

Debit Cards

The Future is Now

How debit cards can enhance your competitive edge for retail customers and your bottom line

By Ellen Clair Lamb

My checkbook never gets out anymore.

I don't hear it complain, but the truth is that I haven't taken it out of my apartment in almost a year. Once or twice a month, I pull it out of my desk drawer and pay a few bills, but I can't remember the last time I used a check to pay for a store purchase. Two pieces of plastic have replaced the checkbook in my purse: my trusty ATM card and a cheerful red Visa check card.

With these two cards, I can pay for almost anything, from groceries to gas to my dog's vet bill, without ever having to worry whether I have proper I.D., and no one ever gives me trouble about having an out-of-state bank account. The cards also give me a paper trail I wouldn't have with cash, since transactions are recorded on my monthly bank statement. With these two cards, I have the convenience of plastic without running up credit card debt that I might not be able to pay off at the end of the month. I'm sold on my debit cards.

I'm not alone. Use of debit cards has exploded in the past five years, as more and more retail outlets have installed point-of-sale terminals and customers have discovered the convenience of a card that replaces both cash and checks in their wallets.

The benefits of debit cards may not be as immediately obvious to bankers. Although last year's Grant Thornton Survey of community bank executives found that 94 percent of community banks plan to offer debit cards within the next three years, one community banker interviewed for this article confessed that his staff is still examining the question of how his institution could make money from debit cards.

He and other like-minded bankers may be asking the wrong question. "It's not really about making money," says James R. Wells, an electronic banking expert and consultant based in Valley Stream, N.Y. "It's about using the most appropriate and least costly payment vehicle for each type of transaction. Using a [online] debit card is far less expensive for a bank than a credit card transaction—in outright processing costs, in the fact that it uses a customer's funds, not the bank's, and in being a less risky transaction owing to it being conducted in real time and requiring a PIN."

Other experts agree that debit cards can benefit community banks' bottom lines by reducing transaction costs and (in the case of offline cards) providing some fee income, but add that the

growth in debit card use and recent technology advances offer opportunities for even greater intangible benefits.

The debit card is "a product that's been extremely popular with consumers," says Genie M. Driskill, chief operating officer and senior vice president of research at Synergistics Research, an Atlanta-based consulting firm. But "one area where we have not seen a great deal of activity," she adds, "is seeing the debit card as a value-added feature of the checking account relationship. It's more or less just another transaction device, and it could be positioned as giving value to the checking account."

Use of Debit Cards Explodes

Debit cards "have truly been one of the success stories of the 1990s in retail banking," says Driskill.

"We talked about debit cards back in the 1970s, [but] they really didn't come into their own until the '90s," she says. "Once you had a strong base of ATM users, when financial institutions began to actively promote debit cards, they just took off."

Synergistics' most recent survey found that 45 percent of households with incomes of \$15,000 or more are active debit card users. Driskill says that these households use debit cards as frequently as they use their credit cards on a monthly basis, although more consumers have debit cards than have credit cards, and consumers often have multiple credit cards but only one debit card.

While the number of debit cards grew considerably in the 1990s, the number of point-of-sale terminals exploded. The result has been the emergence of debit cards as a major payment medium over a remarkably short period of time.

Concerns that debit card use might cannibalize credit card

revenues have so far been unfounded. "Overwhelmingly, people are using debit cards for what used to be cash transactions," says Mike Potter, president and chief executive officer of ACB Partners Inc.

Debit card use often replaces ATM usage. "What we have seen is that debit card users say they are getting cash back at the point of sale, and that they are using ATMs less frequently as a result of that," she says. "We have seen the incidence of ATM 'ex-users' grow, and one of the reasons they say they are not using an ATM is that they are using POS debit ... they don't have any need to go to the ATM."

Statistics bear this out. Use of credit cards grew by more than 50 percent between 1994 and 1998, but use of debit cards more than tripled.

In March 2000, Visa USA reported that credit, debit and business card use had reached an all-time high, with 26 cents of every dollar of consumers' discretionary spending put on plastic. Use of the Visa check card jumped 36 percent from 1998 to 1999, reaching \$183.8 billion in transactions, more than a quarter of Visa's total volume. MasterCard reported almost the same level of growth, a 35 percent increase in the dollar volume of its debit card transactions, between the second quarters of 1999 and 2000.

