FORESIGHT

September 2017

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THE EVOLUTION OF DEBIT CARDS

Debit card issuers are having to fend off increasing competition from new and also traditional payment forms.

Credit cards, decoupled debit, real-time payments, and even Amazon are all trying to take a bite out of debit's enviable market share.

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Introduction

Debit is a successful payment product, there is no doubt about it. Debit still rules in the United States, with nearly 70 billion debit transactions conducted annually by consumers and small businesses. That's more transactions than are conducted with credit cards, ACH, checks, or person-to-person (P2P) payment solutions.[i] Success often garners imitators and copy cats, and debit is no exception. The discussion in this Mercator Advisory Group ForeSight report considers some of the products that function similar to debit cards, meaning that they rely on available checking accounts to fund purchases that are have or will have potential impact on the marketplace that debit currently rules. This include a review of:

- Target REDcard® and other decoupled debit programs
- Credit Card transactors and Commerce Bank's Toggle® solution
- Amazon Prime Reload
- Request for payment solutions

How financial institution (FI) issuers might react to these encroachments on traditional debit territory will vary based upon each institution's payment portfolio characteristics, individual strategy, and product profitability.

Here Now

Decoupled Debit

Decoupled debit, probably the most poorly named payment product, is another form of a debit card. Instead of transactions flowing through the card networks, the amount of a purchase is sent in batch through the Automated Clearing House (ACH) system. Since there isn't the equivalent of a transaction authorization step for ACH, the merchant that sends a decoupled debit transaction through the ACH system will not know with certainty whether the underlying checking account is still open and sufficiently funded. One might think the level of risk would be more than a merchant would want to undertake. With the advent of better risk management tools, however, as well as the savings in processing costs that merchants enjoy by not utilizing the debit networks, some merchants are finding that decoupled debit is financially beneficial. Merchants who deploy decoupled debit typically use the transaction processing savings or a portion to fund a transaction-based rewards program to attract new customers and foster loyalty. Such programs are particularly successful with stores like gas stations, convenience markets, quick serve restaurants, coffee shops, and grocery stores that consumers regularly frequent and where they can build up meaningful rewards quickly. More in-depth background on decoupled debit and how it functions can be found in Mercator Advisory Group's report on the topic, Decoupled Debit: The Start of Mainstream Adoption?, released in March 2017.

The merchant categories where decoupled debit is finding success are those where debit is a favored payment type. So decoupled debit is therefore deflecting transactions away from traditional debit cards. This means that debit issuers are missing out on the interchange income from the transaction now conducted with a decoupled debit card and that debit card transactions are replaced with ACH transactions that cost the issuer to process. Decoupled debit is not exhibiting rapid growth, but it is growing steadily and becoming more than just a payment curiosity.

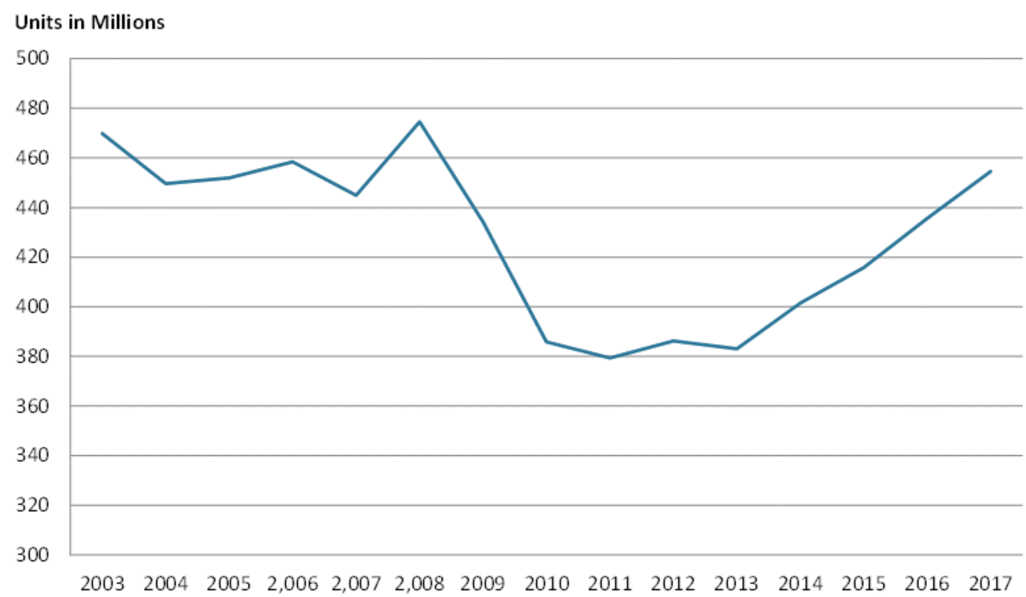
The largest decoupled debit program is Target's REDcard® in debit form, which has been in market for more than five years (Target also has a REDcard credit card). The card's popularity is driven by a 5% discount on purchases made with the card in-store or online and the fact that the card qualifies users for free shipping. The decoupled debit card can also be used to receive up to $40 in cash at the point of sale, mimicking the cash-back feature of bank-issued debit cards. In 2016, 12.8% of Target's sales revenue was conducted on the debit REDcard; this is $8.9 billion in transaction value (slightly more than the revenue from credit REDcard). This share is up from 12.1% in 2013. Financial reporting discloses that REDcard shoppers at Target (both debit and credit) spend 50% more on average than other Target shoppers.[ii]

