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ACHIEVING TOP OF DIGITAL WALLET

THE NEW COMPETITIVE BATTLEGROUND FOR CREDIT CARD ISSUERS

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EXECUTIVE SUMMARY

The credit card market is transitioning to the next phase of competition, one where issuers not only compete to acquire new customers but one where issuers must compete to acquire every single transaction. This shift will have profound implications for financial institutions, networks, merchants, and all others in the credit card payment ecosystem.

Despite tremendous investments to drive top-of-wallet behavior, credit card issuers are struggling to get attractive returns. They are offering ever richer incentives to acquire new customers (sign up bonuses of $500-$1,000 have become the new norm for high-value prospects) and upping the value of their rewards programs to retain and engage the current base. Yet, it isn't working: only 50% of credit card customers used the same primary card over a 2-year period, based on our analysis of a proprietary dataset of 4,000+ active credit cardholders. Customers that switched primary cards generated almost 2X as much net revenue per card, driven by both higher spend and revolve. Revolvers are more likely to switch primary cards – suggesting availability of credit as a driver of behavior. Unsurprisingly, the availability of rich rewards is also a driver – cards with richer rewards gained a disproportionate share of switchers. In the short-term, this lack of customer loyalty benefits issuers who are willing to pay a premium to drive top-line growth.

Looking ahead, the rise of digital payments could be a game-changer for the credit card market, ushering in a new wave of industry dynamics as the battleground shifts from card-based competition to transaction-based competition. Imagine a scenario in which an app recommends — or automatically selects — the 'best' card to use at a given merchant while the cardholder is at the point of sale. In this new phase, the very notion of being top of wallet takes on a whole new meaning. Switching behavior will only intensify and there is material risk that issuers get cherry-picked for the benefits that are the most valuable to consumers but are also the most expensive for issuers to provide.

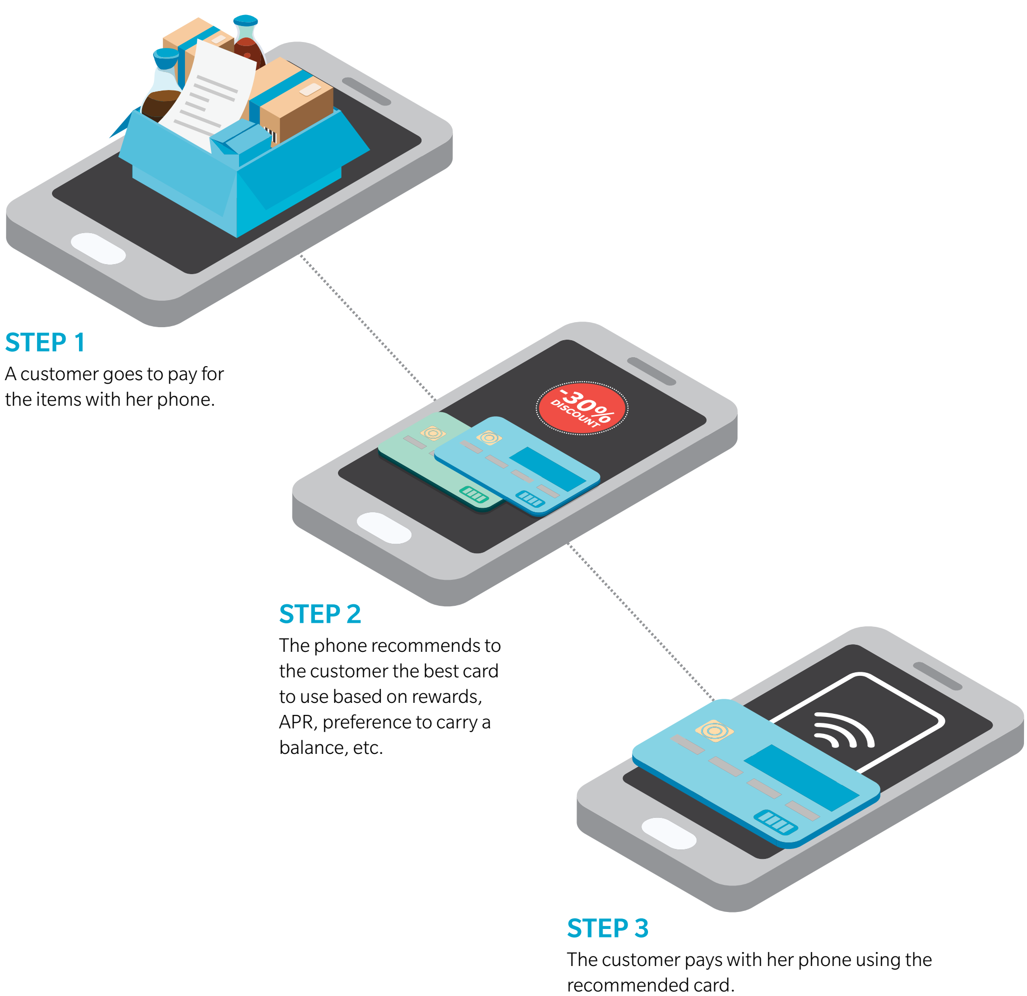
So how should issuers prepare for this next phase? We argue that they need to fundamentally rethink the product construct, with personalization becoming the new core. If customers are going to make transaction-level decisions, then the value proposition also needs to be delivered at the transaction level and in real-time. This includes features such as additional credit lines, promotional APRs, bonus rewards and even product warranties being offered at the point of purchase, depending on the customer's propensity to take up a specific offer. This, in turn, will be informed by what customers care about and how they value one feature versus another, built around meaningful personalization. It also requires clear thinking and explicit tradeoffs on being a card/payment account in a third-party's digital wallet versus owning the wallet and the wallet checkout experience itself. Being top of a consumer's wallet will still represent the Holy Grail for a credit card issuer, but what it represents and how to get there will fundamentally change.

