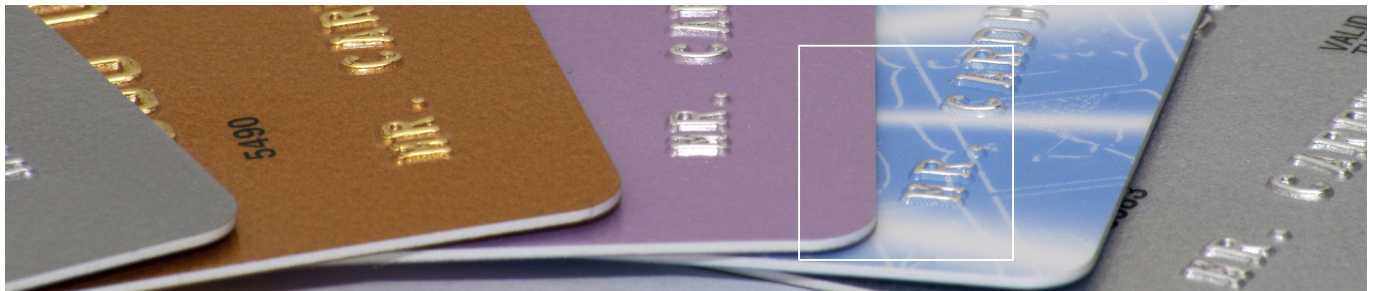


Tapping potential in Europe's card market

Proven strategies for maximizing value from customers



Cards are the fastest growing form of non-cash payment around the world, with both the number and volume of transactions growing by over 13% annually. Despite the current global economic crisis and particularly difficult conditions in the financial services industry, the European card market retains huge potential for growth – currently 80% of transactions in Europe are still made in cash. European card issuers can draw on trends in mature markets to identify the strategies they need to realize this potential. These include building more sophisticated reward programs, introducing enhanced services and developing targeted offerings for different segments.

Rapid growth in card payments means that cards are about to become the most important form of all types of non-cash payment, including direct debit, credit transfer and check. In fact, card payment could soon overtake cash payment as the most widely used form of payment globally. In the past five years, the number and volume of card transactions have increased at an annual rate of over 13%¹, with more than six billion cards now in circulation worldwide. The card market is expected to continue growing, especially in Europe where cash payments still constitute 80% of total payments².

In addition to the opportunities stemming from this growth, the cards business also faces challenges arising from changing customer needs. As the card market develops, customer demands are becoming more explicit: customers require value-added services in addition to convenience and economic benefits. Moreover, competition among card issuers is becoming fiercer as the possession of multiple cards becomes the norm for customers in advanced markets. In Europe, competition will become even more intense with the expansion of the Single Euro Payments Area (SEPA) and the consolidation of issuing banks that is likely to occur given current market conditions.

For card providers seeking further growth, maximizing the value they derive from customers and expanding the customer base

are the key challenges. Card providers can pursue increased customer value in three ways: by retaining existing customers, by acquiring new customers and by targeting high-value customers. Given the current economic situation and European consumers' current strong preference for cash, European card providers should make customer retention their prime focus.

Customer retention

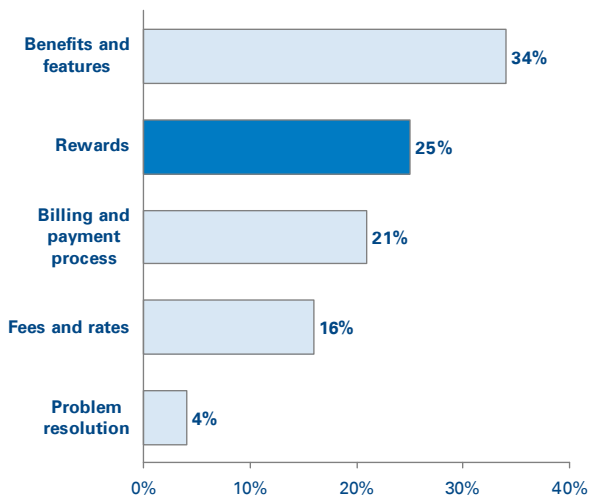
Reward programs

Reward programs have become an essential component of card services and are a crucial means of customer retention, since customers that have collected a high number of points are less likely to switch cards. Customers rate a reward program as the second most important service feature after card benefits such as discounts (see figure 1 overleaf).

