Mobile Payments The Apple Pay Way

Merchant Guide to Credit and Loyalty Transformation 3.0

Mark Sibthorpe

Will credit cards go the way of the Canadian penny?

About the Author

Mark Sibthorpe Kenya 2007: tipped Kenyan banks that P2P mobile payment initiative M-Pesa was going to 'eat their lunch'.

- 2012 Wrote Merchant Guide to Credit and Loyalty Transformation (A-Z)
- 2011 built merchant strategy for coalition credit and loyalty program for 10 large retailers. Estimated $4 billion in transactions per year.
- 2009-2010 in partnership with John Anticoli, revolutionized payments in the Canadian bankruptcy trustee industry by migrating 900 trustees from cheques to electronic payments. Estimated to save several forests and generate $2.5 billion in deposits for partner bank.
- 2001-2009 assisted technology companies in the financial service industry to improve their strategies and grow their market share. Several 7 figure deals in Canada and EMEA.
- 1997-2000 led several high profile Internet projects including a automated web translation initiative that led to deals with Netscape, Siemens, Bank Tokyo Mitsubishi...

BankNews TV Publishing Corp. (BNTV)

BNTV is the publishers of Financial Service Industry Monitor (FSIM), MSBA Mobile Payment Blog, and StartaBank.ca Journal. BNTV was set up in order to assist non-traditional companies, such as merchants, insurance companies, and money services businesses (MSBs) set up, or extend their financial services. BNTV publish numerous types of industry publications in Canada, the US and the United Kingdom, including banking technology journals, market reports as well as industry case studies.

BNTV also provide consulting services geared to helping organizations build financial models for credit and loyalty programs. To date BNTV has worked with financial institutions (FIs), merchants and money service business in Canada, the UK and Africa. BNTV and StartaBank.ca have also organized several workshops for companies and have attracted c-level executives from 60 fortune 500 companies. Representatives of BNTV consulting services division are currently working with 10 large merchants to launch a innovative merchant led credit and loyalty project. In the past clients include Amex, CIBC, Standard Life, Sun Life, and Credit Union Central Canada…

Publications:

2006: Co-published Canadian supplements to IBS Publishing's journals

2007 - 2008: Market Guide to Retail Banking Systems

2007 - 2011: StartaBank.ca Journals and Industry Case Studies

2009: Guide to Retail Banking System Selection

2010 - 2011: MSBA.ca portal for Money Services and Banking

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Foreword

Apple Pay is about to change the way we pay. Merchants that want to understand loyalty, credit, mobile payments and Apple Pay should read this book. It offers readers a step-by-step methodology for evaluating and transforming credit and loyalty programs. The strategies are based on proven examples and facts. The Nectar, Target, Canadian Tire and Walmart case studies are examples of the practical approach I have taken, written with the intent that merchants can use them as blueprints for their own initiatives.

I used every possible source to make the material relevant; in particular, I drew upon actual projects, such as having developed financial models for a coalition of Canadian merchants. Through this and other related projects, I gained insights by employers like Revolution Money, before they were bought by Amex, partners like Discover Financial Services (DFS), First Annapolis and Fifth Third Bank, and a variety of merchant clients.

As for mobile, my journey began in Kenya, where I had the opportunity to journey along with m-Pesa, the reference for mobile P2P. I tracked it from its humble SMS based roots to the present 14 million users. More recently, I was one of the thought leaders in decisions by Couche-Tard/Circle K to join the merchant consumer exchange (MCX), evaluated PayPal and card-linked-rewards leaders, and founded a Passbook think-tank that has attracted hundreds of members.

My goal in writing this book has been to mark the way for merchants looking to avoid costly mis-steps. To this end, like all epic journeys, it begins with the first step: Apple Pay and Passbook.

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Introduction

Apple has launched the iPhone 6. This advanced phone comes out with a payment enhancement that, because it holds 800 million credit card accounts via iTunes, has the potential to overcome friction that has hampered mobile payment evolution. This long anticipated solution is based on near field communication (NFC). Other payment enhancement include tokenization, biometrics and its previously launched PassBook (eWallet). The ability of Apple to overcome mobile payment friction is not assured. Here is a summary of the main issues:

1. NFC has a low merchant point of sale (POS) install base in the US of under 2%. Of these many POS devices are obsolete.

2. Low NFC penetration may be about the change due to the Target and recent Home Depot data breaches. Both of these merchants are implementing urgent POS updates that will include chip and pin technology. This may, by default, enable these merchants to also deploy NFC. The reason for this is because many modern POS systems include NFC technology by default. The carry-on from this is that these data breaches have also prompted a groundswell of followers as the industry reacts to the risk associated with less secure POS devices and also a possible liability shift from card networks to merchants for non-compliant POS devices. In fact, in an article today (see below), MasterCard has set a six-year timescale for all European merchants to replace their existing POS terminals with contactless-enabled tills by 2020.

3. Apple removes data risk. This is because Apple will store cards in the cloud (tokenization). This is a significant risk mitigation factor for merchants. One obstacle for merchants looking to authenticate mobile payments is the risk and technology burden required in order to store card data and/or funds. Apple will essentially remove this friction

because it already stores 800 million credit cards via iTunes. It also means consumers will not have to set up a new account as they are already members of iTunes.

4. Ease of use and low upfront merchant costs. Apple already has a eWallet and is installed on hundreds of millions of devices. This wallet makes it easy for consumers to receive and store coupons, passes, tickets and offers. This eWallet is location based, installed on hundreds of million iPhones, free to use by both consumers and merchants.
5. Strong partner network including Subway, McDonalds, Disney, Walgreens, and of course, Apple stores. Partners like Groupon, Uber, and Panera have also integrated Apple Pay to allow customers to pay without having to enter any payment information.
6. Support from top US banks, including Chase, Citi, Bank of America, Capital One and Wells Fargo. Billed as 'coming soon' are Barclays, Navy Federal Credit Union, USAA, PNC and USBank. Visa, MasterCard and Amex are also part of Apple Pay, comprising 83% of the card market.

Challenges and opportunity for merchants and banks

Merchants are wary of payments costs that impact their bottom line and consumers payment choices are usually determined by rewards. The latest trend is that companies like Twitter are scrambling to implement 'buy' buttons in order to super-charge clicks. Today this will work with online payments, but, with merchant participation, this could transcend to POS: a critical factor considering 96%+ of retail transaction occur at POS.

A relevant comparison is card-linked-rewards. Today companies like EDO, Affinity Marketing and First Data work with banks to push offers to consumers based on the data (credit card) issuing banks. Imagine a fuel station wants to target its competitor. Using card-linked-rewards, the merchant could use the banks data to push offers to consumers based on existing credit card transaction data.

Resulting transaction can be tracked and merchants charged 4% or more per transaction. With Apple Pay, and merchant participation, Twitter, and Google buy ads suddenly become a whole lot more valuable. I.e. if click are worth 1000 times more than views, what is the value of a POS transaction? Therefore the goal would be to move up the value chain to the point of sale. In my opinion, this is why Google put so much effort into its failed NFC based Google Wallet. Card-linked-rewards are explained in detail in this book as this type of reward provides a glimpse into the potential value proposition offered by Apple Pay.

MCX

Card not present transactions are typically more expensive than card present transactions. This is a problem for Apple Pay considering that merchants in Canada and the US already have the highest transaction fees in the world. Because of this, hundreds of the largest US merchants have rallied together to fund the Merchant Consumer Exchange (MCX). MCX is intended to provide a merchant owned network for mobile payments. There are two main reasons why MCX is supported by merchants:

1. To help merchants like Walmart and Target skirt around high transaction fees, or 'merchant discount' which averages about 1.56% in Canada.
2. To protect transaction data and prevent banks using this data against them as they do for card-linked rewards.

These reason could prevent some merchants from adopting Apple Pay. Especially considering that Apple transactions will generally be card not present transactions, meaning transaction fees will likely be even higher than normal merchant discount fees at POS. Most likely card networks might offer a special initial rate, but merchants have learned to be wary of these offers.

Conclusion

Apple sweet spot: Apple iTunes has 800 million consumer credit cards on file. This correlates to the largest tokenization solution on the planet (see below for a recent tokenization article). Apple has developed PassBook, a free and easy to use eWallet that already has an installed base with hundreds of millions of users. The API's for Apple Pay and PassBook are free and relatively straightforward for a developers to integrate with. These are enticing carrots for merchants looking to boost market share and keep costs low.

The sobering consideration is the fact that most (even Apple's PassBook) mobile payment initiatives to date have not worked. Google and the large US telcos are members of an industry littered with the corpses of cash killers that went out in flames. Remember Mondex, a billion dollar Canadian bomb that serves as a reminder of the risks for those that tried to change the way we pay. Yet, Starbucks with 10% of its transaction now on its on mobile platform, and M-Pesa with 14 million active users, show that mobile payments can offer a value proposition enticing to consumers.

How the book is organized

Explores history of payments: for example, it is fact that Visa and MasterCard account for 92% of credit card payments in Canada, and have similar control in the US, Europe and Australia. In the past, they have blocked new entrants, including Amex buying and dismantling Revolution Money, a new innovator that was creating waves and attracting many merchants to the fold. Another example was using merchant exclusivity clauses to block Discover. In order for Discover to gain access to merchant point of sale (POS) terminals, it had to fight Visa and MasterCard and win judgements. The result being that in 2008, Discover was awarded $2.75 billion in compensation, and within a few short years, Discover is accepted by most US merchants. This achievement has played to the hand of PayPal and Google, as both have signed on with Discover, and will use this rapidly growing network in order accelerate their payment crusade and gain access to POS.

Other aspects of the ecosystem, explained in detail in the book, are also highly concentrated. For example, Moneris, the leading

Canadian acquiring processor, controls 45% of Canadian credit and debit payments. This colossal processor is owned jointly by the Bank of Montreal (BMO) and the Royal Bank of Canada (RBC), who drive their customers to their prodigy. The situation in the US is similar, just switch the name Moneris with First Data and Bank of America. Together these behemoths control 44% of acquiring, according to a 2011 Nilson report.

Evolution of market: merchants have launched legal action against the card networks. However, despite favourable judgements in favour of merchants, and against the card networks by US and European courts, ongoing legal action is a constant source of irritation to merchants. This has prompted some merchants, like Walmart, to seek alternatives as per the Walmart case study in this book. The Merchant Consumer Exchange (MCX), is a case in point. MCX (www.mcx.com), due to launch June 2013, is a shared mobile platform, or network, owned and controlled by merchants.

Loyalty: an advantage held by MCX, and merchants like Starbucks in the mobile game, is that rewards are key drivers for consumers in deciding which means of payment to adopt, and rewards are controlled by merchants. The loyalty industry in the US (2006), was pegged at $10 billion dollars and growing, clearly this brings a lot of influence regarding payment choice. The average US household participated in 12 programs.[1] In Canada, Canadian Tire (see Canadian Tire case study) and PC Financial control over 9 million loyalty accounts when taken together. In the UK, Nectar has participation levels in excess of 50% of all UK households (see Nectar case study).

Considering the value of loyalty, the question asked by Karen L. Webster, in a 2007 study, is:

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[1] Barry Berman, 'Developing an Effective Customer Loyalty Program,' California Management Review, Vol 49 No. 1 (Fall 2006) Kelly Hlavinka and Rick Fergisun (is that correct spelling of Fergisun), 'Quo Vadis, Sizing up the Loyalty Marketing Industry' (2007).

“*Given the lack of differentiation and increasing dissatisfaction with rewards programs, is it possible that card marketing and loyalty marketers are operating in an environment where programs essentially cancel each other out, given their relative similarity?*’

Her findings were a definitive “No!”

Webster concludes that loyalty does pay, and references retailer A. Neiman Marcus, a large US retailer that runs a popular loyalty program called ‘InCircle’, as a case in point. In her paper, it was shown that the average InCircle member spends $12,000 per year, or 20 times the spending of non-cardholders. These same cardholders account for 50% of Neiman Marcus’ revenue. What Webster does not reveal in this paper, ‘is whether or not these same consumers would have had the same spend patters without the program in place?’ Nor does she state what Neiman Marcus had to give away in order to attract these consumers and keep them. To answer these questions, and understand the returns on investment (ROI) merchants can expect, look to Chapter 6 for valuable strategies.

Practical case studies: through practical case studies, readers of this book understand the role credit and loyalty play in the success of top retailers like Canadian Tire,[2] Walmart Canada, and Mexico (Walmex), Walmart UK (ASDA),[3] Tesco UK.[4] Target Corp US is an related example and is discussed in detail in the case studies in this book. Target recently sold its receivables to TD Bank;[5] this decision was a multi-billion dollar deal and is covered in the Target case study. The purpose of including this is to show the economics behind the deal, and reveals the thought process driving their strategies.

As shown in the Target case study, receivables are one of the main issues of concern for merchants setting up their own credit/loyalty

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[2] See Canadian Tire case study.
[3] See Walmart case study.
[4] See Nectar case study.
[5] See Target Corp case study.

programs, and dealing with banks is a major focus of this book. Leverage bank relationships, as well as the risk provide insights as well as understanding of how merchants have reacted to banks dumping hundreds of co-brand card programs beginning in 2007.

In summary, this book looks at the factors that are impacting payments, credit and loyalty, especially mobile; and, will provide merchants a blueprint and a roadmap in order to guide decision making. The following is a summary of some of the factors influencing the payment ecosystem; factors that play into merchants decision on how best to fit into the 'digital revolution'.

- Realization by merchants that loyalty pays, and is a must have to be competitive;
- Technology advances and the commoditization of credit and loyalty management technologies drive down costs, and make merchant run programs a realistic option;
- Backlash due to issuers dumping thousands of co-brand programs during the credit crSoftcard;
- Unfair credit card processing costs and anti-competitive practices by the major card networks. This is demonstrated by recent regulatory changes such as the Durban amendment in the US, the 1996 Consent Order requiring Interact Canada to allow all regulated financial service companies to connect directly to the network, and many other actions;
- Potential competitive advantages and opportunities related to mobile payments: new players, data control and control over costs.
- Technologies to permit Smart phones to authenticate transactions at the point of sale and the significance of battle between quick response (QR) codes and NFC.

Chapter 1

Mobile Intro

The credit Softcard, ongoing swipe fee conflict and mobile are the drivers behind an entirely new payment and loyalty ecosystem. Mobile, though, offers merchants the ability to reverse a long-standing trend, whereby the card networks and banks have come to call the shots. The result is that US and Canadian merchants pay the highest transaction fees on the planet. Mobile can change this, and Passbook is the first port of call that I recommend for merchants not already in the game. The cost to leveraging Passbook can range from zero to 8 figures. This chapter describes what is involved and also offers detailed costing examples.

The first Passbook point to note is that it was installed on over 100 million devices within three days of the release of iOS6, September 2012. Passbook a free electronic container (eWallet) permits consumers to store vouchers, coupons, boarding passes, airline tickets, in fact, just about any numerical credential a person might want to store, and would want to present for validation to a merchant or other third party.

Passbook is free!

To help understand the implications of Passbook, a quick summary of relevant market influencers follows.

‘Ignition’ and payment history

Most recently, Google's near field communication (NFC) based eWallet, and also Softcard, a NFC based mobile wallet, backed by T-Moble, AT&T and Verizon, astounded observers when their solutions were not adopted. What these titans failed to note is that a strikingly similar initiative took place in the late 90s, and this also fell flat. The project was called 'Mondex', and the stated purpose of Mondex was nothing less than to cause the 'death of cash'. The Mondex 'e-Purse', backed by the biggest international brands (banks + card networks), thousands of merchants, and billions of dollars, and still failed to ignite.

Pay-By-Touch, a US based cash assassin wannabe, used fingerprints to authenticate transactions. Despite industry and merchant backing, the closest Pay-by-Touch came to igniting, was to burn through $300 million in investor cash, not a surprise considering the criminal background of the founder.[6] Crossing paths, Zoompass, introduced in 2009, was the Canadian P2P mobile payment project backed by three Telco titans. Despite the muscle of Bell, TELUS and Rogers Zoompass was divested in October 2012. Zoompass actually came closer to igniting than Pay-by-Touch, it

National Post, 1998 – by David Akin

Mondex Canada cancelled its pilot project in Guelph, Ont., yesterday, effective Dec. 31, 1998.

A consortium of Canada's 10 largest deposit-taking institutions launched

the ballyhooed and expensive pilot project in February 1997, but more than

18 months later there is little evidence that anyone is using it . Joanne De Laurentis, Mondex Canada Association president, said the consortium is ready to move on. ``We've got what we need from it. We want to validate what we've learned in a new market,'' she said. Another pilot project will be implemented in Sherbrooke, Que., next year. That project, Ms. De Laurentis said, will likely combine debit card functions with the embedded cash of the Guelph project.

``One of our findings is that consumers are saying they are ready for a card that has more than one payment application on it.''

In spite of the millions of dollars in equipment, advertising and promotional offers Mondex and its banking partners lavished on the town, Guelph's 100,000 residents never seemed to find the product that convenient.

``If people thought it was worthwhile then they would have used it,'' said Gord Townsend, the manager of a downtown sports card store. Mr. Townsend's dusty Mondex terminal has processed one transaction since the test run began. ``It's just something that isn't needed, not with Visa, MasterCard, and direct debit.''

Mondex said the 12,000 card holders in Guelph have used the service for more than $3-million in transactions so far.

Back in Guelph, though, it's hard to find anyone who will own up to having one of the cards. ``My card is sitting in the back of my dresser drawer,'' said Alyson King. ``My bank had a promo -- use it three times and get $15 in credit. So I bought three packs of gum and then went out for a nice lunch. I haven't used it since.

[6] Wikipedia, Pay by Touch

managed to lift off high enough so that its leaders could abandoned ship, taking key roles developing Google's NFC based eWallet.

Meanwhile, Starbucks, the coffee confectioner, put egg on the face of JPMorgan Chase for dumping their co-brand Duetta card program in 2007. This was evident when Starbucks hit 70 million mobile transactions January 2013. Starbucks' revolutionary idea was to use QR codes as a means of real-time authentication at its point of sale (POS). The advantages of Starbucks QR coded based strategy:

- Incremental start- up costs;
- Consumers provided the phones;
- Scanners were already in place;
- It could leverage its existing stored value program.

On another continent, Kenyan, P2P eWallet, M-Peza, has attracted 14 million users to date. Its solution, based on SMS based transfers and a physical 18,000 strong agent network (Vodacom), has become the industry reference for mobile payments.

Demonstrating that innovation can disrupt even the fortified acquiring world, Square, attracted millions of small business owners. Square made it possible for them process credit cards via iPhones.

The takeaway for merchants is that Starbucks, Square and m-Pesa solved problems. For example, M-Pesa, leveraging parent Vodacom`s client base, made money transfers available to anyone with a mobile phone. Here are the facts regarding Kenya that made its remarkable growth possible:

- 80% of the Kenyan population is unbanked;
- Vodacom, parent company, 15 million subscribers, more than the total of all Kenyan banks combined,[7] and 18,000 agents;

[7] NBC News, August 8

- M-Pesa's convenient and affordable fees, a fraction of what the banks charge;
- No minimum balance required.

Square's ability to turn iPhone's into point-of-sale (POS) devices for an all-in, fixed cost of 2.95% per transaction, appealed to the likes of crafts people and trade workers. No more awkward situations because merchants can accept credit cards at client locations, bazaars or small owner owned shops. Essentially an entirely new market segment was opened up, and Square caught large acquirers and even PayPal sleeping.

Apple`s ignition strategy

After observing Google and Softcard fail, Apple, a latecomer to the payment party, introduced its own version of an eWallet. What was different in its approach is that its motives were highly influenced by the fact that it does not need payments in order to grow revenues. After all, Apple's primary goal seems to be to sell handsets and, considering the fact that Apple is the top US Smartphone vendor,[8] they appear to be doing a good job of it. However, to keep a lock on this market means adding value. The fact that 49% of mobile phone users want to pay by phone[9] seems like a good way to keep its stickiness.

Considering that Lemon, a promising solution with many Passbook features, had gained millions of takers, and was QR based, likely gave Apple a lot to think about. For example, for iPhone 5, NFC was logically relegated to a 'wait and see' category. The following is a list of some ignition issues impacting both consumers and merchants that Apple would likely have considered:

1. The value Apple`s eWallet brings to the 'i' ecosystem;
2. Determine, 'whats in it for me' WIIFM? Although, 'convenience' is the term used to describe the Passbook

[8] The Globe and Mail, Reuters, February 1, 2013.
[9] Quorus Consulting, 2011 report

value add throughout a Digital Trend article,[10] location based offers is more likely what will keep marketers and users coming back for more.

3. Ability to deliver scale: IOS6 100 million installs including Passbook;
4. Ensure limited or no changes to POS in order to work;
5. Third-party pass creators like PassKit, Tello, and Passdock are filling in the gaps for companies with fewer developer resources which means easy and virtually free to develop passes for both consumers and merchants;
6. Buy in from larger merchants, trendsetters like Square and Starbucks, originators of similar eWallets like Lemon, which began digitizing receipts in 2011, and support from card networks like Amex;
7. Protection for merchant data that does not require consumers to sign up with Apple in order to use a merchant's passes;
8. QR code (barcode) authentication and other means that merchants can integrate existing loyalty programs, without the need for new equipment;
9. Payment efficiencies and avoiding adding, unnecessarily, payment layers or complexity to the payment process;
10. Merchant aversion to high swipe fees.

How it was done

From an operational/technical standpoint, what Apple has created is an app that integrates directly into iOS6. So it can also be considered part of the iOS platform. The development kit includes:

- APIs for features such as Apple's location based positioning;
- Authentication capabilities;

[10] Francis Bea, Digital Trends, October 5, 2012.

- Sophisticated standards and means of authentication using QR based barcodes, and security procedures;
- Apple (likely) learned from the best of the many existing models, and combined them into an enhanced value proposition.

What Passbook will do

QR codes enable passes let users access and authenticate electronic versions of merchant cards, tickets, and boarding passes — all without having to fuss with wallets, purses, or pesky slips of paper.

The idea being that instead of scanning a card, punching a ticket, or standing in line for an event, Passbook users simply present the barcode appearing on their iPhone or iPod touch screen to a mobile agent or clerk. The steps are as follows:

1. Passbook stores individual items as "passes";
2. Passes dynamically update information, such as gate info for a flight, or alerting a user if a parking lot is full;
3. Passbook app will keep track of multiple passes;
4. Passbook was built with location based features as a core service as well as clock-enabled. So when users get near a location their pass will present itself automatically, even if the screen is locked.

What Passbook won’t do

Passbook is not an acquiring processor for stored value, credit or debit cards. This means merchants need to pass these transactions (except for cash) through their existing POS/acquiring relationships, or via a eWallet/stored value account, capable of pulling money from bank accounts.

Apple threat to existing stakeholders possibly even merchants

Digital Trends, Geoff Duncan, issued some warning regarding a couple of possible concerns merchants, and other eWallet providers might want to consider before jumping into Passbook. For example, Finextra recently revealed that Apple filed a patent application designed to replace ATMs by connecting possible cash distributers with other Apple users.[11] Other concerns, according to Duncan, are based on statements made during Apple’s WWDC 2012 keynote. Apple made a point of noting that some ‘400 million people around the world have active credit card information on file with Apple.[12]

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[11] **Finextra, Apple files patent application for 'ad-hoc cash dispensing network, January 31, 2013**

[12] Geoff Duncan, Could Apple’s Passbook become a true digital wallet?, Digital Trends, June 14, 2012.

They use these credit cards to buy music, videos, and apps through iTunes'. The implication, according to Duncan, is that apple could use this data to extend Passbook to merchants who participate in its Passbook program. In this scenario, they would essentially provide a PayPal like authentication service. 'Apple members would basically use their existing credentials to authenticate a transaction. In banking terms, such a system has Apple functioning as a 'third-party aggregator'. The ATM replacement patent application that hit the news January 2013, whereby Apple users can to exchange money with one another through its solutions, as an example of an unexpected scenario.

Duncan also points out that Apple already manages payments for its own products, such as gift cards, music, and movies. The threat or opportunity, being for Apple to extend its capabilities to 3rd party retailers; or, to do as Google does, and attempt to commercialize payment data and offers.

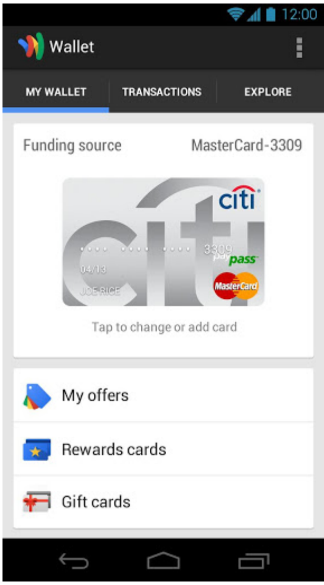
Passbook colossal competitors

Diagrams 1-4 (pages 35-37), show the payment ecosystem from about 2007 to 2012. It is a system undergoing tremendous change, with many new entrants and revenue models rapidly emerging. Below, a list of emerging stakeholders fighting to for a place in the new order of payments:

1. PayPal, a subsidiary of Ebay, has attempted to entice merchants to accept it as a valid form of payment on many occasions. At the NRF conference in NY, which took place January 2013, PayPal announced 23 large merchant agreements to accept its payment credentials at POS. PayPal has facilitated this for merchants by striking deals with NCR and AJB. This will enable PayPal's unique, naked authentication at POS. To work, users simply enter their mobile phone number and a pin to pull funds from their PayPal account. PayPal has also made the decision to issue plastic cards on the Discover rails, reflective of consumer apathy to the effort required to used its naked

authentication as shown in off the record reports telling of low transaction volumes the 2,000 Home Depot locations where it is currently available.

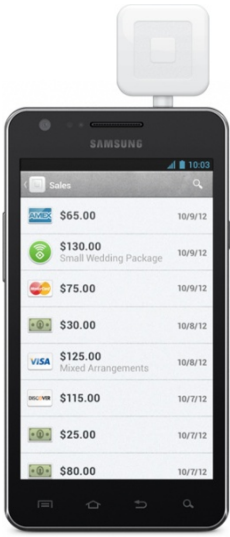
2. Pay with Softcard, the Verizon/AT&T/T-Mobile/ solution. Softcard has attempted to launch its solution in selected markets on several occasions. It has not performed because there are few handsets that support its NFC solutions, few large merchants, and banks have had mixed feelings about supporting a solution that will increase the cost of transactions without providing a sufficiently valuable consumer proposition. There was some praise for Softcard at the NRF event also, from Café Rio, a chain with 50 restaurants. It did not disclose any transaction data.



3. **Google's eWallet**. Google attempted to entice card issuers to use its solution but was rejected by the major telcos and most banks. Large merchants have also rejected Google's solution because of concerns over costs and sharing data. Large merchants also opposed Google's initial solutions because of the possible costs of deploying NFC readers. Google, like PayPal, has given up on its attempt to make the market for mobile payments, and will instead issue its own plastic on Discover's rails.
4. **Merchant Consumer Exchange (MCX.com).** A merchant led mobile payment initiative that has the backing of seven of the 14 largest merchants by sales and 19 of the top 100 largest retailers in the U.S. In total, MCX members operate more than 75,000 stores.[13] Promises a eWallet, Payment switch, tokenization tools, POS integration technologies and much more.

[13] NRF conference 2013, MCX

5. POS developers. Includes the likes of NCR and AJB, which have developed connecting technologies to enable players like PayPal to link to POS devices for merchants using related technologies. Their mobile solutions streamline integration to POS for both eWallets and merchants. In the past, POS developers have felt sidelined and out of the payment solution transaction revenue. This could soon change.
6. Square. Initially developed technology to turn a smart phone into a POS terminal. Square have launched many add on services, including offers and payment authentication at POS. Starbucks invested $25 million into this solution. Starbucks, boast, 'over seven million customers and 2.1 million mobile payment transactions each week with hundreds of thousands of additional Starbucks mobile app downloads each week.' Payment is made by a user opening their Starbucks app and having a barcode scanned by a sales assistant. The user's prepaid account is then automatically debited. Users can also access their app to top up their account, view their recent transactions and track their reward points. More than $1 billion was loaded onto Starbucks cards over the 2012 holiday period, the highest amount ever. One in 10 US adults received one of the company's cards as a gift during the quarter, an indication of its popularity. Nearly 20 percent of transactions on Starbucks cards now come through mobile payments.



7. EWallet and Offers companies, represent slew of promising companies including the likes of LevelUp, Groupon, Living Social, Square and Lemon. These new innovators facilitate merchant offers to consumers.
8. Card-linked-rewards vendors. This group of vendors tie rewards with card issuers and track spend via transactions

using traditional credit and debit cards. According to Ayte group, expected to grow to over $100 billion in transactions by 2015.

9. Facebook Exchange, Facebook Collections, and Facebook Offers are geared to enable marketers to achieve better conversion by allowing them to acquire and leverage word of mouth marketing. By providing transaction opportunities and referrals, Facebook may have one of the most valuable word-of-mouth marketing accelerators that can tap into its 1 billion-user base. Add the ability to push these purchased offers to Passbook and you suddenly have a connection between digital transactions and real word POS. In January, 2013, Facebook announced that it generated $256 million in revenue from payments, mostly related to its gaming credits. Facebook offers the Facebook gift card, that can be redeemed at many leading retail locations.
10. Current Issuers. Banks in the UK are looking to provide naked authentication linking mobile numbers to bank accounts.
11. V.me. Visa's answer to online payments. Users click on V.me logo and pay by simply entering their email address and password.
12. Discover. With $2.75 billion burning in its pockets from its Visa/MC settlement, and strong POS acceptance for its cards, companies like PayPal and Google are eager to run on its rails, so that they can overcome their current lack of traction at POS.
13. P2P. Includes companies such as Vodacom's M-Pesa out of Kenya, which has attracted 14 million users so far.
14. Bitcoin. A crypto currency known for enabling Silk Road, a drug ring facilitated by BitCoin anonyminity.

Passbook success stories with metrics

Apple was wise to adopt a 'wait and see' approach to NFC. Merchants are not falling for the NFC sales pitch. So, unlike Google and Softcard pilots, they have not stalled due to sub-1.7% NFC

penetration at POS. QR codes mean merchants like Major League Baseball (MLB) have already had measured success. MLB and Walgreens have been frank about the results as shown by metrics from a statement shown below:
October 10th, 2012, shortly after the passbook launch, MLB stated, via a market watch report:

Out of all e-ticket buyers, 1,500, or 12%, chose to receive their tickets through Passbook when given the opportunity.

That adoption rate really floored us – there is no question our fans want digital tickets. Fans can use the tickets, forward them to a friend, resell them, or even donate them to charity – and they never get lost or left at home. [14]

CEO of MLB Advance Media Bob Bowman

Alternative methods to authenticate payments at POS
Authentication at POS is a precursor for success. While barcodes and NFC, are pegged as likely solutions to gain adoption, industry adoption is by no means assured. The following is a list of alternative means of authenticating payments, any of which may win the day:

- Wireless
  - Bluetooth, short-wavelength radio transmissions in the ISM band from 2400–2480 MHz
  - NFC standards cover communications protocols and data exchange formats, and are based on existing radio-frequency identification (RFID) standards including ISO/IEC 14443 and FeliCa.[3] The standards include ISO/IEC 18092[4] and those defined by the NFC Forum, which was founded in 2004 by Nokia, Philips and Sony, and now has more

[14] Dan Graziano, Baseball Fans are Quick to Adopt Apple Passbook, BGR, October 10, 2012.

than 160 members. The Forum also promotes NFC and certifies device compliance Wi-Fi[15]

  - Wi-Fi, Such an access point (or hotspot) has a range of about 20 meters (65 feet) indoors. Relies on encryption for security.

- Barcodes or QR codes that are scanned at POS, either by phone or by terminal. Either consumer or merchant can originate code and/or scan.
- Biometrics, authentication by finger print/retina/face recognition.
- Naked transaction (i.e. PayPal and a group of banks in the UK employ something called naked authentication, which is that a user simply enters a mobile number and pin).

Apple just introduced pay-by-voice in its latest iOS6 update, and PayPal announced that it has managed to have its 'Naked' transaction based solution accepted by 23 merchant. PayPal made this claim at the 2013 National Retailer Federation conference.[16] This statement may be more bark than bite though, as PayPal's effectiveness as a payment alternative at Home Depot is questionable, and both parties have been very secretive about transaction volumes.

To further streamline adoption, PayPal has aligned with NCR. The purpose of this relationship is to ease integration for its Naked transactions. NCR provides POS solution to 19 of the world's top 20 banks, 17 of the top 20 retailers, 7 of the top 10 telecom firms, and 4 of the top 5 airlines. So its support in helping PayPal access POS is invaluable.

To show that many different solutions are still in play, the example of US Bank piloting a bridge solution comes to mind. US Bank have come up with a NFC sleeve that works with iPhones. Similar devices

[15] http://en.wikipedia.org/wiki/Near_Field_Communication
[16] PayPal blog

sell for upwards of $60 to $70 per device, as per AT&T's as advertised prices at its retail outlets. This makes its choice of technology a pricy option, without revealing reasons why consumers and merchants will adopt it. Perhaps US bank considers the fact that its sleeve extends iPhone battery life by 50% as the 'value add'?[17]

Google changes strategy

Google's launch attempts did not ignite, in part due to NFC related ignition problems. This cost Google credibility with merchants, and first mover advantage over rival Apple. Another problem it has grappled with is due to the fact that both merchant and issuer are alarmed due to the way Google has insert itself into the middle of transactions (see diagram 4, page 37). Google will be able to use this intermediary position in order to access transaction data, essential to enhance the value of its offers platform. To understand the mechanics of this, refer to page 43 for related information, and an explanation of card-linked-rewards (CLR): this section clarifies the value of Google's approach conceptually similar to CLR. The alternative is 'offers' without data, a model that seems doomed, based on the suffering of Groupon, and likely demise of Living Social.[18]

Google, is now aligned with Discover and will issue its own plastic cards running on Discover's rails. This means it can maintain its strategy as intermediary between the merchants and issuers by adding an additional payment layer, as per diagram (page 37); and it does so without the need for merchant or issuer consent. The following is a summary of the issues Google is grappling with related to its approach:

1. Less efficient. Google ties consumers to their existing credit card accounts that become associated via the eWallet. So

[17] Finextra, January 11, 2013
[18] Rolfe Winkler, The Living isn`t easy at LivingSocial, February 1, 2013

Google actually runs a card not present transaction, adding expense and complexity to the payment process.

2. Alienate merchants and issuers. Neither merchants nor card issuers are happy about this because it means another party will have access to sensitive payment data. For issuers, this may mean they will be denied transaction data, as Google will run the transactions as card not present and place itself between the merchant and the issuer.
3. Data threat. Merchants are concerned that the data Google gathers will be used against them. I.e. Google will be able to sell this data to their competitors.

Google's card base strategy overcomes POS obstacles

Considering payment choices are primarily determined by perceived reward value, here are some reasons Google's card based strategy will likely work:

1. Ad revenue. Google's strategy is to generate revenue from ads, offers, and daily deals. They must have models that show this to make up for the additional costs associated with its less efficient payment processing model.
2. Marketing. Merchants are used to sharing data with card issuers already, and because Google could offer growth, this could override their data concerns. As a final note, the approach is similar to card-linked-rewards (CLR) and this is driving an entirely new loyalty segment.
3. Analytics. Google will make analytics and reporting a key component of its value proposition, as per above, merchants will embrace this if Google have sufficient scale and can attract consumers at a reasonable cost.

Location strategy example: Starbucks

Starbucks, which will integrate with Passbook, plan to also accept purchases from Square's mobile wallet. The advantage for the coffee confectioner is access to Square's merchant directory. To back up its commitment to Square, on October 4th, 2012, in a company press release, Starbucks announced a $25 million investment in Square.

Ironically, Starbuck's interest in Square, however, was not due to notoriety achieved as a result of its innovative dongle that turns iPhones into remote POS terminals. This is not a service Starbuck's will use. Rather Starbucks plan to use Square software in combination with its existing QR code based mobile payment system with an eye to Square's merchant directory. It sees this as a strategic channel for attracting business, 'the value-add' from the merchants perspective. 'This partnership gives millions of Starbucks customers a quick, seamless payment experience, and introduces them to hundreds of thousands of small businesses in the Square directory,' said Jack Dorsey, Square's CEO, in a press release. Presumably, Starbucks and Square will push offers to merchants and drive them to redeem rewards using the apps and its location based services.

Google have found a way into POS, but Passbook ubiquity is more likely if merchants adopt QR codes. Note that QR codes are one of many cogs that must all work together for Passbook to truly ignite. Another component is Passbook's location-based services, a distinguishing feature integrated directly into iOS6.

A possible weakness in its strategy is that Apple's hands-off approach relies on the app developers to figure out these fundamental issues in order to properly configure the solution. So far, the results have not been consistent, as shown in actual users experiences described on the following page.

Apple developers take note: users are reporting poor user experiences.[19] Although there appear to be many reasons Passbook will ignite, developers must learn to optimize the user experience. The following is an example of

[19] Erica Ogg, Apple's New Passbook isn't quite ready for prime time, Gigacom, September 2012.

some growing pains, based on an article written by Erica Ogg.

According to Ogg, 'The first time you launched Passbook, you'll get a screen showing the kinds of passes that can be added, along with a very helpful link to the App Store. That link takes you to a curated list of apps already integrated with Passbook: Amtrak, United, Walgreens, Target, Fandango and more.

Ogg elected to test United's app. She download and launched the United app and, as expected, her boarding passes were available for display via the app. From this point, Ogg had to manually add each boarding pass to Passbook; complaining, 'that users are required by to take extra steps' in order to use it in Passbook. Naturally, the app already displays the boarding passes, so generating a subsequent pass to add to Passbook was the confusing part. A legitimate point and one she says, 'should have been resolved by United's developers'.

Another approach would be for the App to determine the user settings for Passbook, and if their preference was to use Passbook to display boarding passes, then automate the process, and possibly not even display passes in the App.

Focusing in on the Passbook experience, as Ogg explains, 'when I went to find my Passbook pass, the app worked as expected:

I got a well-designed boarding pass with my flight information and a barcode that was scanned by a United gate agent without incident.

In order to emphasize the importance of developers understanding Passbook, here is a summary of Ogg's main observations:

- The implementation of notifications is odd. With still 10 hours to go before my flight's departure, a notification appeared on my screen from United with my flight time. It stayed there all day, even to a certain point after the flight. It wasn't clickable and nothing I did would make it go away.
- Ogg still had to go to the Passbook app once he was at the airport in order to find his boarding pass. 'The way Apple

described it, the iPhone 5′ s GPS would cause the Pass to pop up on my screen when I approached the airport, so I wouldn't have to go searching for it. That didn't happen.'

- Using the app more than once breaks the experience. My United boarding pass is in Passbook. Great! But I also want to get the other available Passbook apps. 'One problem: the link to the App Store within Passbook? It completely disappeared. And there's nothing that tells me how to find it'.

Some of Ogg's criticisms reflect her lack of understanding of what Passbook is supposed to do. For example, she has difficulty finding passbook-enabled apps. When searching 'Target Passbook', for example, she complains that there were no results. Clueing in on this gap, Ogg does point out that, 'this is not necessarily a Passbook bug, but more of a misunderstanding of Passbook; a misunderstanding that reflects a gap between what Passbook does, and what the marketing material and user guide projects. As Ogg demonstrates, the result from a consumer perspective is the same.

For example, when Ogg did find the Target app, she says, 'there was no indication that it was Passbook enabled'. Of course there is no indication of this. This is not how Passbook was intended to be used. What Ogg does not get, is that passes should be part of the booking process, and an option, if a user chooses. I.e. once a ticket is booked, either online or via an app, the pass would be emailed or automatically loaded into Passbook along with other passes; all this to say, that developers need to educate users, and manage expectations according to Apple guidelines, or risk confusing them.

Oggs other nitpicks, again, reflect poor developer understanding of what Passbook is supposed to do, and/or poor user guidance. The examples below demonstrate this:

- Brightness does not correspond to phone settings. She has settings down to save battery, but Passbook passes still display with the 'brightness of a thousand suns (or so)'. This is intentional in order to allow passes to be read by scanners easily.

- It doesn't appear to be designed for the iPhone 5 screens. Somehow Passbook appears on the iPhone 5 screen the way the apps whose developers have not yet modified their apps for the new 4-inch screen do: centered on the display with black bars framing it on top and bottom. Again, a problem with developers who should know better.

Real-time transaction authentication is another concern that is mentioned by several observers. Merchants need have the right barcode scanning technology in place, and ensure it is properly configured in order to authenticate transactions. The alternative is to rely on manual input, not an option for large merchants. Below are some considerations that small merchants might consider in pilot stages or as a bridge solution:

Solutions for small-mid-sized merchants without scanners

- Upgrade or buy scanners that recognize 2D barcodes. More products are going to start using this so it could be a worthwhile (albeit expensive) investment. You might be able to get the company who manages your POS to do that and take the burden of cost.
- Small merchants could acquire iPod touch devices (or old iPhones) to use as scanners, or use Apple's Pass Scanner app (free on the App Store) to scan passes.
- Merchants might also require integration with POS that would allow services to talk to one another. This could be done via Wi-Fi (or you're using data-enabled devices) and you will need to create the necessary integration code.

In order to avoid purchasing or upgrading scanners, some (smaller) merchants might consider manual input, as this would bypass scanning entirely. In this case, pass creators would include information in plain text on the pass. Of course this would work, but there would be consequences. For example, it would slow lines and make capturing and managing data more of a challenge. The carry-on effect being that reconciliation, automated inventory control, and the possibility of fraud risks, would increase too.

Apple versus Google Privacy (Data Usage)

According, Ludovic Privat a writer for GPS Business News, "Apple Takes a Shot at Google with Privacy Policy Website."

Quoted from Apple's website:
"Other companies try to build a profile about you using a complete history of everywhere you've been, usually because they're targeting you for advertisers. *Since our business doesn't depend on advertising, we have no interest in doing this — and we couldn't even if we wanted to. You don't have to sign in to use Maps, and it only knows you by a random identifier that resets itself frequently as you use the app. Maps is also engineered to separate the data about your trips into segments, to keep Apple or anyone else from putting together a complete picture of your travels. Helping you get from Point A to Point B matters a great deal to us, but knowing the history of all your Point A's and Point B's doesn't."*

According Privat, "If you read well, you surely have understood that "other companies" means Google, Google and Google. Well... perhaps Facebook too."

Overview of redemption options

Merchants offering Passes or other rewards, both mobile and card based must consider redemption options. Ideally, real-time redemption at POS would be the first choice. This can be challenging, especially considering that many merchants operate more than one POS solution. The table below show the redemptions options based on a selection of merchants from a variety of vertical. Based on the survey, 11 merchants provide POS integration and offer redemption real-time at POS. This means less than half of the companies surveyed.

