

Crisis in the credit card industry  
Navigating the perfect storm





# Foreword



As the global economy settles in the wake of the crisis, many financial sectors are facing a perfect storm. The credit card industry is at the forefront of these challenges.

The industry landscape is changing and financial institutions need to understand how to achieve growth, efficiency, and compliance in the changing credit card industry while also managing the risks of a radically different marketplace. In this paper, the Deloitte Center for Banking Solutions examines these developments and their implications for issuers.

Several areas have come to the forefront as being most influential. Wholesale markets have stalled, regulatory scrutiny is rising, and new payment models are reshaping the industry. A natural response might be for credit card issuers to adopt a more conservative approach — pulling back in some areas and streamlining in others. An alternative approach is innovation, not just in the traditional sense of product innovation, but across the whole operating model, including the relationship with customers and merchants.

This will not only help growth and improve the customer experience, but also foster efficiency and profitability, creating new dimensions for success.

We hope you find these insights helpful in understanding the challenges facing the credit card industry and how issuers may be able to embrace these changes to be more successful and profitable in the new marketplace.

Yours truly,

A handwritten signature in black ink, appearing to read "Don Ogilvie". The signature is stylized and written in a cursive-like font.

**Don Ogilvie**  
*Independent Chairman*  
Deloitte Center for Banking Solutions

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# Executive summary

The fortunes of the credit card industry have changed dramatically. In just the last two years, credit cards have gone from being one of the most profitable areas of lending to one of the least. Record levels of defaults and stalled securitization markets have rapidly reversed the profitability of the industry. The nine consecutive monthly declines in revolving credit from October 2008 to June 2009 represent the longest pullback since this data began being tracked by the Federal Reserve Board in January 1968.<sup>1</sup> It is unclear when and if the fortunes of the industry will improve.

Given challenging market conditions, a renewed focus on consumer protection from the current U.S. administration is restricting the freedom of issuers to raise interest rates and fees to restore profitability. The proposed establishment of a Consumer Financial Protection Agency (CFPA) suggests more regulation may be forthcoming. Additionally, the requirements for transparency and disclosure to consumers have increased. Merchants continue to complain that interchange fees are high in relation to other costs,<sup>2</sup> while recent legislation reflects a wave of populist sentiment from customers angry at what some have described as abusive practices.<sup>3</sup> As if these developments were not enough, the industry is facing ongoing disruption as part of the transformation of the payment industry.

Regulators want the industry to deliver simpler, more transparent products, yet market conditions suggest they should become more innovative. This leads to conflicting agendas that are difficult to resolve. It may be helpful to think about innovation beyond products to include access to markets, channels, and different models of customer

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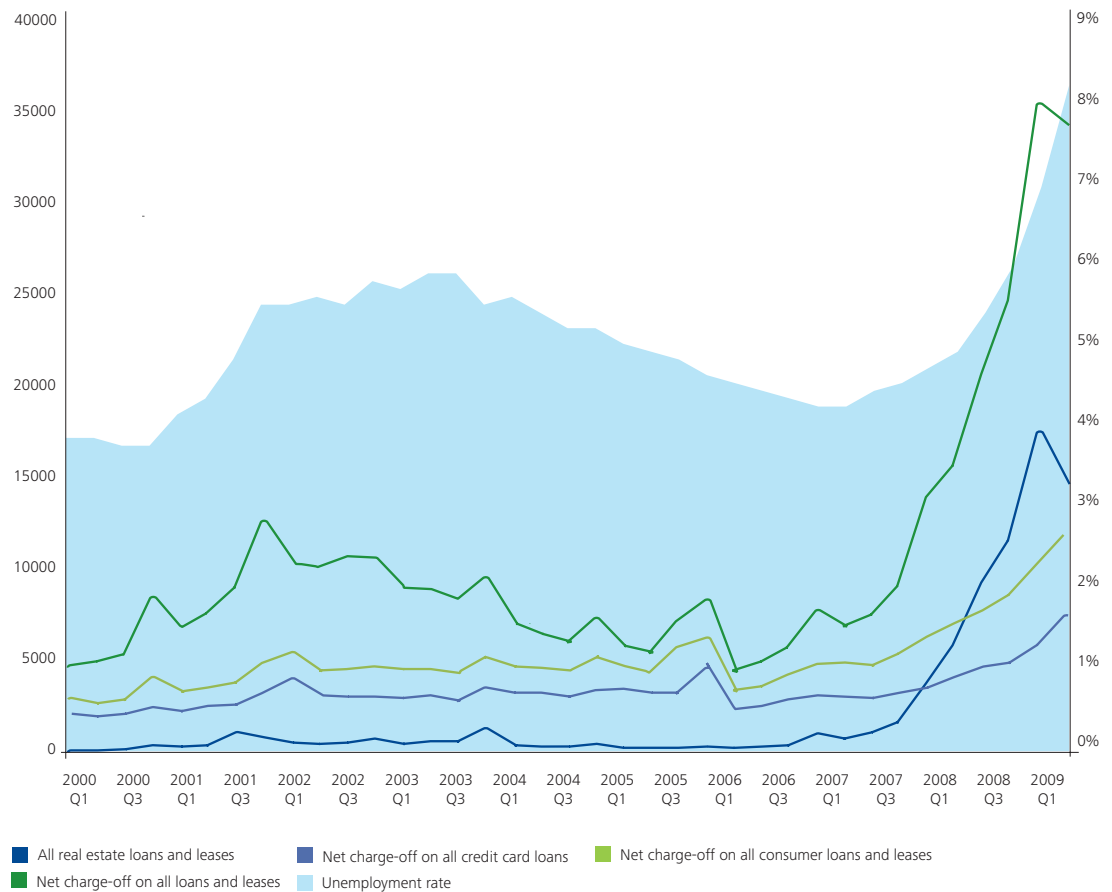
It may be helpful to think about innovation beyond products to include access to markets, channels, and different models of customer and merchant relationships, as well as new approaches to operations and risk management.