For those merchants who don't have the wherewithal to build their own infrastructure for a decoupled debit solution like Target, software and platform solutions are becoming more widely available. First Data, FIS, and ZipLine all offer solutions. ZipLine, formerly National Payment Card Association, is the product owner and processor for decoupled debit programs that are aimed at convenience and petroleum merchants. Some of the larger brands that use ZipLine's product are Cumberland Farms, Speedway, CITGO, and CircleK. The longest-tenured merchant program with ZipLine is the Cumberland Farms program, which in less than four years has processed nearly $2 billion in purchases through its decoupled product and returned $75 million in rewards back to customers who pay using the product.[iii] These are transactions that otherwise would typically have been conducted by consumers using debit cards issued by their banks or credit unions.

Credit Card Transactors

Since the start of recovery from the recession of 2008–2009, credit card ownership has risen in dramatic fashion and has now achieved prerecession levels as illustrated in Figure 1. Continued growth is expected in the near term.

Figure 1: Number of Credit Card Accounts Outstanding in the U.S., 2003–2017

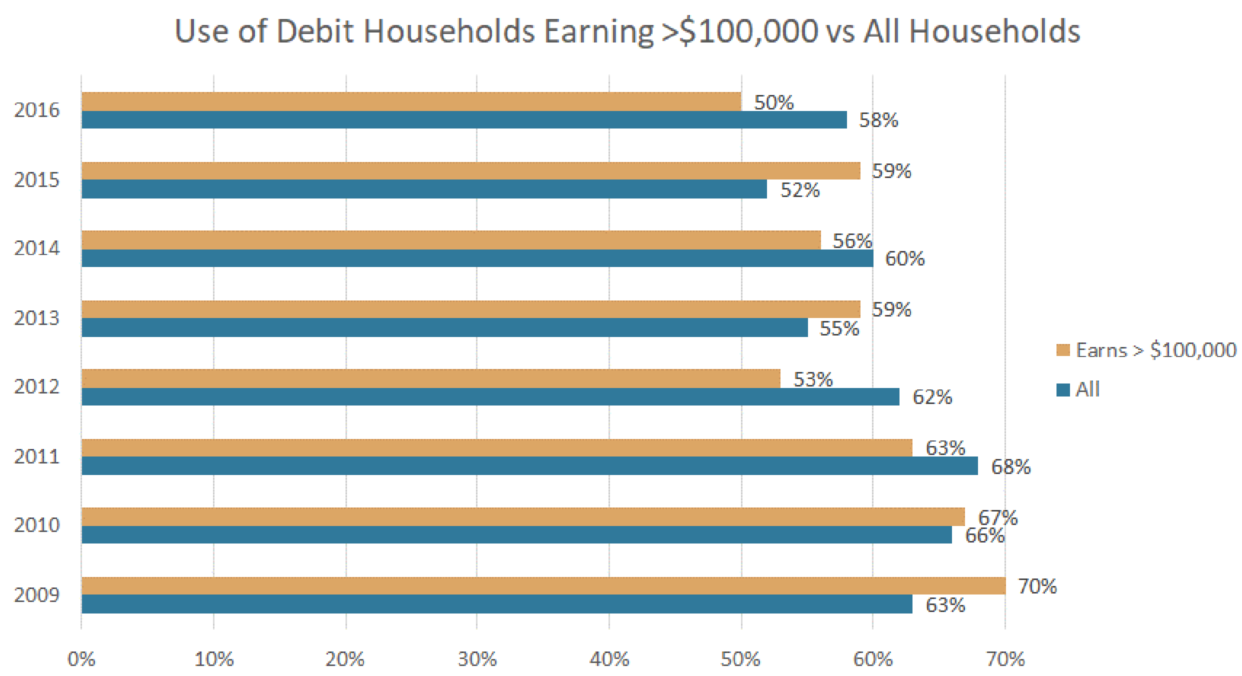


Source: Federal Reserve Bank of New York

During the same post-recession timeframe, there has been a shift away from debit cards by consumers with higher income levels. As primary data from Mercator Advisory Group's CustomerMonitor Survey Series reveals in Figure 2, when U.S. adults are asked each year which payment methods they use, fewer and fewer survey respondents earning $100,000 or more annually say that they are currently using debit cards.

These former debit card users are in part enticed to move their transactions to credit cards because of better rewards. Many are then paying off their balance every month with available funds and using their credit card as an informal delayed debit card. The American Bankers Association in its quarterly Credit Card Market Monitor reports that more than 27% of credit card accounts are used by transactors—that is, individuals who pay their balances completely each month.[iv]

Figure 2: Affluent Shift Away from Debit Card Use



Source: Mercator Advisory Group CustomerMonitor Survey Series, Payments, 2009–2016, Question 29

Here Now, Impact Not Realized…Yet

Toggle®

Commerce Bank has developed a unique service for consumers who use a combination of debit and credit card transactions on a regular basis. The free service called Toggle allows credit card cardholders to select which transactions made with their credit card will be paid off at the end of the payment cycle and which transactions will be allowed to revolve and incur interest charges. The cardholder can select individual transactions, transactions that are of a certain dollar value, or transactions in specified merchant categories to be paid with funds from the cardholder's checking account. Funds will move automatically