

A WINDOW OF OPPORTUNITY FOR CREDIT CARD ISSUERS: TARGETING DEBIT SPENDERS

BY ERIC SCHNEIDER

It is going to be extremely hard for the U.S. banking community to swallow the \$22 billion medicine that has been served up in the form of the Durbin Amendment.¹ The small margin of profitability that was directly tied to debit card issuance has been wiped away with the stroke of a pen. However, this does not mean that debit cards will not play a continuing role in driving bank profitability. As cited in an earlier MasterCard Advisors white paper, the “Durbin Amendment does not make a debit card less important but less profitable.” Specifically, **we cannot overemphasize the role of debit card usage in driving the “liquidity premium,” or the value that is generated by lending funds at a higher rate than those funds earn checking account depositors.** Few banks would deny the deposit stickiness that POS debit usage drives, whether or not they explicitly measure this “liquidity premium.” Even fewer banks attribute this liquidity premium directly to their “debit card business”—let alone to the debit P&L that many have carved out while treating debit portfolio management as a profit center in its own right.

\$22B

IT IS ESTIMATED THAT OVER THE NEXT TWO YEARS, THE U.S. BANKING COMMUNITY WILL LOSE \$22 BILLION IN REVENUE DUE TO THE PASSAGE OF THE DURBIN AMENDMENT.

EXECUTIVE SUMMARY

The steep loss of interchange revenue presents tough decisions for debit card issuers. Most banks are going through a series of changes to reduce services and costs. Chase pulled the plug on debit rewards even before the Federal Reserve issued its final rules on interchange, and most other banks have followed suit. Meanwhile, marketing to stimulate debit card usage has evaporated virtually overnight. And MasterCard is working closely with banks to hone processes and bring new tools to bear as they renew efforts to battle fraud.

Increased Fees: An Unpopular Option

One option, of course, is to replace revenue by increasing fees, either directly in connection with debit card usage, more broadly across the checking account as a whole, or by increasing the likelihood of fees being triggered, for example through higher deposit requirements. MasterCard Advisors has conducted trade-off analysis among different U.S. consumer segments and, unsurprisingly, such revenue replacement strategies are repellent. Many debit cardholders say they will vote with their feet and take their checking account with them to another bank or switch back to cash or checks—an even worse payments scenario for banks than low-interchange debit. (See Figure 1 on the following page.)

FIGURE 1: CONSUMER REACTIONS TO DEBIT CARD FEES

If your bank imposed fees for using your debit card, what would you do?

	MASS MARKET	MASS AFFLUENT	AFFLUENT
Pay fees and continue using debit as usual	6%	5%	6%
Stop using debit; use cash/checks	58%	47%	39%
Stop using debit; use credit cards	25%	43%	51%
Stop using debit; use another product, such as a prepaid card	11%	5%	4%

Source: Advisors Payments Panel, Durbin Amendment Conjoint Study: Assessing the Impact on Consumer Preferences and Debit Issuer Strategies in the Post Durbin Era (April 2011).

The immediate and vitriolic media reaction to Bank of America’s announcement of new \$5-per-month debit card charges merely highlights how difficult it will be for debit issuers to replace lost interchange with higher—or especially new—fees.² As long as there are banks that remain committed to no-fee checking and can promote their benefits, imposing new or higher fees can only catalyze account migration from the likes of Bank of America to the credit unions and local banks that remain unaffected by the interchange components of the Durbin Amendment.

A NEW EMPHASIS ON A NOT-SO-NEW STRATEGY

Given the challenge in replacing lost interchange revenue with debit card fees, issuers ought to consider another strategy: identifying debit cardholders whose POS spend can be migrated to higher-revenue credit card products. Cross-selling credit cards against the DDA base is nothing new. For larger banks and erstwhile monoline credit card issuers, the retail bank file has always been an attractive prospect pool, with lower origination costs and proprietary information available to manage credit risk. What is changing is the impetus for taking a more aggressive stance and investing in more expensive channels, such as direct mail and outbound telemarketing, with offers that are specific to the “captive” population and do not read like a mail piece that could have been sent to anybody.

Even more telling, MasterCard Advisors notes that some retail banks that had once outsourced their credit card portfolio to the monolines in “agent bank” relationships are now exploring taking the business back in house, or have already done so. **These banks are turning to “in-sourcing” despite the risk and operational challenges evidenced during the Great Recession and despite the credit card industry’s own regulatory pressures.** Again, this trend does not suggest that banks are abandoning debit, but rather that they are looking to replace lost profitability in one payment business with increased—or renewed—income in another.