Vertical	Rewards redemption	Fuel redemption
Travel	Online/Phone	Online or when booking
Travel	Online/Phone	Online or when booking
Travel	Online/Phone	Online or when booking
Travel	POS	

Travel	POS	
Fuel/Grocery	POS	POS Cashback
Fuel	Voucher	Voucher sent for each $25
Fuel	Voucher	Voucher sent for each $26
Fuel/Grocery		Rebate at POS
Fuel	Cashback	Cashback
All	CAA reward dollars	CAA rewards dollars
Fuel		
Home decor	Cashback	
Grocery/Fuel	POS	
Grocery	POS	Coupon
Luxury goods	Gift Certificate	
Grocery/Fuel	POS	
Grocery/Parma	POS	
Fuel/Car	POS	instant rebate
All	POS	Rebate or points
All	POS	cashback
All	POS	cashback
All	POS	cashback
All	POS	cashback
All	POS	cashback

Each redemption type offers benefits either to the issuer or to consumers. The table on the following page illustrates various advantages and disadvantages of each redemption type.

	Reward delivery cost	Data	Loyalty value for merchant	Integration cost
Cashback	Low	Low	Medium	Low
Vouchers	High	Low	High	Low
Gift Cards	High	High	High	High
Rebates	Low	Low	Low	Low
Real-time rewards at POS	Low	High	High	Medium

Considering the various redemption options, deciding which to make available to consumers can be daunting.

Payment ecosystem in flux

This section is comprised of a series of diagrams showing how payments have changed since 2007. Understanding this, will give merchants insights into how they can fit into the ecosystem and guide strategic decisions.

Current payment authentication ecosystem

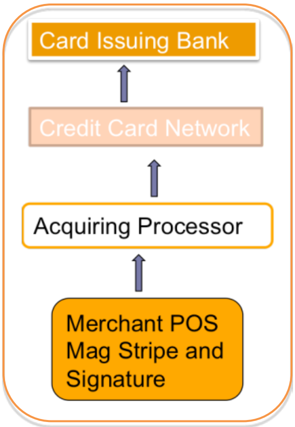


Diagram 1

Diagram 1 at left reflects the money flow for the traditional way most open looped credit and debit payments are made today. There are 5 steps:

1. Payment originates at the merchant point of sale (POS) by card swipe (US);
2. Transaction message (ISO 8583) is pushed to the acquiring processor;
3. The Acquirer routes the payment to the assigned card network (Discover, Amex, Visa, MC);
4. Network routes it to the correct issuer;
5. Issuer approves or declines and returns message

**Note:
SOFTCARD, the Telco lead mobile payment initiative led by AT&T, Verizon and T-Mobile, follows the model described in diagram 1 below, except merchants require a Generation 3 near field communication (NFC) device.

Diagram 2 depicts the evolving ecosystem. This is the system in place today. It is a more complicated system, with new networks and participants. The new participants include point of sales solutions vendors, and card linked rewards vendors.[20] See item 1 and 2 in diagram 3 for example of these new entrants.

[20] Known also as merchant funded incentives

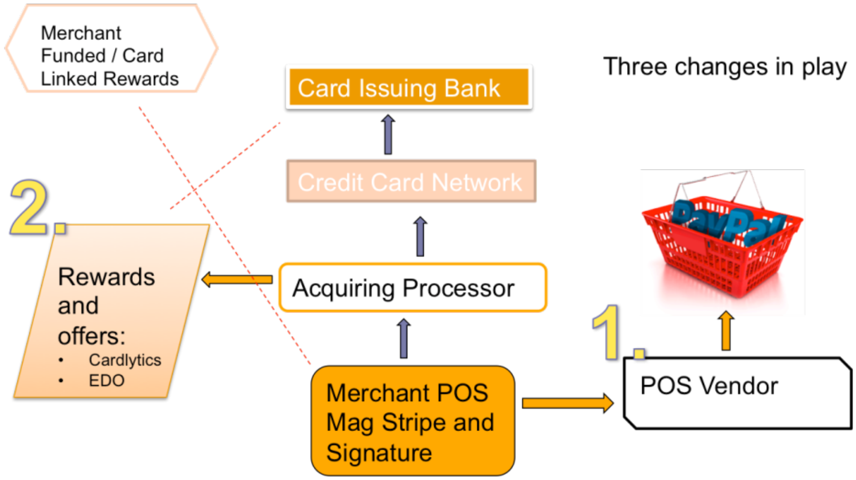


Diagram 2, adapted payment ecosystem today showing PayPal 'Naked Transactions' integrated with POS

Considering the ecosystem has been stable over the past several decades, the dramatic change since 2007 reflects a variety of drivers that include:

- Influence of new stakeholders;
- Merchant frustration with currently payment oligopoly that has anti-competitive pricing and since resulted several 10 figure settlements and fee caps as a result of new regulations, such as Durban;
- EMV and the fraud liability shift initiated by Visa and MasterCard in the US. This means that non-EMV[21] compliant processors and merchants will assume liability for fraud if they are not certified for the new standards.

Current and future ecosystem on following page

[21] EMV means: Europay, MasterCard and Visa, a global standard for inter-operation of integrated circuit card or "chip cards" and terminals.

Diagram 3, current ecosystem

Diagram 4, future ecosystem

Bank reaction to change

According to the 2012 KPMG Banking Outlook Survey, 28 percent of senior banking respondents said these new market entrants (PayPal, SOFTCARD) posed the biggest threat to their business.[22]

LevelUp is also an example of a new entrant causing disruption to the status quo. LevelUp's approach is to leverage existing infrastructure in order to streamline POS integration, and overcome known merchant objections.

Level up has integrated with the following POS systems:

- MICROS
- POSitouch
- Dinerware

Commenting on LevelUp's strategy, Seth Priebatsch, Chief Ninja of LevelUp says:

> *"LevelUp is all about helping businesses save time and make more money. That's why we're integrating with three of the top ten point-of-sale (POS) systems, MICROS, POSitouch, and Dinerware.*
>
> *So what does this mean? Well, for one, LevelUp is now integrated with 30% of all the POS systems that exist. Basically, we just got a lot closer to our goal of becoming the most universally accepted way to pay. We're on a mission to integrate with every existing system out there to make it easier for merchants to accept LevelUp's unique combination of mobile payments and customer loyalty campaigns.*
>
> *LevelUp transactions get logged alongside every other credit card and cash transaction for the day, making it much easier to balance the register at closing. LevelUp's loyalty-driving campaigns get integrated right into the merchant's existing POS system, making it easier to track all of that amazing data on who's coming back and how often, as well as what they're ordering.*

[22] KPMG Banking Survey, June 2012

Mobile Payments costing sample table

The following real-world example represents an analysis done for a parking authority looking into offering mobile payments to drivers. Some key considerations: transaction costs, outsourced verses owning technologies, using automated clearing house (ACH) verses real-time credit card payments. Projected cost over a five year period.

Software Analysis Table	License	Software as a Service (SaaS)	Transaction based
Hardware	$30,000	$30,000	0
Software	$224,000	$224,000	0
Interchange, pass through + other related fees	$2,160,000	$2,160,000	$3,600,000
Integration	$34,000	$10,000	$24,000
Ongoing development	$50,000	$50,000	0
Hosting	$54,000	$54,000	0
Staff costs	$120,000	0	0
Maintenance license fees	$168,000	$168,000	0
Total	$2,672,000	$2,528,000	$3,624,000
Cost per transaction	$0.15	$0.14	$0.10
Solution comprises: IVR, SMS, Web, Web Mobile, eWallet, Rapports…			
Hardware	$90,000	$90,000	0
Software	$700,000	$479,050	0
Interchange, pass through + other related fees	$2,160,000	$2,160,000	$1,800,000
Integration	$108,000	$54,000	$24,000
Ongoing development	$50,000	$50,000	0
Hosting	$54,200	$18,000	0
Staff costs	$525,000	$375,000	0
Maintenance license fees	$120,000	0	0
Total	$3,807,200	$3,226,050	$1,824,000
Cost per transaction	$0.21	$0.18	$0.10

As you can see from the preceding table, the total cost of ownership varies considerably depending on the services and risk a merchant is willing to accept. Some of the considerations that should also be considered are the organizations technical capabilities, budget, risk appetite, as well as a thorough assessment of the vendors in the market. Read the chapter, 'System Selection Guideline', for more on how to select the appropriate software solutions.

Notes on table

- Maintenance 15% of license cost per year;
- Processing cost of $0.12 per transaction * 90,000 per month * 5 years;
- Hosting is an estimate of all hosting requirements including IVR, RendezVous, SMS, and all channels;
- Hardware costs are an estimated cost estimate of $90,000. The IVR only will require less than $30,000;
- Integrations estimate comprised of all required components to meet parking authorities requirements as outlined in RFP;
- Transaction costs for payments could be reduced if the parking authority agreed to allow bank transfers (EFT) as a form of payment in order to fund a stored value account;
- All pricing over 5 years.

What users from different segments will expect from Passbook

Along the lines of value add, when it comes to mobile, merchants will also want to consider the type of service offering consumers will expect. This will impact development costs but, on the flip side, could increase adoption significantly. Below is a very high level sample of some of the services consumers might expect depending on the vertical.

Grocers:

- Recipes
- Grocery list
- Self checkout

Airline:

- Booking online
- Boarding passes
- Offers
- Flight updates
- Itinerary

Fuel/Convenience

- Receipts
- Mileage + expense calculators
- Nearest location
- Pricing
- Offers
- Red bull like info
- Tickets
- Beer pickup packages?

Pharma

- Digital prescriptions
- Barcode display of prescriptions
- Medical info on request

Home improvement

- Plans
- Order material
- Arrange deliver of material
- Video tips

Media company

- Content delivery
- News feeds linking to their publications
- Order publications, cable services, cellphone services, subscriptions and delivery services?
- News alerts
- Offers

All segments

- Access to rewards balance
- Ability to select offers from list
- Preference based offer delivery

Card linked rewards (CLR) and opportunities for Passbook developers to steal a page from CLR's playbook

Regulatory change in the US means that there is a fee cap of $.24 for debit transactions. This has put some debit issuers in a predicament. Card programs have traditionally relied on 'swipe fees' to fund rewards that attract consumers. So the cap has an impact on revenue.

Issuers have reacted to the changes in various ways. Some have tried pushing account holders to credit, while others, like BofA, have tried to implement $5 monthly fees. Neither of which is particularly suitable from a consumer perspective. Consequently, another alternative has gained considerable market attention recently. The concept has come to be known as 'card-linked-rewards' (CLR). The appeal of CLR has been clocked by industry analysts. According to a report by Aite Group (2011), card-linked-rewards are projected to generate $115 billion in sales by 2015.

In looking to understand CLR, the book by Michael Lewis, called 'Moneyball, The Art of Winning an Unfair Game', provides an entertaining analogy that sums up the CLR concept. The book chronicles Billy Beane's experience as GM for the Oakland A's, the lowest budget team in Major League Baseball (MLB). It chronicles the paradigm shift in MLB, from its swaggering, gut feel approach to selecting players and managing teams, to a sophisticated, data driven approach. CLR is works on similar principles, it permits marketers to get past the recent throw the dice, daily deals approach, and instead target consumers by tapping into credit and debit issuer's card data. This enables them to pitch relevant offers, track transactions, and report on the results.

The advantage this gave Beane was to let him target players typically overlooked. Top performers, revealed by statistics to be so, but rejected by managers that could not see their true value. Beane's approach gave the A's a cost advantage and enabled Beane to field a winning team, despite having the lowest budget in MLB. CLR means that merchants can target and analyse offers with relying on the deep discounts associated with daily deals.

A number of variables are used by CLR to target rewards, such as consumers past purchase history, location, income and other relevant demographic qualifiers captured each time a cardholder makes a purchase. Consequently, return on investment (ROI) can be measured. A marketer's dream, which allows merchants to select prospects, such as consumers that shop at rival stores, located within close proximity to their own locations, and fit a specific demographic profile (See chapter 6 for a more detailed discussion on this topic). Another advantage is that only when a transaction is complete is the merchant charged, future transactions are also tracked and reported on. So marketers know exactly the value of each offer and can translate repeat business into profitability analysis.

The effect has been like stirring a hornet's nest, new players and exiting card networks are buzzing around in a frenzy. Statements made as a result of MasterCard snapping up Truaxis, a leading CLR vendor, September 2012, attests to the frenetic evolution of this new segment.

The offer and rewards industry is rapidly evolving as consumers have demonstrated theirdesire for customized offers and savings that truly matter to their individual lifestyles. By adding Truaxis' expertise, its intellectual property and a talented team of software engineers to MasterCard, we increase our capabilities to offer merchants and financial institutions a solution that helps them better connect with consumers while evolving the model from the traditional coupon or daily deals offers programs that are popular today.[23]

Tim Murphy, chief product officer, MasterCard.

Passbook can leverage the Moneyball approach

Understanding CLR is relevant for all marketers, but particularly those considering mobile payments. This is because Passbook can be used in a similar way. Some examples follow:

1. Merchants use content aggregators to target consumers and generated passes;
2. Merchants do not have to invest in proprietary loyalty systems to leverage Passbook and neither do the content aggregators;

[23] Leena Rao, TechCrunch, September 6, 2012.

3. Merchants can capture transaction data and analyse their campaigns.

This, by the way, is not far off from what Google has in mind for its eWallet, and the main reason why Google's strategy is to insert itself in the middle of merchant and issuers.

How money flows for CLR

Typically the merchant pays the vendor and the vendor shares revenue with the issuer. Consumers can either receive a rebate at the time of purchase, or have a credit applied to their account.

Detailed procedure and revenue model for CLR:[24]

- Issuers automatically enrol active accounts into the program;
- CLR increases shopping frequency as evidenced by 30% of subscribers will redeem offers 12 times each year;
- Average offer value: 5% or more;
- Offer placement fee: 4%, a figure that represent the market average;
- FI revenue share: 35%.

Table 1: Example of revenue model

Portfolio attributes	Credit/Debit Card Assumptions
Number of accounts	1,000,000
Percentage active	45%
Number active accounts	450,000
Average US$ per purchase transaction per active account – non-incentive	$50
Average annual spend per active account	$6,000
Number transactions per year per active account	48

[24] Aite Group, The Case for Merchant Funded Incentives, June 2011

Assumptions	
Average merchant funded incentive transaction	$75
Average merchant consumer incentives	10%
Average merchant placement fee	4%
Average revenue share percentage for FI	35%
Average FI revenue share per transaction	$1.05
Calculations	
Participation percentage	30%
% accounts redeeming merchant funded incentive offers	
# accounts redeeming	135,000
Average merchant funded redemptions per active account	6
Number of transactions	2,700,000
Gross dollar value of incentives transactions	$202,500,000
Gross dollar value of consumer incentives	$10,125,000
Revenue share for FI	$2,835,000
Merchant placement costs	$8,100,000
Revenue per participating account	$18

Online marketing transformation

This has huge implications for the evolution of online marketing. To contextualize the value in the way it could be leveraged using Passbook, consider the difference in cost and value of a banner ad impression (view), i.e. paying for eyeballs (CPM) verses click through ads. Typically 2-3 click through has the value of a thousand banner impressions.[25] Considering this, what would be the value in being able to track an online add, and generate a transaction at POS seamlessly? A comparison would be what CLR merchants are happy to pay: a commission of around 4% of the gross sales value, and sometimes up to 10%. In the real world, this means a click through would be worth from $4 to $10 on a $100 transaction. A figure well above the norm today, and clearly something to get excited about considering 96% of Google revenue is from ads. This means Google's current $37 billion revenue could be worth significantly more. This is not what merchants would have to pay if they use Passbook. Merchants using Passbook would only pay the current click through rate, and then be able to pick and choose partners based on actual transactional data.

Incorporating the CLR approach into the Passbook model might look as follows:

1. Vouchers/offers are delivered via third party web sites;
2. Pass created and encoded with web site credentials, and sent to consumer's mobile device via email, or other means;
3. Pass redeemed at POS;
4. Transaction data captured and analysed.

The shortcoming in this scenario is that unlike CLR, passes do not permit analysis of long-term consumer profitability because future spend can't be tracked from a pass, unless it is re-used. Obviously with a credit card consumer transactions are tracked because the same card is used for many, ongoing transactions. Therefore, over a period of time (i.e. six months) the merchant would have enough data to make projections.

Passbook will need to have some additional steps in order to produce more detailed results. The following is a list of some possible workarounds and the pros and cons of each:

1. Make pass dynamic and useable on subsequent occasions
    - Cons

[25] Andrew Stern, 8 ways to improve your clickthrough rate, iMedia, February 2010

        - Difficult to enforce and monitor;
        - Might not be desired by consumers;
        - Might overly complicate transaction.
2. Consumers automatically enrolled in the restaurants loyalty or prepaid program
    - Pro
        - This would work for some consumers and has been demonstrated by Starbucks.
    - Cons
        - Assumes restaurant has loyalty program;
        - May not be something the consumer wants;
        - Even Starbucks only has limited traction using this model. 70 million transactions over 2 years may mean only 300,000 of their users paying via mobile: important but still a niche.
        - May overly complicate transaction.
3. Use third party wallet like Google or PayPal
    - Pro
        - This would permit transactions to be tracked
    - Cons
        - 3rd party would have access to data;
        - 3rd party might charge for data;
        - Assumes consumer has account with 3rd party.
4. Affiliate ties pass to a credit card and subsequent transactions are captured at POS each time the associated card is used at the merchant location. This is one of the approaches used by First Data
    - Pros
        - This resolve the tracking issue;
        - Could be done via First Data if merchant not equipped to manage and store data.
    - Cons
        - This would involve PCI compliance which can be expensive;
        - Only works if same card is used;
        - Comes at a high cost 4% of each transaction is average vendor fee for managing this type of offers;
        - There would likely be data charges;
        - To avoid PCI compliance involves working with First Data or its equivalent.

4% -10% merchant fees reduced to .4% - .5% click though costs, is the incentive for merchants to use Passes in conjunction with content aggregators, as opposed to CLR. This means reduced cost from about $8 million to $800 thousand based on comparable data shown on table 1.

Chapter summary

This chapter explores mobile with a focus on Apple Passbook. This is because Passbook offers merchants the possibility of an entry point for mobile that has a high likelihood of producing a positive return on investment. It looks at the factors that support this argument and compares it to other solutions that have not ignited. It also looks at the way payments are evolving, such as NCR and AJB, as well as PayPal and Discover taking on new roles. Through these examples, readers can pick and choose the best examples from actual strategies and best practices. This will short circuit the development process and help merchants avoid costly mis-steps, such as those made by Google and Softcard.

Chapter 2

Swipe Fees: catalyst for change, catalyst for MCX

Credit card transaction fees, known as 'swipe fees', cut into profit margins. Merchant frustration about high swipe fees has prompted large US merchants to join together to launch the Merchant Consumer Exchange (MCX). Over the past few years, high swipe fee costs has created a rift between merchants', card networks and issuing banks. According to research published on www.unfaircreditcardfees.com, fees average 2% in the U.S., 1.56% in Canada and .79% in the UK. Before discussing MCX, it is helpful to have some background on the payment industry.

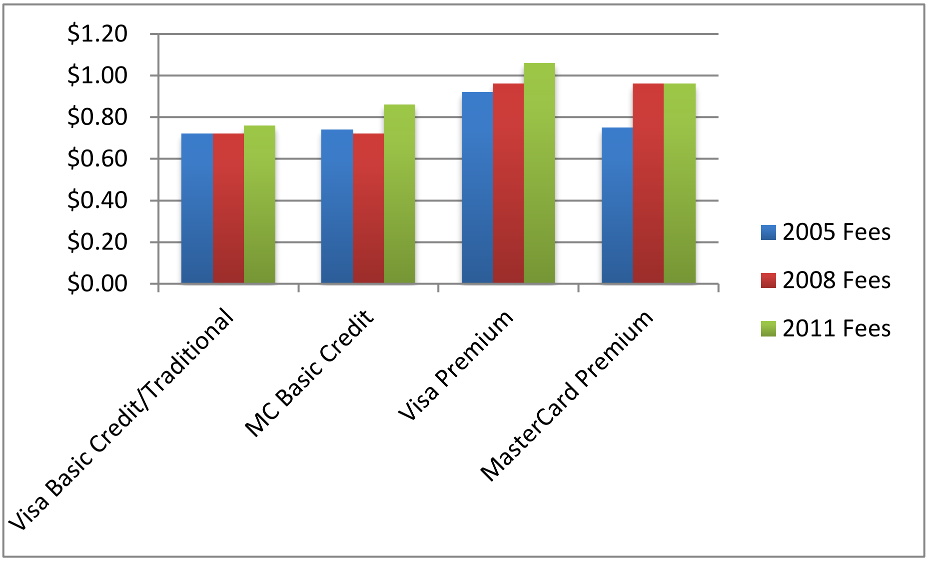
Background of conflict

For years, merchants have been pressuring governments around the world to regulate Visa and MasterCard, for example, Canadian merchants are on record as saying that 'voluntary measures' introduced by the Minister of Finance to control fees have failed to reduce transaction fees or increase competition among card networks. In Europe swipe fees have been capped since 2002 when Visa offered to progressively reduce the level of its fees from an average of 1.1% to 0.7% until the end of 2007 and to cap the fees a the level of costs for specific services.

US lobbying has resulted in fee caps for debit, and, recently $7 billion was awarded as compensation to merchants in recognition of ongoing unfair practices.

As a result of swipe fees, some small merchants, such as Avondale food stores do not accept visa or MC payments. Merchants have many legitimate grievances, and are especially concerned by higher merchant fees applied to premium credit card transactions.[26&27]

The graph 1, below shows the effects fees can have on a $40 dollar transaction. Graph 2, depicts the ratio of payment types by transaction volume in Canada. Note that the value of credit cards over debit card for Canada is $288 billion to $144 billion.



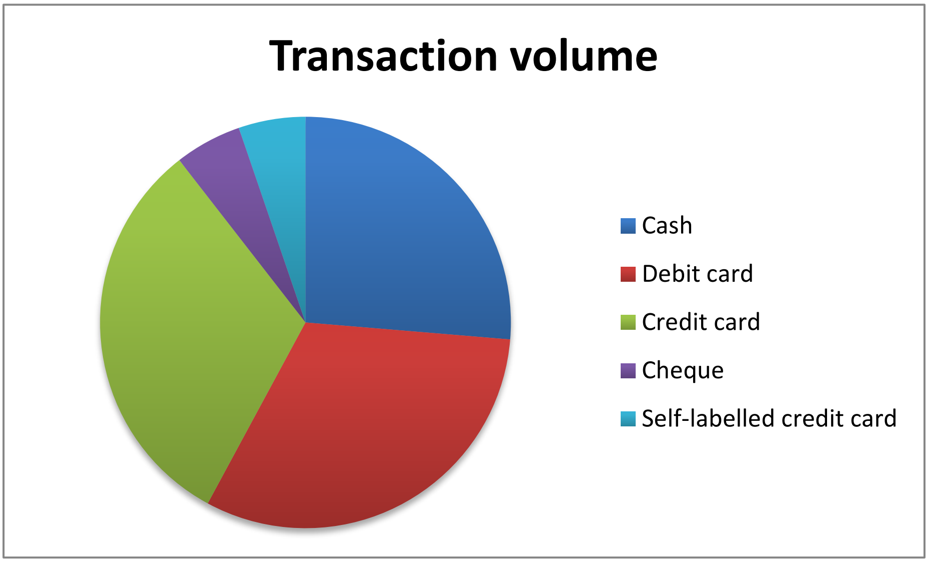
Graph 1, Increasing credit card transaction fees based on $40 transaction value

[26] Dana Flavelle, Retailers plead for credit card regulation, Moneyville, April 14, 2011.
[27] According to the Canadian Retail Council:

Canada is one of the only jurisdictions that doesn't regulate credit card transaction fees. In their view, swipe fees should be charged on a flat fee basis, not as a percentage of the total sale cost; merchants are further frustrated because the 'fees are being increased in an arbitrary and non-transparent way.'

Profit at Visa Inc. rose 28 per cent to $314 million US in its most recent quarter.

Echoing the US actions, a Canadian class action against Visa and MasterCard has been launched. Prior to this, the Retail Council of Canada had joined with the Canadian Booksellers Association, the Canadian Convenience Stores Association, the Canadian Federation of Independent Grocers, the Hotel Association of Canada, the Canadian Independent Petroleum Marketers Association and others -- more than a dozen organizations representing more than 120,000 businesses -- to say, 'enough's enough.' They call themselves, not unreasonably, the StopStickingItToUs Merchants.



Graph 2, transaction usage volumes in Canada

US merchants, having the highest fees, have initiated a backlash, led by the likes of Walmart and Home Depot, who, since the 90s, have engaged in hand-to-hand combat with the payment industry. For example, Walmart led a class action against anti-competitive pricing practices by Visa and Mastercard in 2003 and won over $3 billion in compensation.28 Lloyd Constantine, in his book "Priceless: The Case That Brought Down the Visa/MasterCard Cartel," estimated that merchants will save $87 billion due to forced reduction in interchange fees over the next 10 years, as a result of this victory. While the exact amount is debatable depending on the source, it is likely to be an 11-digit number.
Compounding the frustration felt by merchants are tactics such as concerted bank lobbying as part of Visa/MasterCard's efforts to maintain the level of debit swipe fees.[29] [30] [31]

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[28] Priceless: The Case That Brought Down The Visa/MasterCard Bank Cartel, By Lloyd Constantine, Kaplan Publishing, October 6, 2009.
[29] Fighting merchants is one of the reasons that Visa went public; it used its IPO to raise $3 billion in funds specifically to fight challenges to interchange and its 'anti-competitive practices.'
[30] Dana Flavelle, Canada's credit, debit code tougher than expected, The Star, April 16, 2010.
[31] Tom Brown, Katherine Robison and Samuel Zun, Recap, Fed Meeting Durban, Pymnts, June 2011

American Bank, January 28, 2013 featured shareholders criticism of Visa for lobbying. This is typical of how the payment industry maintain such a concentrated position. As an example, despite the appearance of having won major ruling in its favour limiting Visa and MasterCard swipe fees to $.07 - $.12, per transaction, the feds, backtracked in calculating its final standard. The fee was subsequently increased to $.24. On top of this, a variety of new fees will be put in place by issuers and the networks which seem to negate any gain merchants might have made. Essentially, the jury is still out on whether or not the merchants have gained anything out of this. Although for high value transactions they appear to be winners.

For example, this fee discrepancy was brought up in a January, 2012 article published by The US Association for Convenience and Fuel Retailing, where it was revealed that the Fed considered more than the exclusive costs that Congress mandated, which included authorization, clearance and settlement. In its ruling the Fed invented a third category of cost-`those that are specified to a particular electronic debit transaction but that are not incremental costs related to the issuer's role in authorizations, clearance and settlement, claiming unfettered discretion to decide which of such costs in the third category it would include in allowable cost.' Essentially, according to the article, they 'packed the cost of running a bank into debit interchange.'

Chapter 3

MCX: taking control of credit and loyalty

Tesco UK is an example of a merchant that has taken control of its credit and loyalty program. As the UK's leading supermarket since 1996, when the introduction of the Clubcard helped it move from 15% market share to 18%, to surpass Sainsbury (see Nectar case study). Since then, Tesco has evangelized loyalty and also its other financial services. As a case in point, Tesco has even exported its expertise to North America through its equity interest in Dunnhumby, a loyalty marketing firm currently managing loyalty initiatives at Canadian Tire, a large automotive and household goods retailer, and also Metro, a large Canadian grocer that has had same store sales growth of 3.2% in its grocery division since the introduction of its loyalty program. U.S. customers of Dunnhumby include Macys, an upscale retailer, and Kroger, a leading grocer that has had tremendous growth in same store sales averaging 3.4% from 2007 to 2010.

Although many variables are attributable to same store sales, as a measure of the influence of loyalty, positive growth in a recessionary environment is a good indicator of its impact. Metro, a Canadian grocer is a case in point. Despite experiencing intense pricing pressure, and fierce competition from new entrants like Walmart superstores and soon Target the grocer is thriving.

Further evidence is Tesco's public statements as to how its card program contributed to its rise from the UK's third ranked supermarket, to become the UK's largest grocer, the world's most successful Internet supermarket, and one of Europe's fastest-growing financial services companies.

Case study: Nordstrom card strategy gamble

Highlights:

- The department store offers a credit card and debit card that can only be used at Nordstrom, and a Visa credit card that can be used at Nordstrom and other retailers;
- Nordstrom manages its branded credit cards through its own federal savings bank, Nordstrom FSB;
- For Nordstrom, cards are the key to its loyalty program. As such, Nordstrom operates independent from banks because they want control.

Nordstrom Back-story

Despite industry turmoil, on April 2010 Nordstrom went on record regarding its commitment to its credit backed loyalty program. According to an article by Eric Engleman, published on the site BusinessJournals.com, Nordstrom predicted that, its "efforts to manage its own card will pay off as the economy improves. This is a strategic decision for Nordstrom." The fact is, according to Steve Ruderman, editor in chief of Credit and Collection News, "Nordstrom is no different than any other lender out there. Every lender's delinquencies are up. It's a sign of the times. You've got to manage that portfolio. Nordstrom's ultimate goal is to ride the storm out," said Ruderman .[32]

The 'storm', or rather the credit crSoftcard, revealed how fragile previously profitable credit card portfolios can be, and how poor performance can damage reputations. For example, City Holdings Canada, owner of what appeared to be an enviable card portfolio, rapidly lost its strong reputation as its portfolio losses were revealed. So much so that to insiders, the issuer became known as 'Citi Foldings', a highly derogatory name that gives a sense of how suddenly a leading program turned into a losing program.

For merchants running their own programs, especially private label cards, the challenge is even greater. This is because merchant led

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[32] Banking on Nodstrom by Eric Engleman,: http://www.portfolio.com/executive-style/2010/04/08/nordstrom-manages-its-own-credit-card-program-and-is-banking-on-its-results/#ixzz1I5OBMzM4

portfolios generally have a higher ratio of delinquent accounts than banks and lower yields. Target Corp. is an example that comes to mind to illustrate this point. Over the years, Target has been known as 'creditor of last resort', which no doubt contributed to the companies delinquencies. Delinquencies that topped of 11% of credit card assets between 2007 and 2009. At one point the merchant was writing off $300 million per quarter as a result of delinquent credit card receivables.[33]

Obviously Target's performance and others like it would have played in the mind of Nortstrom when it faced the decision of sticking by its card programs. With such a backdrop, Nordstrom's belief in the value of loyalty programs and successful execution can be appreciated all the more for the risk they took in 'riding out the storm': a risk that paid off.

The payoff was revealed in a recent financial report where, according to Mike Koppel, CFO Nordstrom, its delinquent account situation, that had approached 10%, changed significantly. As he puts it, "The acceleration of payment rates has reduced balances…this business is back on track as we continue to open high quality accounts at record levels, as we believe our cards provide a good service and value to our customers."

Overview of the stress and payoff for Nordstrom

Stress indicators include:

1. Nordstrom saw the delinquency rate on its cards rise from 3.7 percent in 2008 to 5.3 percent;
2. Net write-offs increased from 5.6 percent to 9.5 percent over the same period;
3. The company added $20 million to its reserve for bad debt in part because of 'continued weakness' in California. The chain operates 30 department stores and 23 Rack locations in the state.[34]

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[33] See Target Corp Case Study page 153

[34] http://www.retailwire.com/news-article/14420/nordstrom-takes-diy-approach-to-credit-card-program

The payoff indicators include:

1. Delinquency rate at the end of the third quarter was 3.5%, flat to the second quarter of 2010 and down from 4.9% at the end of the third quarter of last 2009;
2. Write-off dollars decreased $7 million year-over-year to a rate of 8.2% of average accounts receivable;
3. Bad debt reserves decreased by $15 million or approximately 9% of the total reserve balance;
4. Net impact on third quarter earnings per share of roughly $0.01 relative to the companies expectations.
5. Payment rates improved, which was more than offset by a reduction in reserve for bad debt.[35]
6. Currently cards = 4.5% of Nordstrom's revenue.

Despite the obvious risks, it willingly took a gamble because for Nordstrom, rewards equal repeat shoppers. This argument is supported by the fact that the company says its cardholder's visit Nordstrom stores twice as often and spend 20 percent more per visit than those without cards. Cardholders accumulate points based on their spending, and get a $20 store credit for every 2,000 points. Nordstrom executives sum all this up in a statement:

The Nordstrom card program: 'is strategically important to us because of our focus on building customer loyalty.[36]

February 2009, Nordstrom CFO Mike Koppel

[35] Nordstrom Management 2010 Discusses Results

[36] February earnings conference call

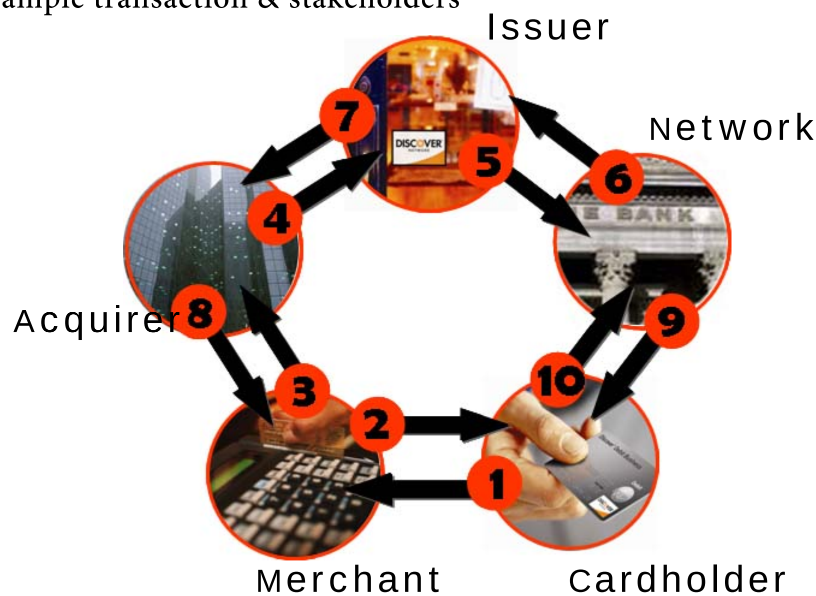
Chapter 4

Card types and network comparison

Payment Card Networks and Key Players Defined

The following section provides an overview of the credit card payments ecosystem. It defines the stakeholders and breaks down credit card fees according to the various participants. [37]

Sample transaction & stakeholders



1. Cardholder makes a credit card purchase at a merchant location;
2. Merchant provides goods and services to the cardholder;
3. Merchant transmits the swiped transaction to its acquiring financial institution via a point-of-sale terminal;
4. The merchant's acquirer reads the transaction and determines its card type and routes it to the appropriate network;
5. The network routes the transaction to the bank which issued the cardholder's card;
6. The issuing bank pays the transaction amount, less interchange, to the network;

[37] Original card network overview provided by Discover Financial Services

7. The payment network credits the acquiring institution, less the network assessment fee;
8. The acquirer credits the merchant account, less the merchant discount fee;
9. The credit card issuer bills the cardholder for the transaction;
10. Cardholder makes payment to the credit card issuer, this can be a competing merchant.

Payment Card Entities

There are a number of entities involved in the payments card market, each provides a specific function to the process. The parties involved, commonly referred to as the four party model, are the Card Issuing Bank, the Cardholders, the Merchant Acquirers and Merchants. The payment network (Discover) links these parties together.

Participants

- Merchants
- Acquiring Processor
- Payment Card Networks (Visa, MasterCard, Discover)
- Issuing Financial Institutions
- Cardholders

Merchants

→ Provides the goods and services for consumer purchase
→ Captures and transmits relevant cardholder data to the acquiring bank via a point-of-sale terminal
→ Pays merchant discount to the acquiring bank in exchange for:
  - Increased sales
  - Guaranteed payment
  - Access to more customers

Acquiring Financial Institution

- Signs and services merchants enabling them to accept cards for payment

- Backs the merchant by providing technology and access to the payment network
- Serves as the interface between merchants and the card networks
- Sets the merchant discount rate
- Settles card transactions between merchants, issuers and the card networks, including the collection of the merchant discount and the payment of interchange
- Represents the merchant in cardholder transaction disputes
- Accepts risk of fraudulent merchants, insolvency or bankruptcy of merchant

Payment card networks

- Establish and maintain the rules and regulations governing the issuance and acceptance of payment cards
- Provides the technology and payment platform which links issuers, merchants, and cardholders on a global basis
- Manages the card brand and creates global card acceptance

Payment networks connect issuers and acquirers and get paid a fee whenever a transaction runs between an issuer and acquirer (i.e. authorizations, clearing and settlement transactions). Transaction volume plays a big role in a payment network's profitability.

Issuing financial institution

- Extends credit or manages customer funds (debit transactions) for cardholders and retains all related revenues
- Settles the cardholder debt with the merchant via the payment networks and acquiring financial institutions
- Assumes all cardholder risks
- Manages the operational activity such as card issuance, monthly billing statements, payment processing, and collections

- Responsible for the adherence to all legal/regulatory mandates – most card legislation is targeted at the financial institutions that issue the cards
- Serves as the cardholder's advocate in any dispute with merchants involving card transactions
- Receives the largest portion of the merchant discount via interchange

Cardholder

- Purchases goods and services from accepting merchants via cards issued to them by a financial institution
- Exercises the responsible use of credit and repays loans as agreed with the issuing financial institution (in the case of credit cards)

How the transactions occur

Dual-message Transaction

The credit card transaction is a dual-message transaction. Two distinct things happen:

1. **Message 1: The Authorization** - The swiped credit card transaction goes to the acquirer through the payment network to the issuing bank who sends back a message authorizing or declining the transaction. This happens in 1.7 seconds from the time the card is swiped. No money is exchanged here.

2. **Message 2: Clearing and Settlement Transaction** - This is where actual dollars are exchanged. The transactions captured by the merchant get transmitted to the acquirer who then submits them to the various payment networks of the transmitted cards. The payment networks go to the individual issuers to collect payment within their settlement window, and settles with the acquirer who settles with the merchant. This can occur 4 hours to 3 days from the time the card is swiped depending on the merchant rules and type of transaction.

Note, for comparison, the debit card transaction is a single message transaction. The authorization and settlement happen at the same time.

Types of fees in a transaction

Merchant Discount

In order to get access to a payment network and to accept cards through the acquiring institution, the merchant has to pay what is called a merchant discount. This fee is the amount of money the acquiring financial institution collects from the merchant as compensation for providing the infrastructure and services required to accept cards as payment.

- Merchant discount is a negotiated rate between the acquirer and the merchant and is usually expressed as a percentage of the sales amount (e.g. 3%)
- The merchant agrees to give up a percentage of the credit card sale in order to gain access to the payment network
- The payment network does not set the merchant discount

Interchange

Generally, while there are variations from network to network, interchange is the payment from the acquiring financial institution (on behalf of the merchant) to the card-issuing bank.

- Typically, interchange amount is set by acquirers and issuers via the network's governance process and varies by market, transaction type, authorization type and a number of other variables
- Interchange is paid out of the merchant discount and is collected by the issuer. The acquiring institution collects the entire merchant discount from the merchant, and pays the issuing institution the interchange for that transaction
- Interchange is a risk-based pricing mechanism. It is designed to compensate issuers for the risks associated

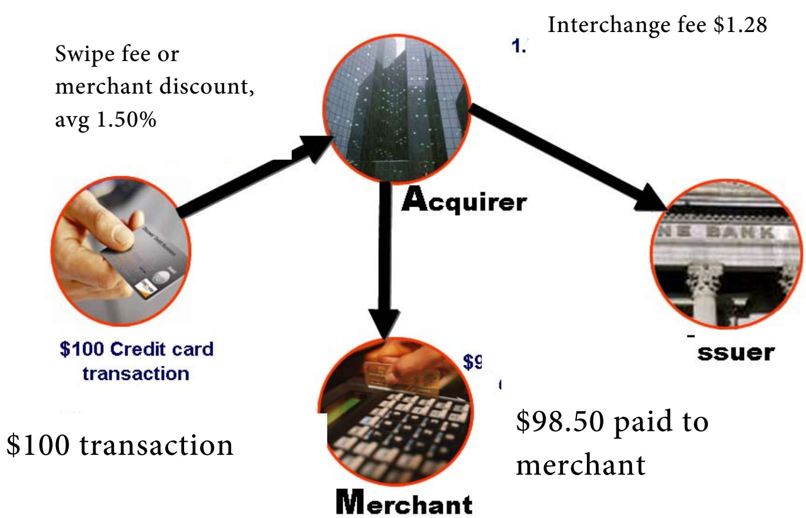
with card issuance and is usually expressed as a percentage of the sales amount plus a fixed fee per transaction (e.g. 1.40% + $0.10/transaction)

- Interchange is based on:
  - → Card type (i.e. classic, gold, signature, business, personal, debit, credit, etc.)
  - → Merchant category (i.e., domestic, offshore, etc.)
  - → Nature of the transaction and settlement (in person vs. online transaction, electronic vs. paper settlement)

Network assessment

This is the fee paid to the network operator, for example Discover. This averages around 10 Bps

How it all works



1. The cardholder makes a $100 credit card transaction
2. The merchant is charged a 1.50% (2% in U.S. and .79% in the UK) swipe fee + pass-through fee by the acquirer

3. The clearing and settlement transaction goes from the merchant to the acquirer through the payment network to the issuing bank
4. The issuing bank identifies the nature of the transaction and subtracts their interchange fee ($1.28) – interchange is often paid out of the merchant discount fee
5. The acquirer keeps their portion of the discount fee and sends $98.50 to the merchant (less if it is a premium card or Amex).

Network operating models

Closed Loop Networks: the payment network acts as both the card issuer and merchant acquirer, thus operating the entire card payment transaction within a closed loop. They are often prepaid (gift cards) and issued by merchants such as Petro Canada, but examples of many credit-backed programs exist too.

- → Benefits: Control of technology and revenues – no interchange
- → Challenges: Gaining widespread consumer acceptance and scale of economies of issuance vs. open networks.

Closed loop networks also include prepaid which are often fee based. Estimates of closed looped transaction value are between $4 and $5 billion by 2015, an insignificant volume compared to debit and credit.[38]

Open Branded Networks: the large card networks (Visa, MasterCard, Discover) acts as the link among numerous card issuers and merchant acquirers, providing the settlement environment and the rules and regulations, which keep the network operating.

- → Benefits: Wider acceptance opportunities and issuance growth (market share);

[38] Task Force for the Payment System Review, September 2010

→ Challenges: limited network control, special interests.

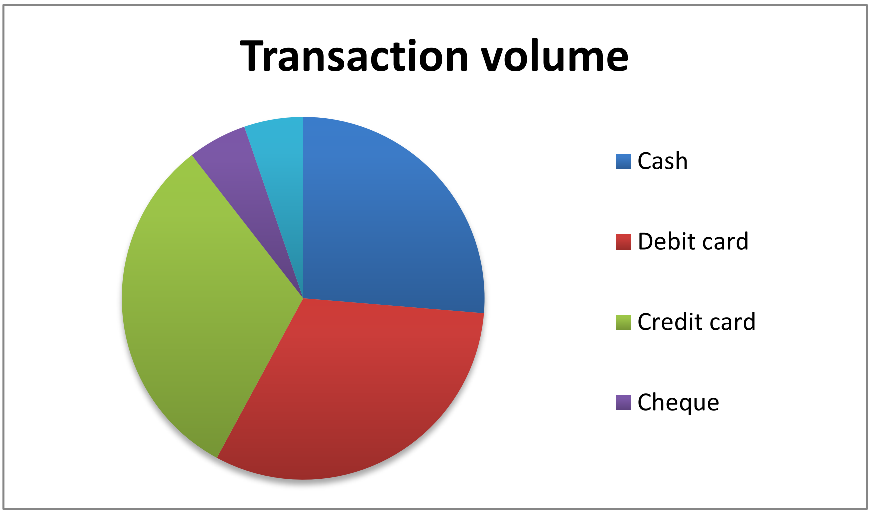
Other card types

The following section is intended to describe the differences between various card and network types. It contains details related to credit card networks, stored value and open versus closed loop networks. A detailed list of card types covered follows:

- Closed system prepaid cards;
- Semi-Closed system prepaid cards;
- Open system prepaid cards;
- Prepaid card advances;
- Prepaid debit card rewards.