In general, reward programs offer cash back, air miles or points. Reward programs are now also being combined with banking services. For example, with its 'Keep the Change' offer, Bank of America has recruited over five million customers since the card was launched in October 2005. With this program, cardholders can automatically transfer the difference between the price of a purchase and the price rounded up to the nearest dollar to a savings account, that then accumulates interest. A similar service is also offered by Credit Lyonnais in France.

1 Euromonitor, Global Financial Cards study
2 VISA Europe

Figure 1: Key factors for credit card satisfaction



Source: The J.D. Power and Associates "2007 Credit Card Satisfaction Study"

Other examples of reward programs combined with banking services include the 'Hi-Point' card from Shinhan Card, where customers can invest their points in a cash management account, and MBNA's 'Mortgage Payment thru Points' program, which allows customers to use their points to pay their mortgage interest.

Link to banking services

Banks have an advantage in customer retention as they can offer account-related services to cardholders. In the advanced markets, banks have exploited this advantage and developed strong relationships with customers by offering both free services and convenience benefits.

Citi, for example, offers cardholders a fee exemption on international spending and ATM usage. Chase gives cardholders US\$125 when they open a new account and make a minimum deposit of US\$100, while Bank of America gives customers US\$100 when they apply for a business account and a check card.

Examples of convenience benefits include the low MDR (Merchant Discount Rate) that Wells Fargo offers to small-to medium-sized businesses, and credit card payment through MMR (Minimum Monthly Repayment) offered by Capital One to its cardholders. MBNA customers can reduce their mortgages with the bank by paying interest with their credit card points, while Barclays' cardholders benefit from interest-free overdrafts and interest-free balance transfers.

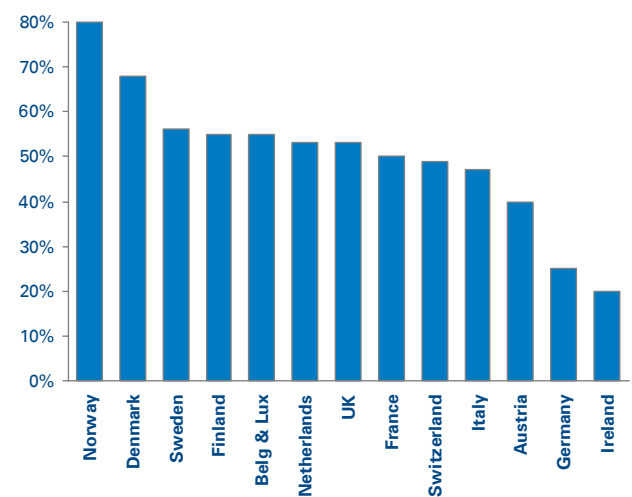
Connecting banking services with cards enables issuing banks to increase usage of both banking services and cards.

Acquiring new customers/increasing usage

Value-added services for the mass market

Debit cards, where payment is taken from the cardholder's account immediately or within a few days, with no interest being charged, dominate European card markets. In the UK, for example, the total amount paid with debit cards is 2.5 times higher than that of credit card payments³. However, in countries such as Germany, debit card usage is low in comparison with cash payments (see figure 2).

Figure 2: Debit to ATM cash withdrawals



Source: European Card Review (Mar/Apr 2008)

Sophisticated, value-added services can be used to encourage cardholders to use their card more frequently. Recently in South Korea, for example, new types of payment cards combining several services have become popular.

