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A First Data White Paper

Profitable Strategies for Increasing Private-Label Card Income

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Introduction

To successfully move forward in an altered regulatory and economic environment, card issuers need a new array of strategies for adding supplemental revenue streams, simplifying operations, and reducing costs.

Issuers of private-label cards suffered brutally from the effects of the recession and its aftermath. First, they were deluged with substantially increased borrower delinquencies and defaults. These were soon followed by stricter regulations, in the form of the Credit CARD Act of 2009. In the midst of these disruptions, shrinking card revenue and escalating operating costs prompted some issuers to put their private-label portfolios up for sale.

Yet the much-maligned store-branded card portfolios may be worth salvaging, for several reasons:

- Delinquencies in the credit card industry as a whole are slowing, including private-label cards
- While private-label cards tend to incur greater losses, they typically generate higher revenue than traditional cards
- Although the Credit CARD Act regulations were impactful to issuers' bottom lines, there are still many opportunities for private-label portfolios to compete profitably in today's marketplace

For private-label card issuers that withstood the recession and are now in the process of navigating through an uncertain recovery, there are still challenges ahead. The CARD Act affects many of the rules related to promotional pricing and APR (annual percentage rate) increases, potentially resulting in decreased card usage, higher issuing costs and reduced overall profit. To successfully move forward in an altered regulatory and economic environment, card issuers need a new array of strategies for adding supplemental revenue streams, simplifying operations, and reducing costs.

This white paper explores innovative revenue-generating strategies and operational efficiency recommendations that card issuers can employ. Together, they offer issuers a plan for creating a more profitable private-label portfolio, while strengthening customer relationships and staying competitive in a changing marketplace.

The State of Private-Label Card Programs

From specialty boutiques to big box discounters, few shoppers have escaped hearing a sales clerk ask, "Would you like to save 15 percent today by opening a credit account?" As the first step in the application process for a store-branded credit card, this ubiquitous phrase helped propel the private-label credit market to nearly $114 billion in total balances by 2007.[i]

Of course, everything changed when the credit crisis and recession struck. By the end of 2009, balances on store cards had dropped to $94 billion,[ii] and delinquencies and defaults had increased to all-time highs. Consumers in financial distress relegated store-brand cards to the bottom of their payment hierarchy, choosing instead to maintain credit on general-purpose cards that could be used to pay for necessities like gas, groceries and utilities. They also postponed purchasing big-ticket items such as televisions, furniture, and other durable goods—the bread and butter of the private-label credit market.

To deal with the poor performance of private-label cards, issuers began to reduce credit lines in order to limit liability and losses. They also began raising interest rates and charging fees that traditionally had not been imposed (e.g. overlimit fees). The outlook was so dismal that General Electric, the largest U.S. issuer of private-label cards, even tried (unsuccessfully) to divest its private-label business in 2008.

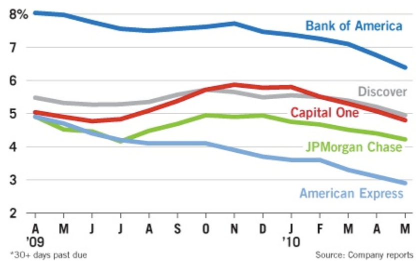
At the same time, the newly enacted Credit CARD Act threatened to make an already weakened business even less lucrative for private-label issuers. The Act set limits on the types of promotions retailers could offer, specifically the "No payments for 12 months"-type of deal. The new regulations require consumers to make at least a minimum payment each month, incrementally diminishing the appeal of the private-label card value proposition. Otherwise, issuers must offer a "true zero" arrangement, in which no interest accrues over the term of the promotion—meaning issuers lose revenue from accrued interest charges.

Another CARD Act item worried lenders and retailers even more—the income verification requirement. As originally written, the law obliged retailers to verify income or assets by collecting copies of customer pay stubs, tax returns, or bank statements. Few shoppers carry these documents with them, making instant credit at the point of purchase virtually impossible to offer—and eliminating one of the major attractions of private-label cards.

Private-Label Prospects Improve

Private-label issuers received something of a reprieve in early 2010. The final ruling on the Credit CARD Act allowed for determining income in other ways than requiring consumers to provide documentation. Instead, issuers can make a "reasonable estimate" of a consumer's income or assets based on statistical models or other empirically-derived approximations.

