – the Jury - who gave their valuable time and considered opinions that make this such an insightful report into the status, prospects and strategies of domestic payments providers.

John Chaplin
Domestic Payment Schemes Jury, October 2018

RESEARCH SUMMARY

The top 10 findings of the Domestic Payments Scheme Jury 2018 were:

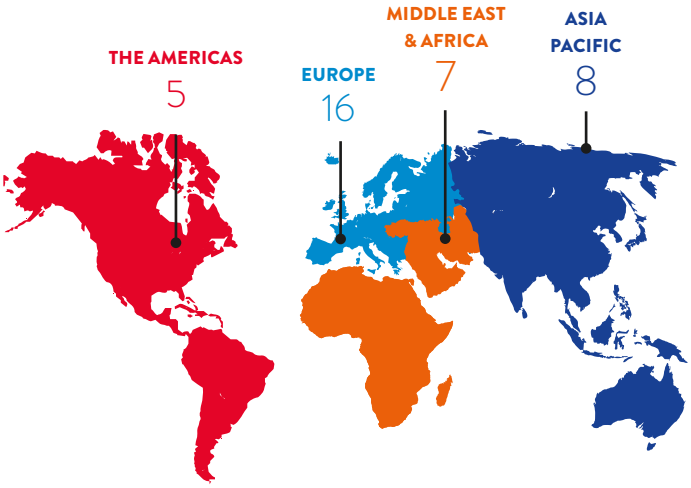
- There was record interest (36 organisations from 35 countries) in participating in the Jury to develop insights and a knowledge base that could be shared with similar organisations.
- Almost 50% of the card schemes also have wider payments responsibilities, especially ACH, mobile payments and P2P transfers. There is a widely held view that to remain card-only in future is strategically very dangerous.
- It is extremely difficult to develop measures of market share that can be accurately compared between markets because of differences in the underlying business models. Where there is genuine competition between domestic schemes and the Very Large American Card Schemes (VLACS), the market shares of the domestic organisations are generally between 35% and 55% of POS expenditure.
- Domestic schemes & switches are optimistic about their prospects. The increased optimism is substantially based on greater support from their member banks and in emerging markets specifically the low-cost approach supports governmental initiatives for financial inclusion.
- Regulators are generally in favour of lower cost payments which is a key attribute of most domestic schemes. In some markets this has caused regulators to actively support domestic schemes & switches. However, in some cases regulatory action has had the opposite effect of inadvertently assisting the international competitors.
- Incentive payments to issuers by the VLACS remain the largest threat to domestic payments schemes. The level of their incentives has increased substantially over the past 2 years. In markets where there is no regulatory protection, domestic schemes may themselves have to find ways to incentivise issuance.
- A majority of domestic schemes & switches have fees that are around 25-50% of the VLACS fees. There is some evidence that at this level, the fees may be too low and inhibit the necessary product development required to remain competitive.
- Almost all schemes have decided that they must have capabilities for e-commerce, contactless and mobile as without them they will be permanently at a disadvantage with the international competition.
- So far four schemes have moved from away from a bank-ownership model but a much greater number think that their ownership structure may have to evolve in the future.
- There has been a significant increase in cooperation between schemes in different markets as it is realised that they do not have the resources or the time to develop everything themselves. The strongest areas of cooperation are currently technical although acceptance is also highly important.

ABOUT THE PARTICIPATING ORGANISATIONS

Where they are based

There has been a steady increase in the schemes participating in the Jury. The first Jury in 2013 involved 17 organisations but for this latest 2018 Jury there were 36 participating organisations from 35 different countries which is a 38% increase over the 2016 level. This shows that momentum is building behind the domestic schemes & switches movement and that the benefits of individual organisations and executives learning from the experiences of other countries is now widely recognised.

The participating Jury members came from all regions of the world.

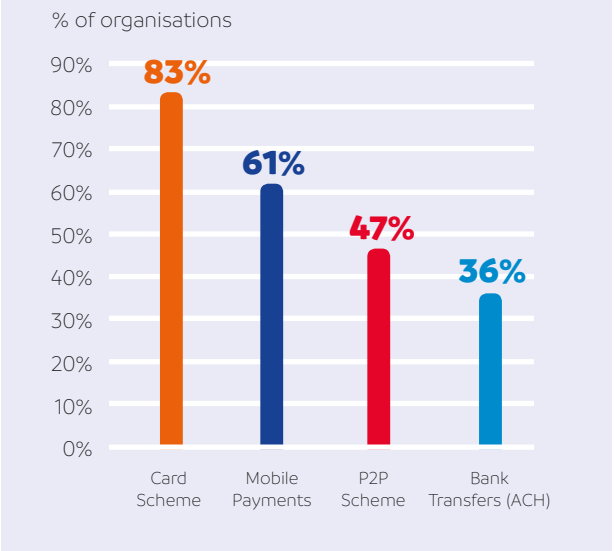


Their remit and role

Of the participating organisations, the overwhelming majority (83%) consider themselves to be card schemes and this was generally their origin. But many now also have wider roles especially in relation to mobile payments and P2P transfers. 36% of the organisations also have responsibility for bank transfers (ACH).

> **"Scheme and switching are separated in terms of accounting, operation and decision making but they are Business Units under the same entity. This permits some synergies"**

ORGANISATION REMIT



Looking specifically at the card focussed organisations, their actual role varies. In some cases, this is because there is a national switch but no actual card scheme, and in Europe there is a regulatory requirement which caused many card schemes to become separate from their switching organisation. So far, this trend has not been copied in other areas of the world apart from Morocco where the Bank al Maghrib also enforced a separation between scheme and switch.

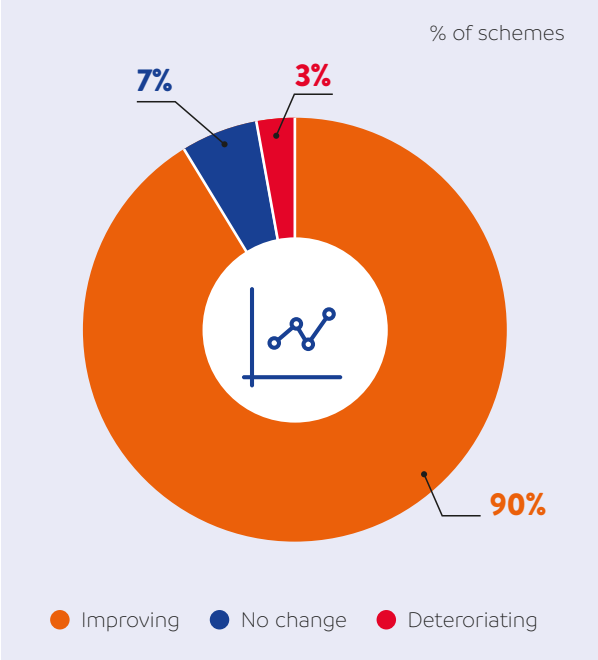
CARD ORGANISATION ROLE

DOMESTIC SCHEMES PROSPECTS

Although almost all executives involved with domestic schemes recognise that they have many major challenges, especially relating to competition with the Very Large American Card Schemes (VLACS), the Jury is generally optimistic about their prospects

