

# TransAct

Debit Cards | Credit Cards | ATMs | Payments



Winter 2005 • Vol. 2, No. 4

## A Brave New World for the Credit Card Market

The last three months have been a tumultuous time for the credit card industry, as the Supreme Court rejected a closely watched appeal, competitors filed lawsuits against MasterCard and Visa, and American Express entered into direct competition with the two bank card companies.

The flurry of activity began Oct. 4, when the Supreme Court declined to hear an appeal from MasterCard and Visa. The appeal sought to overturn a lower court's ruling that MasterCard and Visa had violated antitrust law by blocking U.S. banks from issuing cards on different networks.

On that same day, Discover Financial Services filed a lawsuit against MasterCard and Visa, seeking damages for what it termed anti-competitive policies of the two bank card associations. In conjunction with the lawsuit, Discover indicated that it would soon be testing the waters of the U.S. banking market.

"Discover Financial Services has been in advanced discussions with potential partners regarding issuance of cards on the Discover Network, and we are eager to move forward with these new partnerships," said David W. Nelms, chairman and chief executive officer of Discover Financial.

As Discover flirted with new opportunities, American Express was already involved in an alliance with MBNA Corp., the third-largest credit card issuer in the world. MBNA began issuing American Express-branded cards in early November, delivering on an agreement it reached with American Express in January 2004. It became the first U.S. bank to issue American Express cards.

American Express also launched its own lawsuit against MasterCard and Visa in mid-November, seeking monetary damages from lost business. The lawsuit claimed that MasterCard and Visa policies prevented American Express from providing network services to U.S. banks for more than eight years. In addition to the two credit card associations, the lawsuit named eight major U.S. banks, all members of MasterCard and Visa.

The latest development in the credit card saga involves American Express once again. In mid-December, American Express reached an agreement with Citigroup to begin issuing American Express-branded cards. The first cards will come out in late 2005. Citigroup is the largest credit card issuer in the world. ✕

## ARC Payments No. 1 in Consumer Friendliness

ARC (Accounts Receivable) check conversions are the highest-quality consumer automatic clearinghouse debit applications, according to

research from NACHA-The Electronic Payments Association.

"Not only is ARC the fastest growing application in the history of the ACH network, it performs better than any other consumer-oriented ACH debit application," said Elliot C. McEntee, president and chief executive officer of NACHA. Eighty-two

percent of banks had no concerns regarding any ARC customer-service issues, the NACHA survey discovered. Only one respondent reported any significant issues. The survey involved 34 banks.

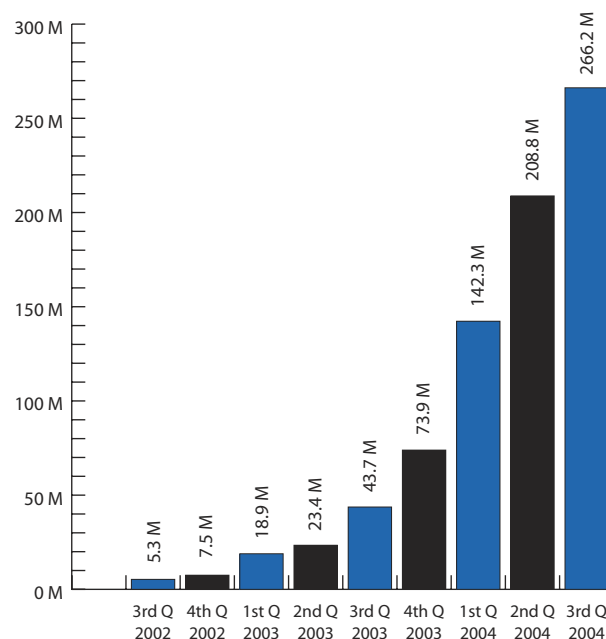
ARC was originally introduced in March 2002. It functions by taking checks delivered to lockbox and remittance locations and converting them to ACH transactions. ARC is typically used for consumer payments, such as credit card bills and mortgages.

There were 266.2 million ARC payments made in the third quarter of 2004, up from 43.7 million a year earlier, and 5.3 million in the third quarter of 2002. An estimated 1.25 billion ARC payments were made in 2004, making ARC the fastest ACH application to reach 1 billion payments.

“The data shows that ARC is working smoothly, and that issues such as administrative returns and consumer acceptance have been successfully addressed,” McEntee said.

## ARC Payments Continue to Grow

*Quarterly ARC volume, in millions of transactions*



Source: NACHA- The Electronic Payments Association

---

## Illinois Launches Crusade Against ATM Double-Charging

Illinois Lt. Governor Pat Quinn called for the end of ATM double-charging in late December. The practice occurs when a customer uses an ATM outside of their bank's network. In most cases, the customers are assessed a point-of-service surcharge from the ATM operator, as well as an ATM usage fee from their own bank. In Illinois, 93.5 percent of ATMs currently double-charge customers.

“It's high time we used the financial leverage of our state government to get big banks to play fair with the millions of ATM cardholders,” Quinn said. “Why should Illinois consumers be forced to watch big banks collect millions of dollars in fees from handling transactions involving our taxpayer money when the same banks are gouging the public with artificial and unfair ATM fees?”

Quinn singled out Washington Mutual as an example of a bank that does not impose any ATM surcharges in Illinois. Washington Mutual

is “proof that larger banks can abolish this fee,” Quinn said. He also proposed that banks doing business with the state of Illinois be required to sign formal agreements stating that they will do away with surcharges affecting the 6 million ATM cardholders in the state.

Washington Mutual declined to comment on Quinn's statement. The bank eliminated ATM surcharge fees in the Chicago area soon after it began opening retail branches there in the summer of 2003. ✕

---

## Smart Cards Poised to Hit It Big by 2012, Says Celent

Could a U.S. breakthrough finally be in the offing for smart cards? Celent Communications thinks so, and, in a December

report, the firm pegged 2012 as the pivotal year when the cards finally gain a significant position in the U.S. market.