and merchant relationships, as well as new approaches to operations and risk management. Currently, issuers are considering a number of options, from exiting the business altogether to redefining business and operating models. Some have set up project management offices to execute a number of quick changes to products, pricing, and lines of credit. Others are taking a longer-term approach, revising business, governance, and operating models to reflect the needs of a new marketplace.

How the market will develop is uncertain. Current estimates point to economic recovery, but how strong will that be? Government regulation looks likely to increase, but how severe and effective will that be? Wholesale markets are showing signs of stability, but when will securitization recover? These uncertainties encourage issuers to plan for alternative scenarios. The key challenge for the industry is innovation — to offer the next generation of card services. The landscape for card services will almost certainly be very different in the future, and a new generation of winners and losers is likely to emerge.

# A perfect storm

**Exhibit 1: Charge-off and unemployment rates all U.S. commercial banks**



Source: Bureau of Labor Statistics, Federal Reserve

The card industry is caught in a perfect storm. Record charge-offs are occurring at a time of increased government regulation. Some estimates suggest that the long-established relationship between credit card loss rates and unemployment levels may be breaking down and that charge-off rates could soon surpass unemployment levels.<sup>4</sup> (See Exhibit 1.)

One issuer has suggested that the days when the old business model of credit cards as a profitable standalone product are over and that credit cards will become a tool in the overall customer relationship, rather than a product marketed as a single service.<sup>5</sup>

This brings sharply into focus the debate about the future of the industry, which is currently split between more diversified bank and monoline issuers. The market appears to be swinging in favor of the banks with their broader funding base, diversified operating platforms, and broader

customer relationships. Yet recent reported results suggest that some banks are performing much worse than many monolines, raising further questions about where the industry is headed.<sup>6</sup> It is likely that all issuers may need to consider a portfolio of options, innovating in some areas while pulling back in others. This will create the need for a more flexible operating model — one that can respond quickly to changing customer needs and compliance responsibilities, as well as variations in transaction volumes and more flexible merchant relationships. For some issuers, a new operating model, rather than an amended one, may be needed.

Issuer strategies appear in need of change. A successful strategy is no longer about maintaining a high level of originations, but instead about picking the right portfolio of customers likely to deliver the highest return. This requires a more targeted approach to business development and an increased emphasis on retaining many existing customers through an improved customer experience. Customer experience appears to vary significantly between issuers,<sup>7</sup> with larger monolines sometimes outperforming some of the diversified issuers. Customer attrition, particularly of profitable customers, is another factor that could eat into industry margins. Issuers must focus more on those customers who must be retained and developed to increase their willingness to stay.

The industry has reached a turning point. Credit card borrowings are likely to fall. Some estimates suggest that credit limits may reduce by as much as \$2 trillion.<sup>8</sup> Even a significant reduction could force a fundamental rethinking of business, funding, and operating models.