THE FUTURE IS NOW

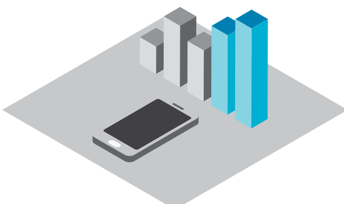
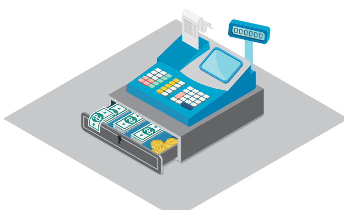
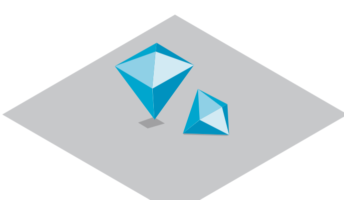
Imagine this: A customer visits a store and selects the items she wants to purchase. She then proceeds to pay using her smartphone. As the customer opens her digital wallet, it prompts her to use a particular credit card based ***on the rewards she can earn on that transaction in that store.***

Alternatively, perhaps the purchase is a splurge and she indicates that she will pay down the amount over time. The app then recommends a different card currently in her wallet, and also shows her two offers — one from a lender offering an installment loan and the other one from a card issuer offering a promotional interest rate on that purchase. She applies for the new credit card using credentials stored on her phone and is approved instantaneously. The new card is added to her wallet, and the customer proceeds to pay for her purchase using this new card.

Exhibit 1: Scenario: Future POS Payments



As futuristic as this scenario may sound, in fact, it is less than a few years away from becoming widespread as many of the historical barriers to digital payments become less relevant.

HISTORICAL BARRIER TO ADOPTION	CURRENT STATE
Low penetration of smartphones and digital wallets 	• Eighty percent of US adults have a smartphone; penetration worldwide is expected to be approximately 44 percent in 2017, and approximately 59 percent by 2022. • Mobile wallet penetration is also proliferating, with China leading the way; 76 percent of metro consumers use a mobile wallet or are interested in doing so. US mobile wallet penetration stands at 36 percent of the urban population and is growing.[1]
Limited merchant acceptance of mobile payments 	• Merchant acceptance of contactless payments is increasing. US retailers representing 35 percent of total sales now accept Apple Pay, up from 4 percent two years ago.[2] In other developed markets, such as Canada and UK, acceptance is already high (for example, 75 percent of Canadian retailers accept contactless payment; the U.K. is targeting 100 percent by 2020).
Difficult to easily provision card credentials to a remote device 	• The iPhone's NFC chip will be open to developers with iOS 11. While developers cannot yet build apps that integrate contactless payments, that day is not too far away. Android already has this capability, but in markets like the US, iOS users drive a disproportionate share of consumer spend. For example, iOS commands more than 3 times the market share in online sales compared to Android.[3]
Little consumer benefit for using mobile payments over a plastic card 	• Growing merchant acceptance, targeted offers, and a seamless payment experience will soon bring mobile payments to parity with cards (not to mention new functionality that allows a phone to be used at an ATM in lieu of a card). • Once transaction selection across cards becomes dynamic, the consumer proposition for mobile could leapfrog over alternatives.

