

Changes in the Credit Card Issuer Processing Market

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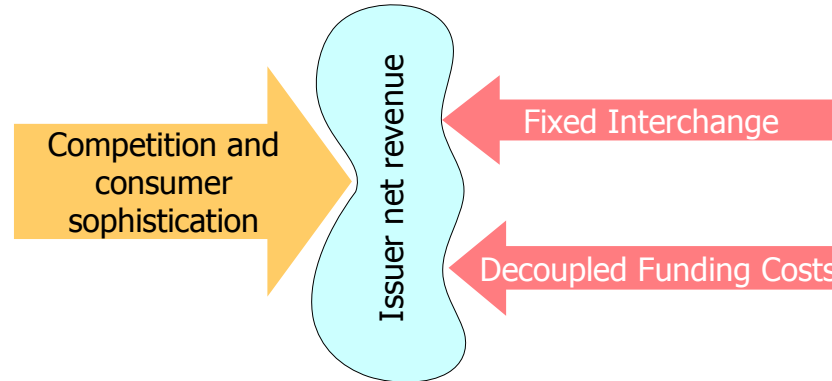
Agenda

- Credit card industry environmental factors
- Impact on processors
- Credit card processing spectrum defined
- Some industry members on the spectrum
- Impact on client and processor strategies
- Conclusions

