

IS YOUR INSTITUTION READY TO RESPOND TO CHANGING CARD REGULATIONS?

By Mark Flamme

There was a lot of discussion leading up to passage of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (“The Credit Card Act”). Now that it has been signed into law, there are plenty of opinions about its potential impact on consumer credit and its implications for the banking industry and the larger economy. Although these macro issues are interesting to discuss, the more pressing questions involve institutions’ readiness and ability to comply. Has your institution considered what comes next?

WHAT EXACTLY DOES THE CREDIT CARD ACT DO?

The Credit Card Act tweaks and accelerates by four months many provisions already approved by the Federal Reserve Board as amendments to Regulation Z. Key provisions of the bill include:

Interest Pricing Flexibility Restrictions

The bill restricts when institutions can change annual percentage rates (APRs) and fees. Specifically, it requires that customers receive at least 45 days advance notice prior to APR or fee changes, and it bans APR increases during the first year that an account is open and requires that promotional rates be fixed for a period of at least six months. The bill also restricts the methods for calculating finance charges by prohibiting rate changes based on “universal default,” tying APR increases to broader indices and banning double-cycle billing.

Fee Limitations

First, the bill restricts fee pricing in general to practices deemed “reasonable” and “proportionate” to the service or behavior being addressed. It also requires that customers opt-in for fee-based over-the-limit services, and it bans fees assessed by bill-payment channel. Third, the bill restricts the ability to issue cards with high fees and low credit limits. Fourth, it requires that payments above minimum be applied to highest interest balances first. Finally, the bill prohibits inactivity fees on gift cards and provides for a five-year life span.

Communication Mandates

The bill requires that statements be mailed 21 days in advance (versus 14 days currently) and that statements contain disclosures about cost of financing, due dates, late fees, and the impact of only paying the minimum balance. In addition, credit card agreements must be posted on an institution’s web site.

WHAT DOES THIS MEAN FOR ISSUERS?

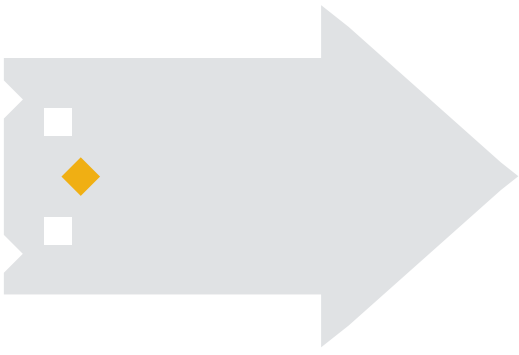
The implications of this legislation will vary considerably from issuer to issuer depending on multiple factors—from current portfolio and customer mix to channel mix, current products, and current pricing and fee structures. For example, analysts believe issuers that typically didn’t engage in many of the banned practices, such as universal default and double-cycle billing, will see little impact.

While the magnitude of the bill’s effect will vary, the implications likely will not. These implications fall into four main categories: economic, competitive, consumer, and operations/technology.

Economic implications

The potential for lower profit is clear as the legislation drives down revenues and raises expenses. Revenue constraints around the ability to re-price, the elimination of double-cycle billing and some fees, and limits on fee amounts will take a toll. Many customers with marginal credit will now become too risky to serve, shrinking the potential market and dropping overall volume.

Likewise, implementation of the bill will drive up ongoing operating expenses. For example, maintaining inactive gift cards on a system of record for a longer period of time will increase account storage costs—costs that can’t be recouped through fees. New notification requirements may increase statement printing and mailing costs. And, for many, enhanced compliance reporting will be more expensive.



When set against the backdrop of continued high unemployment and charge-offs, as well as declining card balances and usage trends, these revenue and expense impacts may be too much for some issuers. Selling a card portfolio may be an attractive option, particularly for institutions that are seeking to generate capital. Offering card products through a correspondent bank may be another attractive option for some issuers.

Issuers that opt to maintain their portfolios will be forced to innovate around new products while scrutinizing their expenses to generate viable returns. Product innovations that tie credit products to hard assets to minimize risk, particularly in the first year of issuance, are likely. Other innovations may be targeted toward driving activation and usage among the most credit-worthy customer segments. These could include new rewards programs, differentiated service levels, exclusive offers with local retailers, etc. On the expense side, institutions will scrutinize marketing dollars more closely and require better return on investment (ROI) metrics. Additionally, portfolio clean-ups will continue to target inactive accounts for reactivation or closure.

Competitive implications

The Credit Card Act will alter the competitive playing field. In general, the winners will:

- ◆ Develop ways to deepen their customer relationships and move their card up in their customers' wallets.
- ◆ Utilize mandated disclosures as an opportunity to communicate proactively with their best customers.
- ◆ Provide clear disclosures that will differentiate them from the pack as the "trusted, honest" card issuer.
- ◆ Demonstrate creativity and speed to market with new products that deepen existing customer relationships and provide credit to marginal segments in a risk-appropriate manner.

These institutions also will rely on a clear customer orientation, strong customer analytics capabilities, and system flexibility to create and speed new products to market.

