

What's in Your Customer's

Capital One's decoupled debit card threatens to seize banks' interchange revenue and, ultimately, their customers' deposit account relationships

- BY LAURI GIESEN -

Just when community banks think the race for deposits and fee income couldn't get any tighter, credit card giant Capital One Financial Corp. launches a new "decoupled" debit card product that could steal the interchange thunder of community banks and other institutions.

Wallet?



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“Competitors are looking for new ways to raid the relationships community banks have with their customers, and this card has the potential to help them do just that,” says ICBA Director of Payments and Technology Policy Viveca Ware about Capital One’s new decoupled debit card offering.

“This will have a significant impact on the banking industry, but it is just one example of how the industry is evolving,” agrees Angela Wong, president of the credit card division for \$4.9 billion-asset First Interstate Bank in Billings, Mont. “This card will separate the debit card from the checking account relationship that we have known for many years.”

Traditionally, the bank-controlled demand deposit account (DDA) is tied directly to a debit card with funds deducted from the DDA to pay for goods purchased with a debit card. The bank holding the checking account then receives interchange revenue from the merchant each time a bank-issued card is used.

But the MasterCard-branded Capital One decoupled debit card changes all that. In this case, Capital One issues the card, but funds can be retained in an account with nearly any financial institution—commercial banks, thrifts, credit unions and brokerage accounts—in the country. Capital One then authorizes the card payments and receives

the funds to pay for the goods by making daily withdrawals from customers’ bank accounts via the ACH. Multiple daily transactions are aggregated into one ACH debit. Capital One then receives the interchange revenue associated with each transaction.

“This will definitely decrease the interchange revenue we receive from our debit card programs,” says Wong.

And that could make it harder for banks to offer many existing services. “It is the interchange revenue from debit card purchases that allows banks to offer consumers other valuable services, such as free checking or rewards programs,” says John Buhrmaster, president of \$270 million-asset 1st National Bank of Scotia, N.Y.

Beyond Interchange

A decline in interchange revenue is just one problem community bankers see with this card. A potentially bigger issue is how it will affect the relationship between the customer and the community bank holding the DDA relationship that Capital One is accessing.

“This could cause disintermediation between banks and their checking account customers,” says Linda Echard, president of ICBA

Capital One Card Features

Gwenn Bezar, an analyst with Boston research firm Aité Group, outlines the following key elements of Capital One’s debit card offering in a new report :

- The card carries MasterCard’s logo, guaranteeing universal acceptance anywhere MasterCard, Maestro and Cirrus cards are accepted, including, ATMs, point-of-sale terminals and the Internet. The card can be used for both signature and PIN transactions, although only signature transactions carry rewards.

- Major merchants are expected to sign on as marketing partners with Capital One.

- Consumers are expected to realize 40 cents of rewards for every \$100 worth of merchandise when the card is used at a retail location that is not a partner of Capital One.

- When the customer uses the card at a store owned by a merchant partner then the customer is expected to receive 80 cents worth of rewards for every \$100 worth of merchandise.

- Of course, Capital One plans to use the interchange from non-partners to help fund the rewards program.

- Capital One will issue the card, but funds can remain in an account with any bank nationally. Capital One will deduct on a daily basis the cost of goods purchased on the card from the bank accounts via the ACH.



Wallet?

Bancard. "It will definitely not help banks build relationships with their customers."

Capital One is expected to market its new debit card to its existing credit card customers. But once the card company has gotten a significant number of customers to apply for the debit card, it is expected to attempt to convince those customers to move their checking account relationships over to Capital One and potentially try to sell them other Capital One products as well.

"Capital One is likely to use this as a base [upon] which to sell additional products," says Kevin Bell, senior vice president and EFT product manager of ICBA Bancard.

This product carries logistic challenges as well. With traditional debit cards, banks have full access to information about the transaction, such as where and when it was made and what was purchased, to address inquiries. With the Capital One card, purchases are consolidated and withdrawals are made on a daily basis, so details of a \$50 purchase won't register if \$500 in charges were made in a given day.

If customers have a question about a purchase made on their card or if they have concerns about a specific debit from their accounts, who do they turn to? asks Echard.

"Will community banks want to tell their customers to call Capital One?" Not likely, she reasons, but there may be no other option.

