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Navigating the cards business in the new normal

An overview of key disruptions and response playbook for issuers

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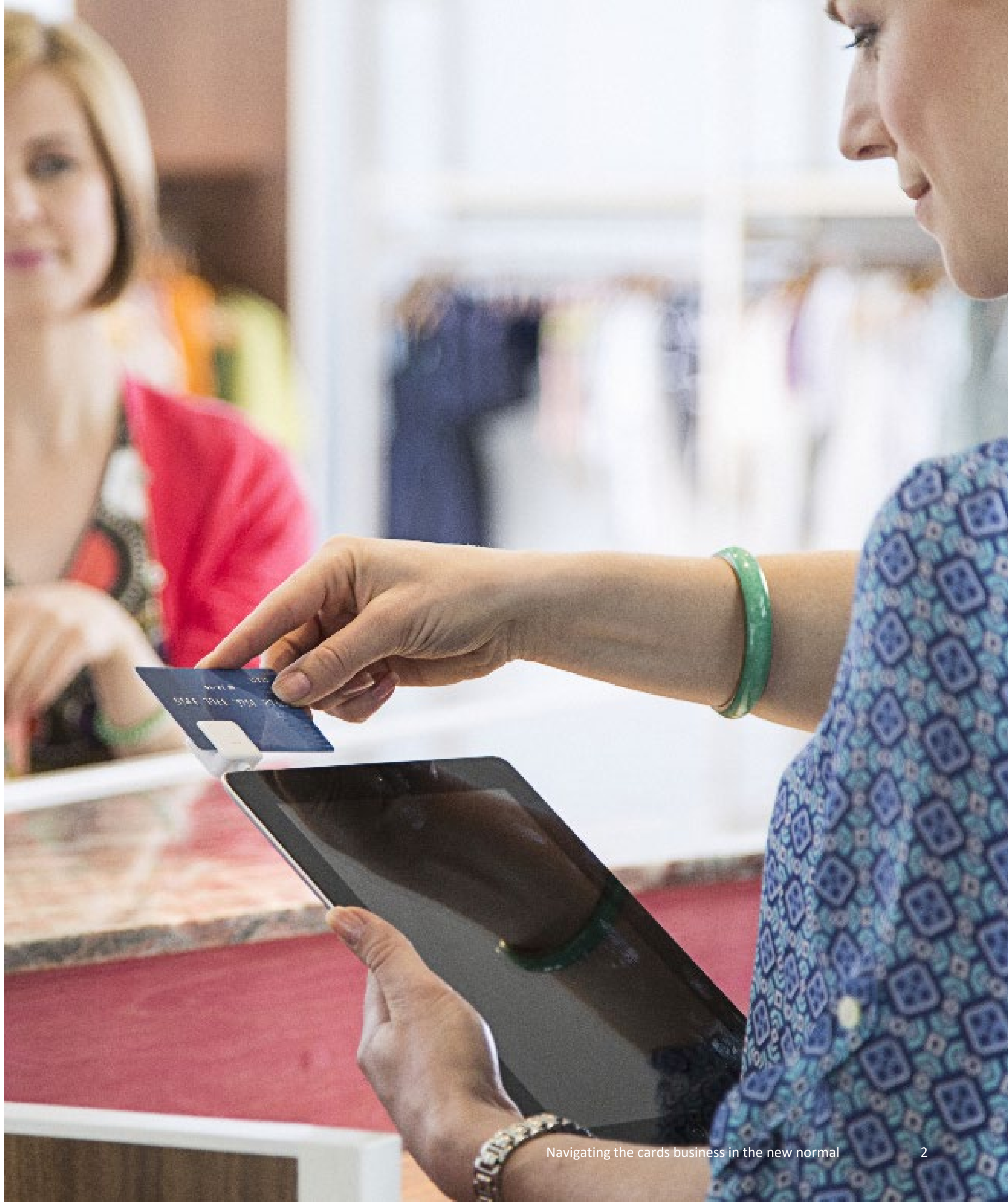
As leaders pivot in response to the impacts of COVID-19 and secular trends in the industry, they will need to make critical decisions to ensure their business's resilience and position themselves to thrive in the new normal.

Deloitte's Resilient Leadership Framework defines three timeframes of the crisis

Respond	Recover	Thrive
Manage continuity	Learn and emerge stronger	Prepare for the new normal

As card issuers move beyond the Respond phase, their focus will need to shift toward making necessary strategic adjustments and investments to thrive in the long run.