In this future state, consumers no longer carry plastic cards in their leather wallets. Instead, consumers' financial lives are handled by their smartphones, and issuers must compete to (1) have a place in this digital wallet and (2) be selected for each payment transaction.

1 Source: ComScore, Strategy Analytics, Forrester Research.
2 Source: Jennifer Bailey (Vice President, Apple Pay) at Code Commerce Conference, San Francisco, 2016.
3 Source: Custora e-commerce pulse Q3 2016.

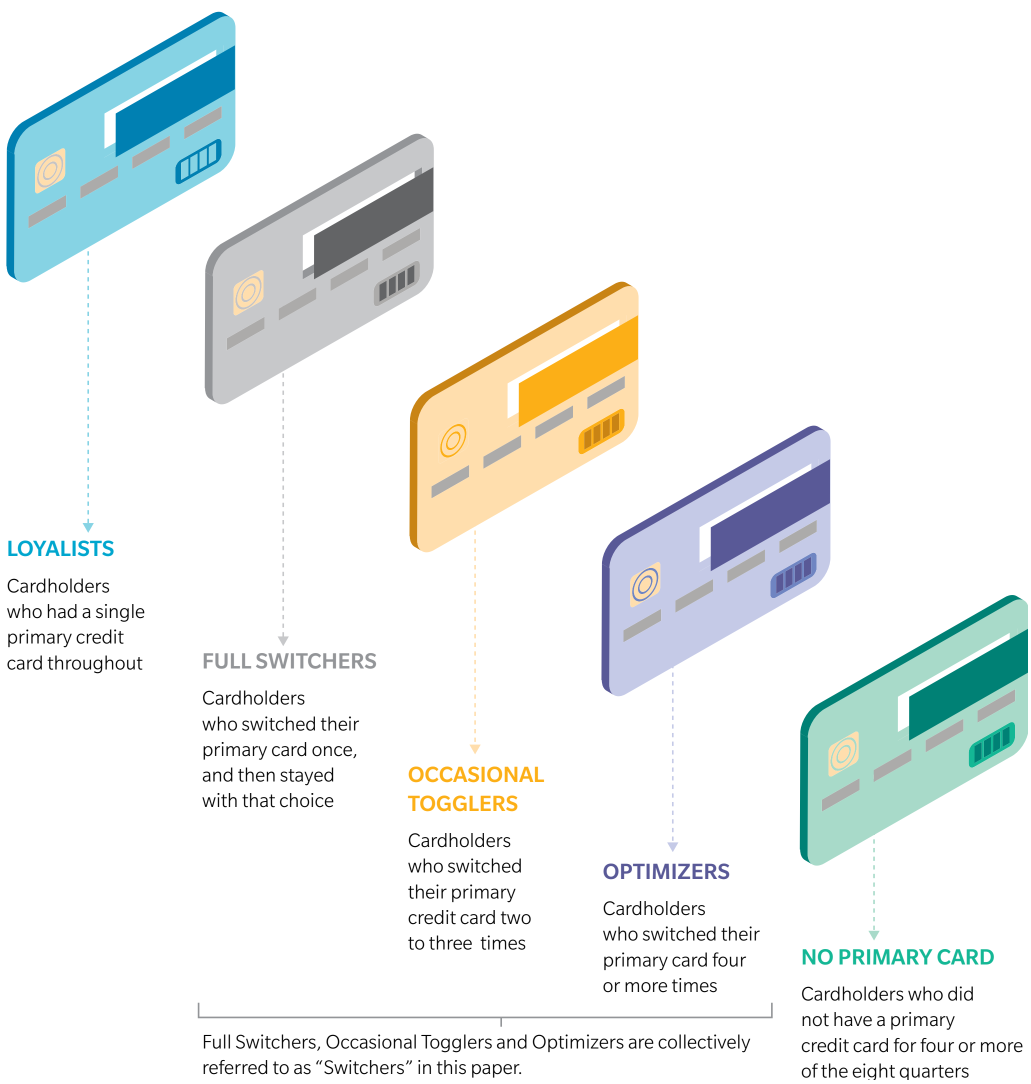
TOP OF WALLET BEHAVIOR TODAY

In order to better understand how this future scenario could play out, we analyzed a nationally representative sample of 4,000+ cardholders to examine their credit card usage across all of their cards over a two-year time period.[4]

For the purpose of our analysis, we defined a "primary" credit card as one that was used by a cardholder for greater than 50% of his/her credit card transactions in a given quarter.

We then defined five mutually exclusive segments based on primary card switching behavior during this time period.

Exhibit 2: Credit card switching behavior



4 The data set is from 2014-2015 which represents the data set with the most current information. We conducted similar analysis over the 2012-2013 time periods and found the results to be comparable.

