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A First Data White Paper

Trends and Opportunities in Financial Institution Loyalty

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Executive Summary

In recent years, most card issuers and financial institutions in the U.S. established loyalty rewards programs for their credit, debit and prepaid accounts. These businesses have successfully used loyalty programs to attract new customers or members and to deepen their relationships with existing customers. It turns out that loyalty programs are a real hit with consumers who like the notion of earning rewards for doing something they will do anyway—spend money.

However, the market conditions for traditional loyalty rewards programs have changed significantly in the post-Durbin era, resulting in traditional program funding models becoming unsustainable. Rather than abandoning the programs that are so popular with consumers, financial institutions are looking at ways to transform their programs to maintain a sufficient level of profitability while still delivering high value to their customers.

Now two emerging forms of loyalty rewards programs are taking hold in the financial services industry: merchant funded rewards programs and relationship programs. As a complement to traditional loyalty rewards programs, these programs provide issuers and financial institutions with opportunities to reduce program operating costs, develop a new source of revenue, drive deeper levels of customer loyalty, and prepare for the emergence of digital wallets and Universal Commerce.

Evolving programs bring opportunities for these smaller financial institutions to introduce programs that allow them to compete against the much larger national brands and to stay current with consumer expectations. In this paper, we look at the market dynamics that are driving the shift toward merchant funded and relationship loyalty programs; the unique aspects of these programs as compared to traditional loyalty rewards programs; emerging consumer trends that will further impact loyalty programs; and the broader proliferation of Universal Commerce that will reinforce the necessity for customer loyalty programs.

The State of Loyalty in Financial Institutions

Market forces and new technologies have caused loyalty programs to enter a state of flux. Fallout from the Durbin Amendment, program saturation, consumer trends, and changing consumer expectations are causing issuers and financial institutions to re-evaluate what they are doing from a loyalty perspective. Clearly the loyalty landscape is changing, and programs are evolving into a format that makes it much more feasible for smaller financial institutions to participate, compete and prosper.

The Durbin Amendment's effects on loyalty programs

Fallout from the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has hit consumer loyalty programs quite hard—especially those for debit accounts. Prior to Durbin, the funding for these programs was largely derived from transaction and interchange revenue. It covered program operating costs, marketing and advertising, and reward fulfillment. Even with these substantial costs, most programs were financially sound and served their purpose of enticing consumers to use a specific card for more purchases, subsequently increasing the gross profit per active account.

These changes have forced issuers and large financial institutions to reevaluate their loyalty rewards programs. Emerging loyalty program formats, including the rise of merchant funded programs and relationship loyalty programs, level the playing field for smaller institutions, which now have the opportunity to get in the game. Smaller financial institutions can develop competitive programs that deepen their relationships with existing customers or members.

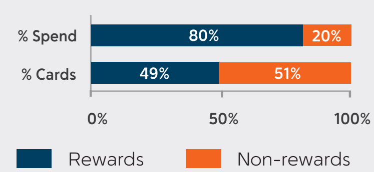
How Loyalty Programs Have Evolved Over the Years

Over the years, card issuers have attempted to differentiate their programs through enhanced fulfillment opportunities, more personalized merchant funded promotions or offerings, and new ways to manage and share points.

Traditional loyalty programs are losing relevance

A traditional loyalty program rewards consumers for using the payment card that drives more revenue for the financial institution, and program funding is supported by the program owner (i.e. financial institution). Earned rewards can take the form of cash back, points toward redemption for select merchandise in an online mall, airline miles, gift cards, or even donations to charities designated by the consumers. Over the years, these programs have proven their value to issuers and financial institutions by driving consumers to spend more with rewards cards compared to non-rewards cards. (See Figure 1.)

FIGURE 1: PERCENTAGE OF SPEND WITH REWARDS CARDS VERSUS NON-REWARDS CARDS



Source: Affinity Solutions

Credit accounts continue to have strong traditional loyalty rewards programs in which the institution is the primary funder of the program. On the debit side, financial institutions have pulled back from their funding of these programs. At one time, it was common for consumers to earn a quarter or a half of a basis point for every dollar spent in the program, but since the regulatory changes of the Durbin Amendment went into effect, there have been dramatic changes in most debit programs. Some banks have already terminated their debit rewards program; others continue to maintain a low level program that may entail bonuses or incentives to drive purchases with the card. In general, however, debit users are rewarded less for everyday transactions.

