



In the Cards:

Capitalizing on Member Business Needs
with a Progressive Credit Card Program

by

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Executive Summary

In staggering succession, Wall Street's big hitters; Lehman Bros., Merrill Lynch, Fannie Mae, and Freddie Mac have been seized, failed or merged.

This unfolding financial crisis is impacting all financial institutions, including Credit Unions. Lenders must become more cautious about how much they lend, and to whom. This is new territory. This is a new world.

For Credit Unions currently offering business member card services, a reinvestment in application and approach is required. Now, more than ever before, it is critical to effectively differentiate between the business and member card services. While obstacles exist, they must be overcome to ensure the progression of a well-intended strategy.

The goal is two sided—exceeding business member expectations while continually generating increased revenues. However, too often a conceptual program does not translate to a successful branch model rollout. The question is: why?

In theory, all Credit Unions can be positioned to capitalize on a business credit card model. However, many rightfully question respective resources and systems in place to successfully operate the program. As a result, many Credit Unions partner with a third party that handles operational issues but also shares in profits. The costly issue of determining in-house processing or outsourcing becomes a central issue and concern.

With proper due diligence, it is possible for a Credit Union to launch a successful program whether through an in-house program, an outsource program, or a combination of both. Determining the right course of action, however, requires a significant investment of time, funds, and resources. Taking the model to the next level has never been more important as the financial topography is changing with many old rules no longer applying.

The potential success rate is the leading incentive. It is estimated that business card issuers have an approximate spending capacity of \$4 trillion. When this statistic is combined with the fact that more than 25 percent of business owners belong to a Credit Union, a clear sense of urgency emerges.

According to a recent study conducted by the Mercator Advisory Group:

- The payment volume of small business credit cards is growing at twice the rate of credit cards overall.
- Small business credit cards benefit from superior commercial card interchange and higher payment volumes per account than consumer cards.
- The small business segment is dynamic, with new prospects emerging continuously, and businesses growing in their financial needs.

- There is a major opportunity to leverage existing small business relationships, as well as prospecting within retail consumer credit card portfolios.

The purpose of this white paper is to investigate program necessities and capabilities thus underscoring business member credit card best practices.

Determining Risk and Plausibility

Before moving forward, it is prudent to determine risks, benefits, and outcomes of offering an enhanced business credit card services program.

Questions should include:

- What are your expectations?
- How would your revamped program fit strategically in your enterprise plan?
- Do you understand the competencies required to provide, underwrite, and service a program?
- Are you currently using a third party vendor?
- Are you prepared to invest/market?
- What markets will you target to attract new accounts?
- How will you cater to existing accounts?
- How will you enhance your rewards program?
- How will you determine your ROI?

The answers to these questions will provide the necessary information to move forward. It's important to note that with an average yield of 10 percent or higher, business credit cards can represent the highest return loan in a Credit Union's portfolio. Therefore, analyzing subcategories within lending groups is critical. The goal is increase income while managing risk.

According to a recent NCUA Call Report, approximately 20 percent of the nation's credit unions currently offer business loans to their members. Loan types include commercial real estate loans, equipment loans, secured lines of credit, and business credit cards.

As the market continues to falter, business owners, both small and large, are turning to credit cards instead of attempting to secure loans. According to the National Small Business Association (NSBA), the percentage of companies using credit cards has jumped from 16 percent in 1993 to 44 percent today.

In the same period, the proportion using bank loans dropped from 45 percent to 28 percent. A Federal Reserve survey showed that the percentage of firms using business credit cards jumped from 34 percent in 1998 to 48 percent in 2003. And numbers from the NSBA and the Federal Reserve show that between 20 percent and 30 percent of all small businesses carry a revolving credit-card balance, rather than paying their bills in

full each month. This equates to higher interest rates and higher revenues for well-positioned Credit Unions.

Business Credit Cards

According to the Mercator Advisory Group, roughly 12 percent of the 6 billion credit card offers mailed each year promote small business credit cards which equates to 720 million offers.

Mercator estimates that total small business spending in the U.S. hit \$4. 7 trillion in 2007; however, the volume charged on small business payment cards, which includes debit, is approximately \$283 billion.

According to the Tower Group, which is owned by MasterCard, in 2005, the top 10 U.S. banks controlled 83 percent of the small business credit-card market. The same banks only secured 32 percent of the Small Business Administration loan market and 14 percent of other small business lending. As the economy continues to struggle, lending standards by larger banks are tightening thus opening up a window of opportunity for Credit Unions.