The purpose of this document is to highlight a few areas of impact and opportunity for Canadian card issuers.



What's at stake

Cards play a critical role for issuers both in terms of direct contribution and cross-sell opportunity

Significance of cards to issuers

Deep penetration of cards
Card penetration in Canada is amongst the highest globally with credit and debit card spend exceeding $800 billion annually and representing close to 90% at POS and e-commerce

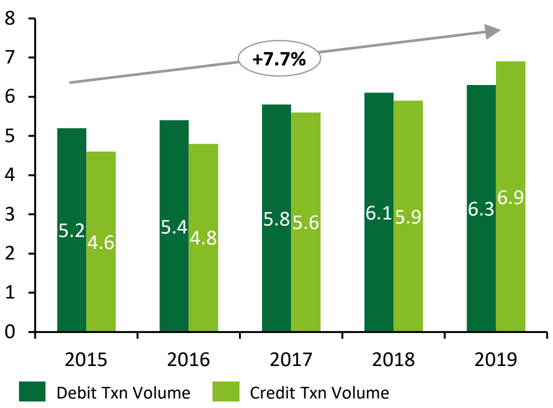
Significant source of revenue
For issuers, cards represent a significant portion of revenue. The largest Canadian financial institutions are estimated to generate over $20 billion annually in revenue from credit cards collectively, with net interest income generating over 65% and non-interest income representing 35%

Gateway to customer relationships
Cards have historically been a key product to acquire net new customers for financial institutions and a significant cross-sell opportunity to gain penetration with other productlines

Key point of interaction
Cards also represent a key point of interaction with the issuer, given the high volume of transactions and activity. Thus, cards have disproportionate influence over the cardholder's view of a multi-product line issuer

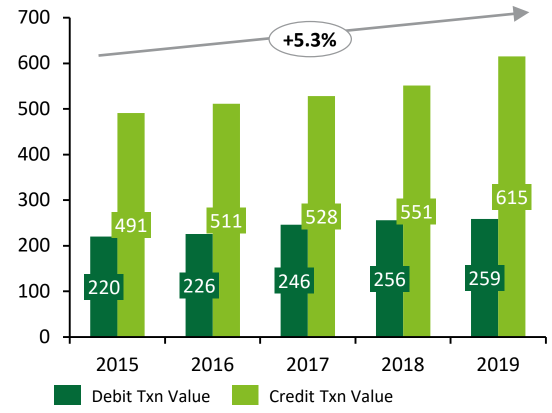
Card Transaction Volume

(bn # transactions)



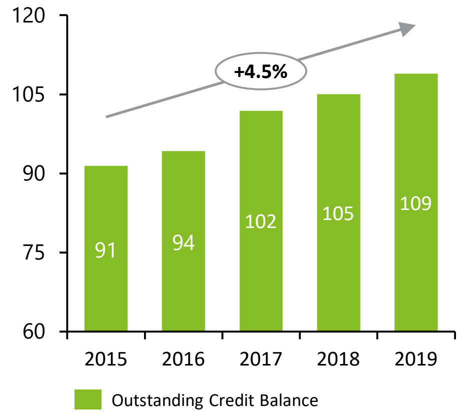
Card Transaction Value

($ bn)



Outstanding Credit Balances

($ bn)



Sources: Company Annual Reports, Payments Canada, Statscan, Deloitte Analysis, Capital Markets Reporting

Disruptive themes

The stable sources of income and traditional relationships have entered a period of significant disruption along the following themes

- Consumer behaviour changes due to COVID-19 accelerated payment trends and increased **pressure on card profit pools**
- **Increasing competition** from new payment entrants and emerging business models impact the long-term outlook
- **Regulatory support** for open banking, broader access to payments infrastructure, and new rails give rise to additional long-term competition

In this paper, we address these disruptive elements and outline near-term steps for issuers to navigate the cards business through the crisis and succeed in the evolved landscape

COVID-19 impact on cards

The pandemic has placed incremental pressure on card profit pools

COVID-19 impact themes

Payment volumes declined and non-essential sectors were heavily impacted

Where there was spend, payment volumes shifted toward e-commerce and contactless methods

Consumers are deleveraging and paying down credit obligations

Social distancing led to greater importance of digital channel capabilities

Key profit and loss impacts

Interchange

- Purchase volumes fell sharply in Q2 of 2020 and has been rebounding along with the reopening of the economy. Higher exposure to card not present interchange rates has offset a portion of the negative impact
- Declining interchange rates from 150 bps to 140 bps is also effective in 2020
- The reduction of travel and tourism significantly reduced cross-border and FX revenue, and commercial card (T&E) spending

