

CARD SCHEMES: BALANCED ON THE DOWNSIDE OF THE PRODUCT LIFECYCLE CURVE

The credit and debit card market is about to undergo radical change, believes GFG Group's General Manager South East Asia, Peter Goldfinch.

The two dominant card schemes, Visa and MasterCard, are faced with growing pressure to reinvent themselves – particularly in mature markets such as Australia and New Zealand. A radical view may be that this goes beyond just upgrading products and services: it requires a complete repositioning of their business.

Even a moderate view would acknowledge that two businesses brands promoting identical products and services, owned by the same shareholders (members), to the same market, is hardly efficient – especially when both are under threat by other market players, not to mention regulators. Such apparent inefficiency has not been a problem in markets where credit and debit card use is growing. But once a market matures, the pool of new cardholders shallows out...

“THE BANK DEBIT CARDS HAVE STOOD STILL SINCE INCEPTION AND NOT DEVELOPED TO SATISFY THE NEEDS OF A CHANGING COMMERCIAL WORLD.”

“REGULATORS, MERCHANTS AND CONSUMER GROUPS PERCEIVE INTERCHANGE AS A SOURCE OF PROFITS FOR BANKS, WHICH USE INTERCHANGE PROFITS TO FUND LOYALTY PROGRAMS.”

Using the Australian market as an example, the statistics are now beginning to support a condition of market maturity. Following growth through the 1990s of 9-10 percent, credit and charge card growth rates continue to track in the 5-6 percent range – although the year May 2002 to May 2003 saw a blip with the growth rate dropping to below 3 percent. An increase in the issuance of charge cards by the major banks in the last 12-18 months could be expected to compensate for the drop in scheme cards.

Debit card growth in Australia has settled down to 1.5 percent to 2.5 percent after mid-1990s growth rates of 9-10 percent. Not shown in these Australia Reserve Bank figures is the shift away from the schemes to American Express and Diners.

Visa and MasterCard – whose members are generally the same banks – are entering a new era in these markets. Growth can no longer be assumed and in fact is likely to decline in terms of transaction counts and retail sales volume. Therefore they will be forced to compete even more intensely against each other and the other brands for exactly the same shrinking base of potential clients. In markets such as Australia, bank credit card divisions, and the schemes, have targeted their own retail banks debit (ATM/EFTPOS) card transaction volumes for growth. Not exactly a rational strategy: a strategy of self cannibalisation, one might argue.

The original view was that debit cards satisfied the budget-spending sector – the fuel outlets, supermarkets, low-end restaurants, etc. Credit cards satisfied the need to purchase high value, one-off and perhaps unexpected purchase where a line of credit was needed. Debit cards replace cash and credit cards replace hire purchase, although obviously credit has always had a niche in the travel and entertainment sector.

Enter the regulators

But now regulators are entering the picture. Regulators see payments as an enabler of commerce. Regulators when reviewing payment mechanisms are looking for efficiency (low cost), accessibility (all can participate) and integrity (minimal risk).

From the Regulator perspective, credit cards as a payment instrument do not score well against any of these measures. They are not efficient (costly). Access is restricted, a concern also with bank debit cards. The schemes perceive a need to support charge backs, signature for authentication and “card not present” transactions – thus compromising the level of integrity and therefore introducing an element of settlement risk. Card schemes balance security against transaction volume. Only when fraud and delinquency costs threaten to reach an unsustainable level is substantive action taken.

The bank debit card schemes are not perfect either. The main deficiency is their limited acceptance (only “card present”). But in many situations there is no single organisation taking responsibility for the development and promotion of the network.

In some cases they operate within a loose arrangement of bi-laterals. There are industry bodies, but their effectiveness has to be questioned as the participants pursue their own commercial agendas.

The bank debit cards have stood still since inception and not developed to satisfy the needs of a changing commercial world.