With opportunity comes challenge. Credit Unions must understand that there are various sub-segments in what is deemed the small business market which includes owner-operated business to companies supporting 100 employees.

Therefore, having a system in place that will identify all scenarios and probable outcomes is required. By covering possible risks, benefits can be better understood.

Take for example, revenues generated from interchange fees. The top five credit card issuing banks (JPMorgan Chase, Citigroup, Bank of America, Capital One and HSBC) control approximately 90 percent of all credit card accounts. Card issuers now make over \$30 billion annually from interchange fees, an increase of 85 percent since 2001.

According to Diamond Research Corporation, only 13 percent of interchange costs go to processing, which is the fee's original purpose, while about 44 percent goes to paying for reward programs, and 35 percent covers cost of funds and profit margins.

For business owners, interchange fees are often considered unfair. For lending institutions, the unregulated practice amounts to significant returns. As one Visa spokesperson explained it, the fees associated with interchange ensure that the transaction is securely processed.

As noted, Credit Unions looking to capture business credit card market share have tough competition such as JPMorgan Chase, Citigroup, Bank of America, Capital One, and HSBC.

Due to a flagging economy, competition exists; however, the pool is shrinking. A recent online search of companies (10/08) offering business credit cards produced the following advertisements. This is the competition.

Advanta Platinum Business Card with Cash Back or Travel Rewards

- Choice of 5% cash back or travel rewards*
- 0% APR for 15 months on balance transfers, 7.99% fixed APR thereafter
- 7.99% variable APR on purchases
- No limit on earnings
- Personalized card – your company name on the top of the card
- No annual fee

Intro Purchase APR: none

Intro Balance Trans. APR: 0 percent for 15 month

APR as low as: 7.99 percent*

Annual Fee: None

Capital One® Visa® Business Platinum with No Hassle CashSM

- 1% cash back on all purchases with no category limits and no restrictions
- 0% APR on purchases until October 2009
- A 25% bonus each year on cash you earned the previous year
- 0% APR on transferred balances until October 2009
- Free employee cards with individual spending limits you set
- No annual fee

Intro Purchase APR: 0% until Oct. 2009

Intro Balance Transfer: 0% until Oct. 2009

APR as low as: 14.99%(V)

Annual Fee: None

Chase Platinum Visa® Business Card

- 0% APR for up to 12 months*
- Visa Business Partner Advantage program - savings from leading retailers with special offers on computer equipment, office supplies and more
- Travel and emergency assistance
- Purchase security and extended protection
- Travel Accident Insurance
- Free online reporting

Intro Purchase APR: 0% for up to 12 months

Intro Balance Transfer: 0% for up to 12 months

APR as low as: 8.99%

Annual Fee: None

Business Debit Cards

The debit segment is undervalued and often overlooked as a loyalty program for small business owners. When approached correctly, it builds significant revenue streams. It is estimated that nearly half of the top 100 banks in the US provide a progressive debit program which offers compelling reward programs.

To date, there are approximately eight million small business debit accounts which equates roughly to one of out of three small businesses. On average, this marks an approximate 18 percent increase from recent years.

According to the 2008 Debit Issuer Study, debit card issuers are broadening their electronic payment services to include new payment devices, targeted cardholder perks such as surcharge-free programs, and greater levels of service. This is a trend, the report stated, that will continue for the foreseeable future and is applicable to business members.

Credit Unions need to look no further than their competition. For example, MasterCard's Debit BusinessCard:

- Reduces the need for checks or cash for increased purchasing flexibility, convenience, and safety.
- Increases money management capabilities with easier and more accurate record keeping.
- Protects against unauthorized purchases providing peace of mind.
- Insures and protects business owners with extensive business and travel services.
- Provides 10 to 40 percent savings on goods and services for business owners.

In order to compete in this submarket, Credit Unions are required to have the following systems in place:

- The ability to automatically deduct funds from business checking account eliminating the need to write a check, show identification, or wait for check approvals.
- Provide no monthly payments or finance charges.
- The ability to have debit cards accepted at numerous locations removing the need to keep petty cash on hand.
- Providing the ability for authorization for immediate shipment of any mail, phone, or Internet orders.
- The ability to set variable daily limits on purchase and cash withdrawals to protect account from fraud.
- The ability to request extra cards for your employees with preset spending limits.

On the strength of a solid program, a Credit Union will be able to pitch perspective business owners with confidence. Business owners' interests are piqued when they know that they can keep track of spending; set spending controls for employees; and reduce the need to use personal funds for business purchases.