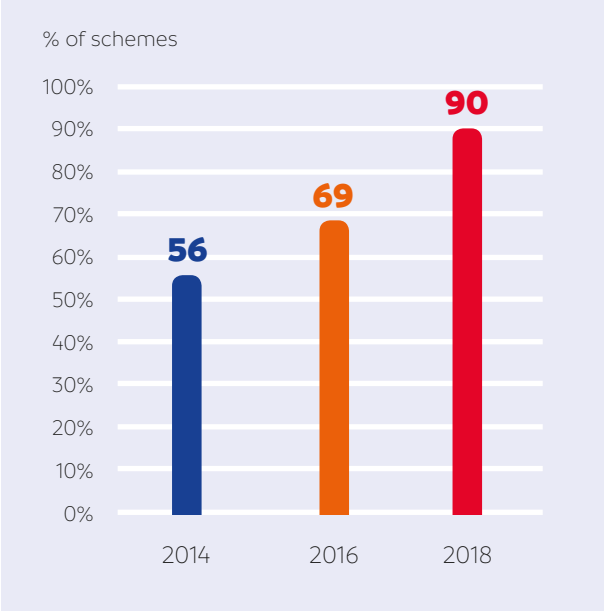
A very high 90% of Jury members consider that their prospects have improved over the past 2 years (67% see significant improvement, 23% see some improvement). And only 3% (1 scheme) view their prospects as having deteriorated.

FUTURE PROSPECTS FOR SCHEME COMPARED TO TWO YEARS AGO



We have tracked the same measure of optimism about prospects since 2014 and there is a very clear trend.

SCHEMES THAT SEE PROSPECTS IMPROVING



We requested information from the Jury on share of domestic debit card expenditure at POS and 50% of the organisations provided figures. However, the figures which ranged from <5% to >95% are very difficult to compare because of the different structures of each market and different reporting approaches.

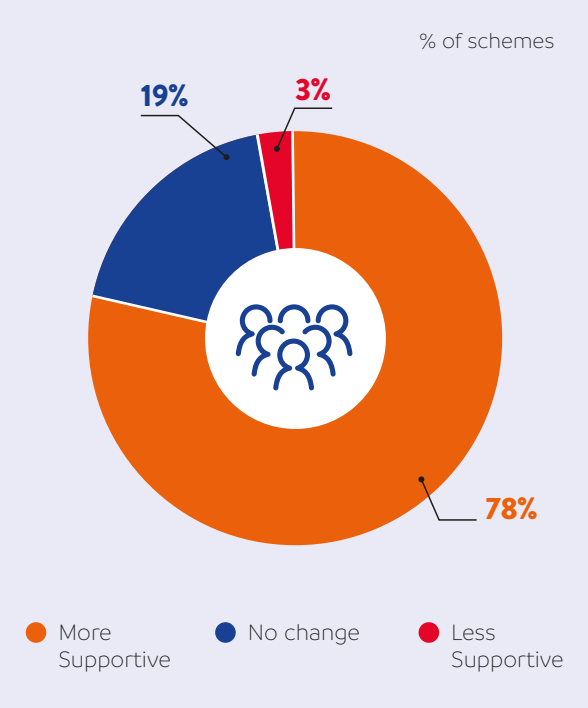
For example, Link in the UK is an ATM-only scheme and therefore intentionally has 0% of the UK POS expenditure whereas MADA in Saudi Arabia has a 100% share of domestic debit card expenditure because of regulatory requirements.

In markets where there is genuine competition between the domestic scheme and the VLACS international schemes, the market shares of the domestic schemes cluster around the 35-55% level. This 35-55% level can be considered as the zone of sustainability and domestic schemes need to plan to reach that zone if they are to prosper and be confident about the future.

The explanation for the increasing confidence about domestic schemes seems to be quite clear. When the 2013 and 2014 research was conducted, many Jury members considered that their banks were becoming less loyal to the domestic scheme and more inclined to the VLACS alternatives.

However, from the current Jury there is a clear picture of the domestic schemes seeing their members as being increasingly supportive.

ATTITUDE OF MEMBERS TO THE SCHEME



A number of Jury members commented that they believe that banks now look more critically at the ability of the VLACS to deliver in reality what they claim to offer.

In markets where there is a strong governmental drive towards financial inclusion, the domestic schemes believe that this makes them increasingly relevant to the country and therefore their members.

"8-10 years ago, our members probably wouldn't have cared if we had disappeared. But they have really fallen out of love with the international schemes especially because their fees have increased so much"

"Visa is no longer seen as the natural ally of the banks and their deal with Apple was seen by our member banks as a big mistake"

"Banks are certainly more supportive of the role of our domestic scheme than they were 5 years ago. They want to retain control of our domestic payments infrastructure"

In some markets, the Jury members said that their banks are supportive because they see their continued existence as a key way to obtain higher incentives from the VLACS.

However, the support does not turn into widespread issuance because the main objective of the banks is to obtain greater incentives and rebates from the international schemes. In the longer term, it is difficult to see how this model is viable because the scheme probably fails to reach the zone of sustainability.

REGULATORY IMPACTS

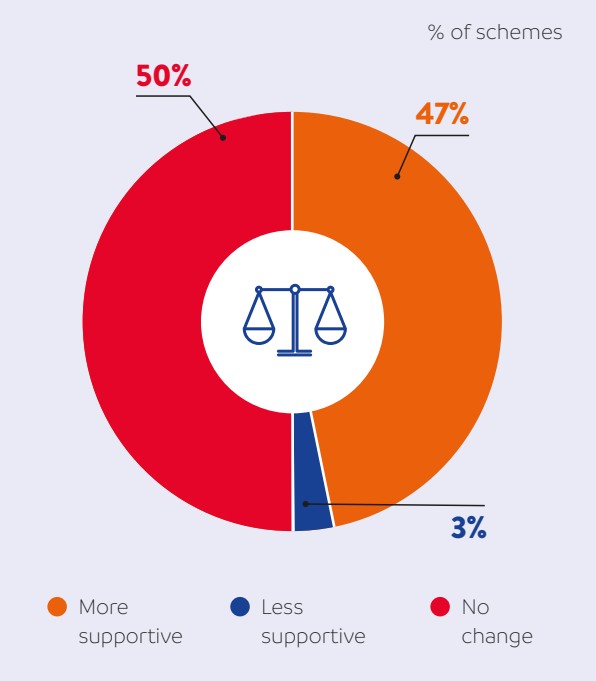
There are few countries in the world where the cards business is not subject to an increasing level of regulation and this subject is top of mind for the executives of schemes & switches.

Although regulation is often considered to be a negative factor for the business, there is also the potential for regulation to have a positive impact. A clear example of a positive impact is in Russia where payments regulations require that payments from the government to consumers must be paid into accounts for which the sole card is a MIR domestic debit card and there are also regulations progressively enforcing merchant acceptance of MIR. And there are other examples of supportive regulation from markets such as India and Vietnam.

Regulation of schemes

The Jury were asked whether the attitude of their regulators is changing towards their domestic scheme and a very clear picture emerged.