Focus on interchange rates

Regulators looking to ignite change with both card types have targeted the method of setting interchange rates. As economists, they consider pricing as a way of changing behaviour and they tend to view interchange as collusive price fixing. The original intent of interchange was to recover costs. Regulators, merchants and consumer groups perceive interchange as a source of profits for banks, which use interchange profits to fund loyalty programs. These loyalty schemes reward transactors (those who pay off their outstanding balance each month), at the expense of revolvers (those who carry forward a balance and pay interest) and merchants.

Transactor spending best fits the debit card model as this sector is perceived to have the funds. But for the high value purchases apart from cheques, the credit card is the only option unless the purchaser wishes to handle large amounts of cash. Debit cards normally have a maximum daily amount restricting usage and the total daily spend value.

The Australian regulators have stimulated change through fixing interchange rates (reducing the rate so only certain costs are recovered), and allowing surcharging by merchants. This change justifies the economist’s theory that consumer behaviour is driven by price.

“THE AUSTRALIAN MARKET OVER THE NEXT 12 TO 18 MONTHS CAN BE EXPECTED TO REALIGN ITSELF THROUGH RADICAL SHIFTS IN POSITION BY KEY PARTICIPANTS.”

“SOME INDUSTRY OBSERVERS ARE PREDICTING THE LARGE BANKS WILL DOWN SCALE ACQUIRING AND DROP BACK TO ISSUING ONE SCHEME BRAND AND THEIR OWN DEBIT CARD.”

In summary what market changes can be expected:

- Banks will drop dual acquiring and either partner with banks acquiring the other brand or simply only accept their own cards.
- AGC (Acquiring Group Companies) type organisations could be formed on similar lines as is the case in Northern Asia, particularly to service the smaller merchants.
- Banks card products rationalise to a single scheme brand, plus American Express, Diners or another similar international card driven by the need to offer a differentiated range of products and retain costs.
- Smaller merchants may step back from accepting scheme cards, especially for lower value transactions and only accept bank debit – assuming their costs remain reasonable. If this occurs the Australian regulators should be satisfied, particularly with credit card usage declining to the benefit of debit. Potential dissatisfaction may come from the impact on smaller merchants. There is scope for the regulators to make additional changes if not fully satisfied.
- Removing the interest free period on credit cards and insist fees charged for “credit card present” transactions be aligned to those charged for debit. Removing cross subsidisation of transactors by the revolvers.
- The introduction of minimum security levels for “credit card present” transactions and move to a non-repudiation position at a level similar to proprietary debit.
- Insist Visa and MasterCard merge. Why have two brands in a domestic market if they are driving inefficiencies in the payment system as each focuses on fighting the other through brand promotion and not through payment system innovation, system efficiency or product differentiation? The price differential between the two schemes is not sufficient to drive cardholder or bank behaviour.
- An alternative approach to the above is to force banks to a single membership situation. This would deliver an advantage to both schemes as it will free them to compete more on their product and service offerings.

Scheme action

The marketer’s approach would be to look for ways for the two schemes to differentiate their products and services. The market will require cardholder choice. If banks drop back to issuing only one scheme card, then the race is on to see who maintains the greatest number of members. Under the existing arrangements a level of inter-operability between the two schemes is required to reduce members’ compliance costs. Differentiation is constrained by the need to contain these costs. This constraint will dissipate.

Scheme differentiation may come from each addressing payment system issues, developing new payment services for existing instruments and building new payment instruments for the virtual world. The schemes may once again take a pioneering role, becoming the regulators of the new payment channels: in effect finding a new purpose through their past.

As mentioned above, bank debit card services need developing. Not as is now by re-branding credit as debit, but as a completely new service targeting not necessarily new cardholder segments but a different sector of payments characterized by value, merchant type and acceptance channel – as well as supporting the existing Eftpos channel.

Consequences

If the schemes do not develop their markets through differentiation, regulators will and are taking control. Other payment brands will grow and new payment instruments will be introduced without their participation.

