Community Banks and the Contactless Economy: New Opportunities for Non-Interest Income

American Bankers Association®

A customer ducks into a store to make a quick $7 purchase. The store is busy, and the customer is in a rush. When they reach for their wallet, they have several choices for payment: a chip credit card; a crisp, new $10 bill; and a contactless debit card that will allow them to tap and go. Which will they choose?

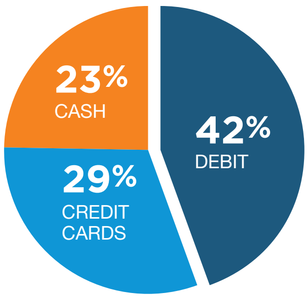
Does it matter? Yes, it does. When you add up the potential interchange revenue on the growing number of transactions that take place each year—especially on the small-dollar transactions still dominated by cash—it matters very much.

Research has long shown that merchants benefit from higher sales tickets and lower operational costs when a consumer chooses an electronic method of payment. Merchants pay to accept card transactions because the interchange investment pays off for them, but what's the advantage for community banks that issue the cards? It turns out that contactless can be win-win-win for banks, merchants, and consumers. If you are haven't begun issuing contactless cards or are looking to better understand the value of a tap and go card, read this white paper to learn more about the opportunity.

CONSUMER PAYMENTS BEHAVIOR IS EVOLVING, AND IT'S UP TO BANKS TO KEEP UP

Consider the data: in its *2020 Findings from the Diary of Consumer Payment Choice*, the Federal Reserve Bank of San Francisco reports that the most preferred payment instrument is debit (42 percent), far ahead of credit cards (29 percent), and cash (23 percent).[1] The study also found, however, that cash still accounts for about 47 percent of transactions under $10.

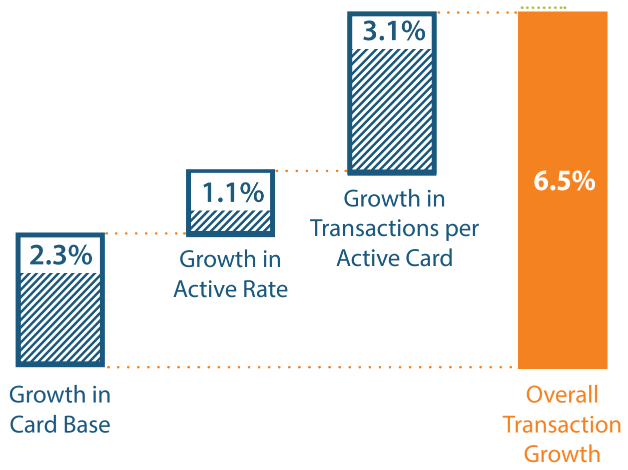
Preferred Consumer Payment Instrument*



**2020 Findings from the Diary of Consumer Payment Choice*, Federal Reserve Bank of San Francisco

Meanwhile, about 77.4 billion debit transactions were made in 2019, according to the 2020 Debit Issuer Study by PULSE, a Discover company.[2] That represents a 6.5 percent increase over the prior year and works out to an average 25.5 transactions per cardholder, per month, excluding ATM activity. This general trend has been in place for some time. Over the past five years, the study found, active cardholders have made on average one additional debit transaction each month.