# Concerns over interchange fees

Interchange fees typically involve a payment from a merchant's bank to a card user's bank for each card transaction. These fees are generally passed through to merchants by their banks and comprise a large fraction of the fees that merchants pay to their banks for processing credit card transactions. In recent years, increases in interchange fee rates, together with growth in the volume of card transactions, have led to a dramatic rise in the total value of interchange fee payments and, consequently merchant costs in accepting credit card transactions.<sup>9</sup>

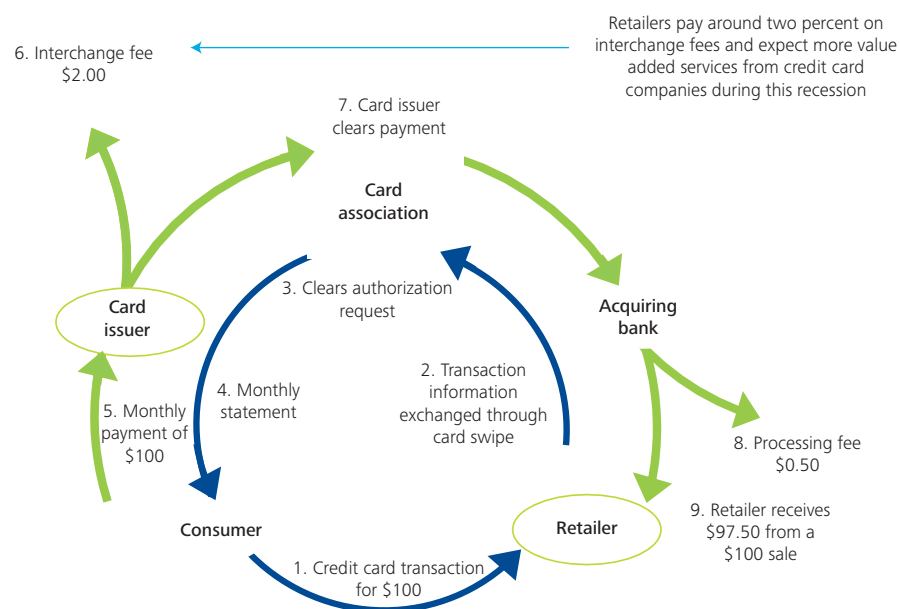
Interchange fees have risen over time to the point where they are the second-largest cost after payroll at some major retailers.<sup>10</sup> Additionally, some retailers claim that credit card companies use penalties to prevent them from directing consumers toward alternative discount payment options, such as cash, debit, and online fund transfers.<sup>11</sup> As a result, merchant concerns focus on the level and sometimes the very existence of interchange fees. The efforts of the retail industry against interchange fees

have been long and arduous, but in the current climate, retailers are hoping regulators and legislators may be more receptive to change.<sup>12</sup>

In contrast, card networks and their supporters contend that cards provide substantial value to both consumers and merchants and that interchange fees are essential for the proper operation of the card networks. They note that a common interchange fee standardizes the terms of exchange between the merchant's bank and the card user's bank and plays an economically important role in influencing the incentives of merchants to accept cards and consumers to hold and use them.<sup>13</sup>

The current structure of interchange fees is outlined in Exhibit 2. The example provides an estimate of the fees involved in a \$100 sale. Retailers pay around two percent on interchange and acquiring fees and expect more value-added services from credit card companies particularly during the recession.

**Exhibit 2. The structure of interchange fees**



Source: U.S. Government Accountability Office Report 06-929

The level of interchange fees has long been a controversial issue in the industry. Merchant associations in particular claim that interchange fees have more than doubled in the last 10 years while the costs of technology have fallen. In January 2007, Microsoft chairman Bill Gates cited high interchange fees as a significant reason Microsoft believes it can be competitive in online micropayments. In response to these criticisms, regulators are increasing their focus on this area. Among the possible additional regulations they may implement are the following:

- Disclosing the exact fees and amounts assessed to retailers so they can offer appropriate discounts to consumers interested in paying by alternative methods
- Giving merchants the ability to negotiate the level of interchange fees

Given this possibility, issuers should consider proactively partnering with retailers to look for additional ways of adding value to their relationships. This could be a win-win situation for issuers and retailers.

Nearly one in 10 consumers chooses credit cards based on rewards that are funded by merchants and can be redeemed where consumers shop most frequently.<sup>14</sup> For maximum effectiveness, such discounts should be carefully targeted, marketed electronically, and redeemable automatically since an all-electronic approach can drive greater repeat usage than the in-statement marketing that has traditionally predominated.<sup>15</sup> By partnering with merchants, issuers might not only increase merchant activity, but also make their cards more attractive to existing and potential customers while reducing the growth of their own rewards costs and liabilities.

# Increased regulatory scrutiny

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The overall direction of financial reform and consumer protection is likely to be toward simpler, “vanilla” products that are easier for consumers to understand. This may pose a challenge for issuers looking to craft innovative product solutions to improve their margins.