ATTITUDE OF TRADITIONAL REGULATORS/ CENTRAL BANKS TO SCHEMES



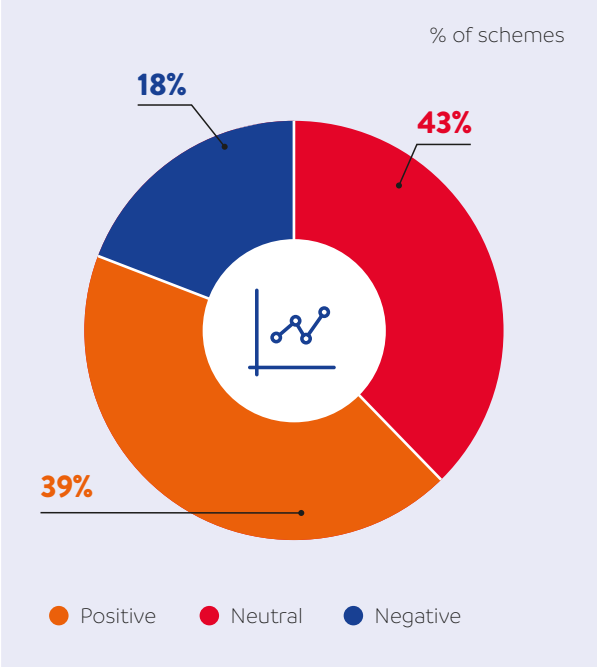
47% saw their regulators as becoming more favourable towards them, particularly in markets where governments are strongly promoting the growth of low-cost, electronic payments. And 50% saw no change in the attitude of their regulators. And almost nobody considered that their regulator was becoming more negative towards domestic schemes.

A critical factor in regulation is whether the results of the regulation are in line with what the regulator intended to achieve. Here the position was less encouraging although still overall quite positive.

"We have decided to engage much more with the regulator and we are beginning to convince them of the benefits of a domestic scheme"

"The Central Bank is interested in intervening on incentives, but they are cautious about the message it might send to other foreign companies. So, they have done nothing"

IMPACT OF REGULATORY CHANGES ON COMPETITIVE POSITION OF BUSINESS



In general, the Jury saw the impact of recent regulations as either neutral or positive for their competitive positioning. However, some schemes in Europe considered that recent regulatory changes were damaging for them. This was attributed to the regulators not having fully thought through the impact of the changes and thus inadvertently handing an advantage to VLACS.

Regulation of switches

Regulators in some markets have been slow to recognise and protect the shared economic benefits of in-country switches. In many markets it is beneficial to have all domestic card transactions within a domestic switch (normally a single switch but sometimes more than one) because the cost of operation is largely fixed and therefore cost per transaction falls as volume increases. There are also benefits in terms of industry-wide reporting and the ability to use the same switch for card and non-card transactions.

However, in the absence of any regulatory controls, bundled incentives by VLACS can cause individual banks to move away from a domestic switch to the international switch. This leads to volume loss and rising per transaction costs in the domestic switch which represents an overall penalty for the industry. In some markets, it is clear that regulators are now considering imposing a requirement for in-country switching of domestic transactions.

This policy is fiercely resisted by the VLACS but the cases of the NSPK in Russia and HPS Switch in Morocco show that it is perfectly possible for all scheme transactions to be processed domestically whilst still leaving room for competition at the scheme level.

"As in many other EU markets, regulatory changes are impacting negatively the card business. The regulator is actively promoting account-based payments, Why?"

"There has been a recent directive for all banks to commence processing (switching and routing) domestic local currency issued international scheme cards locally via the National Switch"

"There is an imminent prospect of regulatory intervention to mandate domestic processing in our own market because one bank pulling out of switch leaves the same costs for everyone else to share"

THREATS AND CHALLENGES

Operating a domestic scheme continues to be a demanding task with many significant challenges to be faced on an ongoing basis

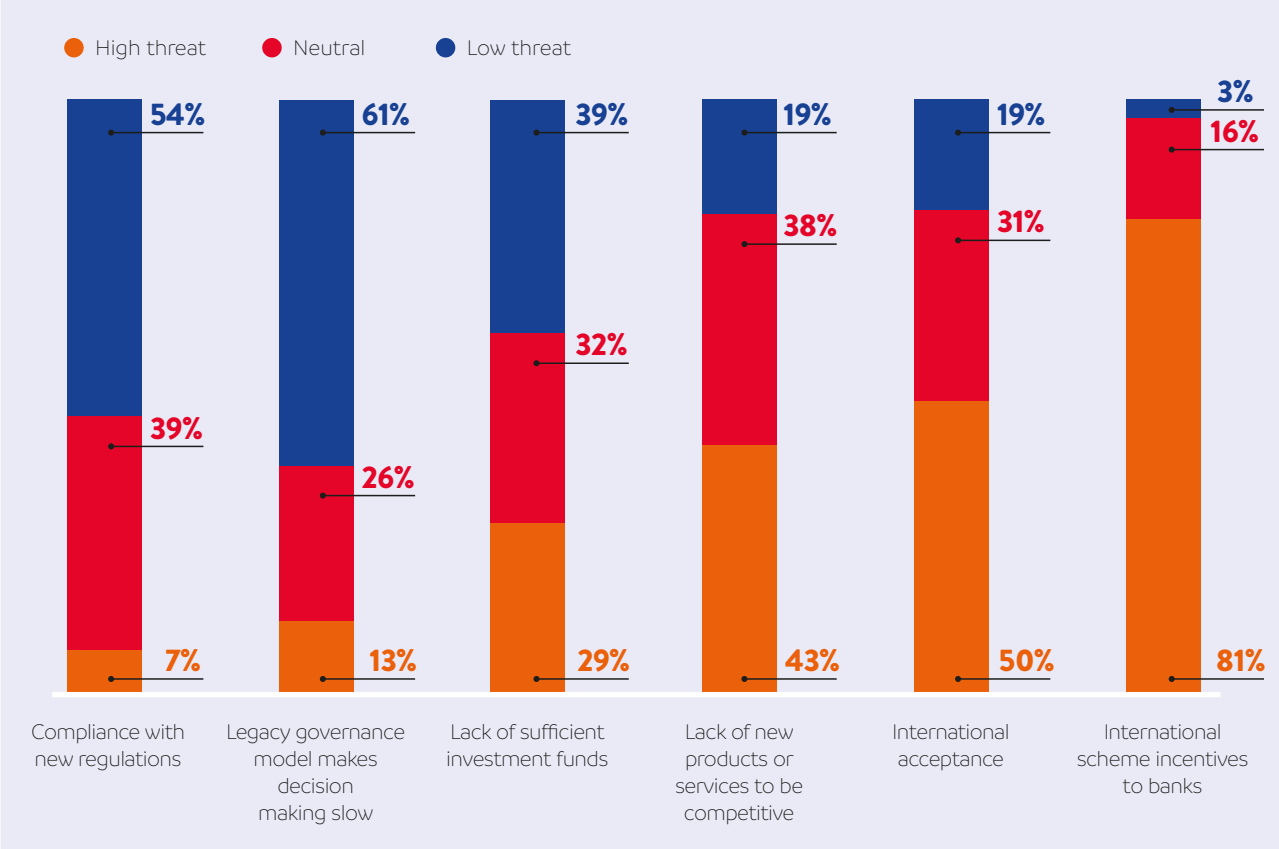
By a significant margin the largest threat is the practice of the VLACS of offering incentives to issuers to secure their portfolios. The finding is consistent with both the 2014 and 2016 surveys and is despite the practice being theoretically controlled or prohibited by regulators in some regions.