Network types include:

- Visa;
- MasterCard;
- American Express (Amex);
- Discover Cards and Discover Network;
- Interac.



Graph 4, payments share by number of transactions, based on data from the 2009 payment report by the Canadian Bankers Association and various other sources.

Each card type has inherent advantages and disadvantages. Below is a table that highlights some practical transactional/functional capabilities and limitations:

Features	Closed Loop	Open Loop	
		Unbranded	Branded
Point-of-sale purchases	Yes—Within issuer's network (can't use a Starbucks card at grocery store)	Yes—Anywhere with PIN keypad or ATMs	Yes—Anywhere with Visa, MasterCard, American Express or Discover logo
Reloadable	Depends on issuer and type of card	Depends on issuer and type of card	Depends on issuer and type of card
Direct deposit	No	Yes—Depends on set-up	Yes—Depends on set-up
Risk of overdraft	None	None	Slight—Depends on reconciliation

Table 1, card type definitions table

Loyalty program types and card options	Nectar	Tesco	Canadian Tire	Airmiles
Script/vouchers	yes	yes	Not through card	No gift certificates available through points
Points only card with vouchers	yes	yes	no	no
Points only + stored value		no	no	yes
Loadable points card and stored value (eWallet)	no	no	no	no
Pre-paid	no	no	attempted	no
Data driven and points based credit card	yes	yes	yes	yes

Table 2, feature comparison between programs

Closed Loop prepaid cards

'Closed Loop' means the cards are only accepted at a single or restricted merchant group. For example, the Montreal transit system's Opus Card.

Closed system prepaid cards have emerged and often replace the traditional gift certificate (script or voucher), commonly known as merchant gift cards. Purchasers buy a card for a fixed amount and can only use the card at the merchant that issues the card.

Sample user fees

Card re-load	Free-$5.95
Card re-issuance	$1.00-$9.95
Monthly maintenance	Free-$3.00
IRVU	$0.50-$1.00
ATM	Free-$5.00
Bill payment	$0.50-$1.50 per transaction
Dormancy fee	$5.00-$15.00
Activity statement	$10.00-$25.00

Regulations

According to the Task Force on Payment Review, Policy Paper C, the legislation regarding these types of cards is extensive. There are 27 legislative acts in Canada alone. These are different for each province. For a detailed look at the regulations the free report, which list applicable regulations by country, can be found at www.paymentsystemreview.ca.

One area where these cards are not regulated by is, at least for closed system prepaid cards. These are not subject to Financial Transactions Reports Analysis Center of Canada (FINTRAC) regulations, but are subject to the Patriots Act for US based issuers.

For example, as debts owed to consumers who purchased the card, these purchases remain on the books of a merchant as a liability rather than an asset. Consequently, gift certificates and merchant gift cards have fallen under state escheat or abandoned property law (APL). However, the emergence of closed system prepaid cards has blurred the applicability of APL. Although in the US, after a certain time period, remaining balances are supposed to be returned to the state where the last known address of the cardholder resides.

No law exists that requires an issuer to provide refunds for lost or stolen cards. Whether a refund is possible is specified in an issuer's cardholder agreement. In addition, most closed system cards cannot be redeemed for cash. When a cardholder redeems all but an insignificant portion of the card on merchandise, that amount is generally lost and is absorbed by the issuer.

Semi-closed system prepaid cards

Semi-closed system prepaid cards are similar to closed system prepaid cards. However, cardholders are permitted to redeem the cards at multiple merchants within a geographic area. A third a third party, rather than the retailer who accepts the card issues these types of cards. Examples include:

- University cards;
- Mall gift cards.

Open system prepaid cards

Open System Prepaid Cards or networks branded prepaid cards are not credit cards, although they are sometimes marketed as ‘prepaid credit cards’. The card issuer for this type of card does not offer credit; therefore, the cardholder spends money that has been prepaid to a card.

Another distinction is that these cards are sometimes marketed as 'prepaid debit cards'. In practice, the value is not actually physically stored on the card; instead, the card number uniquely identifies a record in a central database, where the balance is recorded.

Although these cards are similar to closed system prepaid cards, the difference is that they are endorsed by a retail electronic payments network such as Visa, Visa Electron, MasterCard, American Express or Maestro and can, unlike gift cards, be used anywhere debit cards with the same logo may be used. They are very similar to a debit card except that the record of the funds is not controlled at a deposit taking institution (Sometimes referred to as a 'decoupled chequing account').

Target market

> *The* Financial Consumer Agency of Canada describes prepaid credit cards as "an expensive way to spend your own money"[1]

- Parents who give their children some spending power (which is why they also sometimes are referred to as 'teen cards').
- For people looking for a convenience tool and budgeting aid for global usage.
- Consumers with poor credit, and who are unable to qualify for the line of credit that backs a mainstream credit card.
- Payroll card: used by employers to pay employees.
- Automated Teller Machine (ATM) to obtain cash, and can be used at a store to pay for purchases (at POS).
- People who want to conduct anonymous transactions.

Prepaid Debit Card Rewards

Prepaid Debit Cards have one thing in common with regular debit cards, and that is many offer rewards packages. Whereas, prepaid debit cards need money loaded on them to work, once the money is on them and a customer starts using it, rewards can be attributed to the card in the form of a points system. In the wake of Durban, however, this has changed drastically. While many cards had offered one percent of spend, redeemable for ring tones, music, calling cards and wireless airtime, as well as cash back rewards when signing up for direct deposit or a membership program through the card, many of these programs have been overhauled.

Prepaid debit card rewards also can include a referral reward where the referring entity can get a certain amount of money for every person it refers to the card. The rewards are generally not as lucrative as debit cards associated with a checking account, and less than with a credit card (due to inability to charge interchange on debit network), but they do add an incentive for people with bad credit to purchase a prepaid debit card.

Prepaid debit cards can be purchased at most malls, as well as online. Banks and other financial institutions also offer prepaid debit cards that can be backed by a savings account. Account holders are able to spend up to the amount in the account.

Fees
Similar to open system prepaid, although when linked to a deposit account, fees are sometimes waved.

Closed loop points and cashback with credit card

Cardholders receive points for transactions and have a rules-based credit facility backing their cards. Because of potential credit risk, cardholders are required to complete a credit application. In addition to an overall credit scoring process, merchants will be able to define additional credit terms and exceptions based on their individual situation. In particular for cards issued to patrons of a particular merchant, credit priority will be put in place.

Advantages:

- Allows cardholders to benefit instantly and be rewarded for loyalty;
- Members can use the card to make purchases by opting in and completing a standard credit application;
- Merchants will have additional consumer details and can target clients with specialized offers and incentives based on this information;

- Research shows that members will likely increase their basket size and inter-purchase frequency;
- Merchant issuers can benefit from spending at any merchant participating in the card program.

Disadvantages

- There is potential credit risk;
- Card needs to be funded, which can lead to liquidity risk.

Regulations

If the card issuer funds the receivables, and the card is a private label, it is sufficient to register provincially as a financial service company. If the receivables are to be funded by 3rd parties or the issuing entity manages the receivables on behalf of participating merchants, then the entity would likely have to be regulated by the Office of the Superintendent of Financial Institutions (OSFI). A list of OSFI requirements can be found on the regulators web site.

Points only cards

Works in a closed-loop and semi-closed loop system. Will allow cardholders to receive rewards for shopping at participating merchant stores.

Advantages:

- Allows account holders to benefit instantly from rewards and encourages loyalty.

Disadvantages:

- Limited to issuing Merchant;
- Not transactional and does not permit credit;
- Does not reduce or eliminate interchange;
- Cardholders can potentially double dip rewards if they present a credit card and other competing programs such as Airmiles.

Points with Stored Value cards

Works in a closed-loop and semi-closed loop. This card allows cardholders to receive rewards and also allows members to use the card either as a pre or post-paid card (depending on merchant requirements). Account holders opt-in if they want to use the stored value feature and typically links to their bank account or credit card to the card to load and or withdraw funds. Merchants have the option to decide if they will accept a conditional post-paid payment via EFT, or only accept transaction from pre-funded accounts. Rules can be set up related to payment conditions.

Advantages:

- Allows cardholders to benefit instantly and be rewarded for loyalty;
- Members can use the card to make purchases by opting in and loading their account;
- Members can post-pay if they comply with merchant post pay rules thus eliminating interchange completely;
- Card can also be backed against cardholders' credit card in the event of NSF.

Disadvantages

- Stored value cards are a new concept to consumers and requires consumer education;
- Merchants' employees do not understand the concept of stored value cards and will require education.

Target market

- Transit system farecards;
- Prepaid calling cards;
- Payroll card;
- Incentive cards;
- Gift cards;
- Travel cards.

Regulations

In the US stored value card operators would be required to register as a Money Service Business (MSB) and are subject to state regulation. In Canada, prepaid(gift cards) fall under consumer protection gift card laws. The main concerns typically related to expiry dates and dormancy fees. These terms and conditions must

be made clear. For a detailed analysis of related regulations McMillan have put together a detailed pdf which is available online via link: www.mcmillan.ca
Prepaid are subject to compliance requirements. For Canada, the regulatory body is FINTRAC; US MSBs must comply with the U.S. Patriots act.[39]

Network types

The main financial or payment networks include the following:

- Most regions have a clearing house generally referred to as an automated clearing house (ACH) – for electronic funds transfer;
- Various POS/ATM switching, including NRTTech, Threshold, Everlink and DataWest;
- Interac;
- Visa;
- MasterCard;
- American Express;
- Discover Networks;
- Europe has recently introduces SEPA for European clearing;
- SWIFT is the Society for Worldwide Interbank Financial Telecommunication.

The Canadian Payment Association (CPA) Clears and settles, an average of $173 billion each day. The Automated Clearing Settlement System (ACSS), introduced in 1984, is the system through which the vast majority of payment items in Canada — more than 17 million on an average business day — are cleared. Clearing means the process of exchanging and reconciling payment items that result in a transfer of funds from one financial institution (FI) to another. Settlement means the process of adjusting financial positions of individual FIs to reflect the net amounts due to and from them as a result of the inter-member exchange of payment items.

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[39] Mark Furletti, Prepaid Card Markets & Regulation, February 2004, re USA Patriot Act.

For a more comprehensive view of the payment stakeholders and payment systems consult the following documents:

1. Merchant Acceptance, Costs and Perceptions of Retail Payments: A Canadian Survey: http://www.bank-banque-canada.ca/en/res/dp/2008/dp08-12.pdf;
2. Detailed overview of the Payment System in Canada: http://www.bank-banque-canada.ca/pdf/psac1.pdf;
3. International Research & Benchmarking Survey Results – Core Systems: http://www.cdnpay.ca/imis15/pdf/pdfs_publications/payments_strategy_intl_core_systems.pdf.

Differences between Interac, Visa/MasterCard, American Express and Discover

How American Express differs

American Express typically plays the role of all three parties above, keeping the entire transaction fee. Note that in recent years Amex has begun authorizing other banks to either acquire or issue on Amex's behalf, this is primarily in countries where Amex would otherwise have little or no presence.

Another difference is that Amex has historically charged a higher transaction fee than Visa or MasterCard. The size of the premium can differ significantly: in the US, Amex charges 66 basis points more (2.56% verses 1.9%) than rivals Visa and MasterCard, while in Australia Amex charges more than twice as much as Visa or MasterCard due to Australian interchange regulations.

Amex justifies this higher transaction revenue by having a higher spend ratio. Amex has a disproportionate share of high net worth consumers and uses its strength with affluent consumers to justify charging higher transaction fees.

Amex card spending and fees are responsible for 70% of Amex's card profit, vs. 10-40% for other issuers. Amex also tends to make more money from annual fees than other issuers do.

Typically high margin industries such as hotels, restaurants and luxury goods tend to accept Amex while other segments like grocers and convenience typically steer away.

Discover Card and Discover Network

Discover operates as both an issuer and as a card network. As a card issuer, operating as Discover Cards, they are similar to Amex in structure, but with transaction fees more in line with Visa and MasterCard. Meanwhile, as a network, operating as Discover Networks, they resemble Visa or MasterCard in fee structure and operating methodology.

Infrastructure

As opposed to Amex, MasterCard operates Banknet, a global telecommunications network linking all MasterCard card issuers, acquirer and data processing centres, and uses the ISO 8583 protocol.

The network is significantly different from Visa's. Visa uses a star based system where all endpoints terminate at one of several main data centres, where all transactions are processed centrally. MasterCard's network is an edge based, peer-to-peer network where transactions travel a meshed network directly to other endpoints, without the need to travel to a single point.

Interac

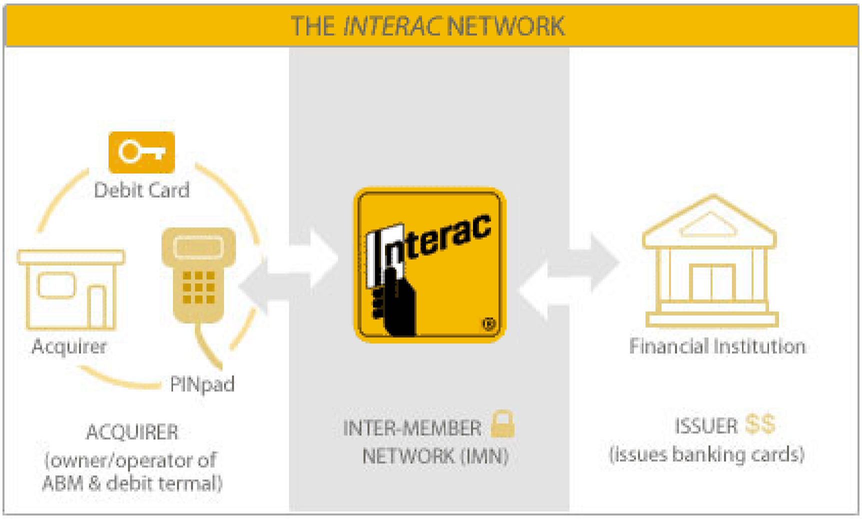
Interac depends on the Inter-Member Network to route transactions. The Inter-Member Network is not a single network, but rather a 'distributed architecture' that processes debit card transactions. The network sends data through high-speed telecommunications lines between members.

Interac at the Point-of-Sale

The card is swiped in the terminal card reader and its customer is prompted to:

1. Okay the transaction amount;

2. Select the account that is to be debited;
3. Enter their Personal Identification Number;
4. Provide a final okay to send the transaction request for approval;
5. Upon completion of a successful purchase, customer takes a debit card and the transaction receipt.



Interac Direct Payments (IDP) purchases are passed through the Interac Network where the cardholder's financial institution verifies their PIN and funds before the approval is returned to the POS. Transfer of funds to its business account then occurs.

Chapter 5

Calculating Rewards: the merchant approach

Loyalty is a thriving business estimated to be worth $10 billion per year in the US alone. It is a large, diverse, industry having many successful examples to draw from in assessing best practices. Some example of leading loyalty evangelists include:

1. PC Financial with 1.1 million active members (4 million cardholders);
2. Tesco UK, 13 million members;
3. Neiman Marcus;
4. Nectar UK with 17 million members;
5. Target Corp US; and,
6. Canadian Tire Financial Services (CTFS) with 1.8 million active members.

The loyalty approach outlined in this section is based on the necessity of establishing a return on investment (ROI). It also means ensuring the program meets the requirements to ensure customer satisfaction.

> ***Tesco spent 300 million GBP over the first three years and about 4.5% of Tesco profits. This investment helped bring them from 3rd place in the UK market to number 1.***

Regarding the latter point, ensuring customer satisfaction usually requires detailed analytics and research. For example, Wakefield Research and ACI Worldwide, show three key areas where loyalty programs struggle. These include:

1. Programs lacking relevance

According to Wakefield's survey, the majority of Americans (75%) are members of at least one retail loyalty card program. The purpose for consumers to join a program is to get discounts on items consumers buy most (62%), yet only 36% actually returned to the store as a consequence of receiving a reward. While 25% of respondents say they received rewards or promotions for items they would never buy.

Based on the above survey results, there is an obvious disconnect between what customers want and what retailers are offering as rewards. This could indicate more pervasive problems with meeting consumer needs.

2. Program rewards not meeting consumer expectations

Some of the key research items to be considered in the development of rewards programs include:

- Retailers need to pay attention to the quality of loyalty rewards and promotions they are providing;
- Findings indicated that 22% found rewards were often too small to take seriously;
- 44% said they had a negative experience from a loyalty program;
- On the positive side, 27% of consumers said they had received a reward or promotion that made them feel valued as a customer.

3. Ineffective communications

Communications is a key aspect of loyalty programs and one that is identified as problematic in Wakefield's findings. Based on the research results, it is clear how communication with consumers is a critical element in customer engagement. Here are the relevant facts:

- 85% of consumers enrolled in a loyalty program report that they never heard from the retailers about it after they signed up;
- 81% said they didn't know about the benefits of a program they've signed up with, or how and when they would receive any rewards.

Despite many program shortcomings, the data reveal that when properly managed, a customer loyalty program can reap significant benefits for retailers.40 That said, most programs, according to Karen Webster, a well known author and consultant who focuses on the payments industry, fall short when it comes to customer segmentation: *Most programs treat all customers the same and make it easy for everyone to join.*[41]

The merchant credit and loyalty strategy, distilled

Key points to maximize ROI:

- Simple to understand and collect rewards and provide real value to members;
- Promote meaningful customer engagement;
- Harness data to help participating merchants out manoeuvre competition;
- Increase value for members such as shared points, ongoing promotions and easy, hassle free redemption;
- Attract at least 1 strong partner. The most successful programs whether stand-alone or in a Merchant coalition involve a grocer or similar anchor. As an anchor, having or being a leading grocer helped both Tesco and Nectar (with Sainsburys as grocer) achieve rapid acceptance;
- Invest in marketing, Nectar UK used direct mail to generate rapid adoption;[42]
- Scale: managing credit and loyalty programs is more efficient as projects reach a certain scale, combining large merchants builds instant scale and creates many efficiencies;
- Many successful programs have a combination of card types. It's desirable to have technology that is flexible and allows many different parameters for both credit and rewards and even prepaidstored value cards (gift cards).

Adapting rewards to the realities of the Canadian market

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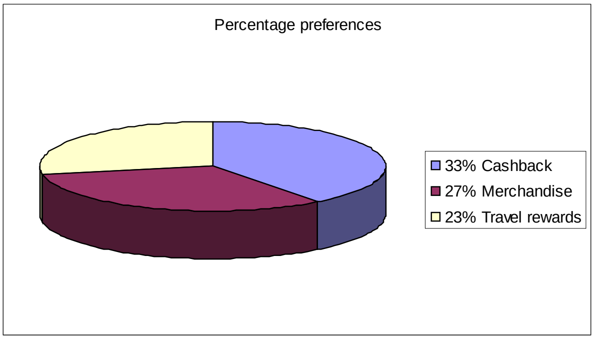
[40] RIS News, Loyalty Programs Miss Mark, April 4, 2011

[41] Karen L. Webster Market Platform Dynamics: Loyalty 2.0, May 2007

[42] Nectar UK attracted so much response through its direct mail campaign that online registration was inaccessible for several weeks and users had to resort to mail-in registration

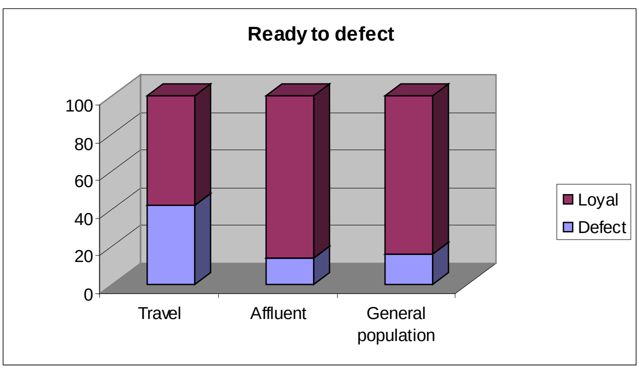
According to RBC, in an article that appeared in Les Affaires, Canadians have expressed clear reward preferences.43 Similar preferences are seen in other market as well. Example of preferences:

- 33% of Canadians prefer cashback;
- 27% merchandise;
- 23% travel rewards.



Graph 5, Loyalty preference graph

The type of reward is a factor in determining which customers are ready to defect. The graph below shows that members of travel related programs are the most ready to defect.



Graph 6 **readinesses to defect graph**

In Canada, merchandise rewards are generally more lucrative and common. There are about 15 Cash reward programs with rewards

[43] RBC data reported in Les Affaires, September 2010

ranging from .5% to 1%, versus 43 points rewards programs that offer ongoing rewards that are redeemable at the issuing merchant stores. Reward levels for merchant led points based programs typically range from .5% to 3%. See page 82 for graph.

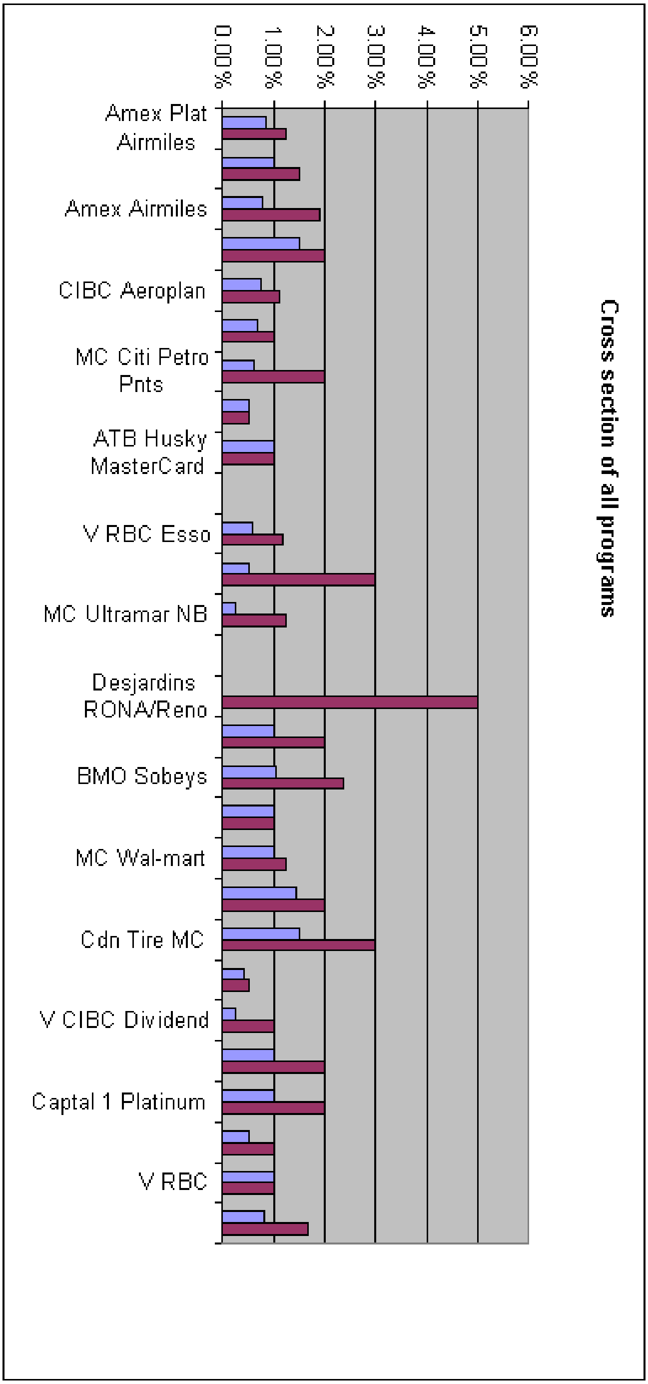


Figure 12, Leading Canadian min/max reward levels

Overall h an
loyalty programs.

These same programs generally also offer ongoing promotional offers with an average max value of 1.67%. For example, CTFS have a variety of promotional offers including substantial fuel rewards. Although CTFS' published base rewards are 1% for purchases in non-Canadian Tire stores and 1.85% in their own stores.44 The fine print reveals rewards somewhat less lucrative as they can be tied to spending levels.

Focussing on credit backed loyalty programs only, the data shows that the main competitors to merchant led programs, based on purchase volumes and total memberships for bank led programs. Banks generally offer frequent flier points or cashback. Canadian examples include CIBC with 3.5 million active members, followed closely by RBC and TD. Banks dominant market position is clear in Canada, and research into the UK shows similar patterns. Data from a 2011 Nilson report shows that 52% of credit cards are controlled by the top 3 issuers, whereas, Visa and MasterCard are the leading card brands with 92% market share (see Table 3). Again, similar figures are available for the UK. Discover in the US seem to have skewed this somewhat, having gained a 12% market share. In France, they have had their own network, but even this seems to have thrown its hat in with Visa.

Market share	Percent cc share	Actual card transaction share	Purchase volume	Value billion s
Visa	61	25.01		164
MC	31	12.71		82
Amex	8	3.28		22
Total credit		Total credit	65%	268
Debit		Debit	35%	144
Gift Card				6

Table 3

Chapter 6

[44] Financial Consumer Agency of Canada, credit Cards Comparison Web site.

How to value reward programs

Analysis of the majority of credit backed loyalty programs reveal typical reward levels that vary depending on when they are redeemed, the products redeemed, where members are in the product cycle, the type of card and much more.

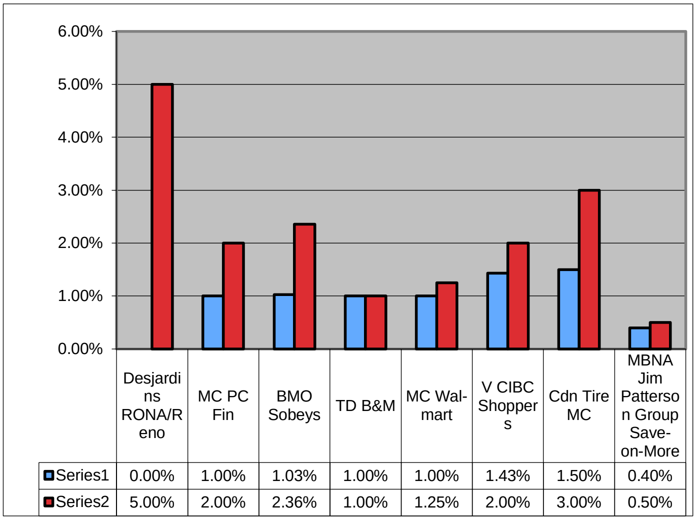
For consumers whose method of payment is usually determined by the rewards offered, this likely explains the general consumer confusion about loyalty programs, a conclusion supported by industry research.

Analysis of rewards makes it clear that different segments offer variable reward levels. For example, stand-alone fuel programs are generally more lucrative when compared against other segments such as grocers. Fuel rewards and rebates can range from 1% of the purchase value up to 10% for specific promotions. Research reveals that the average fuel rewards range between an average min of 1.7% up to an average max of 3.8%.[45]

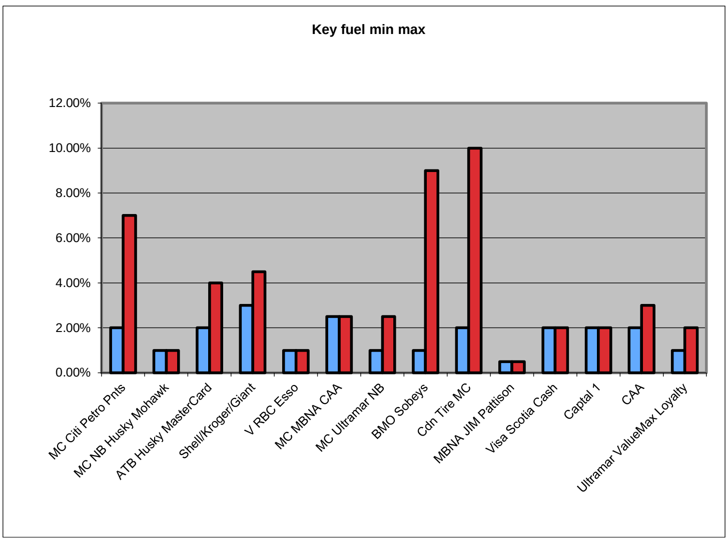
The graphs on the next page illustrate a variety of high profile reward programs.

[45] See loyalty appendix

Canadian rewards graphs by segment

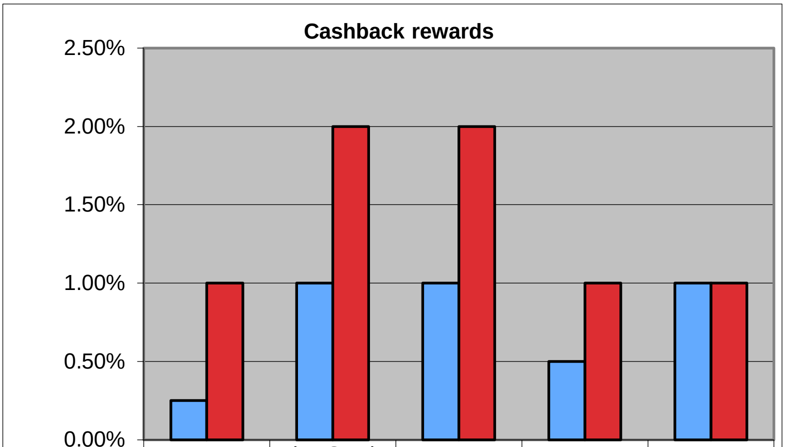


Graph 7, Retail min-max chart



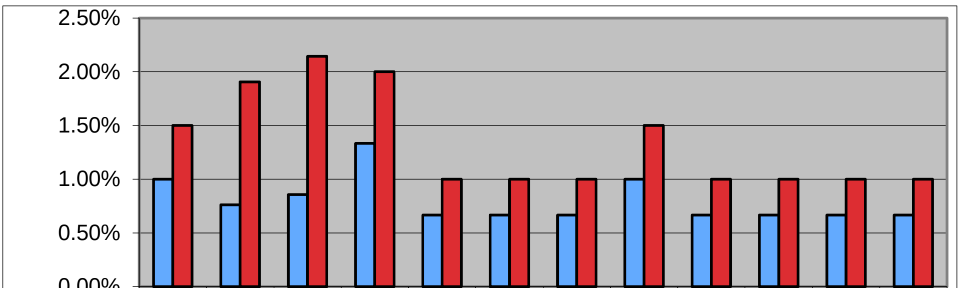
Graph 8, Fuel min-max chart.

****Note that conditions apply for the higher reward tiers.**



	V CIBC Dividend	Visa Scotia MoMomentum Cash	Captal 1 Platinum	TD V cash	V RBC
Series1	0.25%	1.00%	1.00%	0.50%	1.00%
Series2	1.00%	2.00%	2.00%	1.00%	1.00%

Graph 9, cash-back rewards

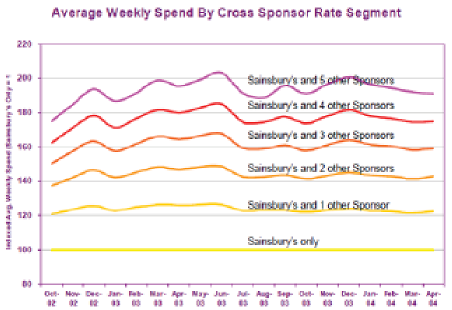


	American Express Aero Plan Plus	American Express Air Miles Credit Card	BMO Air Miles Master Card	Capital One Aspire World MasterCard	Capital One Aspire MasterCard	CIBC Aerogold Visa Infinite	CIBC Aerogold Visa	CIBC Aventura	Diners Club	Royal Bank Visa Platinum Avion	Royal Bank Visa Infinite Avion	ScotiaGold Passport VISA
Series1	1.00%	0.76%	0.86%	1.33%	0.67%	0.67%	0.67%	1.00%	0.67%	0.67%	0.67%	0.67%
Series2	1.50%	1.90%	2.14%	2.00%	1.00%	1.00%	1.00%	1.50%	1.00%	1.00%	1.00%	1.00%

Graph 10, Airmiles min-max rewards chart using fuel gift card to point costs to calculated reward value

NECTAR LMUK COALITION ADVANTAGES

Exhibit 4 Effect of Number of Collection Sources on Size of Weekly Spend at Sainsbury's



Source: Loyalty Management UK.

Note: To be read as follows: Take the average weekly spend for Sainsbury's customers who earn Nectar points at Sainsbury's only, and index this at 100. Now take the average weekly spend for customers who earn points at Sainsbury's and other sponsors and index the spending relative to 100.

Example: Assume the average shopper who collected points from Sainsbury's alone spent £25 a week in June 2003 (a hypothetical number). Then the average shopper who collected from Sainsbury's and one other sponsor spent £30.75 at Sainsbury's in June 2003 (30.75 = 25*123/100). The average shopper who collected from Sainsbury's and two other sponsors spent £35.75 at Sainsbury's (35.75 = 25*143/100).

COALITION SPENDING PATTERNS

LMUK evaluated the average weekly spend for Sainsbury's, a UK grocer, customers. The study revealed that the average shopper increased average spending proportionately to the number of participants in the coalition program. See graph at right for spending patterns.

Similarly coalition member's share of the fuel market increased 3% year on year. This is explained in detail in the accompanying Nectar Case Study.

The implications for coalition members is significant:

- Increased market share
- Increased value for cardholders
- Cross promotional opportunities
- More attractive to cardholders currently enrolled in other programs.

Graph 11, increased spending as more merchants join card program. Source Loyalty Management UK

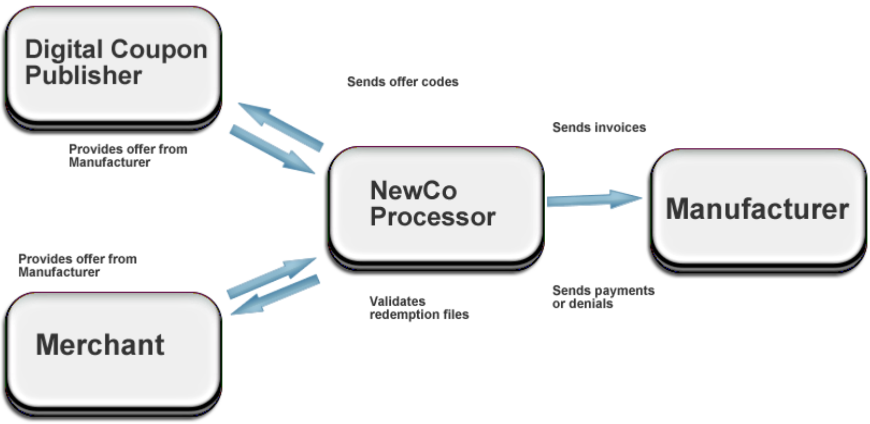


Figure 1, supplier incentive workflow

SHELL / KROGER OVERVIEW

KROGER SHELL FUEL PROGRAM EXAMPLE

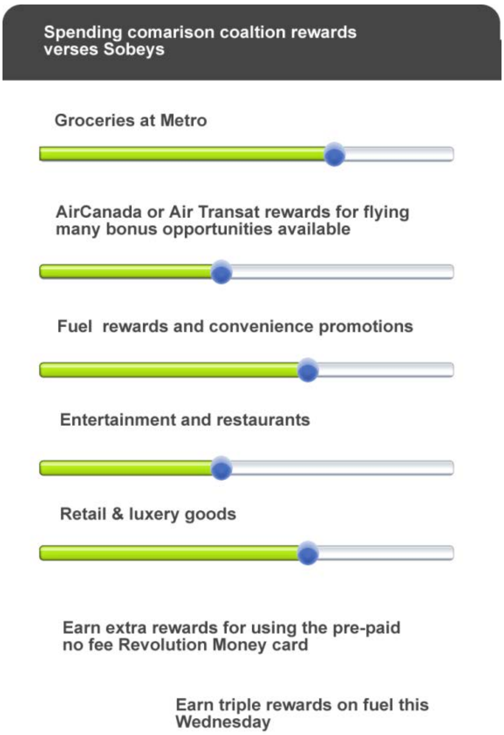
The Kroger fuel program is a good example of the cross promotional opportunities fuel and grocery can offer each other. The program, supported by Dunnhumby, a leading UK loyalty management firm, allows cardholders to receive discounts on fuel purchases at participating Shell locations. For each increment of 100 Points redeemed at the pump, 10¢ off per gallon is awarded at Kroger or select Shell locations on a single fill up.

• 100 Points = 10¢ off per gallon of fuel

There are three ways to earn Points in Kroger stores:

1. Spending on Groceries (normal exclusions apply): $100 in Groceries = 100 Points
2. Non-federally funded Prescriptions: 2 Prescriptions = 100 Points
3. Double Gift Card Points (normal exclusions apply): $50 in Gift Cards = 100 Points
5. Save 10¢ per gallon up to a maximum of 35 gallons of fuel per purchase.
6. Cardholders can view their points balance at the bottom of their Kroger receipt. You can also check your points balance by registering your Kroger Loyalty card number at Kroger.com.

Figure 2, US coalition sample publicity Source Shell.



From the sample spend slider at left; consumers can calculate potential reward values based on their individual spend patterns. This can be a valuable tool to help prospects evaluate and compare programs that might work for them. This would typically generate a cash value result. I.e. $300 in reward value.

Figure 3, sample merchant reward calculator based on Sobeys, a Canadian grocer

Economic impact of loyalty rewards

Credit and loyalty programs, especially merchant programs where points are shared, provide short and long-term benefits to participating merchants. According to Webster, '60% of marketing budgets is allocated to devising and promoting loyalty.'46 This is a significant investment which should be evaluated for return on investment (ROI). The components driving ROI as a result of loyalty programs include:

- Increased revenue;
- Lift;
- Shopping frequency;
- Increased margins;
- Interest from un-reclaimed balances;
- Increased potential for future sales.

In the case of Merchant programs, the ability to cross-promote services is a substantial advantage as well, as demonstrated in the Nectar case study.

Summary list of financial and marketing benefits

- Reduced interchange. Issuing FIs control the majority of interchange. By issuing its own cards, merchants will be able to determine if, when and how the card issuer's portion of each transaction fee is allocated. This revenue can be assigned to cardholders or retained as earnings;
- Future sales. Card programs offer many opportunities to increase lift, shopping frequency and basket size;
- Merchant exposure. Through advertising the card and through statements, merchants get exposure in wallet, via email campaigns and as a result of other promotions that combine to help ensure top of mind awareness. The touch points include:
- In-store card malls;
    - Exposure in wallet, whenever the card is used;
    - Online;

[46] Market Platform Dynamics: Loyalty 2.0, Karen L. Webster, May 2007

- Cross promotions in the case of Merchant programs. [47]
- Card revenue including: fees, net interest margin from revolvers, transaction fees, penalty fees;

Future benefits: commercializing data, customer retention and reduced customer churn.[48]

Value proposition for merchant retail sales

- Re-allocate a substantial portion of transaction fees to merchants own clients;
- Maximize the profitability of customers;
- Offer merchants control over incentives and rewards;
- Manage customer data effectively;
- Retain the best, most profitable customers;
- Enable merchants to target customers with potential to become best customers;
- Reconnect lapsed users with the brand.

Benefits of coalition merchant program verses stand-alone:

- Shared costs;
- Merchant members can pool rewards adding value to the program by making redemption easier and breakage lower;
- Cardholders perceive that they get extra value when they shop through special member promotions;
- Use shared data more efficiently to optimize targeting and for cross promotions.

Loyalty financial analysis

Credit backed loyalty programs have significant financial implications and potential risk for issuers. Some of the key criteria include:

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[47] Research by Nectar UK shows also that by increasing the number of participating merchants increases the gross spend of cardholders. See appendix Nectar Case Study.

[48] Aeroplan processes 29 million rows of data for Sainsbury's alone. Their clients can mine data in less than 2 minutes. Loyalty Marketing UK (LMUK) generated most of its 192 million GBP profits in 2007 by providing data services to Merchant members, marketing and cross-promotion opportunities.

Investment required:

1. The cost of acquiring clients, although much less than for a bank (average acquisition costs range from $69 for Discover issuers to $141 for Amex).[49] Merchant cost to acquire members can be as low as $25 per new account, including issuing plastic, credit checks and other manual checks, and in-store marketing. This estimate can be validated by Tesco, which says its costs for member boarding are 1/5th the cost as compared to typical card issuer;
2. Operational costs of $70-$120 per year including:
3. Credit and loyalty management technology which can cost from$.30 to $2.00 per month or more per active account;
4. Call centres with hundreds of agents required to support large programs that can cost $2.50 to $3.50 per month per active account;
5. Back office support from $.30 to $1.50 per month per active account;
6. Management fees;
7. Estimated payback: it could take 2 - 3 years or more before profitability is achieved;
8. Card funding: funding a portfolio is typically done through a combination of retail and wholesale deposits, equity funding and securitization. The cost of funds for merchant led portfolios can range between 3.5% and 8% per year. 8% would be exceptional, such as during the credit crSoftcard. Cost of funds applies even if the merchant offers credit enhancements, meaning that the funds are secured against risk in situations such as excess consumer defaults.

Merchant cost advantage for credit card member boarding
Low member boarding costs plays to the strength of merchants who, because they own the point of sale (POS), have a cost

[49] Comperemedia May 2009 – April 2010

advantage over bank issuers. Merchants also have the power to offer lower cost rewards, real-time, as part of their day-to-day operations.

For traditional bank card issuers, the cost to attract members can get even higher when incentives, marketing and other fixed infrastructure and staff costs are all factored in. Take RBC, which, in 2010, offered new clients a 5% cashback incentive for grocery purchases, up to a maximum value of $250. This type of reward is a direct cost to the issuer, and is the main cost component to attract new account holders.

Attracting consumers can be costly and may have been the catalyst for TD/MBNA to better the RBC's 5% grocery cashback offer, as TD matched this, and also provide ongoing rewards of 3% thereafter. This would not include other related member boarding expenses, such as: marketing, manual setup fees, security checks, card production and so on.

Value of each account to issuers

For discussion purposes, another way to estimate return on investment (ROI) is to look at the commercial value of a portfolio verses the cost to develop it. This is no easy task as the value of a portfolio has proven to be a moving target. For example, prior to the credit crSoftcard, according to R. K. Hammer in a paper published in 2005, the size of the portfolio affected the size of the premium. Portfolio's under $10 million got up to 17% while those above $20 million could get up to 27%. The following is a sample scenario:

- Assuming a portfolio of 10,000 credit cards
- Debt on the portfolio $13.537 million
- Average balance of $1487.52
- Revolving amount of $1219.79
- Transactor amount $267.7
- Total debt of the portfolio is $13.537 million
- Default rate of 6%
- Operating expenses of 4.9%
- The average rate on the unpaid balances being 12%

- Cost of capital of 5.69%
- Growth 3%.

