VIEWPOINT

December 2017

8 Mill and Main Place, Suite 150 | Maynard, MA 01754
www.mercatoradvisorygroup.com |phone 1-781-419-1700 |email: info@mercatoradvisorygroup.com

2018 Outlook: U.S. Debit Cards and Alternative Products

The adventure of planning for an uncertain future: Let the fun begin!

In early 2017, debit card transaction volume took an abrupt and steep decline. In 2018, issuers face a new normal with lower and unpredictable growth, compressed margins, and ever-changing fraud challenges. Meanwhile, push payments will make debit cards important as the gateway to consumers' and small businesses' transaction accounts. Person-to-person (P2P) payment strategies will become more important to financial institutions as they seek to fend off competition from successful fintech products. Planning faster and real-time payment solutions will reach fever pitch as financial institutions look for profitable use cases and providers aim to make real-time payments ubiquitous.

by Sarah Grotta,
Director, Debit and Alternative Products Advisory Service

Debit Card Reaches Maturity

Debit cards have settled into middle age. They are still vital for everyday purchases and ATM transactions and a new role is emerging for debit as the account identifier for network push payments, but debit card's existence is more routine. The wild years of double-digit high growth appear to be in the rearview mirror as primary activities turn to trimming the fat, controlling costs, and fending off fraud. In 2018, issuers will contemplate the following for their debit portfolios:

- **EMV Reissuance**. Issuers who were early to market with EMV chip debit cards are now planning reissuance. Mercator Advisory Group will be looking for signs of dual (contact and contactless) chip cards to provide greater convenience at the point of sale. In the past, banks, credit unions, and other debit card issuing financial institutions (FIs) have cited the high cost of dual-capable chips and the dearth of acceptance locations as reasons to avoid contactless cards. Although the cost of contactless-capable cards has fallen, they are still more expensive than contact-only cards. Cutting costs is a key motivator, as noted next.

- **Falling Revenue.** Interchange revenue for debit cards continues to shrink both for institutions regulated by the Durbin Amendment and those that are exempt. Large merchants are demanding cuts in interchange, and merchants of all sizes are increasingly optimizing the way they route payment transactions to select the least-cost option. This often results in less revenue for issuers.

- **Ever-Changing Fraud Concerns**. Losses due to counterfeit card fraud have been kept in check by the EMV chip with its built-in security and by improved, evolving fraud solutions, particularly those focused on curtailing losses in card-not-present (CNP) channels like e-commerce. Sophisticated data analysis is applied to provide actionable risk ratings. Those savings are offset by the increased cost of updating and improving fraud detection systems and support, though. As fraudsters' attack techniques continually change, the tools to thwart the criminals' activities need attention and updating, with an eye to fine-tuning the user experience (e.g., to avoid inconveniencing the cardholder by declining valid transactions). Effort will be spent in 2018 to find the right balance between mitigating fraud and creating a great cardholder experience.

Push Payments

In 2018, attention will be focused on the use and adoption of push payments. Push payments are transactions in which the payer or owner of a funding account authorizes funds to be pushed from the account and credited to another person's account or to a business's account. (The converse, pull payments, are used by payees who are initiating a debit of the account of a payer and pulling the funds into their own account.) Push payments are generally less prone to fraud as that account owners making the payment must identify themselves for each transaction and authorize the movement of funds.

8 Mill and Main Place, Suite 150
Maynard, MA 01754
info@mercatoradvisorygroup.com

The global card networks are promoting push payments in the form of Mastercard Send and Visa Direct branded transactions. Venmo (PayPal) and Zelle (Early Warning) are person-to-person (P2P) payment solutions that push funds from one account to another through the use of a debit card number, often within seconds, and certainly within an hour. Push payment networks are also considered for other use cases. Examples are business-to-consumer (B2C) disbursements such as insurance payouts, government-to-consumer payments such as disaster relief funds, or business-to-business (B2B) activity including deposits of daily merchant settlements by the merchant processor. All of these use case examples rely on the presence of debit cards and offer interchange income to the financial institution that receives the funds. It's the debit card number that identifies the routing destination of the funds and the account to which the payment should be posted.