The new Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act)<sup>16</sup> is the latest in a series of regulatory proposals impacting credit card issuers, but it is unlikely to be the last. The CARD Act restricts the ability of issuers to make retroactive rate increases until a consumer is 60 days late, and the prior rate must be restored if the customer pays on time for six months. Restrictions are also placed on other interest rate changes and fees that would reduce credit availability. Card access to consumers under the age of 21 is limited. There is a requirement for the U.S. Government Accountability Office (GAO) to study the impact of interchange fees on consumers and merchants.

In addition, the U.S. administration has proposed to establish a CFPA.<sup>17</sup> If approved, this would transfer the responsibility for consumer protection in financial services away from the depository regulatory agencies to an

agency whose sole mission is to protect consumers. This may create a much tougher environment for financial service providers in general and for card issuers in particular.

Whatever the longer-term outcome of regulatory reform, the near-term consequences of the CARD Act in particular are likely to be a significant reduction in the ability of issuers to raise interest rates and fees as freely as before. According to the American Bankers Association, the bill contains various provisions that limit a lender’s ability to manage risk, price fees, allocate payments, and prudently conduct business. These limits will necessitate reductions in available credit given economic conditions while increasing the price of credit where it remains available.<sup>18</sup>

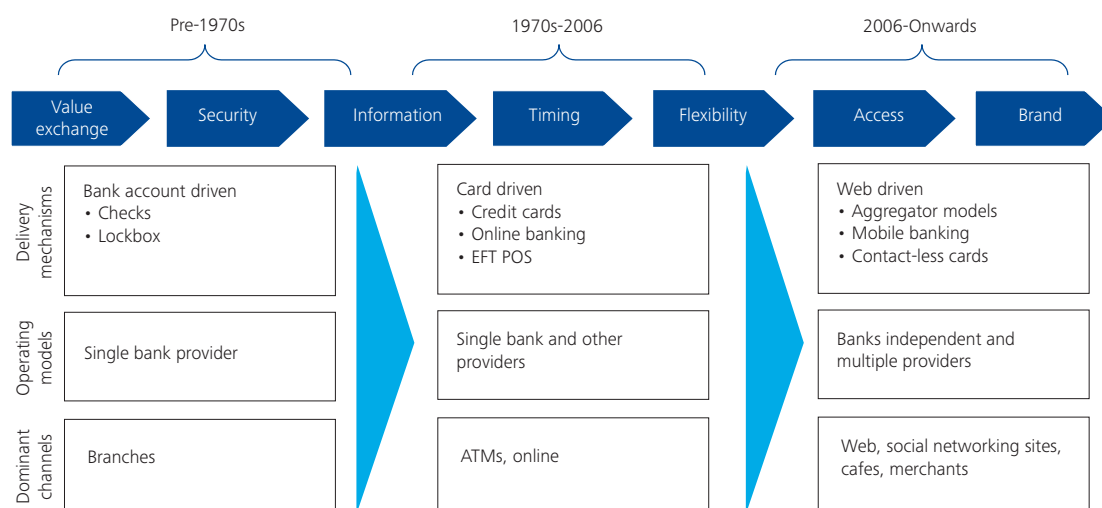
An alternative view, however, is that the CARD Act and the proposed CFPA could be in the best interests of the industry because they may increase consumer demand by giving a seal of approval to safer financial products.<sup>19</sup> However, the overall direction of financial reform and consumer protection is likely to be toward simpler, “vanilla” products that are easier for consumers to understand. This may pose a challenge for issuers looking to craft innovative product solutions to improve their margins.

Merchants fear that the new regulations could result in a reduction in business and an increase in interchange fees. According to one association, “reining in interest rates and late fees is an important step, but it won’t mean anything for the consumer if banks are allowed to just shift the costs to interchange fees and impose rules that adversely impact consumers and merchants.”<sup>20</sup>

# A shifting payment landscape

Changing consumer behaviors and needs are driving issuers to redefine their operating model from lend-centric to spend-centric.

**Exhibit 3: Evolving drivers of the payment value chain**



Source: Research by the Deloitte Center for Banking Solutions

## Issuers should decide whether they are primarily in the credit or payments business

Are credit cards a standalone product or part of a diversified range of financial services? Seen as part of the payment family of products, credit cards can be viewed within the context of the evolution of payment services.

Exhibit 3 illustrates how the drivers of value in the payment industry have changed over the years. It is also interesting to note that the rise of credit cards coincided with a significant drop in the U.S. savings rate. The U.S. savings rate is currently increasing and a new pattern of consumer behavior may be emerging, relying less on debt and more on savings to drive spending. It is still too early to

say whether this will be sustained. However, the growth of online retailing and the development of alternative payment mechanisms, such as PayPal and Bill Me Later, each of which have amassed a significant number of merchant relationships, all point to a new generation of payment services.