from the checking account to the credit card account. Any transactions not specified to be paid from the checking account will revolve. Customers also have the option to move a transaction initially identified to be paid off with checking account funds back to their credit balance. This provides cardholders the opportunity to earn credit card rewards, have a single card for both credit and debit card-like transactions, and be able to vary their decisions about whether to pay with available funds or finance purchases. The bank, having over $10 billion in assets, gets to enjoy the unregulated interchange that accompanies transactions made with a credit card.

This type of consumer-friendly product, which makes it easy for consumers to manage their credit card transactions like a debit card has not realized a material level of market transactions, but it does represent one of several products offering an alternative to traditional debit cards.

Amazon Prime Reload

In June 2017, Amazon began to offer a product called Amazon Prime Reload. This product offers customers of the Amazon Prime subscription service a non-credit-card payment device with a discount of 2% off for any Amazon purchase. To set up the Prime Reload product, Amazon asks cardholders to provide both their debit card and their checking account number, as well as the card issuers' routing and transit numbers. Amazon will then use one of these two payment rails to fund Amazon gift cards that the Prime member can then use to make purchases on the Amazon site. The gift cards are funded not based on a specific purchase amount but preloaded with a requested balance amount from checking account funds. Each additional load activates a new virtual gift card. The Amazon check-out service will use new gift cards to fund purchases after an old gift card is depleted. The requirement to provide both the checking account details and debit card information is interesting since the source of funding is the same. The Frequently Asked Questions section of the Amazon website suggests it's a matter of speed:

> **Frequently Asked Questions:**
> Q: Why do I need to provide my checking account and my debit card?
> A: To fulfill your reload faster, we will sometimes route orders through your debit card instead of your bank account.
>
> *–Amazon website*

Perhaps Amazon will use a debit transaction initially as a means of validating that the checking account exists and is open. Subsequent load transactions could then be completed through less-expensive ACH transactions. It may also be used as a back-up transaction if ACH loads are returned unfunded. Amazon is assuming some level of funding risk since it makes load transactions available within minutes, yet Amazon will not know for a day or more if funds from an ACH transaction have been collected and are good. Should consumers make purchases right away with newly funded gift cards, there isn't time for funds to be collected before purchases need to be shipped to meet the two-day shipping benefit given to Prime members.