Debit Card Transaction Growth Sources, 2019

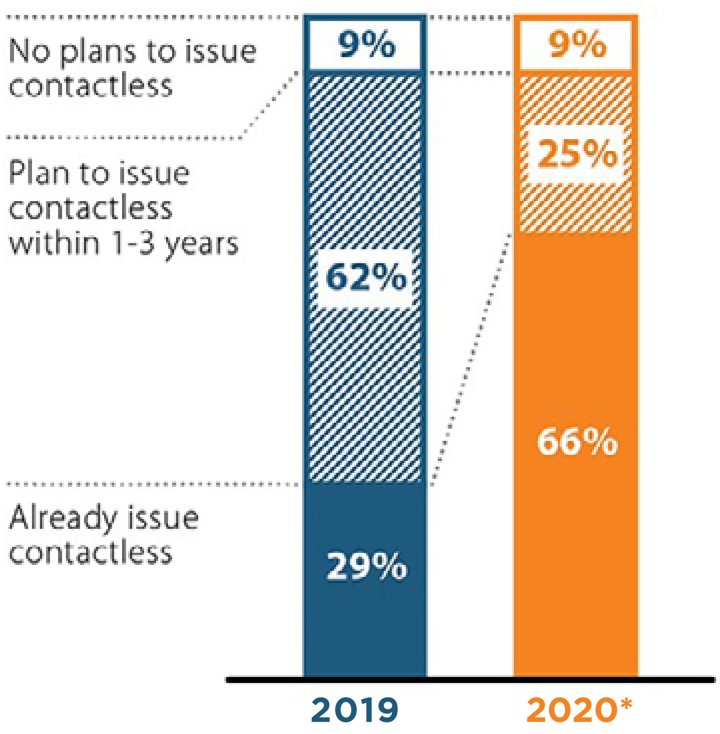


1 https://www.frbsf.org/cash/files/2020-findings-from-the-diary-of-consumer-payment-choice-july2020.pdf (accessed September 14, 2020)

2 https://www.pulsenetwork.com/content/dam/pulse/assets/2020%20Debit%20Issuer%20Study.pdf (accessed September 14, 2020)

Contactless debit cards are gaining particular momentum. At the end of 2019, 11 percent of debit cards were contactless-enabled, according to the PULSE debit study. The figure is projected to be a whopping 87 percent by the end of 2022, according to the study. This growth is driven in part by merchant adoption of contactless technology, but a more compelling driver has been consumer demand. Customers who have seen or experienced the speed and effortlessness of tap-and-go soon find it cumbersome to do anything else. Pandemic conditions have only added a new layer of urgency to the demand for speedy, no-touch transactions.

Contactless Issuance Plans, 2019-2020

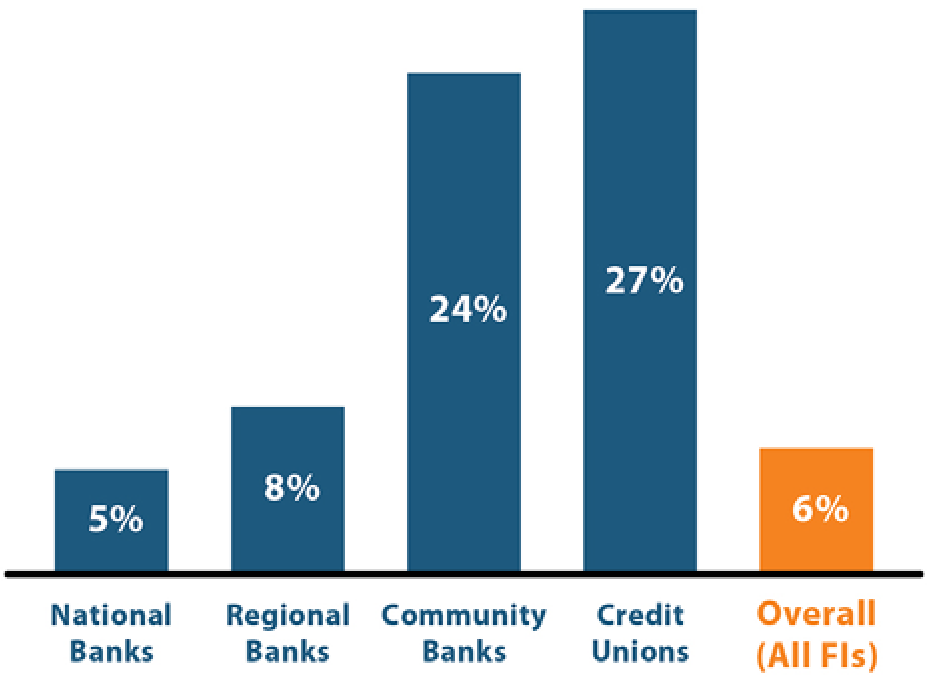


*2020 numbers are estimates based on conversations with issuers in the first quarter of 2020.

