

LEND OR SPEND: WHAT'S DRIVING YOUR CARD BUSINESS?

In a recent interview¹, American Express CEO Ken Chenault mused on an interesting question: the strength, as he sees it, of his card's spend centric, closed loop business model.

It's a question which other payment card CEOs should also be pondering.

Until a couple of years ago, credit card businesses were lend centric: they derived very comfortable profits from customer balances at rates which gave them a substantial margin over the cost of funding: estimates suggest that 40-80% of profits have been derived from spread. For sure, the better-managed issuers adjusted APRs to the perceived risk of borrowers, but the principle remained the same: profits came from accounts receivable, growing at an annual clip of around 5% – with a welcome boost from penalty fees and fat insurance commissions.

Those happy days are gone, almost certainly never to return. Past borrowers are busily paying down their loans – there's even evidence that card borrowings take priority for repayment over mortgages – and new lending is at historically low levels. But if most of your card customers are transactors now, where is profit to come from? Not from interchange or penalty fees, that's for sure: around the world, legislators are punishing banks for real or perceived misdeeds by squeezing these sources of income. Similarly with insurance sales: mis-selling by UK banks has led to compensation claims estimated to run into billions of pounds.

And that leads us straight back to Mr Chenault: his argument is that the golden road to card profitability now runs through spend, not lending. The challenge is that transactors have always had to generate relatively high billings to offset the cost of account handling and move into profitability. But that already high billings level must now rise even further because the earnings on spend are narrowing. Further, the number of free-spending customers capable of generating such high dollar volumes is much smaller than the number of actual or would-be revolvers on whom broadscale issuers have typically concentrated.

Crucially, not only is it a smaller group, it's one which has very different preferences and needs.

For one thing, there may well be a significant proportion of women in the group: there's good evidence that they make up a growing part of the high net worth segment – 27% of the total in 2010, up from 24% in 2008, according to one survey². For another, it's likely to include many older customers moving to the end of successful careers and with their children off their hands. Again, we'd expect to find a solid sprinkling of corporate high flyers and prosperous entrepreneurs. Overall, it's likely that these will be customers with

¹ CNBC.com, 1 June 2011

² Capgemini/Merrill Lynch, "15th World Wealth Report", June 2011

sophisticated tastes, who know their own minds, expect a high standard of personal service, and are resistant to doing tasks themselves which previously banks and airlines did for them.

One other fact about this group: they're in demand. American Express, and in some markets Diners Club, have them at the heart of their business. It's a smart move: according to research from Moody's Analytics, the top earning 5% of Americans now account for 37% of consumer outlays.³ Of course, many banks offer super prime cards to their HNW customers: but often only as part of a bundle aimed at generating and retaining banking relationships. Too rarely have card issuers seen them as a growth centre in their own right.

If Mr Chenault's analysis is correct, that is all now about to change. More issuers will move from lend centric business models to spend centric. In the war for wealth which will follow, how should issuers differentiate their offerings in ways which attract these very desirable customers? At what levels would spend have to set for an account to be profitable, given the increased cost of any enhanced services? Are there enough actual or potential customers in the market who meet such a test?

We believe that there are persuasive answers to these questions.

Question 1: How to create attractively differentiated products?

There is no one-size-fits-all template: markets and customers are too various. But our view is that compelling product offerings will combine some or all of these components.

The technology tsunami: Converging technology combined with instant access to data will transform the nature of the payments business. Suppose a customer plans to buy a digital camera: in the future, instead of just processing the transaction when it happens, smart issuers will tell their customers where to find the bargains – locally, or on the Internet. Amazon and Google have led the way in structuring their responses to reflect user history, but others have followed. In the world of travel, for instance, clever applications integrate previously separate websites for airlines, hotels, restaurants and car rental and personalise them to reflect customer preferences. The capability is there already: the first player to use it to create a game-changing customer proposition will define the rules for the next decade.

Social media: The strength of ASmallWorld, LinkedIn and their emerging competitors lies in their ability to bring together like-minded people. And, contrary to received opinion, the affluent don't disdain these media: a survey of US millionaires by Fidelity Investments found that 85% of respondents use text-messaging, smartphone applications and social media⁴. Issuers focussing on high spenders – or any other cohesive customer segment – would do well to consider how they could use social channels to reach out to and bring these individuals together.

³ Wall Street Journal, 21 June 2011

⁴ Wall Street Journal, 21 June 2011

The power of one: Future brand relationships will have to move from mass produced to custom built – reflecting customer attributes ranging from financial situation through lifestyle to professional interests. This will be a challenge for more traditional banks, with their product-led culture. But far-sighted marketers already see how the reach of the Internet, super-charged by massive server power, facilitates the shift to bespoke services.

The changing nature of rewards: Over the past twenty or so years, rewards have moved from trading stamps through beach towels to romantic weekends in Paris. We think that the industry faces another crossroads in terms of who is rewarded how for doing what. And perhaps the first clue about a new direction will come from carefully differentiated programmes designed to meet the special needs of affluent, high-spending card customers.

Question 2: Extra services cost money. How will they be funded?

Two sources of income are relevant here. The first is earnings on billings: each issuer will have to do its own sums, based on market levels of interchange and overseas/domestic spend mix. But the second income stream surely could be fees: if the offer is attractive enough, there's ample evidence that better-off customers will pay for it. A US study earlier this year suggested that 61% of customers would pay a fee for an improved card rewards programme⁵. How else explain the continuing buoyancy of the luxury goods business in what for many people are difficult economic times? It's telling that recently the only US department stores showing double digit sales growth have been Saks and Neiman Marcus⁶.

Potentially, there's also a third revenue source: not all the customers for such a programme will be committed transactors. Some will revolve, either permanently or occasionally. Intriguingly, the Moody's research quoted earlier found that the savings rate of those high earning Americans (with an average income of \$342,000 in 2008) has plummeted from more than 26% in 2008 to a negative 7% in the first quarter of 2010. When these accounts revolve, balances are likely to be much higher than the average, generating significant interest income.

Question 3: Are there enough customers out there to make the exercise worthwhile?

Again, each issuer will have to do its sums, based on market conditions and expectations about cost. But our experience is that banks in most countries can reach a sizeable number of customers who meet the spend test. At the top end of this segment, Crédit Suisse estimates that there are more dollar millionaires worldwide than there are Australians – around 24m in total⁷.

Let's go get 'em!

⁵ CardLine, 2 February 2011

⁶ <http://business.transworld.net/58843/features/february-2011-national-retail-sales-results/>

⁷ Crédit Suisse, "The Global Wealth Report", October 2010

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