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But U.S. consumers are not going to take up a new credit card, let alone move debit card spending onto a credit card, just for the asking. In 2010 there were 2.8 billion credit card solicitations mailed in the United States, according to Synovate,³ equating to more than \$1.5 billion in marketing investment—and that's just direct mail. Yet an ever smaller proportion of people responds to such solicitations. Far from migrating usage from debit to credit, all evidence suggests that even before the Great Recession, debit spend volumes were on a long-term growth trajectory while credit card volumes were leveling off. Banks need to redirect some of that investment into a much more concerted approach to cross-selling credit cards.

Some banks are looking at product-driven solutions to facilitate increased spending on credit. In August, for example, Fifth Third Bank became the first issuer in the U.S. to launch a combined credit and debit card, called a "Duo Card."⁴ At POS the cardholder can choose whether the transaction draws on a line of credit or available checking account funds. Similarly, MasterCard offers a SmartFlex™ credit product that appeals to consumers' desire to better manage their spending and cash flow—in other words, appealing to core "debit-like" attitudes. In other cases, issuers are simply trying to be in the right place with their credit products at the right time. As the *Wall Street Journal* noted of Citi's rise back to the top of the direct mail mountain, the issuer "is hoping to capitalize on this change by convincing dissatisfied debit customers to use its credit cards instead."⁵

FOCUSING ON CUSTOMER BEHAVIORS

The key objective is to use consumers who have the propensity to move debit spending onto a credit card. People prefer debit cards for many reasons and hold varying opinions of credit cards; it is not all black and white. True, there are consumers who are so credit-averse that they would never consider taking up even the richest rewards card with a reascendant 0%, no-annual-fee offer. There are others, however, who may be predisposed to make the move if given a gentle nudge. MasterCard Advisors believes that the across-the-market "downgrade" in the debit card value proposition may have created the ideal moment for just that nudge.

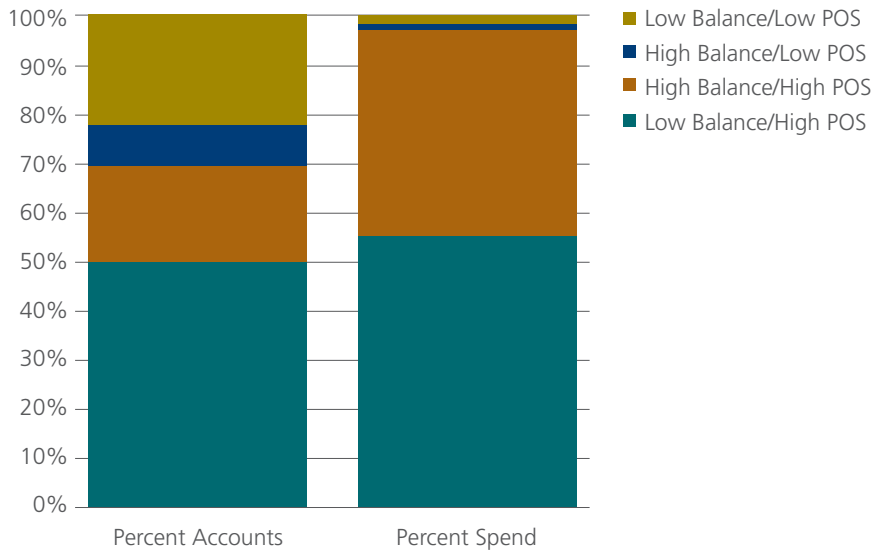
But how can you know, let alone target, someone's hidden predispositions? In our opinion, for the purposes of cross-selling a credit card product on a scale level, you cannot. Rather, issuers need to look at the altogether knowable *behaviors* that betray consumers' *attitudes*.

MasterCard Advisors works with banks to study debit card usage behaviors within the context of the broader checking account. In simplest terms, the level of POS usage (both signature and PIN) relative to the average deposit balance testifies as to how attuned a customer is to using plastic for payments. The average balance and/or presence of an automatic or recurring deposit can also indicate the customer's level of engagement with the bank (i.e., primary or secondary account) and help to predict the customer's total value (i.e., high average balance = good, low average balance = bad).

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Debit cardholders tend to either use their cards at POS a lot—or not at all. As shown below, Advisors estimates that 96% of spend occurs on the 71% of total accounts averaging more than five POS transactions per month. (Interestingly, this clustering of spend is not confined to those accounts with high balances. In fact, as shown in Figure 2 below, Advisors has found that more than half of that spend is generated by accounts with relatively low average balances of under \$1,500.)