Technological improvements, declining manufacturing costs, and the search for new branch applications could help pry the U.S. market open for the much-talked-about payment cards.

Smart cards are plastic payment cards with embedded chips. The chip transmits data to a reader through wireless technologies, such as radio frequency and Bluetooth.

The cards are popular in Europe, but have failed to attract a following in the United States, despite several pushes over the past decade. In March of 2004, for example, Target dropped its smart card program because of a lack of use. Smart-card technology has also been seen as being too expensive, Celent said.

Banks are now investigating branch applications for smart cards, such as using the card at the ATM, according to the Celent report. A smart card could store user preferences for ATM transactions, enhancing customer service, Celent said. Cards could also store deposit and withdrawal slips, allowing customers to insert their card into a reader at the teller line and automatically send their information to the teller's computer screen.

Other factors that will drive U.S. acceptance of smart cards include the growing international popularity of the cards, as well as the proliferation of fraud. Increased fraud "will ultimately push financial institutions to find a better solution to the problem, one with less opportunity for compromise and enhanced authentication. Smart cards will be at the top of the list," said Ariana-Michele Moore, author of the Celent report. ✕

---

## Perspective

### Debit Card Risks Increase, But So Do Profits

By Stacy Reinke

**B**anks will remember 2004 for many things, among them Check 21 and the Wal-Mart debit-card suit. Less celebrated, but just as important, is electronic transactions' edge over check transactions in the United States in 2004. Debit cards accounted for more than half of last year's overall electronic payment growth.

Along with increased debit use has come increased risk. Fraudsters are using new venues, particularly phishing, to snare customer information and misuse funds. More recently, U.S. institutions have experienced more fraudulent pinned activity originating in Europe.

Given the increased fraud, many banks now ask if debit card programs are worth the risk. The answer is "yes," but the program needs to be managed in order to be a solid business proposition.

#### The Well-Managed Program

What are the components of a well-managed debit-

card program? In today's business environment, management needs to be a central theme of successful debit card programs.

#### Risk Management

Current examination rules give risk planning and assessment a central role in all banking products. Debit cards should be no different. You should know how the bank is exposed as a result of offering a debit card program, and how those risks are mitigated. Equally important, the bank must have incident-response procedures in place should exposure occur.

#### Loss Modeling

Every debit card program will have losses as a result of fraud, but well-managed programs confine those losses to an acceptable percentage of the program's overall profit. Your bank's business model should include reasonable loss estimates based on your experience and the experience of similar banks in your area.

Prepare your management team by establishing an acceptable level of losses and having a plan to avoid excessive losses, either by program changes, use of prevention and detection tools, or exit from the program.

### Today's Tools

For many years, Address Verification (AVS) and Card Verification Value (CVV) have been standard protections against fraud. But as bad guys try new schemes, the good guys need to raise their game as well. New tools are now available, such as the Triple DES security standard and the use of random digits in card numbers to prevent thieves from predicting the next card number in sequence.

Visa and MasterCard now offer authentication services to improve the security of online purchases for the customer, issuer, and merchant. MasterCard's "Secure Code" and Visa's "Verified by Visa" require cardholders to enter a password when they shop online.

Additional new tools include neural networks, such as Fair Isaac's Falcon Fraud Manager, which uses data modeling and customer history to report when the individual customer's spending has deviated from his or her typical pattern.

### Your Secret Weapon

The most overlooked tool in a bank's debit-card risk-management program is customer education. Knowledgeable customers don't respond to phishing e-mails. And they review their debit-card activity online or review their monthly statements for suspicious activity.

Many bankers refuse to believe that customers can guard their debit cards effectively. But these doubts ignore two important facts:

- It's the customer's money. Regardless of the limit on customer debit-card losses, theft unsettles customers and motivates them to

prevent it.

- Customer education offers strong marketing advantages for your bank. Nothing sticks to a customer more than caring, conscientious service. Teaching your customers to reduce risk will strengthen your bank's relationships.

While none of these risk management tools is perfect, they can significantly reduce your bank's debit-card risk and, thereby, increase profitability, as well as service to the customer.

With debit cards becoming more basic than checks, risk management will be a fundamental strategy for preserving profits, as well as the safety and soundness of the money supply going forward. ✕

---

*Stacy Reinke manages the electronic banking program at COCC, Inc., a firm specializing in outsourced information technology and support.*

---

## Short Takes

- *Electronic payment transactions topped check payments for the first time in 2003, according to a report released by the Federal Reserve in December. Electronic payments swelled to 44.5 billion transactions in 2003, a 31 percent increase from 2000, while the number of checks paid totaled 36.7 billion, a 14 percent decline from 2000. Debit-card transactions grew at an annual rate of 23.5 percent during the three-year period, reaching 15.6 billion transactions in 2003.*
- *More than 20 million credit and debit cards were issued in the United States during the third quarter of 2004, bringing the total to 870 million. Visa added 9 million new cards, giving it 452.5 million cards and a 52 percent share of the card market. MasterCard added more than 8 million cards and holds a 37.5 percent market share. Discover and American Express accounted for 6.5 percent and 4 percent of the card market, respectively.*

TransAct is published four times per year as a free service to members.  
©2005 America's Community Bankers®  
Send order requests to: Customer Service, ACB,  
900 19th St., N.W., Ste. 400, Washington, DC 20006  
or send a fax to (202) 659-1134.

Publisher: Debra Cope  
Editor: James Swann  
Contributors: Rob Drozdowski, Janice Queen  
For information on ACB Card Services  
contact Janice Queen at (202) 857-5092.