Consumer/Market implications

The Credit Card Act is the result of consumer frustration with industry practices. This frustration, in combination with the financial crisis, has eroded trust in financial institutions, including card issuers.

Issuers that speak directly to consumer sentiments may be able to steal share from other, less proactive institutions. For example, institutions that have never participated in certain controversial practices may consider marketing campaigns with messages that acknowledge consumer frustration, describe their opposition to banned practices, and express their commitment to customers' interests. In addition, they may update their disclosures to use clear, easy-to-understand language about their product offerings.

Operations/Technology implications

From an operations and technology standpoint, leading firms will:

- ◆ Bring new products to market quickly.
- ◆ Develop the capability to analyze customer segments and sub-segments in great detail.
- ◆ Experiment with new strategies to drive card activation and usage among high-potential segments.
- ◆ Experiment with new fees structures and adopt successful practices quickly.
- ◆ Experiment with customer statement disclosures and adopt successful approaches quickly.
- ◆ Negotiate proprietary custom work successfully with their card processors.

WHAT SHOULD YOU DO NEXT?

How does an issuer take advantage of the opportunities inherent in The Credit Card Act, mitigate the risks, and, more importantly, develop the right course of action for its particular institution?

West Monroe Partners recommends four key steps:

1. Identify opportunities to increase current card usage to drive revenues.
2. Identify opportunities to "clean-up" or re-engage inactive card accounts to increase revenues and decrease operating costs.
3. Develop a customer communication strategy focused on honesty, full disclosure, and education about the cost of credit.
4. Devote appropriate resources and effort to the implementation of your strategies.



Given the compliance timeline for the legislation, many institutions already have taken action to capture results during the busy holiday season. Institutions that have waited can still take proactive action that will positively impact their portfolio (see exhibit below).

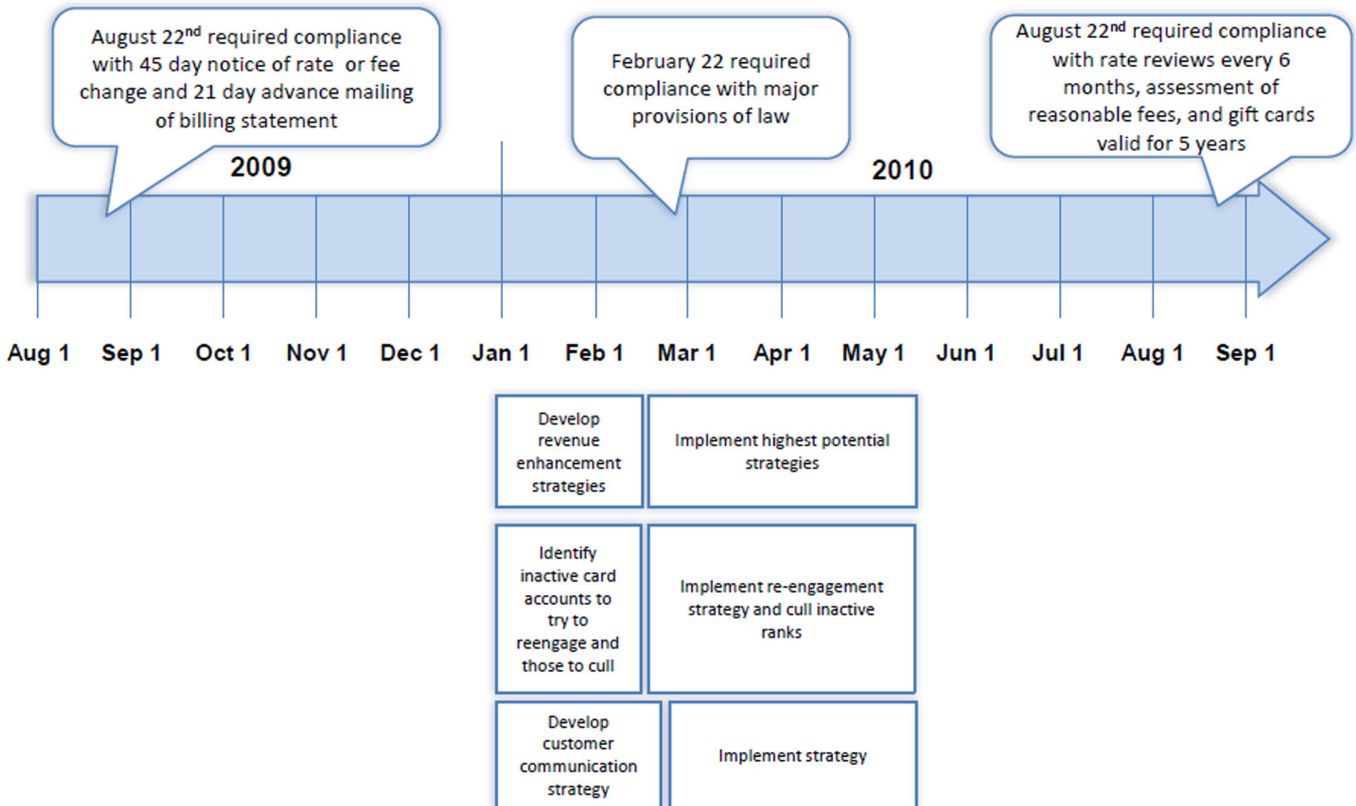
Step 1: Identify opportunities to increase current card usage.