FIGURE 2: CONCENTRATION OF DEBIT SPEND



Source: MasterCard Advisors Analysis, September 2011

In other words, the distribution of debit spend is such that issuers can easily segment those who are already conditioned to use cards at POS.

By cross-referencing on-us checking account behaviors with off-us credit card behaviors available via the credit bureaus, the bank can further refine its segmentation strategies for the purposes of migrating debit spending onto a credit product. At a high level, customers with many open trade lines and/or a high overall line are by definition more credit-friendly, whether they are heavy users (i.e., have high levels of revolving interest) or are controlled users (i.e., tend to be transactors). Consumers with low open lines may be credit-averse or simply at a stage in their lives where they do not have a need for credit. Or credit may not like them: Upwards of 50% of a retail bank’s customer base may be deemed unworthy of an unsecured credit card, depending on the bank’s risk appetite.

Taking the on-us checking and off-us credit behaviors together, we see that there are four target populations for a debit-to-credit migration. (See Figure 3 on the following page.)

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FIGURE 3: ON-US CHECKING/DEBIT VS. OFF-US CREDIT BEHAVIORAL SEGMENTATION

		ON-US CHECKING / DEBIT BEHAVIOR			
		Low Balance / Low POS Spend	High Balance / Low POS Spend	Low Balance / High POS Spend	High Balance / High POS Spend
Off-Us Credit Behavior	High	Disengaged / likely high risk	High-Value Credit Enthusiasts	Disengaged / potential risk	High-Value Blenders
	Low	Disengaged / low value	Paper payment diehards	Low-Value Debit Loyalists	High-Value Debit Loyalists

High-Value Debit Loyalists

We can infer that this population loves their debit cards. A large proportion of the outgoing payments from their checking accounts are at POS via a debit card, and these are high relative to apparent take-up and use of other issuers’ credit cards. We can also deduce from their high average deposit balances that these customers have a high potential value, and we can corroborate their creditworthiness from their credit scores. The barrier to penetrating this segment with a credit card offer may appear high, but the fact that these customers are already demonstrating credit card-like transaction (if not borrowing) behaviors in general suggests there is opportunity to switch their payments. The bank will need to address underlying customer attitudes that cause High-Value Debit Loyalists to use debit over credit out of preference rather than necessity.

MasterCard is also helping issuers alert their cardholders and help them keep their finances in check through its proprietary inControl technology.

One key strategy will be to emphasize terms and benefits that give the cardholder a sense of control over finances and assuage concerns over hidden, disproportionate or sudden fees. These fears are real and have been conditioned by “ugly issuer” actions over the years, including repricing and changes in terms rammed through by banks in the weeks preceding implementation of the CARD Act in 2010. Ironically, issuers have the opportunity to switch debit spenders to credit by embracing and pointing to the underlying control they have been forced to implement in response to regulation. For example, this summer Citi relaunched its Simplicity product with an emphasis on the “peace of mind” that comes with knowing there is no risk of incurring the once-feared “penalty” rate hikes on existing balances based on hair-trigger defaults, which are prohibited under the terms of new card regulations. **MasterCard is also helping issuers alert their cardholders and help them keep their finances in check through its proprietary inControl technology.**

Low-Value Debit Loyalists

We can infer that this population depends on their debit cards for making payments. A large proportion of the outgoing payments from their checking accounts are at POS via a debit card, and these are high relative to apparent take-up and use of other issuers’ credit cards. However, we can also deduce from their low average deposit balance that these customers’ current value may be limited. This may be due to low income levels, which may again be correlated to their off-us credit behaviors. Or it may be due to the customers’ life stage (i.e., students), in which case the bank may take a longer-term view of

potential (although credit card regulations impose certain obstacles to lending to students). Much of the value, however, may lie in the transactions themselves. Even if the deposit balance is low and there is no immediate prospect for revolving income, the issuer has the opportunity to earn more revenue from a transactor when he or she transacts on a credit, rather than a debit, card. As with their High-Value cousins, Low-Value Debit Loyalists will need convincing when it comes to control over finances and protection from fees they may be less able to afford.

High-Value Credit Enthusiasts

Though engaged and parking sizeable deposit balances with the bank, this population conducts most of its plastic payments on credit cards—with competing issuers. The challenge for the bank is not to persuade the customer to move what little debit card spending there is to a credit card, but to first penetrate that customer's wallet with the bank's credit card. This is akin to new credit card acquisition marketing, competing against the major mailers. However, unlike open-market acquisition, the bank has key advantages in the form of (a) multiple pre-existing lines of communication with the customer (i.e., online account management, statement, contact center, branch, regular direct mail blasts) and (b) possession of customer relationship data that may enable a more targeted and aggressive offer than the competition. And if nothing else, certain of these customers may be seduced by the “convenience factor”: the ease of “single sign-on” with one bank to conduct all of their payments. Indeed, this seduction can be sweetened and have the simultaneous effect of protecting deposit balances even as debit spend migrates to credit. Issuers could create incentives for deposit-building within the rewards structure or credit card pricing, in addition to aggressively marketing incentives for direct deposit setups and automatic bill payments, which create deposit stickiness. There is no escaping the fact that new credit card account acquisition will require significant investment, though banks can take some comfort in the fact that such cross-sell efforts are typically much less costly (and risky) than the “open-market” sort.