NPV of the portfolio = $2.504 million

NPV of each card $250.37

Selling price of the portfolio $16.040 million

NPV/Accounts receivable = p = 18.50%

Flash-forward to today's turbulent times and the picture is very different. Distressed programs are being sold at a significant loss, and individual accounts command only a fraction of their former value. For example, TD bought the Canadian portion of Bank of America's (BofA) MBNA portfolio for $8.6 billion CND, a premium over assets equivalent to $55.55 per active account, an amount equal to 1.17% premium for the entire portfolio.

This rough calculation was made as follows:

- *Portfolio had 1.8 million active accounts and dividing this by*
- *The actual premium paid by TD = $100 million over the value of the receivables =*
- *The cost per active account $55.55.*

Note that at the time of the TD MBNA transaction, the actual delinquent accounts, and expected write-offs were not disclosed. Nor is there mention of the fact that a possible motivator for the fire sale is the quarter just prior to the transaction, where Bank of America lost $22 billion. BofA also agreed around the time of the sale, to pay $8.5 billion to various securities investors as a consequence of its part in selling fraudulent mortgages securities.[50]

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[50] Source: Riaz Hussain, Valuation of Bank Credit Card Portfolio, Kania School of Management

Not all recent transactions were sold at a discount. Barclaycard UK's acquisition of Citigroup's card portfolio for $3.2 billion is a recent example that paints a different picture. In this example, after factoring out the portfolios assets (about $2.9 billion), the cost per account is pegged at about $680.[51]

<u>Riaz Hussain: Establishing the value of a credit card portfolio</u>

R. K. Hammer, an investment-banking firm active in the negotiated sales of credit-card portfolios, lists several factors that they consider in the valuation of these portfolios. These include:

(1) Credit Quality, as evidenced by original credit criteria, credit bureau risk scores, behaviour scores, bankruptcy scores, and the trends of those score patterns;

(2) Attrition Rate, the percentage of accounts and balances (and the profitability of those accounts), that close voluntarily (customer requested closure) vs. involuntary (bank revoked);

(3) Income Yields, the APR, annual fee structure, nuisance fee structure, teaser rates outstanding, the percentage revolving; and

(4) Open vs. Closed, the percentage of accounts and balances, that are open to buy vs. those that are closed (but who also may be paying as agreed and, therefore, not delinquent).

For a detailed analysis there is a paper written by Riaz Hussain of the Kanio School of Management. It is available free and is downloadable from the following link:

Source: Riaz Hussain, Valuation of Bank Credit Card Portfolio, Kania School of Management

Portfolio valuation: a moving target

[51] ExtraCreditCards: Barclay's to buy Citi Portfolio, March, 2011

In 2005, Chase paid Sears Canada considerably less per account when it purchased North America's largest merchant portfolio from Sears. The price paid was $2.2 billion, which put the cost per cardholder at $220. This figure was derived based on the 10 million members Sears had at the time of the sale, and assumes that portfolio assets were factored out, making it possible to estimate the cost per client.[52] Compare the 2012 Citi sale of the Petro Point portfolio to CIBC.[53] CIBC paid only for the asset value of the portfolio, about $2 billion, and made Citi eat all of the delinquent accounts, a total value of about $285 million and 1.3 million delinquent accounts. Essentially CIBC, paid a $0 premium for a portfolio with zero delinquent accounts.

These examples illustrate the value of a typical single merchant portfolio, as compared to between portfolios evaluations in the past and the paltry sums that have been paid today for both bank issued and merchant issued portfolios, sometimes sold at or below the value of the assets.

No doubt some of the key factors in the examples cited would have taken into account potential or existing accounts in default, some degree of opportunism, and in the case of the pre-recession Sears program, the fact that closed loop proprietary merchant programs generally produce less revenue for issuers than do branded open looped programs.

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[52] The difference between a single merchant portfolio and a bank portfolio value per account is significant. Single merchant portfolios typically have much lower account balances, higher delinquency rates and lower transaction rates.
[53] CNW September 1, 2010

Here is a related press release on fuel co-brands

Toxic Oil card? CITGO latest supplier to see co-branded credit card killed by bank
By CAROLE DONOGHUE, CPSnet.com
CSP Daily News | January 24, 2012
HOUSTON -- CITGO is losing its consumer co-branded MasterCard. The company is the latest to join the ranks of refiners whose card is being cancelled by Citi, CSP Daily News has learned.

CITGO marketers were told Monday that they would not be able to accept the co-branded CITGO MasterCard after February 29, 2012.

CITGO gave no explanation of the change in its message to marketers, saying only that it intends "to focus on the growth of our CITGO private-label cards."

Marketers must immediately remove any CITGO MasterCard materials, it said.

In a short question-and-answer bulletin sent to cardholders, CITGO said that Citi "has made the decision to discontinue" the card and the last day that they may use the card is February 29.

CITGO marketers said they are not surprised that the card is being cancelled. "It's not going to mean much to us because we only have a few CITGO stations left," said one jobber. "But I think it's a good thing for us because proprietary cards are no-fee or low-fee, and we weren't doing much on the CITGO MasterCard."

Banks have been shutting down refiner co-branded card programs or cutting back the rewards offered because they regard the programs as unprofitable for the amount they must spend marketing them, says a credit card executive with one major oil company.

Oil cards are regarded right now as "toxic" by the banks, said the official.

Banks make their money on credit cards from finance charges, late fees and interchange rates, but those revenues streams have dwindled over the past two years as a result of regulatory reform and more cautious consumer purchasing behaviour, he said.

Banks were willing to take lower interchange rates when they first negotiated oil company card deals but the advent of reward offers have reduced revenues by 50% to 60%, according to some estimates, he said. In addition, many co-brand accounts use their cards for gasoline purchases only and pay-off outstanding balances monthly, which means fewer fees for banks.

Takeaways from the Toxic card press release:

- CITGO feel better off as they prefer their no-fee proprietary card;
- Proprietary fuel cards are often only used for fuel purchased and have few revolvers = no revenue for banks.

Banks cost of funds advantage over merchants

Often for large credit card portfolios, the intention of merchant issuers is to offload credit risk by securitizing the portfolio. This is explained on page 188 in the funding/securitization strategies overview. Essentially, the concept is to reduce capital adequacy ratios by putting the risk on the investor's books.

To illustrate the advantage banks have, two examples come to mind. First, take Royal Bank of Canada whose card portfolio receivables were sold under Golden Credit Card Trust. The coupon rate was 3.51%. This rate was only 82 basis points above comparable Canada bonds, and 152 base points lower than CTFS, which paid a coupon rate of 5.03% in 2008. On a billion dollars, the difference between CTFS and RBC is equivalent to over $15 million CDN in extra costs each year.

Considering that CTFS operate their portfolio prudently, efficiently, and was rated AAA, the discrepancy between the merchants and banks cost of funds reveals a significant cost of funds advantage for large bank issuers. At a cost of $15 million per billion in assets, this puts bank issuers at a big advantage.

Merchants can use rewards to level the playing field…somewhat.

Rewards cost money for merchants, but the costs can be lower than what similar rewards would cost a bank, especially if the benefit to retail sales is factored in.

Essentially, rewards can lead to long-term retail profits for merchants, but are always regarded as a cost center for a bank.[54]

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[54] Except in the case where merchants fund rewards as has become a trend in the US or with certain co-brand programs. Madeline Aufseeser, June 2011, Aite

Therefore, two key merchant drivers for determining the value of rewards are based on the following elements:

1. Rewards must be sufficiently attractive to entice members to join and they should encourage ongoing participation in the program;
2. Merchants must have an indication of increased retail revenue versus rewards costs.

Regarding point 1, typically merchant programs offer a base level of shared rewards. Programs also offer a signing incentive for new accounts. In order to ensure member engagement, most successful programs also offer ongoing promotions. These comprise the costs. That said, merchants are already paying this cost whenever a credit card is used in their stores in the form of the swipe fee. The difference being that unless they have their own card, the fee goes to fund competitors programs instead of their own.

The methodology used to establish reward ROI was based on several studies, including research by Christophe Benavent[55] focused on the grocery vertical; for the convenience store vertical, Dr. Yuping Liu, a professor at Old Dominion University, based the findings on research.[56]

The Benavent study focused partly on establishing the benefits of rewards and the influence rewards have over key variables such as basket size and increased shopping frequency.

Research highlights*:*

- It was demonstrated that basket size for cardholder shopping was 191% greater over time for loyalty program members versus non-members;[57]

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group, The Case for Merchant Funded Incentives: New Opportunities for Card Issuers.

[55] This data was based on 451,000 transactions involving 2,150 consumers over a 156-week period.

[56] Dr. Yuping Liu, at Old Dominion University, Loyalty Marketing Works in the Convenience Industry

[57] Christophe Benavent ET Lars Myers, Analysis of the Efficiency of Loyalty Programs: a Case Study, 2002; Benavent, C. Crié D (2000); "Analyse de

- Promotions produced increased shopping frequency that was measurable and tied to how well rewards are communicated and the type of promotion offered;
- Demonstrated behavioural differences among customers groups and the effect of immediate versus delayed rewards and reward response among various client types.

Based on the results, Benavent recommends that program managers should carefully recruit new customers and discriminate between existing and new clients with respect to the size of the rewards and program stimulation. The analysis further demonstrates the positive effects of mailings and other promotions on shopping frequency and basket size.

Liu's study revealed similar patterns, although the actual figures were somewhat different.

Liu's research focused on the convenience store segment. To support his observations of this segment, Liu analyzed 4.8 million transactions from 2002 to 2003 between 52 thousand loyalty consumers, and compared this against results from non-loyal consumers.

One results of his analysis was to demonstrate increased transaction size for loyalty members, results that echoed Benavent, although the segment was convenience stores. Lui's analysis showed an average 36% ($11.84 vs. $7.52) increase in their transaction size (versus 191% for Benavent) and 2.78 times more shopping frequency for loyalty members verses 1.69%.[58]

Therefore, assuming the following:

- Members of the program were converted from competing credit card users;

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l'efficacité des cartes de fidélité, une étude de cas" in Volle " Recherche en Distribution, Economica. Lars Myers, Christophe Benavent Grocery retail loyalty program effect: self-selection or purchase behaviour change. Published Nov 2008 Academy of Marketing Science.

[58] Dr. Yuping Lui, Loyalty Marketing Works in the Convenience Store Industry, 2002

- Interchange expense was displaced with reward expense (for a net zero cost excluding promotions).

Based on this we can estimate the value of a loyalty customer over 4 years. The results (based on Lui's research results) are:

Loyalty vs. non-loyalty variables	Metrics
Increase shopping frequency	2.78
Normal frequency per year	84
Increased basket	36%
Normal basket value	$7.52
Profit margin	10%
Net annual profit value loyal vs. non-loyal	$152.92

Based on these assumptions, the average value of each loyal customer over 1 year versus a non-loyalty member is estimated to be $152.92. 59. However, based on actual situations, the expected results are not necessarily going to translate into double-digit returns. Mainly because there are many additional variables, such as the fact that many loyalty participants might have similar purchase volumes, with or without the program. Which is why, this book advocates other means of evaluation as described below.

Following on this argument, according to LMUK, increasing the number of participants also increases the gross spend.[60] Further, Koos Berkhout, Nectar's database marketing manager did a study on a segment of random shoppers compared to a control group. The random sample received a one-point bonus in addition to the usual two points for every 1 GBP spent. The sample was monitored for 9 weeks, and revealed that revenue from light shoppers who received the promotion was 10% higher than the control, and remained at 5% above the control for up to 13 weeks. He concluded that the promotion produced a revenue increase of 6.5% over 13

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[59] I.e. retails sales and not including income derived from other factors such as credit card account fees, interest income etc…

[60] [60] John Deighton, Harvard Business School December 5, 2005

weeks for an additional cost of 0.5% of sales during the 4 weeks of the promotion.

Nectar's metrics appear to be more sophisticated than the other studies described. However, another way to validate if loyalty is working that does not seem to be generally applied, is to look at the effect it has on 'same-store sales'. Theoretically, if loyalty programs work, merchants should see increased lift and shopping frequency reflected in increased same store sales. The limitation on this theory is that there are a number of variables influencing same store sales. For example, with oil prices as they are, a convenience store that also sells fuel might experience increases in same store sales because fuel prices are rising. Therefore, in order to test the theory, I looked at comparable merchants from a variety of vertical. In each case, one merchant offered loyalty, while the other did not. I further refined this to track data starting from when merchants first introduced loyalty programs: Kroger in 2008 and Home Depot 2003. The data from the study are revealed on the table on the following page.

Kroger US versus Super Value US

Kroger US			Super Value US	
2010	+2.1%			-6.8%
2009	+2.7%			-2.4%
2008	+5.4%	Loyalty introduced at Kroger		-0.7%
2007	+3% for ten quarters			-0.5%

Home Depot US versus Lowes US

Home Depot			Lowes	
2010	+2.5%			+1.3%
2009	-6.2%			-6.7%
2008	-8.7%			-7.2%
2007	-6.7%			-5.1%
2006	-2.8%			0%
2005	3.8%			6%
2004	5.4%			6.6%
2003	3.8%	Loyalty introduced at Home Depot		6.7%
2002	Negative from 2000-2003			5.6%

The data reveal that the merchants with loyalty programs have had superior same-store sales compared to their competitors; especially in the first years following the launch of a new program. Obviously, a much more detailed assessment and sample group would be required to validate this argument; and clearly other factors can also influence same-store sales results including: market conditions, price inflation/deflation, and high/low competitive pressure resulting in price pressure, poor/good customer service, vertical, good/poor strategies and so on. The key point being that establishing the value of rewards programs for banks and merchants can and should be done using a variety of metrics.

Chapter 7

Moving up the value chain: transforming rewards and offers to loyalty

Having established the potential benefits of rewards programs, this chapter looks deeper into the mechanics of how they work, and how they can transform your business.

Overview of rewards program

1. Point and points management capabilities;
2. Data management business intelligence (BI);
3. Cross promotions and marketing features;
4. Data sharing rules;
5. Promotion variables.

Example of point's definition:

- Goal: to increase frequently, spend and improve brand;
- Rewards will be based on the dollar value of purchases made or on the frequency of purchases;
- Coupons: ability to target individual consumer with specialized promotions and discounts at the till;
- Base rewards or points for consumers equal to agreed value as a percentage of spend (i.e. 1% to cardholder);
- Points can be redeemed using cards at the till or vouchers sent;
- Minimum redemption $10;
- Merchants will fund the base points for transactions that take place within their stores.

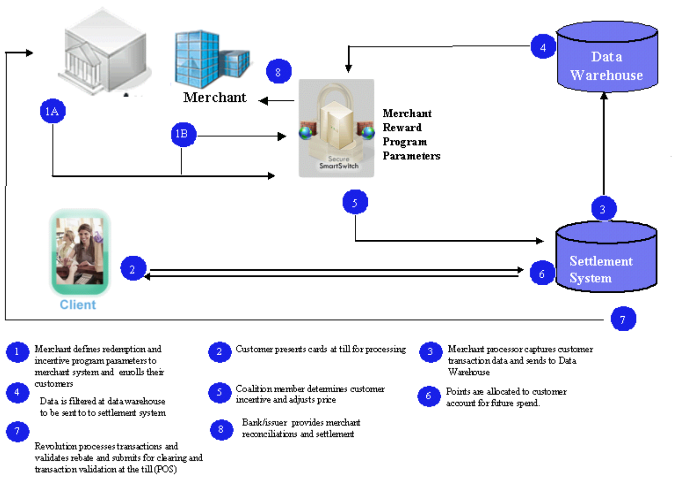
Special promotion

In addition to a fixed percentage reward for purchases at participating merchant locations, special promotions are usually offered by individual merchants with the ability to set the promotional variables.

Sample special promotion

- Airline A offers 5X points and reduced fixed price for business class flights between Montreal and Tampa;
- Variables:
  - Target audience: high net worth located in Tampa and Montreal;
  - Marketing: cross promotions targeting Company B high net worth clients, email, mailer enclosed with The Merchant points update;
  - Duration: September 15-October 15;
  - Marketing collateral: brochure, web collateral (package A), email content, data extraction, data analysis;
  - Budget: $XXX.

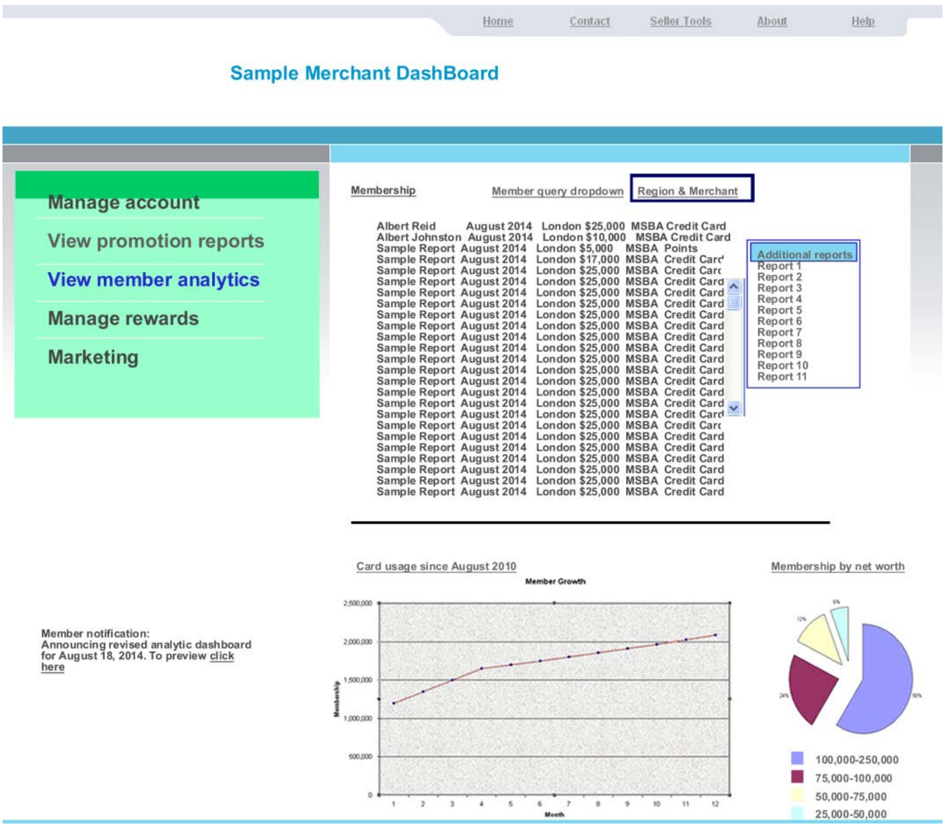
Sample workflow of transaction



Point's dashboard

Merchants will have access to the administration dashboard (see below). The dashboard will permit merchants to define campaigns associated with specific products, dates and consumer segments.

Sample campaign dashboard



Meeting reporting requirements

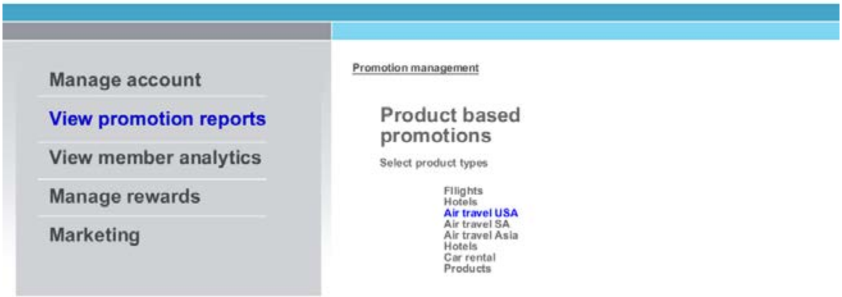
The promotion report dashboard offers marketing administrators access to reports (high level to granular) on all promotions. The data can be sliced and diced in multiple ways, such as:

1. By date;
2. By product;
3. By value;
4. By campaign;
5. By profitability;

6. By region;
7. By cardholder segment Campaign revenue;
8. Revenue breakdown by segment;
9. Revenue by sales source table & graph;
10. Source of sales;
11. Pricing / profitability results and charts;
12. Affiliate campaign results and projections

The above report types are the key to transforming a 'rewards program' into a true loyalty management approach. Specifically, analytics make it possible for programs to be relevant to consumers.

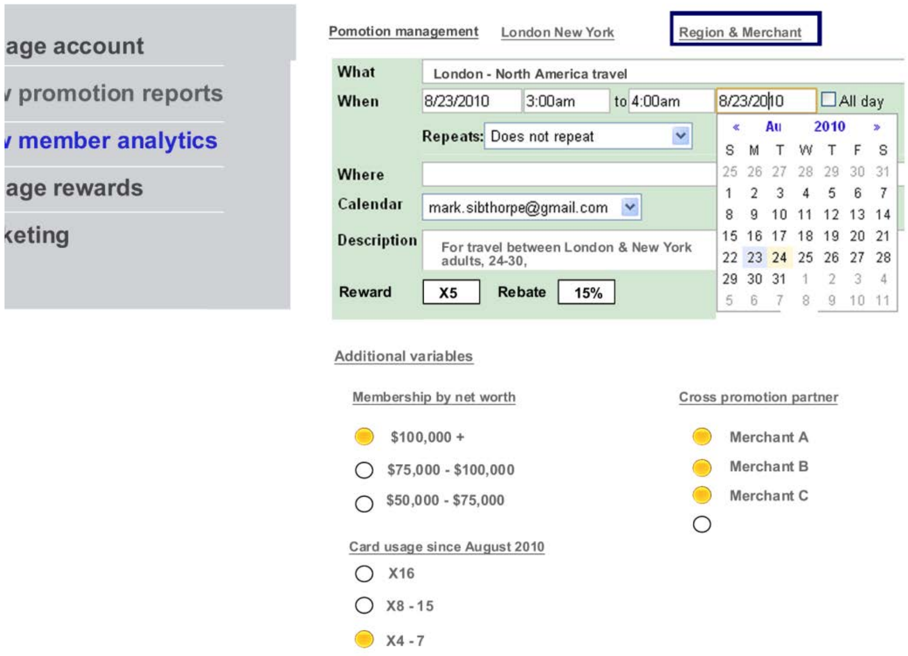
Benefits include access to the merchant's easy points management and rules based dashboard (see sample reporting dashboard image X). This dashboard displays details, such as sales and customer transactional data, and can be set by marketing administrators to display reports according to merchant requirements (see sample list above). A sample product promotion screen shot follows.



Promotion management screen

Marketers will benefit from features such as easy to follow drop down menus that streamline promotion and campaign management.

A well designed dashboard links the reward management dashboard to detailed, drill down views and allows administrators to change campaign parameters, pricing variables and target segments (See promotional management screen & variable management screen below).



Promotion variable management dashboard

Examples of promotional variables include:

1) Product based on variables in product database (note, more than one product can be chosen for each promotion);
2) Price;
3) Dates;
4) Rewards;
5) Rebates;
6) Cardholder variables demographics
   i. Age;
   ii. Income;
   iii. Location;
   iv. Marital status;
   v. Store patronage;
   vi. Frequency;
   vii. Value;
   viii. Product purchasing behaviour;

ix. Interests and activities;
7) Affiliation with Merchant partner/s;
8) Marketing variables
x. Email;
xi. Cross promotion;
xii. Direct mail;
xiii. Partner campaign;
xiv. Online;
xv. SMS;
xvi. Coupons at till;
xvii. Rebates;
xviii. Collateral development;
xix. Real-time budget.

Member analytics and management dashboard

Surveys that I have done with leading merchants indicate that marketing executives want easy access to management dashboards that track cardholder growth, segment profitability, manage member based campaigns and much more. Administrators should be able to track user patterns and customer data across multiple touch points. Some possible variables and reports types include:

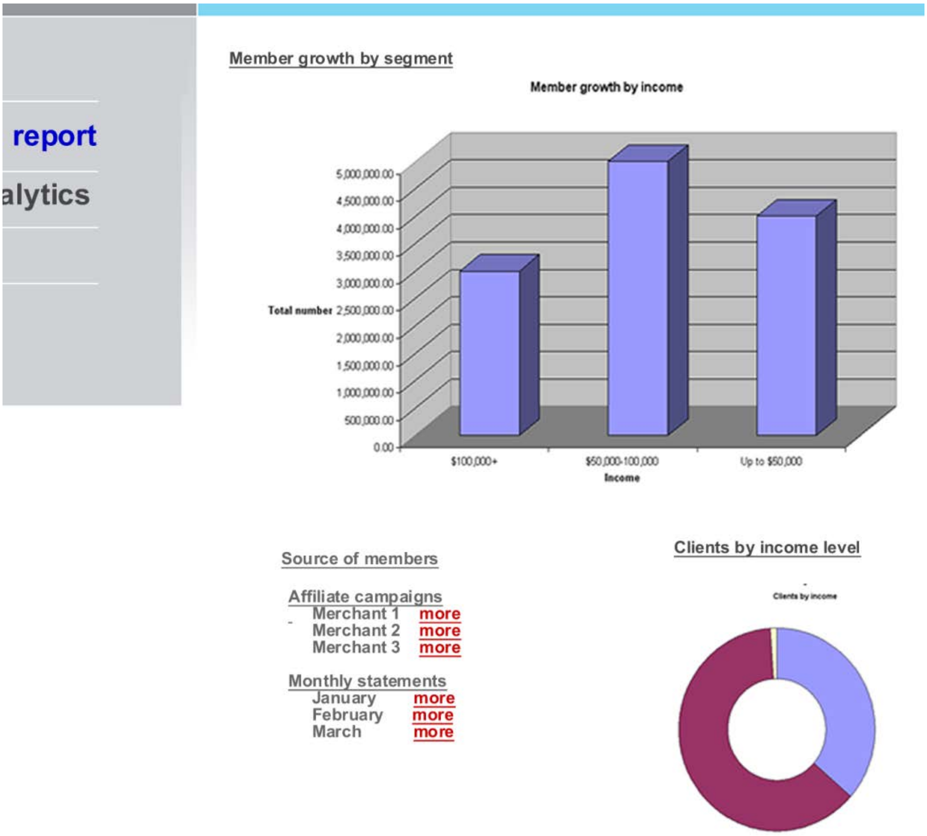
1) Age;
2) Income;
3) Marital status;
4) Address;
5) Occupation;
6) Bank details;
7) Credit card details;
8) Spouse's name;
9) Friends/Connections;
10) Colleagues;
11) Transaction details including all product details;
12) Product preferences;
13) Transaction patterns;

14) Member transactions using the Merchant card at other locations;
15) The budget ratio (share of wallet);
16) Retention rates & customer churn;
17) Customer lifetime value (CLV/CLTV);
18) Customer retention, attrition and lifetime;
19) Potential, existing, and defected customers;
20) The switching ratio;
21) The Enis-Paul Index;
22) Customer profitability;
23) Drivers of loyalty and profitability;
24) Loyalty and profitability models;
25) The 'loyalty and profitability chain';
26) Past, actual, and future profitability;
27) Recency, Frequency and Monetary value (RFM) segmentation;
28) Net Promoter Score (NPS);
29) Attitudinal equity;
30) Customer-centric metrics;
31) New digital marketing metrics;
32) Examining individual customers and customer groups;
33) Statistical primer: the mean, median, mode, variance & standard deviation
34) Reports and client views should enable executives to drill down, providing consumer level data, segmented according to multiple variables. Typically programs will offer pre-set reports, along with the capability for administrators to build their own reports and queries, ideally without technical resource requirements.

Sample data-driven reports:

1) Customer behaviour profiling;
2) Customer lifestyle & demographic profiling;
3) Customer product preferences and repertoire;
4) Product category relationships & cross-selling;
5) Online shopping suggestions;

6) Segmentation and customer tiering;
7) Customer base analysis and trend predictions;
8) Customer flow analysis;
9) Share-of-wallet estimation;
10) Market share estimation;
11) Early defector detection and customer win-back opportunities;
12) Lower cost competitive response;
13) Customer targeting and differentiation;
14) Advertising campaign targeting;
15) Circular efficiency;
16) Offer planning and promotion analysis;
17) Intelligent de-selection of unprofitable customers;
18) Planning and merchandising;
19) Geographical store site selection;
20) Inventory rationalization & selection;
21) Real-time data mining and the 'single customer view';
22) Behaviour prediction based on past events;
23) Affinity marketing strategies;
24) Predictive modeling.



Reporting tools screenshot

In summary, marketers looking to transform a simple rewards program into a loyalty strategy will need to consider the data requirements, reporting and project management capabilities required to deliver what they need.

Marketing opportunities

Tying loyalty to campaigns to measure ROI is essential. Below are channels marketers will typically consider:

- Card printing and distribution;
- TV;
- Radio;
- Newspaper;
- Content creation if required.

Sample campaign dashboard

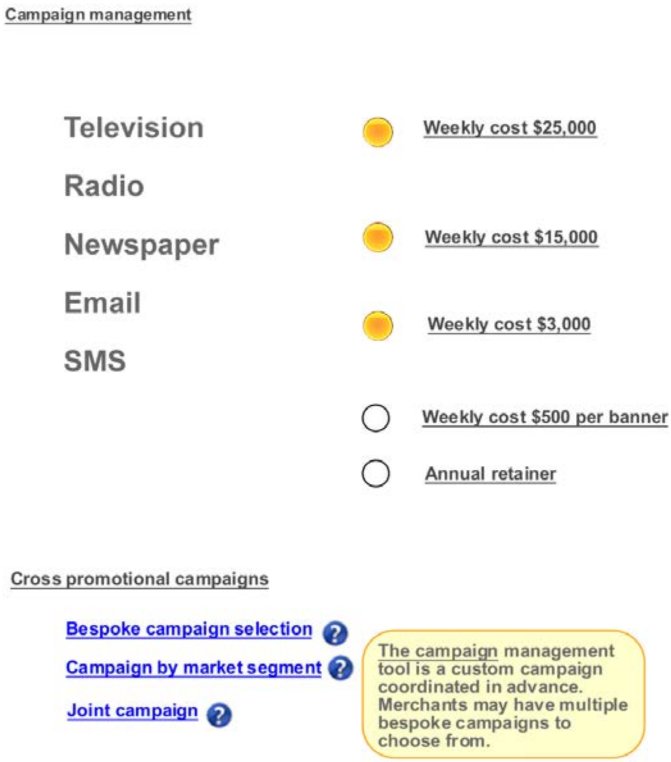


Figure 4 Campaign management dashboard

Chapter 8

Guidelines for working with card issuing banks

This section analyses the issues facing merchants looking to be in the credit card business and considering working with a bank. The objective is to provide merchants with tools to be able to understand their options.

Based on recent market activity, merchants have come to expect to encounter a hostile payment industry. It is a known fact that the card networks have operated in an anti-competitive manner for years. This fact has been substantiated in court judgements on more than one occasion.[61] In Canada, 9 FIs control about 90% of all Visa and MasterCard purchase volume as shown by 2011 Nilson data.[62] No wonder Visa's 2008 IPO, issued at the height of the credit crSoftcard, raised $17.9 billion, the largest in US history.[63]

The acquiring side is also distorted, the largest player being Moneris, a Joint Venture company owned by BMO and RBC. Moneris controls the processing for 350,000 merchant locations, or 3 billion transactions each year. This is almost 45% of Canada's 6.6 billion card transactions, all this controlled by just two banks. See table 6 for a breakdown of the players in the Canadian market. The picture is similar in the US and UK as well.

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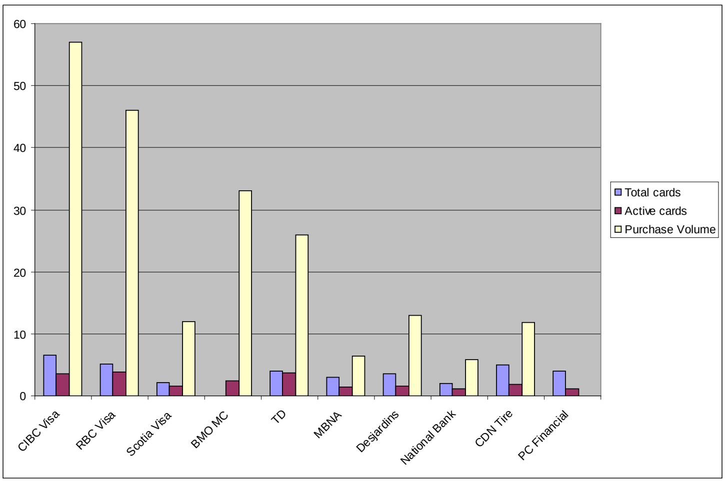
61 Courtney Rubin, Inc.com, October 5, 2010 merchants win the right to offer discounts and show swipe fees to consumers related to card transactions, merchants pay $35 billion a year in fees to credit card companies, according to the Justice Department.

62 Nilson Report, March 2011, page 6-7 table comparing Visa and MasterCard issuers.

63 Benner, Katie. "Visa's $15 billion IPO: Feast or famine?", Fortune via CNNMoney.com, March 18, 2008.

Table 6, Issuer Breakdown showing volumes for banks and merchants based on 2011 Nilson data and other sources.

Issuer	*Purchase Vol*	*Active Accnts*	*Market share by purchase volume*
TD/MBNA	*$46 bn*	*6 million*	*14.7%*
CIBC	*$60 bn*	*4.1 million*	*19.2*
RBC	*$57 bn*	*3.9 million*	*18.2%*
Scotia	*$16 bn*	*1.8 million*	*5.12%*
Cdn Tire	*$10 bn*	*1.7 million*	*3.2%*
PC Financial	*$10 bn*	*1.1 million*	*3.2%*
Total	*286 bn*	*85 million*	



Graph 12, Total cards issued versus active cards (millions) versus purchase volume (billions)

The graph 12 shows the characteristics of various card portfolios, broken down by total cards, active cards and purchase volumes. The variable to note is the contrast between bank issuers, and single merchant issuers. Bank issuers, like CIBC, are generally more profitable than merchant led or single merchant co-brand programs. As mentioned in previous chapters, banks are dumping certain co-brands. This is because many merchant programs are not economically viable for bank issuers. From a bank's perspective, card revenue is derived from fees, interest penalties and from interchange/transaction fees. Merchants, like Target, are more interested in driving retail sales. So the revenue models are different.

The situation in the UK is similar, where, according to the UK Competition Commission (CC), and based on comments by Tesco,[64] UK merchants programs had, ‘more than 11 million store cardholders in 2005, with balances of over £2 billion, versus over £65 billion for the wider credit card market. In 2002 there were 17.5 million store cardholders, a drop of 6.5 million, reflecting a general decline in the store-card market. In 2004, the market was controlled largely by Arcadia, Argos, Debenhams, and Marks & Spencer, which accounted for 50% of the store card accounts and balances.[65]

Different economic drivers as compared to banks, is shown by the indicators from table 6. Scotia Bank and Canadian Tire, a leading retailer, have significant purchase volume to cardholder ratios, despite having similar active accounts. This means less spend per active account on merchant cards. An example to illustrate this point is Tesco UK. Banks, according CEO, Andrew Higginson, ‘would not be fond of the Tesco credit card.’ In fact, Tesco is on record as saying that “banks do not like its model”.[66]

The explanation for the above statement by Higginson is that merchants, like Tesco, are not just looking at fee and interest revenue in evaluating a card portfolio. Merchants derive significant benefit from card programs via increased retail profits. Chapter 4 describe the benefits. So when executives at Tesco say ‘banks do not like their model’, they are referring to the fact that Tesco can afford to make less card revenue, because of the positive impact on retail sales.

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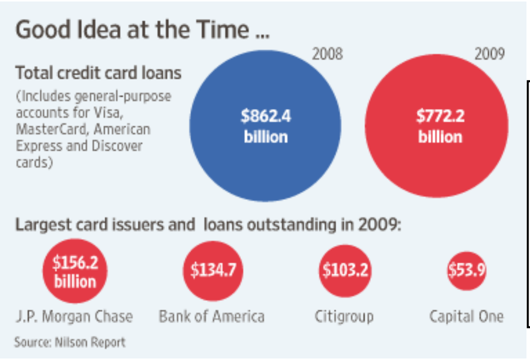
[65] Competition Commission, Store Cards Market Investigation, The Stationery Office, 2007

[66] National Retailers Federation Conference 2011 and http://www.pymnts.com/why-bankers-might-not-be-fond-of-the-tesco-credit-card/

Cards add value in other areas as well. For example, transaction data also help drive Tesco's retail operations.

This discrepancy is made clear in the following extract from the Wall Street Journal (WSJ). Essentially the article summarizes how bankers view and treat retail credit and loyalty card programs:



Graph 13 at right depicts a graphical sample of market share fall for co-brand programs Source Nilson Report 2009

Getty Images as appeared in the Wall Street Journal

Based on 2010 Wall Street Journal (WSJ) article by *Robin Sidel*[67]

The Starbucks' Duetto Visa card was launched with optimism in 2003. It has since been dropped.

According to Sidel, U.S. credit-card companies pulled the plug on many specialized, rewards-loaded cards. For example, J.P. Morgan Chase and RBC both dropped the Starbucks Duetto Visa card and also terminated credit-card deals with a number of other organizations. J.P. Morgan Chase, Citigroup, Bank of America and Wells Fargo all reduced the number of niche-appeal cards.

Chase's unit now has about 110 co-branded credit cards, down from more than 200 in 2008.

The Starbucks Duetto card clearly shows the impact a loyalty program can have for a merchant. Spokespeople for Starbucks said, "the program meant more than just a credit card to Starbucks, it was a means to engage its clients."

[67] Robin Sidel, Issuers Retreat From Plastic, Wall Street Journal, March 23, 2010

The Duetto card generated lots of buzz when it was introduced in 2003. Customers appreciated the flexibility to use it either as a traditional credit card anywhere, or turn it into a prepaid loyalty card by loading money onto it and using it only at Starbucks. Since being dumped, the program has blossomed. It currently accounts for 1 out of every 4 transactions at the retailer, or $1.5 billion dollars. In a recent announcement, management stated that their mobile platform has generated 70 million transactions so far.

Impressive? Maybe for Starbucks, but not so good for the bank, who commented at the time it dropped the guillotine: 'from a bank's perspective, the purchase size and the fact that the (Duetto) card is 3rd or 4th in the wallet reduce the return for the issuer. It was difficult to get the type of scale behind the program that we wanted,' said Gordon Smith, who runs J.P. Morgan's credit-card business. 'It was innovative and creative, but if these cards are small (transaction volume and purchase size), there isn't much earnings power for the partner or the bank.'

Not all programs are considered unprofitable from a banks point of view. Sidel found that Chase is keeping its most successful partner cards, including those offered with Continental Airlines Inc. and Marriott International Inc. The bank also recently entered a new card partnership with Hyatt Hotels Corp.

Examples of programs on the precipice

Citigroup dropped a three-year-old Home Depot Inc. co-branded card called 'Home Depot Rewards', a program that could be used anywhere. The card 'didn't resonate with customers as we had hoped,' said Bill Johnson, who runs the bank's card-partnership programs. The private-label Home Depot card, which can be used only in Home Depot stores, will continue to be supported.

Zale is another example of credit backed loyalty programs on the precipice. With 40 percent of the U.S. sales for the jeweller being made through the credit card, when Citi threatened to cut its program, it became imperative to management that a deal be reached that met the requirements of the bank: Zale's Canada stores had already lost the credit card deal with Citigroup effective June 2010.

Adding urgency to the negotiations process, from the point of view of Zale, was the looming holiday shopping season, and the risk to customer retention in the event the card were to be dropped. As a consequence, Citi was able to demand a $6 million penalty fee for not reaching transaction objective of $600 million on the card.

Recently however, with the return of a more viable card market, Citi and Zale negotiated a new deal with reduced sales requirements. The new requirements from Citigroup were revised to $315 million.

Citigroup also agreed to give up a payment of $396,000 that Zale owed as part of the $6 million penalty that Zale had paid the bank between June and August of that year.

After the deal, Zale saw shares shot up 10%.[68]

Based on an evaluation of programs, the following summary show top reasons why banks believe that co-brands are not viable:

1) Not enough scale;
2) Poor value, customers do not want to carry 17 cards so stick with the ones that provide real rewards;
3) Complicated to understand or administer;
4) Credit risk. Many co-brands become the 3rd or 4th card in the wallet, this can mean credit risk as it becomes the first card not to be paid;
5) Often low value transactions and low balances.

Among the negative factors, credit risk is significant. As an example of added credit risk for merchant programs, Target's Delinquent Receivables (TDRs) were pegged at almost 11% of the portfolio in

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[68] CreditcardsCo, Citigroup holds on to Zale Credit Cards, September 10, 2010.

2007,[69] 6.7 percent January 30, 2010, and 5.9 percent January 29, 2011.

Merchants decisions not to partner with issuing banks

There are many ways merchants can be in the credit card game. Five basic options to consider are shown on the table on the following page. These include: co-brand, self-issued and coalition.

[69] Taken from Target 2010 Annual report. See Target Overview.

Merchant program options table	Co-brand with single merchant	Self-issued
Consumer appeal	Limited appeal and low active user rates for most merchant verticals.	Limited appeal and low active user rates. Usually 3rd of 4th in wallet. Some programs have succeeded in high own card transaction rates at POS.
Profitability of program	Successful where merchants fund rich rewards such as hotels. Hundreds of co-brands dropped during credit crSoftcard due to poor economics.	38% fewer transactions compared to bank issued.
Offer merchants access to data	At the discretion of bank.	Full access.
Possibility of cross promotions	No	No
3rd party risks & liquidity risk	Banks dropped hundreds of co-brand programs during the credit crSoftcard.	Liquidity risk and potentially high costs of funds if economies of scale not met.
Operational costs to merchant	Merchant funds rewards or pays swipe fee.	Operational costs $73 - $102 per active per year.
Risk to merchants	No credit risk. High reputational risk that bank may drop program or impose penalties. Risk to retail profits if rewards program lost.	High operational risk; credit risk; liquidity risks. Programs sometimes not geared to profitability by merchant choice.
Lift	Strong lift as long as no loyalty apathy.	Strong lift but could level off if program rewards not optimized.
Shopping frequency	Proven increase (see above).	Proven increase (see above).
Future proof = innovation	No, banks are usually slowest to innovate.	Limited and expensive

Merchant options	Coalition	Frequent flier	Card Linked Rewards
Consumer appeal	Strong appeal to most consumers.	High	Mid to high
Profitability of program	Likely to rival bank issued programs in terms of active users and spend levels.	$4 billion per year in revenue for merchants.	High
Offer merchants access to data	Full access, with possibility to create enhanced reporting and analytics.	Yes	Yes, but expensive
Possibility of cross promotions	Yes. Studies show that cross promotions can increase market share for participants.	Limited as redemptions online, although AirMiles now offer redemption at POS.	Yes, this is the main intent.
3rd party risks & liquidity risk	Low risk	Low	Low
Operational costs to merchant	Operational costs $90 per active per year initially and lower in subsequent years. Many value added services at shared costs.	0	Cost to fund promotions.
Risk to merchants	Low, governed by OSFI. Merchant risk mitigated by corporate bylaws.	Low	Low
Lift	Strong lift	Medium to high	Low to High
Shopping frequency	Proven increase and stronger over time.	20% of users are frequent travellers.	Low to high
Future proof = innovation	Merchants to benefit from the latest innovations and analytical capabilities.	High but expensive.	High

The following summarizes why coalition led, branded, credit backed rewards is a superior option for merchants regardless of vertical.