The other threats that are highly ranked are a lack of new products & services and the achievement of international acceptance.

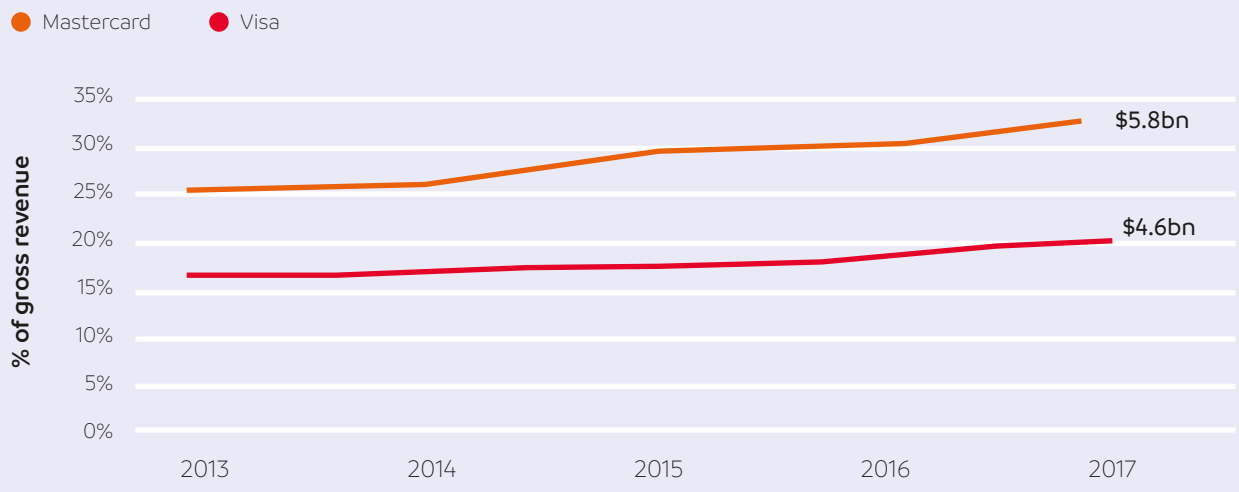
Incentives paid to banks are obviously confidential and therefore the Jury commented that they don't have totally accurate data on the level of incentives. However, based on their interactions with their member banks, the picture that emerges is very clear.

More than 60% believe that incentives have increased and there were no Jury members who believed that there had been any reduction. This perception is confirmed by the data drawn from the Annual Reports of the VLACS which shows that incentives as a % of gross fees are rising and that they totalled more than $10bn in 2017. They almost certainly exceed the combined fee income of all the domestic schemes. This should serve as a wake-up call to regulators around the world as the incentives are designed to use short-term financial gains for issuers to encourage them to adopt products that have a higher long-term cost of ownership. This is damaging for national economies and should be seen by regulatory authorities as unfair competition and a distortion of the free market.

MAIN THREATS TO DOMESTIC SCHEMES



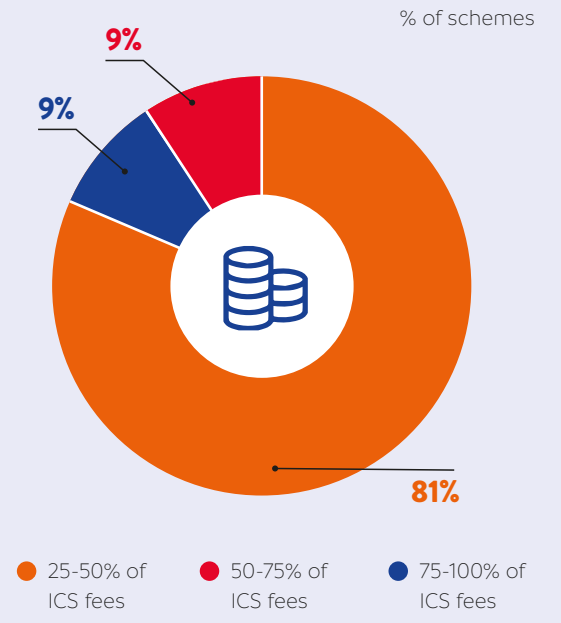
INTERNATIONAL SCHEME INCENTIVES



Source: Annual Company Reports

The 2014 research project compared in detail the comparative costs of using domestic schemes versus using the VLACS for domestic transactions and found that domestic solutions had costs that averaged 45% of the costs of the international alternatives (after all incentives had been included). For the current research, the Jury members were asked how their total fees (i.e. issuer and acquirer combined) compared to the VLACS alternatives.

SCHEME SERVICE FEES COMPARED TO AVERAGE VLACS FEES



"MasterCard and Visa do a great job in hiding their total costs from the banks"

"Large issuers are being offered zero fees by MasterCard and Visa. The tab for this is picked up by the small banks and the acquirers"

"The ICS have no interest in total cost of payment, all they care about is getting large issuers"

The results should act as a spur to regulators to actively favour domestic schemes as lower payment costs are considered to aid overall economic efficiency. However, the data also highlights 2 real competitive problems for domestic schemes:

- Payment schemes are being required by their users to continually develop new products and services and this requires considerable investment. Domestic schemes that have fees that are as low as 25% of the VLACS fees are likely to have funding difficulties unless their members agree different funding models for major projects. In simple terms, a scheme can be too cheap.
- Total fees is the correct measure of total economic efficiency but it conceals a vital difference between the costs for issuers and acquirers. VLACS tend to target their incentives at issuers and in major markets such as Australia and UK, the largest banks are now guaranteed zero fees to secure their business. The deficit in fees is compensated by increasing fees charged to acquirers who cannot switch their business. Many domestic schemes split their fees between issuers and acquirers in a fairer way that better reflects the costs, but in the absence of regulatory protection against predatory pricing by the international competition there is a considerable risk of losing major issuing volumes.

"Some of the ICS deals are crazy. We have seen banks sign 10-year deals but within 2 years the person who signed it has moved on"

The unfortunate reality is that in order to be successful, domestic schemes should set their total fees closer to their international scheme competitors (whilst still maintaining cost leadership) and that they should consider whether they should also incentivise issuers through lower pricing.

"We now realise that we have set our fees too low because we don't have enough funds for development. In the future, we will price closer to ICS levels"

The cost of payments for merchants is heavily influenced by the interchange rate and this is another area of potential competition between domestic and international schemes. There has been widespread global concern amongst merchants and regulators that market forces have caused the VLACS to use higher interchange as a further tool to incentivise issuers. This has led to many regulators from Australia, Europe and Malaysia to introduce controls on interchange.

INTERCHANGE RATES FOR DOMESTIC SCHEMES COMPARED TO VLACS RATES

48% of the schemes are either required by regulation to set their interchange at the same level as international schemes or are choosing to do.

The other 52% are setting them at lower levels. This approach is sensible in markets such as the Kingdom of Saudi Arabia where in-country switching is mandatory or in markets such as Canada where the domestic scheme has a naturally high market share. However, in other markets where there is free competition, domestic schemes need to consider very carefully how to position their interchange levels.