THE OPPORTUNITY FOR COMMUNITY BANKS

Against this backdrop of consumer habits and preferences, the income and relationship potential for community banks can't be ignored. The PULSE debit study found that issuers exempt from Regulation II limits on interchange income—banks with less than $10 billion in assets—earn debit interchange at an average rate of 40.3¢ per transaction. This rate is $1.48, on average for debit card transactions by business cardholders. On an aggregate basis, the study found, debit interchange generates about 25 percent of total non-interest income for exempt issuers. Some community banks reported as much as 32 percent of non-interest income coming from debit interchange.

Debit Interchange Revenue Contribution, 2019



Weighted averages by financial institution type

Even at such levels, notes American Bankers Association Vice President Ed Gross, there's tremendous room for growth. Small-dollar transactions—those under $10—are a particular source of untapped potential. This is because traditionally, such minor transactions are not worth the steps involved in a card transaction—swiping or dipping, waiting for verification, and signing—and cash is still king. But as consumers become accustomed to the contactless debit experience, paying with a tap is expected to displace cash at an increasing rate. In addition, smaller purchases lead to bigger purchases, potentially cementing a bank's debit card at the top of the cardholder's wallet, Gross says.

Before the pandemic, tap-and-go transactions were driven by three low-ticket merchant categories in which cash is being replaced by card payments, the PULSE debit study reports. Those categories are: quick service restaurants, vending machines and transit.

According to a panel discussion at the 2020 BAFT Global Payments Conference, tap-to-pay drives a 20 percent transaction lift in mature markets globally.

> ***"With more contactless debit usage on small-ticket items, banks will earn more interchange on an expanding line of revenue."***
>
> — Ed Gross, American Bankers Association

THE RISE OF A CONTACTLESS CULTURE

Bank of the Rockies, a $176 million community bank based in Clyde Park, Mont., is the state's oldest bank. But it's also a forward-leaning institution intent on meeting the changing needs of its next generations of customers. Bank board member and AVP Michael Grove knows that faster payments options are a primary demand among younger consumers, something he has observed within his bank's footprint. Grove notes that individuals frequently base everyday retail decisions on the ease of paying online or via tap-and-go. As a result, he has led the charge to include contactless debit cards among the bank's payments capabilities.

"We want people to use Bank of the Rockies debit cards," says Grove, who is also a member of ABA's Emerging Leaders Council. But without contactless payments options, "you can't compete for the younger generation. They won't [bank here] just because I'm a nice guy." While relationships are the foundation of community banking, consumers will base their choices on which bank has the products they need.

ABA's Ed Gross agrees. "Look at all the tech apps that have become daily features in our lives," he says. The ones that have become the most indispensable, he believes, are those that have removed the speedbumps from payments transactions, allowing people to simply get what they want and go. It's important to remember, then, that from the consumer's perspective, "payments are the number-one thing that banks do—loans, debit, credit, and merchant services." The surest way to keep customers happy is to smooth out all these payments experiences.

Enabled by near-field communication (NFC) technology, contactless debit cards remove time and friction from the typical in-person transaction. There's no need to pass cash back and forth, swipe a card, confirm the amount or sign a receipt. The customer does not have to insert the card into a point-of-sale terminal and wait for approval; a quick tap or wave of the card over the POS terminal completes the sale. Yet the transaction remains extremely safe because it has all the same security features as a chip card, explains PULSE Executive Vice President Steve Sievert. Just like the contact EMV card, it can't be counterfeited. The only way for fraud to occur is if the plastic is lost or stolen. But because a tap-and-go card never leaves the user's hand during the transaction, the risk that it might be left behind at the point of sale is drastically reduced.