Single merchant co-brands are not an option for the following reasons:

1) Apart from verticals like airlines, banks want to partner only with specific merchant types. Normally these are high margin clients willing to subsidize rewards, offer valuable promotions or provide performance guarantees with penalty clauses;
2) Meanwhile, in many co-brand relationships, aggressive member boarding initiatives are usually paid for by merchants, as are rewards via swipe fees. In many cases, merchants will also fund supplementary promotions;
3) The bank usually keeps most or all card revenue, such as card fees, penalties, and net interest margin. Banks also own the client and the receivables, and may even charge merchants for access to transaction data.
4) Banks have dumped hundreds of co-brands, including popular ones like Starbucks Duetto, over the past 5 years, leaving merchants to pick up the pieces.
5) Merchants cannot leverage cross promotion opportunities, which are proven to increase revenue for all program participants.

<u>Self-issued</u>

1) While this offers merchants control and loyalty benefits, there is considerable liquidity risk when times are bad and only larger pools of cards can attract interest from 3rd party funding efficiently. There are other scale issues and cost considerations that make this a more expensive and less profitable option.

Coalition

1. Coalition programs offer advantages across every category. In summary they offer:

a. Proven ability to increase lift and revenue across the entire group;
b. Profitability that can rival bank issuers;
c. Reduced operational costs due to scale and in the case of this coalition, specialized knowledge of technologies and system selection which will reduce costs of operations;
d. Possibility of cross promotions;
e. Strong consumer appeal across multiple, ongoing reward types and merchant promotions. This will ensure high active users over time;
f. Reduces risk to merchants over self-issue due to strong corporate bylaws and improved capacity to manage liquidity.

Frequent flier (FF)

1) Frequent flier programs are beneficial to airlines. They provide significant opportunities to increase sales. In summary:
    a. Established over 25 years ago as a tool to identify the highest revenue-producing travelers;
    b. Airline marketers readily admit it is difficult to fully quantify the loyalty effect of FF.
    c. The ancillary revenue of FF is $4 annually for seven programs analysed in a 2008 IdeaWorks study;
    d. The total participation in only seven programs 255 million;
    e. Active membership ranges from 25% to 40%;
    f. Typically penetration levels, according to MasterCard average 20% of airline travelers, but can be as high as 44%.
    g. Annual charge activity per active account may range from $15,300 to $22,900;
    h. Airlines typically have holds on cash due to risk of insolvency. United Airlines was give $1 billion increase in the short-term cash position by Chase by

promising to keep its Mileage Plus Visa card with Chase.

2. Card linked rewards (CLR)
    a. No upfront costs, merchants pay for results;
    b. Merchants provided with detailed reports and have ability to measure ROI;
    c. Fulfillment is automatic at POS;
    d. Target or ideal clients base issuer data.

Merchant strategies and relationship structures

Merchant led financial services are growing in importance once again. This is exemplified in the ongoing UK rivalry between ASDA, Sainsbury and Tesco. Together these merchant/financial service companies provide the backstop for three different approaches for merchants looking to extend their financial services.

Sainsbury's recent buy-out of Lloyds Banking Group's 50% of shares for £248 million, is one example of the evolving importance placed on financial services; rival Tesco opening its first current account, which according to Benny Higgins, chief executive of Tesco Bank, "is the final brick in the wall in the building of our bank," is another manifestation of the evolving market structure; meanwhile, ASDA has partnered with Barclays to pilot in-store branches to complete the hat-trick. Coinciding with these financial service roll-outs, discounters are gobbling up market share from the core business of these three retail goliaths.

The official backstory behind Tesco's land-grab, according the Adam Palin of the Financial Times is to tap "…into their large customer bases to offer banking services and shopping under the convenience of one roof. The group (Tesco) has spent approximately £600m building standalone infrastructure since buying RBS out in 2008." However, a contrarian explanation might be that these current accounts offer a cheap source of funding for Tesco's card programs as explained below.

Marks and Spencer launched its free account in May, powered by HSBC, while Tesco plans to go it alone. The downside of Tesco's approach being that "…the new product will slow profit growth at the bank, which reported a whopping pre-tax profit of £153m in the year to February 28, 2014. Considering Higgins already precarious position as a result of Tesco's well publicized loss in market share of late, the question begs: *why bother?* One possible clue is that with about 1 in 9 transaction at Tesco on its own card, we can guess the source if this profit and also be sure that there is a boatload of credit card receivables that require a source of low cost funds.

Tesco plan to entice customers to its new current account by providing a better offer than high street banks. The mechanics being that Tesco will use its virtual bank and introduce newly regulated account switching technologies to smooth consumer transition and allow deposits in-store. Essentially, the Tesco offer involves a monthly fee of £5 which is waived for customers who deposit more than £750 per month. Even more compelling is annual interest as low as 3 per cent on credit balances up to £3,000, no monthly fees payable for using arranged overdraft facilities. Consumers only pay interest on borrowing.

These terms are comparable with new accounts offered by other so-called "challenger" banks, such as TSB, whose Classic Plus account offers 5 per cent on balances up to £2,000 and which requires a minimum monthly deposit of £500.

The trend for merchants to extend their financial services is not restricted to the UK. However, the motivation in other regions, such as the U.S., may be more profit based as opposed to being set up to better serve customer needs and extend rewards programs. The profit argument is supported by spectacular card revenue as follows:

- Macy's 2012 card program profit - $865 million from partner Citi Retail Services versus $528 million for 2010.
- Nordstrom 2014 card program revenue $374 million, up slightly from the previous year.

Apart from motives, there is a significant structural difference between the UK and US which further affect the bottom line. Whereas UK merchants have successfully lobbied to put caps on transaction fees for credit and debit transactions, the same is not true of U.S. and Canadian Merchant transaction fees (merchant discount). The U.S. pay the highest fees in the world, but are capped in Europe.

Common to both the U.S., Canada and the UK is the fact that merchants also typically have a higher cost of funds and are under pressure with respect to liquidity risks. A recent securitization transaction involving Canadian Tire bank, described below illustrates this point, as does Target. Target in particular was adversely affected during the credit crSoftcard and in reaction to significant liquidity issues experienced sold its receivables to TD bank. A detailed case study of Target's liquidity issues and also its recent data breach are covered in my book.

A recent article that appeared in the Globe and Mail illustrate merchant's liquidity concerns facing U.S. and Canadian merchants. According to Tim Kiladze of the Globe and Mail, Canadian Tire Financial Services (CTFS) sold 20% of its card business to Scotiabank. This transaction led to Moody's downgrading Scotia's ratings. This means that if Scotia is hit this badly due to credit risk, clearly, a merchant led FI would feel it even more. CTFS executives say as much in a related statement, "What Scotiabank is offering is a rock-solid backstop," in Mr. Wetmore's words, that will ensure investors never have to worry about funding issues again.

To sum up the deal; Scotiabank has committed \$2.25-billion – \$250-million in a revolving line of credit and \$2-billion through a note purchase facility – that will allow Canadian Tire to fund itself in times of market stress. Scotia also purchased a 20% stake for \$500 million.

On the surface, CTFS has benefitted from some of the lowest costs of capital, with a coupon rate just a few basis points higher that Canada's large banks. CTFS was also the first Canadian asset-backed initiative since the credit crSoftcard, by issuing \$635-million in credit card receivables on February 4th, 2008. To further show CTFS ability to generate funds, the table below offers a glimpse of how CTFS managed is receivables through Glacier Trust. Given CTFS related statements this shows that appearances can be deceiving.

Section summary

A reallocation of swipe fees is a primary reason for merchants looking to be in the credit card business. The structure of this, however, can take many forms.

Successful programs depend on good corporate governance, sound risk management strategies and advanced technology. Factors which mean many merchants do not have the stomach to go it alone; also expense and expertise are significant which explains why many merchants partner with banks. Starbucks is a rare exception, having a huge margin to work with helps. A common trend is sharing the cost by working in a coalition. This is a logical way to rationalize expenses and still get the latest technology and scale required to power a program.

Working together also adds value to the rewards incentives for consumers. This is backed by research that shows that current programs are confusing and often frustrating for consumers. This means establishing a clear program that is easy to understand and provides high-perceived reward value for consumers. So with the combination of excellent rewards, and a very low account boarding cost, a merchant led program begins to rival or exceed the returns of a bank issued program.

Some of the benefits include strategic consumer data, which in the case of Tesco enabled this merchant to gain significant insight in a short time. As Tesco's chairman, said early into the launch of Clubcard, "What scares me about this is that you know more about my customers after three months than I know after 30 years."[70]

To summarize, despite the fact that credit card programs have proven to be very profitable for merchants, as shown by companies like Tesco, having a return on assets of 27% compared to 6% for its grocery division;[71] a new merchant paradigm, where credit and

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[70] Mesure, Susie (2003-10-10). "Loyalty card costs Tesco £1bn of profits - but is worth every penny". *The Independent*.

[71] Rupert Jones, The Guardian, December 10, 2010.

loyalty programs are primarily mechanisms to support retail operations, has emerged. Spearheaded by the likes of Tesco, this view stands in opposition to earlier paradigms by merchants and banks alike, which looked at card programs first as revenue drivers.

Chapter 9

Program marketing

The following section provides an overview of general marketing approaches for merchant-led, credit backed, loyalty programs which could be applied either to a coalition credit backed card project or in scenarios like MCX. Topics covered include: calculating reward levels, initial pilots, and project rollout. Obviously, one of the primary marketing drivers is the perception of the value of the incentives, and this is covered in previous chapters.

Build strategies for successful rollout

Once reward levels are established, a list of general criteria for marketing a card is:

1) Develop staff training, ongoing communication strategies and procedures and marketing material for employees;
2) Testing methodology to evaluate customer receptiveness before rollouts, including regional pilots;
3) Scaled rollout to reduce risk;
4) Ensure efficient issuing capacity;
5) Put in place risk management processes;
6) Ready quick rollout plan and scalability provisions.

Required cross-promotional marketing features

Through regular communication with cardholders and prospects, including reminder mailings, cross-sell and up-sell offers, satisfaction and opinion surveys, and collection of information for member databases, there will be many promotional possibilities. In order for cross-selling to be acceptable to merchants, they will require the ability to set data sharing rules, such as: who, when and how merchant partners have access to data, definition of target market, and define budgets. Merchants also require the ability to negotiate

Tesco Clubcard Direct Mail strategies

Tesco Clubcard use DM to mail its quarterly Clubcard statements. Initially, according to Clive Humby and Terry Hunt, in their book 'Scoring Points', Tesco direct mailing (DM) was considered a big leap of faith. Consumer response validated their beliefs. What they came to learn is that Clubcard members perceived the quarterly mailing not as "junk mail", but as personal mail similar to a bank statement. Tesco DM has since become one of the world's most profitable mailing programs. One of the distinguishing features of the Tesco DM campaigns was that there were 1,800 variations of customer segments, preferences and local details. By 1999, this mass customization of the mailings had risen to 145,000 versions. Today, Tesco sends out between 8-9 million mailings.

Tesco placed a high value on data mining and analytics. So the fact that they were creating a sense of customer frustration through their mailings became something they referred to as 'irrelevance'.

Customers complained that if Tesco were monitoring what they bought, why was it sending them irrelevant coupons? It was found that of the six coupons, two or three might be useable, but this was not enough.

As a result, today its coupons are for goods that the shoppers already buy, and two are for related items. The two bonus coupons are chosen using an analysis that shows that the customer has a high propensity to buy a product, but has not yet tried it.

Tesco strategies:

- Learn what clients want. If customers value coupon redemption, provide this. If certain customer segments have a low response rate then find an alternative that they will respond to.
- Reduce risk by testing ideas and offers with representative sample groups;
- Measure results and tie these to ROI.

cross-selling opportunities with other merchant members. They may also consider setting up affiliate marketing commissions as well. Sample marketing campaign

Goal: 1 million accounts

Budget $25 million per year

Marketing Tools:

1. Web site
2. Referral program;
3. Dynamic employee training and promotions at till
    a. Employee incentives;
    b. Employee contests;
4. Merchant client screening
    a. Email;
    b. DM;
    c. Telemarketing;
5. Conversion from existing loyalty programs;
6. In-store card malls;
7. In-store banners;
8. Gift card conversion;
9. Real world media
    a. TV;
    b. Radio;
    c. Print.

Sources of traffic

- Link from participating merchant sites;
- Referrals program;
- Personal account holder referrals;
- Link from Google ads;
- Email link from merchant ongoing promotions.

Referral program

- Tiered referral program based on referred member's activity levels: $10 for first $1000 in sales; $25 when person reaches $3000 in first year;
- Program linked from Web site, through email communications and add contacts from account dashboard;

- Easy to follow workflow essential.

Overview of components of dynamic training program for staff

a. Training program geared to teach the fundamentals of the cards. Training also helps manage expectations and the role trainees play;
b. Trainees will have the opportunity to earn their own pre-loaded card to spend in any of the participating stores;
c. Video training material and competitions designed to build awareness for the programs and the benefits it will bring to cardholders and the organization;
d. Bespoke for each merchant. Each merchant will have its own version of training material presented in English and French. Components of a training program include;
    i. Training material will explain how the card works;
    ii. The benefits to cardholders;
    iii. Provide responses to questions that customers will typically ask (FAQ);
    iv. Demonstrate how the card fits into the companies overall marketing plans;
    v. Competitions will rank employee understanding of the programs and offer rewards to successful participants;
    vi. Assists to appoint store level experts responsible for local training at local levels;
    vii. Select merchant training center;
    viii. Set up online training that requires sign-in procedure;
    ix. Define employee incentives. Example, offer employees $X value incentive card when they complete their training. This will serve the dual purpose of piloting the system and providing training;
e. Training incentives
    i. Contests;

ii. Cash incentives;
iii. Points;

f. Hostess program setup.

Sample employee contest

Sample employee incentive notice
Sales Associates: receive up to $300 when you sign up 25 new Merchant card accounts. Plus For each new account you receive an entry in the $5,000 shopping spree draw at the end of the contest. Store managers: Win $500 CASH. For each 200 applications taken in your store, managers are entered into a draw for one of 25 $500 CASH draws. Assistant Store managers: Win $250 CASH. For each 200 applications taken in your store you are entered into a draw for one of 25 $250 CASH draws. All Store Personnel: Win $25 CASH if your store reaches the team goal of 200 applications per store.

Contests timed to back to school, Christmas, Mothers Day, Valentines Day, Easter, spring, summer.

- Staff that attract 15 new account applications in 6 week period receive $100 in points;
- Staff that attract 25 new account applications receive $300 in points;
- Award $1 for every $1000 purchased on The Merchant card at the till.
- Announce contest via personal email to employees, online video and even via SMS to employees;
- Offer incentives for employees that take online training related to contests such as $5 in points per session;
- Offer prizes to employees that offer cards to mystery staff;

- Create contest brochure for each contest and YouTube video.

Hostess program

Direct promotion of card programs by staff is considered the quickest, most guaranteed means of client boarding. By talking to clients of merchant's stores, at the point of sale and in the aisles, in conjunction with a strong incentive to join, these programs generally have higher overall activation rates than other forms of credit card acquisition.

Requirements of a hostess program:

- Set up a kiosk near the store entrance;
- Select a promotion that consumers will value;
- Set up a card mall next to the hostess program for busy shoppers;
- Time program according to holidays, store openings or other compelling events;
- Offer instant credit (less than 5 minutes if possible).

Training costs	Cost per day	Cost per person
Instructor + training material		$25
Training material		
Misc training expense	Meal $15 pp	$10
Binder	$10 per trainee	$5
Prizes	$25 per individual that completes online training modules	$25
Subtotal training		$55
Binder development, design and editing	$3,500	$3,500
Video training	$12,000 + $3000 per store to customize	$15,000
Online test development	$3,000	3,000

Pilots and market testing from a sample merchant

Pre-launch marketing

a. Test cities that are contained and can be isolated from other markets;
b. Training requirements for test markets (examples of criteria for training: cardholder recruitment, marketing, regulations (KYC/AML) etc.);
c. Define evaluation parameters for trainers;
d. Identify market segment to be tested;
e. Define test marketing communication channels: integrated email, direct mail, Web site[72] in store promotions, card mall…

Pre-launch test costs 1 city	
Training	$2,315
Marketing material	
$20 per 2.5 feet H X 4 feet W / process color / ceiling mounted with stand & mounts	$6,837
Card mall/card display stands	$3,710
Cards	$4,240
Media creation & placement based on 4 views per person 1-month duration.	$19,200
Shipping fees	$2,200

[72] 68% of recipients will open mail if their name is on it and 35% indicate including a gift card increases the appeal of the mailer.

Direct mail 1000 pieces	$1,040
Cost summary	$39,542

Marketing collateral requirements

a. Physical cards

  i. Define card specs;

  ii. Issue RFP;

  iii. Define vendor selection criteria, quality, security standards etc.;

  iv. Design card look and feel;

b. Secure packaging

  v. Define packaging specifications for direct mail cards;

  vi. Define in store packaging requirements if different;

  vii. Define security requirements and card handling procedures for each card type;

c. Hangers/in-store merchandising displays (card mall)

  viii. Define requirements;

$70 per stand

2. Direct Mail (DM)

Direct mail, using Merchant member data, The Merchant will distribute direct mail to prospects.

a. Determine available data;
b. Determine how administrators will access and manage cardholder data for each merchant;
c. Determine procedures for sharing data (i.e. mailing house, card manufacturer);
d. Agree to privacy policy.

Designing DM package is critical for success. According to Bill Grady, author of, 'Credit Card Marketing,' and a person who has been behind many credit card innovations, "Marketers must convince recipients within 3 seconds to open their package." As he puts it, consumers generally view DM in the following order:[73]

1. The letterhead;
2. The greeting;
3. The signature;
4. The P.S.

Card technology has improved and so has the expectations of consumers. Integrated card packaging, combined with advanced security features has become table stakes.

Pre-approved market segment

Merchants have customer data that can be used to target specific individuals. Typically for Canada, potential cardholders will receive a pre-approved mailer with a credit limit assigned. Prior to issuing the card, the merchant will have pre-screened the prospect and she will have received a credit score that would be tied to her credit limit. Merchants may also tie these campaigns to telemarketing campaigns and other targeted solicitations.

[73] Bill Grady, Credit Card Marketing, John Wiley & Sons, Inc, NY, 1995.

Credit scoring is typically tied to a defined set of variables (example FICO score). In Canada, details on individual credit are obtained through Equifax or Transunion and tied to a complex formula that weighs the amount of debt to credit to calculate the score which is tied to credit risk.

Based on the score, in Canada it is legal to mail pre-approved credit cards, while in the US issuers are required to first obtain approval from prospects before issuing a card.

Factors to consider in pre-screening potential cardholders:

1. Initial cardholder selection
    a. Determine potential target list
        i. Known customers at least 2 times more likely to activate card;
    b. Prioritize list based on various factors
        i. Demographics;
        ii. Location (postal code) ;
        iii. Income level;
        iv. Buying history;
        v. Budget available;
        vi. Other priorities;
    c. Number of accounts needed;
    d. Qualified lists from 3rd parties (rented lists);
2. Pre-screening data management
    a. Choose credit bureau;
    b. Securing source documents;
    c. Determine scoring processes, exceptions, and credit limits;
    d. Optimize/normalize list for processing;
    e. Determine data handling and security processes;
    f. Normalize data for credit bureau and mailing house;
    g. Cross reference data against existing customers or partner lists.
3. Determine campaign type
    a. Direct mail

i. Select mailing house for addressed admail and printing;
ii. See marketing collateral requirements section for details on requirements.
b. Telemarketing
i. Write scripts;
ii. Training;
iii. Signup process.
4. Set campaign management and tracking procedures
a. Assign tracking codes;
b. Provide card production vendor card data;
c. Test cards.
5. Campaign
a. Set reward incentives;
b. Set time limit;
c. Define call to action.

In-store marketing
According to Tim Mason, CEO, Tesco has many ways to reach prospects for its financial services that banks do not. Tesco recruit financial services customers using its physical assets, brand recognition and loyalty. 'It costs us one-fifth the cost to any conventional financial services company.'

Factors to consider in campaigns:
6. Cardholder resources to be made available:
a. Develop detailed online program information and FAQ for self-serve support;
b. Set up 800 numbers and scalable call center[74];
c. IVR system to allow remote self service and reloading of cards via prompts.
7. Manufacturers support

[74] Most companies outsource call centers to countries such as India or the Philippines. In 2005 Nectar UK decided to outsource 80 call center jobs to a company in India. Shell has multiple call center arrangement depending on which card is used. Some examples include centers in Omaha and others in the Philippines.

a. Provide merchants promotional opportunities, discounts, strategies for manufacturers. Build out program;

8. Sales/marketing channels

a. Email: outline email marketing strategy, partners, and campaign opportunities;

b. Direct mail: define direct mail requirements, vendor selection;

c. Define media plan for mainstream and online media

  i. TV;
  ii. Radio;
  iii. Print.

9. Cross promotions: define cross promotion opportunities and strategy;
10. Online;
11. Define online strategy and build web site;
12. Social media: define social media marketing strategy.

Sample launch costs consideration for single merchant

Marketing material by store and by chain.	Card stands per store	Total card stands	Cards per store	Card total
Merchant Stores	1	4,000	400	1,600,000

Staff training per store	Staff training all stores	In-store banners per store	In-store banners total requirement	Total stands required
1	$165,000	3	12, 000	4,000

Set up costs for a retail chain

- Card stands = $280,000;
- Staff training = $165,000;
- In-store banners = $400,000;
- Cards $3,200,000 for chip and pin;

- Total set up costs for a retail store with 4,000 locations = $4,085,000.

Timing campaigns
Ideally merchants will time their campaigns to maximize their relevancy. Hardware companies will market during the springtime, travel companies, leading into summer.

Key promotion dates:
- Mothers Day;
- Graduation;
- Fathers Day;
- Back to school;
- Christmas;
- Birthdays.

Post-Launch Plan
1. Define 3, 6, 12 month contact strategy for consumers;
2. Develop product roadmap for program enhancements;
3. Refine distribution channels.

Future goals for customer spend increase

Goals for each cardholder tier (e.g. spend goal)

Example: 70% of sales being represented by loyalty program members.[75] To reach this goal the organization must do the following:

- Identify the most profitable customers;
- Reinforce brand value;
- Support the customer experience with the brand;
- Strengthen member relationships;
- Increase engagement with members;
- Increase spending.

[75] Canadian tire state that 17% of their clients produce 76% of their revenue, from 2010 financial statement.

Chapter 10

Perspectives on merchants controlling acquiring processing

This is significant because mobile payments have the potential to change the rules of the payments game. Acquiring is not always well understood by merchants. For open looped branded cards, it is the step in the payment process immediately after the transaction leaves the merchant's hands, and just before hitting the card networks, be they Visa, MasterCard, Discover Network or Interac. Chapter 3 covers this in detail.

Acquiring is a volume-based business, and typically becoming a financially viable processor requires scale - something that many retailers do not have. Walmart is an exception has enough volume to be considered efficient, and has threatened to take control of acquiring in the past. That said, despite its size, Walmart has still opted to use a third party for the acquiring processing.

> *To quantify the impact of becoming an acquiring processor on Walmart's bottom line, consider the actual processing costs on its $312 billion sales have only a few million (3-10 million) in processing fees, a figure described by industry experts as "peanuts"*

A more valid argument to justify assuming the acquiring role, which has been put forth by some analysts, reflects Walmart's desire to improve efficiency in the payment process, or even *find new ways to streamline the payments business.* As the merchant consumer exchange (MCX) indicates, this has become more than just a talking point going forward. Early on, MCX announced an initial launch date of June 2013. Obviously this has been pushed back and there is currently no official launch schedule.

Background on acquiring

Overview of the acquiring processing market in Canada

In Canada there are only 7 direct payment processors and many independent service operators (ISOs). The current environment is the result of a strategy shift that took place starting about 10 years ago. At the time the banks controlled acquiring but spun out this service to 3rd parties. Perceived need for high volume, and commodity pricing is what prompted banks to separate their issuing and acquiring services. Also, at the time, banks generally had either Visa or MasterCard relationships and needed to offer both in order to be efficient. Moneris was the first Canadian firm to combine processing for both and managed to capture 45% of the Canadian market.

Recently, however, some FIs have reversed earlier decisions (as agreements expire) and are actively growing their processing business. For example, March 2011, CIBC said it would terminate its sponsorship of Global Payments and force Global to become a direct processor. Similarly, TD severed its relations with First Data in 2009. First Data is now regulated as a loan company and Global Payments has made a similar application with Canadian regulators. This leaves CIBC and TD free to steer their merchant clients to their own processing services.

US processors include:

- BAMS (Bank of America Merchant Solutions) 20% market share
- First Data Corp. 14% market share (NYSE: FDC) is a leading provider of electronic commerce and payment solutions that was aligned with TD for approximately 10 years ending in 2009. First Data have a small presence in Canada but serve 4.6 million merchant locations globally, 1,600 card issuers and millions of consumers. The company's portfolio of services and solutions includes credit, debit, private-label, gift and other prepaid card issuing and merchant transaction processing services; fraud protection and authentication solutions; check guarantee and verification services through TeleCheck; as well as

Internet commerce and mobile solutions. The company's STAR Network offers PIN-secured debit acceptance at 1.9 million ATM and retail locations.

- Chase Paymentech Solutions 11% market share is North America's largest transaction processor for businesses accepting payments via point-of-sale, hospitality, Internet, and recurring billing for merchants of all sizes and industries. In 2005, Chase Paymentech processed approximately 15.5 billion transactions, and more than $560 billion in annual bankcard volume

> For a merchant considering taking on the acquiring responsibilities the requirements are substantial. The following is an overview of some key steps necessary to become a direct acquiring processor:
>
> - Create an entity: registering a loan company will suffice in Canada;
> - Become or find an underwriter. Typically the 'processor' that handles the actual merchant account, sets transaction fees, and issues merchant statements enters into a direct relationship with the processing underwriter, which is the "bank" in the relationship. To become a processing underwriter, or bank, requires millions of dollars (in the case of Walmart US it was estimated at $125 million) in capital to allow for the underwriting burden of Visa payment transactions. (See page 197);
> - Certification: Note that to become a direct processor requires individual certification directly with Visa, MasterCard, Amex, Discover and Interact. Certification applications require investments of $50 - $100 K per network plus integrations costs, PCI compliance and significant technology infrastructure. Issuing and acquiring certification are separate applications.

Processors typically process the following payment types:

- VISA;
- MasterCard;
- American Express;
- or any combination of the three;
- Debit;
- Discover or Diners.

Other important payment merchant processing requirements include:

- Sepa *(in the UK)*
- *C*heque clearing and settlement;
- *E*lectronic bill payment*s;*
- *W*eb-based payment*s;*
- *EFT/ACH.*

Note that a significant portion of processor revenue is typically generated from renting or selling POS devices, gift card programs, as well as services and software sales. To achieve scale, processors often partner with ISOs[76]

Overview of acquiring based on an extract written by Moneris US[77]

Greg Cohen, President of Moneris US is very aware of the rates merchants pay to accept credit cards, and the scrutiny they are under. Cohen is quite frank about the way the industry has been exposed in the media; an industry he acknowledges that has been

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[76] ISO means "Independent Sales Organization" and MSP means "Member Service Provider."

- An ISO/MSP is any organization that is registered respectively with Visa, MasterCard and a sponsoring Member Bank and who is charged with the duty of acquiring merchant contracts and supporting them on behalf of their sponsoring bank.
- An ISO/MSP is not a financial institution but rather a business that provides services "on behalf of" a Member Bank. Only an actual financial institution can become a Member Bank with Visa/MasterCard.

Sometimes ISO/MSP's loosely refer to themselves as "ISO's" or "MSP's" instead of the full term but it all means the same thing - a company that works on behalf of a bank to setup and manage merchant accounts.

[77] Greg Cohen, Where Does the Money Go, Transaction World, No Date

filled with reports of alleged collusion and price fixing. "Merchants have complained publicly and filed a number of well-publicized lawsuits. He wrote, as a result, both businesses and the public are now much more aware of the costs of accepting credit cards."

Cohen feels that Moneris is "in the trenches, feeling, hearing and seeing its merchants pain every day." His frustration is that many merchants "complain to, and even blame us (acquiring processors) for the high costs, or pressure us to lower our rates and fees. In the midst of this environment, it is only natural to wonder exactly where the various fees go, and how much of the situation we can actually control."

Chapter 3 breaks down the players and proportion of fees. Cohen argues that 65% of the total cost of merchant acceptance (the swipe fee)—nearly 2/3 —goes to the issuer. This figure is supported by a 2006 Canadian government sponsored survey that indicates 65% to 80% percent goes to the issuer.[78]

In Cohen's scenario, the majority of the networks' revenues are derived from charging the acquiring banks 'assessments' per transaction of approximately 9.5 bps and the processors a small fee—approximately $0.005—for each transaction processed through their networks. The effective revenue stream the networks receive is 0.10%— or 10 bps—of every transaction. Spread over the billions of dollars, this equates to a large amount. The last major piece of the pie is the acquirer.

For the sake of ease, Cohen lumps acquiring banks, processors and ISOs together as stakeholders in the payment ecosystem, each with its own revenue stream. To make his point, Cohen references consultants First Annapolis, a well-known consulting firm.

Cohen's analysis is based on a merchant with a gross annual processing volume between $250,000 and $500,000. For this example, the acquirer revenue equals 0.94% of the processing

[78] Canadian Economics Association, Papers, 2007

volume. Of course this will vary by merchant and is based upon the merchants' average ticket size, business type and so on. Never the less, the 94 bps, commonly known as the 'Acquirer Spread', represent 31% of the total cost of merchant acceptance.

The Acquiring BIN/ICA Sponsor and the processor together make up only 15% of the Acquiring Spread, or 14 bps. Cohen points out that, "The underlying transaction risk is held solely by the sponsoring financial institution (the Issuer)".

To justify the fees of the acquiring processor, Cohen lists some of the items it is responsible for:

- Certifies hundreds, if not thousands, of POS systems;
- Maintains authorization systems and communication networks and settles billions of dollars annually;
- Ensures that all of its systems (authorization, clearing and settlement) remain compliant as the networks request numerous changes throughout the year.

Breakdown of acquiring revenue:

- The Acquiring bank that provides the BIN and ICA averages 2 bps and the processor only 12 bps;
- Of the Acquiring revenue—85%— lies in the distribution channels. In the traditional Super-ISO model, which includes both a sale office and sales agent, the ISO too must pass a share of his 80 bps downstream;
- Super-ISO will pass 45 bps through the channel and retain 35 bps as gross profit to run his business;
- Sales representatives, receive as much as 25 bps—or 56% of the sales offices' revenue—downstream. [79]

Payment trends

[79] The model works similarly to a multi-level business, as the upstream entity makes less per sale, but collects revenue from multiple sources.

Cohen identifies an emerging trend of interest to retailers, and this is the collapsing of layers in the distribution channels. Many processors and acquirers have come to realize the majority of the revenue lies in distribution, and have developed large and often sophisticated sales organizations. By eliminating levels of the distribution channel, they are able to create efficiencies in the market. Similarly, Super-ISOs may sell directly to the merchants and remove sales offices and merchant-level salespeople, creating additional market efficiencies (see table 8).

STAKEHOLDER REVENUES & SPREADS IN CARD ACCEPTANCE

			$250,000 Annual Volume
Merchant's Cost of Acceptance	2.99%		$7,475
Issuer*	1.95%	65%	$4,875
Network	0.10%	3%	$250
Acquirer**	0.94%	31%	$2,350
Acquirer (BIN/ICA)	0.02%	2%	$50
Processor	0.12%	13%	$300
ISO Rev	0.80%	85%	$2,000
ISO GM$	0.35%	44%	$875
Sales Office	0.45%	56%	$1,125
Sales Office GM$	0.20%	44%	$500
MLS	0.25%	56%	$625

* Provided by First Annapolis

** Provided by First Annapolis for merchants with annual processing volume of $250K - $500K

Table 8

In defence of acquirers, Cohen pushes the blame for high costs directly on the issuers. He feels that the current model is amazingly efficient, but constantly comes under scrutiny in the courts and the marketplace. This is ironic considering the emphasis BMO & RBC put on the card divisions and the fact that a large portion of this revenue is likely to be attributed to device rentals.

Conclusion

With the emergence of mobile payments, and the risk of even more payment layers, the argument for MCX is evident. The June 2013 launch will surely have the payment industry on tender hooks in anticipation.

Chapter 11

System selection guidelines

Assuming the merchant has made a decision to become a card issuer. Based on this, the Issuers goal is to implement *industry* compliant (Proprietary, Visa, MCI or Discover) Issuing services for its cardholders, comprised of Merchant member clients.

This section highlights the procedures put in place in order to select credit, loyalty and support services (call centre, back office support).

Examples of procedures required for the selection is outlined with a merchant program specifically in mind. Therefore, in selecting credit and loyalty solutions, there are several issues to heed, mainly, security, data protection, reputation and financial risks.

The selection procedure is modelled also on the fact that the merchants are established retailers located in more than one country. Therefore, scalability, multiple currency and regulatory adaptability of the solution were each considered a must have. Finally, certifications with the major networks, certification with regulators, French and English language support are also placed high on the list of priorities.

With this in mind, the following is an approach to system selection based on real examples. The approach was distilled from published papers and system selection workshops involving 48 FIs and actual selections done on behalf of 10 merchant issuers. The following section summarizes a best practice approach to system selection based on the merchant's requirements and system selection guidelines.

The first step is to define standard procedures for identifying, appraising and selecting the systems available on the market. The process is designed to help merchants avoid common pitfalls, understand how the vendors in the desired market operate, and finally offer tools to negotiate a price to its best advantage.

Contents of this section

- Introduction;
- Importance of comprehensive business strategy
- People factor
- Dealing with vendors / Getting executive approval / Building a team
- Building a business case and project planning
- Getting executive approval
- Building a team / How to engage the end user
- Structure & evaluate RFI
- Establishing a relationship with vendors
- Structuring the RFP
- Dealing with vendors
- Steps to follow
- Assessing the proposals
- Assessing the preferred system
- Negotiating the deal
- Planning for implementation

Introduction to software selection

Selecting and implementing a credit and loyalty solution is risky, can be expensive, and the wrong choice can hamper an Issuers ability to operate or even lead to failure. It is a well known fact that IT spend for FIs is typically the second highest non-interest related expense (second only to human resources) for most issuers.

Business drivers for change

High interchange fees, the desire by merchants to control the payment process, a strong preference to reward merchant's own clients and 'own' customer data are among the key business drivers for merchants.

As this sample project is assumed to be a Greenfield installation, there are no issues related to replacing or converting from existing systems. However, it is based on a coalition assumption, whereby participating merchants all have their own POS devices, and acquiring processing in place, there is a need to ensure the selected system would be capable of a seamless integration with a variety of POS systems in the build at a reasonable cost (in the case the merchants want to issue a private label card at some point).

Importance of comprehensive business strategy

The first step before looking into systems is to understand the business strategy and to build a business case. It is critical to understand:

- Their core processes;
- The market and how new issuers could fit in;
- The merchants' clients and what they expect;
- Employees and management at each participating merchant and the way the business operates;
- The products it offers today and into the future;
- Potential conversion issues from existing programs

The people factor

Any company looking to launch a credit and loyalty project should also be aware of the importance of managing people. People management can make the difference between success and failure in any IT project. According to Sean Jackson, CEO of Meridian Credit Union, managing people is one of the most important challenges in implementing a new system. After all, changing a core banking system will affect the way a FI operates from the teller to the CEO: Meridian changed over 50 applications as part of their conversion process.

"In the case of Meridian, people management was doubly important because the company was formed through the merger of Niagara and HEPCO credit unions, whose staff were both attached to their respective systems," Jackson adds. "Some of the issues that make people management such a complicated issue are that IT staff, as well as end users, tend to become very threatened about changes to core systems." In the case of a Merchant, because several participating merchants had existing programs, this meant for some the elimination of existing programs and the possibility of layoffs of entire departments. As such staff must also be trained on a new program. Be aware that some staff may be resistant and scared of changes, not to mention the emotional attachment they may have to programs already in place.

A particular situation to avoid is one where effort becomes directed towards proving one program is superior to another. This can, and does, lead to compromises and quick fixes, to the detriment of business strategies. This overview touches on the importance of building a team and encourages Merchant members to pay careful attention to involving individuals from many levels in the decision making process.

The people factor is one of the most important elements in any selection and is expanded on further in this section.

Dealing with vendors

Cutting through vendor noise can be difficult. Vendors are experts at confounding potential clients with jargon and buzzwords that seem designed to make it difficult to understand what is under the hood. From the latest buzzwords like cloud computing, SOA and J2EE to understanding the nuts and bolts of a credit management and loyalty management systems, there is a lot to know.

It often seems that vendors are all saying the same things, and they all promise the world. This is why it is particularly important to keep your search grounded on the project requirements and not to get caught up in every trend driving the industry (the jargon).

One of the main considerations for any issuer, especially those in regional markets like Canada, is the fact that there are only a few vendors capable of providing a localized solution that meet localized requirements. This eliminates many options as most outside vendors and regulators are not certified with regulators, the existing payment networks, the card networks, OSFI for reporting, or other entities as required.

Birds-eye view of selection process, 10 key steps

Step1. Build a business case

Build a business strategy and base the IT strategy on this. Only with the blueprint as a guide, is it possible to define business processes, workflow, functional requirements, sales channels, reporting requirements (both internal and for external regulatory bodies) and ensure the resulting plan is justified by an objective business case.

Step 2. Get approval for resource requirements

This is essential to ensure that sufficient resources are available to the project. At this point a time-line should be created detailing member involvement, project teams, roles and responsibilities. You should begin to earmark budgets for outside expenses including software, consultants, travel, hardware and legal. Costs should be allocated based on perceived ROI. Board level approval for budget and overall project plan based on business value needs to be obtained before moving to further steps.

Step 3. Assemble a selection team and ensure buy-in to the business strategy and business case.

The selection team involves key stakeholders at various levels from operations to IT. For this project we identified the technical requirements (hardware, software, architectural) necessary to execute the business strategy. Some key points:

- Define the features and functionality requirements;
- Define your system for evaluating vendors.

According to Greg Marsh, an independent consultant serving many Canadian FIs: "this is probably the hardest lesson to learn - be prepared to spend much more time than the vendor states. Organizations can only move at their own pace and any attempt to change this will fail."

This is also true of vendors.

Step 4. Vendor qualification steps

1) Write a request for information (RFI) document and identify a shortlist of potential suppliers.
2) Evaluate RFIs based on agreed metrics.

3) Meet qualified suppliers, ideally 3-10, and share your technical and functional requirements document.
4) Issue an RFP based on functional requirement document.
5) Evaluate RFPs.

Vendor analysis procedure

1) If requirements are met by the shortlist of suppliers, contact each of the vendor's clients directly and request feedback based on pre-defined parameters. Do not rely on Vendors to provide reference clients for obvious reasons. Ideally meet with FIs that match your organization's profile. Arrange product evaluation at client's sites either independently or in conjunction with vendors;
2) Arrange product demos;
3) Select the systems that fit your criteria.

Step 5. Negotiation and Implementation Planning

After systems and vendors have been chosen, the ensuing negotiations are very important. The selected system is something the organization will have for a period of 3 to 10 years; it is important that the agreement with the vendor reflects that level of commitment from both parties. Implementation planning carried out in this phase forms part of the contractual agreement.

Step 6. Implementation

Implementation or conversion can take from 3 months to more than a year. Even with the same system, the process can vary dramatically. The variables are resources and customization requirements. A typical implementation or conversion will last from 6 – 9 months.

Assuming that you have defined your requirements based on your business strategy, a next step would be to quantify the value of your IT spend. This helps to assign budgets and avoid investing into products and markets that are never going to produce the kind of returns necessary in order to justify your spend.

HSBC

Of course when you are considering large projects, this approach can be a challenging process, but it is worthwhile because rewards can be significant. A clear example of the benefits of following this approach is demonstrated through HSBC's decision to purchase a card processing company.

In part, HSBC's decision was based on their development strategy which followed a philosophy of 'build once, deploy many.' As the following example demonstrates, the philosophy makes complete sense given that HSBC plan to make this system operational in 26 countries. What follows is an illustration of how development strategies should influence technology decisions.

The business requirements for wanting credit card processing technology was to allow HSBC to optimize the management of their credit card processing business, reduce costs and grow the portfolio up to 25%. At the time, HSBC performed 440 million credit card authorizations a year, all of which were processed by the bank's UK data centre.

The result was that after considerable evaluation, HSBC embarked on one of its most successful global technology rollouts called Whirl/eChamps credit card authorization and accounting platform. This technology was acquired three years prior when HSBC bought US Household International (now branded HSBC Finance). At the time, the platform consisted of 17 linked applications, including credit assessment, risk-based pricing, card ordering and transaction processing and reporting.

The scope of the project was immense, under its program, HSBC installed and localized versions of the system in 26 countries, including Mexico, the US, Canada, the UK, Australia and the Middle East. The internet protocol (IP)-based system's multi-language interface is intended to streamline deployments to be completed within defined timelines it has proven to be capable of adding features and functionality securely and uniformly across multiple locales. In keeping with its 'build once, deploy many' IT strategy, HSBC said that customization of the software was kept to less than 5% for each roll-out, with 70% of development work being undertaken by HSBC in India.

Derived business value:

- 89% of HSBC credit card accounts support Whirl and eChamps
- Reduced transaction processing costs, generating an estimated annualized saving of £23 million
- 25% growth in credit cards use without any incremental cost increases.

The above metrics are a great example of the kind of factors that had been anticipated in HSBC's decision-making process at the time.

Step 7. Structuring and evaluate the Request for Information (RFI)

The goal of the RFI is to narrow down the field of potential bidders. So, while the RFI should be loosely based on the subsequent RFP, the objective is not necessarily to identify the potential candidates but to eliminate the hopeless ones that are clearly not the right choice for the FI. Ideally the 'long shortlist' will consist of 2-3 vendors. In Canada this is not a big challenge because FIs are starved for choice due to limited competition.

Therefore, in writing the RFI, one of the objectives, apart from narrowing down the field, is to interest potential vendors by providing a document that contains enough detail to make some basic decisions. Avoid making the effort of completing a full-blown document that only is unattractive to vendors.

This is because completing a full-blown RFP is a considerable commitment and vendors will want to know that they have a reasonable chance of winning before making the investment required. Evidently the RFI should be based on the IT requirements document. Fundamental areas of concern at this point are:

- Vendor's financial situation;

- Vendor's client list;
- Vendors ability to support your project;
- The relevance of the vendor technology;
- Development path of the technology.

The RFI should provide the vendor with an overview of your requirement specifications and functional requirements. For example, if you need the software to work on an Oracle database or use .net, it should be stipulated. Define and prioritize as follows: essential, important, important but not essential immediately, and nice to have.