Credit Card Industry Environmental Factors



Cardholder

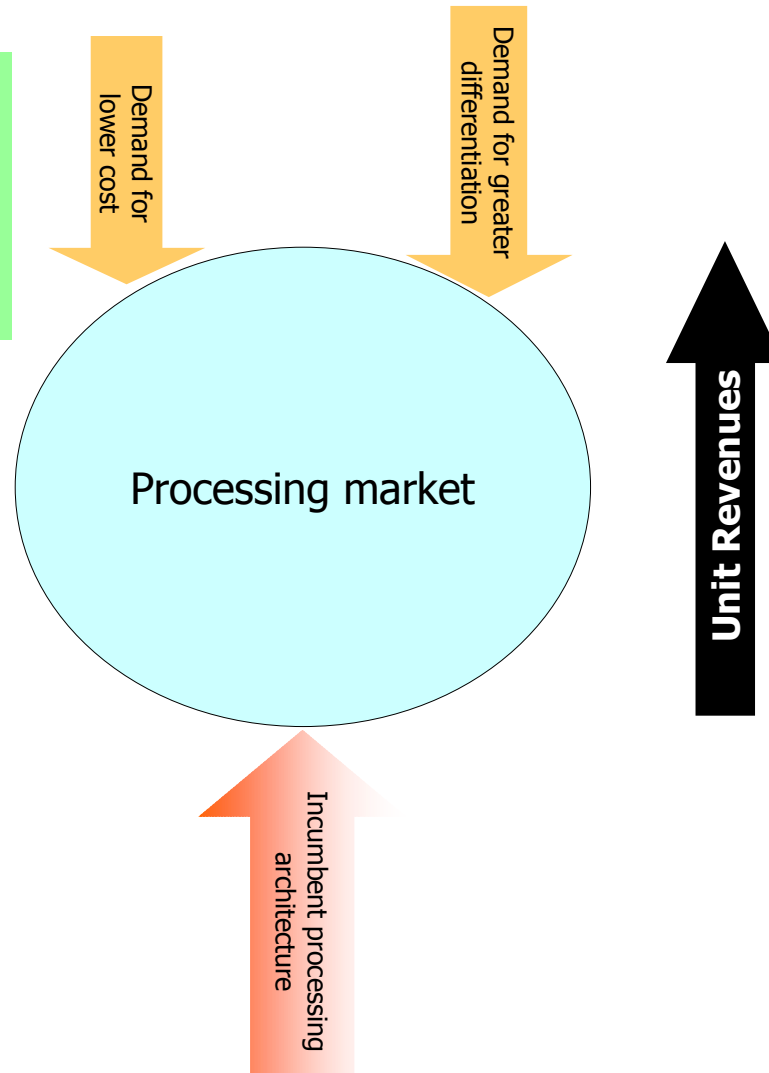


Issuer

- Increasing competition (>5B outbound solicitations per year):
 - Reduces loyalty (>6 cards per household)
 - Reduces pricing power for terms (300bps drop *after* funding cost normalization from 1992-2002)
 - Increases demand for rewards (>60% of credit card purchases attributed to rewards)
- In addition, increasing customer sophistication increases “transactor” behavior (>55% of cardholders)
- All of this squeezes net revenue against a fixed interchange environment and decoupled funding costs.

Environmental Impact on Processors

- Revenue tightness and weakening consumer loyalty to traditional bank brands has driven issuers to *simultaneously* push their incumbent processors to reduce pricing *and* differentiate/unbundle their offerings.

