Nonbanks’ Role in the Provision of U.S. Retail Payment Services

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Nonbanks in the Payments System

- Nonbanks have always been a key component of the U.S. payments system
- Nonbanks have enhanced competitiveness and efficiency
- What is new is the heightened prominence and visibility of nonbanks
Kansas City Fed Studies

“Nonbanks in the Payments System”

- Key findings of the study
  - Nonbanks are pervasive
  - Nonbank business relationships with other participants are complex and intertwined
  - Nonbanks are rarely directly involved in settlement activities
  - Both nonbanks and banks are increasingly susceptible to operational risk
What is a Nonbank?

- In this study, a nonbank is defined as any firm that is not a bank, where a “bank” is an institution that accepts demand deposits.
- Can be owned or governed by bank.
## Nonbank Payments Activities

### Table 1 – Nonbank Payment Activities

<table>
<thead>
<tr>
<th>Activity</th>
<th>Description</th>
<th>Representative Nonbanks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AUTHORIZATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Check Authorization Vendors</td>
<td>Supply check authorization and guarantee services to merchants.</td>
<td>eFunds, TeleCheck</td>
</tr>
<tr>
<td>Fraud System Vendors</td>
<td>Provide fraud detection services to merchants and financial institutions.</td>
<td>Thomson Financial, Bridger Systems</td>
</tr>
<tr>
<td>Online Transaction Security Systems</td>
<td>Provide online transaction security systems to merchants and financial institutions.</td>
<td>Baltimore</td>
</tr>
<tr>
<td>Certificate Authorities</td>
<td>Provide certificate-authority services in PKI-based secure environment.</td>
<td>Verisign, iTrust, Identrus</td>
</tr>
<tr>
<td>Authorization ISOs</td>
<td>Provide check verification and credit and debit card authorization services to small and medium-sized businesses.</td>
<td>Heartland Payment Systems, CardService International</td>
</tr>
<tr>
<td><strong>PROCESSING</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hardware Providers</td>
<td>Provide ATM and POS terminals, plastic cards, etc.</td>
<td>Diebold, Hypercom, NCR, Orbethur</td>
</tr>
<tr>
<td>Software Providers</td>
<td>Provide banking software.</td>
<td>Fiserv, S1</td>
</tr>
<tr>
<td>Core Data Processors</td>
<td>Provide processing for demand deposit account and core systems.</td>
<td>Fiserv, Altel, Jack Henry</td>
</tr>
<tr>
<td>Check Outsourcers</td>
<td>Provide internal check processing services to financial institutions.</td>
<td>Fiserv, EDS, Metavante</td>
</tr>
<tr>
<td>In-house Remittance Processors</td>
<td>Billers and other corporates that perform their own remittance (lockbox) processing.</td>
<td>GE Capital, American Express, State Farm</td>
</tr>
<tr>
<td>Remittance/Lockbox Processors</td>
<td>Provide remittance (lockbox) processing to corporates and some areas of financial institutions, e.g., credit card bill payments, loan payments.</td>
<td>Regulus, Remitco</td>
</tr>
<tr>
<td>Check Clearinghouses</td>
<td>Provide check clearing and settlement services to financial institutions.</td>
<td>WesPay, NYCH/SVPCo</td>
</tr>
<tr>
<td>Archive Services</td>
<td>Provide payment-related archive and retrieval services.</td>
<td>ViewPointe</td>
</tr>
<tr>
<td>Payroll Service Providers</td>
<td>Provide payroll and related tax services to private and public sector employers.</td>
<td>ADP, Ceridian, PayChex</td>
</tr>
<tr>
<td>ACH Outsourcers</td>
<td>Provide internal ACH processing for financial institutions.</td>
<td>Fiserv, EDS, Metavante, Checkfree</td>
</tr>
<tr>
<td>ACH Operators</td>
<td>Provide central clearing functions (receipt, editing, and transmission) for ACH network participants.</td>
<td>EPN, Visa</td>
</tr>
<tr>
<td>Card Issuer Processors</td>
<td>Provide processing services to general purpose card issuers, including the issuing of statement, receipt, and deposit of payments.</td>
<td>First Data, Total Systems</td>
</tr>
</tbody>
</table>
## Nonbank Payments Activities