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High-Value Blenders

These customers are a cross between High-Value Credit Enthusiasts and High-Value Debit Loyalists; their penchant for plastic cuts across both credit and debit, qualifying them as high spenders on both fronts. The barrier to switching from debit to credit spend may be relatively low here, though a bank will likely need to overcome established compartmentalization of spend between plastic types (e.g., debit for everyday spend or low-ticket items, credit for discretionary and big-ticket items). However, there is a risk on the other side of the opportunity coin. The moment a bank “downgrades” the debit program and disrupts High-Value Blenders’ debit card spend, customers within this segment may be inclined to switch that spend to their top-of-wallet credit card. If that card is issued by a competitor, the bank needs to do everything it can to displace that credit card before causing disruption to the debit program. In this scenario, the richness of the debit spending data should allow the bank to better understand its customers’ needs and how to position offers that will compel the desired migration. It's just a question of beating the competition to the punch.

Trojan Horses

Finally, there is one additional population of which we cannot lose sight: those checking account customers who already have a credit card with the bank. It almost goes without saying that these customers should be the bank's best friends, and one of the major hurdles in migrating debit spend to a credit card has already been overcome: getting the bank's credit card into their hands. Surely, all that needs to be done is for the bank to remind the customer to "turn on" credit spending just as the debit program is "downgraded." Even here, however, issuers should not be so complacent. Many of those credit cards may have been originated when the checking account was opened at the branch and have remained dormant ever since, even while the customer piles up credit card balances on other issuers' cards. The convenience that comes from consolidating the payments relationship with one bank is not enough to overcome a possible lack of usage incentive emanating from an uninspiring value proposition, a line of credit that is not commensurate with the customer's ability to use the card to pay his or her bills, and/or neglect (i.e., lack of usage stimulation marketing).

As with the High-Value Blenders, the bank stands to lose debit spending to a competing issuer's credit card when the latter card sits in pole position within the wallet. The bank needs to ensure that its own credit card offering—including rewards, pricing, line assignment, servicing, and so forth—is not just compelling, but more compelling than the competing credit card the customer is already using. In other words, there is a need for an "upgrade" to the bank's credit card value proposition just as (or, if at all possible, before) the "downgrade" to the debit offering goes into effect. In MasterCard Advisors' experience, this is especially true among the smaller and regional banks that have outsourced their credit card business and are considering unraveling their agent bank relationships. For too long the credit cards offered in the name of these smaller banks have understandably been passed over by consumers despite their broader banking relationship. Few of these cards are striking in their innovation, pricing, or rewards—and fewer still, for good reason, stand apart from the own-branded cards marketed by the agent banks themselves.

Of course, it's not all as easy as it may appear. MasterCard Advisors recognizes that there are nuances in the segmentation, that no two portfolios are alike, and that there is no singular "playbook." Our work with U.S. issuers is highly customized and attuned to the different advantages and challenges they bring to the table. Nevertheless, we find that the same range of strategies needs to be considered by banks, depending on the high-level behavioral segments introduced above. (See Figure 4 on the following page.)

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FIGURE 4: STRATEGIES FOR CREDIT CARD OFFERING

	HIGH-VALUE DEBIT LOYALISTS	LOW-VALUE DEBIT LOYALISTS	HIGH-VALUE CREDIT ENTHUSIASTS	HIGH-VALUE BLENDERS	TROJAN HORSES
Marketing emphasis on overall banking relationship/trust/convenience			✓	✓	✓
Implement and emphasize “control” features incl. tools (e.g., purchase controls and alerts)	✓	✓			
Targeted messaging and offers based on debit spend and behavioral analysis	✓	✓	✓	✓	✓
Emphasize incremental benefits ties to credit relative to debit (e.g., rewards, float, dispute rights, insurance, concierge, etc.)	✓	✓		✓	✓
Product value proposition enhancement	✓		✓	✓	✓
Ensure competitive line assignment policies in place			✓	✓	✓
Ongoing usage stimulation and incentives	✓	✓	✓	✓	✓

Behavioral segmentation, even at the highest level, can play a key role in finding and then focusing communications on those cardholders who are most likely to switch spend to a compelling credit product. Taking this a step further, issuers can hone their approach by analyzing a customer’s current debit spend, for example to target accounts that are already exhibiting credit card-like spending behaviors. MasterCard Advisors has developed targeting models for this very purpose, discriminating between debit and credit card usage behaviors based on a detailed assessment of spend patterns across hundreds of merchant types.