P2P Payments

Financial institutions' rush to align resources in order to integrate Zelle with their mobile and online banking capabilities has begun. The largest bank owners of Zelle's parent company Early Warning are mostly integrating directly to the Zelle platform. Other banks and credit unions are queuing up to have industry processors help with the integration project as well as manage settlement, reconciliation, and ongoing activities. The Zelle P2P product is a rarity in the payments and banking industry. Not since the launch of the global card brands have we seen so much agreement among bankers about aligning with a single product brand, a common user interface, and pricing to both institutions and end users. And not since then have we seen FIs agree to pay for a product that results in the enrichment of product owners that are not only financial institutions in their own right but also competitors. The dedication of resources is also notable given that Zelle and P2P transactions are in the early stages of adoption and the full impact of a common product brand across all financial institutions yet unknown and also given that the support costs are greater than for existing P2P solutions.

Financial institutions that have not yet decided to join Zelle will likely be mulling over their options in 2018 and determining whether the common Zelle brand is necessary and represents their best choice for P2P services. They will be seeking answers to such questions as:

- How can the investment be justified if the prevailing fee for P2P transactions is zero? Many financial institutions will simply consider this a cost of doing business and a feature of consumer checking accounts, necessary to stem the ebbing tide of financial transactions as cardholders turn to financial technology (fintech) companies' transaction solutions.

- Will the Zelle brand generate new revenue by attracting new customers, or will any well-promoted P2P solution with a good user experience and broad acceptance work? Currently, in light of limited promotion in the marketplace and technical issues with the stand-alone Zelle app still to be worked out, some financial institutions are not joining the rush to implement and will continue to support their existing P2P products. They are watching for signs of growth in the number of new Zelle customers beyond the conversion of existing P2P users before jumping into the fray.

- Will consumers value Zelle more than other non-FI based products such as those offered by cherished brands such as PayPal, Apple, and Facebook? The likely outcome will be that consumers will adopt multiple apps. Which apps they use will be depend more on context (whether the individual is using a banking app or is on Facebook) and the app selected by the individual or business who is sending funds. The consequence is likely to be that P2P transactions will be fragmented across a variety of providers. This will be confusing for consumers and not ideal for financial institutions, who want to be at the center of all their customers' financial transactions. Interoperability will be key to ubiquity. Zelle represents a big step forward for FI-offered P2P, but third-party solutions will need to be integrated at some point.

- Will Zelle truly become the conduit not just for P2P transactions but also for business-to-consumer and government-to-consumer deposits? Discussion has been enthusiastic about P2P's ability to further eliminate paper checks from these channels, but the market will take time to develop. P2P promises cost savings for businesses and government entities eliminating checks, but they will need to adapt their internal systems for accounting and reconcilement to incorporate the new payment form factor.

- Will a viable consumer-to-business (C2B) market evolve, adding a new twist to the bill-pay market? Informal C2B transactions where consumers are paying their landscaper, a nanny, or other micro business will continue to grow. Offering bill-payment services through P2P for larger enterprises will struggle to find a niche. Bank-based bill-payment services and the more popular and growing biller-direct solutions are serving the market well with mature solutions, integrated fraud management, and back-end management tools for the business, which will keep them from being replaced by a P2P-style solution.

- In the long term, will Zelle become a successful mobile payment application as necessary to a financial institution as payment cards, ACH, and wire transfer are today? As consumers acclimate to P2P services and incorporate P2P into their payment habits, they will want to be able to use that same trusted app for more activities. In the long term, those providers that can offer an excellent user experience with other transaction and payment capabilities will drive the consolidation of transactions and payment apps.

These are big decisions requiring thinking about the role that P2P might play in the future. It will be understandable if some FIs take time in 2018 to assess how all this is unfolding.

Faster and Real-Time Payments

More resources will be dedicated in 2018 to understand the future of faster payments (like Zelle) and real-time payments being developed in the United States under the auspices of the Federal Reserve. Those activities will be closely watched as the Federal Reserve executes its chosen role of bringing players in the payments industry together to collaborate on solutions and to act as a catalyst to advance the national interest in real-time payments. The Fed will also help to corral resources to solve thorny problems regarding the security of real-time transactions, building a settlement system, and establishing guidelines and a regulatory framework. The industry will also watch with interest the launch of The Clearing House's real-time solution developed with Vocalink.

The target year for faster payments to be fully functional and ubiquitous, as established by the Fed's Faster Payments Task Force, is 2020. This date is aspirational though, since implementing a brand new payment type, not just a new form factor, is not easy. It's not just faster transaction speed that makes this new payment type unique. It is also its continual availability and enhanced transaction data availability as well as the dramatic ways that it changes current fraud detection practices, balancing, and reconcilement activities.

