

Visa Check Card

II

A New Entrant In the Debit Race

Prepared by Dove Consulting

I

Preface

About Dove Consulting

Dove Consulting is an international management consulting firm that has been advising clients in the financial services industry since the early 1980's. The firm offers deep expertise and innovative solutions in the areas of payments, interactive financial services and distribution management in combination with a full range of large-scale and business transformation services. Dove also serves clients in the Consumer Goods, Beverage & Food and Consumer Broadband industries.

Dove Consulting has offices in Boston, Atlanta, Charlotte, Minneapolis, San Francisco, and London. For more information, please call 617-482-2100 or visit our web site at www.consultdove.com.

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Summary of Findings

1.1 Introduction

Dove Consulting undertook this Study, "Visa Check II: A New Entrant in the Debit Race" in November 1998. With the support of eight sponsors, our objectives for this work included:

1. To understand the economics and pricing of the Visa Check II product versus on-line and off-line debit product alternatives.
2. To understand and quantify the benefits / risks of Visa Check II versus existing on-line and off-line products from various constituent perspectives, including:
 - Issuers
 - Merchants
 - Regional Networks
3. To discuss the qualitative aspects of the findings from our research and to provide Dove Consulting ' point of view based on study findings and our experience in the debit industry over the past 18 years.

The research methodology employed is outlined in more detail later, however, we were fortunate to engage 22 participants in this work, each contributing both quantitative and qualitative perspectives. The comments and analyses presented are based on their input; our findings from this study are summarized in this Chapter under three headings:

- Key Product Findings
- Economics and Pricing
- Benefits and Risks of Visa Check II

The opinions of the participants expressed herein are not necessarily those of Dove Consulting or its management, but instead reported by Dove for the information of the reader.

1.2 Key Product Findings

The Visa Check II product (VCII) itself does not differ markedly in feature or functionality from the debit products presently offered in the market.

- A 'me too' product, VCII has substantially the same characteristics as the existing Visa Check / regional network combination products.
- Visa Check II has distinguished itself based on price and network access when compared to existing debit products.

Comparative Product Characteristics of Debit: Consumer Perspective

Product Characteristic	MasterMoney Off-line Debit	Visa Check Off-line Debit	Regional On-line Debit	VCII
Signs for a transaction	Yes	Yes	No	Yes
Enters a PIN for on-line transactions	No	No	Yes	Yes
Gets cash back at the point of sale	No	No	Yes	Yes
Uses the card at an ATM	Yes	Yes	Yes	Yes
On-line POS Brand	Maestro	Interlink	Regional	Visa
ATM Brand	Cirrus or Regional	Plus or Regional	Regional	Plus (unless regional brand differs from POS)
Can use the card abroad to make purchases	Yes, signature based	Yes, signature based	No, ATM use only	Yes, signature based
Has a large distribution network nationally	Yes	Yes	Yes, through sharing agreements	Yes

Figure 1.1

From the standpoint of price, VCII distinguishes itself from a combination Visa Check / Regional POS card only on the basis of on-line debit interchange. Today, VCII on-line debit interchange is approximately four times higher than regional network interchange.

Visa Check II Interchange Pricing

Transaction Type	Rate	Interchange at \$40 Purchase Size
Signature based – retail	1.25% + \$0.10	\$0.60
Signature based – supermarket	\$0.40	\$0.40
PIN based – retail	0.55% + \$0.10	\$0.32
PIN based – supermarket	\$0.25	\$0.25

Figure 1.2

With regard to network access, VCII precludes the presence of any competing POS mark on the card. Visa has no requirement that all cards issued by a financial institution display 'no competing mark'. This only applies to VCII.

The regional networks stipulate (in many cases) within their operating rules that every card must bear the POS mark of the network. As a result, a financial institution is unable to segment its cardholder base into VCII versus regionally marked cards. This key issue has fueled much discussion regarding the 'all or nothing' nature of the product.

1.3 Economics and Pricing

Issuers

Pre-tax profits for POS debit vary, with on-line debit lagging off-line debit and Visa Check II significantly. Visa Check II delivers \$0.24 in profit per active card per month more than traditional off-line debit with regional network on-line debit combination. This was true for study participants, who experience a higher total number of off-line transactions per active card than the industry in total. For the industry at large, this difference is much greater, with VCII generating \$1.52 per month more in pre-tax profit than off-line debit.

