The End of Interchange?

Capital One's decoupled debit card could revolutionize the industry

By Tom Wright

According to payments industry consulting firm Mercator Advisory Group, last year consumers opted for paying by debit as frequently as by credit. And this year debit card transactions are predicted to surpass credit card sales by market share. In this type of growth market, there are many opportunities for creative incarnations of debit cards and associated rewards. Yet Capital One Financial Corporation has managed to leapfrog all of its competitors with what some observers are calling a major breakthrough in card issuing. Its decoupled debit card product relies on settlement through the automated clearing house (ACH) network and does not require cardholders to have a demand deposit account with Capital One.

Capital One's entry into debit cards appears to open up a new era in debit card competition. Unlike traditional debit cards in use today, Capital One's new product can be linked to any bank or credit union account and used for purchases and ATM withdrawals, just like the debit cards consumers get from financial institutions when they open checking accounts. There will be no fees associated with it, according to Capital One, unless the financial institution imposes its own fees. Right now, the card is only available to select Capital One credit card users, but it will be widely available next year, according to the company.

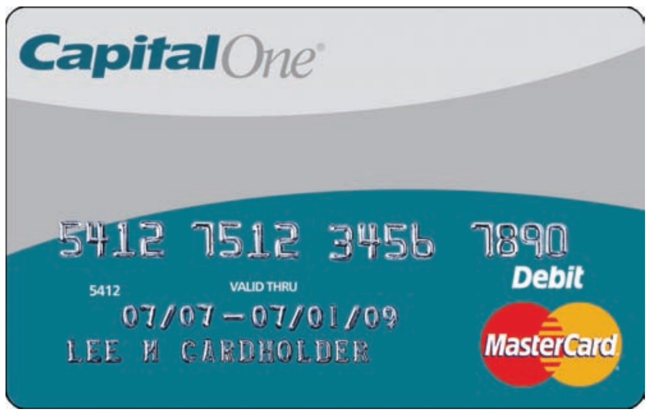
Not the First

Of course, Capital One is not the first company to roll out plastic cards tied to the ACH network. Debitman, now Tempo Payments, launched its card and network in 2000. And companies such as FEDChex and National Payment Card have closed loop ACH/loyalty cards that are targeted at larger retailers such as convenience stores, gas stations and supermarkets. What distinguishes Capital One's offering from other programs is its pairing with MasterCard: Capital One's card will be honored everywhere that MasterCard is accepted. Sheetz, a family-owned convenience store chain based in Altoona, Pa., is Capital One's first merchant partner to implement the new decoupled debit card.

After linking their current checking account to the Sheetz Debitz MasterCard, cardholders will earn rewards based on purchases made at Sheetz and anywhere else that MasterCard is accepted. Customers will earn bonus points on all purchases made at Sheetz. These rewards will be given in the form of Sheetz gift cards that can be used to make purchases in any Sheetz store.

Patty Hayward, senior analyst in the Debit Advisory Group at Mercator Advisory Group, says "the decoupled debit card will have a strong appeal for consumers who love rewards." But she adds that "this card will change the way that consumers think about debit cards and could possibly cause a lot of confusion in the marketplace. I think there will be a steep learning curve."

Consumers with a Capital One credit card will be able to pool their rewards from the two products, earning the same level of points, miles or cash back no matter which type of card they use.



More Rewarding

"There is a huge potential for co-branded decoupled debit cards," says Gwenn Bézard, research director at Aite Group. "The rewards value of the card is two to five times superior to the rewards you get with any other debit card." The Aite Group anticipates that competition on rewards will force major financial institutions to accelerate their shift to enterprise rewards to resist consumers' cherry-picking of the debit card product.

Paul Grill, a partner of First Annapolis Consulting in Linthicum, Md., agrees. "Capital One is a great marketer, and this product is going to put pressure on banks to offer much better debit card rewards." He also predicts that it will lead banks to consolidate their rewards programs to include their customers' complete relationships: loans, deposit products, credit/debit cards, etc. Citibank has a relationship rewards program dubbed ThankYou Points that delivers points for the depth of the Citibank relationship and the amount of debit card spending.