Debit cards have also become attractive products for small businesses. MasterCard has found that the average business debit cardholder spends three times as much as the average consumer debit cardholder, which corresponds to its finding that small businesses make almost 90 percent of company purchases with cash or checks. Such programs typically target companies with annual revenues of less than \$5 million and with 10 or fewer

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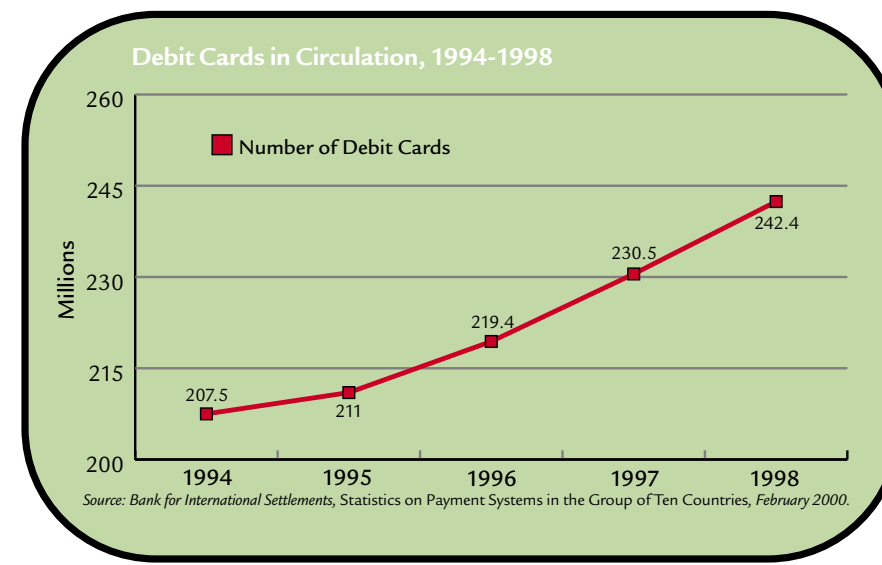
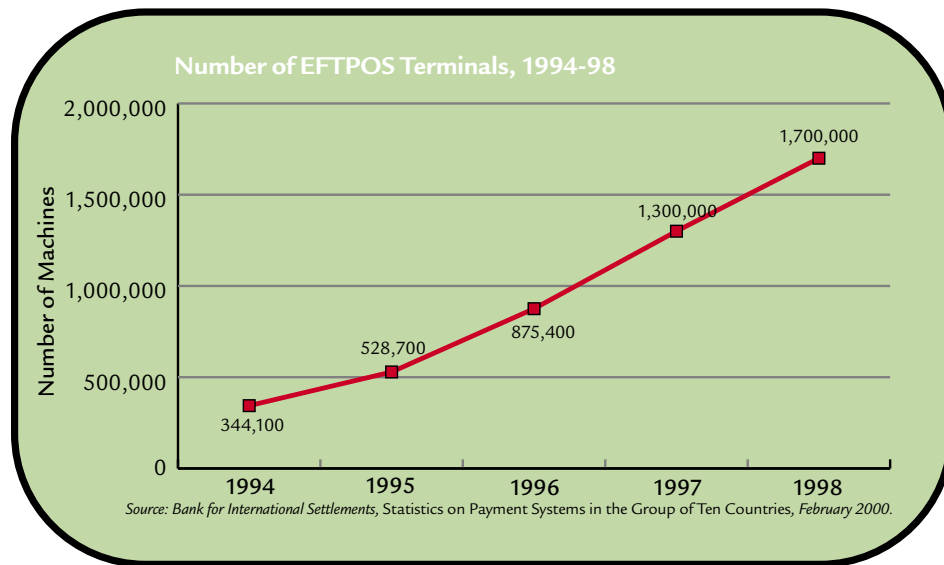
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employees, and offer product discounts, customized limits and ATM withdrawals.

Online vs. Offline

Debit cards come in two types: online and offline. I have one of each.

