ROY STEPHENSON
Strategic planning and marketing
www.roystephenson.co.uk

# COURAGE OR CAUTION?

Who'd want to manage a payment card portfolio?

Industry veterans say that times have never been tougher. As well as the always-with-us woes of acquiring and keeping good quality accounts, card portfolios now face an existential threat from mobile and a growing range of electronic payment challengers.

**The pain, the pain**

Start with acquisition. Time was that the chief worry facing marketers was how many people would respond to their new cards campaigns. Today, an escalating concern is that the responders may not even be who they say they are. Just this month, authorities in the US put up for trial a ring of 18 alleged fraudsters who are said to have got away with $200 million – and the investigators say it could be much more[1]. The sums stolen are getting bigger (one security firm claims that first party fraud has generated more than $18 billion in credit card losses globally in 2012) – and so is the sophistication of the scammers. According to the FBI, the suspects now on trial used a variant of first party fraud – a combination of manufactured identities, stolen identities, and real identities to set up the venerable "long firm" scam.

Coming later in the card life cycle, and more widely publicised, is third party fraud, using stolen card data. Typical of the advanced skills used by criminals is a group which last year used skimming devices imported from Hungary to grab card data from ATMs, pinhole video cameras to record customers entering their PIN numbers, and blank plastics on which to encode the data. Proceeds? Around $3 million so far, stolen from 6,000 bank accounts[2].

Still more worrying are the increasingly sophisticated large scale hacking attacks designed to steal industrial quantities of passwords and customer data. Understandably, institutions are tight-lipped about their experiences, but there's very little doubt that attacks are growing in frequency and reach. Astonishingly, the clandestine websites where the data are sold even offer money-back guarantees.

Let's put a bold face on it, and assume that we're running a high quality portfolio, where cyber security, fraud and credit losses are firmly under control. Even better, spend, revolve rates (for credit cards) and income are all meeting targets. Excellent news – but how long will it stay that way? Because there is a host of competitors out there who would love to grab these valuable customers. How to keep them? One thing is absolutely sure: so long as all the account-holders see is a transaction-handling commodity service without any distinguishing features, they are at risk.

---

[1] *Payments Source*, 7 February 2013
[2] *Forbes,* 11 Feb 2013

**So what price loyalty?**

It has become the classic route to building customer retention: create a rewards programme. But what should it offer? How much should it cost?

Looking at the customer offer, in 2013 there can be no doubt that, in most markets, broadscale undifferentiated rewards programmes are simply not good enough. Customers these days are daily exposed to personalised promotions which reflect their interests and past behaviours. What works for Amazon ("You may also be interested in….")will work for your rewards programme; yet all too often we see awards catalogues which are barely beyond the beach towel and steak knives stage.

As to cost, against a backdrop of falling interchange and narrowing net interest margins, it's inevitable that the space available to fund generous rewards is shrinking rapidly. Once, issuers could work with a relatively rich funding rate and console themselves with the thought that even well-run card rewards programmes wouldn't see a points redemption rate much higher than 70%. But difficult times have a habit of focussing customers' minds: consequently, we see a higher propensity to redeem those valuable points. Evidence of the change comes from a regulatory filing by American Express in the US: in 2012, 94% of Membership Rewards points were being redeemed, up from 93% in the previous year and 90% in 2008.The latest change cost the company $342 million, the company said[3].

*Incidentally, the new provisioning rate means that American Express will hold a balance sheet liability for Membership Rewards of $5.8 billion.*

Against this background, it's not surprising that issuers are looking for another source of programme funding – and the choice often falls on merchants. It's an approach which has worked well in emerging economies, where retailer margins are often wider, business is booming, and there is a greater focus on growth and market share. But it has stuttered in Europe and North America, where merchants, in any case in a more combative posture versus the card industry, will look very hard at the results from programmes they are funding. Absent clear incremental gains, they will vote with their feet.

**Talking about a revolution**

As if all this were not enough, now add the mounting threat from alternative payment methods.