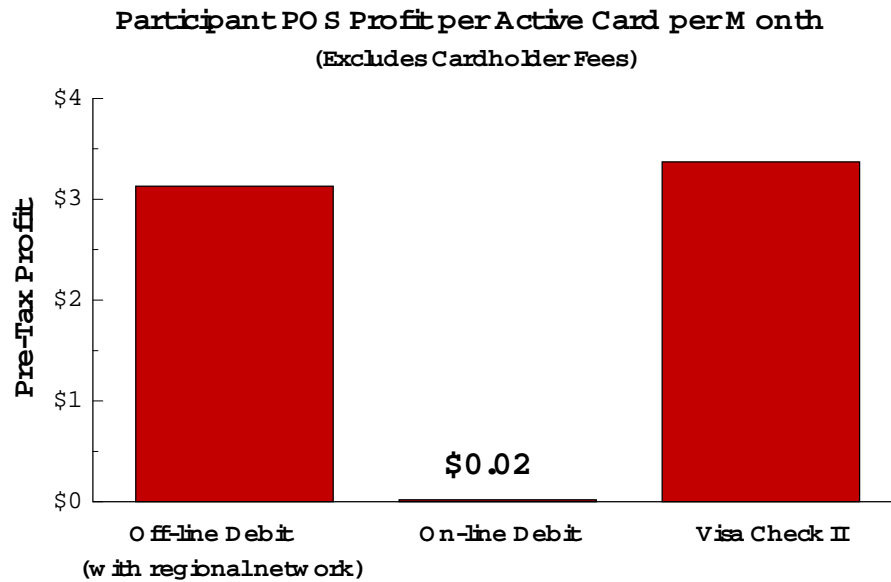


Figure 1.3

For participants, when including the impact of ATM interchange expense on card profitability, the profit difference between VCII and Visa Check / regional on-line programs closes to \$0.10 per active card per month. This is due to lower ATM interchange expense for regional networks (\$0.441 per cash withdrawal, for example) versus the national networks. Excluding cardholder fees, on-line debit cards cost issuers \$1.34 per month for ATM and POS. Compared to the industry at large, VCII delivers \$1.38 profit per active card per month more than traditional off-line debit.

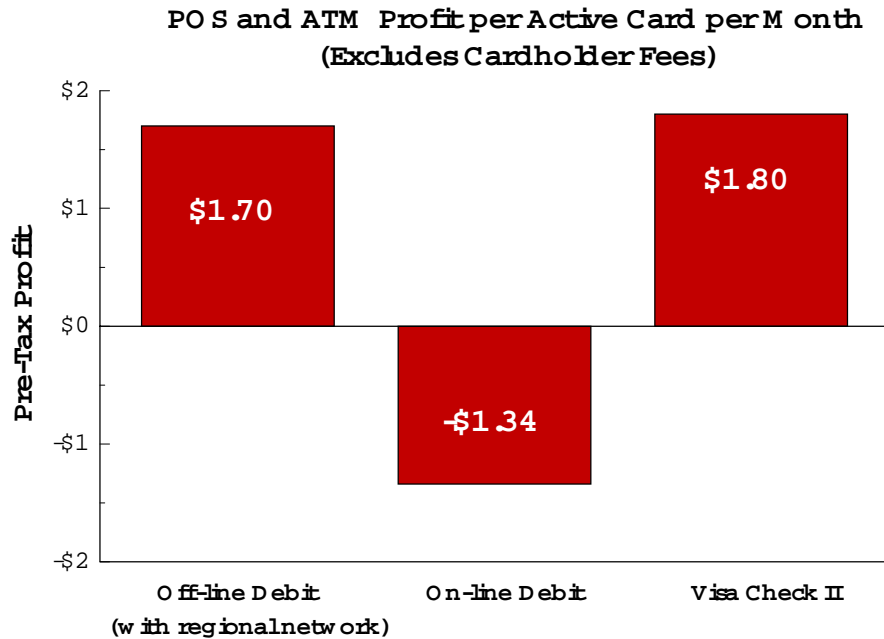


Figure 1.4

Merchants

A merchant's total transaction cost of payments is driven by two primary factors: processing fees and internal costs. In 1998, payment costs by merchants exceeded \$3 billion for on-line and off-line debit. If Visa Check II successfully displaced all regional network on-line debit transactions, merchant cost would grow approximately \$400 million per year, based on 1998 volumes – an increase of 13%.