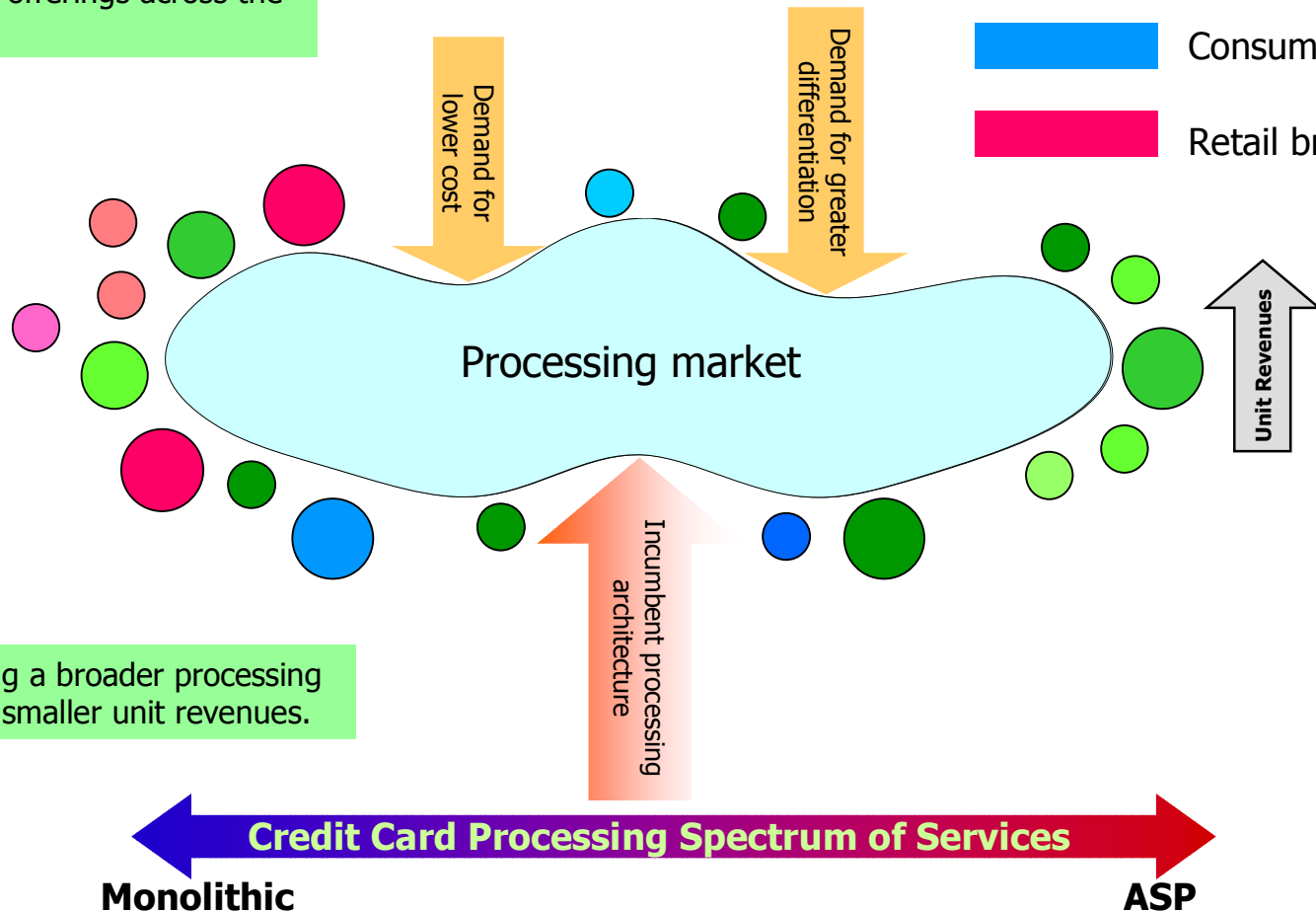


Environmental Impact on Processors

➤ Issuers (both traditional and consumer/retail branded) will choose from offerings across the spectrum.

Issuer Types

- Bank
- Consumer brand
- Retail brand



➤ This is forcing a broader processing market with smaller unit revenues.

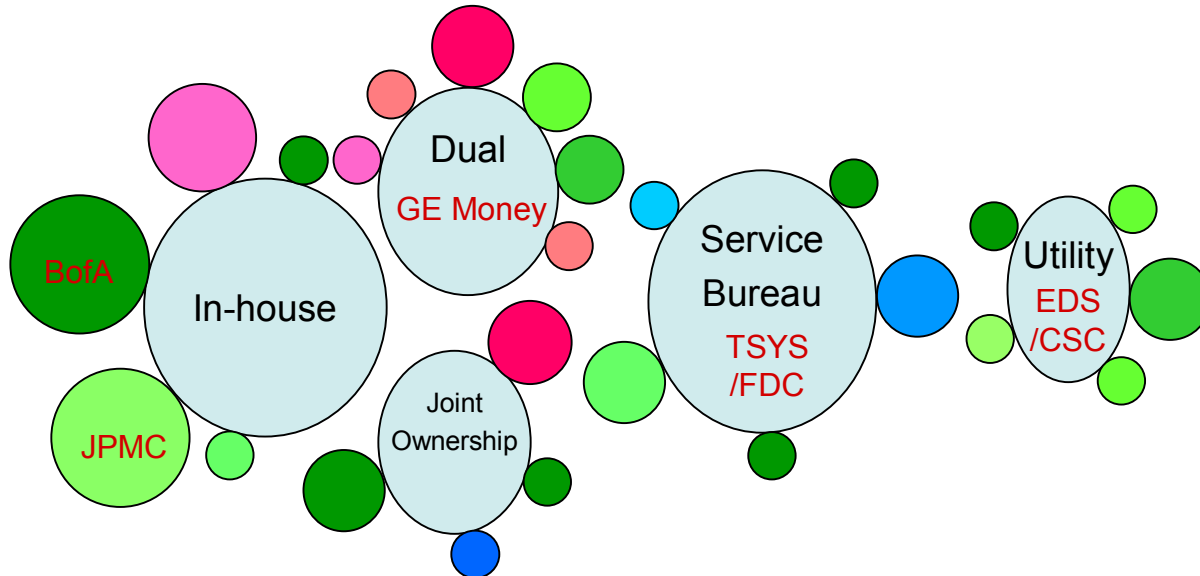
Environmental Impact on Processors

- Each option will be led by a processing model and a processor (may be a new or repurposed entrant) that meets the unique needs of the model.
- Other than in-house, every other option is an **outsourcing** construct.

