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Credit Cards Can Build Business for Community Financial Institutions

It's time to establish a profitable presence in the credit card market—and add a catalyst for stronger customer relationships

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Introduction

The recent economic turmoil has both transformed consumer behavior and profoundly altered financial institutions' business practices. Economic instability curtailed consumer spending and credit utilization, and high unemployment resulted in escalating credit defaults. Simultaneously, new banking regulations and increasingly stringent credit standards reduced credit access for many consumers.

As the economy recovers from the recession, many consumers who have a deposit-centric relationship with their preferred financial institution are likely to be seeking to develop the credit side of that relationship. The credit they desire, however, may not require a formal loan product like an installment loan or a home equity line of credit. The customer may be credit challenged or may simply not currently need these products. What many consumers—and businesses—do need right now is a convenient way to augment their short- to intermediate-term cash needs beyond their earnings and savings.

Credit cards are an excellent method for enhancing the credit side of institutions' relationships with both individual and commercial customers. Issuing credit cards provides an additional way to gain incremental revenue by extending credit for customers' day-to-day cash management needs, without the costs of repeatedly opening, closing and re-opening small loans.

The market for credit cards has changed dramatically over the last two decades. In the aftermath of the economic crisis, today's credit cardholders appear to be more cautious and frugal in their spending habits. Unlike pre-crisis credit card users, today's cardholders increasingly view credit as a valuable financial tool that needs to be used and managed carefully—instead of as a spending instrument for living beyond their means.

Given the nature of the changing credit card market, financial institutions need to recognize two important features of the credit landscape:

1. Credit cards, along with debit cards, deposit accounts and traditional loans, are a cornerstone of the core financial services that consumers expect from their primary financial institution.

2. Cautious cardholders can still be profitable cardholders. Consumers want and need short-term credit; they value the convenience and flexibility to make occasional purchases on credit without the hassle of using more formal lending arrangements. No one wants to encumber a house with further debt just to buy a TV or pay for car repairs.

The emphasis on building customer relationships is much stronger today than it was years ago when many banks and credit unions sought to reduce their costs by selling their credit card portfolios. Financial institutions realize they need to expand customer relationships in order to maintain loyalty and minimize attrition. Without credit cards, they are missing a piece of the banking relationship that is highly valued by consumers.

Financial institutions should attempt to build a relationship that satisfies all of a customer's needs for credit products; if they don't provide that comprehensive set of offerings, another financial institution will. With the economic recovery under way, the timing is ideal for financial institutions of all sizes to make credit cards a profitable component of their product portfolios.

What to Know About Today's Credit Card Market

Consumer credit cards are the largest source of revenue for financial institutions. Fees and net interest income from consumer credit cards account for 40 percent of the $277 billion U.S. payments industry. With commercial credit cards included, total credit card accounts are responsible for more than half of total payments.

If the economy warms up and consumer spending rebounds, demand for credit is likely to increase. Experts expect the recovery in credit markets to be slow but steady as pent-up demand is released for cars, appliances, vacations and other big-ticket items.

It's not just the economy that is heating up—so is competition for credit-worthy consumers. Credit card issuers, after clamping down on their risk levels during the long recession, are increasingly ready to do business again. As the economic recovery gains traction, watch for a surge in issuer initiatives to attract new customers. For newcomers to the credit card business, it makes good business sense to enter the market in the vanguard of the emerging trend, not in its maturing stages.

The Pendulum Swings Back

Before the turn of the millennium, credit cards were a standard offering for financial institutions of all sizes. However, technology changes and emerging economies of scale resulted in a highly consolidated competitive landscape for credit cards. Many issuers eventually sold their portfolios to larger institutions, which were winning business with heavily promoted low teaser interest rates, easy balance transfers and attractive rewards programs. Consequently, the percentage of outstanding credit cards issued by the largest 10 financial institutions increased from 63 percent in 1996 to 91 percent in 2008.[1]

Only 36 percent of U.S. financial institutions were still issuing credit cards by 2008. The vast majority (almost 95 percent) of active card accounts reside with 16 Tier I issuers, all of which are banks.[2]

Of the approximately 8,000 credit unions in the United States, only slightly more than half offered credit cards in 2008. For banks, the numbers are even more dramatic: 80 percent were not issuing credit cards in 2008. This figure represents a vast number of institutions foregoing the opportunity to build a complete customer relationship that includes a full range of credit products.

In spite of the market dominance of large issuers, a countertrend is beginning to emerge. Today, there are sound reasons why small to midsize institutions can profitably serve the credit card market. This paper makes the case that yesteryear's decision to discontinue issuing credit cards may merit reconsideration for the new era of banking that is emerging. By reentering the credit card market (or entering for the first time), financial institutions of all sizes can expand their customer relationships and add a new source of revenue.

Why Issue Credit Cards?

