Spending Power: Cards Strategy Series
Where is the Value?
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Spending Power: Cards Strategy Series
Where is the value?

The pressure on card issuers is continuing to increase: Regulators and consumer groups are challenging pricing and therefore profitability, innovation is noticeably absent, growth rates are slowing, and specialist processors and associations are expanding across the value chain. In this environment, a detailed understanding of where value exists (and may be captured) will be a key determinant of success for all players — for card issuers to protect their profit pools and for others to capture share.

Being able to identify and size the pools of value across the card issuing value chain, and consequently selecting and executing a strategy to capture these in a systematic and focussed manner, is something that we have seen many card issuers attempt to address. This Viewpoint sets out where we believe the value exists, the relative scale, as well as discussing some themes we believe are critical to capturing a greater share, or defending, these value pools.

Overview of analysis
Based on our work with a broad range of industry players across the credit card value chain, we have identified the key revenue and cost value pools for issuers. Increases in revenue pools or reductions in cost pools create profit opportunities. Exhibit 1 indicates the relative scales of value pools for a mature credit card market. Approximate monetary values are provided for the UK market as an example. These have been derived on the basis of value actually accrued and not attributed, e.g. brands are valuable but only if they draw in customers or encourage spend, which respectively is captured elsewhere in the value chain.

Exhibit 1
UK consumer credit card market value chain (US$ annual value)
As discussed in other Viewpoints in this series, we believe that there are markets which behave similarly, and that whilst the actual numbers will be different, the relative scaling and importance would be similar in equally credit mature/maturing markets, such as the United States, Australia, Turkey, Greece or Canada. For developing/growing credit card markets, such as Germany, where use of revolving credit is not as widespread, the model would look markedly different.

Discussions with our clients have indicated that these findings challenge established perceptions, particularly with regards to the value attributable to brand, and the value of loyalty. Once again, these value pools measure the flow of real monies and not the value of brand perception or other second or third order effects. As a result, we believe there is significant evidence to substantiate our assertions.

**Brand:** Many issuers have invested significant amounts of money into the creation and maintenance of their brand, and believe that recognition and perception of the brand is both a key differentiator and buying criterion for customers.

Whilst this was a successful, and necessary, approach for issuers at a time when card penetration and usage was not high, mature market customers are increasingly less drawn to brands and more to products and offers. Customers in mature markets are well developed in their ability to source personal credit independently of their core banking relationship and on the basis of product price and features.

We believe that card issuers should reflect much more carefully on the value of their brand compared to the advertising and promotional costs incurred. Interestingly, the value card issuers attribute to the other’s brands, through the mechanism of co-branding and partnerships is quite marginal. Typically only £10-15, even for major well known brands, and in some cases we have seen, not at all.

Players in this business should ask themselves iconoclastic questions like: What is the real value of the brand in an ongoing relationship with customers? Do customers stay loyal on account of brand and if so, what type of customers? Do investments in brand create or destroy value in a mature market? Do issuers confuse the value of a brand with the perceived value of functionality that is associated with a card – and do customers think about it the same way as issuers?

**Credit:** Credit has long been the major value pool in mature credit usage markets. However, we have observed trends which suggest this will likely come under significant pressure.

Multiple factors are adversely impacting loss-adjusted net interest margins. These include: increasing regulatory and consumer group focus on personal indebtedness and interest rates; ever-improving analytically based customer understanding capabilities, which are resulting in finer/more aggressive pricing strategies, and; increased levels of competition. Supplementary to this, the cost end of loss-adjusted net interest margins is seeing increases after years of reductions, due to the impact of monetary policy, changes in securitisation costs, and an increasing trend of loss provisions.

Leading issuers are responding to these factors but we have observed many issuers still playing the share game rather than focusing on enhancing marginal yield. For example, we have noted that the ‘cost of capital’ competitive lever has been underutilised by large depository institutions which are also issuers. The utility of capital purchasing power is a forceful argument for consolidation, and a large issuer (e.g. a deposit-taking institution) may immediately create synergy value through acquiring a smaller player and growing the value pool.

Outstanding balances and revolving rates in developed markets have traditionally been high, but it would be erroneous to believe these can be maintained. The introduction of sweep products, simpler (e.g. online) transfers between accounts, ongoing focus of consumer groups, increased availability of flexible substitute products, use of aggressive price discounting as a primarily marketing tool, and the ever increasing customer awareness of the cost of borrowing on cards, assail the credit value pool.