Merchants will have no technical problems with the transition, as MasterCard is a name they are familiar with and no new systems are required to accept the card. Most analysts agree that larger retailers that partner with Capital One on the co-branded card should enjoy enhanced loyalty and repeat transactions.

Bruce Cundiff, senior analyst with Javelin Strategy & Research of Pleasanton, Calif., says "overall, it's a brilliant strategy and should be a positive for participating merchants." But he expressed concerns that cardholders may be confused about the mechanics of the program, e.g., who to call in case of a fraudulent charge. "Plus, they may not like having to deal with reconciling both a bank statement and a Capital One statement," Cundiff says. If the card is stolen and fraudulently used, consumers will need to contact Capital One, not their financial institution.

Threat to Issuers

Debit card issuers, on the other hand, have very little to like about Capital One's foray into decoupled debit cards. Cundiff puts it bluntly: "This is hitting them squarely with a threat to interchange revenue and also a 'decoupling' of the entrenched relationship with their account holders that the debit card brought them. Consumers who want to earn merchant rewards can now do so without switching banks, and those consumers with affinity for debit cards now can use them without earning interchange for their particular bank."

"Incumbent deposit institutions will need to react to the risk of disintermediation as their business model, which is based on punitive fees and interchange income, comes under pressure," says Bézard.

Hayward highlights another expense: "Many cardholders will call their bank first when there is a problem with the card, and that is an expensive customer service issue of banks."

Financial institutions holding these accounts could charge fees for these debits to the account holder, but Hayward believes "this approach would cause a huge rift with their customers." They could try to prohibit these debits. In fact, ACH-blocked accounts are common, particularly for business accounts, but this is on shaky legal ground. Equally unstable is the idea of asking regulators to ban the practice on safety and soundness grounds, because the risk of insufficient funds is on Capital One, not the depository institution. Petitioning the card networks to ban these programs or adjust interchange fees to compensate the account-holding institution are options, but it appears that their odds of success would be slim, especially with MasterCard because it is Capital One's partner.

The bottom line is that any depository institution risks losing customers to another institution if it discriminates against these ACH transactions. Hayward contends that the best defense is a good offense: "They must counteract with better rewards programs and marketing campaigns."

Hope for Interchange?

Glenbrook Partners analyst Allen Weinberg says that "banks should be very worried about decoupled debit cards," but Tempo Payments may be riding up to save the day for financial institutions looking to protect their interchange and fee income. The company is pitching its Tempo Payment Platform, a hosted system of processing services from Tempo's debit network, to prospective issuers of decoupled debit cards. According to Anthony Ruebner, Tempo's vice president of Business Development, "Tempo Debit enables financial institutions to quickly establish and operate bank-independent debit payment processing through the Tempo Payment Network, or other leading payment networks, by leveraging the Tempo Payment Platform." An issuer could use Tempo software modules for application processing, account administration, customer service, ACH risk analysis, authorizations, settlement, nonsufficient-funds processing and reporting. Pricing is on a subscription basis and depends on the services and modules the financial institution uses. Ruebner is convinced that "decoupled is the future of the debit landscape."

Tempo may be upbeat about decoupled debit, but some in the industry feel that even with MasterCard's blessing and support, the new card is not great news for the payment networks.

"It is a bit of a negative for Visa and MasterCard. They can't be too excited about it—especially Visa," Cundiff says. "What is bad for Visa and MasterCard issuers is bad for Visa and MasterCard. This could also affect the competitive balance with the other networks, both American Express and Discover as well as the EFTs." Bézard agrees and predicts that "decoupled debit cards will expose Visa, MasterCard and the incumbent EFT networks to new competition from the likes of American Express and Discover in the debit arena."

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>
> –Allen Weinberg, analyst, Glenbrook Partners

Voting With Their Wallets

But some aren't sure that consumer uptake will enable decoupled debit to have a long-lasting impact on the card and banking industries. "This is an industry shaker, but consumers are fickle and it could be difficult for them to break out of the traditional debit card model," Hayward says. Cundiff also reserves his full endorsement: "Will consumers go through the extra steps to enroll in the program? Are merchant-oriented rewards enough to drive sufficient transaction volume (or even initial uptake) to make for a successful product? I think the immediate success of the product is suspect, but I suppose it depends on how Cap One is defining that success." ***TT***