To this end, a Credit Union must also provide a business owner with detailed monthly bank statements for easy account reconciliation, expense reporting, and identification of tax deductions.

Software enhancements and tools that business owners can use to organize, consolidate, analyze, and manage card spending data is essential.

A new market trend is decoupled debit, an alternative based ACH debit card solution utilizing two existing systems not designed to work in combination with each other. This includes the ACH network and branded payment networks such as MasterCard, Visa, and NYCE.

While considered a risk in some circles, due to account validation concerns, decoupled debit is one way in which banks are trying to assume this portion of the debit pie. Credit Unions should be on notice as the benefits include allowing the intermediate service provider to capture the interchange income from card transactions.

Attractive, personalized card offerings, and reward programs are the driving indicators, which is underscored in the Capitol One Labs national advertising campaign.

Credit Union Approach

As indicated in the aforementioned advertisements, interest rates, rewards, and no annual fees are among key ingredients to a successful cards program. Therefore, a Credit Union has to be prepared for pricing optimization – a one size fits all approach will not suffice.

The advantage Credit Unions hold over industry juggernauts is the ability to provide a personal touch and the ability to build upon existing loyalty programs. Understanding members' needs and goals is critical. Often, an owner of a small-to-mid-size business will be a member of a Credit Union but apply for credit card business services through another Credit Union, or more likely, a leading financial institution like Bank of America. The question is: why?

For one, larger institutions have systems, metrics, applications, and staffing in place. At this juncture, a Credit Union must decide whether it will go it alone or partner with a third party (see section: In-house or Outsource). To build a successful program, a Credit Union must convey to its members that it can offer:

- Convenience by separating business and personal expenses.
- Tracking of small business expenses.
- Point of purchase time savings.
- More locations and business checks.
- Additional cards for authorized employees.

Along with these benefits, a Credit Union will need to have a web-based program supporting convenient, 24-7 access to the following:

- Setting controls and limits.
- Establishing a list of authorized employees and vendors.
- Enhanced reporting using an online record of every cleared transaction.
- Electronic billing and settlement.
- General ledger compatibility with many software applications.
- Enhanced protection against unauthorized or beyond-limits use.

Typically, Credit Unions are too conservative and do not offer adequate business lines which in turn forces potential business to competing financial institutions. A recent survey found that on average members use credit cards 44 percent of the time as secured loans and 30 percent to carry balances. In addition, many use cards as a cash management tool.

Program Drivers for a Credit Union:

1. Strengthening member loyalty and relationships.
2. Increase non-interest income (fees and interchange).
Revenue drivers: 65 percent Finance Charges, 16 percent Fee Income, 19 percent interchange.
3. Increase profitability (industry average for credit card ROA is 1.83 percent).
4. Improve the member experience (in-house management vs. outsource).

Credit Unions can enhance an existing card program by following a major lending trend which is an emphasis on platinum credit cards, which 90 percent of major banks offer. The following benefits are to be included: travel insurance, disability coverage, auto rental insurance, and purchase assurance warranty.

Five Steps to Successfully Managing Card Programs

1. **Portfolio Management**
 - a. Continual monitoring of accounts and data.
 - b. Growing the portfolio.
 - c. Adding continuing value.

- 2. Providing Attractive Products**
 - a. Choose the right offers for the market segmentation.
 - b. Platinum: carries an air of prestige, privilege, desirability.

- 3. Marketing**
 - a. Providing a well-planned annual program using multiple contact points.
 - b. Include introductory rates.
 - c. Balance Transfers.
 - d. Reward Cards.
 - e. Convenience Checks.
 - f. Staff Incentives.
 - g. Consider an add-on product to existing credit approval products.
 - h. Edge to edge customer printed cards.

- 4. Achieve Profitability**
 - a. Effective management will navigate changes in portfolio ROA.
 - b. Make changes in pricing, promotion, rates, and utilization.
 - c. High performing credit card issuers:
 - Utilization is 28 – 30%.
 - Outstanding AVG balances \$2,400.
 - AVG credit lines are \$8100.
 - d. Mid-size credit union averages.
 - Utilization is 44%.
 - Outstanding average balance: \$1,341.
 - Average credit lines: \$3,003.

- 5. Loyalty Programs**
 - a. Should increase card usage.
 - b. Should strengthen credit union relationships.
 - c. Should be easy to interpret, apply, and understand.
 - d. Should be an effective communication tool.

While a concerted marketing campaign is required, the majority of business accounts are derived in-branch – where existing relationships can be built and new relationships forged. In a recent study, Visa found that in-branch marketing is the most cost-effective channel for generating new cardholders.