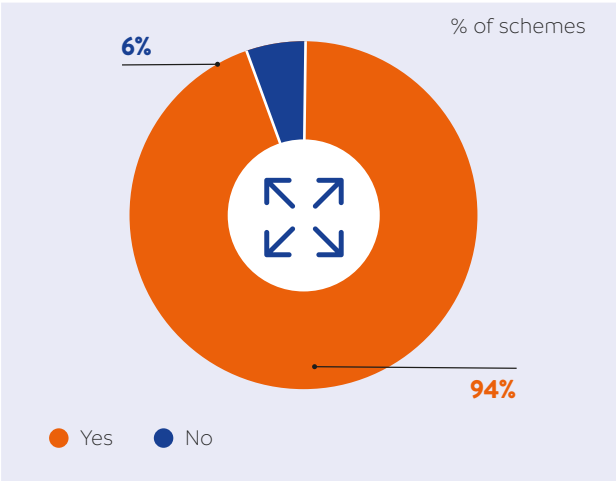
PRIORITIES AND STRATEGIES

In terms of priorities for domestic schemes & switches, there are two that rank significantly ahead of all the others in the view of the Jury.

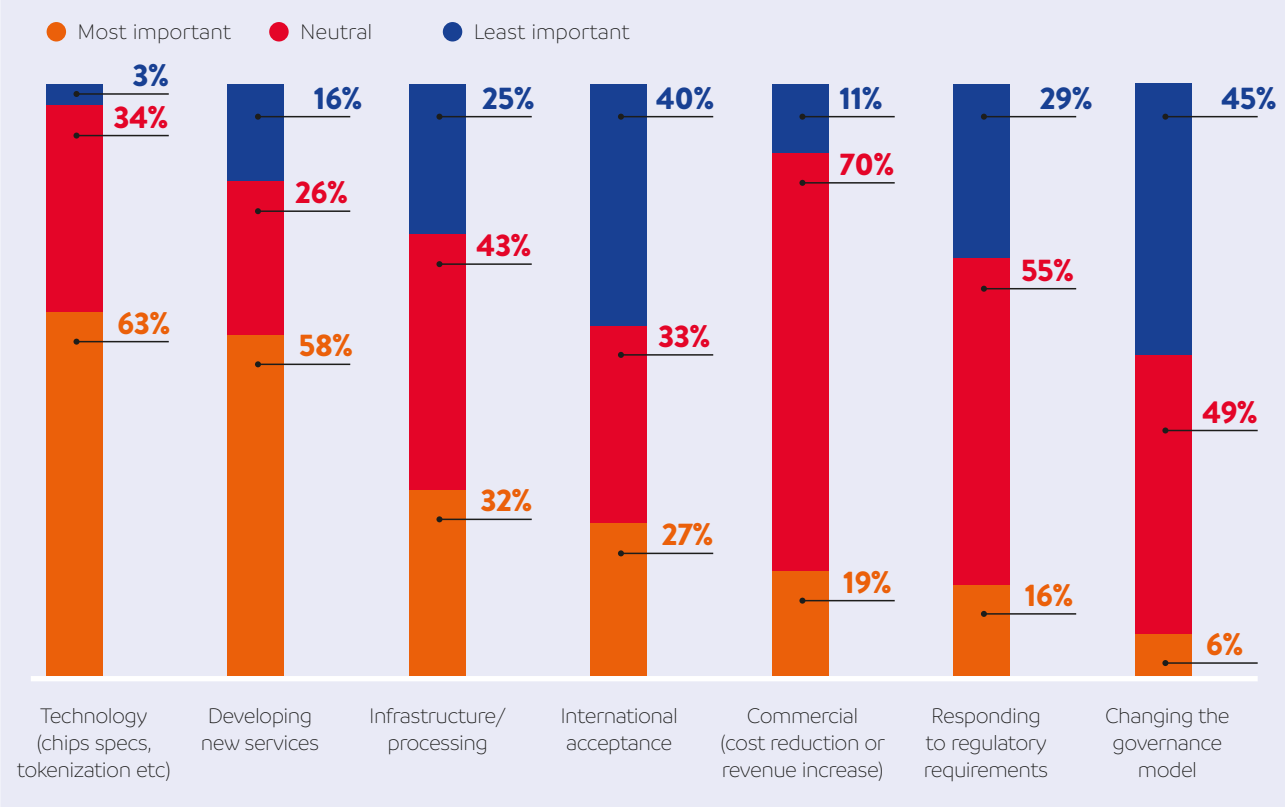
The top priorities are the development of new products & services to enable members/users to respond to the market need for continuous innovation and investment in technology especially in chip specifications and tokenisation.

The question of whether domestic card schemes should stay with a card only model or expand into other services is very important. The Jury, with only 2 exceptions, consider that schemes expanding beyond cards is now essential.

SHOULD DOMESTIC SCHEMES EXPAND BEYOND THE CARDS?



MOST IMPORTANT PRIORITIES OF DOMESTIC SCHEMES



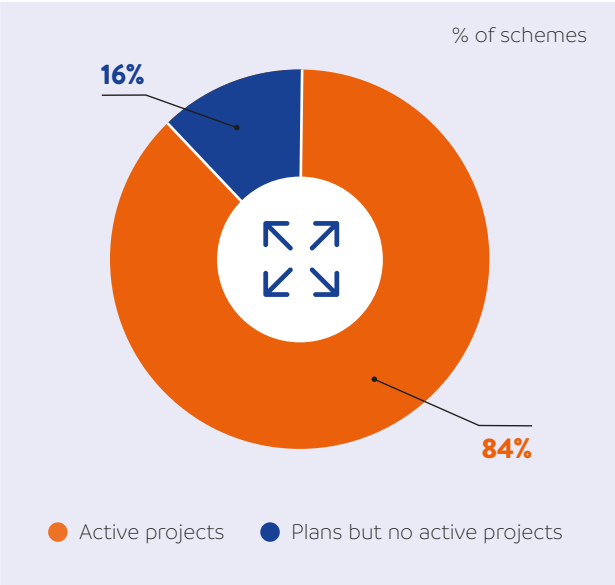
This mirrors the finding of the 2016 research except that those believing that the payments market is evolving and that it is not wise to stay with a cards-only model has increased from 83% to 94%.

The strategic desire to move beyond cards is reflected in real activity with 84% of the organisations allocating resources and having active projects, with the other 16% reporting that they are in the planning phase.