The positive news on income-verification, combined with improving credit trends, helped begin to disperse the dark clouds hanging over the entire private-label card business. Charge-offs for private-label receivables were 10.4 percent in July 2010, down substantially from the 11.6 percent reported in June, according to the Standard & Poor's Rating Services U.S. Credit Card Quality Index.[iii]



Credit card delinquency rates continued to improve, maintaining a months-long trend.

Source: Sense on Cents. June 16, 2010

The private-label card market also received a boost from the poor performance of co-branded credit cards. Some companies in recent years had abandoned their private-label cards in favor of co-branded ones that could be used more widely (like Target's Visa card, for example). However, many issuers found that low transaction volumes and interest income did not justify the expense of managing these co-branded programs. In addition, tighter underwriting standards began to make it more difficult for consumers to even qualify for the cards.

With less credit available and shoppers tightening their wallets, retailers are placing greater importance on simply getting customers to make purchases in their stores, rather than providing credit for use somewhere else. Additionally, in order to help drive sales to cost-conscious consumers, retailers are increasingly emphasizing store-exclusive and private-label-branded product offerings.

Benefits of Private-Label Cards

Store card chargeoffs exceed general-purpose cards

Retailers know how important private-label credit programs can be to their success, since many consumers still seek to use store credit to purchase big-ticket items. For example, jewelry retailer Zales reports that 40 percent of its U.S. sales come from customers using the store's private-label card.[iv]

For issuers, retail cards represent both risk and reward. Even in a robust economy, the store cards ordinarily incur higher delinquencies and charge-offs than general-purpose cards, with the average user possessing a slightly less credit-worthy profile.

However, this greater risk is rewarded: private-label cards typically generate higher revenue than traditional bankcards. Issuers of private- label credit cards collect $16 to $18 in interest and fees on every $100 loaned out, compared to the $14 to $15 per $100 loaned on general-purpose cards.[v]

With the economic recovery underway, private-label cards are once again a promising proposition. Now, rather than trying to offload store card programs, issuers have the opportunity to enhance their overall credit portfolio by capitalizing on the higher average return of private-label cards.

Three Revenue-Boosting Strategies for Private-Label Issuers

It's clear that retailers and issuers in today's altered economic and regulatory environment cannot rely on outdated practices if they wish to keep their portfolios profitable. In order to take optimum advantage of the income potential that exists in private-label cards, they need a new approach. Here, we look at three strategies for boosting private-label card revenue.

1. Give customers more reasons to use their cards.
The recession may officially be over, but unemployment remains high and consumers are still pinching pennies and carefully evaluating how they use their credit. Yet, even within the constraints of the Credit CARD Act, there are effective ways to entice consumers into pulling out their store-branded plastic to make purchases.

- **Instant discounts and special promotions** – Rather than limit the customary 15 percent discount to the first day, give customers an automatic discount every time they use their card in order to encourage more frequent usage. Or, offer discounts on specific items (e.g., exclusive or private-label branded products) to lure customers into the store and boost add-on sales.

- **Customized payment terms** – To compensate for the CARD Act-mandated elimination of the "same-as-cash" credit deals, extend the terms on promotions so the minimum payments become attractive from the customer's perspective. Another option is to offer equal payments, whereby the consumer pays a set amount each month. This type of budgeting arrangement is something many consumers are looking for to help manage their monthly expenditures.

- **Rebate programs** – Taking a cue from general-purpose cards, give customers rebates or points when they use their cards for cash-back rewards, bonus shopping discounts or access to exclusive sales events.

- **Advanced account management tools** – Deploy enhanced account features like fraud alerts, payment reminders, electronic statements and mobile payments. Providing consumers with advanced account management tools helps retain their business and stimulate card usage after the initial credit purchase. In addition, these tools can help customers to better manage their accounts and payments, resulting in a greater capacity for them to spend at retail partners' stores.

- **Co-branded debit cards** – With the increased use of debit cards by consumers and a tighter credit market, consider offering a co-branded debit card that draws against a checking account linked to that card. A debit solution may be just what debt-averse customers are looking for.

- **Prepaid solutions** - Recently proposed Durbin Amendment regulations may springboard prepaid cards to the forefront of payment options for many consumers and retailers. As the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act are clarified, retailers should explore the opportunities prepaid solutions bring to their sales goals and payment choices.