**Table 1 (Cont’d) – Nonbank Payment Activities**

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<tr>
<th>Activity</th>
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<th>Representative Nonbanks</th>
</tr>
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<tr>
<td>Card Merchant Processors</td>
<td>Provide merchant processing services to financial institutions and merchants.</td>
<td>First Data, Concord</td>
</tr>
<tr>
<td>Credit Card Networks</td>
<td>Provide networks for clearing and settlement of credit card transactions.</td>
<td>Visa, MasterCard, American Express</td>
</tr>
<tr>
<td>EFT Networks</td>
<td>Provide networks for clearing and settlement of ATM and debit card transactions.</td>
<td>Concord/Star, First Data/NYCE, Visa, MasterCard</td>
</tr>
<tr>
<td>ATM ISOs</td>
<td>Provide ATM services such as sales, leasing, and management, typically to nonbank organizations.</td>
<td>eFunds, E*Trade, American Express</td>
</tr>
<tr>
<td>EBT Service Providers</td>
<td>Manage the distribution and tracking of EBT funds to recipients.</td>
<td>eFunds, Lockheed Martin</td>
</tr>
<tr>
<td>EDI VANs</td>
<td>Provide network and software to effect EDI payments and document exchange between large corporates.</td>
<td>Sterling Commerce, Harbringer Corp</td>
</tr>
<tr>
<td>EIPP Service Providers</td>
<td>Provide network and security services for business-to-business payments.</td>
<td>Bottomline</td>
</tr>
<tr>
<td>Internet Banking Platform Providers</td>
<td>Host Web banking platforms for financial institutions.</td>
<td>Digital Insight, Metavante</td>
</tr>
<tr>
<td>EBPP Service Providers</td>
<td>Provide bill payment services for consumers and presentment and payment receipt services for billers.</td>
<td>Checkfree, Metavante, Princeton eCom</td>
</tr>
<tr>
<td>P2P Internet Payment Providers</td>
<td>Provide payment solutions for online person-to-person payments.</td>
<td>PayPal, Western Union</td>
</tr>
<tr>
<td>Retail Wire Services</td>
<td>Provide money transfer (money wire) services to consumers.</td>
<td>Western Union, MoneyGram</td>
</tr>
<tr>
<td>Check Cashing Services</td>
<td>Provide check cashing services.</td>
<td>ACE Cash Express, Pay O Matic</td>
</tr>
</tbody>
</table>

### INSTRUMENT PROVISION

| General Purpose Credit Card Issuers   | Issue general purpose credit cards or charge cards.                          | American Express, Discover, Diners Club      |
| Private Label Credit Card Issuers     | Merchants offering store credit cards and third parties that provide card issuing services to merchants. | Sears, Chevron, GE Capital                   |
| Debit Card Issuers                    | Issue debit cards to consumers for retail purchases and fleet debit cards to companies for retail purchases. | Exxon, Mobil                                 |
| Stored-Value Card Issuers             | Issue stored-value cards for closed or open systems.                         | Stored Value Systems                           |
| Money Orders                          | Issue money orders.                                                          | United States Postal Service, Travelers' Express |
| Travelers Checks                      | Issue travelers checks.                                                      | American Express, MasterCard/Cook, Visa      |

**Sources:** Global Concepts 2002, Hayashi et. al. 2002
Nonbank Roles in Traditional Payments

Chart 1
Nonbank Roles in Traditional Payments

- **Check**
  - POS
    - 1. Without Truncation
    - 2. With Truncation
  - Lockbox
    - 3. Bank as Processor
    - 4. Nonbank as Processor

- **ACH**
  - 5. ACH Transaction

- **Credit Card/Offline Debit Card**
  - Card Present
    - 6. Visa/MC Networks
    - 7. First Data Network
  - 8. Card Not Present

- **Online Debit Card**
  - 9. PIN-based Debit Transaction

- **Retail Wire Services**
  - 10. Western Union Transaction

11-12-02
Nonbank Roles in Emerging Payments

Chart 2
Nonbank Roles in Emerging Payments

- Check Conversion
  - POS
  - Lockbox
    - 15. Bank as Processor
    - 16. Nonbank as Processor
  - Visa
  - 11. ACH
  - 12. EFT
  - 13. In Network
  - 14. Out of Network

