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PASS-THROUGH vs. SELF ADMIN vs. FULL SERVICE PROCESSING:

What's better for your credit union?

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Executive Summary

With the Durbin Amendment poised to go into effect, financial institutions of all sizes are placing added emphasis on alternative payment products to mitigate potential lost debit revenue. Credit cards are particularly well-positioned, as improvements in credit quality and historically low interest rates have improved profitability, making the cards an attractive alternative or complement to debit cards.

Expenses to support the issuance of credit cards are significant. Credit card processing and servicing (to include card production, activation, account and transaction processing, payments, statementing and back office services) are among the primary drivers of operating expenses. Processing can either be performed in-house by the issuer, outsourced to a third-party credit processor, or by a combination of the two. Although pricing is often a fundamental driver in the selection of an operating model, several other decision criteria should play a role in the evaluation. This paper analyzes the three operating structures that are most commonly utilized by credit union credit card issuers: full service (outsourced), self administered (hybrid in-house/outsourced), and pass-through (in-house).

At a high level, the full service structure is a processing model in which the credit union effectively outsources the operational aspects of its program in addition to the database of record to a third-party provider while maintaining responsibility for card sales and marketing. Similarly, processing in the self-administered structure resides on a vendor platform with specific elements of the program such as cardholder servicing and chargeback processing performed in-house. Lastly, the pass-through model involves the least amount of third-party support as the majority of card issuing functions are performed internally with a vendor providing network connectivity for the authorization and settlement aspect of credit card processing and other ancillary services. A detailed overview of each structure follows with a particular focus on the roles and responsibilities of each party as well as the trade-offs between the operating models.

The paper then addresses how credit unions, based on characteristics and needs, could select the operating model that best fits its desired business objectives and service philosophy. A detailed breakdown of evaluation criteria highlights how attributes including cost of ownership, flexibility, control, features and functionality, and internal subject matter expertise contribute to the thought process and rationale behind credit union decision making. The analysis will illustrate that no structure is universally superior, and that a credit union's selection should be based upon its own unique characteristics, mission statement and member service capabilities.

Credit Card Processing Overview

The credit card issuer processing market is highly competitive and comprised of well-established providers serving the bank and credit union communities. Although several large financial institutions process cards in-house, the majority of issuers partner with companies such as FIS, First Data, and TSYS to facilitate credit transaction processing and support services. The numerous functions needed to support a credit card program are highlighted in the diagram below, and can be classified into three primary functions: processing, production services, and account servicing.

Exhibit 1: Processing Functions

Processing

Application Processing
- In-Branch Instant Applications
- Mail/Internet Applications
- Application Scoring
- Underwriting

Core Transaction Processing
- Authorizations/Trans-actions
- Fraud Scoring & Pre-vention
- File Generation

User Interfaces
- Servicing
- Data Maintenance
- Product/Marketing Set-up

Production Services

Plastics/Fulfillment
- Embossing
- Card Carriers & Inserts
- Activation Labels

Statements & Production
- Pages & Image Printing
- Validation
- Marketing & Educational inserts
- Mailing

Loyalty/Rewards
- Earning Calculation
- Redemption
- Fullfillment
- Settlement

Account Servicing

Payment Processing/ Billing
- Monthly Cardholder Payments
- Convenience Checks
- Payments

Member Service
- Live Agent/IVR Sup-port
- Lost/Stolen Account Management
- Fraud Inbound and Outbound Calls
- Disputes & Charge-backs
- Online/Mobile

Collections
- Early/Late Stage
- Skip Tracing
- Auto Dialer
- Systems Connectivity