Citigroup and Zale Negotiate Win-Win Agreement

After nearly ending its relationship with Zale Corp., Citigroup's retail-partner card unit designed an agreement that helped both parties. Citi had planned to terminate the contract because Zale failed to meet the agreed-upon credit sales volume minimum of $600 million. Under the new contract, Citi reduced the minimum level of annual net credit to $315 million. However, if Zale's net card sales fall 20% or more during any 12 months, Citi has the option to end the arrangement.[vii]

2. Provide retailers more flexible options

Although private-label cards can be more profitable than general-purpose cards, they represent a riskier proposition for issuers, especially when retailers control the customer relationship—including marketing and promotions.

One way to increase a store card's income potential is to negotiate deals with retailers in which they have more incentives and greater accountability for driving store-card sales volume.

A market-leading aggregator of private-label cards, Citigroup, dropped Home Depot's co-branded card—but kept the home improvement store's private-label card in its portfolio after a favorable revenue-sharing agreement was negotiated.[vi] Under this arrangement, Home Depot is provided with the economic incentives to push enough sales volume through the card program to at least cover the cost of the program, if not make a profit.

Citi also worked out a deal with jewelry retailer Zale Corp. when the store's private-label card failed to perform as expected. (See sidebar.)

Another opportunity for private-label card aggregators generate increased revenue is by brokering partnerships (i.e., coalitions) between non-competing retailers to accept each other's store cards. The ability to use a private-label card at multiple retailers can potentially elevate the card in a consumer's purchase card hierarchy. Issuers can also develop rewards programs that span across the merchants within their portfolio.

3. Get innovative in finding new revenue sources

In today's credit landscape, the rate of new private-label account openings has dropped dramatically, in part, because many consumers are unwilling to even apply for additional credit. Furthermore, the Credit CARD Act places limits on increases in APRs, so replacing lost revenue by simply raising interest rates is not a simple solution.

In order to make up for fewer customers and stricter regulations, issuers and retailers must work together to find new revenue streams.

- **Generate revenue through fees**
  There are a number of ways to incorporate new fees without compromising customer relationships. One way to approach fees is to customize them

based on customer preferences, which can be identified using analytics. For example, issuers can package distinct fee packages built around credit limits, statements (paper or electronic) and late payments. Different customers get different fee packages based on their risk and behavioral profiles, as well as their personal preferences.

Issuers also can expand their array of fees. A "deferred interest extension" fee lets consumers pay to extend the deferred or lower payment for a current promotion that's about to end. Another account feature could allow certain customers to exceed their credit limit for a fee.

There are numerous ways to attach fees to special services or promotions, so consumers are not surprised and do not interpret them in a negative way—thus protecting the retailer's brand and customer relationships. The key is to target fees to the most profitable consumers for maximum results, and to make it clear that the customer is receiving something of value in exchange for the fee.

- **Introduce insurance/auxiliary programs**
  Fees are an excellent way to generate additional revenue, but they are often only associated with one-time events. For recurring revenue, auxiliary programs such as product protection plans, warranties, credit protection, and insurance are excellent opportunities. While some retailers have their own programs, issuers can partially, or fully, fund the programs as part of their credit solution packages.

- **Look to new technology to drive sales**
  Retailers are leading the way in capitalizing on Mobile technology, with the deployment of contactless readers and location-based services to offer instant coupons and promotional messages to shoppers. The rapid acceptance of this emerging technology presents the opportunity for issuers to offer contactless card products, as well as mobile account management, marketing, banking, and couponing. Private-label cards that offer the increased convenience and flexibility of Mobile applications will potentially be the ones used most often by tech-savvy consumers, and will be the most attractive to retailers.

Four Operational Strategies for Even Greater Profitability

Automate New Fee Structures for Easier Implementation

To generate additional income, an issuer may implement a fee structure for value-added services. The challenge becomes how to automate charges for unique activities such as deferred credit extensions. By employing an automated credit solution tool, the processes become streamlined as the correct fee is coded to be applied automatically.

To make the most of new revenue-generating strategies for private-label cards, it is important to consider the operational implications. Here are four operational strategies that can help drive even greater profitability for private-label portfolios.

1. Use analytics to increase effectiveness
When implementing new fees, promotions, and services, it is critical to do it for the right reason, and for the most appropriate accounts.

Advanced analytic tools can help issuers and retailers predict how offers and programs will be adopted by consumers, thus saving time and money on implementation, and increasing the overall profitability of each program.