"To remain relevant, domestic cards schemes must look beyond cards and enable other form factors for payments"

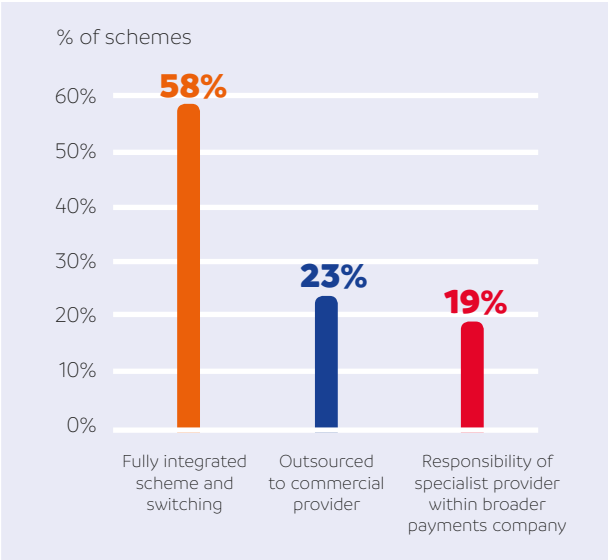
"Card payments and mobile (non-card) will converge in the retail space. Our long-term strategy must address this convergence"

PROGRESS ON EXTENDING BUSINESS BEYOND CARDS



A key strategic decision for a card scheme is whether to have an integrated scheme & switching model or whether to have a separated model.

BUSINESS MODEL FOR SWITCHING OF TRANSACTIONS



The most popular strategy favoured by 58% is to operate a fully integrated scheme and switching model. This model allows for more sophisticated pricing approaches and gives maximum control over data. 19% of schemes outsource the switching to a dedicated technical services organisation within the same overall group (an example is the Verve scheme in Nigeria which relies on its parent Interswitch company for processing). The remaining 23% have a fully separated/outsourced model, often as the result of regulatory intervention. This can cause coordination challenges as well as disputes about the ownership of data and value-added services but from a positive perspective it facilitates 'best in class' switching services to be managed by a specialist provider of technical services. Some European markets and also Morocco fall into this category.

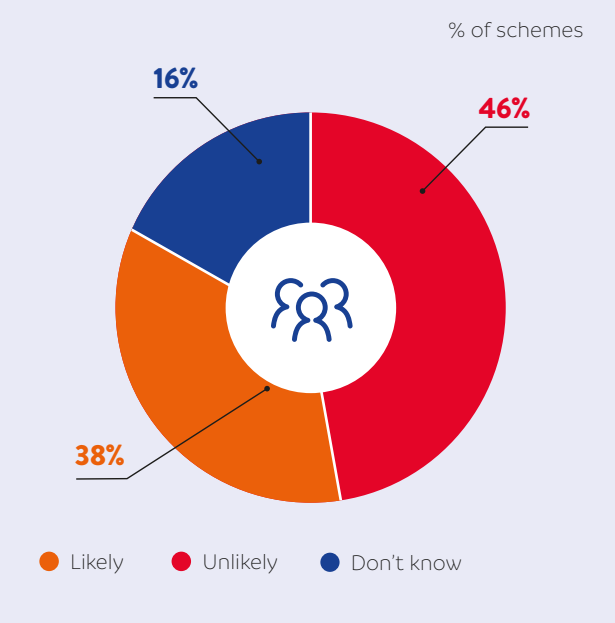
For specialist and separated switching providers, it makes sense for them to provide services to as many schemes as possible in order to maximise economies of scale. This should make it possible for these switching organisations and the VLACS to partner. However, currently the VLACS are committed to a strategy of attempting to enter the national switching markets and this makes such partnerships almost impossible unless the regulator takes action as in Russia and Vietnam.

OWNERSHIP AND PARTICIPATION

So far, there have been only limited changes to the ownership of domestic schemes & switches. Dankort in Denmark (as a part of NETS) ceased to be a bank-owned organisation in 2014 and Verve in Nigeria (as part of the larger Interswitch group) was sold by the banks to private investors in 2012.

More recently the national switch of Morocco was sold by the banks to HPS as a private company in 2016 and the sale of Paymark in New Zealand was announced in early 2018 and is waiting regulatory clearance.

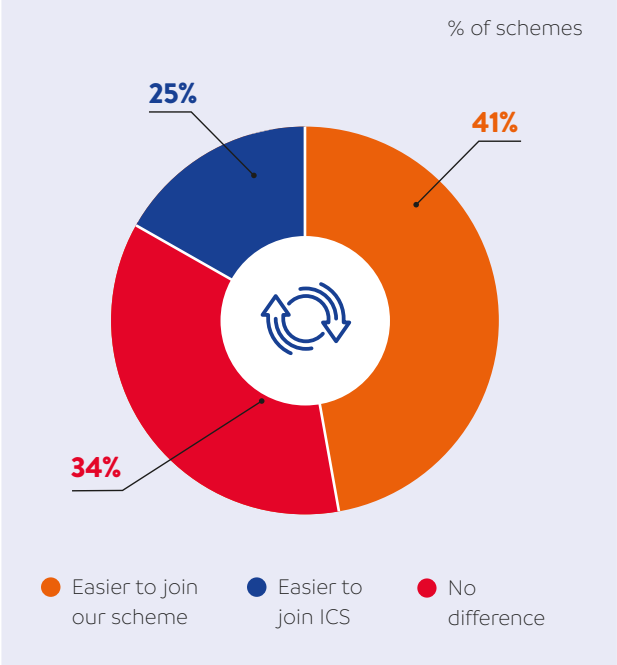
LIKELIHOOD OF OWNERSHIP STRUCTURE TO CHANGE IN NEXT 3 YEARS



It is striking that as many as 38% of the Jury see some change in their ownership structure as likely. This may not mean outright sales as in the 4 quoted examples but can also be changes such as the recent merger of the 3 previously competing Spanish schemes into a unified organisation or the spin-off of MADA in Saudi Arabia from direct central bank control.

Even though the clear majority of schemes and switches remain directly owned by banks, it is becoming increasingly important to allow access to non-banks, especially fintechs. The Jury considered whether the bank-owned model makes it easier or more difficult for fintechs & non-bank acquirers to gain access.

EASE OF PARTICIPATION FOR NEW MARKET ENTRANTS



41% of the organisations considered that they have made it easier for the non-banks to obtain access. However, there is a substantial minority of 25% who said that it is easier to join the VLACS because their banks owners do not wish to enable new market entrants. This must be seen as a strategic own goal by driving potential customers to the competition and is an invitation for regulators to take action.

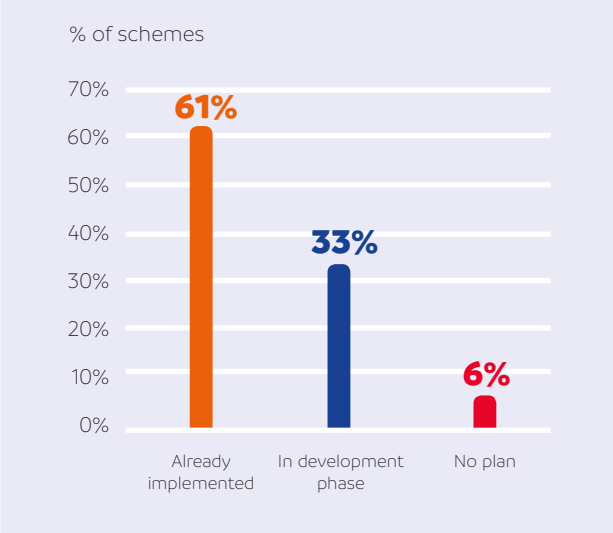
ENABLING THE FUTURE

For domestic schemes & switches there are services in addition to authorisation, clearing, settlement and fraud control that are essential in order to remain competitive.