Things to avoid: Vague questions like, "Is the system flexible?" Instead define your requirements more precisely. For example, ask, "Will the system let me add loan products with a variety of parameters, terms, workflow….."

What to include:

- Realistic timeline for reply;
- System selection timeline;
- List of times and contacts for questions, not for sales meetings.

Step 8. Evaluating the RFI

When selecting credit and loyalty management systems the relationship is projected to last from 3-10 years, but the longer the better. Assume the decision is more that just about the technology; there are many other factors that should be considered. For example, you want your business to be of interest to your vendor. One suggestion offered by Clive Burton, former head of development for Kindle (Acquired by Misys and 2000 implementations worldwide) is, "You need to be big enough to be on their (vendor's) radar but not so big that you represent more than 20% of their annual revenue. If you are too big, for example, you represent 60% of a company's revenue you might as well buy them."

Going back to the HSBC case study, the vendor size may have been a consideration as to why it bought the vendor. The reason for this is due to possible concerns that the vendor gets acquired or becomes insolvent; this possibility presents an intolerable risk for a large project.

Another concern relates to global software vendors with none or few clients the client country. In Canada the issue is that you might not be adequately supported because the vendor's market share does not generate enough revenue necessary to keep the product current for a particular market; the result being that the software will stop being supported.

Step 9. Establishing a relationship with vendors

Having identified a shortlist of vendors, a pragmatic strategy is to confirm your findings through contact with their clients. Naturally you will want to identify clients with a similar profile in order to obtain relevant information. Of course vendors would prefer that prospects make arrangements through them, but this is not always necessary and you will find that many merchants are more than happy to talk on or off the record about their experience.

A vendor's customers are really the best testimonial as to what you can expect. In fact, McDade said that attending the Open Solutions vendor conference with 1500 of their clients present was a contributing factor in her company's decision-making process. As she puts it, "In speaking with other Open Solutions clients, they all said that they had hiccups during conversions, as well as other problems. What we heard though was how well Open Solutions dealt with issues. They are very responsive. The fact that I can pick up the phone and call Elliot Lipsey (formerly general manager for Open Solutions Canada) whenever there is an issue, and the fact that he personally oversees monthly planning sessions demonstrates where their priorities are."

Steps to take prior to meeting vendor clients

In order to keep costs in check it was arranged to put in place several procedures before meeting vendor clients. Our goal was to prepare in advance with structured questions that cover key issues. The goal was to meet the IT Manager, the CIO, the CFO, and various individuals representing the heads of the relevant operations departments.

In checking references, we chose a client that closely resembled our future operations and that was operational for several years. This offers the ability to see how the new systems affect their operations. Some key questions:

- How satisfied are they?
- What were the major issues they faced?
- What would they change?
- What would be their advice to another client?
- How satisfied were they with the vendor support at each stage: pre-planning, implementation, training, post-implementation, ongoing product support?
- What resources were required on their part? What resources would they recommend?
- Is the day-to-day vendor maintenance and support what you expected?
- How do they measure the ROI and based on this, has the system delivered on the promises?

Advice on dealing with vendors

The Merchants were seeking a vendor that could take responsibility for the day-to-day operations of the technology. The vendor was not seen as an extension of their IT department, but rather as a partner and a trusted resource. Our goal was to address the real issues, even when the issues do not reflect well on the organization.

In the Merchant's case the objective was to enhance our management expertise. Therefore, it was important that vendors could support merchants with key knowledge.

Budget was also a consideration. The merchants wanted a pay as you go scheme in order to minimize risk.

Gap analysis

The selection process typically reveals technology gaps. To address these issues, a common strategy is to define a series of test cases based on the FI's real or anticipated requirements. Test cases can cover up to 100 pages and might even involve demonstrations using specified operating environments or connecting to 3rd party applications. Typically tests can take several weeks to prepare and require input from several departments.

The aim of the test cases is that they will allow the team to log all shortcomings (gaps). The team can then determine the requirements needed to bridge all gaps and queries that are logged. Subsequently it will be possible to go through each item to determine if the solution can meet the requirements within budget. The end result being that FIs have a good idea about real costs, system capabilities and the advantages and disadvantages of the preferred systems versus other possible choices.

Step 10. Negotiations

For the Merchant, entering this phase of the process, the most important consideration was to understand our goals and what we were willing to pay to achieve them. Using BPO as an example, two vendors were selected. As both vendors selected were looking to grow their presence in the Canadian market we recognized that this gave us leverage. We were also aware that one of the vendors would have opportunities to build relationships with the merchants and wanted to offer other services. Our goal was to secure the best possible value that also worked for the vendors. This did not mean price alone.

Examples of motivators for a vendor apart from price:

- Vendors' accounts that they can reference;

- A new entrant often needs business so badly that it will often give away their software if they see a new client as a possible beachhead;
- Vendors are often paranoid about losing business to the competition.

Here is a list of cost considerations typically considered in the negotiation phase:

- Deployment, who will deploy and what are deployment costs?
- Training: what are the training requirements? How will they be carried out?
- Are enhancements the responsibility of the vendor or the issuer?
- Are you the first FI in your region? If so, what is the localization costs and risks?
- Are you the first FI to use a new version, module, operating system or database?
- What are ongoing maintenance costs and what do they include?
- Who owns the code in the event of a situation where the vendor goes insolvent, is bought-out or stops developing the code?
- What is the development path of the product and who pays?
- When do payments start and how is the product licensed?
- What 3rd party licenses, if any, are required to operate the software?

All of the above points can influence value or price

Pre-implementation steps:

1) Ensure that both Merchant members and vendor commit to resource allocation;
2) Ensure that the Vendor makes all modification and enhancements based on the functional specifications;
3) Ensure that adequate training material and resources to train staff are allocated;

4) Plan the implementation;
5) Make modifications to the merchants' other applications and test;
6) Configure the system in conjunction with the Vendor;
7) Freeze code changes on applications pending conversion;
8) Modify or create procedure documents and user manuals;
9) Write project timeline and deliverable schedule;
10) Avoid unnecessary frustration by putting structures in place to deal with the many issues that will prove challenging. This includes establishing a steering committee and procedure for problem escalation.

Building an RFI & RFP

Project Vision

1) To implement a Chip Compliant Issuing service for the Merchant;
2) To successfully introduce *industry standard credit cards* to The Merchant members comprised of cardholders;
3) To implement transaction processing solutions with advanced fraud detection features;
4) To implement risk management processes and procedures;
5) To implement clearing and settlement processes and procedures;
6) To implement a multi-channel customer support centre capable of responding to Merchant member cardholders' issues;
7) To implement reporting and analytical solutions for both credit and loyalty modules that will be available to Merchant member administrators in real-time via an online reporting dashboard;
8) To implement portfolio management and accounting features for credit management/securitizations;
9) To ensure data integrity and minimize privacy and financial risks to Merchant members.

Merchant objectives

Noted below are the project objectives, which describe in more detail what it is that the project is going to achieve.

Merchant business objectives

- To participate in *Industry standard* issuing services to enable the Merchant's cardholders access to funds, services and products at acquiring merchants and companies;
- To implement industry standard issuing services, thereby increasing access channels for the participating merchants and cardholders;
- To provide a new 24/7 cardholder support service to support issuing cardholder inquiries and complaints.

Technology objectives

Vendor stand-ins for Merchant and does PIN/MAC/Chip validation and transactions authorization based on business rules established and cardholder balances provided by Merchant. Real-time transactions would be processed on behalf of Merchant and updating cardholder accounts would be hosted on the vendor premises. Vendor would provide revised cardholder status and balances for updating the Issuing system.

1) Device driving (ATM and POS intercept processing);
2) Issuer support (stand-in, card issuance/management);
3) Credit card management;
4) Merchant accounting;
5) Fraud detection/investigation;
6) Wholesale interbank payments (clearing, local wire transfer, corporate finance);
7) SOA;
8) Support industry standards (example 8583);
9) EMV compliant;
10) Open operating platform;
11) Quality standards (availability, DRP, etc.);
12) Deploy commodity based hardware;
13) Support for multiple comms (X.25, dial, IP, etc.);
14) Support for regional/national/legislative/regulatory standards to meet (beyond international norms);

15) On-us processing may be strategic depending on if issuing is proprietary or through an existing network (closed loop v open).

Access to reports

The system should allow each merchant to connect directly to the main system in order to access reports, it should partition data and allow for individual and combined loyalty management. Cardholders will also require access to detailed account data and have support for standard functions related to credit and loyalty management.

Scope:

1) Identify the strategic technology objectives of the merchant and their importance to the credit and loyalty system strategy of each merchant;
2) Identify the decision criteria to be used as a basis for evaluating and selecting the solution;
3) Document the process and results of the evaluation performed by the Merchant to determine its system recommendation;
4) Identify and evaluate the risks and costs associated with the card management system options under evaluation; and,
5) Present the card management system recommendation and the basis for its support.

Costing considerations

The Merchant anticipates operating in a service bureau relationship but has several considerations available:

1. Service bureau, where the merchant engages a company which hosts and operates a standardized card management system application as a service to multiple financial institutions and retailers;
2. In-house management mode, where the Merchant installs and operates its banking system application on in-house computers, to be operated under the direct control of the Merchant;

3. Facilities management operating mode, where the Merchant hires a qualified technology services company to operate its banking system application and computer hardware, either on The Merchant's premises or hosted by the service providers.

4. Decision Criteria	5. Weight (%)
1. Meets business needs (proven functionality, member service, all other)	**17.40**
2. Provides management control over technology	**14.15**
3. Supports timely management information on sales and key performance indicators	**12.05**
4. Supports all service delivery channels (call centre, electronic, interactive)	**11.50**
5. Supports the needs of end users (ease of use, speed, training)	**10.55**
6. Proven vendor performance and accountability	**9.40**
7. Efficient to maintain and support	**8.40**
8. Manages and controls risks	**8.20**
9. Affordable	**6.05**
10. Political issues and concerns	**2.30**
Total	100.00%

Table 9, Evaluation of Business Needs

Some expected business capabilities:

1. The native functionality of the system includes:
    a. Supporting all of the required product and service features;
    b. Implementing new products and services;
    c. Performing calculations;
    d. Producing reports, statements and forms;
    e. Facilitating data input;
    f. Supporting all of the required connectivity to external networks, and;
    g. Supporting business activities such as sales, marketing and general business development. Generally speaking, data input and reporting are

used extensively, so attention should be paid to evaluating these aspects.

2. Functionality of the system must combine the right mix of native functionality with the ability to integrate with other components.
3. Consideration of service aspects of the system. Issues such as speed and accuracy of service.
4. Operational effectiveness (including developing, implementing and maintaining sound and efficient operating procedures and fully trained staff).
5. Detailed reference checks, documenting functionality requirements and independently evaluating the full extent of functionality.

Service Requirements

The RFP general and service questions were intended to address the requirements in the various related services provided by the vendors.

These questions fall into the following service categories:

1. Card management system application, support, maintenance and development;
2. System operation and management services;
3. Systems implementation services.

Project Plan Approach

PMBOK is an example of a project methodology used to manage each of the phases related to the project and is suggested as an example of a methodology; Refer to PMBOK Guide – Guide to the Project Management Body of Knowledge – Third Edition; It is expected that the bidder will have a documented approach and provide related details. We expect, at minimum, the following before agreements are made related to the project:

1. Initiation: Create and approve the Project Charter;
2. Outline: the method by which the project will be further defined, the project team appointed and the Project Office established;

3. Planning: Define the overall planning process to ensure that the phases, activities and tasks are undertaken in a co-ordinated fashion;
4. Execution: Describe the phases and activities required to build, test and implement the deliverables of the project.

Monitoring and Controlling

1. Define the process to monitor and control the project;
2. Closure: Describe the steps required to release the deliverables to the business, close the project office, reallocate staff and perform a Post Implementation Review of the project.

Example of overall plan outline

A summarized project plan example follows:

1. Statement of Work Signoff. Necessary to ensure requirements are understood and agreed to prior to project planning and execution;
2. Project Planning Signoff. Necessary to ensure detailed requirements are defined and activities are assigned to responsible parties, since multiple stakeholder organizations are involved in the project.

Project Execution Completion

1. Signoff required to commence Vendor Certification and Acceptance Testing;
2. Vendor Pre-Certification & Certification Signoff. Required for *Interac* and MCI EMV Issuing certification;
3. The Merchant Certification Signoff. Required to implement and commence pilot;
4. Issuing Implementation Signoff. Required to commence pilot;
5. Issuing Pilot Signoff. Pilot necessary to ensure systems and procedures are implemented and operational prior to general release;
6. Cardholder Issuing Signoff. Required for general release;

7. Project Closure Signoff. Required for project closure.

Dependencies

Noted below are project activities which:

Will impact on another activity external to the project;

Will be impacted on by the non/delivery of another activity external to the project:

1. Test Chip Cards Pre-Certification;
2. Certification;
3. Card Design;
4. Card Production;
5. Production Chip;
6. Pilot;
7. General Release.

Project Considerations: Risks

Noted below are the most apparent risks associated with the project. Risks are defined as 'any event that may adversely affect the ability of the solution to produce the required deliverables.' Risks may be Strategic, Environmental, Financial, Operational, Technical, Industrial, Competitive or Customer Related;

1. R1: There are multiple third party deliverables and dependencies to deliver required results;
    a. Medium - Very High: Complete detailed project plan to ensure all team members understand project timelines, activities and responsibilities;
2. R2: Technology solution provider is unable to deliver required results;
    b. Medium - High: Complete a pilot project to prove the full technology solution

Issues

Noted below are the highest priority issues associated with the project; Issues are defined as 'any event, which currently adversely affects the ability of the solution to produce the required deliverables';

1: The Merchant has limited knowledge and experience with Issuing;

2: The Merchant plans to use expert resources to provide Issuing services and facilitate implementation.

Assumptions

Noted below are the major assumptions identified with the project to date:

1. Network registration fees, audits, certifications, annual fees and transaction fees;
2. The Merchant will be responsible for all card related costs including, but not limited to, card design and validation, card plastic, card production and PIN devices;
3. The Merchant's individual merchants will be responsible for card activation, banking system SCD/IDP transaction;
4. Updates, cardholder adjustments and CAFT updates to Vendor;
5. Vendor will provide *Interac* and Discover integration Services to The Merchant;
6. Vendor will provide Gateway Interface;
7. Vendor will manage The Merchant Network Certification with card network;
8. Vendor will provide issuing services including card order generation, cardholder PINing;
9. Systems, policies and procedures implemented will be compliant with *Interac*, the card network and PCI rules and regulations.

Essential Features

- Sufficient transaction processing capabilities and potential to scale up in the event of rapid user adoption that exceeds expectations;
- Verify if the system uses latest technology and methodology;
- Multilingual and multi-currency.

Essential Security Criteria

- Meets PA-DSS requirements and is capable of supporting multiple chip and pin environments;
- Cryptographic process for PIN generation and verification;
- Account validation features are available, and;
- Fraud management features are available and are proven.

Chapter 12

Business Process Outsourcing (BPO)

Merchant issuers have several goals in evaluating BPO services. Some of the typical BPO requirements for a card program for a single merchant include:

- Hundreds of trained agents providing customer care, fraud management and many other functions;
- Training, quality control and management staff; and,
- Facilities and software to house and support the people supporting the functions.

Costing BPO requires a detailed understanding of each individual support process. This is because each process, such as 'lost cards,' requires variable levels of resources and varying levels of agent expertise. For example, for customer support, the services required range from skip tracing, data capture, virtual messaging, lost card management and collections. Collection requires even more relevant experience.

Therefore, it is necessary to define all of the individual processes and then determine the average handle time required to complete each one. With this information it is possible to calculate usage ratios that can be tied to the number of active members projected, and this permits resource requirement calculations if the member projections are realistic.

According to Tim Rankin, a former VP at NCO, a leading BPO firm, cost is not the only consideration behind successful selections. Other factors such as quality, the ability to reduce roll-rate, customer churn, audit scores, as well as many other factors are critical to realizing the portfolio's objectives.

Considering the estimated size of the Merchant portfolio, an approach that can reduce risk and ensure optimal pricing is to choose more than one vendor. This approach optimizes performance and resource allocation because the client can shift to the best performing vendor. Resource allocation can be objective as it is based on performance measured by a scorecard.

According to Rankin however, “this is a common strategy, and one that is often supported by the vendors as well”. The multi-vendor approach has other benefits besides ensuring a competitive environment. It also means that vendors can be selected based on specific skills. Again vendors agree with this. This is because vendors recognize that they are not always the most efficient at every process. Some vendors are stronger at certain processes or may lack skills. French language support is an example that relates to a program that will be based in Quebec; depending on the processes and resource requirements, these types of considerations could have a big influence on the vendor selection process.

Selecting a vendor is not the end of the job. To get the best performance, Rankin advocates portfolio administrators implement an ‘active-active’ or hands on approach to managing BPO services. Capital One is a case in point. According to Rankin, this was one of his best performing portfolios because of the fact that Cap One are hands on when it comes to vendor management. Typically, they will have staff on site and actively participate in Q&A and other key activities. They will even participate in training sessions, which adds value to the process.

Hands on is important also for other reasons. For example, Rankin cautions that measuring vendor performance via a ‘scorecard’ is not an easy task. This is because there are a variety of factors that make a portfolio profitable. Cap One understands this and sees their success as a reflection of their mathematical approach to card programs.” Cap One's reputation for applying science to their approach to credit card portfolios carries over to its BPO vendor management style. It’s an approach that he feels allows them to look beyond the scorecard. “But it can only be applied when the client is involved with the vendor,” Rankin says.

For example, take the case where one firm performs better on an audit, but its call recording is lower, or its roll rate is poor. Cap One will pick this up and weigh it against a possible collection rate that is exceptional and its churn rate low, factors that contribute more to long-term profitability.

Of course they will not discount the red flags, but being on the ground will allow them to optimize their assessment, and because of the strong relationships in place, it also means they are able to help the vendor fix the problem.

Rankin's advice for multiparty vendor management:

- Remember BPO is a people business, so relationships matter;
- Use an audit score to measure vendors, but look deeper: a top performer can balance the scorecard with a big picture view that takes into account other factors;
- Hands-on vendor management improves performance. Think of how Cap One dedicates resources, to the point where they will station people in remote locations.
- Your BPO vendor is often your company's strongest brand ambassador.

BPO recommendations

Based on the goals of the Merchant and the nature of the BPO market, a multi-vendor approach that leverages the best of each vendor is considered a strong, long-term option. Some key processes, like one vendor will manage back office support, while more resource dependent processes and less business critical will be divided among more than one vendor. According to Rankin, a good merchant strategy is to keep BPO services on-shore in the initial phases to control the customer experience as the program rolls out. This will ensure initial quality control, and, as the program matures allow processes to be optimized between on and off shore services and minimize risk.

Chapter 13

Corporate structure, roles and responsibilities. Note, applies to credit backed only

Any FI, especially a merchant owned FI, requires mechanisms to minimize risk to the participants, and to ensure that it is run efficiently. This section documents the structure of an actual trust company.

The guidelines in defining the management structure consist of five groups of committees as follows:

1. Trust Committee
    - A. Board of Directors;
    - B. Senior Executives;
    - C. Audit Committee;
    - D. Nomination and Remuneration Committee;
    - E. Corporate Governance and Corporate Social and Environmental Committee;
    - F. Risk Management Committee;
    - G. Managing Director;
    - H. Executive officers;

Trust's Committee

Trust's Committee is entitled to have full authorization in managing Trust's operation in accordance with its stated objectives and regulations, resolutions of all shareholders' meeting, as well as applicable laws and regulations. Authorities and Responsibilities of the Trust's Committee are described below.

Composition

The number of Trust Committee members shall be in compliance with the adoption by the shareholders meeting but shall not be less than 5 directors. At least 3 members or one-fourth of the Board (whichever is higher) shall be Independent Directors, and not more than one-third of the Board shall be Executive Directors, comprised of founding Merchant members.

Roles and responsibilities

- Manages the Trust to ensure that its business and affairs are in line with articles of association and resolution from shareholders' meeting.
- Arranges a Board of Directors' meeting at least once a month, forming a quorum of not less than half of the boards' members. Resolutions of the meeting must be passed by a majority vote.
- Arranges an annual ordinary general meeting of shareholders within four months from the last day of the Trusts' accounting period. Other meetings of shareholders stated above shall be called 'Extraordinary Meeting'. The Board of Directors may hold an extraordinary meeting whenever the Board thinks fit, or when it receives a notification letter submitted by shareholders. In such cases, the meeting shall be held within 1 month from the date of receiving notification letter.
- In case of directors absent or Board of Directors vacancies, a meeting can proceed as usual. However, if present directors are less than the number forming a quorum, a meeting can be held only for the purpose of voting a representative for those vacant seats.
- Behaves according to Code of Best Practice of Directors of Listed Companies.

Authorities

- Each individual director has one vote. A majority vote of attending directors is necessary to pass any resolutions. In case of an equality of votes, the Chairman must exercise a casting vote.
- Directors of the board, which have potential conflicts of the interest in any agenda, shall cease from voting on such

matters and may be invited out of the meeting temporarily by the chairman.

- The Trust Committee is entitled to have authority to perform all Trust's operations. The Trust's chairman, one of the managing directors and more than two of the authorized directors can jointly sign and seal to take all actions on behalf of the Trust.
- Apart from having the authority to appoint general managers, officers, and authorized dealers of the Trust, the Trust's Committee can also determine duties, remuneration, rewards, and remove individuals from any position.
- The Trust Committee may delegate the power to appoint and remove officers of any position to the general manager. If the authorized head manager is also a director of the board, this person shall be called managing director.
- The Trust Committee can appoint an advisor or an advisory board and determine their remuneration to provide professional advices on the Trust's business as they think fit.

Scope of Authorities

According to the Trust's rules, the following actions can be carried on by the Trust's Committee in case that they are granted approval as a resolution from the Trust's shareholders' meeting.

- Approval of balance sheet and profit and list statement;
- Approval of profit allocation;
- Election of new directors to fill new vacancies or in place of those to be retired by rotation;
- Appointment of auditors and fixing of their remuneration;
- Increment and reduction of registered capital;
- Transfers of capital reserve to compensate the retained loss; Dividend payment;
- Issuance and reallocation of new shares;
- Debenture issuance;
- Sale or transfer of all or substantial part of the Trust's business;

- Purchase or acceptance of transfer of other public or private companies' business;
- Entering into, amendment or termination of any agreement concerning a lease out of all substantial part of the business of the Trust.

Executive Committee

The executive committee is in charge of the following functions by the Trust committee.

- Credit approval, debt adjustment, bad debt write-offs;
- New investment appointment approval (in level of non-line-management executive vice president and senior executive vice president);
- Purchase and acquisition approval in compliance with procurement policies;
- Credit risk evaluation, debt restructuring, and bad debt write-off;
- Business plans consideration;
- Procurement processes consideration;
- Hiring advisors and procurement consideration;
- Business operation consideration as the Executive Committee think fit or in emergency case which may cause damage to the Trust and report directly to the Trust's Committee as soon as possible;
- Other function assigned by the Trust's Committee.

Audit Committee

Responsible for financial report and information disclosure

A. Reviewing if the Trust's financial reports are correct, complete, reliable and in compliance with acceptable accounting standards;
B. Discussing with auditors about critical accounting issues which may affect credibility of the Trust's financial statement;

- Difficulties or serious conflicts during the course of audit;
- Fact and disputes between auditors and management;
- Effectiveness of internal control systems;
- Failure incurred in current year which may cause damage to the next year accounting;
- Draft an annual financial plan and notes to financial statements.

Auditor's report

A. Discuss any transactions with conflict-of-interest tendency to consider whether the Trust discloses correct and adequate information, and the transaction recording is correct and transparent;
B. Requests accounting evidence in case of doubtful transactions or transactions with a conflict-of-interest tendency that are present and may affect the Trust's operation in significant ways;
C. Consider if information submitted to regulatory agencies is consistent with that of the financial statements.

Internal control

Reviewing the efficiency of internal control based on standards of The Committee of Sponsoring Organizations. Internal auditors are responsible for internal control systems evaluation on an annual basis apart from reviewing internal financial control with financial auditors.

Financial auditor

A. Ensuring financial auditors' independence;
B. Reviews scope of functions of auditors and internal auditors to eliminate redundancy in financial audit with consideration of resource using efficiency;
C. Considers the appointment of auditors and their remuneration before proposing in shareholder's meetings;
D. Requests reports and annual audit result of the Office of the auditor general of Canada and making recommendations to

review necessary and critical issues including suggesting important matters to the Trust's Committee;

Internal Auditor

A. Ensures internal auditors' independence;
B. Directly supervises the internal audit function while the operation within the function remains under the supervision of President;
C. Monitors internal audit function to get along with ethical and corporate governance including setting accepted standards and also reviewing and evaluating auditors' ethic before proposing or the Committee's approval;
D. Regularly evaluates and reviews the charter of internal audit function;
E. Considers and approves the internal audit strategies, annual internal audit plans, and budgets for internal auditing to achieve the effectiveness and efficiency of internal auditing activities. Also prioritises internal audit activities based on risk factors;
F. Reviews internal audit report and conducts confidential meetings with internal audit executives to evaluate if there is any intervention from management and executive team that may affect the independence of internal auditors;
G. Investigates the optimization efficiency of the Trust's assets with internal audit executives based on the Trust's policies or guidance;
H. Investigates and considers the identified as well as Management's counter measures together with management team;
I. Considers the assignment, punishment, and deprivation of internal audit executives according to the proposal of the President before proposing to the Committee's approval;
J. Evaluates the performance of the internal audit executives;

K. Arranges regular revision of internal auditing efficiency, by external independent evaluators (Independent Quality Assessment Review) at least every five years.

Compliance to Laws, Rules and Regulations

Ensures that the Trust is complying with Laws, Government's Rules and Regulations and related controlling organization to prevent damage such as fine warning, and protect the Trust and Management Team's reputation.

Risk management

A. Investigates significant risks and reviewing the adequacy and standardization of the internal auditors' risk assessment methods with external auditors;
B. Ensures that the Trust's Committee and Top Management Team are aware of major risk as well as operational risks;

Working Evaluation

Arranges self-evaluation and Audit Committees annual working evaluation with the Trust's Committee as the evaluator

Roles and Responsibilities

- Sets policies, criteria and strategies in the remuneration nomination process and distributes reward and other benefits structure for the Trust's Committee and Senior Executives;
- Proposes remuneration' suggestion and other Trust's benefits;
- Recruits qualified candidates in accordance with applicable laws and presents to the Trust Committee for further appoint as the Trust's Committee and Senior Executives;
- Monitors the structure of the Trust's Committee and considering appropriate number of them to fit in with organization and situational changes;
- Proposes the prospective committee to replace those committee who vacate his office;

- Remunerates the Trust's Committee and Senior Executives accordingly to their roles and responsibilities;
- Plans strategically the evaluation and evaluating of Senior Executives;
- Proceeds with other tasks assigned by the Trust's Committee.

Corporate Governance and Social and Environmental Responsibility Committee.

Roles and Responsibilities

- Sets policies on Corporate Governance, Social and Environmental Responsibilities of the Trust and subsidiaries;
- Monitors the Trust's operation to comply with corporate governance stated by Trust of Canada, The Stock Exchange of Canada and the Securities and Exchange Commission with social and environmental responsibilities;
- Always reviews the Trust's policies on Corporate Governance, Social and Environmental Responsibilities to comply with international standards and other related institutions;
- Proposes good governance and appropriate rules setting for the Trust's Committee and other appointed committees;
- Sets appropriate rules on business ethics of the Trust including good governance for Senior Executives;
- Supports good organizational culture and participating in sustainable Social and Environmental Responsibilities activities for the benefits of society;
- Appoints extra committee to support the works of Good Corporate Governance, Social and Responsibilities;
- Other tasks assigned by the Trust's Committee.

Nectar case study

Nectar card Merchant overview

Sainsbury Tesco Rivalry

At the time Nectar launched, Tesco was the dominant retailer and had been operating its own loyalty program successfully for years.

Meanwhile, Sainsbury's, previously the market leader, was losing ground to both Tesco and ASDA (discount grocer bought out by Walmart). Sainsbury's agreed that it could benefit from the Merchant initiative and signed a multiyear contract with LMUK (Nectar). With this anchor, LMUK recruited BP, Barclaycard and Debenhams, a department store retailer.

The Nectar card was launched in September 2002 as a partnership between Sainsbury's, Debenhams, BP and Barclaycard and founded by Loyalty Management UK (LMUK). One of the main motivations behind the card was a response to consumer sentiment in which cardholders felt that there were "too many loyalty programs in the market" which caused confusion and made it difficult to earn and track rewards. Sainsbury's, the UK's third largest grocer at the time, was also responding to Tesco's Clubcard launched in 1995, which had attracted 20 million members.

Nectar redemption partners

Argos, Direct Wines (Laithwaites), McDonalds, Planet Hollywood, Whitbread (Brewsters, Brewers Fayre, TGI Fridays), Blockbuster video, Odeon Cinemas, Historic Royal Palaces (Tower of London, Hampton Court, Kensington Palace), Jorvik Viking Centre (York Archaeological Trust), Legoland Windsor, Tussauds Group (Madame Tussauds, Alton Towers, Chessington World of Adventure, Thorpe Park, Warwick Castle, London Planetarium), Cadbury World, Dynamic Earth, English Heritage, Kew Gardens (Royal Botanic Gardens), Living Well Health Clubs, Sealife, Whipsnade Animal Park, Executive Golf Club, MegaBowl, AquaXcite, Exhilaration and Orient Express, Avro, BMI, TAP Air Portugal, KLM, Eurostar, Eurotunnel, Lunn Poly, Virgin Atlantic Airways, Air Europa, Best Western Hotels, British European (Flybe), DFDS Seaways, Gatwick Express, Heathrow Express, Singapore Airlines, Stansted Express, NSPCC, Red Cross, Tommy's and Free Kicks

Key features of the program

- Member benefits
    - Redeem: members can redeem points at any of the participating retailers including travel, groceries and merchandise;
    - Relevance: points can be earned quickly by shopping at over 6,000 partner outlets, and wherever an American Express card is used. Also, consumers that pay for goods in a partnered store using American Express earn additional Nectar points;
    - Easy to use: members can collect points easily by either redeeming them at point of sale or collecting vouchers;
    - Communications: Merchant members can receive updates efficiently through sophisticated marketing such as quarterly points updates, online point balances and other offers that provide value to consumers and promotional opportunities for merchants.
- Benefits to merchants
    - Lift: Members spend more per transaction and by frequency;
    - Up-Sell: Customers could be offered incentives to buy higher margin products and services;
    - Acquisition: Merchants could identify new members that were not previously clients and offer special promotions;

- Retention: Member churn is reduced;
- Cost efficiencies: Magnetic stripe cards were chosen because, at the time, "smart (chip) cards were considered unnecessary for the purpose the cards serve."[80] Management felt that an obvious benefit of selecting magnetic stripe technology is that most point-of-sale equipment can remain unchanged (presenting a significant infrastructure cost saving) when new partners join the program.

BBC extracts Friday, 20 September, 2002

Nectar Launch Technical Hitch

Nectar's Achilles' heel, predictably, was technology. Although the scheme was open to applications by post, over the phone or online, it offered those who registered on the Internet a reward point bonus. But when the deadline of 17 September rolled around, those millions hoping to sign up online found that they were locked out. Not just once, but over and over again.

The situation got so bad that Nectar admitted defeat in the short term and has asked customers wishing to register or to see their account balance to not do so until further notice. At one stage, according to Ian Barber of Barclaycard, the Nectar website was getting 10,000 visits an hour.

Too many, too soon

"The online operation was simply taken by surprise by the demand, the whole thing has been far from ideal," Mr Barber says. A Nectar spokeswoman - who, perhaps understandably, did not want to be named - blamed the hitch on the huge number of inquiries.

Nectar points overview

•Cardholders earn one point per litre of BP fuel bought (BP also added point bonuses to each customer's Nectar account at 100 litre intervals, with the first two bonuses being 100 points each, and subsequent bonuses being 50 points each), two points per £1 spent at Debenhams (until 15th February 2008);
•Two points per £1 spent at Sainsbury's. Until Barclaycard left the program;
•One point for every £2 spent using any Barclaycard credit

[80] Peter Clark, Details Nectar Coalition Loyalty Program, The Wise Marketer, September 2002

card. The American Express partnership (replacing Barclaycard) provides consumers with 1 point per £1 spent using the co-branded card in most places.

See ‘Programs and Rewards for Members’ section for more details on programs.

Nectar launch campaign

Nectar predicted that it would capture 50% of UK households within the first year and backed up its assumptions with a £40 million launch campaign. The campaign targeted 12 million consumers who were clients of the four initial retail partners. Campaign highlights:

- Over 10 million registration packs (each containing a 'primary' and a 'secondary' card) were issued within its first week;
- Television advertising on all major UK channels;
- Press and outdoors print advertising.

Campaign results

There was an immediate demand that exceeded initial expectations and caused load problems on the Web site which were reported by the BBC who referred to the problems as, 'Nectar's Achilles heel.' The problems were greater than anticipated, resulting in some much-publicized problems with the Nectar web site.

Founder

Sir Keith Mills, was one of the founders of Loyalty Management International, which, in the past, had established a very similar Merchant loyalty program under the Air Miles banner in Holland, Spain, the Middle East (UAE), and Canada.

Cost advantage

- According to Mills, typical costs associated with the running of an in-house loyalty program are often between 5% and 20% of the total cost of that program. Instead, Nectar's points-issuing partners pay somewhat lower administration fees to LMUK for its business, marketing and operational expertise.

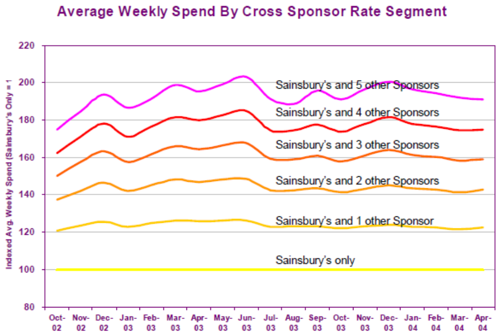
Early metrics

- September 2003, Nectar revealed that some 13 million UK households had collected a total of 74 billion Nectar points since the program's launch in September 2002.
    - Of that points total, 42 billion points were issued for qualifying transactions, while 32 billion points were transferred into the program from points-issuing partners' previous reward program;
    - Of the 13 million activated Nectar accounts (i.e. accounts to which points have been assigned), some 10 million were active at the time (defined as having earned points on the card during the previous 13 weeks). This represented a household penetration rate of 50%, and an Active/Inactive Member ratio of

    - 10:3 (that is, 76.9% of activated members were collecting points on a regular basis);[81]
    - In terms of redemptions, LMUK's figures (at the time) showed that 5 million individual redemption claims had been made during the first year, across the full range of available rewards. Effectively, this revealed an average of 0.5 redemptions per active member, per year;
    - According to technology partner Infosys, Nectar has successfully created the desired cross-selling between its retail points-issuing partners, with 75% of collectors now using at least two sponsors, and 62% of collectors saying they are actively spending more with the sponsors because of the Nectar program;
- A study by BP and Sainsbury's, both of which sold gasoline, demonstrates that both have taken market share from competitors that were not part of the Nectar program; [82]
- More than 50% of points were earned at Sainsbury's while 80% of points were redeemed at the grocer;
- 67% of Nectar points obtained within the first 18 months were redeemed;
- According to LMUK, increasing the number of participants also increases the gross spend. [83] Further, Koos Berkhout, Nectar's database marketing manager did a study on a segment of random shoppers compared to a control group. The random sample received a one point bonus in addition to the usual two points for every 1 GBP spent.

[81] The Loyalty Guide, July 21, 2010
[82] John Deighton, Harvard Business School December 5, 2005
[83] [83] John Deighton, Harvard Business School December 5, 2005

Exhibit 4 Effect of Number of Collection Sources on Size of Weekly Spend at Sainsbury's



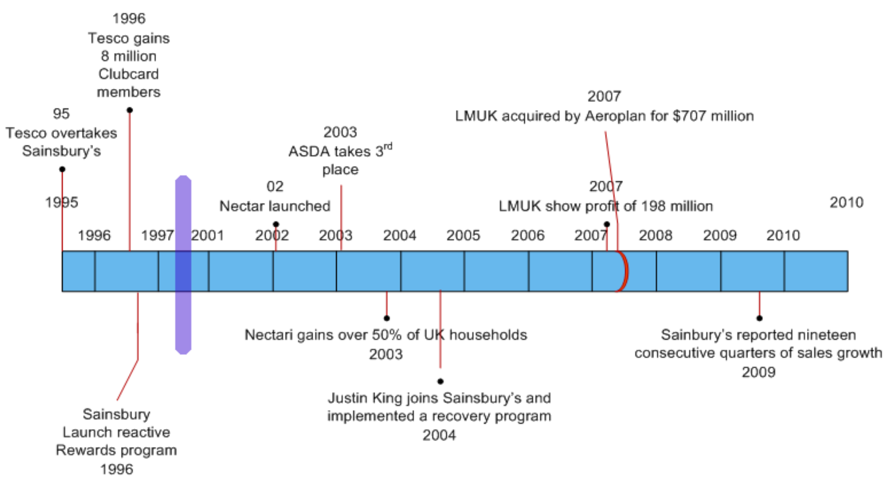
Source: Loyalty Management UK.

Note: To be read as follows: Take the average weekly spend for Sainsbury's customers who earn Nectar points at Sainsbury's only, and index this at 100. Now take the average weekly spend for customers who earn points at Sainsbury's and other sponsors and index the spending relative to 100.

Example: Assume the average shopper who collected points from Sainsbury's alone spent €25 a week in June 2003 (a hypothetical number). Then the average shopper who collected from Sainsbury's and one other sponsor spent €30.75 at Sainsbury's in June 2003 (30.75 = 25*123/100). The average shopper who collected from Sainsbury's and two other sponsors spent €35.75 at Sainsbury's (35.75 = 25*143/100).

The sample was monitored for 9 weeks and revealed that revenue from light shoppers who received the promotion was 10% higher than the control and remained at 5% above the control for up to 13 weeks. He concluded that the promotion produced a revenue increase of 6.5% over 13 weeks for an additional cost of 0.5% of sales during the 4 weeks of the promotion.

Nectar key events Timeline



Key dates

- 1980 Sainsbury is market leader;
- 1985 the Chairman reported that over the preceding ten years profits had grown from £15 million to over £168 million, a compound annual rise of 30.4% – after allowing for inflation a real annual growth rate of 17.6%;
- 1992 marks a year of many mistakes by David Sainsbury and his successors, Dino Adriano and Peter Davis, including the rejection of loyalty cards;[84]
- 1995 Tesco launched Club card loyalty scheme. Points accumulated for every 5GBP spent were converted quarterly into Clubcard vouchers, which could be redeemed in any Tesco store. At the time David Sainsbury, Chairman of Sainsbury's derided the loyalty scheme, as no more than an "electronic version of Green Shield stamps," since the cost of running the loyalty program was notoriously high. It cost Tesco 300 million GBP over the first three years and about 4.5% of Tesco profits. These costs include an update to the point-of-sale (POS) technology and the supporting computer systems to handle the Clubcard information, and a call center in Dundee to handle the anticipated 45,000 call per week. Within eighteen months, calls to Tesco's call center were averaging 130,000 per week. Even so, Tesco broke-even on their initial expenditure whilst it took six to seven months to cover incremental costs against sales.[85]
- 1996 Tesco had raced past Sainsbury's taking number one spot, moving from 15% to 18% market share and gaining 8 million Clubcard members. The success of the Clubcard program forced competitors to respond. Sainsbury launches its own reward program to limited success, to be replaced with the Nectar Merchant program in 2002;
- 2001 Tesco's Clubcard loyalty scheme had attracted about 20 million members, of which over ten million were active

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[84] Hosking, Patrick (2004-10-20). "Rot set in at the family firm back in 1992". *The Times* (Times Newspapers): p. 48.
[85] Lord Ian MacLauren, Tesco : every little helps, Empresa, 2002.

users.[86] Tesco poached the contract to offer AirMiles with its loyalty card;[87]

- 2002 Nectar launched and within 18 months captures over 50% of UK households as members;
- 2003 ASDA becomes second largest retailer demoting Sainsbury to third place;
- LMUK invests 40 million GBP over first 3 years;
- 2003 Nectar had accumulated a 400-gigabyte database of demographic and behavioural data on 21 million active and lapsed collectors, covering 800 million transactions. Each sponsor was sent their own detailed product-level information;
- 2004 Justin King joins Sainsbury's and implemented a recovery program. Having come from ASDA King planned to review the Nectar program. 'Justin King, the new chief executive of Sainsbury's, has told Nectar's parent company, Loyalty Management UK, that he wants to slash the supermarket giant's £20m annual budget for promoting the scheme and offering Nectar cardholders discounts and free gifts;[88]
- 2005 LMUK shows profit of 35 million GBP;
- 2007 LMUK show profit of 198 million GBP and LMUK acquired by Aeroplan for $707 million CDN;

[86] Lord Ian MacLauren, Tesco : every little helps, Empresa, 2002.
[87] Stephen Foley, Sansbury's shows little loyalty to Nectar, The Independent, October 25, 2004.
[88] Stephen Foley, Sansbury's shows little loyalty to Nectar, The Independent, October 25, 2004.

- 2009 Sainbury's reported nineteen consecutive quarters of sales growth, most recently in October 2009. King praised the Nectar loyalty scheme for consolidating 'its position as the UK's number one loyalty scheme with around 17 million registered card holders and regular Sainsbury users are up over 800,000 versus the same period the previous year. Nectar and coupon at till are proving to be a winning combination enabling us to deliver relevant and targeted offers which our customers really value.'

July 2003, British media reports of the losses made to-date by Nectar attracted much attention in both public and marketing circles, despite the LMUK explaining that the financial situation was very much as had been expected from day one. "The accounts lodged with Companies House are very much in line with LMUK's expectations, and LMUK is encouraged by the figures so far".

Initial investment

•July 2002, LMUK secured a commitment of £25 million in equity financing for the program from private equity firm Warburg Pincus and Barclay's bank. The investment in LMUK was made jointly by two funds, Warburg Pincus International Partners (a US$2.5 billion fund), and Warburg Pincus Private Equity VIII (a US$5.3 billion global fund that closed in April 2002). LMUK is headed up by a well-experienced team of loyalty marketing professionals who, between them, have over 90 years of experience in the field;
•(2002/2003) loss on paper of some £32 million;
•(2003/2004) showed a loss of only £8.99 million. This means that the reduction in loss, year-on-year, was approximately £23 million. 2005 showed that Nectar had made a profit of some £25 million during the year, and expected to see double-digit profit growth going forward.