For example, issuers may want to see which program will perform better: a warranty program or a rebate program. Using predictive analytics, they may find that the warranty program will perform better with certain customers, while the rebate program will be more attractive to others. With this information, issuers and retailers can implement customized promotions based on geography, demographics, and psychographics.

Analytics also are beneficial on the front-end to attract high-profit cardholders, as well as for designing programs that persuade inactive customers to use their cards. By performing analytics on their card portfolios, issuers and retailers can determine more efficiently the strategies that will net the greatest benefits.

2. Outsource for significant savings and access to innovation
One critical question facing both issuers and retailers is, "How do we easily deploy compelling and profitable card promotions without a lot of technical development?" The answer is outsourcing.

Outsourced credit portfolio management tools give issuers the flexibility to price accounts based on individual customer characteristics, and to assign the appropriate terms and promotional offers to targeted cardholders. These automated services allow issuers to more quickly and easily implement smarter offerings for retailers and consumers.

3. Capitalize on fraud management innovations
Advanced fraud management services help issuers and retailers detect fraud and gain visibility into shopper behavior, as well as to define rules that effectively assess risk and resolution variables. With an efficient and accurate way to mitigate risks, issuers reduce charge-offs and save time and money for an even more profitable card portfolio.

4. Provide incentives for cost-saving consumer behaviors

If the administrative costs of managing cards are getting out of hand, turn to customers to help reduce some of those costs. For example, electronic statements are significantly less expensive than paper statements—so give customers a reward for switching to email statements or conversely, charge a fee for paper statements. Take the same approach with self-service account management to drive consumers to a Web site for account information and problem resolution, rather than contacting a comparatively expensive customer service representative.

Conclusion

Despite the long-awaited inklings of sustained economic recovery, private-label cards are up against difficult challenges in the radically transformed credit and regulatory environment. And consumers are thinking twice before applying for store cards, and those who already have them are often reluctant to use them.

Persistently challenging economic conditions, coupled with the Credit CARD Act's tougher regulations, mean that managing a profitable private-label portfolio will require new strategies for attracting and retaining customers, working with retailers, generating revenue, and running an efficient operation.

Fortunately, new approaches to optimizing private-label card income can be implemented, including:

- Increasing card usage through promotions, offers, and services tailored to customer preferences through analytics
- Developing mutually beneficial agreements with retailers for cost and revenue sharing
- Expanding revenue streams through the addition of fees, insurance/ auxiliary programs, and new technologies (like Mobile), and using analytics to determine which programs are most effective
- Implementing operational strategies like outsourcing and enhanced fraud management to create efficiencies and drive greater profitability

Together, these recommendations can give card issuers the edge in maintaining a profitable private-label portfolio, while strengthening their customer relationships and staying competitive in a changing marketplace.

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[i] Packaged Facts. Private Label Credit Cards in the U.S. 6th Edition. September 2006.
[ii] Saha-Bubna, Aparajita. The Wall Street Journal. "Store-Brand Credit Card Boom." August 19, 2010
[iii] Johnson, Andrew. American Banker. "Store Cards Regain Favor as Co-Brands Disappoint." September 30, 2010
[iv] American Banker. "Store Cards Regain Favor as Co-Brands Disappoint." September 30, 2010
[v] Saha-Bubna, Aparajita. The Wall Street Journal. "Store-Brand Credit Card Boom." August 19, 2010
[vi] Johnson, Andrew. American Banker. "Store Cards Regain Favor as Co-Brands Disappoint." September 30, 2010
[vii] Ibid

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About the Author

John Patton is vice president of client relationships in the Financial Services division of First Data and is a retail card processing subject matter expert within the company. Patton joined First Data in 1988, and has held a variety of roles across operations, client relations, product development and IT. Prior to his current position, he was in product development working on large company initiatives and with First Data client executives in the development of innovative product solutions in the retail and co-brand card space. As director of product development for the First Data re-architecture effort, Patton designed and managed new industry-leading features used by retail card issuers today including real time payments, real time fraud scoring and real time new accounts.

Before that, he was a business systems consultant responsible for analyzing client business systems to determine where current features and functionality could be leveraged in the First Data system. Earlier in his career at First Data, Patton managed all aspects in the development and launch of over 100 co-branded card products on the First Data system.

Patton holds a bachelor's degree in business administration and real estate from Midland University. He holds several patents with focus on the retail payments space.