Credit cards foster loyalty. At financial institutions of all sizes, customers expect to find a broad range of services. When an anticipated service, such as a credit card, is not offered, the potential customer relationship is incomplete, and the institution's customer base is more vulnerable to competitive churn. Ron Shevlin, a senior analyst at Aite Group, asserts, "Branded credit cards offer a compelling opportunity for community financial institutions that understand the value of building long-term customer relationships and rewarding customers across the entire relationship."

This is true for both individuals and commercial customers, especially the small-business customer base that is so important to local and regional financial institutions.

The presence of credit cards in the product line enhances the customer relationship by enabling consumers to fulfill a broader range of credit needs from one trusted source. Consequently, most card issuers view the credit card offering as a vital catalyst for customer retention and "wallet share."

Credit cards drive profit. Consumer credit is a dominant source of revenue for most financial institutions. Consumer credit cards can be a consistent, recurring source of interest, fees and interchange income.

About two-thirds of credit card revenue comes from interest income. This serves as an excellent complement to deposit accounts, where fees drive a high portion of the revenue. Another 20 percent of card revenue typically comes from interchange charges, which amount to 2 percent or more of every transaction cleared through the issuing bank.

Credit cards build the brand. The institution that offers more services is in a better position to win the next mortgage, home equity loan or car loan. Credit cards are a key component needed for offering a full range of deposit and lending services. With a complete product line, plus a respected brand built on a foundation of personal service, the financial institution enhances its ability to cross-sell and ultimately strengthens its ties with consumer and commercial customers. Deposit accounts and credit cards are the two main pillars of wallet share that can lead to auto loans, mortgage loans, IRAs and CDs.

Credit cards provide a convenient avenue to funds. With credit cards, consumers obtain the funding they need—for short- or long-term requirements—without the need to fill out more forms or to open and close loans repeatedly. From the financial institution's perspective, unsecured credit cards serve as renewable loans that result in a stream of interest income and fee income.

Credit cards have manageable risks. Obviously, credit risks are present for any type of loan product, but they do not represent major obstacles for institutions with sound underwriting practices and the ability to price risk appropriately. As for fraud risks, institutions with reliable fraud prevention measures can expect to contain fraud losses to minimal levels. Moreover, providers of the more sophisticated credit management services use neural networks for fraud scoring and decisioning systems to probe every transaction for potential fraud and to verify suspicious activity with cardholders.

Why Credit Card Products Have Become More Attractive for Smaller Financial Institutions

The business case for issuing credit cards is much stronger today than it has been in years past. The key reason for this change is in the options available to financial institutions for managing their credit card portfolios.

In the past, determining a credit card portfolio management strategy was an unpleasant dilemma for all but the largest institutions. The card issuer's choices were few: It could decide to implement and administer its own in-house solution, or it could cobble together a patchwork of external services to handle the multitude of card administration chores. Both of these approaches were costly and inefficient, so many institutions reluctantly resorted to a third option: They sold their portfolios and exited the credit card business.

No longer does an institution need an excessively large operating budget to address the full range of its credit card management functions. And no longer is it necessary for a smaller institution to accept one-size-fits-all services with no opportunities for distinctive branding and personalization.

Today, full-service credit issuing solutions are robust, flexible, comprehensive and cost-effective. Services are available that can handle everything from origination to remittance and collections. Best of all, sophisticated credit card programs can be implemented as quickly as 120 days.

According to Dennis C. Moroney, a research director at TowerGroup, "Community financial institutions are now able to leverage the functionality and technology that could only previously be supported by larger credit card issuers."

Affordable technology now enables financial institutions to design card programs that incorporate their unique brand, identity and messages. Communications associated with the entire customer life cycle can cost-effectively support the financial institution's brand, including the initial terms and conditions, plastics, statements, customer service and the Internet banking experience.

In addition, consider some of the cost-saving potential that can be realized by financial institutions today as they deploy cardholder support services. It is unnecessary for the bank to implement expensive call centers for inbound customer service calls; the leading solution providers offer 24/7/365 customer call center support for credit card customers. Nor do banks have to worry about creating or maintaining Internet banking Web sites to accommodate their online credit card customers. Solution providers offer Internet banking applications uniquely branded with the community financial institution's desired look and feel.

Solution partners also support dynamic statement printing, e-delivery and mail services incorporating the messaging and branding of the financial institution. Correspondence, compliance and disclosure notices, and promotional inserts can be dynamically printed along with statement correspondence to avoid expensive preprinted materials.

With these new, advanced credit card management solutions, card issuers aren't forced to use generic branding. Each issuer can design the appearance of the card, so every transaction gives the consumer another visual reminder of his or her relationship with the institution. The same philosophy of customizing the entire card solution for each individual financial institution extends into other areas. For example, a bank or credit union can uniquely cast its own credit administration policies. Each institution has the flexibility to define and easily change underwriting policies, credit limits, balance-transfer policies and other parameters related to individual cardholder accounts or the entire portfolio.

Marketing Opportunities Widen for Smaller Banks and Credit Unions

With many institutions continuing to maintain tight constraints on their credit lines and terms, it creates opportunities for other institutions to either enter the credit card market for the first time or to expand their market share. The timing is right for smaller institutions, in particular, to use credit cards as a way to establish deeper, closer relationships with their customers.