The emergence of the next-generation merchant funded loyalty program

Merchant funded loyalty programs allow issuers and financial institutions to retain the traditional program benefits of increased card spend and increased loyalty while simultaneously reducing (or virtually eliminating) program expenses. What's more, program owners can leverage merchant funded rewards to increase share of wallet, card activation and customer retention, and to lay the groundwork for participation in Universal Commerce, which we'll discuss later in this document. While merchant funded loyalty programs are in their early stages today, Aite Group projects that they will be mainstream industry offerings by 2015.[1]

In a traditional merchant funded program, a program vendor contracts with local to national merchants to provide offers that enhance a specific program's currency. For example, a retailer might offer accelerated point earning opportunities for purchases made during a specific time period (e.g., "Earn 10 points per dollar spent in July"). Portfolio segmentation and the use of data analytics in developing highly relevant offers to specific consumers and affecting their profitable behavior are the keys to making a merchant funded loyalty program successful. As an example, consumers who frequent a specific home improvement retailer may be presented with an offer from a competing home improvement retailer in their area.

Offers may be targeted to consumers based on their past purchase behavior and communicated through a multitude of channels which can include typical interactions with their financial institution. An offer may be embedded in a consumer's card statement or checking statement, or in a banner ad on the front page of their bank website.

Merchants will pay for programs and promotions that are targeted and that actually achieve their goals of incenting consumers to buy goods or services from that merchant. These kinds of promotions are often far more lucrative for the merchant than general advertising, and their effectiveness can be measured, analyzed and further refined to enhance the next campaign.

Financial institution loyalty programs are becoming more sophisticated and tailored to consumers through promotions with unique and real-time redemption opportunities. In addition, financial institutions are getting creative in their use of multiple channels to communicate offers. They may use email, text messaging and/or other channels through which the consumer is available (and agreeable) to receive communication.

Because the ability to closely match offers to consumers and to convert those offers into purchases is a crucial success factor, an issuer or financial institution must be judicious in its review of the program vendors and the strength of their customer segmenting and targeting capabilities and their customized offers. It's important to ensure that consumers are going to get the highest value from the offers, which in turn will help drive purchases, offer redemptions and, ultimately, revenue. (See sidebar.)

Partnering with the Right Program Vendor

The success that a financial institution has with a merchant funded loyalty rewards programs is largely dependent on the program vendor that is chosen to operate the program on the financial institution's behalf. Thus it's critical that the financial institution select a program vendor as a partner with the following characteristics and capabilities:

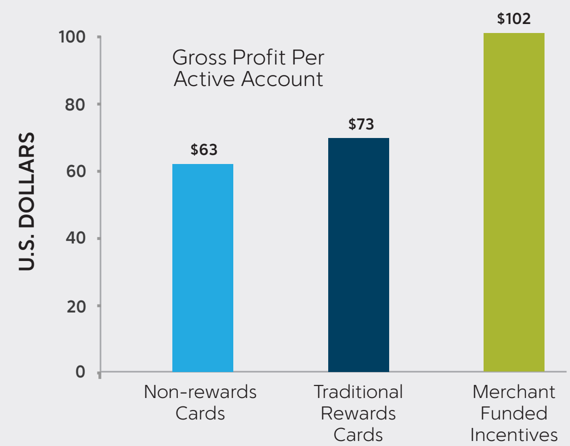
- Delivers a strong and varied merchant network that is continually evolving to bring more value to consumers
- Seamlessly integrates program technology with the program owner's infrastructure
- Superior capabilities to perform market segmentation and data analytics that will lead to increased redemption of offers
- Supports a wide array of marketing channels and campaigns
- Delivers offers to consumers based on their communications preferences
- Provides easy consumer rewards access and redemption capabilities
- Focuses on market trends and brings innovation into the program, such as the use of social media to acquire and engage consumers; the use of geolocation to deliver very targeted and timely offers, and the use of mobile wallets to store and redeem offers
- Provides a smooth pathway to Universal Commerce and to immerse the financial institution in the modern shopping experience that today's consumers expect

[i] Aite Group, "The Case for Merchant Funded Incentives: New Opportunities for Card Issuers," June 2011.