Judging by their actions, quite a few issuers are burying their heads in the sand and hoping that the e and m challenges will go away. But the evidence is growing that a significant number of customers want these new capabilities. In Ireland, for example, 20,000 customers preregistered this month for Bank of Ireland's new mobile money transfer feature before it was even launched[4]. Across the Atlantic, 13 million JP Morgan Chase customers use its mobile banking service, and 8% of all bank transactions in the US are now carried out on a smart phone[5]. No question, there's still resistance and uncertainty out there, especially among merchants, but it's hard to escape the feeling that the use of plastic as a payment vehicle is beginning to move into the end game.

[3] *Wall Street Journal*, 15 January 2013.
[4] *Finextra*, 5 February 2013
[5] *Wall Street Journal*, 11 February 2013

**To compete…or not**

Taking the picture as a whole, it's clear that in many markets every stage of the card product life cycle is under attack. And that pressure is showing through in the bottom line: ROI in the industry is way off the juicy 20% plus returns that cards generated in the past.

The question is, what to do about it.

At a time when for many issuers card profitability is nearing historic lows, it's not easy to make the case for investment. But there is a choice to be made: accept a gradual (or maybe not so gradual) run-down of the business, and leave it to what will likely be a combination of a few large existing players and some new entrants, or make a commitment. Because the fact is that so long as there is economic life, there will be payments to process.

Already, some of the main actors are declaring their strategy: La Caixa, Spain's biggest domestic bank, and widely regarded as one of the savviest institutions in the country, has just announced that it is selling off what may be a majority share in its credit cards unit[6]. And this is no sideshow: Caixacard has about 12.5 million cards in circulation, giving it a 21% market share.

*In a related move that may have been a straw in the wind, back in 2010 La Caixa spun off its acquiring business via a joint venture with Global Payments.*

On the other side of the question by contrast, Visa, MasterCard and American Express are all investing heavily, both in their own resources and by taking a string of equity positions in technology front-runners. In the UK, Barclaycard and Santander are building a strong track record in innovation and product development.

Certainly, not all the trial balloons we see being launched will actually take off: a great technical idea may not be a great business idea. Some instantly feel right: who wouldn't sooner pay in a cheque by photographing it with a smart phone rather than plodding round to the branch with it? Others need to prove themselves: despite the proven power of social media, the new American Express/Twitter partnership somehow feels like more of a stretch. Ultimately, the test will be whether the new capabilities are sufficiently desirable to both buyers and sellers for them to replace the existing methods.

**Data means power**

One element which almost certainly will play a role in this is the ability to see, and crucially be able to use, the data on each side of the transaction. That could add real value to both the merchant and the customer. Here, a closed loop business like American Express has a built-in advantage: Josh Silverman, President of U.S. Consumer Services, makes no bones about it, commenting recently that "We think of ourselves as more a data company that happens to be in financial services."[7] But it's also possible to see potential in data hook-ups between the card associations and issuers.

From another standpoint, it's likely that a killer mobile app will exploit the great advantage that a smart phone has over a card: it can communicate. Temptingly, the phone also knows where you are,

---

[6] *Wall Street Journal*, 14 February 2013

[7] *Payments Source*, 11 February 2013

but there has already been controversy about whether using the capability is a step too far in intruding on customer privacy.

Maybe it's a question of letting a thousand flowers bloom and seeing what does best.

**Choosing sides**

Overall, the strategic choices are becoming clearer. Smaller institutions and those with a more cautious mindset may conclude that this is too rich a bet for them to make. As a result, we may see them take a leaf out of the La Caixa book and exit the card payments business, perhaps migrating their portfolios to a white label operated by a larger player. On the other hand, the big beasts could decide that this is a sector that they absolutely have to compete in, and screw up their courage to make the hefty investments necessary.

It will be fascinating to watch the decision process at work.

***Stop Press***

*Visa and JPMorgan Chase have just announced that they are to create a new joint business – Chase Merchant Services. This will combine the acquiring, issuing and processing functions to "deliver added value to merchants and provide a better experience for cardholders." Another straw in the wind?*