FIGURE 5: DEBIT AND CREDIT SPEND CATEGORIES



Source: MasterCard Advisors Analysis

As one might expect, key variables in this model relate to discretionary (e.g., general merchandise stores and airlines) relative to non-discretionary or “everyday” spending in categories such as eating places and drug stores, as shown in Figure 5 above. However, MasterCard Advisors has found that there are other, more subtle “tip-offs” that can be identified, including understanding a cardholder’s usage of cards for e-commerce and bill payments.

Targeting customers who have the propensity to nudge their spend from debit to credit cards is, of course, only half the battle. Using available on-us and off-us data, issuers also need to target cardholders based on their potential to generate other income, for example through interest on revolving balances, annual fees, or take-up of fee-based enhancement services. On its face, the interchange differential between credit and debit may seem convincingly attractive to an issuer. But this positive differential will be offset by the cost of funding credit card balances, loan losses, and rewards. Indeed, the “net interchange” equation will be most challenging when a debit spender becomes a credit card transactor with low-interest revenue and high reward costs. Issuers will have to finely tune their models to solicit the right prospects relative to the product construct.

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CONCLUSION

Those banks directly affected by the Durbin Amendment have little choice but to cut costs and dilute the value of their debit card offering to their customers. However, while closing the door to running debit card portfolios as profit centers in their own right, the legislation has opened a window of opportunity for issuers to nudge spend from debit to credit cards. Certain issuers have already started down this path, no doubt impelled by an interchange differential of over 150 basis points, or \$1.50 for every \$100 transaction. MasterCard Advisors agrees that the opportunity seems compelling. For instance, if issuers could migrate as much as 10% to 15% of the spend to credit from debit—just among the high-balance/high-POS population as defined above—they would recapture upwards of \$1 billion in interchange revenue over the next two years.

Issuers who take a broad-brush approach to this opportunity, however, run the risk of making a bad situation worse. They risk wasting money on marketing offers with low take-up. They could push customers to other banks with more compelling debit or credit card products. They almost certainly would pile on value-destroying rewards gamers. In general, a bank that takes a one-size-fits-all approach risks throwing the precious liquidity premium “baby” out with the interchange “bathwater.” Banks must start with a deep understanding of their existing retail customer base and then target only that subset of the population that exhibits both the propensity to migrate their spend and the potential to be more profitable than if they had been left alone. These prospects then need to be compelled, through a combination of education, communication, and outright financial incentive, to get over whatever barriers may have previously prevented them from favoring credit. Nobody said it would be easy. But as the cards industry has shown when faced with challenges to its business model in the past, it’s worth hunkering down and doing the hard work.

ENDNOTES

- 1 Estimated revenue loss over next two years, in MasterCard Advisors white paper, "Revenue Creation and Cost Recovery Post Durbin: The Path Forward for Retail Banking" by Ben Colvin et al.
- 2 "Banks Plan New Fees for Using Debit Cards" by Andrew R. Johnson, *Wall Street Journal*, September 30, 2011
- 3 Mail Monitor: Acquisition Report, 4th Quarter 2010
- 4 "Fifth Third Bank Introduces Duo Card: Fifth Third Is First U.S. Issuer to Offer Combined Credit and Debit Card," Fifth Third Bank, Press Release, August 24, 2011
- 5 "Debit or Credit? Citi Places Its Bet" by Suzanne Kapner, *Wall Street Journal*, September 20, 2011

AUTHOR

Eric Schneider

Group Head Cluster Lead
Consulting Services
eric_schneider@mastercard.com

CONTRIBUTING CONSULTANTS

Ben Colvin

Senior Vice President
Global Debit & Pre-Paid Knowledge Center
Ben_Colvin@mastercard.com

Amit Jain

Principal
Emerging Payments Strategy Knowledge Center
Amit_Jain@mastercard.com

Michael Angus

Senior Vice President
Emerging Payments Strategy Knowledge Center
Michael_Angus@mastercard.com

JP Gerard

Global Solutions Leader
Development Services
JP_Gerard@mastercard.com

Adam Granoff

Managing Consultant
Development Services
adam_granoff@mastercard.com

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