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Cards and the Price of Profitability

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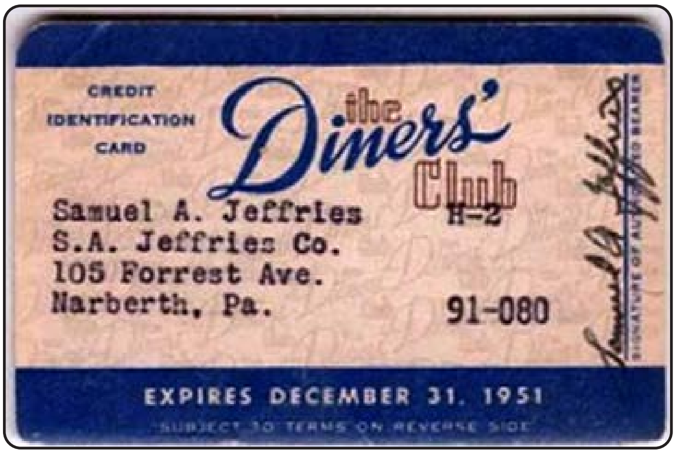
THE FIRST CARDS

Using bankcards is a part of everyday life in the 21st century. While some consumers use cards for the convenience of not carrying cash, others use credit cards to purchase items that they would prefer to pay over time rather than immediately. This convenience began more than 60 years ago and comes with a price that creates profits for card-issuers.



The first bankcard, called Charge-It, was introduced in 1946 by John Biggins of the Flatbush National Bank of Brooklyn in New York. The Charge-It worked like this: the cardholder would make a purchase at a merchant, the merchant would send a paper copy of the purchase to the bank and the bank would in turn settle with the merchant and debit the cardholders account. All purchases had to be local and the cardholder had to have an account with the bank.

In 1949, Frank McNamara – then owner and president of Hamilton Credit Corp. – was at a business dinner when he realized he had forgotten his wallet. To pay for the meal, his wife had to bring his wallet to him. The embarrassing situation led him to create the Diners Club card, which allowed members to pay restaurant bills monthly. The card itself was wallet-sized and made of cardboard. The purpose of the card was for convenient use at multiple locations with a middleman between companies and their customers. In 1951, 20,000 of these cards were in circulation, and a decade later, the cards were made of plastic.

A purple card was introduced in 1958 by American Express for travel and entertainment expenses. In 1966, the first nationwide credit card was introduced by BankAmericard (Bank of America), now known as Visa. Also in 1966, another group of card issuers joined to form the InterBank Card Association (ICA). Today, this group is known as MasterCard.

While these big names in the card issuing business were addressing basic payment needs by creating methods that moved away from cash and allowed consumers an easier and more convenient way to pay, another interesting business model was developing… card fees.

Card fees, of one type or another, became an integral part of the profit model for these financial institutions. Interest charges and card fees generate the highest income for the card issuing business.

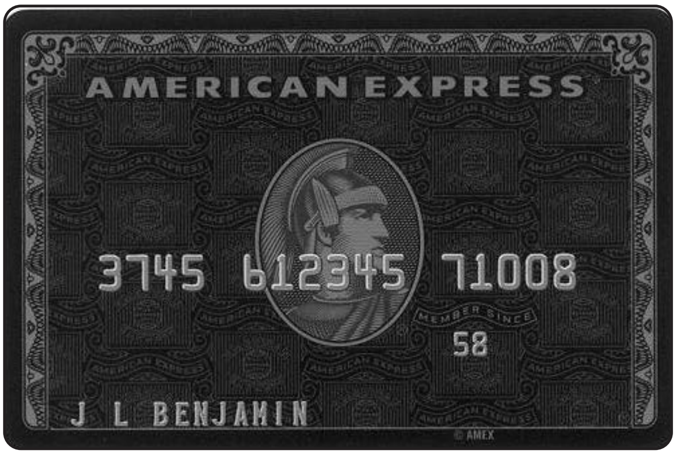
This document focuses on the following fees charged by card issuers:

- Plastic and membership fees
- Transaction fees
- Account fees
- Interchange - the unknown fee

PLASTIC AND MEMBERSHIP FEES

Plastic fees have evolved over the years and include a variety of charges for membership fees, renewal fees, replacement card fees and more. Plastic fees started out as a way to recover the cost of the plastic used to make the cards as well as the personalization of the plastic specific to the cardholder. Various product types such as Classic, Gold, Platinum and Corporate each were printed on their own card design, and, while the cost to produce the plastic was about the same, plastic fees became a payment for membership. Not only were the new card fees different across the various product types, but renewal fees were also applied. A cardholder would be charged a fee for the new card and then another fee for the renewal card.

As the quality of the plastic improved and cards were able to last longer, expiration dates were extended from a year to two and three years, and the annual fee was introduced. This was not a fee for a new piece of plastic but a fee on



the anniversary date of the account – a membership fee.

The American Express Black Card – also known as the Centurion Card – is an example of a status symbol card with a membership fee. This card, made of platinum, is offered by invitation only and annual spend must be around $250,000. The card carries an initiation fee of $5,000 and an annual fee of $2,500. It is estimated that there are between 30,000 and 100,000 of these cards issued worldwide.

Plastic fees can also be charged for a card that is lost, stolen or damaged. These fees are known as replacement card fees. In addition, fees can be charged for additional or supplementary cards on the account.

TRANSACTION FEES

Another fee revenue stream for card issuers is a charge based on card usage. This can include certain transaction types such as use at another bank's ATMs and even foreign exchange fees.