Outstanding Balances

- With reduced purchase volumes and government support programs in place, consumers are deleveraging out of prudency and demonstrating higher payment rates. Outstanding balances fell approximately 12% as of Q3 YoY
- Payment deferral programs have also impacted net interest margins

Acquisitions & Attrition

- Customer acquisitions decreased sharply in Q2, particularly on travel rewards credit cards
- As acquisitions rebound, cash back cards are performing significantly stronger on a relative basis to travel cards

Risk

- While delinquencies have performed well so far this year, it is expected to rise as deferral programs expire and government support diminishes
- Credit risk appetite on front book diminish given increased uncertainty on credit quality

Key questions for issuers

- What changes to credit card rewards, offers, and overall value propositions are required to stimulate spending while maintaining economic resiliency?
- What are the key digital capabilities and technology investments required to reduce operational costs?
- What strategic partnerships are required to develop unique value propositions and reduce costs to compete?
- Beyond COVID-19, what are the other disruptors in the market which necessities a strategic response in the next few years?

Emerging competition and enablers

New and emerging competitors, products, and enablers pose a significant threat to legacy business models

	Emerging impact themes	Strategic implications for issuers	Sample strategic players
Expansion of Big Tech	• BigTech has developed significant payments capabilities with successful penetration in several jurisdictions globally. Whether it is under a closed loop ecosystem or one which leverages current banking infrastructure, success has been driven by the ability to offer adjacent services with payments at the center to monetize their massive user base	• Our reliance on BigTech has only increased during the pandemic and trust with their brand has grown, eroding traditional trust advantages of incumbents • In several jurisdictions, the convergence of P2P and P2B payments further accelerated the traction and penetration of digital wallets. In these scenarios, this convergence represents the greatest threat of disintermediation to incumbents	amazon.com facebook
Rise of Buy Now, Pay Later	• FinTechs successfully penetrated the e-commerce market with BNPL models, offering lower cost of borrowing and more transparency to consumers • BNPL's market share capture is expected to accelerate with the growth in e-commerce, expansion into POS, and increase in purchasing power of Millennials and Gen Z	• Competitive pressures on outstanding balances. Installments (e.g., Pay in 4) from third-party providers will reduce net interest revenue and emerging post purchase financing solutions from issuers will cannibalize higher interest revenue • Growing penetration and evolving business models increase risk of disintermediation. In some jurisdictions, BNPL has become a leading checkout method and has significant potential to disintermediate incumbents, and even more so as funding flows evolve outside of credit and debit rails	paybright zip afterpay affirm
Growth of challenger banks	• FinTechs and digital banking entrants have increasingly used the prepaid product construct to gain a foothold in the payments space • In this construct, the product is positioned as a spending account with a slick digital-led customer experience, meaningful rewards or interest on deposited funds, along with personal financial management tools	• Economic turbulence will bolster the use of prepaid. With the economic downturn, segments of the population become averse to incurring credit card debt, producing tailwinds for prepaid products • As new entrants deepen penetration and introduce incremental offerings, the impact to incumbents multiplies. Incumbents will need to determine segments with the highest attrition risk and develop competitive offerings and strategic bundles across the issuer in order to mitigate losses	FINANCIAL MOGO Wealthsimple KOHO
Payments-as-a-Service	• Emerging payment cloud-based infrastructure providers have enabled new entrants to enter cards with significantly lower upfront expenditures	• Cloud offerings reduces time to market dramatically and enables agility on product development. Payments-as-a-Service represents a significant opportunity not only FinTechs but also for incumbents to take advantage of as well	MARQETA GALILEO stripe

Real-time payments and open banking

New payments infrastructure and the era of open banking will produce opportunities and challenges for incumbents