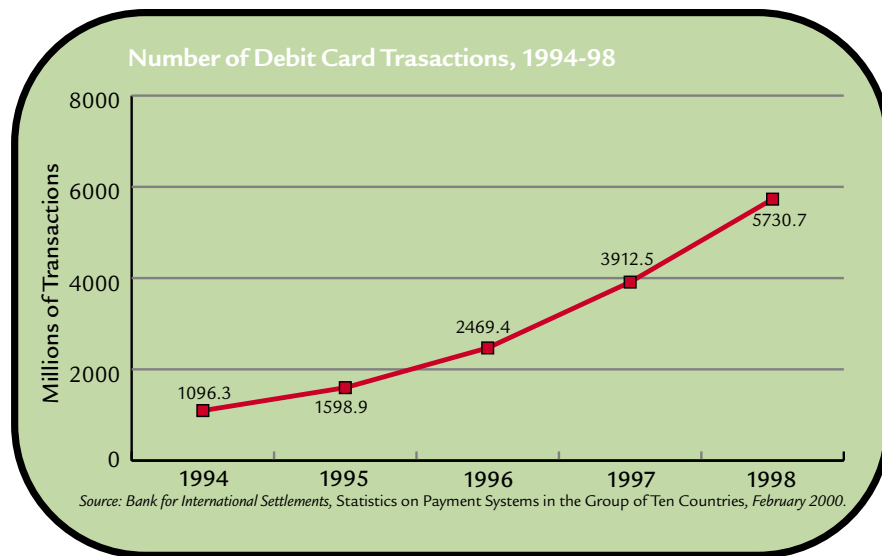
Online cards are the automated teller machine cards, and require personal identification numbers (PINs) at the point of sale. Offline cards are the Visa or Mastercard “check cards,” that use the credit card interchanges to process the debit transactions. ATM debit cards are “single-message” systems, while check cards are “two-message” systems, going to the credit card authorization center and then to the customer’s financial institution.

Consumers don’t understand the difference between a PIN-based online debit card and an offline Visa or Mastercard check card, Synergistics’ Driskill says. But consultant Jim Wells says it can be an important difference for banks.

“Offline debit cards ... are really charge cards with a right of offset against a depository account,” Wells says. “Transactions are processed over the more expensive credit card networks, lack PINs and aren’t real-time.”

Offline transactions require institutions to send multiple “positive balance files,” or PBFs, to various service providers, which can be complicated and expensive. Because of these multiple messages and delays in

posting, it’s possible for a customer to overdraw a demand deposit account using an offline debit card—something that isn’t possible with online cards. Thus, banks have a strong incentive to encourage their customers to use online debit cards.



Banks can increase their options by offering cards that have both online and offline features, using systems such as the Electronic Funds Delivery (EFD) product developed by Equifax. The EFD system offers a single-point authorization option, which provides

authorizations based on one positive balance file (PBF) that is sent to Equifax each day. Banks that use the EFD system have all debit transactions, including signature, PIN point-of-sale and ATM withdrawals, routed to Equifax for authorization, rather than having to provide multiple positive balance files themselves. This helps banks reduce their risks, since authorizations are based on just one balance, preventing cardholders from overdrawing their account balances.

Another feature of the EFD system, currently under development, provides the option of online, real-time authorization for institutions that want to keep the authorization function in-house. Equifax would receive the transactions, then route them through a gateway link to the institution for authorization.

Making online debit cards usable over the Internet is the next crucial step. Driskill notes that the Internet and e-commerce have been major factors encouraging the use

of offline debit cards. “The major concern has been that there’s no way to use online debit cards [over the Internet] because they’re PIN-based,” she says. “But the offline cards aren’t. Once consumers are assured that it’s secured, that could be an

area to encourage and increase usage.”

Recently enacted digital signature legislation may offer other avenues for guaranteeing debit card transactions over the Internet without requiring customers to disclose their PINs.