In the credit card world, probably the most commonly known fee is the cash advance fee. This charge can be a flat amount but is usually a percentage of the cash advance transaction. This fee is charged for using the credit card to obtain cash and is in addition to the actual cash advance transaction amount.

ATM fees are also common fees. Sometimes called service charging or surcharging, this is where the owner of the ATM charges the cardholder for usage of the ATM. These fees can be as high as $5 per transaction and are usually a flat amount. In almost all cases, the fee is charged to another bank's cardholder because the cardholder uses an ATM not managed by their own bank. Even when a cardholder uses an ATM managed by their own bank, there are fee structures that allow for a number of free transactions until, for example, the third transaction onward when a fee is then applied. While it is possible for a cardholder to be charged a fee for using their own bank's ATM, these fees are usually restricted to certain card product types. Using another bank's ATM can also trigger a fee by the issuer of the card called a non-bank or foreign ATM fee.

Acquiring banks (banks that deploy ATMs) around the world charge ATM fees and the amount varies from country to country. On April 1, 2009, the Reserve Bank of India issued a directive to all commercial banks in that country to stop charging ATM fees if the card was issued in India. ATM usage doubled overnight.

Yet another dimension to card usage fees is the structuring of fees based on where the card was used. Charges can be assessed for local, foreign or regional usage of the card. Some issuers charge a currency conversion or foreign transaction fee. This fee is usually a percentage of the transaction and is charged if a transaction is completed in a currency other than the currency of the card.

A fee that is not as common is a negative response or decline fee, which is charged for each declined authorization request.

ACCOUNT FEES

One of the most notorious account fees is the overdraft charge. This fee is applied when the account is overdrawn. The United States Federal Reserve estimates that between $25 billion and $38 billion are earned annually in overdraft fees. The United States Credit Card Act of 2009 seeks to regulate overdraft fees by requiring banks to have their customer opt-in for overdraft protection.

Delinquent credit card accounts are charged a past due fee which can vary for each month that there is no payment received. For example, the fees applied can be $35 if one month past due, $50 if two months past due, $60 for three months past due and so on.

Ironically, another fee is the dormant or inactive account fee. A fee is levied on the account after a specified period of not using the account. This fee is especially common with prepaid card programs and is meant to be a breakage fee of the remaining unused balances on prepaid cards.

Other account fees include service charges on the account itself. For example, a statement fee will be applied if the cardholder chooses to receive a paper statement rather than an online statement or a monthly maintenance fee if the account drops below a certain balance.

INTERCHANGE – THE UNKNOWN FEE

If a cardholder uses their card at a merchant or foreign ATM, they are playing their part in interchange – which is yet another facet of the entire card fee structure. Interchange is the fee charged for passing transaction information between the merchant, merchant bank, card association (Visa, MasterCard, American Express, etc.), and the issuer. The acquiring bank pays the issuing bank a fee that in theory is supposed to help the issuer recover costs associated with the management of the card balances and/or the floating of credit. The acquiring bank passes the cost of the interchange fee to the merchant.

Several factors determine the interchange rate. The rate can be a percentage of the transaction or a percentage

Whether driven from an outsourced or in-house environment, Euronet's debit, credit and prepaid card issuing products provide standard card fee functionality that includes:

- Plastic fees
- Account fees
- Transactions fees
- Service and Surcharging
- Management of fees at the BIN, Product and Card level
- Domestic, Regional and Internal fee management
- Fees based on authorization response
- Fees as a flat amount or a percentage of the transaction
- Period, monthly and annual fees
- Fee subscriptions
- Manual and custom fees

plus a flat amount. Factors affecting the interchange fee include the following:

- How the card number was entered; swiped at a terminal or manually keyed
- How long after the transaction was authorized that it was presented for settlement
- Was the transaction a CHIP or EMV transaction?
- Was the transaction signature or PIN based? Signature based transactions usually demand a higher interchange rate. This is why some merchant terminals will ask for a PIN without even giving the cardholder the opportunity to select signature. When a cardholder signs a receipt rather than enter their PIN, the acquiring bank pays as much as 75 cents on each $100, which is about half of what is paid on a PIN based transaction. This adds up considering the number of transactions completed daily.

Interchange rates can be as high as 2.5% of the transaction amount.

A charge that falls under the interchange rate fees umbrella is a card association assessment fee. This fee goes directly to the card association. For example, Visa's fee is .0925 cents and MasterCard's fee is .0950 cents per transaction.

SUMMARY

Determining the fee structure, tracking income and fee expenses are important measurements of any card-issuing program. Fees have come under significant scrutiny by both regulatory organizations and cardholders themselves.

Cardholders will often choose cards that are free of annual fees. Even in this instance, card-issuers have an approach to maintain card fee revenue with loyalty offerings. Cardholders that get something in return, such as airline miles or cash back, seem more likely to tolerate fees. At the end of the day, there is a thin line between profitability and customer retention. A well-planned, flexible fee structure is paramount to a successful issuing program.

A solution provider such as Euronet that offers robust card fee functionality and a means of tracking profitability from the fee structure selected by a financial institution is an important asset to a card-issuing program.

It is imperative that a financial institution's fee program has the flexibility to charge different fees, understand the revenue from those fees and tailor the individual cardholder's fee structure as needed to prevent attrition.

Card issuers must find new ways to secure the high profitability they have been experiencing from card fees. The ability to adapt to new challenges in regard to this revenue stream is certainly an important part of the price of profitability.

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