In addition to the cardholder segmentation, we defined payment behavior:

TRANSACTORS:	Those cardholders who revolved a balance in zero to one of the eight quarters.
MIXED:	Those cardholders who revolved a balance in two to seven of the eight quarters.
FULL REVOLVERS:	Those cardholders who revolved a balance in all eight of the eight quarters.

We then profiled each segment to better understand the drivers of switching behavior and expected outcome for issuers. Based on our analysis, we identified three key themes:

1

THERE IS LIMITED LOYALTY TO CARDS/ISSUERS TODAY.

2

CUSTOMERS WHO SWITCH MORE OFTEN GENERATE HIGHER REVENUE.

3

AVAILABILITY OF CREDIT AND RICH REWARDS BOTH DRIVE SWITCHING BEHAVIOR.

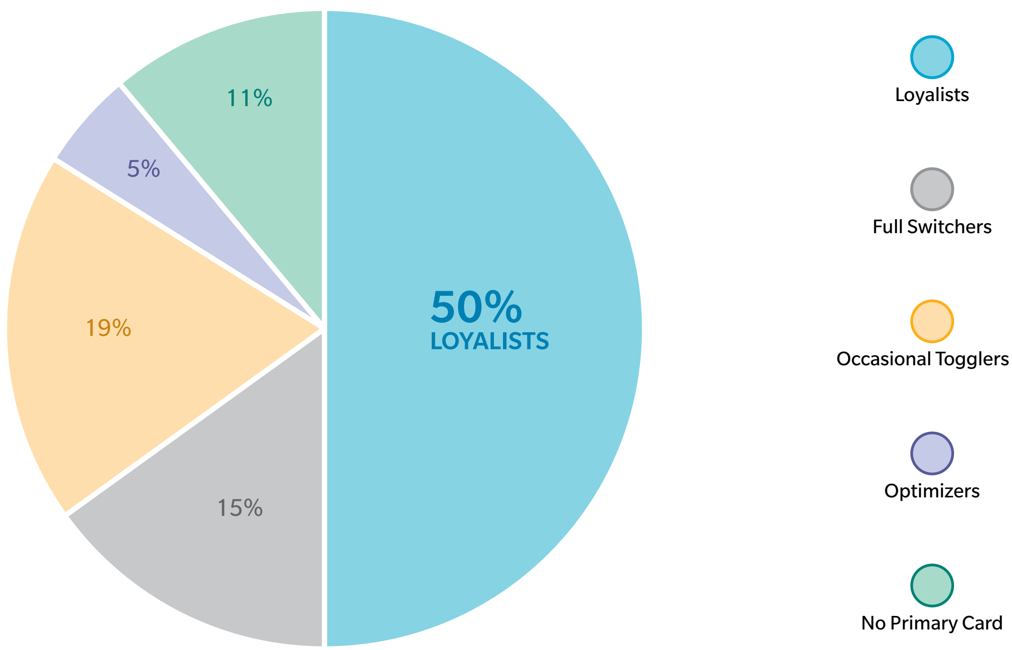
1. LIMITED LOYALTY EXISITS TODAY

In our sample, only half of the cardholders had a single primary credit card throughout the two-year time period. Meanwhile, two in five cardholders switched their primary card at least once, and 11 percent of customers did not even have a primary credit card for four or more of the eight quarters, implying either that they did not spend much or that they allocated their spending across at least three credit cards.

