




Facing the Debit Dilemma: Issuer Strategies

The announcement of Visa and MasterCard's settlement of the merchant class-action lawsuit in April 2003 took the financial industry by surprise. Debit card issuers rushed to calculate the negative impact on their earnings, and promptly began to re-assess their debit card strategies.

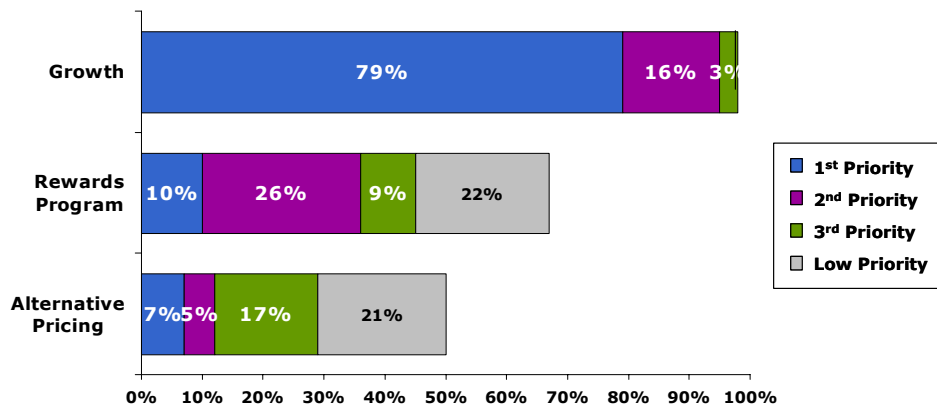
In the aftermath of the settlement, many issuers were tempted to introduce 'quick fix' solutions—increasing or introducing fees, dropping costly rewards programs and other measures—to help bridge the gap in their revenue and profit contribution forecasts. But after further evaluation, most issuers have opted for a more cautious 'wait and see' strategy, citing three primary reasons:

1. The market remains uncertain  *"Come January, interchange rates will be reset. We want to be sure we don't become knee-jerk reactors. Anything could happen."*
2. Market dynamics are perceived to be unchanged  *"The market is not structurally changed; offline debit is simply less profitable."*
"The customer value proposition has not changed."
3. Long-term growth potential outweighs short term losses  *"Debit cards will continue to be a growth product; the alternatives are cash and check. Everybody will be wise."*

Strategic Priorities

Rather than make reactionary changes to their debit strategies, issuers are choosing long-term solutions. Growth is their number one priority, with a focus on increased card penetration, activation, and usage. Changes to rewards programs and pricing are secondary considerations, if they are even being considered at all.

Debit Strategic Priorities



1. Growth

Interchange revenue is driven by debit card purchase activity. With less interchange revenue per transaction post-settlement, many issuers are determined to boost the growth rate of their transaction base. As the EVP in charge of debit cards at TCF Bank stated, while revenue per transaction will decrease by about 30% (for signature debit transactions), total transaction volume has been growing by roughly 25% annually. With some additional promotions to increase card activation rate, TCF can make up the 5% difference, "there is still a lot of room left for this product to grow."

To drive growth, many issuers intend to pursue their existing strategies more aggressively:

- Staff training and incentives
 - Tying incentives to card usage rather than card issuance
 - Improving follow up processes with new customers
- Consumer education
 - Creating tools to simulate POS 'trial' for new customers
 - Targeted marketing for inactive/low activity customers
- Data-mining and customer research
 - Conducting segmentation analysis by geography, customer type, account type
 - Tracking e-check and ACH transactions for targeted mailings

Some issuers are developing innovative programs and incentives to increase activation and usage:

- Deploying 'instant issuance' machines to activate cards at the time of account opening
- Distributing calling cards with free minutes that are activated once a cardholder makes a certain number of signature debit transactions

Many issuers are also looking for new venues in which to grow debit, and are exploring new growth outlets such as Internet payments and recurring payments.

2. Rewards Programs

With less revenue per transaction, there has been much speculation as to the future of debit rewards programs.

- Will issuers stop these programs? With lower margins, can financial institutions continue to support expensive rewards programs, such as cash rebates or airline miles?
- Will more issuers introduce reward programs? In an attempt to boost debit growth, will more financial institutions roll out rewards programs to stimulate card usage?

In summary, no major changes are anticipated with respect to debit loyalty programs.

Issuers that currently have rewards programs intend to maintain them, although with some modifications to the cash value associated with particular rewards, given the changes in the underlying economics. For these financial institutions, the value of active, high-spending cardholders earning rewards is still attractive, even in this new, lower revenue environment.

Among issuers that do not currently offer a rewards program, few are planning to introduce one, and many of those that were considering implementation have tabled their plans. That said, a handful of issuers are looking to introduce non-traditional or 'alternative' rewards programs, and many smaller issuers indicated interest in participating in Visa or MasterCard programs.

"We're working on a bank-wide loyalty program that crosses multiple products/levels of service."

"We are planning to launch a non-traditional rewards program - it's a cross between a rewards program and an affinity program."

"We're looking at Visa Extras, since it's not that costly."

It makes intuitive sense that issuers would not necessarily want to introduce rewards programs and increase their costs at the same time that their revenues are decreasing. However, for many financial institutions, the true value of a rewards program is less in the card itself and more in the additional loyalty such programs deliver to the overall banking relationship. Cardholders with rewards-based debit cards are much less likely to leave the bank and tend to maintain higher account balances than cardholders without rewards.

3. Debit Pricing

With less interchange per transaction, financial institutions could turn to cardholders to make up the shortfall. Increased transaction or card fees would be a very quick path to filling the revenue gap...at least theoretically.

Changing cardholder fees is a very low priority for issuers, viewed by many as a last resort. Many issuers view new or increased cardholder fees as a short-term and ill-advised solution that is counter to their longer-term objective of growth.

- Issuers do not want to create a disincentive for card use.
- For most issuers, the DDA—not the debit card—is the primary banking relationship.

Although many consider fees to be a low priority, several issuers are nevertheless evaluating different fee structures.

- Some issuers are considering 'per transaction' fees for PIN or cash-back transactions.
- Others are considering 'per card' fees, despite the risk of deterring issuance and activation.

No issuer wants to be the first to implement a new debit fee. And while some are evaluating different fee options, most are adopting a 'wait and see' policy until the market stabilizes, or at least until the largest banks move first.

So, after speaking with 61 debit card managers responsible for more than 58MM debit cards, what did we find?

We found an industry poised for continued growth. Rather than implement short-term 'fixes,' managers are committed to getting more debit cards into more consumers' (and small businesses') hands, encouraging these cardholders to use their debit cards, and to use them more often in more venues.

With this level of resolve to grow their way out of the revenue shortfall, the prospects for the debit industry look very bright indeed.

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