Periodic promotions, including mailers (virtual and hardcopy), are essential to increasing existing card holder use while generating new accounts; however, web-based promotions are often successful and cost-effective.

In the final analysis, a credit union’s goal is to make their credit card the “top of the wallet” choice for business members – when they think credit card, they’ll think your card.

Marketing Best Practices

- Underwrite with other business products.
- Pre-approve with business loans, DBSs, and merchant services.
- Use opt out vs. opt in.
- Target current DBA Members.
- Partner with SEGs.
- Promote branch Incentives.

In-house or Outsource?

With the benefits of enhanced business member card services outlined, the next issue to determine is whether to continue outsourcing services to a third party or streamline operations in-house. This is a significant decision and will determine the future growth of the business card program.

For many Credit Unions, a barrier exists. Components of this barrier are comprised of often unfounded fear-based anxieties such as not having sufficient knowledge or training to handle an in-house program.

Since nearly all Credit Unions handle loans, the necessary systems to underwrite a credit card program internally are likely in place. To varying extents, a Credit Union is likely already assuming the “middle man” role by fielding credit card-based calls from members that are ultimately directed to a call center handling member accounts.

In-house requires serious investment as a module is required to be added and integrated into the existing core processor.

On average, an in-house program will cost between \$25,000 and \$40,000; however, this does not include associated internal processing costs and maintenance. This approach requires the credit union to place the entire credit card loan process on the main frame core system. As a result, the business member would have access to that account in real time in the same fashion as loan account balance, overdraft statement or ATM applications.

Along with system investments, training and additional staff is often required when implementing an in-house operating system. The core vendor facilitating the technology will train users on how to use the module and how best to implement the product line.

This includes, but is not limited to, adding new credit cards to the program, increasing credit lines, and extracting data reports. The new program will be seamlessly integrated with all in-place Credit Union’s offerings and will not be subject to fragmentation by including a third party.

The benefits, however, usually outweigh investments. In time, monies will be recouped and reinvested in the business card service program. And while the term “in-house” often creates the image of more staffing and overhead, in actuality, when properly executed, an in-house program allows for a streamlined, cross-integration of all operating systems.

According to a recent report by PEMCO Technologies, Credit Unions considering in-house operations should expect the following daily tasks which are usually split between card services and the IT department:

- 1.5 – 2 hours daily, per program, for CTF management, daily posting, card issuance, file transmissions, risk-based review of reports such as card activation failure and inactive cards and calls relating to items such as lost/stolen cards, compromised cards and neural network alerts.
- 1 – 2 hours per month, per program, for card inventory management, file creation, and reports review.
- The ability to maintain a separate database on another system.

Not all components of an in-house program need to remain in-house. What the former seemingly counterintuitive statement means is that Credit Unions can outsource compliance which is a “pay as you go” system and handled per dispute. Another outsourced element is 24-7 service. For business members requiring assistance at 11 p.m. on a Sunday night because their card was declined, they can call a third party call center that will handle issues and concerns for roughly two cents per call.

Outsourcing the entire program is a viable and often necessary road to travel when first introducing a business credit card services program. As noted earlier, credit unions that partner with third party vendors also relinquish the ability to capture all derived revenues. At a certain point, a decision has to be made to either grow the program or allow it to remain marginally profitable but static.

The average cost per outsourced account is approximately \$2.25. If we look at a Credit Union with approximately 60,000 members and \$500 million in assets, it is safe to assume that there is a 20 to 25 percent credit based penetration rate, which equates to approximately 10,000 household accounts.

The monies given to the third party vendor can be reinvested in an in-house program. And while the above statistic underscores household member accounts, business members comprise nearly 25 percent of household member accounts. Therefore, offering “sticky” products and services will attract new business member accounts thus increasing enrollment and ROI.

In some cases, Credit Unions have sold the assets to their credit card portfolio to a major bank under an Infinity program. While the Credit Union name remains on the card, the bank handles all aspects of the relationship and provides the Credit Union with a monthly stipend, which strips the Credit Union of the ability to develop relationships with card holders.

The reasons credit unions should seriously consider in-house program include:

- Ability to manage all facets of member relationship.
- Ability to handle member calls from inception to completion without third party interference.
- Ability to understand member paying and spending habits.
- Ability to cross-sell product and services.

Business Rewards Cards

While the buoyancy of the economy remains in flux, it will eventually rebound. As the clock ticks, securing new business will be difficult.