	Emerging impact themes	Strategic implications for issuers	Sample strategic players
Development of Real-time Rails	• Over 50 countries globally have done or are in the process of modernizing their national payments infrastructure • In Canada, discussions on Real-time Rails are well underway, with target go-live in 2022 • While rules and access to payments infrastructure are not yet established, the principles of payments modernization encourage further innovation and competition in the marketplace • While much of the discussion has been on the application to commercial payments, there is still significant potential for retail payments to be disrupted under certain conditions, as we have seen in several advanced jurisdictions globally	• Cards have historically plugged into digital wallets and maintained their share of spend, albeit through a different interface. However, this link is fragile and can be disintermediated under certain conditions. New entrants, over time, can gain access to the payments infrastructure and Real-time Rails whether direct or sponsored • Real-time payments has inherent advantages over card-based payments for acceptors, including faster speed and access to funds, irrevocability, likely lower costs relative to credit, and greater data richness. Acceptance could increase quickly when available. Incumbents must use this window of opportunity to prepare • Successful incumbents will need to determine how best to defend and grow. As the future payments infrastructure opens, incumbents need to identify where to collaborate to gain scale and compete effectively, including identifying new sources of differentiation	VOCALINK mastercard Interac PAYMENTS CANADA amazon pay UPI UNIFIED PAYMENTS INTERFACE swish
Era of Consumer Directed Finance (Open Banking)	• Open banking is leading to the democratization of data around the world and eroding historical advantages of incumbents but offers incremental opportunities to leverage • In Canada, the Department of Finance has undergone consultations over the past few years. These consultations have resumed in November 2020 after a period of pause due to COVID-19 • The current assumption is that account information will be part of the scope and likely include core transaction information from chequing, savings, debit and credit cards • We also expect data aggregators to continue to gain penetration under today's market conditions	• Loyalty and gamification can be enabled on a whole new level. With one view of a cardholder, open banking enables the ability for rewards and offers to be more personalized, yields opportunities for platforms, issuers and merchants • Product comparators will gain greater power. Based on historical spend and borrow behaviours, product selection and recommendations will be grounded more than ever • Cost of acquisitions will increase as competition intensifies. It will be easier for consumers to share historical transaction records and income information to apply for new cards. New customer acquisitions will require greater level and differentiation of offers, and the market as a whole will be more competitive to acquire and retain cardholders • Personal financial assistance and digital advice become key interactions. Cardholders will favour the issuer or platform with the best dashboard to interact with to see a holistic view of their finances, to obtain digital advice for optimization of their finances, gaining value over managing disparate cards independently	PLAID Finicity flinks drop YOLT claritymoney

Areas of opportunity introduction

Incumbent issuers will need to consider the following during and beyond the pandemic

Short-term actions in the first few months of COVID-19

At the beginning of the pandemic, issuers needed to maintain operational resiliency, mobilize the workforce to remote work, and took several common steps to respond to the crisis:

1. **Provide financial relief**: Roll out minimum pay deferrals and interest rate reductions
2. **Raise contactless limits**: Increase contactless limits and adjust approve/decline rules and fraud strategies

Completed during Wave 1

3. **Mitigate credit exposure:** adjust credit policies and line assignments to reflect risk outlook
4. **Prepare for more delinquencies**: Shore up provisions, collections capacity, and capabilities

Continued Opportunity for Wave 2

Medium term resiliency approaches

As we look ahead beyond the immediate response, issuers will need to make strategic choices about their value propositions to remain competitive and bolster their digital capabilities to meet the needs of their customers:

Value Propositions Reinvention

As consumers behaviour is permanently altered, the new normal prompts a need for new and reinvented products and services

End-to-End Digital Transformation

As the secular momentum builds to all things digital, incumbents face a tremendous challenge in doubling down on digital transformation while looking to achieve near-term cost reductions

The following pages looks closer at each of these 2 opportunity areas

Value propositions reinvention

Issuers must revisit value propositions to remain relevant as disruptive forces shift cardholder needs and yield opportunities to capture

1) Revisit what is relevant in rewards

As consumer purchasing behaviours settle into the "new normal," issuers may need to update segmentation classifications to reflect how needs and engagement drivers have evolved. Several tactics may be used to maintain cardholder engagement:

- *Offer flexibility:* Offer flexible earn categories based on personal spending behavior. Enable the transfer of travel points for cashback or everyday redemption options
- *Tailor spend stimulation:* Collaborate with merchants and co-brand partners to customize and generate targeted spend stimulations
- *Support avid travellers:* Offer enhanced travel services, COVID-19 related insurance and work with travel merchant partners to develop exclusive experiences

2) Address rise of installments

As BNPL increases penetration, issuers are under pressure to determine an appropriate response and innovate to defend spend and revolve. Several models could be considered but appropriate testing should be done to minimize unintended cannibalization of profitability

- *Installment cards:* A new breed of cards is emerging in advanced jurisdictions to emulate the installments experience
- *Merchant partnerships:* Establish merchants to enable installment offers for specific customer segments, further enhanced by access to open banking data
- *Card purchase conversion:* Cardholders can convert transactions into installment plans after their purchase
- *BNPL Partnerships:* Partner with BNPL providers to generate win-win exclusive offers and cross-sell opportunities for issuers