Nectar financial highlights 2007 to present

- 2007 LMG had revenue of GBP198 million and adjusted EBITDA of GBP23 million;
- 2007 LMG was acquired by Aeroplan Income Fund (under Groupe Aeroplan) for £350 million ($717.5 million) plus

working capital adjustments of £18 million ($36.9 million) for total consideration of £368 million ($754.4 million);[89]

- Forecasts for the 2008 calendar year revenue was anticipated to be in the range of between GBP205 million and GBP215 million. Adjusted EBITDA is expected to reach between GBP25 million and GBP27 million;
- According to Aeroplan's financial statement in 2009, Aeroplan derive revenue from breakage (unredeemed points) and report this to be about 17%. See slide page 27. GBP1 billion worth of rewards to its members over the first five years of its life;
- Revenue for 2009 for Groupe Aeroplan was
    - 2007 $906.4 income $189.7 million;
    - 2008 $1,458 million income $219.1 million;
    - 2009 $1,437 million income $163.8 million.

[89] Aeroplan Income Fund acquired LMG from Sir Keith Mills (Chairman of LMG), global private equity investor Warburg Pincus and the management team for a purchase price of. RBC Capital Markets acted as financial advisor to Aeroplan in this acquisition and has, through a banking syndicate, provided the debt financing necessary to complete the transaction.

Revenue model

1. Nectar, a subsidiary of Aeroplan, earns the majority of its Gross Billings by receiving a market service fee from its accumulation partners for each Nectar Point issued to members. Accumulation Partners, generally have long-term contracts containing minimum commitments. When members redeem Nectar points for rewards, Nectar pays redemption partners a redemption service fee for fulfilling the reward to the member;
2. Operating cost, not included in the cost of providing rewards, include the maintenance of the system used to manage Nectar points balances and security, marketing costs such as advertising and communications, employee costs and contact centre costs.
3. Nectar also generate revenue by offering an Internet shopping portal, Nectar e-Stores, was launched in October 2005. This portal averaged 1.4 million visits per month in 2009.
4. Travel revenue potential, according to Rupert Duchesne Nectar will use its relationship with Air Canada and Star Alliance and virtually every hotel group in the world and the leading car rental chains.

Aeroplan business units [90]

Aeroplan revenue is derived from an entirely different model than nectar

- Groupe Aeroplan derives its Gross Billings from the sale of GA Loyalty Units and marketing services to its Accumulation Partners. The marketing services consist primarily of advertising and promotion related services;
- Members accumulate GA Loyalty Units through their purchase of products and services from an extensive

[90] Ian Landry, Airline Convergence 2009

network of Accumulation Partner, representing brands in credit and charge cards, grocery, airline, retail and other industries;

- The gross proceeds received by Group Aeroplan at the time of sale of GA Loyalty Units to its partners, known as Gross Billings, are deferred and recognized as revenue upon the redemption of GA Loyalty Units for GAAP purposes, except for Breakage.
- Upon the redemption of GA Loyalty Units, Group Aeroplan purchases Airline seats, shopping discounts or other products or services in order to deliver the reward chosen by the member. At such time, Group Aeroplan recognized expense equal to the cost of the reward, and the deferred revenue related to the GA Loyalty Units being redeemed is recognized as earned revenue in relation to the operation of Merchant loyalty programs include contact centre expenses, information technology costs and selling and administrative expenses.

** Management feels the weighted average breakage factor currently used by Management is presently 20% of current GA Loyalty Units issued (mileage float run-up diagram above). Breakage is recognized as revenue over the estimated life of GA Loyalty Unite, currently 30 months for the Aeroplan Program. The current estimated life of a Nectar Point issued under the Nectar Program is 15 months. [91]

Nectar Card Rewards Overview

Nectar programs rewards for members

[91] Oliver Wyman, Airline Conference 2008.
[91] Oliver Wyman, Airline Conference 2008.
[91] Ian Landry, Airline Convergence 2009
[91] Oliver Wyman, Airline Conference 2008.

Members can use the Card on the high street, online or even on holiday and you'll collect points at a faster rate than ever before.

You can also double the points you collect at Nectar partners. Simply hand over your Nectar loyalty card and your new Nectar Credit Card at participating partners and you'll collect up to 4 points for each full £1 you spend1 plus double Nectar points for the first 3 months1.

Card benefits like:

- Double Nectar points for the first 3 months of Card membership;
- 2 points for every full £1 spent on the Nectar Credit Card at Nectar partners;
- 1 point for almost every full £1 spent on the Card everywhere else;
- 500 MorePoints1 for every £500 you spend on your Card, each calendar month.

Collect points faster with the Nectar Credit Card

- Collect Nectar points wherever you use your Nectar Credit Card - online or on the high street - you'll collect 1 Nectar point for every full £1 you spend. And when you spend with Nectar partners like Sainsbury's, BP Homebase and Expedia, you could collect up to 2 points for every full £1 spent. So you can collect up to 4 points per full £1 at most Nectar partners when you use your Nectar Credit Card and Nectar loyalty card at the same time;
- It's easy. For every £500 spent in any calendar month, members collect 500 EXTRA Nectar Points (MorePoints). £1,000 in one month equals 1,000 Nectar points, £1,500 equals 1,500 points. And so on...
- American Express affiliation means that members can use their card all over the world - wherever American Express is accepted;
- Nectar Credit Card charges interest at a typical 19.9%APR .4;

- 24/7 Card replacement and Purchase Protection Benefit;
- No annual fee.

Nectars database and IT systems

Table A

Collector Quintile	Percent of All Points Collected	Revenue per Month to Nectar (£millions)	Cost to Manage Customer Data (£ millions)	Contribution[a] (£millions)	Percent of Contribution
Top 20%	61%	£12.1	£2.6	£9.5	136%
Second 20%	20%	£4.0	£2.6	£1.4	21%
Third 20%	9%	£1.8	£2.6	-£0.8	-11%
Fourth 20%	8%	£1.7	£2.6	-£0.9	-13%
Last 20%	2%	£0.3	£2.6	-£2.3	-32%

Source: Company records.

[a]Contribution is revenue less redemption cost less cost to manage customer data.

Table 10

Sample report

The combined data derived via the Nectar program is owned by Nectar's operator, rather than the partners. This data includes the necessary customer registration details, and information about the number of points earned for each transaction (but not about the specific purchases).

Data agreement must follow key guidelines:

- The terms of the Data Protection Act;
- Each customer's individual information preferences;
- LMUK's own internal database principles.

LMG has rolled out several distributed virtual appliances, using 5 Terabytes for analytics, 2 Terabytes for testing, and 1 Terabyte for business continuity and disaster recovery support.

Data input included:

- Paper-based forms available in stores or received through mailings; online; or by phoning a call centre.

- By 2004 millions of households were collecting points, and both retail and service partners were making as many as 50 extracts a month from their Nectar databases to gain intelligence to guide campaigns.
- 96% of records were considered 'PAF perfect' ('PAF' is the UK's official postal address file, as maintained by the Royal Mail).

Example 1 business intelligence (BI) in action

Project Brand Health

- The system also shows what goods consumers are buying alongside a particular product, and if a product declines in sales it will show what other products consumers have switched to.
- Data on how well a particular brand has performed before and after a promotion and New Product Development will monitor how well new products are selling in stores.
- Media Optimiser, to provide reports on how well different types of promotion in different media are working.
- Self-Serve system for suppliers that want to monitor sales of their own products in the supermarket chain. LMG will store the data from Sainsbury's stores in its own database, and send relevant data to the Self Serve system at the suppliers to produce reports.
- Specific information on who was buying what, for customers who are in the Nectar card loyalty scheme. "We'd be able to show information like: women aged 18-30 in a certain part of the country are buying a lot of Diet Cola," he said.

Technology suppliers

- Adobe Air and Adobe Flex technology for reporting, i.e. generation of pie charts to bar charts.

- Kognitio, a provider of business intelligence and data warehousing systems and, Trillium Software to help ensure the accuracy of contact details for Nectar points collectors.
- BI TS Discovery, the data profiling and analysis component of the Trillium Software System (data quality being the main goal). The company provides direct mail services and manage mail to list accuracy to over 10 million new cards to collectors.

Database usage Example: coupon program

Program to reward customers with targeted money-off vouchers at the till.

Data from Nectar will be used to provide reward coupons that give up to 20% off branded and Sainsbury's own brand products. Brands including Unilever, Heinz and Proctor & Gamble have signed up to the program.

"We know that 50% of shoppers take coupons and vouchers with them when they shop, and it's a really practical way for people to stretch their budgets, especially in the current economic climate."

Gwyn Burr Sainsbury's customer director[92]

Outsource partners

- Platform developer: Infosys Technologies
- Print and Production: since 2004 Nectar has worked with a variety of suppliers including some market leaders such as Mohn.
- Registration and Fulfillment: Nectar maintain control of Points Update Mailing and registration kits as well as replacement of lost, stolen or damaged cards.

Contact Centres: phone, email, webchat and mail interactions are outsourced to Sitel.

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[92] Rosie Baker, Marketing Wee, Sep 2009

Canadian Tire Financial Services (CTFS) card case study

CTFS has had tremendous success with its card portfolio over the years. In fact, CTFS' card program has been nothing less than exceptional, even rivalling the revenue of its retail divisions. For example, in Q1 2008, its credit card earnings before income tax was $53.6 million compared to $43.6 million for its retail operations.[93] This was early in the credit crSoftcard when the card industry as a whole was writing off billions of dollars in bad debt.

Some company firsts:

- CTFS is viewed as a global leader in loyalty programs. Canadian Tire money (script) has been around since 1958. As a pioneer, the script originally earned 5% of the eligible purchase price, but was subsequently lowered to 3% and then 1.4%. It is now 0.4% as they convert from script to 'Money on card programs' as explained below. First for the firm was in 1995 when CTFS became the first non-deposit taking financial institution worldwide to launch a MasterCard;
- In 2000, CTFS created an innovation on its card and launches Canadian Tire 'Money on Card' whereby card holders receive 'Money' or script on their cards for purchases at Canadian Tire stores;
- CTFS set up Glacial Credit Card Trust and successfully launched its card program;

93 Canadian Tire Financial Report, 2008

- Marked another first when it became the first Canadian asset-backed initiative since the credit crSoftcard, by issuing $635-million in credit card receivables on February 4th, 2008.

Despite owning a consistently profitable card portfolio, according to recent company reports, the firm's emphasis on loyalty appears to be geared to defend its enviable position as a leading Canadian retailer. According to president and chief executive officer, Stephen Wetmore, "In 2011 the retailer will offer in-store financing and use the Canadian Tire credit card to attract more customers."

Wetmore cited the loyalty program as one of the drivers of future growth for the companies retail operations as it~~s~~ faces growing competition from the world's "largest and most sophisticated retailers (likely reference to Walmart who recently launched their own MasterCard and bank in Canada, and Target Corp. recently acquired by Zellars: large Canadian retailer) and also the changing demands posed by an aging population and new Canadians."[94]

Wetmore further added that CTFS will utilize electronic loyalty programs to generate data that help retailers manage their stores by allowing them to track what people are buying and where.

Apart from a recognition that loyalty can pay, Wetmore's comments may also be a reflection of the market's perception of card programs. Due to the high cost of capital paid to securitize its portfolio prior economic models may have also forced the retailer to re-evaluate its business model, which previously focused on the revenue over the marketing value of the card program.

Key corporate data

In 2008, Glacier sold $600-million of five-year notes that pay 5.03 per cent annually, a price that represents a 150 basis point premium to a benchmark federal government bond. When Glacier last sold

[94] Dana Flavelle, The Star, Ink May be fading on iconic gas money, May 15, 2009.

five-year notes in November 2006, it offered a premium of just 35 basis points. Glacier also sold $35-million of subordinated notes Monday at 250 basis point above the benchmark bond. The Glacier program is designed to let Canadian Tire raise up to $3-billion by selling notes backed by money owed to the chain by its credit card-carrying customers.

About CTFS

- 58,000 employees;
- 1,200 retail stores and gas bars and a major financial service provider and chartered bank;
- 1.8 million active accounts, and 5 million MasterCard holders = 1 in five households;
- 378 Marks Work warehouse stores;
- CTFS, with Canadian Tire Bank, currently employs more than 1,600 people;
- The Service Quality Measurement Group Inc. (SQM) has repeatedly recognized us as the ‘Best Call Centre in North America’ and an organization whose overall customer satisfaction ratings are at the world-class level.

Key dates

- 1995 CTFS became the first non-deposit taking, financial institution worldwide to launch a MasterCard called the Options MasterCard;
- 2000 CTFS expanded Canada's oldest and most recognized loyalty program, Canadian Tire 'Money' paper coupons, by launching the Canadian Tire 'Money' On The Card awards program;
- 2003, Canadian Tire Bank was established.

Consumer perception of the CTFS’ credit backed loyalty program

For patrons of Canadian Tire, this card provides a competitive reward value. There are 4 card options that offer different reward types. From occasional $.10 per litre in fuel savings to 3X and 5X rewards on promotional items. Typically, Canadian Tire rewards are 1.5% cashback that is used in Canadian Tire stores only.

Card drawbacks

- No free travel insurance and car insurance for business travelers;
- No car insurance;
- Interest rate higher than average at 18.9 to 24.6% compared to typical card interest is about 18.50%, while some cards can be as low as 9.9%.

Card financial highlights

- Securitization through Glacial Credit Card Trust;
- Value of loan portfolio: Card receivables were $4.2 billion at the end of the third quarter 2009 compared to $3.6 billion in 2007. This represents a 4.3% increase over the $4.0 billion portfolio at the end of the comparable 2008 period, attributed to select limit increases, balance transfer offers and a lower customer payment rate;
- Card funding sources:
    - Q4 2009, at quarter end, Financial; Services had more than $590 million in retail deposits and $1.45 billion in broker deposits;
    - $1.17 billion of committed bank lines are available to Financial Services;
    - $530 million retail deposits;
    - Medium Term notes (MTN) $750 million;
    - Commercial paper $800 million;
- Net write offs: net write-off rate for the total managed portfolio on a rolling 12- month basis was 7.30%, compared to 6.04% in the comparable 2008 period;
- 2008 revenue: Financial Services' earnings was $131.0 million in 2009, versus $195.8 million recorded in the prior year;

- CTFS sold is mortgage portfolio in 2009 for $162 million pre-tax.

Card features

Card types

1. Gas advantage MasterCard

Target clients: Drivers looking for competitive fuel pricing.

Card benefits: 2 cents and up to 10 cents* off per litre of gas at Canadian Tire Gas Bars.

How it works

1. Swipe the card at the pump
2. Watch the litre price turn back INSTANTLY

Curve card

Additional card features

- Purchase protection
  - Feature description
    - Product Protector® provides optional product warranty and price protection coverage for all purchases made on your Canadian Tire Credit Card – regardless of where the items are purchased*.
    - Product Protector is endorsed by Canadian Tire and underwritten by Aviva Insurance Company of Canada.

Product Protector Benefits

- Automatically doubles the Canadian Tire or manufacturers' warranty on eligible products for up to two additional years, to a maximum of seven years in total.
- Repairs or replaces eligible purchases that are lost, stolen or damaged within 90 days of the date of purchase.
- Pays you the price difference if you buy an eligible product and then find it for a lower written advertised price within 60 days (up to a total of $1,000 per calendar year).

- Covers purchases made at any retailer in Canada or around the world*.
- 30-day Money Back Guarantee

Travel insurance

CTFS travel Insurance is arranged by Securiglobe Inc. and endorsed by Canadian Tire .

Insurance providers:

- Blue Cross
- Co-Operators (Destination)
- Co-operators (MedGuard)
- Co-Operators (TIC)
- Industrial Alliance Pacific (Travel Underwriters)
- Manulife Financial
- Echelon (Medica)
- AIG Commercial (MedTrotter)
- Reliable Life (MediGlobe)
- Royal & Sun Alliance (ETFS)
- Royal & Sun Alliance (Globetreck)
- SRI
- (Seven Corners

High margin client rewards programs

Get up to 5x rewards

For the month of July, Options Elite card members could earn BONUS Canadian Tire 'Money' rewards1 on their purchases at Canadian Tire stores2. Here's how:

CTFS financial overview and securitization strategy

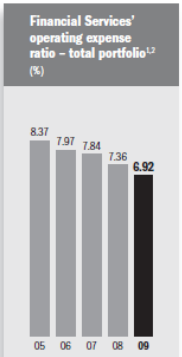
Glacial Credit Card Trust Asset-Backed financial highlights

Glacier Credit Card Trust
Asset-Backed Notes, Series 2005-1, Series 2006-1, Series 2006-2 and Series 2008-1
Reporting Period = May 1, 2010 to May 31, 2010

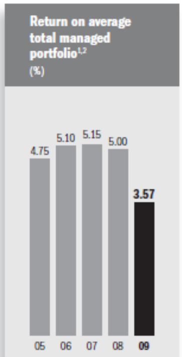
Summary of Notes Outstanding	Senior Notes	Subordinated Notes
Series 2005-1		
Principal Outstanding	$344,925,000	$20,075,000
Interest Rate	4.187%	4.507%
Expected Repayment Date	19-Nov-10	19-Nov-10
Series 2006-1		
Principal Outstanding	$300,000,000	$17,460,000
Interest Rate	4.271%	4.571%
Expected Repayment Date	18-Nov-11	18-Nov-11
Series 2006-2		
Principal Outstanding	$238,650,000	$13,890,000
Interest Rate	4.405%	4.765%
Expected Repayment Date	20-May-14	20-May-14
Series 2008-1		
Principal Outstanding	$600,000,000	$34,930,000
Interest Rate	5.027%	6.027%
Expected Repayment Date	20-Feb-13	20-Feb-13
Selected Account Performance		
Pool Balance		3,975,537,280
Collections (excluding recoveries and interchange)		1,013,480,268
Collection Rate		25.53%
Yield (excluding interchange, annualized)		15.96%
Yield (including interchange, annualized)		20.28%
Net Written-Off Amounts		25,868,011
Net Write-Off Rate (annualized)		7.82%
Series 2005-1 Ownership Interest		
Ownership Income Source		3,795,353
Ownership Income Share		1,283,237
Ownership Income Source as a % of Principal Outstanding (annualized)		12.48%
Ownership Income Share as a % of Principal Outstanding (annualized)		4.22%
Enhancement Draw Amounts		$0
Series 2006-1 Ownership Interest		
Ownership Income Source		3,300,845
Ownership Income Share		1,166,387
Ownership Income Source as a % of Principal Outstanding (annualized)		12.48%
Ownership Income Share as a % of Principal Outstanding (annualized)		4.41%
Enhancement Draw Amounts		$0
Series 2006-2 Ownership Interest		
Ownership Income Source		2,625,016
Ownership Income Share		957,405
Ownership Income Source as a % of Principal Outstanding (annualized)		12.47%
Ownership Income Share as a % of Principal Outstanding (annualized)		4.55%
Enhancement Draw Amounts		$0
Series 2008-1 Ownership Interest		
Ownership Income Source		6,601,689
Ownership Income Share		2,785,495
Ownership Income Source as a % of Principal Outstanding (annualized)		12.48%
Ownership Income Share as a % of Principal Outstanding (annualized)		5.26%
Enhancement Draw Amounts		$0

Notes reporting period = May 1 2010 to May 31

Gross margin
Gross margin is Financial Services' total revenue less direct expenses associated with credit card, personal and line of credit loans and insurance and warranty products. The most significant direct expenses are the provision for credit losses associated with the loan portfolios, the loyalty program and interest expense.



[1] Figures have been restated for the implementation, on a retrospective basis, of CICA HB 3064 – Goodwill and Intangible Assets and the amendments to CICA HB 1000 – Financial Statement Concepts. See sections 17.1 and 17.2 for additional information.
[2] Excludes the impact of the 2006 stock option modification.



[1] Figures have been restated for the implementation, on a retrospective basis, of CICA HB 3064 – Goodwill and Intangible Assets and the amendments to CICA HB 1000 – Financial Statement Concepts. See sections 17.1 and 17.2 for additional information.
[2] Excludes the net effect of securitization activities, gain on disposal/redemption of investment, costs associated with the sale of the mortgage portfolio and gain/loss on disposal of assets.

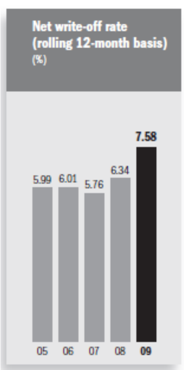
The return on the total managed portfolio has decreased in comparison to 2008. The Canadian economy continues to be challenged with an increase in unemployment rates resulting in rising consumer bankruptcies, a deterioration of the aging of receivables and increased write-offs. Other variable costs also increased such as an increase in interest expense caused by carrying excess liquidity.

Financial Services' credit card accounts (MasterCard, VISA and proprietary store cards) provide increased earnings potential through the cross-selling of balance-based insurance products and other financial services being offered by Financial Services. As Financial Services introduces lower rate credit cards and other loans receivable, the reduction in gross margin as a percentage of gross average receivables will be offset by continued growth in loans receivable, higher sales of insurance and warranty products and ongoing improvements in the operating expense ratio.

As part of the strategic planning process, management set a long-term goal of managing Financial Services' pre-tax return on the average total managed portfolio in the target range of 4.5 to 5.0 per cent. As shown in the table above, Financial Services has met or exceeded this target over four of the last five years, but missed the target in 2009 for the reasons noted above. Management believes the pre-tax return on the average total managed portfolio will fall within the target range in the longer term, as unemployment levels and consumer spending behaviour return to historical norms.

Portfolio quality

	2009	2008	2007	2006	2005
Net write-off rate (rolling 12-month basis)	**7.58%**	6.34%	5.76%	6.01%	5.99%
Account balances less than 30 days overdue at end of period	**95.92%**	96.46%	96.36%	96.44%	96.31%
Allowance rate	**3.07%**	2.36%	2.41%	2.42%	2.52%



Net write-offs
Net write-offs represent account balances that have been written off, net of collections of amounts previously written off. Net write-off rate is the net write-offs expressed as a percentage of gross average receivables in a given period.

The 2009 rolling 12-month net write-off rate on the total loans portfolio was negatively impacted by an increase in write-offs and consumer bankruptcies as a result of a significantly more challenging economic environment and rising unemployment levels as well as a reduction in the rate of portfolio growth.

While bankruptcy costs increased, analysis of the business segment's performance versus national statistics indicates that Financial Services continues to experience lower costs than would be expected compared to its peers due to its effective credit risk strategies over the past few years, which improved the quality of the loan portfolio.

Taken from published annual report 2009

Periodic fluctuations in write-offs, aging and allowances occur as a result of a variety of economic influences such as job growth or losses, personal debt levels and personal bankruptcy rates, as well as changes caused by adjustments to collection strategies. The increase in the allowance rate compared to 2008 is due to an increase in the credit card portfolio aging. However a number of actions have already been taken to manage the quality of the portfolio and write-off rates are expected to return to acceptable levels over the longer term.

Allowance methodology Financial Services is required to maintain an allowance for future write-offs that will be incurred in the receivables portfolio.

Allowance
The allowance is an estimate of the amount of receivables as at the balance sheet date that will be written off, over a set period, pursuant to Company policy. It is determined using historical loss experience of account balances based on the aging and arrears status, with certain adjustments for other relevant circumstances influencing the recoverability of the loans.

5.3.4.4 Insurance and ancillary products

An important part of our Financial Services business is the ability to provide our large credit card customer base with additional products and services that enhance their loyalty to Canadian Tire and increase the return on our portfolio of receivables. These products and services include insurance offerings (credit protection, life and accident), warranty coverages, roadside assistance and identity theft coverage. We are continually searching for and testing additional value-added products and services for our customer base.

Of the earnings from these ancillary products and services, our creditor insurance and warranty services businesses are the most significant. These products and services have been offered to customers for more than 20 years. Financial Services is very experienced in managing the associated risks. The creditor insurance risk and warranty risk relate primarily to our card customer base and are borne by our reinsurance subsidiary which operates in Bermuda under professional management, together with the services of reputable and experienced actuarial and administrative services organizations.

5.3.4.5 Financial Services' financial results

($ in millions)	Q4 2009	Q4 2008[1]	Change	2009	2008[1]	Change
Gross operating revenue	$ **237.7**	$ 212.4	11.9%	$ **909.9**	$ 820.4	10.9%
EBITDA[2]	**57.0**	57.9	(1.4)%	**205.3**	218.1	(5.9)%
Earnings before income taxes	**38.4**	45.8	(16.0)%	**131.9**	192.0	(31.3)%
Less adjustment for:						
Costs associated with sale of mortgage portfolio	**(5.3)**	-		**(5.3)**	-	
Gain (loss) on disposals of property and equipment	**0.4**	-		**(0.3)**	(0.6)	
Net effect of securitization activities[3]	**(1.0)**	(10.6)		**(7.8)**	(2.9)	
Adjusted earnings before income taxes[2]	$ **44.3**	$ 56.4	(21.5)%	$ **145.3**	$ 195.5	(25.7)%

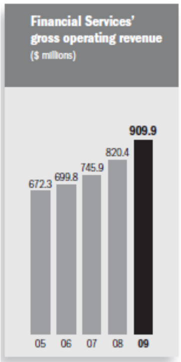
[1] 2008 figures have been restated for the implementation, on a retrospective basis, of CICA HB 3064 – Goodwill and Intangible Assets and the amendments to CICA HB 1000 – Financial Statement Concepts. See sections 17.1 and 17.2 for additional information.
[2] See section 18.0 on non-GAAP measures.
[3] Includes initial gain/loss on the sale of loans receivable, amortization of servicing liability, change in securitization reserve and gain/loss on reinvestment.

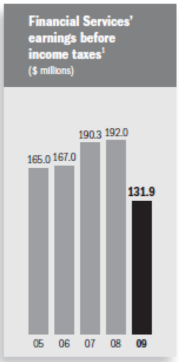
Explanation of Financial Services' financial results

Fourth quarter Financial Services' gross operating revenue increased by 11.9 per cent over the fourth quarter of 2008 largely as a result of an increase in credit interest earned due to an increase in yield and an overall growth in the gross average receivable balance. This was partially offset by a 6.3 per cent decrease in revenue from insurance services.

Earnings before income taxes for the fourth quarter decreased significantly in comparison to the same quarter last year. The primary reason for the decline in earnings growth during the quarter was the increase in loan loss provisioning resulting from a softening economy and credit market conditions and its consequent impact on consumer bankruptcy and write-off rates, as noted above. It was also attributable to an increase in interest expense caused by carrying excess liquidity. These increased funding and bankruptcy costs were partially offset by a continued effort to reduce ongoing operating costs. The operating expense ratio as a percentage of GAR was 6.92 per cent versus 7.36 per cent at the end of 2008. In addition, Financial Services incurred non-operating costs associated with the sale and wind-down of mortgage activities of $5.3 million.

Taken from published annual report 2009





[1] 2008 results have been restated for the implementation, on a retrospective basis, of CICA HB 3064 – Goodwill and Intangible Assets and the amendments to CICA HB 1000 – Financial Statement Concepts. See sections 17.1 and 17.2 for additional information. Data required to restate the information prior to 2008 is not available.

Full year 2009 Financial Services' gross operating revenue increased in 2009 due to an increase in average account balances in the loans portfolio leading to growth in loans receivable, albeit at a slower pace than in previous years, as well as higher credit sales and a slowing of customer payments.

Earnings before income taxes for 2009 decreased significantly in comparison to 2008. The primary reason for the decline in earnings growth during 2009 was due to the increase in the loan loss provisioning as discussed above under the fourth quarter results. There was also a substantial increase in interest expense, as noted above. Offsetting these costs were well-managed operating expenses in 2009 compared to 2008.

5.3.4.6 Business trends

The total Canadian bank card market (which is comprised of all MasterCard and VISA branded credit cards as reported by the Canadian Bankers Association) has grown consistently over the past five years, offering an attractive growth opportunity despite intense competition. While Canada's major banks are the market leaders, U.S.-based credit card issuers are gaining market share and are redefining customer expectations. With the increasing number of credit cards available, consumers are looking for relationships with organizations that offer good value, exceptional service and programs that reward them for their loyalty. Growth of the credit card portfolio and the continued strength of the Canadian Tire brand provides an opportunity to grow the number of credit card customers that have one or more of our ancillary products and services.

5.3.4.7 Economic overview

As noted above, the year ahead is projected to remain challenging due to the slow pace of economic recovery and high unemployment levels, with the consequent impact on consumer confidence. Financial Services expects credit card write-offs over the next year to remain at the current elevated level.

Financial Services continually monitors bankruptcy rates in Canada and adjusts its lending policies according to current trends and economic indicators. Consumer bankruptcies in Canada have increased 31.2 per cent year-over-year (as of November 2009). Meanwhile, Financial Services' bankruptcy growth rate of 23.6 per cent was well below the national average.

Efforts to reduce the exposure to higher credit risk associated with increased bankruptcies have been underway over the last several quarters through measures such as reducing credit limits for inactive accounts, actively changing the percentage of near-prime consumers in the portfolio mix, improving predictive scorecards to identify high-risk customer behaviour and further enhancing collection strategies.

5.3.4.8 Business risks

Financial Services is exposed to a number of risks in the normal course of its business that have the potential to affect its operating performance. We have undertaken a third-party review of risk management and the results were positive. The following are some of the business risks specific to Financial Services' operations. Please refer to sections 14.2, 14.4 and 14.5 for a discussion of some other industry-wide and company-wide risks affecting the business.

Highlights taken from published annual report 2009

Financial highlights 2009

CANADIAN TIRE FINANCIAL SERVICES (Financial Services)

($ in millions) Q3 2009 Q3 2008(1) Change 2009 YTD 2008 YTD(1) Change

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Total managed

portfolio end

of period $4,174.4 $4,002.3 4.3%

Gross operating

revenue $ 222.0 $ 197.8 12.2% $ 672.2 $ 608.0 10.6%

Earnings before

income taxes 18.7 47.6 (60.8)% 93.5 146.2 (36.1)%

Less adjustment for:

Gain (loss) on disposal of property and equipment	(0.5)	(0.6)		(0.7)	(0.6)	
Net effect of securitization activities(2)	(9.0)	(9.1)		(6.8)	7.7	
Adjusted earnings before income taxes(3)	$ 28.2	$ 57.3	(50.9)%	$ 101.0	$ 139.1	(27.4)%

(1) 2008 figures have been restated for implementation, on a retrospective basis, of the CICA HB 3064 Goodwill and Intangible Assets and the amendments to CICA HB 1000 - Financial Statement Concepts. Please refer to Note 2 in the Consolidated Financial Statements.

(2) Includes initial gain/loss on the sale of loans receivable, amortization of servicing liability, change in securitization reserve

and gain/loss on reinvestment.

(3) Non-GAAP measure. Please refer to section 15.0 in Management's

Analysis of financials

Financial Services' total managed portfolio of loans receivable was $4.2 billion at the end of the third quarter, a 4.3% increase over the $4.0 billion portfolio at the end of the comparable 2008 period due to select limit increases, balance transfer offers and a lower customer payment rate.

Financial Services' gross operating revenue was $222.0 million in the quarter, a 12.2% increase over the $197.8 million recorded in the prior year, reflecting an increase in yield resulting from various pricing initiatives and an increase in the total managed portfolio of loans receivable.

Earnings before income taxes for the third quarter decreased significantly compared to the same quarter last year due to the increase in loan loss provisioning resulting from increased bankruptcy and write off rates noted below and an increase in interest expense caused by carrying excess liquidity.

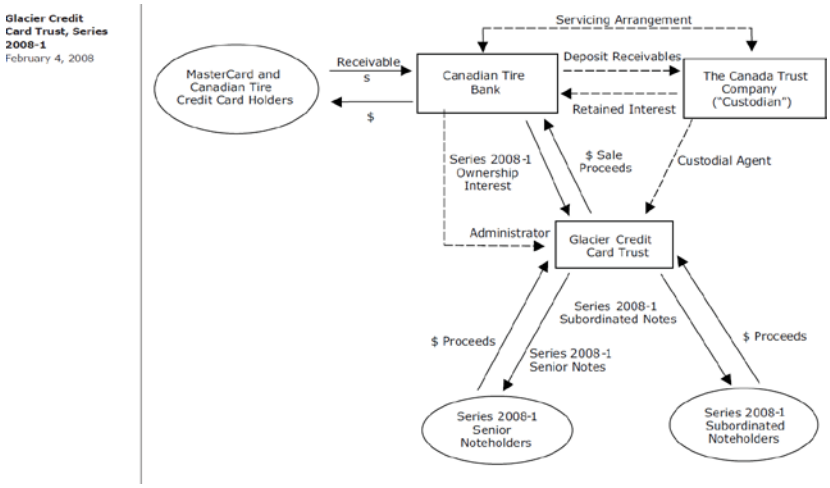
The net write-off rate for the total managed portfolio on a rolling 12- month basis was 7.30%, compared to 6.04% in the comparable 2008 period. While bankruptcy costs increased, analysis of Financial Services' performance versus national statistics indicate that Financial Services continues to experience a lower growth in bankruptcies than the Canadian average due to its effective credit risk strategies. Overall aging of past due accounts deteriorated by 47 basis points from September 2008.

As previously announced, Financial Services' sold its mortgage portfolio, approximately $162 million pre-tax, to National Bank of Canada, but is continuing to invest in its retail and broker deposit products. At quarter end, Financial Services had more than $590 million in retail deposits and $1.7 billion in broker deposits. The average term of maturity for the broker deposits is approximately 30 months.

Looking forward, the government has announced new credit card legislative changes that come into effect at varying times during 2010, and will impact items such as interest charges, payment allocation methodology and credit limit.

Source of financing taken from 2010 investor presentation

Glacial Credit Card Trust flow



Funding and liquidity highlights

Financing Source	Amount Available	Description
Committed bank lines of credit	$1.17 billion	• Provided by 10 domestic and international financial institutions • Supports the $800 million commercial paper program • No amounts were drawn on the bank lines as at April 3, 2010
Commercial paper program	$800 million	• Canadian Tire had no commercial paper outstanding as at April 3, 2010
Medium Term Notes (MTN) program	$750 million	• New Shelf Prospectus completed as of April 8, 2009, providing for access up to $750 million • $200 million was drawn upon as an MTN issuance in June 2009
Securitization of receivables	Transaction specific	• Handled through Glacier Credit Card Trust • Glacier Credit Card Trust had issued $163 million of commercial paper
Broker GIC deposits	No specified limit	• Funds are available through broker networks • $1.45 billion in broker GIC deposits as at April 3, 2010
Retail deposits	No specified limit	• Retail deposits consist of High Interest Savings Accounts, Tax-Free Savings Accounts and retail GIC deposits • Financial Services held $530 million in retail deposits at the end of April 3, 2010
Sale/leaseback transactions	Transaction specific	• Strategic transactions involving Company owned properties

Securitization is an important funding program, in the past and future, but we have alternatives

Financial Services continues to have access to multiple sources of funding including:

- Operating cash flow
- Broker deposits
- Retail deposits in the form of high interest savings accounts and GIC's

In addition, $1.2 billion of committed bank lines are available to Financial Services.

By the end of the third quarter, Financial Services had pre-funded the majority of the approximately $500 million required during the balance of the year to repay maturing short-term GIC deposits and finance the increase in receivables that will result when Glacier term notes mature. The cost of this conservative approach was approximately $5 million for the quarter.

News release February 11, 2008

Glacier Credit Card Trust closes public offering of $634,930,000 in five-year term notes

TORONTO, Feb. 11 /CNW/ - Glacier Credit Card Trust today announced it has completed its asset-backed offerings of $600,000,000 of Series 2008-1 Senior Notes and $34,930,000 of Series 2008-1 Subordinated Notes.

The Series 2008-1 Senior Notes were offered at par with a coupon rate of 5.027 percent. The Series 2008-1 Subordinated Notes were offered at par with a coupon rate of 6.027 percent. Both Series 2008-1 Notes have an expected repayment date of February 20, 2013. The Senior Notes were rated 'AAA' and Standard & Poor’s Ratings Services and DBRS LIMITED rated the Subordinated Notes ‘A’.

"Despite generally challenging capital market conditions, investors continue to respond favourably to the Trust's offerings, reflecting the market's overall confidence in the growth and quality of receivables generated by Canadian Tire Bank," said Marco Marrone, president and CEO of Canadian Tire Bank.

BMO Nesbitt Burns Inc. and Scotia Capital Inc. served as lead underwriters for the offering of the Series 2008-1 Senior Notes. Other syndicate members for the offering included CIBC World Markets Inc., RBC Dominion Securities Inc., TD Securities Inc., Merrill Lynch Canada Inc. and National Bank Financial Inc. BMO Nesbitt Burns Inc. and Scotia Capital Inc. served as underwriters for the offering of the Series 2008-1 Subordinated Notes.

Glacier Credit Card Trust was established to purchase undivided co-ownership interests in a revolving pool of credit card receivables of Canadian Tire Bank, a wholly owned subsidiary of Canadian Tire Financial Services Limited. These receivables are generated from the use of Canadian Tire MasterCard(R) credit cards and Canadian Tire retail credit cards.

Walmart case study

Industry discussion: Walmart's goal to become a bank, and rationalize swipe fees and payment efficiencies.

Walmart serves customers and members more than 200 million times per week at more than 8,000 retail units under 53 different banners in 15 countries. With fiscal year 2009 sales of $401 billion, Walmart employs more than 2.1 million associates worldwide.

From a payments point of view Walmart's global transaction volumes are on par with the combined debit and credit transaction of all Canadian merchants; And at $15 B, its net income is three times the largest Canadian bank, RBC, which has revenues of $28 B, and net income of $5.1 B.

So in June 2010, when Walmart launched a bank in Canada, the financial service industry took notice. According to Walmart executives, the initiative was basically a culmination of effort by the retailer to rationalize its transaction processing costs. Other related activities include:

- Established banking operations in Mexico under the banner Walmex;
- Operating a bank and card portfolios in the UK under the banner ASDA;
- Attempted to launch an Industrial Loan Corporation (ILC) which prompted the Federal Deposit Insurance Corporation (FDIC) regulators to place a moratorium on ILCs that prompted Walmart to withdraw its application to operate an ILC;
- Led a class action suit against anti-competitive practices by Visa and MasterCard and won $3 billion in compensations as well as an estimated $87 billion in future savings;
- Growth in alternative financial services like cheque cashing.

Some concerns voiced by US FIs and the payment industry related to Walmart's possible ILC:

- The main concern was that Walmart proposed Utah-based industrial loan corporation centered on fears by the banking industry, consumer groups, and legislators that the No. 1 retailer, which has 3,700 stores in the U.S., wants to run a banking operation that would compete for consumer deposits;
- There was also concern that Walmart could establish an alternative payments system;
- Finally, there was concern about other big merchants attempting similar projects, which could potentially lead to a wider payments shakeout.

Other U.S. ILC owners include General Motors Corp., BMW, GE Capital, Sears, Volvo, and Morgan Stanley Dean Witter. The largest, owned by Merrill Lynch, has assets of $65 billion and would rank 17th on a list of the country's largest banks. According to information obtained from the FDIC, pending federal legislation would effectively remove the conditions for the Bank Holding Company Act exemption imposed on ILCs in 1987.

Some industry comments were that, "Walmart has the potential to be a formidable force in the payments business," says John Hamby, senior vice president and manager, Merchant Services Center, at Manchester, Conn.-based NewAlliance Bank. "Walmart has a big footprint and when they start marching, the rest of us take notice."[95]

Industry reaction to Walmart's attempt to start an ILC gives a good insight that industry feels about the impact Walmart could have in the payment industry. For example, the Federal Deposit Insurance Corp., which must approve Walmart's application, held public hearings on its request and devoted a portion of its Web site to the review process.

[95]Jane Adler, What happens if Walmart gets a bank? DocStock, April 2010

“Walmart has major forces aligned against it,” notes consultant Paul R. Martaus, president of Martaus & Associates, Mountain Home, Ark.[96]

Obtaining an ILC license is widely considered to be comparable to operating a bank. According to documents obtained from the FDIC, “Legislation would allow ILCs that cannot currently offer demand deposits to offer their functional equivalent, Business NOW Accounts. This, in essence, makes ILCs full service banks, but outside the scope of the Bank Holding CompanyAct.” (http://www.fdic.gov/news/conferences/future_jordespeech.html).

In the case of Walmart, one incentive for wanting to set up an ILC was to reduce processing costs. “The reason Walmart wanted to launch an ILC was, to reduce credit and debit card transaction costs,” says Jane Thompson, Walmart’s former Financial Services President.

“Transaction processing fee reductions are one of the main motivators for Canadian merchants entering the Financial Service Industry,” says Robert Elliott, a lawyer at Fasken and Martineau. “For example, it was an important concern with regard to Sears which had 10 million credit card holders. Sears launched a bank in 2002 and in 2005 sold this arm to JP Morgan Chase and Co. for $2.2 billion in cash.” [97]

A reallocation of credit card transaction fees is a primary incentive for many merchants to open banks or other types of financial service companies in both Canada and the US. However, according to industry experts, “They (Walmart) don't need an Industrial loan company (ILC) charter (a type of banking license) to play an important role in expanding access to financial services, they can do so by partnering with banks and other types,” comments Sheila C. Bair, US Federal Deposit Insurance Corporation (FDIC) Chairman

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[96]Jane Adler, What happens if Walmart gets a bank?, DocStock, April 2010

[97] Sears Press Release : Sears expect to receive more than $100 million in annual revenue as part of the deal.

in her published statement. Thompson basically echoes this sentiment in her published statements, which says the company, would continue to pursue alternative financial services products, regardless of FDIC approval.

"Since the approval process is now likely to take years rather than months," she said, "we decided to withdraw our application to better focus on other ways to serve customers. We fully intend to continue to introduce new products and services that champion those who deserve convenient, lower priced financial services. Walmart has 2 to 3 million transactions a week for its existing financial services."

Thompson points to the potential cost savings of in-house payment processing paled compared with the new business it is growing with financial services. Walmart now offers payroll check cashing, express bill payment, money orders, money transfers and Walmart branded credit cards.

Industry speculation

Addressing the widespread belief that Walmart has ulterior motives, Jane Thompson, a former top payment-service executive at Sears, Roebuck & Co. and then president of Walmart Financial Services, testified at the April FDIC hearings that "the purpose of the bank would be to sponsor credit card, debit card, and electronic check transactions—nothing more."

She went on to explain that the bank charter would allow Walmart to eliminate the sponsorship fees paid to third-party banks. (Visa and MasterCard rules require transactions coming into their networks to come from banks.) She added: "The [Walmart] bank would not have computers and systems to perform the actual processing of payments."

But Heires says sponsorship fees matter to Walmart for two reasons. First, the company expects electronic forms of payment to grow, which in turn, will increase sponsorship fees. Electronic payments are currently growing at 12% a year. Also, he says, "Saving money is our culture. We watch pennies like no other company." The money saved on sponsorship fees will be passed on to customers in the form of lower-priced products, he adds.

Heires insists the retailer's bank application is not an effort to reduce its interchange expenses. He argues, however, that interchange fees are high and Walmart would like to see those fees reduced. Previously, Walmart led a merchant class action challenging certain Visa and MasterCard policies that the associations settled for $3 billion in 2007 and this resulted in lower debit card fees. But it's not participating in the pending crop of merchant suits against Visa and MasterCard over interchange.

"It's unlikely [Walmart] is doing this because of payment processing," says First Annapolis's Abbey. "The amount they have at stake by displacing an acquirer is nothing. It's peanuts." He adds: "Consider the amount of capital [Walmart] has to have in the bank and the only upside is the avoidance of the fees they pay the acquirer? That's a real suboptimization of capital. It's too expensive."