For many consumers, despite significant investments in better products, service and rewards, their loyalty to their current credit card issuer is strong — until a better offer comes along. Conversely, for issuers keen to achieve top-line growth, there is a large segment of the market open to change at any given point in time.

Exhibit 3: Breakdown of cardholders by segment

PERCENTAGE OF CARDHOLDERS, 2014-2015



Switching has a material impact on the revenues generated by a customer. Post-switching, a customer's spend on what was their primary card drops by almost two-thirds and revolve drops by approximately 10%.

Exhibit 4: Full switchers

AVERAGE USAGE COMPARISON: "WHEN PRIMARY" VS. "WHEN NOT PRIMARY"

P&L ITEM	WHEN PRIMARY		WHEN NOT PRIMARY	% DIFFERENCE
Average annual speed	$12,145	VS	$4,866	-60%
Average revolve	$1,553		$1,430	-8%

In many industries, it is usually much more profitable to retain an existing customer than to try and acquire a new one. Indeed, Exhibit 4 would suggest that keeping a cardholder and securing primary card status with that customer is the most economically advantageous path. However, that's not the case.

2. "SWITCHERS" GENERATE MORE REVENUE THAN "LOYALISTS"

Customers who show the least amount of loyalty and have No Primary Card generate 95 percent more net revenue than Loyalists, driven largely by their higher revolving balances.

In general, as the degree of switching increases, net revenue per customer also increases. The increase is largely driven by higher revolving balances, though these customers also have reasonably high levels of spending.

Consumers who switch provide a positive signal to other issuers and a lack of loyalty is indicative of higher expected revenues. This simple yet profound insight helps explain much of the current "arms race" among issuers, as product propositions increasingly grow to entice new prospects with better rewards or easier financing.

Exhibit 5: Average spend and revolve balance by segment (per cardholder)[5]

MORE SWITCHING

	LOYALISTS	FULL SWITCHERS	OCCASIONAL TOGGLERS	OPTIMIZERS	NO PRIMARY CARD
ANNUAL SPEND	14,763	**16,290**	13,523	10,467	9,857
REVOLVE BALANCE	2,776	3,265	3,900	4,002	**5,846**
% DIFFERENCE IN NET REVENUE (COMPARED TO LOYALISTS)		+23%	+37%	+41%	+95%

LOW HIGH

5 Net revenue defined as interchange income plus net interest income, minus rewards expense.

3. THE AVAILABILITY OF CREDIT AND RICH REWARDS DRIVE SWITCHING BEHAVIOR

Eighty-eight percent of customers that have No Primary Card are "full revolvers," implying that availability of credit is a key driver of switching. These customers are effectively using whichever card has the highest available line. Not surprisingly, 58 percent of these customers are near prime or lower (FICO<720) as compared to 37 percent for the other segments.

Exhibit 6: Revolving balance and spend behavior across segments (percentage of cardholders)

CUSTOMER TYPE	Transactor	Mixed	Full Revolver	REVOLVING BALANCE: Total balance	REVOLVING BALANCE: % with $0 balance	SPEND: % with <$50 monthly spend	SPEND: % with >$2K monthly spent	SPEND: Average monthly spend
Loyalists	36%	27%	37%	$2,776	46%	8%	20%	$1,230
Full switchers	33%	31%	36%	$3,265	46%	6%	22%	$1,357
Occasional togglers	28%	28%	44%	$3,900	38%	2%	16%	$1,127
Optimizers	22%	22%	56%	$4,002	28%	4%	10%	$872
No primary card	8%	12%	80%	$5,846	12%	43%	10%	$821

Transactor Mixed Full Revolver

In addition, rewards are a key driver of switching behavior, as expected. Cards offering richer rewards gained share among Full Switchers, as can be seen in Exhibit 7, where credit cards offering a rewards value of more than 1.50 percent to consumers gained 9 percentage points over the two-year timeframe. By contrast, cards that lost share had worse or no rewards.