Before the pandemic, contactless payments were considered a convenience. Since the arrival of the COVID-19 pandemic, however, they've become for many an essential need. "Consumer behavior changed overnight," explains Jennifer Schroeder, PULSE Executive Vice President of Product Management. "We don't often see a hockey-stick shape in the curve," she says. Dramatic changes appeared in several places: a shift from brick-and-mortar to online purchases, an increase in PINless bill payments, and a surge in contactless in-person transactions. Before the pandemic, "customers acted out of force of habit, and continued dipping [their EMV cards] even though they had dual interface cards. But the pandemic changed how they thought about it." As casual contact came to be viewed as a serious risk, consumers who had a contactless option increasingly used it.

> ***"Merchants who thought they had more time to implement contactless are accelerating their plans."***
>
> — Jennifer Schroeder, PULSE

Beyond that, merchants and consumers are now thinking more broadly about all the interactions they have with payments, says Schroeder. "The term 'contactless' is not just about tap-and-go," she says. People are thinking about all the ways they can reduce physical contact, whether it's online payments, curbside pickup, or home delivery. The concept of contactless has "taken on a generic meaning that goes across the customer experience," she says. "It has absolutely accelerated."

> ***“The move toward contactless cards is different from the earlier migration from magnetic stripe cards to EMV cards. This time, it’s not us telling the customers they should like it, but the customers telling us they demand it.”***
>
> — Mike Grove, Bank of the Rockies

CONTACTLESS REACHES CRITICAL MASS

As with many fintech innovations, contactless cards presented issuers with a chicken-or-egg quandary early on: Who will implement the technology first, the card issuer or the merchant? Is it worth launching a new product that has not yet developed a strong demand—or even much opportunity to use it?

“Contactless is a technology that has been around since the 1990s,” Sievert explains. But without merchants offering contactless POS terminals, it struggled to gain traction, a gap that was closed when merchants upgraded terminals during the chip card transition (these new terminals largely included contactless capabilities). Demand for the technology in U.S. markets came mainly from consumers who had traveled abroad and observed the card in action in other countries.

“The whole payments ecosystem is different outside the U.S.,” says Schroeder. With different infrastructure and requirements, “we always have different problems to solve for.”

“Contactless is finally ready for prime time,” says Sievert. A 2020 study by the National Retail Federation and Forrester found that 58 percent of all retailers now accept contactless cards, up from 40 percent last year.[3] And among the nation’s largest retailers, the contactless acceptance rate tops 80 percent.[4] The NRF study also found a significant increase in consumers’ use of no-touch payments arising from COVID-19. Of the retailers who offer contactless payments, 94 percent expect a continued increase in customer usage of contactless.

3 https://nrf.com/media-center/press-releases/coronavirus-leads-more-use-contactless-credit-cards-and-mobile-payments (accessed September 17, 2020).

4 https://www.philadelphiafed.org/-/media/consumer-finance-institute/payment-cards-center/publications/discussion-papers/2020/dp20-03.pdf (accessed September 18, 2020)

One retailer that emphatically supports that view is Hy-Vee, a grocery chain with 275 stores across eight Midwestern states. Hy-Vee Senior Vice President Andy Schreiner notes that the store was an early adopter when it enabled contactless payments in 2018. “We’ve always prided ourselves on seeing where the consumer is going and providing what they want, when they want it, and how they want it,” says Schreiner. “It’s important that we stay ahead of the curve when it comes to innovation.” In the early days, Hy-Vee customers were not using the tap-and-go feature at a high volume, but store management was confident in their decision to offer contactless.

