

The Debit Dilemma

On April 28, 2003 the debit world changed. Two days later, it changed again. MasterCard and then Visa settled a landmark class action case with merchants that had been raging for seven years. The terms of the settlement (see table) and events in its wake have changed the debit industry and potentially the card associations forever.

Settlement Terms

Component	Description	Visa	MasterCard
Honor all	Removal of 'honor all cards' policy; new structure allows merchants to choose which methods of payment to accept (i.e., debit only, credit only, both)	√	√
Payment to merchants	Immediate payment from each association of \$25MM, followed by annual payments ¹	\$2.025B (\$200MM/yr for 10 yrs)	\$1.025B (\$100MM/yr for 10 yrs)
Interchang rates	Lowered interchange rates for offline debit beginning 8/1/03; new rates as of 1/1/04 ²	Decrease by 48 bp	Decrease by 33%
Rule changes	Debit cards must be re-issued with the term "debit" or similar language on the face of the cards Merchants must not be prohibited from providing discounts to consumers who use other forms of payment	√	√
exclusivity	Enjoinment from signing network exclusivity contracts with banks for debit card transactions	√	

The impact of the settlement on debit card issuers is enormous and sufficiently material to warrant public disclosures of negative earnings. By way of example, Bank of America, indicated that they will suffer an earnings hit of \$60 million in 2003 and \$130 million in 2004³ – a \$0.09/share reduction in earnings. Without a doubt, the settlement is a seriously negative development for all banks and credit unions.

If all of this is not bad enough for debit card issuers, consider three important events that have occurred since the settlement:

¹ The associations are exploring various financing options to permit one lump sum payment next year based on the present value of this ten-year payout.

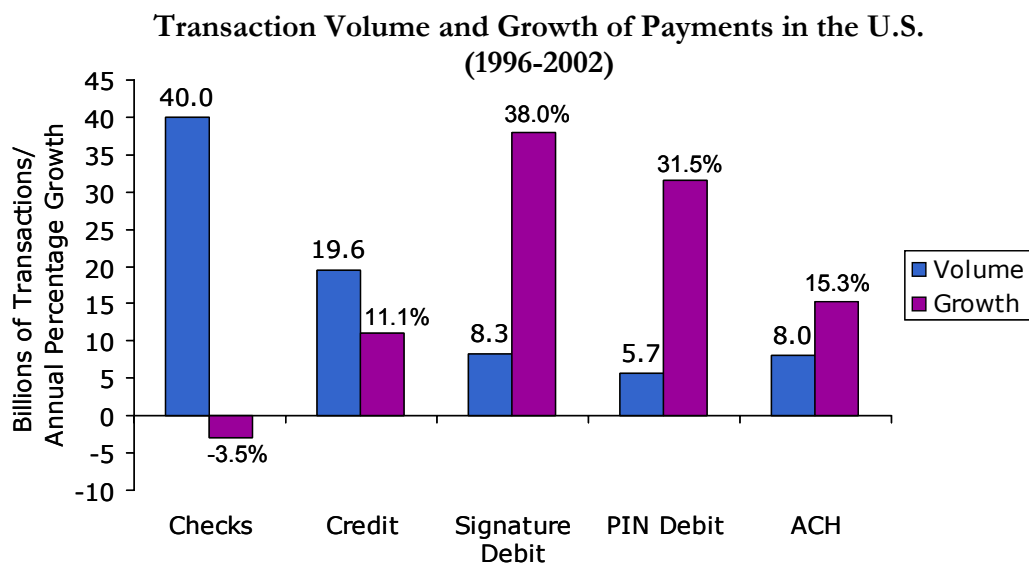
² The interchange rate for signature debit transactions starting in 2004 is unknown. Card acceptance will no longer be tied to credit card acceptance, nor will there be a price cap. Financial institutions are currently divided on whether rates will increase or decrease from their post-settlement level.

³ CardLine, August 12, 2003

- Some very large merchants (e.g., Home Depot, Toys ‘R’ Us) opted out of the settlement, and are pursuing independent lawsuits against Visa and MasterCard. The impact of this is anyone’s guess, but at the very least it could generate a separate set of negotiated agreements on a merchant-by-merchant basis.
- Some mid-sized banks that are large debit card issuers like TCF Financial have filed suit against the card associations to block them from entering into an agreement that represents all of their members. When members of a horizontal cooperative, such as TCF is with Visa, file lawsuits that attempt to overturn rules (as was the case with ATM surcharges 10 years ago), it is almost a certainty that more change will occur.
- Visa instituted a ‘Settlement Service Fee’ on June 20 that requires any of Visa’s top 100 debit issuers to pay its share of whatever is still unpaid of the \$2 billion settlement if the bank’s debit volume slips more than 10% from its September 2002 levels – a condition certainly met if any financial institution chooses to leave Visa.