Portfolio Management
- Risk Mitigation
- Line Management
- Risk Scoring

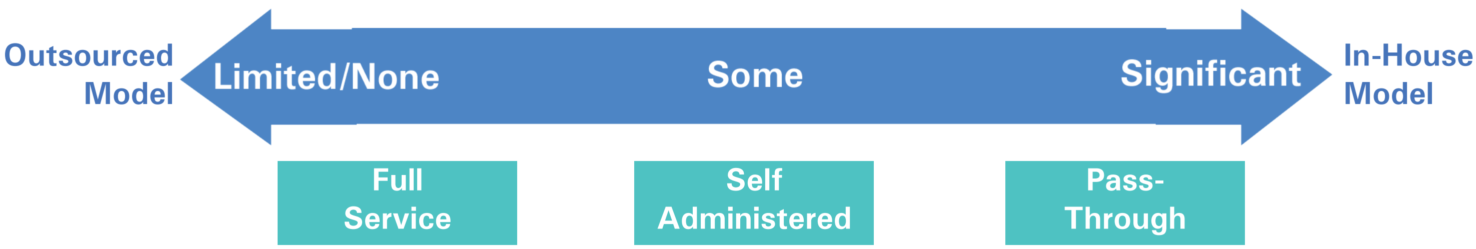
Processing is comprised of application processing, core transaction processing and user interfaces (connectivity). Production services include plastics and fulfillment (plastics production), statement generation, and loyalty/rewards administration. The final category is comprised primarily of back office and labor intensive functions such as payment processing, member service, collections, and portfolio management.

Available Operating Models

There are three primary operating models supported by issuers in the credit union community. The primary distinction among these models is the level of direct involvement a credit union elects. On one end of the continuum is the full service model which most closely resembles a fully outsourced arrangement. On the other end of the spectrum is a pass-through model, most similar to an in-house program. A self administered program is a hybrid approach with characteristics of each.

Exhibit 2: Operating Models

Level of Credit Union Involvement



It is estimated that a substantial percentage of community credit unions employ the pass-through credit card processing structure today. Furthermore, evidence suggests that size is not an absolute predictor in the division of credit unions selecting a full service model; rather small credit unions are just as likely to select a self administered or pass-through model as a larger credit union. It seems that a primary reason contributing to this phenomenon is inertia; meaning credit unions selected pass-through at some period in the past and have not revisited the decision to make changes since. Additionally, as their service philosophy has evolved to include direct servicing control over inbound questions regardless of the channels members use to request assistance with their credit card accounts, the pass-through model is viewed as advantageous as credit unions are able to maintain a strong sense of ownership and involvement in their card programs.

Full Service

The full service credit card processing model is best characterized by limited credit union involvement, as a third-party provider administers the card program on its behalf. Under this arrangement, the card program resides on the vendor's platform where cardholder account information is maintained. The processor settles Visa/MC transactions daily and performs daily balancing on behalf of the issuer. With limited exceptions, the processor also performs most ancillary services such as 24-hour cardholder member service, processing lockbox payments, handling lost/stolen reporting, dispute processing, fraud management, and statement production. The primary advantage of this structure to a credit union is the ability to offer a competitive credit card program without making significant investments in internal resources and capabilities.

Although daily involvement is not required, credit unions employing this model are still responsible for establishing credit underwriting criteria, setting product pricing, assisting with

Visa/MC licensing and implementation, establishing internal controls, funding daily settlement accounts and developing a working understanding of operational procedures.

Self Administered

A self administered program represents a hybrid approach to credit card issuing in which both the issuer and processor are involved in daily program management. Under this arrangement, the card program continues to reside on the processor platform, allowing credit unions to take advantage of a robust platform (similar to a full service) while maintaining the flexibility to select ancillary services based on need (similar to a pass-through). Although the set of functions performed in-house varies, credit unions typically prefer to handle member facing services including cardholder servicing and chargeback processing. This structure is advantageous for credit unions looking for robust features and functionality without giving up control over the member experience.

Pass-Through

Further along the continuum towards an in-house program is the pass-through model. The primary differentiator of this model, as compared to a self administered option, is that the card program resides on the credit union's own internal core account processing system. Under this arrangement, the credit union will set up an online connection to its processor for authorizations and file transmissions. The processor settles Visa/MC transactions daily and provides daily posting files to the issuer's core system. The CU's core processing system is responsible for posting transactions and payments as well as calculating fees and finance charges for cardholders. This structure provides greater control of in-house functions with the added flexibility of selecting ancillary services typically associated with a full service model, a la carte. These ancillary services typically include lockbox payment processing, after hours lost/stolen reporting, dispute processing, fraud management and even statement production. The result is the ability to invest into internal capabilities for functions it wishes to support in-house while outsourcing the rest.