As noted earlier, business owners will look toward credit before attempting to secure a loan. With that said, they will be inundated with credit card offers, many of which will offer attractive interest rates and balance transfers. The number of loyalty program members in the U.S. today is estimated at more than 1.3 billion.

For many, however, the rewards offered will sway their decision. A recent Edgar, Dunn & Company research survey found that rewards programs are a greater incentive than a reduction of interest rates when acquiring a new credit card account. Thirty-five percent of individuals surveyed pointed to relationship rewards as their top incentive.

Visa, for example, found that 81 percent of U.S. households participate in at least one reward program via a debit card. In addition, three-fourths of all credit card volume and four out of five card transactions in 2006 were linked to rewards. Overall, loyalty programs have grown 36 percent since 2000.

In order to build a loyalty reward program, the proper technologies have to be in place. This includes systems to capture account transactional data, assigning point values, storing data, and reporting and retrieval of the information from a primary database.

The program must also be adaptable to new card product technologies such as contactless cards and biometrics. In addition, an easy accessible and traversable coinciding website is essential to afford account holders the ability to review respective standings.

According to a report by Edgar, Dunn & Company, rewards credit cards represent half of all preferred credit cards today. 83 percent of rewards card owners use their cards. Four out of five holders of reward cards are considered low-risk accounts. Visa and MasterCard estimate that 50 percent of its issuers operate rewards programs tied to their credit card offering with 20 percent offering debit reward programs.

On average, business users spend more than personal cardholders. For example, travel expenses, gasoline, office supplies, and restaurant dining. Therefore, it is important that

they understand which spending activities generate reward points, and if there are reward limits in place.

On average, every dollar spent equals one reward point for a credit card while every \$2 spent on a debit card equals one point. Incentives should be developed to drive a streamlined process. For example, business members can be offered 2,500 for each checking account opened and 10 point each month for automatic billing.

While cash rewards were once considered the leading rewards offering, a recent report from Auriemma Consulting found that the attraction of cash back programs is decreasing in favor of travel rewards or lower interest rates.

While member rewards programs sometimes require fees, business members should never incur charges for a rewards program. This approach can present challenges as many reward programs carry costs equal to 20 to 25 percent of the incremental interchange revenue generated.

As gasoline prices remain in flux, so does jet fuel making business trips a money-sink for many small-to-mid-size business owners. Therefore, cards offering rewards programs are gaining popularity. For example, Capitol One No Hassle Miles card offers 1.25 miles for each dollar spent on purchases; no blackout dates or seat restrictions; no expiration date on miles; and no limit on the miles you can earn.

Credit Unions are in a unique position in that due to their size, they implement any type of rewards program they wish. It can be regional or based on demographics. Ramping on online services; however, is necessary, and often costly. The goal is to retain and drive card usage. To this end, Credit Unions should focus on cross-selling coupled with a strong value proposition.

When approaching marketing campaigns, it is critical to advertise incentives that will tie the business member to the credit union such as offering balance transfers and convenience checks.

Business members should be encouraged to redeem points through the Credit Union website which can facilitate sales for partnering companies. Items can include digital cameras, iPods, prepaid gift cards or lower fees and preferred interest rates.

For the Gen Y demographic, Credit Unions should offer downloadable ringtones and other programs aimed at attracting next generation members. Capitalizing on existing relationships with loyal members will ultimately result in a higher rate of adoption for business owners.

According to Furnace-Giltner & Associates, offering an ongoing rewards program for debit card holders will reduce the rate at which customers “backslide” into the slow spending habits by nearly 20 percentage points. Sustained card usage is essential to increasing interchange and NSF revenues as residuals cover rewards program costs.

When approaching your existing rewards program, determine how you can enhance the following five key principals:

1. Transparency
2. Relevance
3. Affordability
4. Attainability
5. Value Perception

Conclusion

Building a solid business credit card services program will position a Credit Union to keep pace with competition and develop inroads to new revenue streams from both existing members and potential members.

Due to the increasing cost of acquiring card-carrying customers, Credit Unions must focus on developing a solid rewards program, which is critical to success. A recent study by the Tower Group found there is an increasing need for financial institutions to implement loyalty programs not only to complete but also to survive.

With an eye on the future, respective Credit Unions must also take a hard look at their current offerings and determine if it is prudent to enhance an existing program by building an in-house module.

While investments are required, returns, such as interchange fees and interest income, are guaranteed. Competition with national lending institutions will prove trying for certain Credit Unions; however, compelling interest rates, balance transfers, and progressive reward programs will turn more members into business credit card members.

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