Even if a financial institution is small, its brand is important to customers. A Forrester survey found that brand name was a key factor in the choices of 29 percent of U.S. online adults who opened a credit card in the prior 12 months.[3] That's a clear sign that consumers want to use the card of their preferred bank or credit union.

For institutions that have won a consumer's deposit business, there's a significant potential to parlay that bond with the consumer into a stronger relationship. The opportunity to win credit accounts is particularly favorable for brand-new deposit accounts and for younger customers in the early stages of finding the best mix of products and services for their financial needs.

Of course, this approach requires proactive initiatives to ensure that branch personnel seize appropriate opportunities to promote credit cards. Employees need to cross-sell credit card products when a customer opens checking and savings accounts. Customer service representatives should make selected callers aware of special offers based on prescreening parameters.

Credit Card Management Services: What to Look for in a Full-Service Processing Solution

Many financial institutions want to offer credit card products, but they believe that entering the credit card business is prohibitively expensive and complex. They haven't been able to justify the high costs of providing personnel and technology for administering an internal program.

How can small to midsize banks and credit unions offer credit card products without the high costs formerly associated with supporting bankcard programs? The answer is to seek out providers that specialize in offering effective, scalable credit card processing services customized to the client's needs.

In general, seek a comprehensive suite of services that can effectively support the institution's brand and provide fully flexible administration of the credit card program—with all aspects of the program, including card production, available from a single source. The solution should be fully scalable to select the optimum combination of services for required needs and expand both functionality and volume over time.

The key is to recognize that the launch of a credit card requires more than just a system to process payments and issue statements. A financial institution can offer not just a credit card supported by administrative processes, but rather a complete credit card program that impacts customer loyalty and represents a bank or credit union's brand.

In evaluating a credit card program for a bank or credit union, here are the primary attributes to look for in a full-service processing provider:

→ **Rapid implementation.** The provider's solution should enable a financial Institution to be up and running quickly with all the capabilities it needs to enter the credit card business.

→ **Full functionality.** Make sure the provider's solution offers the ability to select which functions to outsource and which can be managed internally. A customized solution can include application decisioning, transaction processing, billing and customer correspondence. In addition, the solution can include any or all of these service functions:
  - Customer service
  - Risk and fraud management
  - Application processing
  - Flexible delinquency and collections policies
  - Production and delivery of embossed, branded cards
  - Back-office services

→ **Innovative loyalty and reward programs.** Some of the more sophisticated merchant-funded reward programs enable a financial institution's customers to receive targeted offers from merchants based on their purchase behaviors and life stages.

→ **User-controlled branding and messaging, including statements and Web sites.**

→ **Support for small-business and commercial accounts.**

Conclusion

In today's economy, many financial institutions may feel like they are facing a powerful headwind. But the economic landscape for credit issuers isn't as unfavorable as they may believe. "If you think about the entire U.S. population as a risk portfolio, it's safe to say that the portfolio is indeed improving," according to Dann Adams, president of Equifax U.S. Consumer Information Solutions.[4]

While it is far from clear how long the recovery will last or how strong it will be, the best time to capitalize on any emerging trend is in its early stages. For small to midsize financial institutions, an opportunity to create new revenue streams and to build stronger relationships with customers has already arrived. Consumers want and expect more services from their most trusted financial institutions.

By adding credit card accounts to the product mix, a financial institution can offer customers all four cornerstones needed for building their financial futures: demand deposits, savings accounts, traditional loans and the convenience of revolving credit accounts. That in itself opens more doors to cross-selling and improves the likelihood of higher customer retention rates.

The decision to offer credit cards isn't easy, given the intense competition in this market. However, as virtually every industry has seen, the inexorable movement toward greater consumer choice and better service can quickly shift market share to the organizations that are most proficient at adapting to rapidly changing customer needs.

Sources

[1] First Annapolis Consulting. Presentation to First Data. 14 January 2010.

[2] Ibid.

[3] Strothkamp, Brad. "How U.S. Consumers Choose a Credit Card Provider." Forrester Research. 25 November 2009.

[4] Chernikoff, Helen. "U.S. consumer-debt delinquency rates fall: Equifax." Reuters. 17 May 2010.

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About the Author

Stephen Hug is currently vice president of Strategy and Innovation for First Data's Financial Services, supporting the credit market products. Leveraging the company's vast resources, Hug focuses on developing solutions to meet the needs of First Data's financial institution and retail customers.

Previously, Hug served as vice president of First Data's Debit Services and was part of the Product Management and Development team. He was responsible for providing strategic leadership and research to drive innovative risk and fraud solutions to protect financial institutions customers.

Hug joined First Data in 1990, serving in a series of finance and management positions, including controller, market strategy, and product development. His financial management background, along with his vast experience in payment processing, credit card fraud and risk management, usage and retention, and retail payment processing provide Hug the foundation to collaborate with First Data's clients to drive innovation and product management.

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