Banks will rationalise their card bases to reduce costs. In Australia large banks have the potential to reduce their operational costs considerably by rationalising the cards they issue. The banks high net worth cardholders can be sold a scheme plus Diners or Amex card, and the lower tier customers to a scheme and possibly Bank card. The banks would only have a minor reduction in their overall active card base with improved operating profits.

About Peter

Peter Goldfinch, GFG Group's General Manager South East Asia, is a respected analyst and commentator on global trends in payment technology.

One of the original founders and shareholders in GFG Group, Peter has a background of more than 23 years in the information technology industry, most of which has been involved with consulting and systems development for banking and finance customers in 25 countries.

He has particular expertise and experience in payment systems, including mobile payment systems. His career highlights include pioneering work on the first ATM and EFTPOS networks.

In the mid-1990s, he played a key role in the introduction of credit and debit cards into the Russian market, working with GFG's customer SBRF.

About GFG

GFG Group is a highly-specialised payment solutions company, providing its clients with products, advice, and systems integration and outsourcing services. Accredited by the World Bank, the company has established a global presence over the last decade – delivering leadership payment solutions to more than 50 customers in over 40 countries.

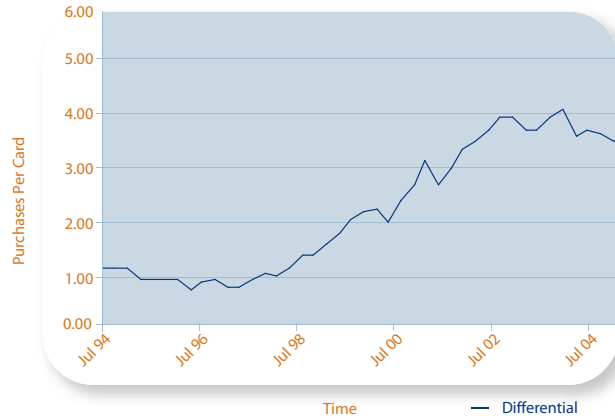
A key element in GFG Group's success is its focus on development and investment in five high-demand payment solution areas:

- Card Management Systems
- Mobile Payment Solutions
- Customer and Merchant Loyalty Systems
- Managed Services
- Payment Tools

The company's core research and development team is based in Auckland with consultants and technical staff located in the international offices to provide front line 24 x 7 support for customers in multiple geographies.

Australian Card Usage Trend

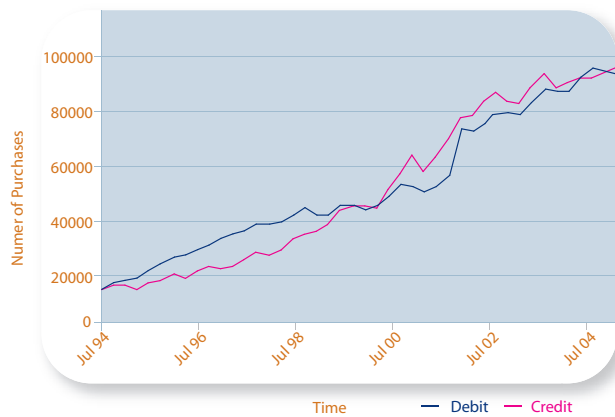
The following graph is an illustration of the trend in the usage differential between credit (including charge) cards and debit cards. In mid-May of 1997 a credit card was likely to be used one more time a month than a debit card. In 2002 that number grew to five and ignoring seasonal trends, the differential has remained at this level.



Source: Reserve Bank of Australia

This graph is only indicative as credit card numbers have grown faster than debit. But this is a sign of maturity. Transaction growth is not keeping up with card number growth. Transactions per card is therefore stabilising prior to an expected fall.

This next graph shows the growth in absolute transactions numbers (purchases), of the two card types.



Source: Reserve Bank of Australia

Demonstrated is that credit in late 1999 and early 2000 exceeded debit and maintained the advantage until recently. The trend is not decisive as credit could move ahead again. No doubt the Australian regulators will be watching to see if debit can start to dominate as it did in the mid to late-1990s.

There are interesting times ahead.