While the United States charges forward to develop real-time platforms, other payment choices are appearing that also offer faster transactions and greater availability but do not fully embrace all the attributes defined by the Fed for real-time payments. Among these are same-day ACH, Mastercard Send and Visa Direct push payments, Early Warning solutions (including P2P), and others. These products and platforms will in some cases steal market share from real-time payments because they are fast enough and convenient enough. Same-day ACH (SDA) transactions are now available for both credits and debits as of September 2017. Over 10 million SDA transactions representing greater than $9 billion in value were conducted in October alone. Push payments are showing up in more and more applications for P2P and B2C channels with the promise of more cross-border opportunities on the horizon. In some instances, these precursors to real-time payments will have the effect of creating the market by making transactions that settle within hours or minutes or seconds the norm, thus paving the way for real-time transactions.

Financial institutions will contemplate how to justify a new payments option when the monetization of the investment is unclear and current revenue streams will be disrupted by it. An example includes the request-for-payment option, which operates as a direct transaction link from a merchant to a consumer and cuts out many of the other participants in the payment value chain, including the networks that facilitate interchange revenue to issuers.

Financial institutions are hearing that adopting RTP (real-time payments) is necessary for competitive parity both domestically and internationally. The argument is made that with more activities happening in real time, consumers and businesses have an expectation that money should move just as quickly. Unfortunately, those attributes are not particularly helpful to build the business case. 2018 will be about shoring up the justifications for real-time payments, and each institution will decide which channel or specific market it serves is most likely to benefit from these services and which available or proposed solution best fits its needs. The 25 owner banks of The Clearing House, which represent the majority of the addressable transaction market, will be the earliest adopters of RTP. Other large institutions that are not owners of The Clearing House but have corporate business clients that demand the benefits of real-time payments will feel competitive pressure. The remaining financial institutions will take the time to find the business model that makes participation in a real-time platform viable for them. This may be found in the long-term cost benefits of a newer and more efficient system, or a federal mandate is still a possibility.

Conclusions: Laying the Foundation for Continued Relevancy

2018 will likely be looked upon as a year in which decisions and plans were created that set in motion changes to the underpinnings of the payment systems in the United States, defining the direction of payments in the U.S. for years to come. Adoption of new solutions and capabilities may not follow for some time, but the planning and investments will be made in the near term. Financial institutions will determine how they must evolve and modernize payments to take advantage of newly available technologies and remain competitive as non-bank organizations of all types incorporate payments or payment management tools as part of their products and services. This includes fintech organizations as well as large retailers, e-commerce providers, social media, and others. Decisions made now will determine how well financial institutions will prevent the commoditization of their role in payments. As payments continue to shift and change form, debit along with existing and developing alternative payment types will be thought of less as a product and more as part of a continuum of transaction solutions, the infrastructure that executes money movement through the user's preferred form factor, which may be a card, phone, computer, or wearable or connected device and with the desired attributes of speed, availability, and cost.

For more information about this report, please contact:

Sarah Grotta, Director, Debit and Alternative Products Advisory Service
sgrotta@mercatoradvisorygroup.com
1-781-419-1704

Mercator Advisory Group is the leading independent research and advisory services firm exclusively focused on the payments and banking industries. We deliver a unique blend of services designed to help clients uncover the most lucrative opportunities to maximize revenue growth and contain costs.

Advisory Services. Unparalleled independent and objective analysis in research documents and advice provided by our Credit, Debit and Alternative Products, Prepaid, Customer Interaction, Commercial and Enterprise Payments, Emerging Technologies, and Global Payments practices.

Primary Data. *CustomerMonitor Survey Series* presents eight annual Insight Summary Reports based on primary data from Mercator Advisory Group's bi-annual surveys of 3,000 U.S. adult consumers to determine their behavior, use, preferences, and adoption of current and emerging payment methods and banking channels to help our clients identify and evaluate business opportunities and make critical business decisions. The Small Business service presents three annual reports based on Mercator's annual *Small Business Payments and Banking Survey.*

Consulting Services. Services enabling clients to gain actionable insights, implement more effective strategies, and accelerate go-to-market plans. Offerings include tailored project-based expertise, customized primary research, go-to-market collateral, market sizing, competitive intelligence, and payments industry training.

PaymentsJournal.com. The industry's only free, analyst-driven, online payments and banking news information portal delivering focused content, expert insights, and timely news.

For additional copies of this report or any questions, contact Mercator Advisory Group at 781-419-1700.