Issuers may wish to consider developing their services in the context of the evolution of payment services, seeing credit cards as a general eCommerce solution providing consumers with the ability to research products online or through social networking sites, offering discounts for targeted merchants and a range of settlement options. One option for credit cards might be to become

a multipurpose instrument with both debit and credit features or even be a Web-based concept. As a physical and a Web-based service, consumers could make online purchases using the online version of their credit card services without having to reveal their account number to the World Wide Web. In some parts of Europe and Japan, even mobile phones are being used as payment devices. These have a prepaid amount stored on a chip with the phone used in the same way as a contactless payment card relying on near-field communication technology. The concept of a credit card and the form it might take are likely to change significantly over time, assuming both a physical and virtual dimension.

Finally, cards can also provide deposit services. Issuers may wish to consider allowing customers the opportunity to prepay their credit cards and receive interest or more favorable credit terms. They might also consider offering deposits services, where the balance could support existing borrowings, perhaps justifying a higher credit limit based on the demonstration of the borrower's liquidity that suggests they may be a lower risk than a constantly indebted borrower. Banks generally experience a lower level of losses with borrowers with whom they also maintain a deposit relationship. Combining credit cards with deposit services may not only reduce charge-off rates, but it also may make credit cards more relevant to a new generation of thriftier consumers, as well as contribute to additional funding flexibility.

There are significant opportunities for developing the card product in addition to rewards, personalization, and pricing structures. Whether through the payment or credit line or as a diversified banking tool, issuers should consider a clear product development path to forestall disruption and address some of the current industry challenges.



# The new paradigm of risk management

Twenty years ago, the credit card industry was primarily a short-term lending business. Subsequently, issuers determined that the biggest profits didn't come from people who repaid their balances regularly, but from customers who maintained a constant level of debt. As a result, consumer loans became a perpetual earning asset. This created a substantial revenue stream from interest payments and fees on late payments and credit limits that had been exceeded. Today, Americans have an average of 5.3 all-purpose cards in their wallet and the average household has \$10,679 in consumer debt.<sup>22</sup>

However, the growth of a business model that relies to a large extent on continual borrowings creates significant risk management issues during difficult economic times. Issuers may want to provide incentives for borrowers to repay balances with lower interest rates. This could enhance customer experience, broaden card acceptability, and potentially reduce risk as well. It would also bring issuers more in-line with regulatory guidance.<sup>23</sup>

The fall in originations has been dramatic. During 2Q09, U.S. households received 349.1 million credit card offers, a 67 percent drop from the 1,060 million offers received during 2Q08. Yet, this was only a six percent decline from the 372.4 million offers received during the first quarter of this year, which suggests the origination recession may finally be reaching a bottom and issuers may be becoming less risk averse.<sup>24</sup>

However, with the continued weakness of securitization markets and the impending changes in accounting rules related to securitization vehicles, issuers are likely to remain more cautious than before and have become more interested in better understanding their customers in order to more accurately gauge their willingness and ability to repay. A 2002 study of how customers of Canadian Tire were using the company's credit cards found that 2,220 of 100,000 cardholders who used their credit cards in drinking places had missed four payments within the next 12 months. By contrast, only 530 of the cardholders who used their credit cards at the dentist had missed four payments within the next 12 months.<sup>25</sup>

A renewed focus on default management has now become a critical success factor for the industry. (See Exhibit 4.) It may also provide a more effective mechanism for compliance management.

By segmenting customers into different loss probability buckets and prospects for collectibility, it becomes easier to develop collection strategies based on where customers appear on the matrix and their psychographic score detailing their behavior, profile, and characteristics. An emphasis on performing standard and routine processes efficiently and effectively is paramount to success in addition to compliance with recent government legislation (i.e., CARD Act) and other regulations (i.e., Fair Lending Act).

