The Next Big Thing

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Polaris Partners

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Massive cuts to interchange are fundamentally altering the financial dynamics of payment cards. Add in squeezed net interest margins and lower revolve levels, and issuers around the world are scrambling to re-engineer their business models. In the process, they're dusting off an approach to rewards that had for most been put in the "too difficult" box.

Understandably, managers are looking hardest at the expense side of their P&Ls. And in many C level suites, that's putting the cost of rewards programmes under intense scrutiny. Historically, a rule of thumb has been to return to credit card customers at least 1% on spend in the shape of perceived rewards value (less on debit card transactions). Customers see lower levels as not worth engaging with. But 1% is hardly affordable if, as will shortly be the case in Europe, interchange is fixed at only 20 or 30 basis points on debit and credit cards respectively. And issuers in other territories could well have to adjust to the same supposedly customer-friendly regime.

On this analysis, cashback programmes are clearly the most threatened: responding to reduced interchange by cutting the return percentage strikes at the heart of the customer offer.

So what are the other options? They may include:

- Cancelling the programme
- Reducing the value of the reward by changing redemption rates and earn rates
- Shifting as much as possible of the cost elsewhere – typically in the form of merchant-funded programmes
- Introducing (or increasing) annual fees

Each has its pros and cons:

Option	Pros	Cons
Cancel the programme	▪ Major savings	▪ Customer backlash – change usage levels or attrite ▪ Spend shifted to continuing competitive programmes
Reduce the value of the reward	▪ Some savings ▪ May be not immediately obvious to the customer	▪ Negative media comment ▪ Negative consumer interest group reactions ▪ High spend customers migrate to competitors
Squeeze better value from rewards providers	▪ Some savings ▪ Unlikely to cover drop in card revenue	▪ Merchant resistance as economic climate improves
Shift as much as possible of the cost to merchants	▪ Savings – to be quantified ▪ Potentially, additional marketing funds from merchants ▪ Creates platform for relaunch	▪ Need to prove conclusively incremental value to merchants as price for their participation ▪ Merchants will ultimately control the value of the rewards programme
Introduce (or increase) annual fees	▪ Additional income to offset revenue lost ▪ Ends potential cross-subsidy from non-programme customers	▪ Need to demonstrate programme value ▪ Customer attrition ▪ Negative media comment ▪ Negative consumer interest group reactions

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On the face of it, not a very tempting menu of choices.

Making the best of it

One option that has found favour has been to get merchants to fund the rewards programme. The US, for example, has seen a sharp increase in merchant-funded programmes and an even sharper decline in points programmes. According to the 2014 PULSE Debit Issuer Study[1], in 2011, 62% of debit issuers offered points rewards programmes. By 2013, this had fallen to 39% of debit issuers. Over the same period, Merchant Funded Discount Networks (MFDNs) grew from 38% of debit issuers in 2011 to 55% in 2013.

Merchant-funded programmes are open to the charge that they may fail because they cannot prove to participating merchants that they generate more income than they cost. Ways have been found to try to address this: one approach features revenue-sharing, for example. Despite these potential concerns, in the US the trend to MFDNs is expected to continue: a reported 75% of exempt (under the Durbin Amendment) issuers and 100% of regulated issuers planning to launch new rewards programs are leaning towards merchant-funded offers.

But today's hot option is Big Data. That's to say, issuers (and associations) sharing with merchants customer transaction and behaviour information, suitably anonymised, to drive rewards programmes for their mutual benefit. This makes such good sense that the wonder is that it has taken so long for the industry to get around to it. But it has also to be recognised that data-sharing is simply a means to an end. And that end has to be increased value for customers combined with increased profitability; which means using the data intelligently. Some merchants will rise to the challenge, some won't – but the issuer (or the association) has to invest the same resources into data-mining either way. In practice, data-sharing is most often used to support merchant-funded discount programmes – which brings us full circle.