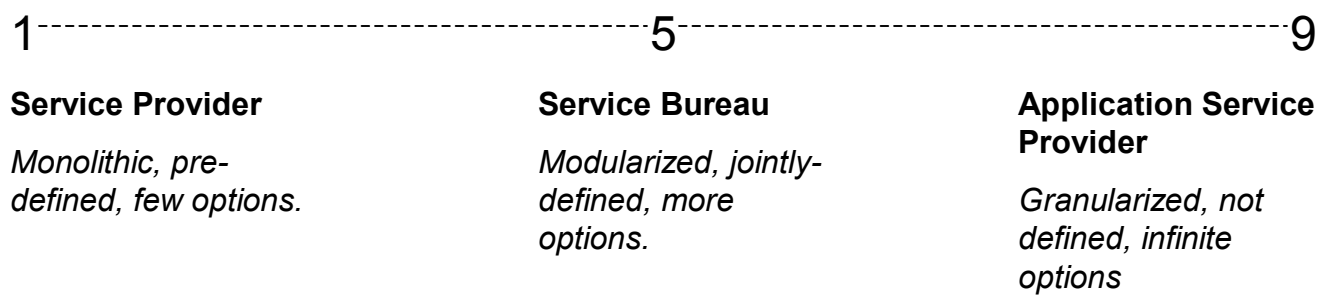
Issuer Types

- Bank
- Consumer brand
- Retail brand

- Multiple, distinct processing/issuing options – all are new or significantly revamped, will emerge.



Credit Card Processing Spectrum



INFRASTRUCTURE	TECHNOLOGY & OPERATIONS MANAGEMENT	BUSINESS MANAGEMENT	PRODUCT ATTRIBUTES
Hardware	Software Development Life Cycle	Product Strategy	Card Account Asset
Software	Service Management	Sales, Marketing and Account Management	Card Issuance
Data	Documentation	Intellectual Property	Card Branding
Customer Service		Pricing of the Service	Rewards
Back-office		Cost Drivers	Settlement
			Regulatory Liability

Credit Card Processing Spectrum

INFRASTRUCTURE	Credit Card Service - 1	Service Bureau - 5	Application Services Provider - 9
Hardware	Owned and operated by Provider. Not dedicated to Client unless the scale is very large. Platform type chosen to meet Provider's strategic needs	Hardware owned by Provider but dedicated to Client by region or instance of machine. Often driven by need for data segregation.	Hardware owned by Client. Purchased (or leased) from Provider or third-party.
Software	Owned and maintained by Provider. Code, architecture, data structure and internal parameters not revealed to Client. Client purchases productized services, not application features and functions.	Owned and maintained by Provider, but internal parameters and some data structure revealed. Client participates in parameter selection, and data interfaces, but does not customize internal functions or architecture. Third-party application additions generally not allowed.	Software may be owned by either Provider or Client. Provider may license to Client internally developed software or re-sell third-party software. Client may add applications to the architecture.
Data	Data is internal to the Provider. It is structured and maintained in a manner that is invisible to the Client beyond general statements of integrity, security, and redundancy. Data is the sole property of the Provider, under restrictions of use provided by the Client.	Data is internal to the Provider, but its structure and manipulation is often revealed to the Client. Client may restrict access and location of the data to specific functions, departments, or platforms.	Data is the property of the Client. Its method of storage and use is dictated by the Client. Provider not responsible for data beyond general security and integrity requirements.
Customer Service	Provided as an integrated part of the product or service. May allow limited Client branding.	Client often manages front-end customer requests and then performs a hand-off. Customer service data of record maintained by the Provider but reported in detail to the Client.	Provider participation in customer service is allocated on an FTE basis based on the Client's operational design. Client maintains data of record, though Provider may shadow it.
Back-office	Back-office is dedicated to the requirements of the product or service and is shared among Clients. Handoff of tasks to the Client is well-defined, little joint ownership of process.	Back-office is modularized by function and can be obtained by Client to the degree they wish. However, internal functions are generally controlled by the Provider.	Back office functions and processes are defined by the Client. The Provider develops a human resource model to provide the services as dictated.