Some of the areas for issuers to address include: Can sourcing of capital be done more efficiently? What will the impact of regulation be, particularly if some form of price controls and/or an element of transparency is enforced? What other sources of value may exist if the credit value pool is seriously adversely affected? We predict that the winner in this value pool will eventually be the institution with the combined lowest cost of funds and operating costs.
**Transaction processing:** Transaction processing is an important value pool derived from the issuer interchange revenue portion of the Merchant Service Charge (MSC). The transaction processing value pool has been subject to changes across card markets, ranging from gradual reduction (the most common situation), to dramatic regulatory change (as in Australia where interchange rates have almost halved) to selective increases (as in the US). In addition to regulatory and market competitive activity, structural and technological changes are also impacting this value pool for issuers.

In addition to regulatory focus on interchange (underway in several European countries), as per the experience in the Australian market. How to respond to current and projected shifts in value to players elsewhere in the end to end value chain?

**Fees and product commissions:** Advanced card companies may be able to make around 30% of their income from such add-on charges, greatly improving ROA. In some economies, like Germany, the card is dependant on an annual fee to break even, but this is not the case for the UK. But we have counted over 30 different types of fees that card companies can charge, sometimes explicitly (e.g. late or over limit fees), and sometime implicitly (e.g. FX fees, rates and pricing).

The cross selling of ancillary products, whether directly related (payment protection insurance), adjunct (travel insurance) or totally independent (wine clubs), is a different category of income. The operational and financial risk dimensions are different, as the issuer is only taking commission for retailing the goods and services of others.

Continuing to ride this revenue source may require tact, as customers relationships are increasingly soured through exorbitant fees. Some issuers may break ranks and position themselves as consumer champions. Cross selling of the customer database seems still in its infancy, and there is significant room to grow this area both in terms of intelligence of identifying sales opportunities, and structuring the offer. However, data privacy and customer saturation may set natural limits to this.

**Operations and servicing:** We have noted that at many issuers, in-house processing and servicing is increasingly suffering from poor capabilities, uncompetitive speed to market and an overall lack of investment in operations and systems. This has largely been due to the cost required for improvements, particularly if an issuer has a small portfolio size. In response, the leading current strategy for issuers has been to outsource processing to one of a number of third party vendors. Although highly successful at addressing industry level innovation and marketing capabilities, increasingly, the ability to differentiate and continue to capture per-unit cost reduction is under question. Given that such outsourcing decisions must be made over seven to ten year horizons, the long term implications may be substantial.

Diversified issuers, who also run acquiring businesses, have benefited from the increase of on-us transactions that cut the Association out of the transaction. This move has interesting implications for the future role of Associations, but is not without longer term risks for issuers. These might evoke retaliatory actions from the Associations – at the extreme a censure or even an exclusion from some of the Associations’ value added services.

Alternatively, new technological developments are reducing issuer value pool capture through innovations such as Dynamic Currency Conversion, where the value derived from foreign currency conversion has moved two significant value sources (the foreign exchange transaction and the fee for the transaction) away from issuers and to acquiring processors. Other similar initiatives are also under development.

The challenges we have for issuers include: The size and extent of the impact of regulatory focus on interchange (underway in several European countries), as per the experience in the Australian market. How to respond to current and projected shifts in value to players elsewhere in the end to end value chain?
issuers do not integrate market, business and operational activities well, resulting in higher cost and poorer service and quality levels. We have noted that leading issuers are applying lean manufacturing and six-sigma techniques but still fail to apply higher impact initiatives such as product architectures or ‘design for manufacture’ techniques.

Key challenges for issuers in the operations and servicing space largely revolve around: Are your cost to serve and quality levels a positive, negative or neutral market differentiator? If operations are outsourced, have they been contractually or otherwise ‘future proofed’ for major technological (e.g. mobile commerce), economic or other changes?

**Fraud management:** Technological advances in fraud management are rapidly emerging, particularly in response to the surge in the level and sophistication of fraud in the cards industry over the past ten years. Whilst European initiatives such as Chip&Pin technology are expected to reduce fraud significantly, they involve major investment in new terminal and network equipment, as well as core system reprogramming and mass card re-issue. The UK has already decided to fully implement Chip&Pin however other nations are hesitating due to the costs involved. Alternative technologies are emerging which address some of the cost and functionality issues with Chip&Pin fraud management but these are not operational as yet. In addition, these fraud management technologies only address some forms of fraud.