Under the pass-through model, credit unions are responsible for reporting credit card accounts to credit bureaus and maintaining compliance with association rules and relevant government regulations. Credit unions selecting this structure often need dedicated resources or several part time resources allocated to the administration and management of the card program. Although the credit union may determine to outsource certain ancillary services (e.g., lockbox payment processing, dispute & fraud processing, and member service), processors are typically contracted to perform only core credit card processing functionality such as authorization and settlement procedures.

In all three models credit unions are responsible for funding credit card receivables as well as marketing the cards to their members. Exhibit 3 summarizes the key functions needed to support a credit card program with a checkmark indicating the functions performed by a third-party processor under each model.

Exhibit 3: Operating Model Comparison

Function	Full Service / Outsourced	Self Administered	Pass-Through
Applications Processing	Optional	Optional	Optional
Card Production	✔	✔	Optional
Card Activation	✔	✔	Optional
Fraud Prevention	Optional	Optional	Optional
Visa/MC Authorizations	✔	✔	✔
Transaction Posting	✔	✔	NA
Settlement	✔	✔	✔
Online Settlement	✔	✔	Optional
Statement Production	✔	✔	Optional
Payment Processing	✔	Optional	Optional
Cardholder Member Service	✔	Optional	NA
Retrieval Processing	✔	Optional	Optional
Chargeback Processing	✔	Optional	Optional
Collections	Optional	Optional	NA
Member Service	✔	✔	✔
Business Development	✔	✔	✔
Enhanced Services	Optional	Optional	Optional
Marketing Support	Optional	Optional	Optional
Online Account Management	✔ / Optional	✔ / Optional	NA

The functions identified as "optional" are typically performed by the issuer, although the processor can provide these services as well.

The following sections of the whitepaper provide a framework describing the selection criteria a credit union may employ to determine its preferred issuing model.

Decision Criteria

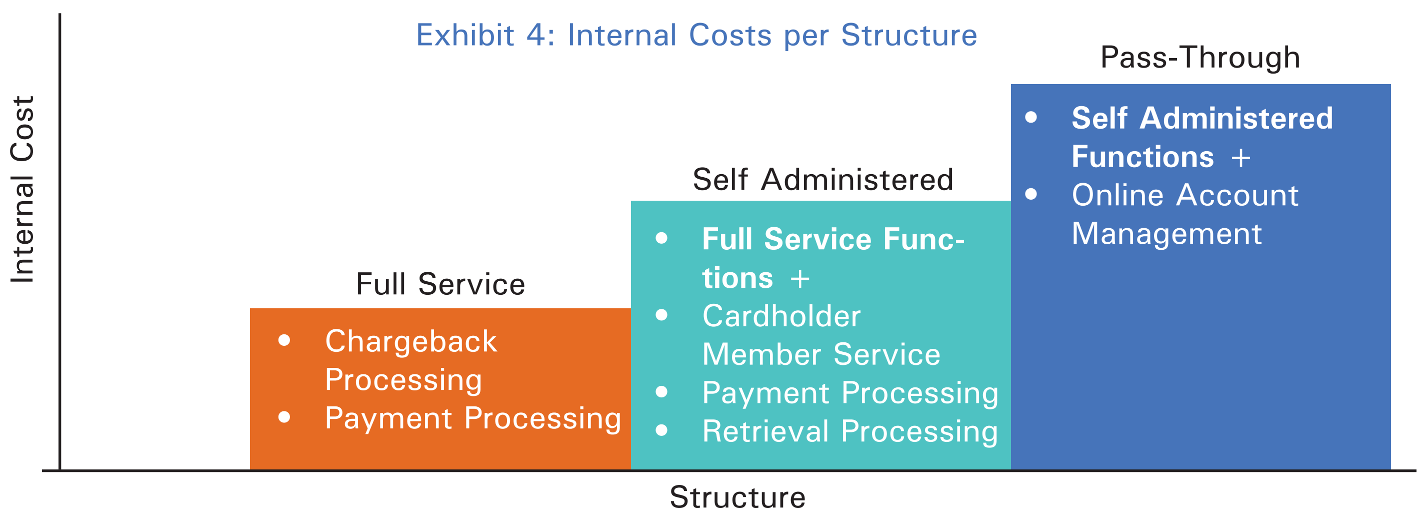
A credit union should evaluate its credit issuing options through the implementation of a structured review process. This process should include the creation of an analytical framework through which all key business priorities are captured, thereby allowing for a direct comparison of the various operating models available. Although the relative weight of each criterion will vary among credit unions, the discussion below is intended to provide insight towards approaching the decision process.