Credit Card Processing Spectrum

TECHNOLOGY MANAGEMENT

Credit Card Service - 1

Service Bureau - 5

Application Services Provider - 9

Software Development Life Cycle

Software applications requirements and strategy is driven by the marketplace as perceived by the internal product or service owner. They create development requirements in conjunction with the technology owner. The Client does not participate in this process directly.

Clients are brought more closely into the development strategy through formal interfaces to product management, such as client conferences and user groups. Clients are more aware of the underlying technology and its potential effects on their own strategy. Provider development roadmap often used as a sales tool.

Software development is managed jointly. Requirements created in concert with the Client. Client may provide their own development personnel or integrate it from third-party vendors.

Service Management

Client may have little or no direct influence on incident management, depending on how customer service and branding is shared. Change management completely hidden behind Provider product management.

Will have customer-oriented SLAs and will be involved with incident and problem management, at least at the summary report level. No direct impact on change management, though will participate in topics relating to release cycles.

Client directly participates in incident management with access to ticketing systems. Client may itself be a referral group. Participates in problem management and resolution, reviewing outstanding problems regularly. Enters change requests directly for small changes (such as IMACs), and participates directly in release planning.

Documentation

Documentation released to Client is limited to sales documents, product descriptions, legal notifications, implementation schedules and bulletins. No visibility of process or system documentation.

Similar documentation as Credit Card Service, but granularity increases to the module level. Interface documents (mostly process, project management and high-level reporting) are added, and are more detailed. Does not include detailed system management documentation or code. Allows Client to see how system and operational modules interact and are managed at an architectural level, but direct manifestation of features and functions is often hidden.

Documentation can be any level of granularity, including detailed data structures, source code, and machine configurations. Client often develops its own project management documentation and control structures with which the Provider must conform.