This product is targeted to customers who do not want to use one of the available credit options or simply can't qualify. This melds well with Amazon's outreach to lower-income individuals, who are debit card loyalists and who frequently shop at a mainstay Amazon competitor, Walmart. (Note that Amazon recently lowered its prime membership cost by 50% for those customers who could prove they are receiving benefits such as Temporary Assistance for Needy Families (TANF), Supplemental Nutrition Assistance Program (SNAP), and Women, Infants, and Children Nutrition Program (WIC). [v])

The Prime Reload product was introduced just recently, so its impact on the debit market is unknown, but given Amazon's reach and current growth strength, it has potential for a large impact on debit by channeling volume away from debit to ACH. If Amazon allows Prime Reload customers to use the payment device in Amazon's recently acquired Whole Foods stores, not just to order from Whole Foods online, this adds more opportunities to spend with Prime Reload in a location where debit is often used.

An Eye on What's Next

Request for Payment

As real-time payments (RTP) begin to take hold in the United States, one of the products that is expected to ride the faster payments rails is a "request for payment" solution. This is a card payment alternative whereby a merchant will text, email, or otherwise notify a customer in near real time the total amount of a purchase the customer has just made. Once the customer agrees to pay the amount presented, funds will move directly from the person's checking account into the merchant's settlement account within seconds. The product could manifest itself as a (faster) decoupled debit solution if the customer downloads an app for each merchant that offers the service. Or it could be offered as a payment app though a financial institution, usable at multiple merchants. That financial institution would need to have the means of distribution to ensure that a compelling number of merchants could accept the request for payment option.

This type of product has already been rolled out in other countries where real-time payments are readily available. Vocalink, the organization that developed the technology for The Clearinghouse's real-time payments platform in the U.S., has created a request for payment solution called Zapp that is up and running in the United Kingdom. Currently it is being used for mobile and online transactions with banks such as Barclays (the Pingit product) and HSBC, with a promise that physical store locations will also be available.

Listed on the following page are some of the benefits of this product that suggest that it may gain traction.

Benefits of the "request for payment" solutions:

- Real-time payments transactions are often less costly than a typical card-processed transaction in countries where real-time payments are available.
- Funds are available immediately to the merchant, which helps with cash flow management.
- This is a credit-only transaction in which the consumer approves the transaction and pushes the credit to the merchant, which reduces fraud.
- Financial benefits to the merchant afford the merchant the opportunity to fund customer rewards as has been done with decoupled debit programs, supporting customer acquisition and loyalty.

New payment types take time to catch on, so the rollout of a request for payment solution won't happen overnight. Customers will have to be open to paying with their phones, which has not caught on in the United States. There has to be a compelling number of merchant acceptance locations, and consumers will need a reason to use a new payment type given that they are comfortable with the methods available to them today. Financial institutions don't have an interchange incentive with this payment type, but they may want to consider it to hold on to customer payment transactions.

Conclusions

Debit is attracting more competitors hoping to seize some of its market share as the most frequently used payment type. Other payment providers envy debit cards' position as a critical part of consumers' everyday transactions. If they could convert those transactions to faster or less expensive non-card types of payments, so much the better.

Debit still rules, but the payment products discussed in this ForeSight report and others not yet identified are lining up to seize the throne. Debit issuers seeing the arrival of these new payment forms are concerned that they will become less influential in their customers' payment activities, have fewer revenue opportunities, and be relegated to the unenviable role of simply managing deposits and transaction traffic while others create payment options to engage consumers. While debit issuers and their service providers still have the majority of transaction volume, now is the time to plan for responses to the emerging new payment products. Issuers will need to determine if they want to aggressively fend off the competing payments with new products and services or if they will leave the business of payment transactions up to others and seek out other roles to play in consumers' financial lives.

Endnotes

[i] Federal Reserve Payments Study 2016
[ii] https://corporate.target.com/annual-reports/
[iii] http://www.csnews.com/industry-news-and-trends/technology/cumberland-farms-smartpay-program-hits-75m-savings
[iv] American Bankers Association, Credit Card Market Monitor, July 2017
[v] https://techcrunch.com/2017/06/06/amazon-launches-a-low-cost-version-of-prime-for-customers-on-government-assistance/

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