> ***“We know [contactless] has the same fee structure and the same fraud protection [as EMV transactions]. But the biggest thing for us as a retailer is that the front-end experience for consumers is so much better.”***
>
> — Andy Schreiner, Hy-Vee

Although the store saw a spike in contactless payments in 2020 after the pandemic hit, Schreiner says that the advantages of the technology go way beyond the need to minimize physical contact. “More than anything,” he says, “customers want to get through the checkout process faster, and that comes with providing quick and easy payment options.” Feedback has been overwhelmingly positive and contactless transactions have increased every month over the last two years. While contactless payments do go up on weekends, when younger people do their shopping, Schreiner is quick to add that usage goes beyond that demographic. As consumers are issued new contactless cards, they are so surprised by the speed and ease of tap-and-go that they begin to seek retailers that can offer that experience.

With the convergence of consumer demand and merchant uptake, banks are now in a position to get on board or miss the boat. According to the PULSE debit study, surveyed issuers identified contactless cards as their top debit-program priority. Deployment is taking shape as banks try to keep their card at the top of their customers’ wallets.

IDENTIFYING THE RIGHT TIME FOR CHANGE

Most card issuers plan to roll out contactless cards on a gradual basis, the PULSE study found. Under a typical timetable, the upgraded cards would be issued to all new cardholders. Existing cardholders would receive their tap-and-go cards according to their natural reissuance cycles. That is, when existing cards expire—or are lost, stolen, or damaged—the replacement cards would be contactless. Because new chip cards were issued three to five years ago, this timetable is expected to lead to an 87 percent penetration of contactless cards by the end of 2022.

Is that soon enough? Or should banks be stepping up the pace? “That depends on the card issuer and what their portfolio looks like,” says ABA Senior Vice President Steve Kenneally. As an association that supports banks of all sizes and missions, he notes, “we would like all of our members to adapt technology that is right for them as quickly as they can.” But what’s right for them depends on many factors. “If you have a bank that issued their cards six months ago and has just a small portfolio, for example, reissuing may not be a top priority.” PULSE’s Schroeder adds, “With the transition to chip cards, there was a looming shift in fraud liability. So we encouraged banks and merchants to make that transition as soon as possible. With contactless cards, liability isn’t looming.” This time, she says, banks should be looking at their own cardholder portfolios to decide what makes sense for them.

HERE ARE SOME QUESTIONS FOR BANKS TO CONSIDER

- **Does your footprint contain numerous retailers that have contactless terminals your customers want to use?** Although merchant participation has rapidly increased overall, local conditions—along with the specific characteristics of a community bank’s customer base—might make contactless cards less of a priority. It helps to know your customer and your community.
- **Do you serve an area with a mass transit system that accepts contactless payments?** Cities like New York, Boston, Chicago and San Diego have begun to enable contactless payments in their transit systems. This generates tremendous tap-to-pay usage among transit passengers. Not only that, it appears to spur a significant increase in tap-to-pay purchases at the businesses immediately surrounding transit stations, according to a panel discussion at the 2020 BAFT Global Payments Conference.
- **Do competitor banks in the same market offer contactless cards?** Sometimes cardholders, while waiting in line to pay for a purchase, see someone ahead of them who’s able to just tap-and-go, Schroeder notes. “And that’s something they want to be able to do.” Kenneally agrees that sometimes it’s necessary to prioritize contactless for competitive reasons. “If customers are aware of and value contactless, you may not want them to have to go to a different bank to get it,” says Kenneally.

- **How soon can your bank handle the cost of taking on a contactless program?** Five to six years ago, the transition from magnetic stripe cards to EMV chip cards was time consuming and expensive. “At that point,” Schroeder says, the transition “involved hundreds of unique tags of data.” Moving from contact cards to contactless cards, she says, is far simpler. Sievert adds, “The price point for contactless cards has come down in comparison to years past”—in most cases, amounting to less than a dollar per card.
- **How much of your bank’s non-interest income comes from interchange fees?** For banks that earn 25 percent or more of their non-interest income on debit interchange, it’s critical to maintain a primary position in their customers’ payments routines. Those banks, Gross says, “have to stay top-of-mind, top-of-wallet, to generate the continued strong income.” Keeping up with new technologies will have to be a part of that plan, he adds. “If it’s a substantial part of the business, and the bank has a reissue on the table within the next two years, it’s important to get started on evaluating that now.” Schroeder agrees that it’s smart to begin the process early. “No matter what, she says, it takes longer than you think.”