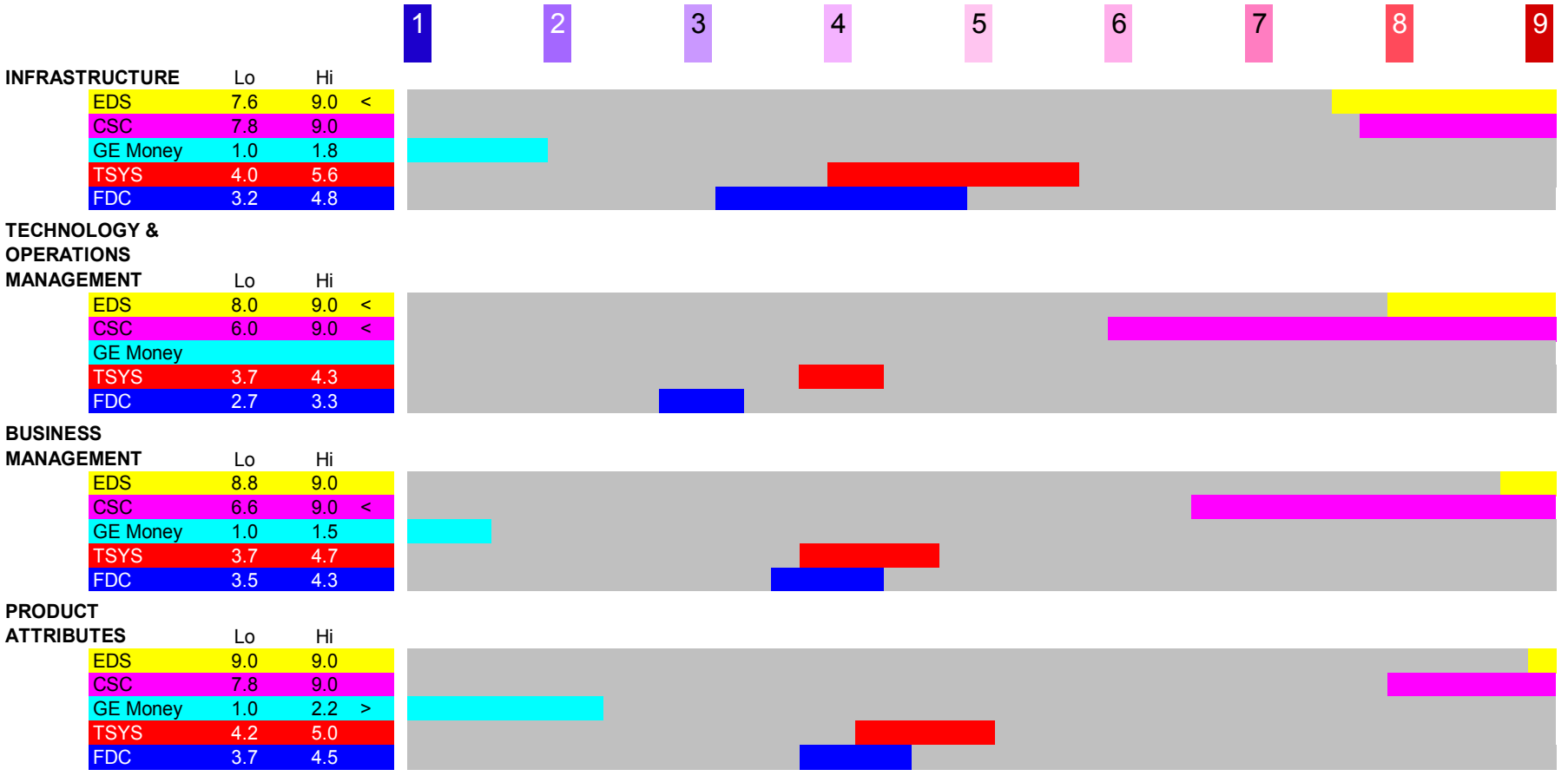
Credit Card Processing Spectrum

BUSINESS MANAGEMENT	Credit Card Service - 1	Service Bureau - 5	Application Services Provider - 9
Product Strategy	The features and functions provided by applications and operations is the "product" that is marketed and sold. IP or other internal value may be used in sales process indirectly, but they are not directly competitive.	Features and functions are productized, within the scope of a parameter space and processing architecture. Internal values, such as cost mitigation, scale leverage, software development leverage, and modularity are directly promoted to the market.	Internal values, such as IP, individual Provider applications, management and staff competency, and the size and quality of IT infrastructure are the products. Features and functions are assumed to be fungible and their competitiveness and suitability are the Client's responsibility.
Sales, Marketing and Account Management	Sales, marketing and account management, as well as P&L management, are product-oriented. Technology and operations serve product feature and function needs, and investments are justified by the product P&L. Client-level profitability is generally only a concern for sales compensation.	Generally, P&L is still product-oriented, but some Clients may be separated as "VIP" due to scale, or through leverage of other relationships they may have at the Provider. Pricing of services is more granular, with some being treated as "cost-plus" or "pass-through". In certain instances, customer revenues may be shared.	P&L evaluation is Client-oriented, with the overall relationship often being treated as a joint venture. Client has high-visibility into Provider costs. Components of technology, such as hardware or software, are priced independently, and are managed as products by their respective owners, which may be inside or outside of the Provider. Sales and marketing are focused on the share of total outsourceable components of the Client have been installed at the Provider.
Intellectual Property	Maintained by the Provider, with no right of transfer to Client unless contracted separately.	Client shares in the benefits of the IP as it is developed, though the core knowledge is held by the Provider. The Client may contract that certain IP may be used by the Client in a limited way, especially if the contract terminates early.	Client and Provider own the IP they bring to the table. Shared ownership may result from development produced by joint venture.
Pricing of the Service	Generally priced on units of provision of the end service, such as transactions, share of interchange or dollars settled. Internal costs, unless highly discrete, are allocated internally and not passed on to the Client.	Greater degree of granularity in pricing, and may include discrete application processing, licensing fees or operations charges.	Pricing is internal cost or module driven. Margin is negotiated, often with links to internal or external factors, such as cost of labor, or to efficiency targets.
Cost Drivers	Managed and controlled by Provider technology departments, with sensitivity to internal product group needs. Generally not "charged-back" to the product groups, but budgeted through general allocations to the enterprise.	Individual Provider modules or processes may have internal budgets and possibly cost targets. Some transaction or use-oriented costs may be charged to the product groups. Clients may share directly in cost mitigation for certain commodity elements of the processing or operations.	Client and Provider jointly develop the cost model, with a high-level of transparency by the Provider.