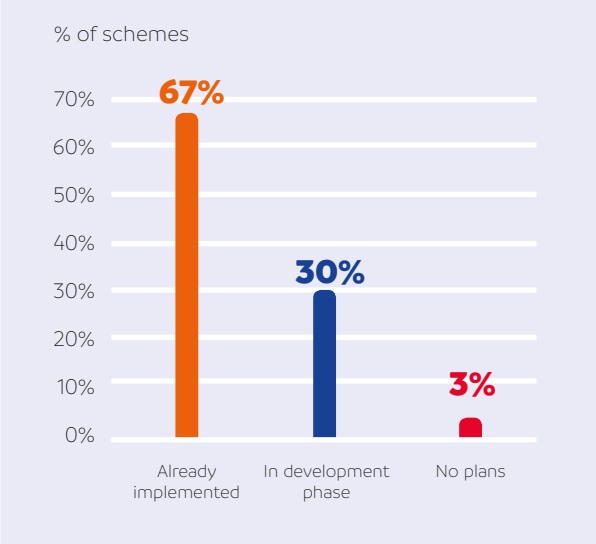
The days of arguing, for example, that support for e-commerce is not required have gone; it is now a ' must have'.

We asked the Jury to explain the readiness of their schemes for the 3 key requirements of support for e-commerce, contactless technology and mobile enablement. As these are widely supported by the VLACS, it is a question of being competitive.

STATUS OF DEPLOYING CONTACTLESS TECHNOLOGY



STATUS OF ENABLING E-COMMERCE TRANSACTIONS



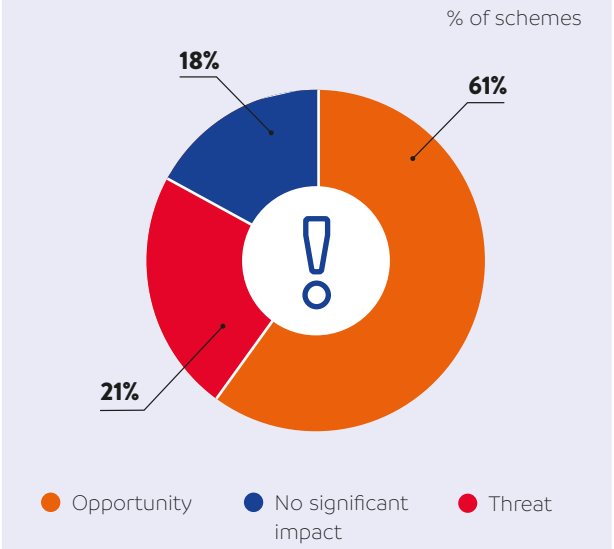
61% of the schemes have already implemented contactless technology and most of the remainder are in the development phase. In many markets, contactless has been quite slow to achieve real traction but in markets such as Australia and UK there has been explosive growth. Some of this growth is incremental low value transactions which is a net gain for the payment system, but there is also considerable migration from contact to contactless. In markets where the domestic scheme is cobranded with either of the VLACS this creates a potential for significant market share loss if the VLACS follow their normal practice of requiring to be the default application and the regulator does not act to restrict the practice.

E-commerce enablement is running slightly ahead of contactless with the sole exception being the Link scheme in UK which is ATM only. Increasingly many large merchants favour an omni-commerce model whereby customer transactions can no longer be defined by the traditional card present or card not present descriptions. In many markets, account-based push transactions are already being accepted by e-commerce merchants. So for domestic card schemes it has now become essential to support this transaction type.

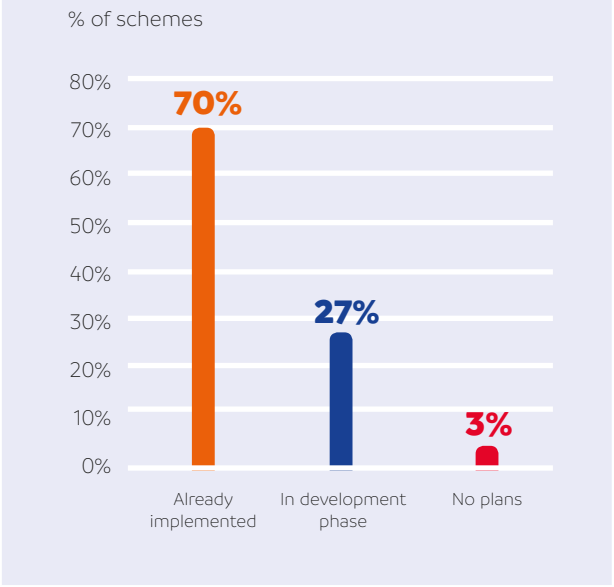
We wished to understand whether generally domestic schemes see the move towards a mobile-first world as a threat or an opportunity, as it disrupts the established business model especially in markets where there is co-badging with international schemes. Overall, there is a feeling that this move represents an opportunity especially as many of the major banks are reluctant to allow the VLACS to have as much influence and control over this channel as they have traditionally had over the traditional card channel. The schemes seeing mobile-first as an opportunity are 3x those viewing it as a threat. However, several Jury members said they view it as both an opportunity and a threat because the major international schemes are investing heavily in this area and are continually presenting new capabilities to their members.

We questioned the Jury about whether their view of the potential opportunities was being matched by real developments. 70% stated that they had already launched mobile capabilities although the type of support ranges from relatively low level such as support for Apple Pay or Google Pay or full-function mobile schemes such as MADA Pay in Saudi Arabia.