3) Curate a personal experience enabled by the possibilities of data sharing

Issuers must capitalize on the opportunities from consumer directed finance and take steps to curate a personal experience for cardholders. Additional examples include:

- *Data-driven interest rates, credit limits:* Enable smart credit limits and interest rates that reflect real spending and pay down behaviours
- *Monitoring of cash flow and overall credit health:* Consolidate across accounts and institutions and generate personalized financial insights and advice
- *Consumer-driven goal setting:* Help cardholders set goals for spending and savings, motivate achievements with gamification and rewarding milestones
- *Data driven rewards and offers*: Enable dynamic rewards, offers that maximizes customer value and monetization opportunities with your ecosystem
- *AI powered refinancing advisor:* Support borrowers with smart refinancing of credit card balances to generate retention across multiple products

4) Leverage enablers and collaborate to compete

Issuers must establish an ecosystem of partners that strengthens back-office infrastructure and consumer-facing capabilities

- *Processing platforms strategy:* Develop a card processing platforms strategy to leverage payments-as-a-service and cloud capabilities, develop the transformation roadmap to migrate strategic portfolios from legacy infrastructure
- *Build ecosystem partnerships:* Develop a robust ecosystem strategy with a focus on partnerships that bring incremental value-added services to cardholders to improve competitiveness against digital platforms
- *Develop real-time payments strategy:* Develop a cohesive real-time payments strategy in conjunction with card-based strategy which aims to increase issuers volume in new payment flows and mitigate potential loss to new entrants. This may include a connection service provider model
- *Build utility coalitions:* Collaborate within the financial services industry to build partnerships that facilitate reduce costs of competing with digital platforms while allowing room for differentiators

End-to-end digital transformation

Increasing consumer demand and raising table stakes force issuers to consider doubling down on the menu of digital capabilities

1) Optimize digital acquisitions

As acquisitions take place increasingly via digital channels, issuers needs to conduct ongoing search and funnel optimization to maximize applicants, conversion rates

- *Refresh target acquisition:* Perform economic analysis, update PV models, approval rules, and line assignments to determine optimal target acquisition to reflect pandemic dynamics and future value proposition updates
- *Optimize search, affiliate, social capabilities:* Continuously assess SEO performance and paid search to improve effectiveness and cost of acquisition
- *Tailor and optimize digital journeys:* Tailor website messaging and features, simplify application processes and improve usability to maximize conversion

2) Deliver fast digital onboarding

Increased efficiency and effectiveness in onboarding and card provisioning will help issuers with greater acquisitions and activation

- *Advanced adjudication:* Use advanced data and analytics, as well as new datasets to enhance credit risk management, enable faster onboarding, allowing issuers to expand reach and manage credit quality
- *Virtual card provisioning:* Power instant and digital issuance to have customers to use their card right away, improving activation rates and enabling digital & e-commerce transactions

3) Advance authentication and controls

Issuers have an opportunity to provide delight in key authentication interactions and empower the cardholder with elevated control

- *Biometric cards and activation:* Some regions have begun to issue biometric cards to increase security and take contactless capabilities to a newlevel
- *Complex controls:* Delight cardholders with smart budgeting and spending controls, supported by real-time smart alerts

4) Differentiate in spending experiences

Issuers have the opportunity to deliver a digital-first cardholder experience that enables seamless digital transactions in new payment flows & mediums

- *Wallet provisioning*: Reduce e-commerce friction and enable push provisioning to activate credentials in digital wallet solutions (e.g., secure remote commerce)
- *Integrated loyalty:* Push contextualized offers and enable automatic redemption and communications to cardholders
- *Sectors of tomorrow:* Differentiate in up-and-coming transaction flows, such as social commerce, voice commerce and Internet of Things

5) Elevate digital servicing

Issuers must move quickly to digitally service consumers to reduce costs of operations and improve responsiveness during moments that matter

- *Dispute resolution:* Make it easier for clients to request and monitor dispute transactions from the convenience of the mobile app
- *Servicing with conversational AI:* Differentiate services through real-time text and messaging for high volume queries based on Natural Language Processing
- *Digital collections:* Explore digital pre- and post-delinquency contact strategy and personalized treatment to minimize charge-offs

For more information, please contact the following individuals.

Martin Ho
Digital Payments and Commerce Leader
Deloitte Canada
martho@deloitte.ca

Todd Roberts
National Payments Leader
Deloitte Canada
toddroberts@deloitte.ca

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