Credit Card Processing Spectrum

PRODUCT ATTRIBUTES	Credit Card Service - 1	Service Bureau - 5	Application Services Provider - 9
Card Account Asset	Generally (though not always) owned by the Provider.	Negotiable	Owned by the Client.
Card Issuance	Produced by the Provider or its vendor. Client generally only involved with timing (so that card fulfillment is coincident with other Client - to - customer communications) and the selection of card activation features.	Client may choose Provider or a separate vendor for plastic production. Provider, however, manages the process and fulfillment.	Client dictates plastic production and fulfillment and interacts with Provider for production and fulfillment files.
Card Branding	Co-branded or white label "powered" by Provider brand. Uses Provider's BINs.	Variety of models.	Normally the Client's card. Provider often not a bank.
Rewards	Client uses Provider's reward products, features and promotional documentation.	Client can integrate a third-party program. However, Provider often has several programs they are already integrated with from which to choose.	Rewards can be modular or built by the Client from the ground up.
Settlement	Invisible to the Client. Only financial interface the Client has with the Provider is the monthly invoice for the service.	Settlement can be directed to multiple endpoints. Some amount of reporting and reconciliation, over and above what the Provider performs, is often undertaken by the Client.	Settlement is the Client's business function, often outsourced to the Provider.
Regulatory Liability	Generally to the Provider as issuing bank.	Depends on where the asset is held.	Client.

Some Industry Members on the Spectrum



- Traditional Monolithic/Insource Processors
 - Creating more flexibility and control for the client*
 - Challenge: delivering flexibility from a monolithic infrastructure
 - Developing a client-facing service structure
 - Organizational chart: account management
 - Service management extended to the client
 - Modularization of the product
 - Especially risk (underwriting and authorization) and customer support
 - Activity versus allocated infrastructure cost
 - Flexibility drives costs differently
 - **Question:** How far to the right do we go given our target market and our capacity for internal change?

- Traditional ASP/Data Processors

Bringing more credit card specific knowledge and scale to bear on a highly flexible architecture

- Challenge: Acquiring and applying *credible* credit card IP
 - Developing a card-oriented processing platform
 - Acquiring staff with specific credit card backgrounds
 - Risk (underwriting and authorization)
 - Operations (collections, case processing, legal/reporting)
 - Business development
- ***Question***: How far to the left can we go before we're not taken seriously?

- **Fit** – It is more important than ever that portfolios are matched to processors that will provide the IP, cost, flexibility and control required for a particular client strategy.
 - Who “owns” the business, the client or the processor?
 - Does the client want to control the business and what is offered to customers, or is the client lending brand and customer access to a credit card provider?
 - Is this a partnership or vendor relationship?
 - Are risks and rewards to be shared?
 - How much does the client know or care about the specifics of the credit card business? Conversely, how much does the processor need to know about the client’s industry and the nature of its customers to be successful?

Conclusions

- The credit card processing market is in transition.
 - New models are forming and portfolios are and will gather around them.
 - The existing incumbents are somewhat weak (domestically) and also in transition.
- There are a variety of potential new clients:
 - Bank issuers wanting to increase control and product differentiation.
 - Retail brands that want to finesse interchange and leverage brand.
 - Consumer brands strong enough to drive cardholder loyalty.
- The transition is causing portfolios to move or come into existence.
 - Excellent opportunity to sign new relationships, if the right *fit* can be found.