The proposed bank's initial capitalization would be $125 million, according to an amended business plan the company submitted March 31 to the FDIC. Asked about the wisdom of allocating $125 million to recoup only several million dollars a year, Walmart's Heires emphasizes that the company expects all forms of electronic payments to grow. "The savings will increase," he says.

Heires also notes the company's margins on retail sales are razor thin—3.6% last year—and he expects the bank to earn a better return on the company's money than the chain would from its retail operation. 'We will put the money [in the bank] to work,' Heires says. "This is not as onerous as you might think."

"I'm sceptical," counters payments consultant Allen Weinberg, managing partner at Glenbrook Partners LLC, Menlo Park, Calif. "It's not clear they'll save any money." He believes it's a pretty safe assumption that Walmart, because of its size, gets the lowest possible processing fees. "The overhead of setting up a bank and dealing with regulators will cost millions. To go through all that hassle for a couple million bucks? It makes me want to take a closer look at the numbers."

Though the payment processors and banks with whom Walmart currently works likely will take a hit, the full impact on them remains unclear. Walmart says it uses about a half dozen banks as sponsors, though it refuses to name them.

A New Network?

The outcome for processors may depend on Walmart's wider plans. Unlike Costco in Canada,[98] the company says it doesn't plan to acquire transactions for other merchants. "The bank will have one customer and that will be Walmart," Heires says.

At the hearings, FDIC chief operating officer John Bovenzi asked Walmart opponents whether they might be satisfied if any changes Walmart made to its plans would be subject to review. But even if a promise is extracted from Walmart to do what it says it wants to do, many remain sceptical. "I can see the possibility that [Walmart] may take small-business clients away from community banks as a merchant acquirer," says Linda F. Echard, president and chief executive at ICBA Bancard, an Arlington, Va.-based payments processor and a subsidiary of the Independent Community Bankers of America trade group.

But consultant and former Visa USA executive Norman G. Litell, of Berkeley, Calif., thinks Walmart might want the entire processing chain under its umbrella in order to gain further control over payment operations and technology. "They can try and squeeze a bank and a processor, but there is a limit," he says. "The biggest argument [for a bank charter] might be that they will have the

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[98] Costco have an exclusive deal with Amex to issue cobrand cards to its members and receive a lower interchange or transaction fee with the cards are used in its stores. There is also an associated rewards program.

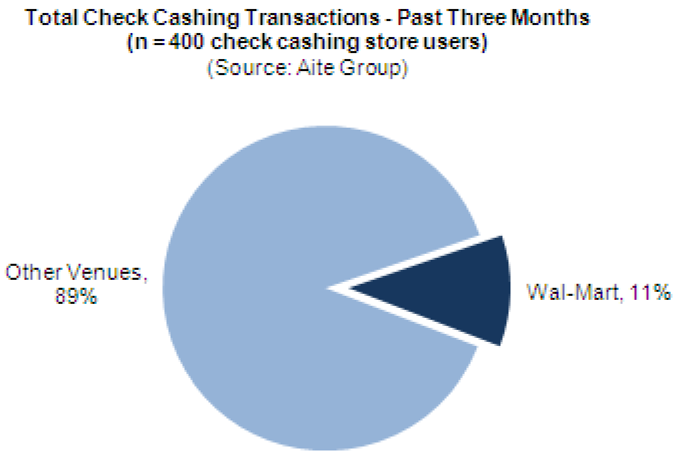
flexibility of being able to try different technologies and control the pace of adoption."

Veteran acquiring executive Hamby of NewAlliance Bank believes Walmart is capable of setting up an entirely new, low-cost payments system. "There's an opportunity there for someone to create a payments system without all the fluff," he says, noting that the current system is expensive for merchants. "An entity like Walmart has the clout to be the catalyst." In hindsight, this is exactly what the merchant consumer exchange is all about, and Walmart is a huge driver behind this initiative.

Getting more control over payment processing might just be Walmart's first step in reducing interchange, by far the biggest single expense in accepting bankcards. "I assume Walmart is trying to find a way to reduce fees by bringing transaction processing in house," says attorney K. Craig Wildfang, a partner with Robbins Kaplan Miller & Ciresi LLP, a Minneapolis-based firm co-leading the interchange lawsuits against Visa and MasterCard. "If they can establish their own network, then they can argue that they should not pay full interchange fees." Or, he adds, Walmart could possibly eliminate interchange fees altogether.

Of course, by becoming its own card issuer, Walmart could not only generate more revenue but also collect a portion of its own processing fees. Walmart's Heires is careful to say the company has not stated any plans to have a self-issued credit card, begging the question whether such a plan exists but hasn't been announced. Walmart currently has a private-label credit card issued by General Electric Co.'s GE Consumer Finance and a GE-issued Walmart Discover Card in which transactions flow on the network of Morgan Stanley's card unit, Discover Financial Services. And while Walmart has not officially launched a debit card, Heires says the company currently has a small test under way with a GE debit card in four locations. Meanwhile in Canada, Mexico and the UK, Walmart has launched banks and issues its own cards and MCX is scheduled to launch in June 2013.

Boston, MA, April 22, 2009 – A new report from Aite Group, LLC evaluates Walmart's penetration of the alternative financial services market - specifically the check-cashing segment. Based on data collected in Aite Group's Q4 2008 survey of 400 consumers of check cashing services, the report provides insight into the opportunities and challenges Walmart faces in check



Over the last few years, U.S. retailers have developed an interest in providing alternative financial services - including check cashing, general purpose prepaid cards, money order purchase and bill payment - to unbanked and underbanked consumers. Perhaps none has been as successful as Walmart. It's an ideal venue: Among regular check cashing store customers, 92% shop at Walmart at least once per three-month period. Still, less than half of the surveyed population cash checks at Walmart stores, with most preferring traditional check cashing centers due to a perceived convenience.

'In the check cashing space, Walmart is now a force to be reckoned with' says Gwenn Bézard, research director with Aite Group and co-author of the report. 'Still, the value proposition of regular check cashing stores remains very strong relative to Walmart's MoneyCenters. Gaining greater market share won't be a walk in the park.'

How cards are funded

Merchant portfolios should not rely on limited funding sources. For example, one of the main consequences of the credit crSoftcard was liquidity problems for issuers. This is because many issuers relied almost exclusively on 3rd party securitization to fund their credit card portfolios: a catastrophic approach for many.

Regulators should have flagged these issuers but this went right over their heads. The result was a meltdown in the credit card asset backed security (ABS) market. Securitization basically means using 3rd parties to fund a portfolio is covered in detail in the following section.

A well-balanced portfolio, such as Canadian Tire's has a mix of funding. In the case of Canadian Tire, the breakdown as published in their 2010 financial overview is demonstrated as per the table below.

Financing Source	Amount Available	Description
Committed bank lines of credit	$1.17 billion	• Provided by 10 domestic and international financial institutions • Supports the $800 million commercial paper program • No amount were drawn on the bank lines as at April 3, 2010
Commercial paper program	$800 million	• No commercial paper outstanding as at April 3, 2010
Securitization of receivables	Transaction specific	• Handled through Glacier Credit Card Trust • Glacier Credit Card Trust had issued $163 million of commercial paper

Retail deposits	No specified limit	• Fund are available through broker networks • $1.45 billion in broker GIC deposits as at April 3, 2010
Retail deposits	No specified limit	• Retail deposits consist of High Interest Savings Accounts, Tax-Free Savings Accounts and retail GIC deposits • Financial Services held %530 million in retail deposits at the end of April 3, 2010
Sales/leaseback transactions	Transaction specific	• Strategic transactions involving company owned properties

As shown in the table above, with billions at stake, funding a credit card portfolio poses liquidity and financial risk. For potential issuers, this is a huge consideration in determining the viability of any card program. This is why keeping the cost of funds low and ensuring no dependency on one funding source is considered critical. The following is a possible sample strategy that an issuer might consider:

Year 1

- First $60 million will be funded by merchants; after,
- Up to $150 million:
    - 25% deposit brokers
    - 50% industry based retail deposits
    - 25% merchants

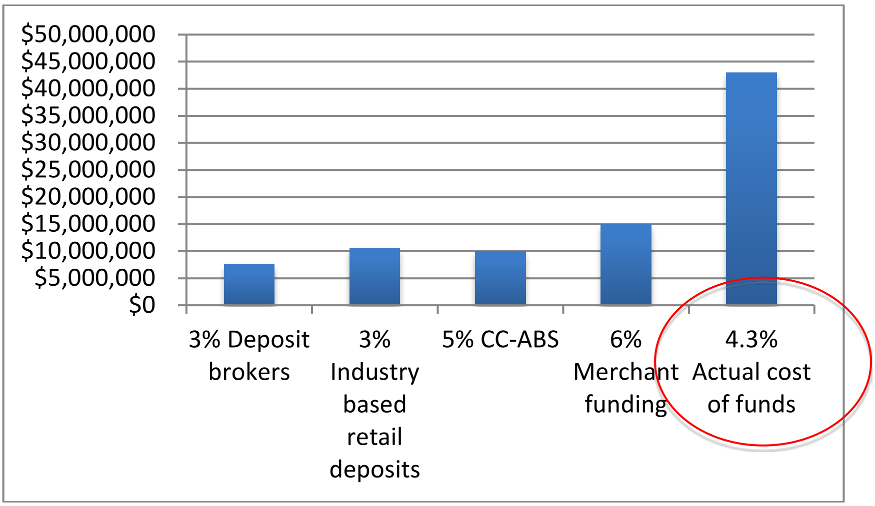
Year 2

- Up to $750 million
    - 25% deposit brokers
    - 30% industry based deposits
    - 20% credit card asset backed securities (CC-ABS)
    - 25% merchants

Year 3 – 5

- Up to $1.5 billion
    - o 20% deposit brokers
    - o 25% industry based deposits
    - o 30% CC-ABS
    - o 25% merchants

Chart X, sample cost of year 2 funds based on $1 Billion credit card assets



Chapter 16

How Credit Card Asset Backed Securities (ABS) work

For discussion credit card ABS means the receivables are pooled and sold off to investors. Proceeds of which are used to fund the credit card portfolio and also move the receivables from the issuer's books.

Typically these pools are marketed through a special purpose vehicle (SPV), which creates, and sells the securities, proceeds of which are used to pay back the card issuer.

Problems with this strategy emerged when the owners of the assets (investors) lost confidence in the value of the underlying assets. The resulting trust issues essentially pulled the rug out from credit card issuers.[99]

Issuers with diversified funds were able to avoid catastrophe. For example, most Canadian banks weathered the storm and many are even better off as a result of the crash, which decimated many issuers.

Bank of America in particular has seen its value plummet as has Citi. Citi, in particular seen as the inventor of securitization, was a victim when the engine of its growth turned out to be its undoing.

Credit card asset-backed securities (ABS) were first issued in 1987. Since that time, the credit card ABS market has become the primary vehicle by which the card industry funds unsecured loans to consumers. [100]

The ABS market also includes mortgage-based and mortgage-backed securities, collateralized mortgage obligations and real estate mortgage investment conduits. Unlike most of the underlying asset types in the ABS market, credit card loans do not have a fixed payment amount or amortization period. Mortgages, auto loans, student loans, and home equity loans typically have a pre-determined term.

The creation of credit card ABS is considered one of the most important financing innovations in the card industry's brief history. That said, card issuers have come to recognize limitations in ABS as a funding source. This concern was made clear during the credit crSoftcard when liquidity issues threatened to unseat the card industry. As such, a prudent approach to funding a card portfolio would be to have more than one source of funding for receivables. Some examples were covered in the previous section and include retail deposits, broker based deposits and equity funding.

[99] www.wikipedia.com
[100] Mark Furletti, Asset Backed Securities, December 2002.

Another reason this approach makes sense is because retail deposits can be much less costly than ABS. The downside for issuers is that retail deposits limit growth in the sense that they do not offer any possibility of taking the receivables off of the issuer's books. This means that capital adequacy ratios must be maintained. For a merchant, this means equity financing, which can be expensive. Typically this means that an issuer must maintain equity from 4% to 12% of the portfolios asset base, a calculation that is based on many variables. For a portfolio with $1 billion in assets, this means $40 to $120 million.

Consequently, during the crSoftcard, many issuers had to issue shares in order to meet capital adequacy ratios.

The actual process of securitization is very similar to that of securitizing mortgages and other loan obligations. A card issuer typically sells a group of receivables (a pool) to a trust. The trust then issues securities backed by those receivables. To illustrate how this works, here is an example: if there are 10 cardholders in a pool, each with a balance of $1000, the bundled portfolio would be a $10,000 package. This might even be broken up and then be sold to investors in blocks.

Securitization, in contrast to standard corporate bonds, or retail deposits, often use the ABS in order take the risk off the issuer and on to the investor. Essentially, the issuer structures its securitization to achieve a sale of the underling receivables for accounting purposes. Merchant card issuers will adopt securitization strategies in order to reduces risks, reduce the cost of funds or to grow their portfolio.

Types of securitization

Master trust

A master trust is a type of SPV suited to handle revolving credit card balances. It has the flexibility to handle different securities, such as credit card pools with different risk ratings, at different times. In a typical master trust transaction, an originator of credit card receivables, such as Canadian Tire or Target Corp., transfers a pool of those receivables to the trust. The trust then issues securities backed by these receivables. Often there will be many trenched securities issued by the trust that are all based on one set of receivables. However, these can also be broken up and sold differently depending on various concerns, such as the markets appetite for risk (AAA vs. BB).

For merchant owned portfolios, typically the merchant (or its merchant controlled service providers) would continue to service the credit card receivables.

Merchants looking to use this type of structure should consider some of the risks involved with master trusts specifically. One risk is that the timing of cash flows promised to investors might be different from the timing of payments on the receivables. This might be difficult to predict for new portfolios, but over time these can generally be predicted with a certain range and depending on the time of year and other macro economic factors. For example, credit card-backed securities can have maturities of up to 10 years, but credit card-backed receivables usually pay off much more quickly. To solve this issue, these securities typically have 3 different periods:

- A revolving period. During the revolving period, principal payments received on the credit card balances are used to purchase additional receivables.
- An accumulation period. During the accumulation period, these payments are accumulated in a separate account which is managed by the credit card trust.
- An amortization period. During the amortization period, new payments are passed through to the investors.

All three of these periods are based on historical experience of the receivables and rated by analysts. The assigned credit rating is based on many variables, such as revolvers, delinquent accounts, portfolio growth etc.

Typically the merchant issuer will maintain ownership of the accounts while the investor owns the receivables. This can cause issues with how the seller controls the terms and conditions of the accounts. In most agreements, there is language written into the securitization prospectus that protects the investors.

There are many risk types associated with portfolios. For example, three is a risk that payments on the receivables can shrink the pool balance and under-collateralize total investor interest. To prevent this, often there is a required minimum seller's interest, and if there was a decrease then an early amortization event would occur.[101]

Issuance trust

In 2000, Citibank introduced a new structure for credit card-backed securities, called an ‘issuance trust’. The advantage this structure has is that it does not have limitations that master trusts sometimes do, such as the requirements that each issued series of securities have both a senior and subordinate tranche. Some other benefits to an issuance trust:

- More flexibility in issuing senior/subordinate securities
- Possibility to increase demand because pension funds are eligible to invest in investment-grade securities issued by them
- Reduce the cost of issuing securities.

According to T Sabarwal, this has influenced issuers to adopt this structure such that issuance trusts are now the dominant structure used by major issuers of credit card-backed securities.[102]

Owner trust

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[101] T Sabarwal "Common Structures of Asset Backed Securities and Their Risks, December 29, 2005

[102] T Sabarwal "Common Structures of Asset Backed Securities and Their Risks, December 29, 2005

The advantage of an owner trust is increased flexibility in allocating principal and interest received to different classes of issued securities. Some advantages:

- Interest and principal due to subordinate securities can be used to pay senior securities
- Can tailor maturity, risk and return profiles of issued securities to investor needs
- Income remaining after expenses is kept in a reserve account up to a specified level and then after that, all income is returned to the seller.
- Owner trusts allow credit risk to be mitigated by over-collateralization by using excess reserves and excess finance income to prepay securities before principal. This leaves more collateral for the other classes. [103]

Limited Liability Company *(LLC)*

Target Corp has set up a Limited Liability Company. A type of company, authorized only in certain states, whose owners and managers receive the limited liability and (usually) tax benefits of an S Corporation without having to conform to the S corporation restrictions. An S Corporation is a corporation that has between 1 and 100 shareholders and that passes-through net income or losses to shareholders.

Disadvantage to Issuer

- May reduce portfolio quality: If the investor only acquires the most secure portion of the portfolio, the quality of the remaining portfolio may be more risky and, therefore, increase capital requirements.
- Costs: Securitizations require scale as they can be complicated, they require expensive management, underwriting, rating and ongoing administration fees.

[103] T Sabarwal "Common Structures of Asset Backed Securities and Their Risks, December 29, 2005

- Size limitations: Because of the underlying costs, securitizations are not cost-efficient for small and medium portfolios, or new unrated portfolios.

Advantages to investors

- Opportunity to potentially earn a high rate of return;
- Investors can choose the level of risk;

Overview of Target Corp's Credit Card Portfolio

Target's 2013 data breach is the second-largest theft of card accounts in U.S. history, surpassed only by a scam involving retailer TJX Cos. that affected at least 45.7 million card users. Targets data breach, while likely old news for insiders in the financial service industry, is a story that is still unfolding.

This document is intended to demonstrate the significance of Target's card portfolio to its operations, and assess how this might impact its operations and possibly even the Merchant Consumer Exchange (MCX), given Target's prominence as a driver for this project.

One clear consequence of the data breach is that Target has become the 'target' of numerous law suits. According to Reuters, Timothy Baer, Target's legal counsel, spoke with state prosecutors December 23rd to address concerns about the data breach. According to reports as many as 40 million credit and debit cards of shoppers who visited Target stores were stolen and regulators and other stakeholders smell blood.

Another effect of the data theft has been a hit on Target's value: a 2.8% share value drop, about $1 billion in market value to be precise. Worse, according to Reuters, was a drop in Target's consumer perception scores. Reuters indicates also that Target's Buzz score for the week preceding the data breach was 26 and dropped to -19, a drop of 45 points.

The fourth key area of impact due to the data breach has translated to a drop of 10-15 points on purchase consideration, and this could take some time to normalize. According to Ted Marzilli, chief executive of YouGov BrandIndex, based on Citibank and Sony, which were hit by fraudsters in the past, Target could take 12 weeks or longer to recover, unless more problems emerge.

Target's woes related to the card breach comes on the heels of a lacklustre Canadian launch. Another area of concern that is of note is that apart from the current crSoftcard, Target was particularly hard hit as a consequence of the credit crSoftcard. For example in 2008, its net-write-offs was $300 million in each of the first two quarters of fiscal 2009. This risk was likely the reason that Target put its US credit card receivables on the trading block. A portfolio snapped up by TD. Meanwhile, in Canada, Target partnered with RBC in Canada for both its debit and credit card portfolio.

Looking to the future, Target has joined several other merchants in an attempt to create an alternative payment network. The purpose is to gain control of mobile payments in order to protect data and maintain control. Given the risk credit and payments pose to Targets operations, as evidenced by the recent data breach, as well asTarget's history of missteps with regard to its card portfolio, and also considering Target's prominence with respect to MCX, the question that comes to mind is, 'how will this data breach impact on the MCX project?'

Before broaching this subject, I would like to make clear the importance credit and loyalty have to Target's operations. Therefore, the following section is intended to provide a detailed background on Target's credit and loyalty programs. The objective being to illustrate the significance that credit and loyalty have for its operations. The implications for MCX will be outlined in the conclusion at the end of this document.

History of Target's credit and loyalty card programs; resulting in a very strong association with Canadian banks

Based on 03/11/11	10-K	Annual report which provides a comprehensive overview of the company for the past year

Target National Bank, a limited-purpose bank based in Sioux Falls, S.D. In 2004, received approval for its industrial bank charter in Utah.

Target card revenue summary[104]

Target manages one of the largest retailer led card programs in the US. The portfolio has been extremely profitable leading into the credit crSoftcard. For example, in 2005 Target made $645 million from its cards. In 2005, Target earned interchange revenue of $124 million. Since then Target has incurred heavy losses as a consequence of write-downs due to bad debt in the aftermath of the credit crSoftcard. In reaction to this, as of February 2011, Target has declared its intention to sell off its card receivables and concluded a deal with TD bank in late 2012.[105] At the time of this announcement Target directly owned $2.4 billion of its $6.4 billion card portfolio.

Target got into trouble due to its underwriting procedures designed to promote retail sales. Target has built a reputation for offering Red Card store accounts to consumers with limited credit histories, and to consumers attempting to repair their credit.

As a consequence, in 2008 Target's net-write-offs were expected to stabilize in the range of $300 million in each of the first two quarters of 2009, levels ensuring an allowance for doubtful accounts at the end of fiscal 2008. Target expected to generate moderate credit card profits in 2009.

In fact, Target's Credit Card Segment profit increased to $201 million from $155 million as a result of improved portfolio performance (Spread to LIBOR) and reduced funding costs.

The reduction in Targets investment in the portfolio combined with these results to produce a strong improvement in segment ROIC.

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[104] http://investors.target.com/phoenix.zhtml?c=65828&p=irol-sec

[105] http://www.bizjournals.com/twincities/news/2011/11/23/target-may-sell-credit-card-debt.html

Segment revenues were $1,922 million, a decrease of $143 million, or 6.9 percent, from the year before. The decrease in revenue was driven by a lower Prime Rate, lower average receivables, higher finance charge and late-fee write-offs, and lower late fees due to fewer delinquent accounts offset by the positive impacts of the terms changes implemented.

In 2010, Credit Card Segment profit increased to $541 million from $201 million, reduced bad debt expense. The reduction in its investment in the portfolio combined with these results produced a strong improvement in segment ROIC. Segment revenues were $1,604 million, a decrease of $318 million, or 16.5 percent, from the prior year, which was primarily driven by lower average receivables as well as reduced late fees. Segment expenses were $980 million, a decrease of $644 million, or 39.7 percent, from the prior year, driven primarily by lower bad debt expense due to lower actual and expected write-offs. Segment interest expense on non-recourse debt declined due to a decrease in non-recourse debt securitized by credit card receivables.

February 2013, Target Canada announced that its Debit Card, a proprietary card issued by Target Canada, will link to the cardholder's existing chequing account, and can be used only at Target stores in Canada. Royal Bank of Canada will issue the no-annual-fee Target RBC MasterCard, which can be used anywhere MasterCard is accepted. In addition to the instant 5% savings on almost everything at Target stores, Target RBC MasterCard cardholders will earn Target GiftCard Rewards® on purchases outside of Target, anywhere MasterCard is accepted.

Credit Card Segment Results	2010		2009	
(dollars in millions)				
	Amount	Rate	Amount	Rate (d)

Finance charge revenue	1,302	18.3	1,450	17.4
Late fees and other revenue	197	2.8	349	4.2
Third party merchant fees	105	1.5	123	1.5
Total revenues	1,604	22.6	1,922	23
Bad debt expense	528	7.4	1,185	14.2
Operations and marketing expenses *(a)*	433	6.1	425	5.1
Depreciation and amortization	19	0.3	14	0.2
Total expenses	980	13.8	1,624	19.4
EBIT	624	8.8	298	3.5
Interest expense on nonrecourse debt collateralized by credit card receivables	83		97	
Average receivables funded by Target *(b)*	2,771		2,866	
Segment pre-tax ROIC *(c)*	19.5		7	

Target receivables summary

2010 period-end gross credit card receivables were $6,843 million compared to $7,982 million in 2009, a decrease of 14.3 percent.

Average gross credit card receivables in 2010 decreased 14.9 percent compared with 2009 levels.

2009 period-end gross credit card receivables were $7,982 million compared with $9,094 million in 2008, a decrease of 12.2 percent. Average gross credit card receivables in 2009 decreased 4.0 percent compared with 2008 levels. This change was driven by the tighter risk management and underwriting initiatives described above, fewer new accounts being opened, and a decrease in charge activity resulting from reductions in card usage by its guests, partially offset by the impact of lower payment rates.

Sale of receivables

January 2011, Target announced plans to actively pursue the sale of its credit card receivables portfolio. As of January 29, 2011 the gross balance of its credit card receivables portfolio was $6,843 million, of which $3,954 million was funded by third parties and $2,889 million was funded by Target. By January 2012, Target reversed its earlier strategy and announced it would retire financing provided by JPMorgan Chase. Target said it will pay Chase approximately $2.8 billion. Target said, 'Our desire to sell the portfolio on appropriate terms remains the same today as it was when discussions began, but we believe that now is not the time to finalize a transaction,' said Doug Scovanner, EVP and CFO of Target. Target believes that a transaction could occur later in the year.[106]

How Target Funds rewards

Historically, Loyalty Program discounts were recorded as reductions to sales in its Retail Segment. Effective with the October 2010 nationwide launch of its new 5% REDcard Rewards loyalty program, Target changed the formula under which its Credit Card segment reimburses its Retail Segment to better align with the attributes of the new program. These reimbursed amounts were $102 million in 2010, $89 million in 2009 and $117 million in 2008. In all periods these amounts were recorded as reductions to SG&A

[106] http://www.marketwatch.com/story/target-corporation-temporarily-suspends-efforts-to-sell-credit-card-receivables-2012-01-18

expenses within the Retail Segment and increases to operations and marketing expenses within the Credit Card Segment.

Target eliminates its Visa card relationship

Beginning April 2010, all new qualified credit card applicants received the Target Card, and Target announced that it would no longer issue the Target Visa to credit card applicants. This would typically lead to reduced card use and, therefore lower card balances

Beginning October 2010, guests received a 5 percent discount on virtually all purchases at checkout every day when they use a REDcard at any Target store or on Target.com.

REDcard Penetration	2011	2010
Target credit penetration	6.3%	5.2%
Target debit penetration	1.1%	0.4%
Total store REDcard penetration	7.4%	5.6%

January 2011, Target experienced an increase in REDcard penetration. REDcard penetration for the fourth quarter of 2011 was 7.4 percent compared to 5.6 percent in the fourth quarter of 2010.

Card revenue historical summary

Credit card revenues are comprised of finance charges, late fees and other revenue, and third party merchant fees, or the amounts received from merchants who accept the Target Visa credit card.

(a)Loyalty Program discounts are recorded as reductions to sales in its Retail Segment. Effective with the October 2010 nationwide launch of its new 5% REDcard Rewards loyalty program, we changed the

formula under which its Credit Card segment reimburses its Retail Segment to better align with the attributes of the new program. These reimbursed amounts were $102 million in 2010, $89 million in 2009 and $117 million in 2008. In all periods these amounts were recorded as reductions to SG&A expenses within the Retail Segment and increases to operations and marketing expenses within the Credit Card Segment.

(b)Amounts represent the portion of average gross credit card receivables funded by Target. For 2010, 2009 and 2008, these amounts exclude $4,335 million, $5,484 million and $4,503 million, respectively, of receivables funded by nonrecourse debt collateralized by credit card receivables.

(c)ROIC is return on invested capital, and this rate equals its segment profit divided by average gross credit card receivables funded by Target, expressed as an annualized rate.

(d)As an annualized percentage of average gross credit card receivable

Receivables Rollforward Analysis							
(millions)	2010	2009	2008				
Beginning gross credit card receivables	7,982	9,094	8,624	(12.2	%	5.4	%
Charges at Target	3,699	3,553	4,207	4.1	%	(15.5	%
Charges at third parties	5,815	6,763	8,542	(14.0	%	(20.8	%
Payments	(11,283	(12,065	(13,482	(6.5		(10.5	
Other	630	637	1,203	(1.1	%	(47.1	%

Period-end gross credit card receivables	6,843	7,982	9,094	(14.3	%	(12.2	%
Average gross credit card receivables	7,106	8,351	8,695	(14.9	%	(4.0	%
Accounts with three or more payments (60+ days) past due as a percentage of period-end credit card receivables	4.2	6.3	6.1				
Accounts with four or more payments (90+ days) past due as a percentage of period-end gross credit card receivables	3.1	4.7	4.3				

Allowance for Doubtful Accounts						
(millions)						
Allowance at beginning of period	1,016	1,010	570	0.6	%	77.1	%

Bad debt expense	528	1,185	1,251	(55.4	)	(5.3	)
Write-offs *(a)*	(1,007	(1,287	(912	(21.8	)	41.1	
Recoveries *(a)*	153	108	101	40.2		8.3	
Allowance at end of period	690	1,016	1,010	(32.1	)%	0.6	%
As a percentage of period-end gross credit card receivables	10.1	12.7	11.1				
Net write-offs as a percentage of average gross credit card receivables (annualized)	12	14.1	9.3				

Write-offs include the principal amount of losses (excluding accrued and unpaid finance charges), and recoveries include current period principal collections on previously written-off balances. These amounts combined represent net write-offs.

Other Performance Factors

Net Interest Expense

Net interest expense, which includes the interest expense on nonrecourse debt collateralized by credit card receivables detailed in the Credit Card Segment Results above, was $757 million for 2010, decreasing 5.5 percent, or $44 million from 2009 due to lower average debt balances and a $16 million charge related to the early retirement of long-term debt in 2009, partially offset by a higher average portfolio interest rate of 5.3 percent in 2010, compared with 4.8 percent in 2009. In 2009, net interest expense was $801 million, decreasing 7.5 percent, or $65 million from 2008. This decline was due to a lower average portfolio interest rate of 4.8 percent in 2009, compared with 5.3 percent in 2008, partially offset by a $16 million charge related to the early retirement of long-term debt.

Credit quality as of January 2011

The credit quality segmentation presented below is consistent with the approach used in determining its allowance for doubtful accounts.

Receivables Credit Quality (millions)			2010		2009
Non-delinquent accounts (Current and 1 - 29 days past due)					
	FICO score of 700 or above	$	2,819	$	2,886
	FICO score of 600 to 699		2,737		3,114
	FICO score below 600		868		1,272
Total non-delinquent accounts			6,424		7,272
Delinquent accounts (30+ days past due)			419		710
Period-end gross credit card receivables		$	6,843	$	7,982

Under certain circumstances, Target offer cardholder payment plans and modify finance charges and minimum payments, which meet the accounting definition of a troubled debt restructuring (TDR). These concessions are made on an individual cardholder basis for economic or legal reasons specific to each individual cardholder's circumstances. As a percentage of period-end gross receivables, receivables classified as TDRs were 5.9 percent at January 29, 2011 and 6.7 percent at January 30, 2010. Receivables classified as TDRs are treated consistently with other aged receivables in determining its allowance for doubtful accounts.

Structure for funding for Credit Card receivables

As a method of providing funding for its credit card receivables, Target sell, on an ongoing basis, all of its consumer credit card receivables to Target Receivables LLC (TR LLC), formerly known as Target Receivables Corporation (TRC), a wholly owned, bankruptcy remote subsidiary. TRC LLC then transfers the receivables to the Target Credit Card Master Trust (the Trust), which from time to time will sell debt securities to third parties, either directly or through a related trust. These debt securities represent undivided interests in the Trust assets. TR LLC uses the proceeds from the sale of debt securities and its share of collections on the receivables to pay the purchase price of the receivables to the Corporation.

Target consolidates the receivables within the Trust and any debt securities issued by the Trust, or a related trust, in its Consolidated Statements of Financial Position based upon the applicable accounting guidance. The receivables transferred to the Trust are not available to general creditors of the Corporation.

In 2005, Target entered into a public securitization of its credit card receivables. Note holders participating in this securitization were entitled to receive annual interest payments based on LIBOR plus a spread. The final payment on this securitization was made in April of 2010 as discussed in Note 19.

During 2006 and 2007, Target sold an interest in its credit card receivables by issuing a Variable Funding Certificate. Parties who hold the Variable Funding Certificate receive interest at a variable short-term market rate.

Funding receivables strategy

As mentioned, in the second quarter of 2008, Target had sold an interest in its credit card receivables to JPMorgan Chase (JPMC). It bought these back early in 2012. For discussion purposes the terms of the deal are shown as follows:

The interest sold represented 47 percent of the receivables portfolio at the time of the transaction. In the event of a decrease in the receivables principal amount such that JPMC's interest in the entire portfolio would exceed 47 percent for three consecutive months, TR LLC (using the cash flows from the assets in the Trust) would be required to pay JPMC a pro rata amount of principal collections such that the portion owned by JPMC would not exceed 47 percent, unless JPMC provides a waiver. Conversely, at the option of the Corporation, JPMC may be required to fund an increase in the portfolio to maintain their 47 percent interest up to a maximum principal balance of $4.2 billion. Due to declines in gross credit card receivables, TR LLC repaid JPMC $566 million during 2010 and $163 million during 2009 under the terms of this agreement. No payments were made during 2008.

If a three-month average of monthly finance charge excess (JPMC's prorate share of finance charge collections less write-offs and specified expenses) is less than 2 percent of the outstanding principal balance of JPMC's interest, the Corporation must implement mutually agreed-upon underwriting strategies. If the three-month average finance charge excess falls below 1 percent of the outstanding principal balance of JPMC's interest, JPMC may compel the Corporation to implement underwriting and collections activities, provided those activities are compatible with the Corporation's systems, as well as consistent with similar credit card receivable portfolios managed by JPMC. If the Corporation fails to implement the activities, JPMC has the right to cause the accelerated repayment of the note payable issued in the transaction. As noted in the preceding paragraph, payments would be made solely from the Trust assets.

		2010		2009

Securitized Borrowings (millions)				
	Debt Balance	Collateral	Debt Balance	Collateral
2008 Series *(a)*	$ 2,954	$ 3,061	$ 3,475	$ 3,652
2006/2007 Series	1,000	1,266	1,000	1,266
2005 Series	—	—	900	1,154
Total	$ 3,954	$ 4,327	$ 5,375	$ 6,072

All interests in its Credit Card Receivables issued by the Trust are accounted for as secured borrowings. Interest and principal payments are satisfied provided the cash flows from the Trust assets are sufficient and are nonrecourse to the general assets of the Corporation. If the cash flows are less than the periodic interest, the available amount, if any, is paid with respect to interest. Interest shortfalls will be paid to the extent subsequent cash flows from the assets in the Trust are sufficient. Future principal payments will be made from the third party's prorata share of cash flows from the Trust assets.

(a)The debt balance for the 2008 Series is net of a 7% discount from JPMC. The unamortized portion of this discount was $107 million and $177 million as of January 29, 2011, and January 30, 2010, respectively.

Credit card receivable portfolio breakdown

Age of Credit Card Receivables	2010	2009

(dollars in millions)	Amount	Percent of Receivables	Amount	Percent of Receivables
Current	$ 6,132	89.6%	$ 6,935	86.9%
1-29 days past due	292	4.3%	337	4.2%
30-59 days past due	131	1.9%	206	2.6%
60-89 days past due	79	1.1%	133	1.6%
90+ days past due	209	3.1%	371	4.7%
Period-end gross credit card receivables	$ 6,843	100%	$ 7,982	100%

Credit card receivables are recorded net of an allowance for doubtful accounts and are its only significant class of receivables. Substantially all accounts continue to accrue finance charges until they are written off. All past due accounts were incurring finance charges at January 29, 2011 and January 30, 2010. Accounts are written off when they become 180 days past due.

Allowance for doubtful accounts

The allowance for doubtful accounts is recognized in an amount equal to the anticipated future write-offs of existing receivables and includes provisions for uncollectable finance charges and other credit-related fees. We estimate future write-offs on the entire credit card portfolio collectively based on historical experience of delinquencies, risk scores, aging trends and industry risk trends.

Allowance for Doubtful Accounts (millions)	2010	2009
Allowance at beginning of period	$ 1,016	$ 1,010

Bad debt expense		528		1,185
Write-offs *(a)*		(1,007	)	(1,287
Recoveries *(a)*		153		108
Allowance at end of period	$	690	$	1,016

(a) Write-offs include the principal amount of losses (excluding accrued and unpaid finance charges), and recoveries include current period principal collections on previously written-off balances. These amounts combined represent net write-offs.

Deterioration of the macroeconomic conditions in the United States would adversely affect the risk profile of its credit card receivables portfolio based on credit card holders' ability to pay their balances. If such deterioration were to occur, it would lead to an increase in bad debt expense. The Corporation monitors both the credit quality and the delinquency status of the credit card receivables portfolio. We consider accounts 30 or more days past due as delinquent, and we update delinquency status daily. Target also monitor risk in the portfolio by assigning internally generated scores to each account and by periodically obtaining a statistically representative sample of current FICO scores, a nationally recognized credit scoring model. Target update these FICO scores monthly.

Segment reporting

Business Segment Results (millions)	2010			2009			2008		
	Retail	Credit Card	Total	Retail	Credit Card	Total	Retail	Credit Card	Total
Sales/Credit card revenues	$65,786	$1,604	$67,390	$63,435	$1,922	$65,357	$62,884	$2,064	$64,948

Cost of sales	45,725	—	45,725	44,062	—	44,062	44,157	—	44,157
Bad debt expense *(a)*	—	528	528	—	1,185	1,185	—	1,251	1,251
Selling, general and administrative/ Operations and marketing expenses *(a), (b)*	13,367	433	13,801	12,989	425	13,414	12,838	474	13,312
Depreciation and amortization	2,065	19	2,084	2,008	14	2,023	1,808	17	1,826
Earnings before interest expense and income taxes	4,629	624	5,252	4,376	298	4,673	4,081	322	4,402
Interest expense on nonrecitsse debt collateralized by credit card receivables	—	83	83	—	97	97	—	167	167
Segment profit	$4,629	$541	$5,169	$4,376	$201	$4,576	$4,081	$155	$4,236

Unallocated (income)/expense:									
Other interest expense		677			707			727	
Interest income		(3	)		(3	)		(28	)
Earnings before income taxes	$	4,495		$	3,872		$	3,536	

(a)The combination of bad debt expense and operations and marketing expenses within the Credit Card Segment represent credit card expenses on the Consolidated Statements of Operations.

(b)Loyalty Program discounts are recorded as reductions to sales in its Retail Segment. Effective with the October 2010 nationwide launch of its new 5% REDcard Rewards loyalty program, we changed the formula under which its Credit Card segment reimburses its Retail Segment to better align with the attributes of the new program. These reimbursed amounts were $102 million in 2010, $89 million in 2009 and $117 million in 2008. In all periods these amounts were recorded as reductions to SG&A expenses within the Retail Segment and increases to operations and marketing expenses within the Credit Card Segment.

Note: The sum of the segment amounts may not equal the total amounts due to rounding.

Total Assets by Business segment		2010			2009	

	Retail	Credit card	Total	Retail	Credit card	Total
Total assets (millions)	37,324	6,381	43,705	37,200	7,333	44,533

Chapter Summary

With 7.4% of its sales tied to its RedCard loyalty program, Target's future is locked to cards, despite the fact that its policies are to offload credit risk. TD bank has acquired its US card portfolio and Target has partnered with RBC in Canada. This satisfies Targets management by providing the merchant control of the loyalty aspect and offloading of credit risk.

This is where the future of Target's role as a driver behind MCX becomes clouded. Given the fact that MCX is merchant led, the question of who will be assuming the risks associated with managing this payment network is left unanswered. Perhaps Target is considering restricting its Mobile operations to de-coupled debit or offer based. This would be a mistake because reality proves that consumers want easy credit, and that Target's card growth was fuelled on this. In building its portfolio prior to the credit crSoftcard, Target was known as the 'creditor of last resort' for a reason. Target's 2011 RedCard debit versus RedCard credit penetration of 6.3% versus 1.1% debit transaction serves to illustrate this point.

Having experienced first-hand the fickleness of merchants with respect to credit risk, and recognizing consumer preference for credit especially as opposed to de-coupled debit, the future of MCX becomes less obvious. Just look at PayPal's underwhelming success at Home Depot for proof of this. More pressing, however, is the pressure from newcomers like Amazon and other competitors from Asia and Europe in building successful mobile payment models.

Perhaps Target's recent data breach will be water under the bridge, on the other hand, it could foreshadow trouble ahead for MCX.

Case Study: STM, Montreal, launches mobile pilot project

Montréal, September 2012

On the occasion of TranspoCamp, organized during En Ville sans ma voiture events, the Société de transport de Montréal (STM) announced a unique customer loyalty program. Indeed, the STM launched an innovative customer rewards program through a smart phone application this fall. The application is available on iPhone devices.

This iPhone application – called Apollo, is available to OPUS cardholders participating in the project, exclusive and personalized offers. These are based on the socio-demographic profile of customers and their preferences, according to information they have previously chosen to share with the STM.

One of the benefits for the STM is the possibility to analyze certain data contained in the OPUS card. This will all the STM to push targeted offers based on user preferences. Since the application is available on a smart phone, customers will also have the opportunity to receive offers based on their location. The combination of all these elements makes this program unique and innovative.

The STM rewards customers. 'For the past two years, the STM has taken a new direction, a 2.0 change if you will, to develop a closer relationship with its customers who are more and more trend-conscious. We've grown from an era where 1.2 million customers travelled anonymously in public transit to a world where we can communicate directly with every person. The launch of this program responds to a need expressed by a portion of customers. They've told us that they want access to solutions in mobile technology that will improve the customer experience. They also appreciate being rewarded for their loyalty. This application turns out to be a unique tool that places the STM at the forefront in the field of customer relationship strategy. We know that every customer has habits, behaviours, preferences and needs that are particular to the individual. The advantage of this program is precisely to present offers that are suitable and personalized, at the right time and at the right place. It's our way of thanking and attracting new customers to public transit,' declared STM's chairman, Michel Labrecque.

By offering discounts, privileges or fun activities, the STM wants to encourage customers to continue to contribute to Society in Motion, whether by using the bus or métro more often, by acquiring a yearly membership, or by convincing a friend to use public transit, etc.

As for other benefits and exclusive offers, it should be mentioned that the STM is currently in discussions with important retailers and major event partners such as: IGA, Jean Coutu, St-Hubert restaurants, Au Pain Doré, l'Opéra de Montréal, the Osheaga Festival, and the Montréal Impact, as well as major Transportation Cocktail partners such as: Bixi, Communauto, Taxi Diamond and Vélo Québec. Other companies are also invited to participate in this great venture!

The program launched in the fall of 2012 as a pilot project. For this purpose, a pool of OPUS cardholders received an invitation to download the application. This pilot project enabled STM to assess the appeal of different offers suggested, and test its user friendliness of the first version of the application. At the end of the pilot project, the application was adjusted and made available for download on a broader basis. An Android version of the application was also developed and made available as well as for other operating systems (OS).

Mark played an instrumental role in introducing Pacific & Western Bank of Canada to Canada's leading software provider for Trustees in bankruptcy. That introduction paved the way for a project that will see our Bank provide integrated banking services to this niche industry while at the same time providing us with access to a deposit base that will significantly reduce our overall cost of funds.

Neil Beaton, President Pacific Western Bank / Versabanq

Not only does Mark's experience bring a unique insight onto the complex inner workings of the credit card merchant loyalty market, but he's book takes it further in providing a "lessons learned" and "how to" methodology for launching a successful card program..

John Anticoli, Consultant in the financial service industry

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