**Exhibit 4: A default management model**

	Loss mitigation	Collectables		
Psychographic score ↑	<b>Negative disposable income</b> Cooperative, returns calls, openly provides information, keeps promises	<b>Some disposable income</b> Cooperative, returns calls, openly provides information, keeps promises	<b>High disposable income</b> Cooperative, returns calls, openly provides information, keeps promises	Rehabilitatable
	<b>Negative disposable income</b> Somewhat cooperative and responsive to questions, provides some information but personal questions are out bounds, sometimes keeps promises	<b>Some disposable income</b> Somewhat cooperative and responsive to questions, provides some information but personal questions are out bounds, sometimes keeps promises	<b>High disposable income</b> Somewhat cooperative and responsive to questions, provides some information but personal questions are out bounds, sometimes keeps promises	
	<b>Negative disposable income</b> Uncooperative, does not answer or return calls. if they answer, they are usually aggressive and may hang up. Never keeps promises and will not give any information	<b>Some disposable income</b> Somewhat cooperative and responsive to questions, provides some information but personal questions are out bounds, sometimes keeps promises	<b>High disposable income</b> Somewhat cooperative and responsive to questions, provides some information but personal questions are out bounds, sometimes keeps promises	
	LOW	Payment risk score		HIGH

Source: Research by Deloitte Consulting LLP

# The imperative of innovation

## Innovation will be critical to insuring that issuer operating models become more flexible, efficient, integrated, and supportive of other bank products

Given significant challenges and future uncertainties, issuers are faced with a number of strategic options. Some may choose to exit the card business, at least for a time. Others may decide to remain but to retrench by eliminating lines, reducing expenses, and lowering their risk profile. A third approach has been to launch short-term marketing, product, and operational initiatives under the direction of a project management office.

However, these approaches may not be sufficient given the degree of change that the industry has experienced recently. Issuers may need to fundamentally rethink their business, funding, and operating models if they are to respond to new economic conditions and capitalize on the opportunities they present. It is important to distinguish between short-term pressures and longer-term shifts that may transform the structure of the industry, particularly through the impact of new technology.

It is traditional to think about innovation as primarily product-driven, but the opportunities for innovation are much broader and potentially more significant in other areas, such as risk management, channel management, operations, and customer and merchant experience.

Customer experience, in particular, appears to vary significantly between issuers,<sup>26</sup> with larger monolines sometimes outperforming diversified issuers and with one affinity provider, USAA, significantly outperforming all other issuers. To protect their margins, issuers will need to focus more on retaining and building relationships with their profitable customers.

Issuers may need to consider a portfolio of options — innovating in some areas while pulling back in others. This will require a flexible operating model that can respond quickly to changing customer needs, transaction volumes,

merchant requirements, and compliance responsibilities. Some issuers may need to go beyond making incremental improvements and instead create a fundamentally new operating model.

In this effort, issuers should consider the extent to which they can deploy new technology to improve efficiency and increase flexibility. For example, the use of rules-based engines may provide issuers with an easier method to adapt to changing regulations, while the increased use of analytics may help segment customers on the basis of risk and spending habits.

### The dimensions of innovation

The dimensions in which innovations may operate for cards may include the following areas:

- **Access.** Innovations that allow consumers the broadest possible access to payment options from a single-payment solution. An example might include the development of a multipurpose payment solution for any type of transaction. Services like PayPal and Bill Me Later capitalize on the concerns some issuers have of providing their credit card details on the Internet, but they may also contribute to fragmentation of the payment space. The market may be ready for a universal payment solution that offers mobility, access, and multiple-payment options taking both a physical and virtual form.
- **Markets.** Innovative methods of serving large geographical or sociogeographical payment segments of clusters. An example might include the use of prepaid cards to distribute rewards or benefits to particular classes of consumers or the deployment of online payment services to Generation Y or Generation X customers through personal digital assistants or social networking sites.
- **Flexibility.** Innovations that allow rapid adjustments of payment options, for example, the ability to tap into macroeconomic shifts, such as the growth in savings or value-based arrangements with merchants to increase business or target a particular customer segment.

- **Cost/Scale/Control.** These are innovations that create cost advantages through scale, technology, or other unique features. Examples might include the use of predictive analytics to improve risk management or customer segmentation, the use of a rules engine to reduce the cost of implementing new regulations, or the sharing of processing technology to reduce costs and gain access to new technology. Innovations in this area may generate the highest returns since they are not immediately visible in the marketplace and are more difficult for competitors to replicate.
- **Insight.** Innovations that deepen understanding of customer needs or behavior, such as the ability to assess the willingness as well as the capacity to repay debt or to increase card usage based on opportunities with favored merchants.
- **Relationship.** Unique ways of establishing lasting customer intimacy, trust, and loyalty through an enhanced customer experience whether through loyalty programs, product offerings, access to merchant discounts, or exceptional call center services.