Cost of Ownership

Vendor pricing and program expenses play a key role in the selection of an operating structure. Research suggests that credit unions place a significant emphasis on third-party vendor costs and strive to obtain attractive pricing for purchased services. If a credit union requests pricing for multiple relationship models (full service, self administered and pass-through), it is not uncommon to see full service invoice pricing 10% to 25% above comparable pricing for the other models. Such differences have led to the belief that full-service processing is more expensive than pass-through or self-administered options. Reaching such a conclusion simply on the basis of comparing vendor prices for options is misleading as it ignores the added expenses of bringing functions in-house for credit unions not selecting a full service option.

A more comprehensive approach to comparing projected expenses is to create a fully loaded cost accounting view of each structure. Under the full service model, very limited internal resources are required for program administration and servicing. Conversely, the other models require a credit union to deploy resources to support card management and member service. These internal personnel expenses must be factored into the overall cost of running the program. For example, a credit union utilizing a cost accounting approach would allocate appropriate FTE salaries for supporting member service as an expense of its overall credit card program. Furthermore, a credit union should capture additional program expenses such as, technological upgrades on its platform, system maintenance, as well as any costs associated with ensuring regulatory compliance. Once complete, a credit union will have the information needed to accurately compare the "all-in" costs of each operating model available. Exhibit 4 provides an illustrative example of how internal costs increase similar to a cost step function as additional functions are performed in-house.

Exhibit 4: Internal Costs per Structure



There are two primary challenges that frequently preclude credit unions from performing a thorough cost accounting analysis as described in Exhibit 4. First, the analysis adds a level of complexity which many credit unions elect not to pursue, and secondly, credit unions find it difficult to isolate specific internal costs associated with supporting its credit card program. More specifically, credit unions frequently employ resources that jointly support both credit and debit card programs in addition to ACH/EFT channels utilized by their members. As such, electing to move to a full-service environment from pass-through does not necessarily create an opportunity to re-allocate or reduce card operations headcount.

Despite these challenges it is imperative that credit unions attempt to quantify all costs (both internal and outsourced) when deciding between credit issuing operating models. Focusing exclusively on readily identifiable vendor costs ignores a substantial portion of overall operating expenses and can lead to the selection of a sub-optimal arrangement.

Flexibility & Control

Flexibility and control are two attributes often mentioned by credit unions as key decision criteria in the selection of an operating model. There are clear differences in the level of flexibility and control that exists between the two ends of the processing spectrum. On one end, the full service model limits the extent of credit union involvement in the routine management of its credit portfolio. On the other end the pass-through option provides credit unions with the ability to customize its program to look and feel how it sees fit. The self-administered option sits in between, providing more opportunities for customization than a full-service model while maintaining some level of engagement in the daily management of the portfolio.

Generally speaking, full service programs administered by a third-party vendor tend to be static in their operations. At the onset of the program the credit union normally selects program attributes from a robust set of service offerings and capabilities. Card features and functionality, online account maintenance, activation IVR and member service capabilities will be consistent across issuers on the processing platform. Limited customization is available. Additionally, it is typically more time consuming to introduce new card products or program enhancements.

On the other hand, pass-through programs (and to a lesser extent a self administered program) provide credit unions with the flexibility and control to customize credit card programs. Credit unions will have significantly more involvement in program decisions such as product design, card features and benefits, and back office operating rules and procedures. This added flexibility not only allows a credit union to differentiate its program, but also provides opportunities to quickly react to changing market conditions.

Two other factors credit unions often consider when making a processing platform decision is the impact on member service and the overall economics. From a member service perspective, credit unions on the pass-through or self-administered platforms have an inherent opportunity to provide a higher, more consistent and more responsive level of service than when the service is outsourced to a third party by the very fact that a third party processor is given parameters by the credit union to resolve member inquiries and complaints that are typically more restrictive than a credit union member service rep. Credit unions on the pass-through or self-administered platforms tend to be larger in terms of asset and portfolio size and often already have a sizable member service call center, a strong philosophy toward providing high levels of member service,

CASE STUDY: Pass-Through Credit Union

Citing control as its number one priority, a Tennessee-based credit union has operated a pass-through structure to support its 23,000 card portfolio since the inception of its program. The credit union has nine dedicated support staff administering both credit and debit cards and providing the ability to control all facets of the member relationship. Aside from core transaction processing, its third-party vendor supports after-hours member service as well as back office handling of fraud and disputes.