CHOOSING THE RIGHT PARTNER TO ENSURE A SUCCESSFUL DEPLOYMENT

As pillars of safety and security, banks are expected to move deliberately and compliantly, resist passing fads and carefully weigh the consequences of every decision. On top of that, community banks face particular challenges when it comes to dedicating resources to innovation and negotiating with their core providers. What’s more, any change that affects customers will require a marketing campaign to explain what is happening, why it’s happening and how it works. Working with the right partner can make the difference between the success and failure of any initiative.

Bank of the Rockies, which chose the ABA endorsed debit program from Discover in 2018, determined it was time to upgrade its debit capabilities to include mobile and contactless cards. A giant leap for a small bank? Dan Osterkorn, a Discover Debit account executive who works with Bank of the Rockies, points out that banks of all sizes benefit from the help of network partners and brand partners. Even just knowing how to interact efficiently with a bank technology provider can be an issue for many banks.

For Bank of the Rockies, Grove says, “having someone with the clout and the know-how of Discover made it a lot easier” to get the ball rolling with the core. “They know exactly who to talk to and exactly the right verbiage to use.”

So when Discover contacted Fiserv, it hit the ground running. “On the card side,” Osterkorn explains, “we started the certification process by asking: What chips are we using today? What chips should we use going forward? What are your capabilities? What are your lead times for certification?” A network partner with entire departments of people who have done this work for years will find it easy to do the heavy lifting to eliminate barriers and advocate for the issuer, says Osterkorn.

Configuring and manufacturing the cards is just the beginning. Education is essential to the success of a new card rollout. And that starts not with the customer, but with bank employees. As with the rollout of chip cards, frontline staff must be prepared to show customers how—and why—to use the new card. PULSE's Sievert adds that change can be disruptive, so it needs to be prioritized within the bank. The key, he says, is to make sure staff is focused on engagement and education even before the card is deployed. "Set expectations," says Sievert. Take advantage of early opportunities to emphasize the benefits of the card "to drive it to top-of-wallet status and minimize disruption." Grove agrees: "At our bank, the best way to get information out is through our frontline staff. Most of our customers come into the bank at some point during the month." Talking to their favorite tellers, explains Grove, gives customers the opportunity to ask questions, learn—and believe in the new card.

From the beginning, Bank of the Rockies has relied on Discover Debit's Marketing Hub as a one-stop-shop for its debit program marketing needs—from staff training and bank-branded collateral to guidelines and card design tools. Consistent messaging to the customer, Schroeder says, should be coming from every channel: the bank's website and social media platforms, direct mail and email, and especially in the mailer that delivers the new card. Answering all questions up front will minimize disruption and get the cardholder to activate the card as soon as possible, says Schroeder. The goal is for the new card to be top-of-wallet going forward—before someone else issues a similar card to your customer.

How important is that? It depends on the bank. Kenneally advises that if you have access to a product that's faster, safer—and in an era of pandemic contagion risk—has the potential to save lives, "it's something you should look at." Grove expects that Bank of the Rockies will be the first community bank in its market to offer contactless. Even so, he says, looking back, "I wish we could have done it sooner."

KEY TAKEAWAYS

Here are a few key points to remember as you implement contactless debit cards at your institution:

- **Choose the right partner.**
  If you need help navigating a contactless card issuance consider looking at your technology partners including your debit brand network to see who can provide the best service and guidance.
- **Ensure your debit card is top of wallet**.
  If your bank relies on generating non-interest income, keeping your card top of wallet continues to be an important way to generate interchange revenue.
- **Encourage contactless card use for transactions of all sizes.**
  There is tremendous room for growth in debit transactions and interchange revenue if consumers prefer the ease of tap and go to pulling out cash from their wallet.