This form of merchant funded loyalty program is becoming more predominant today in the post-Durbin era due to its winning value propositions for all the participants:

- Financial institutions and issuers are able to defray some expense of the loyalty program by shifting the cost of the incentive or value of the points to the retailer.
- Merchant partners are able to drive increased sales through more meaningful offers to more qualified customers.
- Customers receive higher value and more relevant targeted offers, and have the opportunity to accumulate reward points more rapidly.

FIGURE 2: LOYALTY PROGRAM GROSS PROFIT COMPARISON



Source: Aite Group

Research conducted by Aite Group on DDA portfolios with an average of 100,000 accounts revealed that the merchant funded rewards program has a 40 percent higher gross dollar profit per active account per year than the traditional reward program, and more than 60 percent higher profit than a card program that offers no rewards at all.[2] (See Figure 2.)

Taking loyalty programs up a notch with relationship programs

Relationship loyalty programs actually surfaced in the 2006 timeframe with the Citi Thank You program, so they have been around (but under the radar) for some time. With the economic downturn in 2008-2009, we saw a quieting of relationship programs, but there is resurging interest today. In a relationship loyalty program, multiple accounts are linked together to generate additional rewards earning power. For example, consider a family with multiple accounts, including the parents' joint checking account with debit cards and a joint credit account, plus the children's teen checking accounts with associated debit cards. All of these accounts can be linked together so that any rewards earned on any of the cards or accounts accumulate in one pot.

Since points accumulate faster, participants can earn bigger rewards. (Who needs a toaster? Let's get a 60" flat screen TV!) These programs fit very nicely with the trend of consumers using social media applications to build and strengthen their personal relationships. Now they can bring banking into their social circles. Cardholders can share their rewards among family, friends and classmates by linking their accounts. What's more, this practice creates a gifting environment that didn't exist before.

Preliminary research from the programs in the mid-2000's showed that two things happen when consumers link their accounts to accelerate their earnings:

1. The participants become more engaged in the program because they deliberately act in specific ways to make sure they gain the biggest benefit from that program, and
2. By having these reward relationships linked together, the participating customers are more likely to stay engaged long term in that banking relationship.

One challenge for issuers and financial institutions is identifying which accounts can be linked. A key success factor in relationship loyalty programs is to allow consumers to establish their relationships and link their reward accounts on their own, such as through a web-based application. This allows like-minded people with a shared objective to designate their

[2] Madeline Aufseeser, Aite Group, "The Case for Merchant Funded Incentives: New Opportunities for Card Issuers," June 2011.

preferred usage of rewards. For example:

- Members of an extended family can link accounts to accumulate points or airline miles that will be applied toward a grand vacation for the family.
- Close friends and relatives can use their shared rewards to pay for a newlywed couple's honeymoon.
- Community supporters can funnel their reward points to support a charitable organization's mission, such as renovating homes for disabled veterans, or providing food and shelter for abandoned animals.

There is also a social aspect which presents a new dynamic for financial institutions because it creates buzz about the rewards program and encourages engagement through this new avenue of linking accounts, sharing points and accelerating the value of the relationship. Some banks are already benefitting from encouraging their cardholders to ask for points or tell people about their linking relationships through Facebook.

Emerging Trends that Will Have Relevance to Loyalty Programs

There are several consumer technology trends that are certain to impact card loyalty programs. Program owners should keep an eye on these trends and partner with the right providers who can incorporate them into their loyalty program offerings.

Universal Commerce

Universal Commerce is commerce that happens anytime, anywhere, and on any type of device. It blurs the lines between in-store commerce, eCommerce and mobile commerce such that many aspects of commercial activity are seamlessly integrated into one experience. From a consumer's perspective, shopping, payment, marketing (i.e., offers and coupons), loyalty, and money management all blend together in both offline and online experiences.