IMPACT OF MOBILE-FIRST MODEL ON COMPETITIVE POSITION



STATUS OF ENABLING MOBILE PHONE TRANSACTIONS



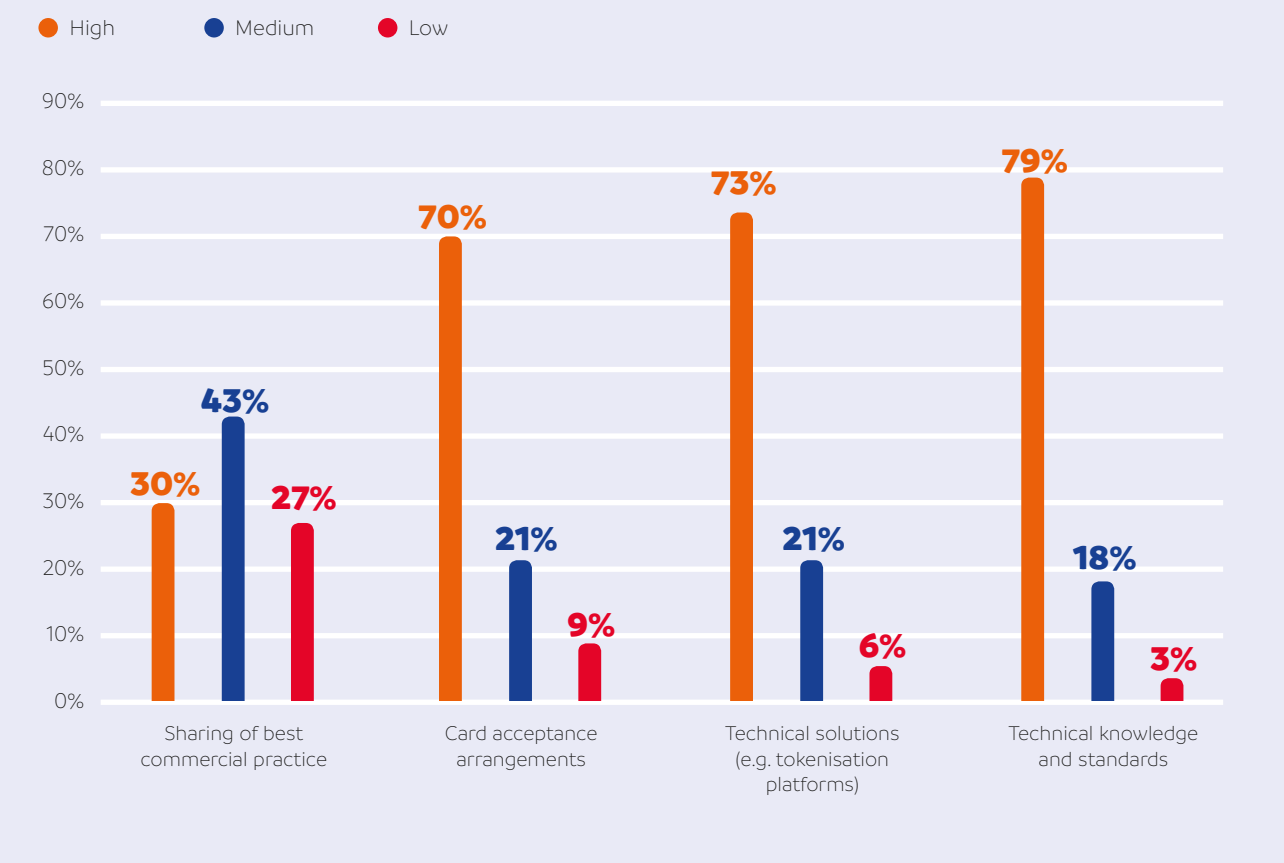
Clearly, the tokenisation capabilities required for mobile payments are an area for potential cooperation between domestic organisations as this can represent an area of high expenditure.

COOPERATION – THEORY AND REALITY

The success of the international conferences and the establishment of some regional forums in Asia and Europe shows that there is an appetite for cooperation between organisations.

We asked where the schemes & switches saw the greatest potential for meaningful cooperation with organisations in other countries.

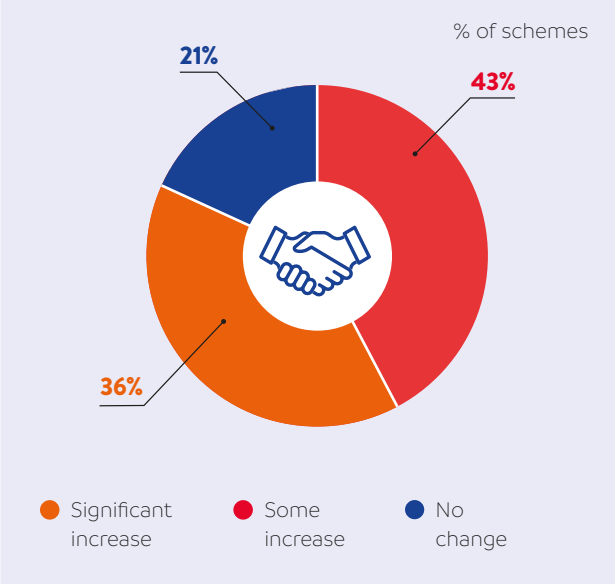
AREAS WITH MOST COOPERATION POTENTIAL



The top area for cooperation potential was technical standards but shared technical solutions and cross-border acceptance also scored highly. Sharing of best commercial practice was the lowest potential and scored significantly lower than in 2016, suggesting that more organisations have come to the view that the commercial strategies have to be unique to their market.

The Jury members reported how their organisations are responding to the potential benefits. Approximately 80% reported an increase in their cooperation.

CHANGE IN LEVEL OF COOPERATION IN THE LAST 2 YEARS

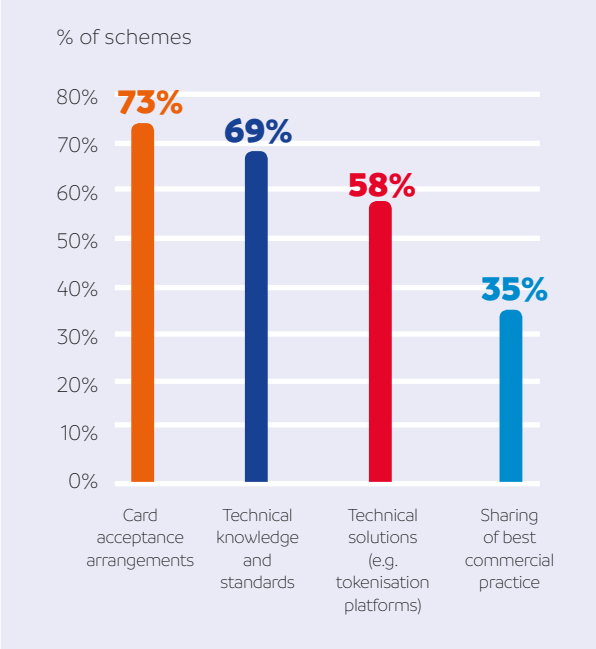


For the organisations that reported an increase in cooperation, we looked at how actual cooperation aligned with potential and there are some differences. Card acceptance is top-rated in actual cooperation largely because there are organisations such as Discover Financial Services highly focussed on addressing this need. And organisations such as MIR that are developing their own international network also rely on cooperation with the schemes in their target markets

"We have been able to successfully implement several activation and usage x-border promotional campaigns along with Discover, in the most significant international destinations for our cardholders"

Technical knowledge & standards also scores highly, but shared technical solutions still under-perform compared to the potential. This reflects the reluctance of domestic organisations to rely on organisations for key services despite the obvious and significant financial benefits.

AREAS OF INCREASED COOPERATION



"We realise that we must be more prepared in future to share technical solutions with other domestic organisations. We don't need to build everything ourselves and we can't afford it. Cooperation is a key strategy for us"

ABOUT THE AUTHOR

John Chaplin is adviser to a number of leading payments organisations in Africa, Asia, Europe and Middle East. He previously held senior roles at both Visa and First Data where, amongst other responsibilities, he gained experience of providing domestic switching & processing services in multiple markets. More recently he has advised domestic payments schemes and/or switches in Australia, India, Morocco, Nigeria, Norway, Turkey, UAE and Vietnam.

John is a board director of Interswitch in Nigeria, Global Processing Services in UK and Sentenial in Ireland. He is actively involved with African private equity as payments adviser to Helios Investment Partners.

John is also the organiser and chair of the Global Payments Innovation Jury which publishes its views on developments in the payments industry every two years. In 2017, the jury also launched its first reports in Africa and China.

He has published 3 previous reports into domestic payment schemes:

- *The Outlook for national payment schemes in a global economy* (2013 with Andrew Veitch)
- *National Payments Schemes: Drivers of Economic and Social Benefits?* (2014 with Andrew Veitch and Prof Jurgen Bott)
- *Domestic schemes in 2016: A global status report*

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