- EBPP
  - 17. Biller Direct
  - 18. Consolidator

- EIPP
  - 19. Lockbox
  - 20. Consolidator
  - 21. Sending
  - 22. Receiving

- P2P
  - 23. Western Union MoneyZap
  - 24. Sale
  - 25. Redemption

- Stored Value
  - 26. EBT
  - 27. Visa
  - 28. Payroll Card
  - Single Purpose
  - Multi-Purpose

11-12-02
Recent Nonbank Developments

- Major retailers attempting to move into banking for payments processing purposes, e.g., Wal-Mart, Home Depot
- Third-party service providers extending their reach globally, e.g., First Data Corporation, TSYS
- Change in organizational structure of nonbank card networks, e.g., MasterCard, Visa
Recent Nonbank Developments

- Nonbanks acquiring EFT networks, e.g., Discover (Pulse), Metavante (NYCE)
- Merchants attempting to gain more control over payments environment via litigation, legislation, and adoption of alternative payment mechanisms, e.g., steering toward PIN debit, acceptance of Debitman
- Data breaches
Observations

- Nonbank issues are showing up on more radar screens
- There is a growing awareness of rising nonbank presence and an increased concern about possible associated operational and System-wide risks
- Consequently, there is a heightened focus on supervision of nonbank providers of payment services
“The Supervisory Framework …”

- Key findings of the study
  - Increase in nonbank payments providers tied to increase in electronic payments
  - Potential for greater operational and System-wide risk
  - Many, but not all, major nonbank payments providers are supervised
  - Control of payments system risk should place more emphasis on interrelationships between participants
Authority for Nonbank Supervision

- Bank Service Company Act (1963)
  - Supervisors can examine bank-related services provided by nonbanks
  - Applies to both bank-affiliated and nonbank-affiliated service providers
    - Supervised service providers are treated similarly whether bank affiliated or not
Supervision of Nonbank Payment Providers

- Federal Financial Institutions Examination Council (FFIEC)
- Supervision is conducted jointly among federal agencies (OCC, FRS, FDIC, OTS, NCUA)
- Jointly, these agencies develop supervisory standards, examination policy, and examiner training programs
- Benefits of this coordinated effort
  - Reduction of regulatory burden
  - Improved use of examination resources
Two Examination and Monitoring Programs

- Multi-regional Data Processing Servicer program (MDPS)
  - National program administered by the FFIEC
  - About 17 nonbank service providers

- Regional Data Processing Servicer program (RDPS)
  - Administered by regional and district offices of FFIEC agencies
  - About 150 nonbank service providers
Recent Operational Risk Incidents

– April 2004: Two-day crash of U.S. Central Credit Union’s network for handling ACH transactions delayed transactions for as many as four days

– March 2004: First Data Corporation overcharged 800,000 credit and debit card transactions to accounts of Wal-Mart customers
Recent Data Breach Incidents

- February, August 2006: Two incidents of breached debit cards, including PIN numbers, from U.S. retailers that resulted in numerous unauthorized ATM withdrawals and many financial institutions reissuing debit cards.

- February 2004: ChoicePoint data broker revealed information on 145,000 consumers to sham businesses that resulted in over 750 incidents of identity theft.
Observations

- Whether current regulatory framework is adequate depends on factors that are presently insufficiently documented
  - Nature of operational risk and sharing of information
  - Frequency of payments disruptions occurring at vendors outside current supervision program
  - Effect of concentration on “System-wide” risk
Closing Remarks

- Nonbanks have always been a key component of the U.S. payments system.
- The importance of nonbanks in the payments system is likely to increase even more over time.
- Heightened visibility of nonbanks raises significant questions and it is important that policymakers continue to monitor and study industry developments.
Next Steps

- Joint ECB-Kansas City Fed project
- Kansas City Fed Conference
  - “Nonbanks in the Payments System: Innovation, Competition, and Risk”
  - Santa Fe, New Mexico, USA
  - May 2-4, 2007
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