The focus of industry regulation is toward more vanilla products. Yet issuers must innovate to some degree in order to weather the current market turbulence. Innovation can be conducted across any of these dimensions without increasing product complexity. Additionally, issuers can go a long way to easing concerns about product transparency by having simpler and more comprehensive communications with customers.<sup>27</sup>

### The growth of alternative payment models

Bill Me Later offers an alternative payment solution to credit cards and an attractive alternative payment solution for merchants. The Bill Me Later, Inc. network includes more than 1,000 online stores, catalogs, and travel partners, including many well-established industry brand names. Millions of consumers rely on the safety and convenience of Bill Me Later's payment solutions when shopping online, via phone, and in-store, particularly if they are concerned about releasing their credit card details to the Internet. More stores are being added all the time. Merchants testify that Bill Me Later has brought them additional business while lowering their processing costs.

Newegg.com opted to partner with Bill Me Later's then parent i4Commerce, because it offered a payment alternative, Bill Me Later, as well as a Preferred Account Program. This suited Newegg.com's strategy to offer customers different payment options and reduce transaction costs.

Bill Me later offers an alternative payment method to credit cards for customers. Customers only have to enter three pieces of information: their name, the last four digits of their social security number, and their birth date. This option is attractive for a retailer, because it provides discount rates that are lower than traditional credit cards. According to the Bill Me Later Web site, their payment solution can reduce transaction costs by 30 to 40 percent.

In October 2008, eBay purchased Bill Me Later and now dominates the market for online deferred payments made using real-time credit. Amazon.com is now promoting "Checkout by Amazon™," allowing online users to pay via their Amazon login credentials at other participating merchants. eBay is seeking to integrate PayPal and Bill Me Later into a single, online wallet.<sup>28</sup>

The online bill payment space has been expanded by two additional services. The first is Acculynk, formerly ATM Direct, which is working with both the ACCEL/Exchange Network (owned by Fiserv EFT) and NYCE Payments Network (owned by Metavante) on piloting personal identification number (PIN) debit on the Internet. ACCEL/Exchange will deploy commercial online PIN debit by year-end 2009. The second is NACHA Secure Vault Payments (SVP), which NACHA is advancing as a lower-cost alternative for bill and other payments.<sup>29</sup>

### E-Money: Innovation in the payment space

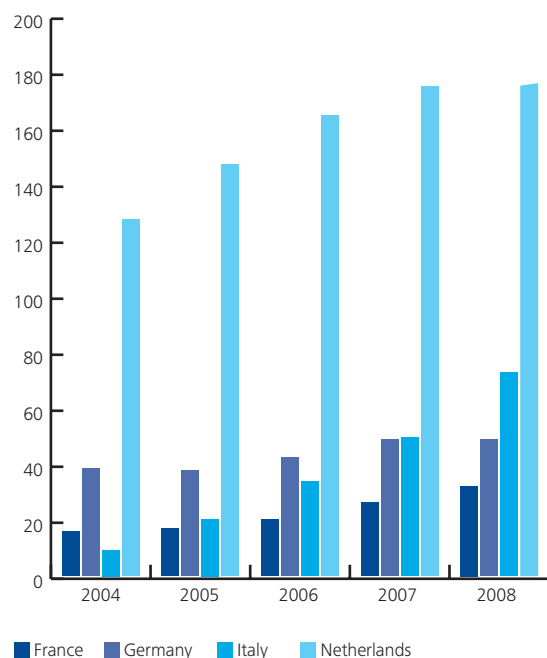
The concept of E-Money has been around since the 1990s but to a large extent as a fringe activity. However, it is now beginning to gain ground in a number of countries. (See Exhibit 5.) It is particularly widely used in Singapore, where there are approximately 1.7 billion e-money transactions per year and 2.69 cards with e-money functions per inhabitant.<sup>30</sup> E-Money is a unit of value that is stored on a particular medium and can be used for all kinds of payments. It is a new form of money that supplements cash and money on account and can be created by a bank or a company. The units of value on the storage medium act as a prepaid bearer instrument. Value is transferred from chip (or hard disk) to chip (or hard disk). It is no longer merely the transfer of information used to settle accounts. Instead, purchasing power is embodied in the electronic units.

E-Money can either use SmartCards that store purchasing power paid for by the customer in advance or transmit electronically stored units of value via networks like the Internet or mobile radio networks for cell phones. E-money can be used to pay small amounts economically without the need for cash, for example, in retail stores or at automatic vending machines. Although credit or debit cards could also be used, they may be too costly for small payments. Another key area is the Internet, where information and services that are now free may begin to charge a fee once people are able to simply and anonymously pay small amounts.

Special discounts for consumers who use e-Money are already being offered. In Germany, for example, "E-GeldKarte" users can get a 10 percent discount in some parking garages in Frankfurt.