Although the new fee protects Visa, it also creates a fairly significant obstacle for the largest debit issuers to take actions that might reduce their settlement exposure. In addition, it places a very stiff penalty on those debit issuers who might choose to switch to MasterCard (or other payment networks). At least in the U.S., MasterCard’s Maestro program is weak to non-existent, and this may very well keep it in that position for some time.

Given the settlement and all of the post-settlement hype, one might surmise that the end of debit is only a matter of time. Not so. Consumers have already voted, and the results endorse debit with astounding clarity. Debit, whether it be PIN-based or signature-based, is supplanting other forms of payment – particularly checks – at an unprecedented rate (see chart).



The question is not so much whether debit will continue to grow – it will. For all intents and purposes, debit will very soon be the primary access vehicle to demand deposit accounts (DDAs). For some customer segments it already is. In the aggregate, our

models suggest that debit transactions will exceed credit card transactions this year and will surpass check volume within four years.

Consequently, the real question is what banks can do, given the realities of the market and the settlement, to make debit a profitable form of payment.

Strategy #1: Fee Your Way Out of the Shortfall

Our knee-jerk reaction to this is, “Oh no, not more fees.” Most banks already have fee schedules that confuse and often surprise their customers. Raising fees or instituting new ones would surely raise customers’ ire, and in doing so increase what is already an endemic problem across the banking industry – DDA customer attrition is north of 15% for most banks and above 25% for ‘new-to-bank’ customers. The hidden cost of a fee increase will surely be an increase in customer attrition.

That said, there are holes in the current fee structure that most banks have in place for debit cards.

- Less than one-third of banks charge some or all of their cardholders a fee for PIN debit transactions (typically \$0.25). There might be room for action here, but it’s important to recognize that fee increases have an inverse and adverse effect on transaction volume – introducing cardholder transaction fees reduces per-card activity levels by 40%⁴. Consequently, total revenue may decline.
- We are not aware of any banks that explicitly charge a fee for PIN debit transactions that include cash back at the point-of-sale. For many customers, receiving cash back is a simple time-saving convenience. For other customers, cash back is a means of avoiding what would have been a surcharged ATM withdrawal. In either case, value is provided to the cardholder without a commensurate fee.

Strategy #2: Grow Your Way Out of the Shortfall.

Given the underlying growth in debit, this might be the more appropriate, although more difficult way to proceed (i.e., growing volume will be slower and will require more planning than simply raising a fee).

- *Card issuance:* Although strong in aggregate, card penetration continues to be weak in areas. Some banks still do not issue signature debit cards to all of their DDA customers, due to the presumed risk associated with this payment vehicle. We believe this is unwarranted. To open a DDA, banks already perform a risk assessment of the new/potential customer. ChexSystems™, the leading new account risk management product, provides banks with sufficient information about the consumer to warrant issuing a signature debit card – if they are solid enough to be offered a checking account (particularly in these days of regulatory oversight

⁴ Debit Issuer Survey: Cardholder Fees & Industry Outlook, PULSE EFT Association, August 2002

associated with the post 9/11 era), they are solid enough to have a signature debit card as well.

- *Card activation and usage:* In the U.S., activation currently runs at about 50%, and active cardholders use their cards 10-12 times per month (on average). There is tremendous upside here. Best-in-class debit card issuers are achieving activation levels north of 66% and card usage levels of more than 17 transactions per month.
- *Reward Programs:* Of particular significance is the impact of reward programs like airlines miles. Benchmark usage for card issuers with these programs is 75% higher than cardholders without a miles program.

Yes, there are mileage ‘junkies’ out there and they do respond favorably to reward programs. The question post-settlement, however, is whether any card issuer can continue to afford these programs since they were largely funded by interchange. The answer is yes, although perhaps on a smaller scale (e.g., with a higher annual fee to attract highly motivated spenders).

- *Recurring Payments:* The hidden settlement gem is the elimination of the ‘Honor All Cards’ rule. Companies that operate on very low margins (e.g., utilities) have shied away from accepting debit because credit acceptance (complete with much higher interchange rates) came along with it. Not so any more. Utility companies can now accept debit by itself. Migrating monthly checks to debit card payments for utility bills alone creates an enormous opportunity for banks. Visa has sized the recurring payments market at \$1 trillion. Even at the \$0.26 level – the signature debit interchange for grocery stores – interchange fees for banks would be very material indeed.

Debit as a form of payment is clearly the future. Merchants obviously know this – otherwise they would have not brought suit against Visa and MasterCard. Consumers know this – they are selecting the card as their favorite form of payment at the point of sale. Banks know this – net income contribution derived from debit is undeniably material.

The settlement changes the dynamics of debit significantly but it does not obviate the importance of it or the need to make it even more attractive. For banks, debit is the keyhole to the DDA lock. It must not only be profitable, but it must also be controlled by banks because as debit goes, so goes the heart of the payments system.

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