This structure has provided the credit union with the ability to offer a highly-customized suite of credit card products, reduce operating expenses, and maintain direct involvement in the handling of member inquiries. While the credit union would prefer access to its processor's more robust data analytics and reporting resources, its core system is able to provide adequate capabilities.

The credit union has evaluated moving to a full-service model on several occasions. These evaluations have concluded that switching models would not provide the preferred level of control and would result in higher operating expenses relative to its current operations.

and empower their employees to resolve inquiries and complaints timely and efficiently, leading to high levels of overall member satisfaction.

Regardless of the processing platform, there is an economic cost to providing service. While telephonic and web based service technologies have significantly reduced the level of staffing needed, live cardholder servicing has become a 24 x 7 x 365 value proposition among the large, national issuers that credit unions are competing with. Having that level of coverage is expensive and usually incrementally more expensive for a credit union to provide it than a third party processor.

Accordingly, it is the quality of service the credit union wants to deliver to its members and the cost associated of delivering that service that most often drive processing platform decisions.

The determination as to which structure is more beneficial to the credit union from a flexibility and control standpoint ultimately depends on the level of involvement a credit union wishes to undertake. If it wishes to take an "auto pilot" approach and is comfortable allowing a third-party to service its members, than a full service relationship is likely appealing. However if the credit union prefers to customize its program and maintain control of member facing functions, a self administered or pass-through program may better fit its needs.

Features & Functionality

Full service and self-administered models typically provide credit unions with more robust system features and functionality because the credit union's card program resides on the processor's platform. This dynamic provides the processor with increased cardholder data and information allowing for added functionality including risk decisioning, fraud analytics and the ability to run multiple promotional campaigns concurrently. It also allows a credit union to utilize the robust reporting and data analytics programs credit processors maintain. Additionally, credit union members will have access to the processor's servicing capabilities via an online web portal, the ability to pay by phone, as well as other benefits that may not be available in-house. Third party processors also actively invest in enhancements such as mobile banking applications and SMS alerts. Processors are able to offer these benefits because they are able to spread the extensive R&D and implementation costs to support such functionality among many members, as opposed to a single credit union undertaking the expensive initiatives independently.

Credit unions employing a pass-through program may be able to replicate many of the benefits of the other two models depending on its own or other partners' technical capabilities. Robust data analytics and reporting can be accessed via a processors card management platform and credit unions often have access to enhancements such as mobile banking and SMS alerts on an a la carte basis. However, additional time, configuration and resources are often required to do so. This dynamic makes it more difficult to identify and capitalize on opportunities to improve profitability.

The importance of this selection criterion will ultimately depend on the type of program a credit union wishes to deploy. A credit union wishing to offer a more standard card program may not require the more advanced features a full service program provides. On the other hand, if a credit union intends to offer the most robust products, the full service option may be more advantageous. Regardless of the selection, it is appropriate to evaluate the contrasting features and functionality and ultimately ensure the selected model fits with the strategic direction of the card program.

CASE STUDY:
Full Service Credit Union

A mid-Atlantic credit union with roughly 33,000 accounts utilizes a full service credit processing model. Doing so allows it to focus on growth initiatives and profitability without tying up resources in the daily administration of the program.

Citing the Credit Card Act of 2009 as an example, the credit union enjoys "piece of mind" knowing key aspects of the program such as compliance, association updates, monthly billing, card plastics and potential card compromises are handled by its processing partner. The CU performs some member-facing functions in-house, notably member service during business hours and initial chargeback / dispute processing. Responsibility for these in-house functions is shared between credit and debit operations. The CU has considered taking responsibility for additional areas, but has found it more efficient to leverage experienced partner resources for areas such as product pricing, card promotions and reporting.

One limitation raised by the CU is lack of customization on the full-service option, specifically in the area of fraud where rules are consistent among all credit unions on its partner's platform. To overcome this limitation the CU licenses additional in-house fraud prevention software to meet its needs.