The opportunity to create a differentiated offering, control costs and capture value should not be restricted to industry-wide activities. Self-evolving predictive behavioural models, prompt actioning of concerns and adjustable limits, credit checking and data management are all tools that have assisted fraud management.

The key challenges for issuers (and regulators) here are: Which fraud management technology has the best ROI? Can fraud management capabilities be market differentiators? Is the continued rise in the cost of fraud inevitable? How should it be paid for?

**Data mining, marketing and product development:** Card issuers have been investing significant amounts in building marketing and data mining capabilities over the past five years. We have seen these capabilities provide significant value through targeted customer offerings, retention and improving portfolio yield. Competence in these areas is now well understood to be a competitive necessity in all developed card markets and the level of sophistication is continuing to increase. We believe first mover advantage still exists within developing markets to employ these analytical techniques.

However, many issuers we have observed have not fully and effectively integrated data mining, marketing and product development efforts whilst leading issuers are building competitive advantage by linking these closely as well as broadening the customer and product scope under which these are managed integrally. Best practice is to apply ‘test and learn’ techniques for customer and product propositions to optimise the generation of value. This has worked well in areas of cross/up selling, next-logical products, predictive churn management and retention measures. The profitability of this approach is self evident, and has been seen to improve customer profitability by as much as 30%.

The challenge for card issuers is therefore: In developed markets, how to fully leverage these capabilities and build competitive advantage? In developing markets, what is the best approach towards investment in these capabilities and the optimal ROI initiatives?

**Loyalty programs:** The nature and value of loyalty programs have been confusing for many consumers, retailers and issuers alike. The myriad of programs each with its own unique structures has ended in being
increasingly expensive for many issuers. Our work with issuers has demonstrated that many programs, once fully costed, actually destroy value (see Exhibit 4). Many issuers in developed markets have now become aware of this and as a result, the level of benefits offered has been steadily falling and programs have been greatly simplified. Many programs have now been reduced to becoming a cost of doing business rather than a source of differentiation and therefore generate marginal value.

The generally accepted benefits of loyalty programs are significantly harder to capture in the cards business than is often recognised. Many card issuers already benefit and capture much of that value in other ways – for example monitoring customer behaviour – without the need of running such a program.

An efficient loyalty program is able to identify customers, monitor their behaviour, and identify and impact potential increases to profitability while delivering real value to the customer. Many of these things are already easily available to card issuers, and the incremental benefit is often marginal.

Card companies will need to take a clear stand on whether they believe their loyalty program creates value and act on it. Their conundrum will be that it does for some clients and does not for others. Being stuck in the middle with an undifferentiated and poorly developed program is the worst course of action in an increasingly sophisticated customer world – so they will need to chose to do it properly, or not do it at all.

Exhibit 4
Credit Card profitability with and without an attached loyalty program

Conclusions
Our analysis into the sources of value in the credit card value chain have identified a number of differences to common perceptions in the issuer industry. These differences are not only due to different interpretations of how value is created, but also from taking a more holistic view of the sources and uses of funds across the value chain. The main finding is that common perceptions of sources of value may not be consistent with this value chain element view, primarily:

• Brand and loyalty is worth much less than has been typically assumed

• Profits from credit and transaction processing will diminish significantly

• Future profits will come from operational excellence or information based customer management

Issuers cannot be expected to address all value pools with equal emphasis, particularly when growth is slowing in developed markets or near term payback is not as attractive in developing markets. As a result, a better understanding of value pool size, underlying trends and drivers, and aligning this to an issuer’s strategy, will enhance long-term success.
This viewpoint is one of a series focusing on growth, profit enhancement and innovation in the global cards and retail payment businesses. Another viewpoint you may be interested in:

**International Growth Opportunities:** Major card markets have experienced similar levels of growth and development over the past 10 years and are now experiencing some common challenges with regards to future volume and profit growth prospects. This Viewpoint lays out a way of thinking about international growth and specifically seeks to address four questions: 1. Which international growth strategies can an issuer consider? 2. How should issuers think about markets? 3. How can value be captured in chosen markets? and 4. What capabilities are required to implement an international growth strategy?

**Visions of the future:** Market pressures are increasingly more demanding in terms of customer management, operational and technical capabilities of issuers. Increasing customer sophistication, advanced product features and greater customization all contribute to an acceleration in the development of the market, and increased pressure from media and consumer groups has made it an increasing focus for regulators. Set against these trends, this Viewpoint identifies the key developments we see occurring and evaluates what these might imply.
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