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Rebuilding the Operating Model for Credit Card Companies

U.S. credit card companies were already facing some fundamental challenges before the worldwide liquidity crisis began. Now, with the U.S. economy in a recession, these companies are being forced to consider changes to their operating models. Reactions that were common in past downturns—such as cutting overhead or eliminating some suppliers—will not suffice. Instead, these companies and the banks that own them must reduce excess capacity across functions, create shared capabilities with other card issuers, and provide third-party services.

Banks have been hit by a once-in-a-century financial storm and have taken shelter. The credit card industry, of course, has gotten caught in the same storm, and credit card executives are looking at operating model changes that might protect their threatened franchises. The decision by American Express to turn itself into a bank holding company (following the example of two investment banks, Goldman Sachs and Morgan Stanley) is an example of the extreme adjustments that credit card issuers are willing to make. This decision also brought an end to the era of monoline credit card players in the United States.

Although the liquidity crisis is new, other problems have been developing for some time. Since 2006, for instance, there has been a sharp rise in credit card payments overdue by more than 180 days. The percentage of credit card balances that the industry will write off as uncollectible will likely exceed 9 percent by the end of next year, compared to 4 percent in 2006.¹ Consumer caution about credit levels has been growing for more than a decade: Growth rates in U.S.

consumer credit dropped precipitously in the mid-1990s and have essentially been flat since 2002.² Furthermore, consumers are less inclined to blithely pull out credit cards whenever they make purchases, as indicated by the decelerated growth of credit card purchases since 2001.³ Add to these factors a new level of regulatory scrutiny over fees and pricing tactics that have been deemed unfair and deceptive, and the industry has all the ingredients for slower revenue growth.

All these issues have been exacerbated by the recession, which is reducing the demand for credit. Americans worried about job security have started to save more, with personal savings as a percentage of disposable income increasing from less than 1 percent in 2005 to nearly 3 percent as of the second quarter of 2008, and are cautious about accumulating credit card debt.⁴ With many issuers eliminating “teaser” or promotional interest rates, consumers also have fewer incentives to make use of new cards.

Likewise, the supply of credit is decreasing. Indeed, many issuers are

taking steps to protect themselves against a surge in consumer defaults—in ways that will impact their near-term revenue. For instance, card companies have been closing inactive or risky accounts at a much higher rate than in the past. They have been cutting credit limits in ways that would have been unthinkable a few years ago. In a recent review of a portion of American Express cardholders—the sort of review the company does on an ongoing basis—American Express adjusted the credit available to half of the cardholders it examined.⁵ In similar reviews in the past, the company typically cut the credit lines of 20 percent of the cardholders it reviewed; this time, half of the accounts in review had their credit slashed. More recently, a prominent banking analyst from Oppenheimer & Co. said that the U.S. credit card industry may cut more than \$2 trillion in credit lines over the next 18 months to address risk concerns and regulatory changes. The industry has also tightened credit score requirements for those seeking new cards and has reduced direct mail solicitations in the third quarter of 2008 by 25 to 30 percent compared to the same period in 2007.

THREE WAYS TO REBUILD THE CREDIT CARD OPERATING MODEL

The declines in both the supply of and demand for credit have left issuers with excess capacity. Excess capacity is not a new phenomenon in the credit card industry, of course—it happens every time there’s an economic downturn. What’s different this time, however, is that rather than excess capacity existing just in back-end functions such as processing, fulfillment, and servicing, it will also exist in core areas such as strategy development and marketing execution. Credit card companies cannot cut some overhead, end their relationships with certain suppliers, and assume their efforts will suffice. The necessary response is both deeper and more creative, and it will center around three efforts.

1. *Reduce excess capacity across functions.* So far, most cost-reduction efforts within credit card companies have focused on overhead and non-core functions. This isn’t enough. The industry’s structural changes warrant reductions along the entire credit card value chain. To ensure that internal costs are justified, issuers will want to assess their current operations from end to end to identify excess capacity (both people

and infrastructure) in all key activities. As issuers curtail their acquisition efforts, for instance, they will want to adjust capacity related to the origination of new accounts, including campaign execution, sales, application processing, and credit decisioning. Reducing capacity may naturally lead to a reevaluation of current sourcing strategies and a new push to make some existing processes more efficient.

2. *Create shared capabilities with other card issuers.* The era of credit card issuers doing everything on their own has ended. By joining forces, credit card companies will be able to create industry utilities to handle the processing of nonstrategic activities across the value chain. For instance, groups of issuers should think about forming a joint utility for collections of overdue accounts. Only such collaboration will help bring maximum efficiency to collections and eliminate the zero-sum game in which one issuer’s gain is another’s loss. Customers may favor a collections utility as it would likely receive the enthusiastic support of regulatory authorities.

3. *Provide third-party services.* A third way for credit card issuers to achieve cost efficiencies is through scale, including the commercialization of non-core services. By providing key services (e.g., statement issuance, customer service, collections, and recoveries) to smaller regional banks or issuers, credit card companies can achieve economies of scale and thus reduce their overall operating costs.

Endnotes

¹ Moody’s

² Federal Reserve

³ The Nilson Report

⁴ Bureau of Economic Analysis

⁵ AnnaMaria Andriotis, “Banks Lowering Consumers’ Credit-Card Limits,”

SmartMoney.com, November 14, 2008.

CONCLUSION

Banks should embark on a series of initiatives aimed at transforming the operating models of their credit card units. In addition to finding new ways to collaborate with each other and with co-brand partners, issuers should make changes to their current operations and delivery models to reduce the excess capacity that has become glaringly apparent. Standing still is not an option. With the foundation shifting, it’s time to act.

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