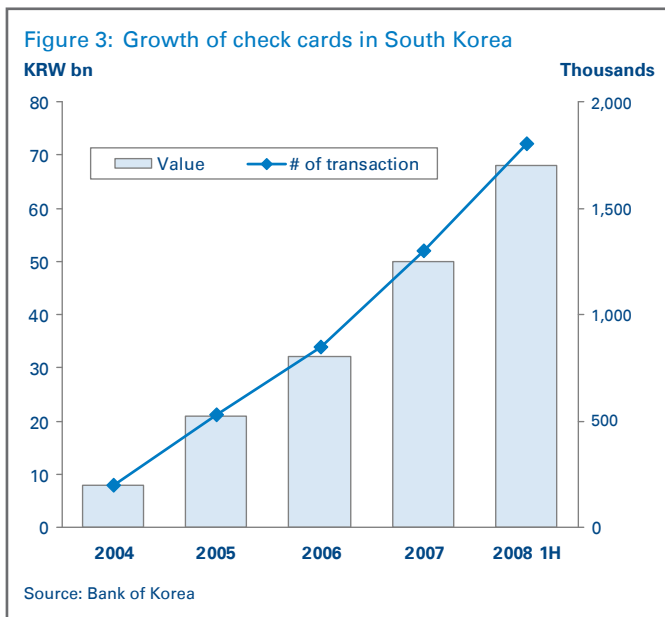
The South Korean market is one of the most developed credit card markets in the world, with people having, on average, more than three credit cards each⁴, from 17 issuers. However, following the consumer credit crisis in 2003, check cards have become popular.

Check cards were developed in 2000 as a hybrid of debit cards and credit cards to encourage customers to spend more on their cards without undue risk to the card provider. Check cards differ from credit cards in that payment is drawn directly from the cardholder's checking account, but are similar in that they offer alliance services and that payment is approved by the cardholder's signature. By using check cards, consumers can enjoy the benefits of both credit and debit cards.

³ European Card Review, July/Aug 2008

⁴ Bank of Korea

Whereas in most markets debit cards are based on a separate network relative to credit cards, e.g. Maestro vs. MasterCard, check cards in South Korea are based on the same network as credit cards. As a result, they are extremely widely accepted and this has given rise to rapid growth in recent years (see figure 3). Debit cards, by contrast, are rarely used.



The popularity of check cards comes from the diverse services they offer. These include the traditional benefits of credit cards, such as discounts, air miles, cash back and monthly bill payment. They also offer banking services linked to the cardholder's bank account and allow cardholders to save money through benefits such as free ATM withdrawals, no fee for overseas spending and bonus deposits.

Securities companies have now started to issue check cards based on cash management accounts (CMA). CMAs have become popular for managing salaries and yield higher interest than banks' general savings accounts. They also allow holders to invest in MMF (Money Market Funds) or bonds through their card.

Multifunctional cards: migration from debit to credit

Convergence is taking place not only between the card industry and other industries, but also between different kinds of cards. The multifunctional cards launched recently broaden cardholders' payment options.

In France in June 2008, for example, Credit Agricole introduced 'La Carte Bancaire Double Action' MasterCard which allows cardholders to choose between debit and credit at the time of purchase. Prior to this, in 2007, Woori Card in South Korea launched 'Worri V Card', which allows cardholders to pay an initial amount with debit and the remainder with credit. Multifunctional cards lower entry barriers to credit cards and can help card issuers migrate debit-card holders to credit-card users.