Encouraging Debit Card Use

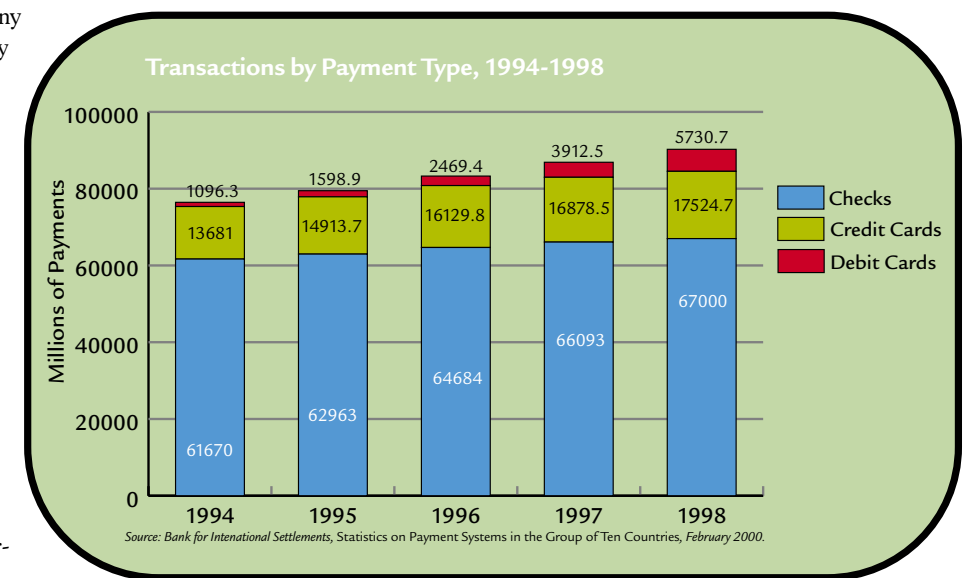
Debit cards may have taken on a momentum of their own, and their use is likely to grow independently of banks’ efforts; *The Nilson Report*, an industry newsletter, predicts that debit card volume will grow by 780 percent between 1998 and 2010.

That doesn’t cancel out marketing opportunities for banks. In fact, many consumers may not be aware that they can use their ATM cards to buy things; a PSI Global study found that while 59 percent of households reported that they had an ATM card, fewer than 40 percent knew they had an ATM/Debit card.

Driskill sees two main strategies for encouraging the use of debit cards: persuading consumers who have ATM cards to use them as debit cards, and encouraging those who already use debit cards to use them more often. Surveys have found that “people who haven’t used ATM cards at the point of sale don’t have any objection to it,” she says; it’s a matter of education and marketing.

Ironically, banks’ success in marketing their credit cards may make consumers less likely to use their debit cards. “Banks have trained customers so well to use credit cards ... that we use them for virtually everything,” says Jim Wells. “So consumers use credit cards (and the bank’s money) to buy a quart of milk, a tank of gas, etc., where we used to plunk down cash, just to build up frequent flyer points.” Of course, banks recoup greater refunds on credit cards.

Indeed, Synergistics’ surveys have found that adding credit card-type features would



probably make customers more likely to use their debit cards. Its most recent survey of households with annual incomes of \$15,000 or more found that customers want their debit cards to offer features similar to those available from their credit cards—merchandise discounts, cash rebates and reward points. Loyalty and co-branding programs are already emerging as strategies for increasing debit card usage among the nation’s largest financial institutions. Several large banks now offer offline debit cards that give customers frequent-flyer miles (Chase Manhattan’s Chase/Continental Banking Card, a MasterCard debit card) or free telephone time (TCF’s Express Phone Card, a Visa check card that gives free minutes on MCI/WorldCom).

A Familiar Product

In less than a decade, debit cards have gone from being an unfamiliar product to something that consumers want and expect from their financial institutions. Debit cards can help both consumers and small businesses manage their cash, and online debit cards can help financial institutions prevent overlimit transactions at the point of sale. Debit cards can also save financial institutions money when consumers use them instead of checks.

Debit card usage is only likely to increase over the next several years, until debit cards are as widely used as ATM machines.

Developing methods to use online debit cards for e-commerce and Internet purchases is the next step in boosting debit card use.

Meanwhile, community banks can position both online and offline debit cards as major features of their checking accounts, and can use these cards to increase their own brand recognition and build customer loyalty. As debit card usage increases, it's likely that more and more customers will be leaving their checkbooks at home. **■**

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