Average Cost of Payments

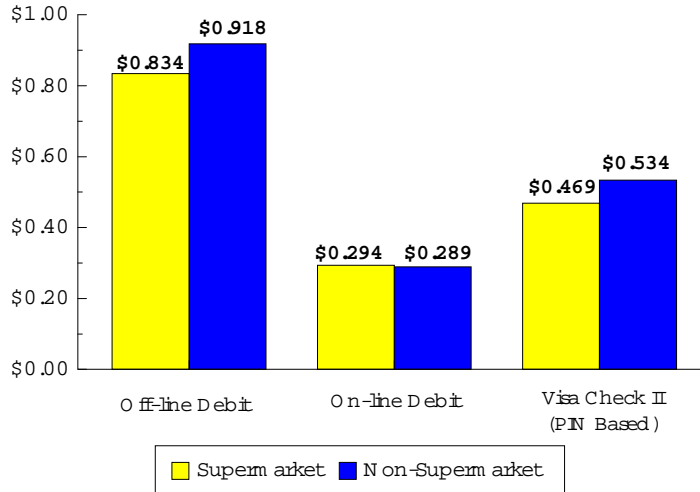


Figure 1.5

When comparing the cost of debit to other forms of payment accepted at merchant locations on a guaranteed payment basis, off-line debit is premium priced when compared to cash and check. For on-line debit, the price / value relationship is discounted, or less expensive on a guaranteed payment basis than cash or check to the merchant.

Debit Price/ Value Relationship Versus Cash and Check

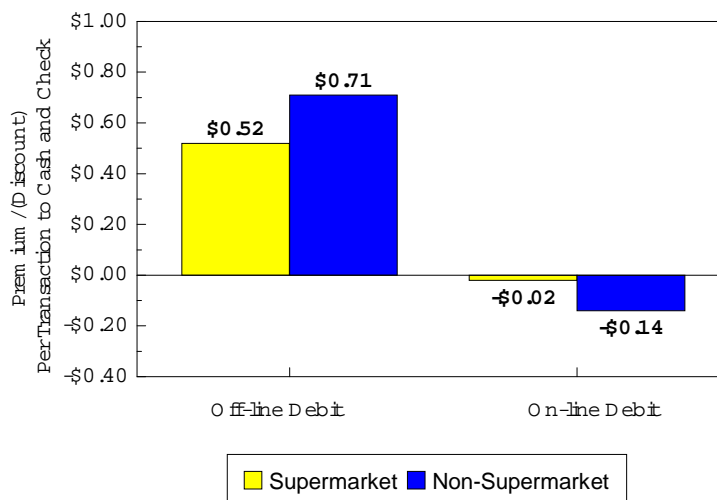


Figure 1.6

Regional Networks

1998 POS volume contributed \$677 million in value to the regional networks throughout the U.S. Volume grew at a rate of 24.8% in 1998, versus ATM growth of only 2.2%.¹ As a result, POS debit is an increasingly important part of regional networks' business proposition.

As regional networks consolidate, on-line debit programs have become more 'super regional' or even national. For example, with the consolidation of Star and Honor, the combined network will process more than 67 million on-line debit transactions per month – 45% of all on-line debit volume nationally. This demonstrates the market power these networks have relative to the POS product.

1.4 Benefits and Risks of Visa Check II

Issuers

In research conducted with participating issuers, we found they generally are hesitant to embrace the Visa Check II product for four primary reasons:

- Pending litigation has caused heightened concern in the issuer community.
- Commercial banking relationships with merchants are potentially strained with the issuance of the VCII product. Y2K priorities have not allowed financial institutions to look closely at the requirements of Visa Check II.
- The stake issuers have in the regional network infrastructure is too great to ignore.

Only one participating issuer has made a decision to move forward with launching the Visa Check II product, based on their desire to capture additional fee income plus operational efficiency opportunities. This particular bank is not an owner in a regional network.

Merchants

Merchants have increased their voice and presence in the payments industry, especially over the past two years. Visa Check II has further heightened the sensitivity of the merchant community with regard to the cost of payments.

- Merchants have demonstrated the ability to influence payment behavior at the point of sale. Some of the largest national

¹ Bank Network News 1999 EFT Data Book

merchants prompt consumers for on-line debit, for example, by asking the consumer to enter a PIN.

- Payments represent nearly \$3.1 billion in expense to merchants annually.

Regional Networks

The impact of debit volume erosion on the regional networks is great. If Visa Check II successfully migrates volume away from the regional networks, the result would most likely be increased pricing elsewhere in the product mix. We estimate that this increase could be as much as 15%.

Finally, given the business case put forth by Visa relative to interchange pricing for on-line debit, VCII has already been successful in creating a regional network response. Three of the large regional networks (Honor, Pulse, and MAC) have announced increases in issuer interchange fees in the last several months. So, without having to issue a single Visa Check II card, transactions issuers are already beginning to see higher revenues for PIN-based transactions.