Targeting high-value customers

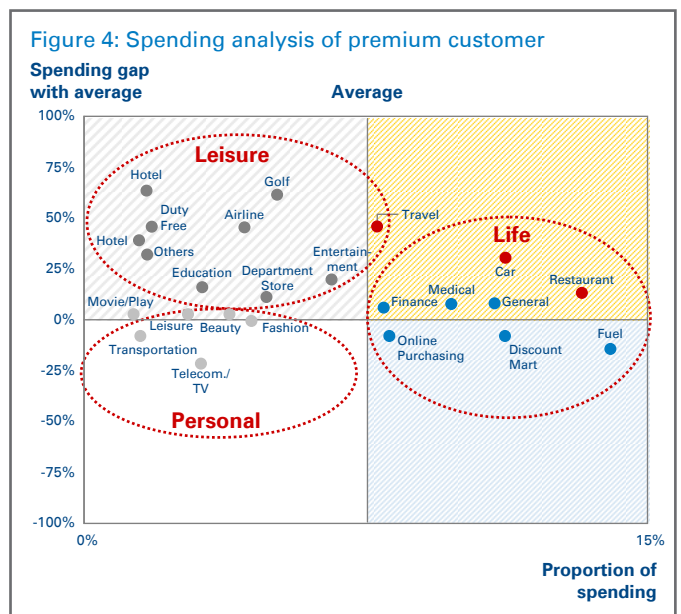
Importance of the premium segment

The spending of high-income customers is less affected by economic change than that of other customers. Despite the worldwide recession, sales of luxury goods are increasing: LVMH and Gucci Group announced sales growth of 9.6% and 15.1% respectively for Q3 2008 compared with Q2 2008. Sales also increased compared with Q3 2007 by 3.1% and 8.8% respectively.

As premium customers generate considerable spending and repayment is rarely overdue, they are a 'cash cow' for card issuers. In the United States, the highest-spending 1.5% of cardholders account for approximately 20% of total credit-card spending⁵. Card issuers should therefore focus on premium credit cards for this high-value customer group as a core product.

Exclusive privilege: reflection of lifestyle

As customers pay significantly higher annual fees for premium credit cards, service offerings should be much more valuable. Analysis of spending behavior is essential to understand the lifestyle of high-income customers and develop targeted products that reflect this (see figure 4). For example, one of the best-known premium cards in South Korea, 'the Black' from HyundaiCard, offers discounts on luxury brands as well as a speaker series called 'Time for the Black'. This offers cardholders the opportunity to meet global celebrities such as the CEO of Louis Vuitton and the former CEO of Harley-Davidson.



Challenges for European card issuers

Merchant relationship management

Developing card services will require card issuers to develop advanced pricing skills, to manage profitability effectively and to build strong, professional relationships with merchants.

Since the merchant service fee for each card product is usually different, strong relationships with merchants are key to achieving both service excellence and profitability. In Europe, developing these relationships will prove challenging for card issuers as most are banks without their own card-operating functions. By contrast, in advanced markets, such as South Korea, many banks have their own card-operating function. Since operating companies such as VISA and MasterCard undertake most of the negotiations with merchants, the opportunities for European card issuers to develop relationships with merchants is limited. Therefore, effective cooperation with operating companies will be important for issuers developing new card services.

Consumers' strong preference for cash

Besides the use of cards for business and travel, cash payments still dominate daily purchases in Europe. In Germany, in particular, credit cards account for only 6% of all retail payments while cash constitutes 61% and debit card 29%⁶. To encourage card payments, it will be necessary to persuade consumers that cards are secure and convenient. Targeting segments that currently show the least reluctance to use cards could be a good starting point for increasing card payments.

Uncertainty from the SEPA Card Framework

In Europe, a significant change in card schemes is expected to take place. Banks from the largest markets – France, Germany, Italy and the Netherlands – are considering creating a new card scheme, the SEPA Card Framework, offering pan-European payments. If the new card scheme is created, there will be significant changes in interchange rates, the cost of investment, business models and competition among operators. These changes will affect issuers' profitability and have an impact on card schemes as well as card products and services.

Conclusion

Despite the dominance of cash, Europe is the second largest card market after the United States. As followers rather than leaders in the global market, issuers in Europe can learn from successes in the advanced markets.

Current consolidation among European banks is one driver for growth since it will enable economies of scale in cards as well as the bundling of card services with other financial services. Even though the current global economy and industry dynamics are not favorable for card issuers, there are already growth opportunities beginning to emerge in the Asian markets, for example. Taking the development of stronger relationships with their customers as their starting point, card issuers have the opportunity to pursue expansion not just in their local market, but across borders too.

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