Siemens Information and Communication Mobile (ICM) has joined forces with Stuttgart-based Brokat to develop a system that debit amounts ranging from thousands of euros to just a few cents. Known as Pay@Once, the new system works as follows: a payment service provider — a cell phone operator, bank, or other financial services company, for example — creates a special account for the user, who can administer and replenish it at any time using the Internet or a cell phone. Users can make online purchases via cell phone, play lotto, or even transfer a sum of money to another cell phone. In each case, the transaction is set in motion by the simple push of a button. For reasons of convenience, small amounts can be transferred without a security check, whereas larger sums — for which the user stipulates the threshold — require a PIN code.<sup>31</sup>

Exhibit 5. The growth of E-Money (millions of transactions)



Source: BIS

### A more flexible and agile approach to operations

The need for innovation challenges all issuers to adopt a more flexible approach across a number of areas:

- **Technology platforms.** Issuers may wish to consider the extent to which they can deploy new technology to improve efficiency and increase flexibility. Issuers with strong technology platforms and flexible operating models may wish to consider offering their processing capabilities to other providers or seek alliances in processing, competing more in service delivery and customer experience.
- **Leveraging merchant relationships.** Bank issuers in particular may wish to consider the extent to which they can leverage their broader retail relationships to expand their merchant networks or alternatively redefine the merchant relationship in the context of a broader banking relationship. By packaging interchange fees with other service fees, bank issuers may be able to get an increased share of customer wallet, while merchants may be able to negotiate reduced interchange fees.
- **Exploiting opportunities in recession.** Changing patterns of consumer behavior create opportunities as well as threats. Targeting special programs with discount retailers may be an opportunity to improve merchant relations and drive increased card usage. Advertising sales opportunities on more discretionary items present another opportunity. Additionally, to the extent that card issuers can diversify revenue streams through innovation and additional product opportunities, they may reduce the impact of a lower level of economic activity.
- **Legislative pressure on fees and rates.** Pressures here will force issuers to revisit business and operating models, perhaps radically. Getting to the heart of regulatory concerns about product and pricing transparency and the clarity and comprehensiveness of customer communications may be a way to reduce a potentially rising tide of regulatory attention.

# Uncharted waters

As issuers face unprecedented market challenges, the temptation may be to adopt a more conservative stance. But the more successful companies in this industry are likely to be those that can convert the current challenges into opportunities through innovation, while cutting back in those areas which are no longer profitable or may expose the issuer to undue risk.

It is important to distinguish between current market challenges and longer-term shifts within the industry. The former may be passing phases while the latter are transformational. The growth of Internet commerce and online retailing are examples of transformational themes that the industry must adapt to. The recent announcement by the New Zealand Commerce Commission that has reached an agreement with Visa on interchange fees, allowing merchants to negotiate fees individually and charge customer different rates for different payment mechanisms, could create a significant challenge for current card business and operating models.<sup>32</sup>

The role of government may also be transformational. The severity of government regulation may vary with the business cycle, but the longer-term trend toward increased regulation is unmistakable (going back to The Truth in Lending Act of 1968). Issuers may wish to consider a more aggressive approach to championing customer issues, having clearer and more comprehensive communications and educating customers on responsible debt management to allay regulator and legislator concerns.

This is not a time for marginal adjustments. For many issuers, a paradigm shift may be required. Some issuers may reinvent credit card services within a broader range of payment or other financial services through a more diversified approach. Others may adopt a single-product approach but excel in customer segmentation, risk management, and operations.

Although the current challenges may seem forbidding, they represent important opportunities. Reconnecting with customers and merchants provides issuers with the chance to move from adversarial relationships to win-win partnerships. Innovating across a number of key dimensions may create opportunities for enhanced performance without increasing product complexity.

Although the business outlook is difficult to predict with any certainty, many expect a slow recovery. What is becoming clear, however, is that the credit card marketplace will be significantly altered. Credit card issuers will need to respond to these new realities by introducing fundamental, innovative changes across their organizations.



## Endnotes

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The Commerce Commission has signed an agreement with the Visa International Service Association and Visa Worldwide Pte Limited (Visa) settling the Commission's claims against Visa in relation to credit card interchange fees. The Commission's proceedings allege that the rules of the Visa scheme providing for the payment of multilateral interchange fees, together with related rules, breached the restrictive trade practices provisions of the Commerce Act.

- Credit card issuers will now be able to individually set the interchange rates that will apply to transactions using their credit cards, subject to maximum rates determined by Visa. These rates will be publicly available.
- Merchants will no longer be prevented from applying surcharges to payments made by credit cards or by specific types of credit cards. Merchants will also be able to encourage customers to pay by other means.
- Visa has confirmed that non-bank organizations or companies who might wish to provide acquiring services to merchants are permitted to join the Visa network as acquirers if they meet relevant financial and prudential criteria.

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