If this reasoning is correct, reduced interchange will inevitably lead to rewards programmes being cancelled, reduced in value to the customer, or more complicated to manage – the last two are not exclusive, of course. And there's evidence for this: when the Reserve Bank of Australia reduced interchange rates, the US General Accounting Office took a look at the results. Their commentary on the effect on rewards programmes could hardly be clearer: "*In Australia, issuers reduced rewards and raised annual fees following that country's interchange fee cap.*"[2]

Dare to be different?

So far, so depressing. But some banks are taking a broader view. Their argument runs something like this:

Challenge 1: Today's hyper-watchful, hyper-competitive banking climate makes customer loyalty even more important. And in this context, loyalty means not just tenure but also holding multiple retail products and services

Challenge 2: Fierce pressures on card profitability mean that card rewards programmes are ever more difficult to fund

Maybe, these bankers are saying, there's a solution which meets both these challenges: a bank-wide loyalty programme (bwlp). An initiative like this would draw on the fatter margins usually associated with retail products to fund a programme driving sales of the entire range of customer banking products and services.

Start with debit and credit cards – frequent transaction levels make them a natural programme platform – and then extend the rewards earned to term deposits, insurance, savings products, e-banking... Rewards values would reflect individual product profitability, and there could even be a multiplier, based on the number of products held and calculations of customer lifetime value.

For the bank, there are three commanding benefits:

- Almost by definition, the programme would boost customer profitability by encouraging, on the revenue side, cross-product holding, and on the cost side, a move to cheaper e-servicing alternatives
- At the same time, it increases "stickiness": the more products a customer holds, the less likely she is to switch
- Properly managed, it allows the bank to make genuine claims around delivering incremental customer value across the board.

[1] www.pulsenetwork.com/

[2] www.gao.gov/new.items/d1045.pdf Nov 2009

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So much for the theory. The practice is a lot harder.

Here be dragons....

First, there's a real downside: it's an option open only to banks. Monolines would have to find some other solution. But practitioners who have actually worked with banks to explore bwlp development report real difficulties in making them happen:

The silo effect Frustratingly often, mortgages don't talk to deposits who don't talk to bancassurance, who don't talk to cards....

Who owns the customer? Or, to put it another way, Who funds the programme?
How do we measure profitability? It's all too common for different product silos to take very different views of the profitability of the same customer

How do we integrate our back offices to support the programme? In many institutions, business units have built their own IT support facilities with little regard for cross-product functionality

No doubt, these can be real problems. But well-established programmes like Citi's ThankYou, launched in 2004, have shown that it can be done. Following their lead, before the 2008 crash other banks were actively investigating whether they too could create a bwlp. Came the crisis, and the over-riding imperative became the need to survive. Now that a degree of stability has been restored, interest is reviving: some banks are seeing the opportunity and finding ways to tackle the roadblocks.

One thing is essential: the impetus must come from senior management. The retail boardroom is the position best placed to take a whole customer view, and persuade business unit bosses that maximising product profitability comes second to maximising bank profitability.

Potentially, a bank-wide programme does two extremely useful things. It broadens the rewards funding base from cards to the entire retail banking range. And as a direct result, it creates massive cross-sell opportunities. Not an easy strategy to implement: but for banks that can pull it off, this could be the next big thing.

Thanks to Ron Mazursky for valuable insights

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About the Author

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With more than 20 years of experience in the payment card industry, Roy was previously with American Express, where as VP and General Manager, he launched the highly successful commercial card business in the UK, going on to lead product rollout across EMEA and latterly Latin America/Caribbean.

As a consultant, Roy works with banking and payment card clients around the world, identifying and advising on best practices in customer marketing and relationship management. He has also undertaken assignments in media, utilities, airlines and retail.

He has developed and audited coalition and bank loyalty programmes in the UK, Ireland, the Netherlands, Spain, Canada, Dubai, Kuwait, Australia, Singapore, Spain, Israel, Turkey, Saudi Arabia, Brazil, Chile, Venezuela and Mexico.

Roy has also advised on airline FF programmes, and has been the rewards lead in the MasterCard Advisors pool.

He speaks fluent Spanish, reasonable French and is the author of Marketing Planning for Financial Services (Gower Publishing). He has a B. Com, holds an MA in Management Studies and is a Fellow of the RSA.

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