New technology and consumer expectations are driving the emergence of Universal Commerce. Today's consumers are impatient and savvy—they want what they want when they want it, and they take full advantage of opportunities to get it quickly and at great value. Fortunately for consumers, there are new technologies and services that enable those expectations to be fulfilled. These new technologies make it possible for consumers to quickly find the things they want, research them, see what others think about them, search for the best value, and make a purchase. Consumers are able to do these things while sitting at their desks or in their cars or while using a smartphone inside the store. By the time they make their purchase decisions, consumers are far better informed than ever before.

Now is the time for all financial institutions to be learning about Universal Commerce and planning a strategy to plug in to the ecosystem. Providers of financial services will want to not only engage directly with consumers who purchase and use their financial services, but also engage with merchants to offer services and merchant-branded payment products. In both cases, financial institutions win by capturing consumer mindshare directly and enabling the commerce strategies of their merchant customers.

Mobile payments

The term "mobile payment" generally means the ability to initiate or accept an electronic payment via a smart phone, tablet computer or some other portable or remote device. It's a nascent trend in the U.S. but globally there is strong participation in mobile payments. The research firm Gartner expects that 2012 worldwide mobile payment transaction values will increase 62 percent over 2011 and surpass US$171.5 billion. Sandy Shen, research director at Gartner, says the firm expects global mobile transaction volume and value to average 42 percent annual growth between 2011 and 2016. The company is forecasting a market worth $617 billion with 448 million users by 2016.[3]

Most mobile payments solution providers are looking at ways to incorporate loyalty rewards and redemption into their solutions. Not only do consumers have an expectation that mobile payments will support their loyalty programs, but vendors are using rewards as an enticement to get consumers to embrace mobile payments. As merchants choose to deploy specific mobile payment solutions, they will certainly want to include their own reward incentives at the point of sale. This will be an opportunity for merchant funded loyalty program vendors to bring more merchants into their networks.

Digital wallets

Another trend that is related to mobile payments is the emergence of digital wallets (also called mobile wallets). A digital wallet provides access to a variety of financial or commerce related functions or services, often (but not exclusively) via a mobile device. The most basic function of a digital wallet is to hold a collection of stored payment credentials, coupons, offers, etc. that can be used to initiate payment and redemption transactions. What's far more interesting, however, is that a digital wallet also can manage a variety of additional value-added services beyond payment capabilities, such as merchant offers, coupons and discounts; loyalty program incentives and redemption; location-aware offers and services; and comparison shopping.

As with mobile payments, there is no "standard" implementation of a digital wallet in the U.S. today. This is an emerging market, with dozens of innovative solutions being commercialized by merchants, mobile network operators, technology firms and other players. For issuers and financial institutions, the important thing will be to get their portfolios into as many digital wallets as possible—including their own, as consumers prefer branded virtual wallets from their own banks—to ensure the broadest possible market. They also should begin to partner with the providers that innovate the way that consumers interact at the point of sale.

Conclusions and Key Takeaways

- Traditional loyalty rewards programs offered by issuers and financial institutions may be less profitable or even unsustainable due to changes in market conditions. New merchant funded rewards programs hold the promise of lower expenses and a new source of revenue. At least one prominent analyst firm has concluded that merchant funded programs can have 40 percent higher gross profits than traditional rewards programs. Even small financial institutions must consider the new types of loyalty programs in order to remain competitive with the larger brands.

- There is a critical new player in any merchant funded loyalty program: the program vendor. This company brings the merchant network, the underpinning technology, and the analytics capabilities to the table. The quality of this vendor's solution elements and capabilities will determine the level of success that a financial institution' program can achieve.

- Loyalty programs of all types will be impacted by the emerging trends of mobile payments and digital wallets, and the broader environment of Universal Commerce. Financial institutions should keep an eye on market developments and be conscious of the need to plug into mobile payments, digital wallets and uCommerce in the not-too-distant future.

[3] CMSWire.com, "Gartner Predicts Nearly 62% Increase in Mobile Payment Transactions," May 29, 2012.

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