Issuers can drive greater usage by increasing card activation rates and transaction volume. Increasing card activation rates starts with targeting the right customers. Are there common characteristics among the customers who activate and use your cards? Are there common characteristics among the customers who don't? The first step is to analyze your customer base to gain insights necessary for effective targeting. Then, make it easy to activate your card. Do you provide instant decisions and issuing? Do you provide incentives to activate the card immediately and use the card to open a balance?

Understanding your customer base requires answering these and other questions:

- ◆ Which customer segments are heavy, medium, and light users?
- ◆ What are the common characteristics of each user group?
- ◆ What are low users using instead of your credit card (e.g., your debit card or another issuer's credit card)?
- ◆ Why don't low users use your card more often?
- ◆ What would create an incentive for them to use your card more?
- ◆ At which retailers do most customers use your card?

Through this type of analysis, you will be able to identify attractive, high-use segments on which you can focus your marketing and sales processes. Likewise, you can use this information to develop new products and rewards programs that drive higher usage, and you can establish marketing partnerships with local merchants that your high-priority customers patronize. Information and analysis is critical, but your key to success will be your institution's flexibility to experiment with different products and marketing campaigns and adapt quickly to adopt those that best meet your customers' needs.





Step 2: Identify opportunities to “clean-up” or re-engage inactive card accounts.

Forty percent or more of many issuers’ accounts are inactive. Inactive accounts increase operating expenses when processor costs are based on accounts on file. But, inactive accounts also present a significant opportunity to re-engage with potentially profitable customers. Calling segments of these customers—particularly those who have larger relationships with your institution—not only is a great way to reconnect with these individuals; it provides you with an avenue for understanding why customers don’t use your card and to introduce new rewards and incentives. On the other hand, analyzing inactive accounts also can help you close accounts and terminate relationships with certain customers who do not have significant relationships with or profitability potential for your institution. Several major issuers already have been aggressive in “cleaning up” their portfolios by culling inactive accounts.

Step 3: Develop a customer communication strategy focused on honesty, full disclosure, and education about the cost of credit.

Given current customer sentiments, now is the time to highlight your organization’s customer-centric approach and practices. Developing a communication strategy around honesty and full disclosure could be a differentiator. Successful communication strategies deliver consistent messages through marketing campaigns, statement disclosures, and even sales processes.

Step 4: Devote appropriate resources to the implementation of your strategy.

Too often, sound strategies fail because organizations don’t allocate the appropriate level of resources to critical projects and/or because employees attempt to execute these efforts in their “spare time.” Transitioning to the new regulatory environment demands that institutions reconsider the effort required—not only for compliance, but for their future performance and success. What can you do now to ensure an efficient and effective transition?

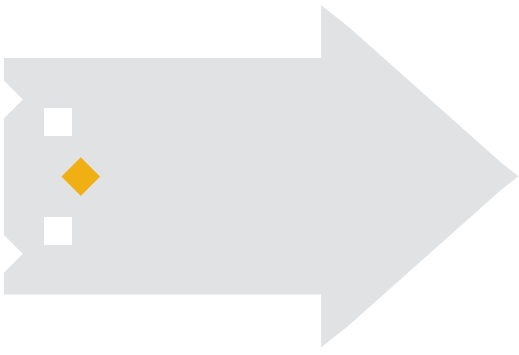
First, take the time to develop a detailed set of requirements, both for compliance and for your profitability and communication strategies. Then, collaborate with your processor and internal technology group to ensure a common understanding of responsibilities for meeting those requirements. Don’t assume that your processor will make sure your portfolio is compliant with the new legislation. In fact, many issuers will be surprised to find that compliance will require some in-house system changes. Finding out sooner rather than later is vital.

Second, negotiate hard to maintain control over custom development. Issuers frequently complain that their own innovations become the processor’s innovations and subsequently are made available to competitors.

Given the immediate need for new products and the opportunities to differentiate through clear statement disclosures, maintaining some control over these items will be crucial. Processors have shown a willingness to negotiate periods of exclusivity for certain developments; however, the trade off may be higher development costs. Alliances with out-of-footprint issuers may provide an option to negotiate control while sharing development costs.

Third, invest time and effort in low-cost experimentation that enables you to measure results quickly and adjust your strategies. Innovation often comes when an organization learns from multiple failed efforts. In the current environment, a test-and-learn experimentation approach can make a lot of sense. Structuring small-scale, inexpensive pilots of merchant alliances, rewards programs, and marketing campaigns can provide insights into the drivers of customers’ card usage. Even a failed effort can highlight what doesn’t work for particular customer segments, enabling you to refine your approach. The key to using this approach successfully is measuring the results of each “experiment” and gleaning and disseminating the lessons learned throughout the organization.

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POINTOFVIEW

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