Exhibit 7: Switching behavior by rewards benefit for full switchers

RICHER REWARDS

VALUE OF REWARDS TO CONSUMER (% OF SPEND)	SWITCHED FROM	SWITCHED TO	NET CHANGE
>150 bps	10%	19%	+9 pp
100–150 bps	60%	58%	-2 pp
1–100 bps	15%	14%	-1 pp
No rewards	14%	8%	-6 pp

IMPLICATIONS FOR ISSUERS

Since availability of credit and rewards drive a high degree of switching today, it is only natural that things will become even more transactional — pun unintended — in the world of digital payments. As we look forward and see this new phase on the horizon, we believe that credit card issuers need to fundamentally rethink the product construct, with personalization at its core. If customers, or their apps, are going to make transaction-level decisions, then there has to be a compelling value proposition each and every time the card is used.

At the highest level, the credit card will continue to serve as a source of credit and as a payment mechanism. Beyond that, how it is used to fulfill both needs will change significantly.

TO CONSIDER A FEW ACTIONS THAT A HYPOTHETICAL ISSUER ("ISSUER A") MIGHT CONTEMPLATE:

- A customer who tends to occasionally carry a balance goes to an electronics store to purchase a television. Several issuers offer bonus cash-back associated with that category of purchases during that time. "Issuer A" therefore decides to offer a low APR on that purchase and an extended warranty, but no rewards.
- A customer who often carries a balance is buying furniture. Instead of offering a lower interest rate than the merchant, "Issuer A" decides to offer 5 percent cash back, positioned as a 5 percent discount on the purchase.
- "Issuer A" offers 3X rewards on travel and captures a disproportionate share of consumer spend in that category but is significantly underweight in other spend categories. It introduces a minimum spending threshold across all spend categories, in order to qualify for the 3X rewards on travel.

In each of the examples, "Issuer A" has to fundamentally rethink the value it is delivering to its customer — at an overall level and for each specific transaction. It has to do so in a way that not only maintains its relevance for the customer through personalized offers, but also preserves margins.

This trade-off results in a conscious choice to **not** be top of wallet for all transactions. Also note the blurring of the lines between the traditional segments of "transactors" and "revolvers." Our research shows that even "revolvers" care about rewards, hence "Issuer A's" explicit actions to force the consumer to choose between one of rewards and interest rate in the second example above.

AS "ISSUER A" IS EXECUTING ON THESE ACTIONS, WHAT COUNTER STRATEGIES MIGHT "ISSUER B" AND "ISSUER C" EMPLOY?

How will a consumer know that "Issuer A" offers bonus points in furniture stores in the second quarter, while "Issuer B" requires the purchase to meet an overall monthly minimum, and a new issuer is willing to offer promotional financing for a large purchase for cardholders with an excellent credit history? And how will they know in real-time, at the point of purchase, and change their behavior accordingly? It's quite possible that digital wallets will house this intelligence, guiding consumers to the best payment method for each particular transaction, optimizing across consumer profiles, spending patterns, merchant demand and issuer propositions. Consumers will gladly use these apps to help simplify their lives and improve their finances.

It's not a great leap to believe that these intermediaries will own the customer relationship, not the issuer. Given the plethora of attractive card options in most markets – particularly those with high interchange rates – we believe that this is almost inevitable. Once established, the intermediary will be well positioned to extract rent from both issuers and merchants, demanding royalties in return for better placement and transaction flow.

In this phase, issuers may be forced to choose where to compete: for the loyalty of consumers or of their bots? At the very least, they will need to decide what resources to allocate for each objective at any given point in time.

Issuers with large card bases and strong brand awareness are likely to want to "double down" on their customer-centric capabilities, building their own digital interfaces and seeking to continue to "own" the customer relationship. However, they will also need to enable their cards to be used in third-party wallets – and constantly optimize resources across the two. Meanwhile, smaller issuers and other "white label" sources of capital will partner with third-party digital wallets, reaching consumers via an attractive user interface and intelligence-driven offers.

CONCLUSION

The increased prevalence of digital payments will profoundly change how credit card issuers deliver value to consumers. It will force them to compete at the transaction level and reinforce their relevance on a daily basis. Personalization will become the capability to build, and issuers will compete on the basis of understanding the choices their customers are likely to make. Being top of wallet will require ceding that spot for certain transactions. Preserving this paradox is an essential requirement for profitable growth.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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