

All About Payment Cards

Payment cards offer consumers more security, convenience, and control than any other payment method. The wide variety of cards available – including credit, debit and prepaid – offers enormous flexibility, as well. Payment cards give people the power to purchase items in stores, on the Internet, through mail-order catalogues and over the telephone. They save merchants time and money, enable them to attract and retain more customers, and help them grow their businesses.

The Origin of Payment Cards

Although the first payment card can be traced back to the local “Charg-It” card introduced by John Biggins in his Brooklyn neighborhood in 1946, the Franklin National Bank in New York formalized the practice by introducing the first bank-issued credit card in 1951. Over the next decade, several banks emerged in major cities to work with customer merchants to accept payment cards. However, this system limited consumers’ use of payment cards to an area restricted by the regional banks’ merchant customers.

The concept of a wider payment network was born in the mid-1960s when the InterBank Card Association (now MasterCard Worldwide) brought consistency to credit cards. InterBank developed payment network systems to process the exchange of funds between merchants and cardholders, standardized the billing process, and established rules and procedures to reduce fraud and other abuses.

The first debit transaction, using an automatic teller machine (ATM) card and personal identification number (PIN) to make a purchase at the point of sale (POS), occurred in the 1980s, and the first debit transaction authorized by a signature rather than a PIN was processed in 1988.

Prepaid cards, in the form of gift cards, have been around since the 1970s but have more recently emerged as a widespread form of payment. “Closed-loop” cards are limited to specific merchants, and were embraced by the telecom industry in the United States in the 1980s. They were followed by specific retail chains in the early 1990s and soon became the plastic equivalent of a paper gift certificate. “Open-loop” prepaid cards, which are accepted at more than one merchant, expanded in the United States as electronic benefits transfer (EBT) cards, which 1996 federal welfare reform mandated to replace food stamp coupons. Payroll cards debuted in the late 1990s and were used primarily by employers to pay unbanked workers (workers without bank deposit accounts). Branded prepaid gift cards were already available in Europe for a number of years when they first appeared in the United States in 1999. Today, both major bank card associations offer prepaid cards that consumers can use at any location that

accepts credit or debit cards bearing the credit associations' logos. Prepaid cards are also increasingly used in flexible spending account (FSA) applications.

Payment Card Networks and Systems

MasterCard Worldwide operates a four-party payment system that processes transactions, routing payments between cardholders' and merchants' financial institutions via enough communications lines to encircle the globe nearly 400 times. MasterCard sets interchange rates, markets its brands to consumers, and develops programs that financial institutions offer their customers. MasterCard also links the four parties involved in each transaction (hence the name four-party system) as described below:

- The cardholder's issuing bank markets and issues MasterCard payment cards to consumers.
- The cardholder uses a MasterCard payment card to purchase goods and services at more than 23 million acceptance locations around the world.
- The merchant accepts MasterCard payment cards in exchange for goods and services.
- The acquiring bank enrolls merchants into programs that accept MasterCard, Maestro and Cirrus-branded cards.

The payment card universe also includes three-party payment systems. In a three-party system, the company operating the network interfaces directly with merchants and consumers, in addition to processing transactions, issuing cards and enlisting merchants to accept those cards. Because three-party systems cannot tap into the marketing power of issuing and acquiring financial institutions, they lack the global reach offered by four-party systems, such as that achieved by MasterCard.

Types of Payment Cards

Consumers have three types of payment cards to choose from – credit, debit and prepaid (also known as stored-value) cards. Most consumers choose at least two, and many choose all three:

- Credit cards offer consumers and businesses short-term lines of credit and a variety of repayment options. Having a line of credit gives consumers the ability to cover unexpected or large expenses as well as make basic everyday purchases, and it helps consumers establish credit histories. A credit history is needed to apply for mortgages, vehicle loans, and other long-term financial commitments and can also be useful in other situations such as applying for employment or insurance. Small businesses find credit cards advantageous for many of the same reasons that consumers do, and today more than half of all small businesses in the United States use a credit card for financing. More than 1.2 billion credit cards are now in use around the world,¹ accepted at more than 23 million locations.² In 2003, credit cards were used in nearly 25 billion transactions totaling more than \$2.3 trillion.³

¹ Euromonitor International, 2003.

- Debit cards are linked directly to consumers' deposit or brokerage accounts, allowing instant access to cash from ATMs around the world and at many retail point-of-sale locations. In the United States alone, there are more than 234 million debit cards in use, generating more than \$60 billion of sales each month, and debit is used in one out of every three retail transactions.⁴ Two billion debit cards are in use today around the world,⁵ making debit the fastest growing and most popular form of payment. Worldwide, there were nearly 70 billion debit transactions in 2003, with a total value of \$5.5 trillion.⁶
- Prepaid cards, also known as stored-value cards, are among today's fastest growing payment methods. A set amount of money is "loaded" onto the card prior to use, and many prepaid cards can be reloaded over and over again. During a transaction, the purchase amount is withdrawn from the card's value. Recognizing the flexibility and control offered by prepaid cards, companies are beginning to use them for employee benefits, such as health savings and dependent care accounts. And prepaid gift cards are exploding in popularity. According to the Pelorus group, gift card sales alone are expected to top \$95 billion in 2005, up from \$61 billion in 2003.⁷

There are two types of prepaid cards: single-purpose and multipurpose.

- Single-purpose cards, which are also known as closed-loop cards, are designated for a specific merchant or purpose. These include store-branded cards, prepaid telephone cards and benefits cards offered by employers.
- Multipurpose cards, also known as open-loop cards, are branded with the logo of a bank card association. A MasterCard-branded prepaid card, for example, can be used to access cash at ATMs and to purchase goods and services wherever MasterCard credit or debit cards are accepted. Gift, payroll and EBT cards are examples of multipurpose prepaid cards.

² MasterCard International, 2005.

³ Euromonitor International 2003.

⁴ CardWeb.com, Inc. "Debit Cards," *Card Track*, June 2005 as accessed on 8/17/05 at <http://www.cardweb.com/cardtrak/news/2005/june/10a.html>

⁵ Euromonitor International, 2003.

⁶ *Ibid.*

⁷ Berner, Robert. "Gift Cards: No Gift to Investors," *Business Week*, March 3, 2005, accessed 8/17/2005 at http://www.businessweek.com/bwdaily/dnflash/mar2005/nf2005033_4312_db016.html.