Despite this limitation the full service option provides the credit union with the best opportunity to optimize internal capabilities and partner strengths to maximize profitability.

Internal Resource Requirements

Credit card issuance is more complex today than ever before as a result of increased government regulation, ever changing network operating rules and anticipated enhancements (e.g., mobile payments). The level of internal knowledge and expertise required as well as the ability to support program requirements from a resource perspective should play a significant role in the decision making process.

In selecting the full service model, the requirements mentioned above become less imperative as critical functions are performed by the vendor. Although it is important that the credit union maintains an understanding of its credit card products, a dedicated team is not needed. This structure allows credit unions with limited resources to focus on core competencies.

Pass-through, and to a lesser extent self-administered programs, require more in-house credit card expertise to be successful. Aside from dedicated resources to handle in-house services, credit unions operating a pass-through model are also responsible for driving mandated Association upgrades and enhancements its processor supports into its front and back office support teams; an ongoing process that may require substantial education and internal training efforts. Despite these characteristics, a number of credit unions still operate pass through models as their preferred choice. In turn, to be successful they must ensure they have the appropriate level of internal resources, knowledge and expertise.

Other Considerations

There are a number of other considerations credit unions may wish to take into account when evaluating options. One example is the credit processing capabilities of its core banking platform. In today's market, core banking platforms typically have modules that can perform many of the functions and services required to support a credit card portfolio. Therefore, credit unions with technologically advanced core systems may be able to perform some functions in-house, such as data analytics and reporting, with limited additional investment. However it is important to note that although a core system may be able to replicate certain functionality, they are not able to provide the capabilities and hands-off approach of a full service processing model.

Another aspect that may drive a credit union's selection is member preferences. The proliferation of online functionality has led many consumers to move towards paperless statements, on-line bill payments, mobile payments and P2P. A credit union mindful of this trend may place increased emphasis on the R&D and support capabilities a full service vendor is able to provide and support. Alternatively, credit unions operating a self administered program must either self-integrate or maintain similar functionality in-house because the processor may not maintain the necessary cardholder data to support such services. However, it is common to see processors support channels of member preferences that focus around the card authorization and settlement data so functionality such as mobile alerts, P2P, and data analytics may be available for the credit union to self-integrate into the core system.

Lastly, implementation requirements may play a significant role in a credit unions decision. Credit unions selecting a full service model often have dedicated resources throughout an implementation process in areas such as customizing statements, finance charge buckets, fee buckets, and the like. Alternatively, credit unions selecting a pass-through model are responsible to implement code on its core system to support pass-through functionality. Regardless, in both scenarios credit unions are responsible for determining which areas of their front and back office procedures require modification to fully integrate a new program to guarantee a successful launch.

Summary / Conclusion

Credit unions need to evaluate a variety of considerations when selecting a credit operating structure. The table below summarizes the similarities and differences between the models.

Exhibit 5: Decision Criteria Summary

Criteria	Full Service	Self Administered	Pass-Through
Cost of Ownership	Higher vendor pricing; limited internal expenses	Aspects of both	Lower vendor pricing; substantial internal or core expenses
Flexibility & Control	Limited	Similar to Pass-Through	Considerable
Features & Functionality	Robust system features and functionality	Similar to Full Service	Dependent upon in-house capabilities
Internal Resource Requirements	Some	Similar to Pass-Through	High level of involvement and SME needed
Member Service	Vendor provided	Either in-house or outsourced	Credit union provided

Given the likely reduction in debit revenue as a result of the Durbin Amendment, credit card issuance is expected to become a more important component of overall profitability for financial institutions of all sizes. Credit unions have proven that they can effectively compete in this market. However, success is reliant on efficient card operations – that is, a credit union must select an operating model that best suits its specific capabilities and goals. If a credit union desires daily program involvement, increased flexibility and control over decision-making, and has the internal core capabilities and expertise to manage the program, a self administered or pass-through program may be advantageous. However, if a credit union prefers less daily involvement while maintaining its ability to offer its members a card program with robust features and functionality, the full service option may better suit its needs.

In conclusion, although each model has benefits and limitations, no one structure is necessarily better than another. What is most important is that a credit union's selection is based on a thorough assessment of its internal capabilities, its member's needs and the operating model's alignment with its overall credit card strategy.

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