Having the account held by a community bank, for example, while having Capital One authorize the transactions could create other customer service problems as well. "What if Capital One puts a \$1,000 limit on purchases on a card and a customer who has \$5,000 in her account wants to make a \$2,500 purchase? The customer will get turned down and then she'll be mad at her community bank even though it was Capital One that declined the transaction," says Ware.

There are lots of similar scenarios where

customers could have problems with debit purchases and blame their community bank.

Some transactions may not even clear the bank the same day, resulting in more opportunities for consumer confusion about available balances and the potential for customers to overdraw their accounts as a result.

"You are going to potentially have two debit cards with different issuing institutions tied to the same DDA account. There is bound to be confusion with daily spending limits and balances," says Bell. Not to mention the havoc this method of transaction processing will have on banks' authorization risk models.

This could also create problems for customers who use online banking applications to check their balances, says Bell. "Customers who want to see their financial records will have to go to two Web sites. When they go to their bank site, they will only see that there was an aggregate ACH debit. They'll have to go to the Capital One site to see what the transactions were." By contrast, customers who use their bank-issued debit cards will see all the debit transactions spelled out in detail along with all other banking transactions.

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- Kevin Bell, ICBA Bancard

Tip of the Iceberg

And more cards may arise that deviate from the traditional debit card model. "This is just the tip of the iceberg," says Wong. Other examples already include a card issued by Tempo Payments Inc., a third-party company. Although Tempo is not a financial services provider that could sell other financial products to consumers, its card product is a means for merchants to avoid fees.

With Tempo, retailers sign up to accept the card and then they debit customers' banks via the ACH. They pay a small flat fee to Tempo and the banks receive no revenue from the transactions. The good news for bankers is that only a few retailers nationally accept the card. But because the Capital One debit card has the MasterCard logo on it, it can

be accepted anywhere that takes MasterCard—giving it widespread acceptance.

And payments experts believe the Capital One card—which offers a lucrative rewards program for customers who use it—will appeal to consumers. “I think it will take a while for this card to take off, but I expect it will be quite successful within 5 to 10 years,” says Gwenn Bezard, a banking analyst for Boston-based Aité Group. “The rewards are significantly superior to mainstream debit cards in the market today.”

And Capital One may be just the first in line with this card as other monoline credit card companies are expected to follow suit.

Opportunities for Advancement

Rather than bemoan their fate, community banks could view the Capital One card and other similar offerings as an opportunity to revitalize their own card programs, experts say.

“Banks will want to look at the control features and benefits they have with their existing credit and debit card programs and determine how they can make them more appealing,” says Echard.

The first thing banks should do is make sure they’ve offered a debit card to all their qualifying customers. That could prevent some customers who were not offered the bank product from going to Capital One, Bell says.

But banks need to look at their rewards offerings as well. The reason the Capital One card is appealing is because its rewards are rich, and it allows consumers to combine points from credit and debit card purchases.

“Banks may want to look at repackaging their existing DDA products and how they reward customers. They don’t have to match exactly what Capital One is offering, but they have to make sure what they have is competitive in the market,” says Echard.

Indeed, banks will have to make sure that their rewards offerings aren’t so rich that their cards

become unprofitable. And while banks need to have competitive offerings, they won’t have to match or better the most lucrative offerings. “We have the advantage of service, and for customers who care about service, our card doesn’t have to have as rich of rewards as every card in the market. We just have to be competitive and promote our services,” says

Buhrmaster.

While many community banks already offer rewards for credit card use, few offer rewards on debit cards. Fewer still allow consumers to combine their debit card rewards with their credit card rewards—as Capital One does. That is one place for banks to start, Echard says.

Taking a cue from combining debit and credit card points, banks may look at the emerging idea of relationship rewards where banks give rewards points to consumers who engage in a variety of activities that the bank wants to promote—loan application, electronic bill payment services, etc.

“A program where customers get rewards across multiple products would be a good way for banks to fight off cards like this,” says consultant Bezard. And it would emphasize the idea of relationship banking, which is so important to community banks.

But just having an attractive card product is not enough if a bank’s customers don’t know how good it is. Many community banks today don’t promote their debit card offerings sufficiently.

“Community banks are often quite modest about some of their offerings,” says Echard. “Their customers may not realize that their bank’s card product is as good as any others out there. [Banks] need to get that message across and let their customers know what they have available.”

In the end, banks may be forced to respond to the Capital One challenge. “We have no choice but to compete,” says Wong. “Customers will go where there is a product that satisfies their needs.” **ib**

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