Mobile Payments the Apple Pay Way

A merchants guide to credit and loyalty tranformation

Mark Sibthorpe

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 already changing 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. In 2012, I was one of the thought leaders in decisions by Circle K to join the merchant consumer exchange (MCX), and was involved in similar projects as early as 2010. I evaluated PayPal and card-linked-rewards leaders, and ran 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 miss-steps. Like the beginnings of mankind, this book begins with an apple; or more specifically, Apple Pay and Apple 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, but it is looking promising. 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. This has not stopped Apple from attracting 700,000 merchant locations as of March 2015.
2. Low NFC penetration may be about the change, due in part, 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, but not old-school fraud. 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:

> "*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

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

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 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 crisis;
- 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 crisis, 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 Isis, 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 managed to lift off high enough so

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

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;
- 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

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[7] NBC News, August 8

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 Isis 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 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;

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[8] The Globe and Mail, Reuters, February 1, 2013.
[9] Quorus Consulting, 2011 report
[10] Francis Bea, Digital Trends, October 5, 2012.

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;
- 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] 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

[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.

(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;
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%.

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[23] Leena Rao, TechCrunch, September 6, 2012.
[24] Aite Group, The Case for Merchant Funded Incentives, June 2011

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
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.

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

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
     - 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 Isis.

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]

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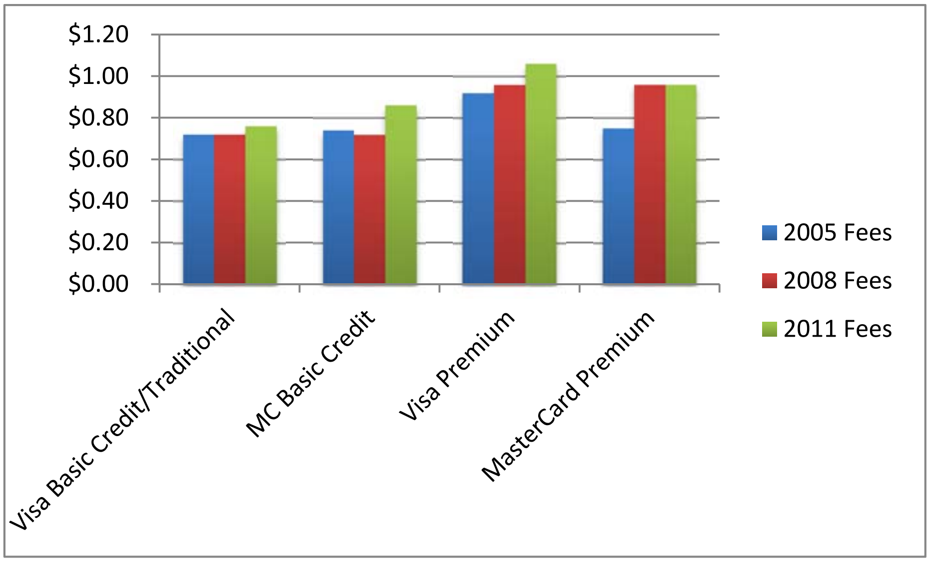
[26] Dana Flavelle, Retailers plead for credit card regulation, Moneyville, April 14, 2011.
[27] According to the Canadian Retail Council:

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.'

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

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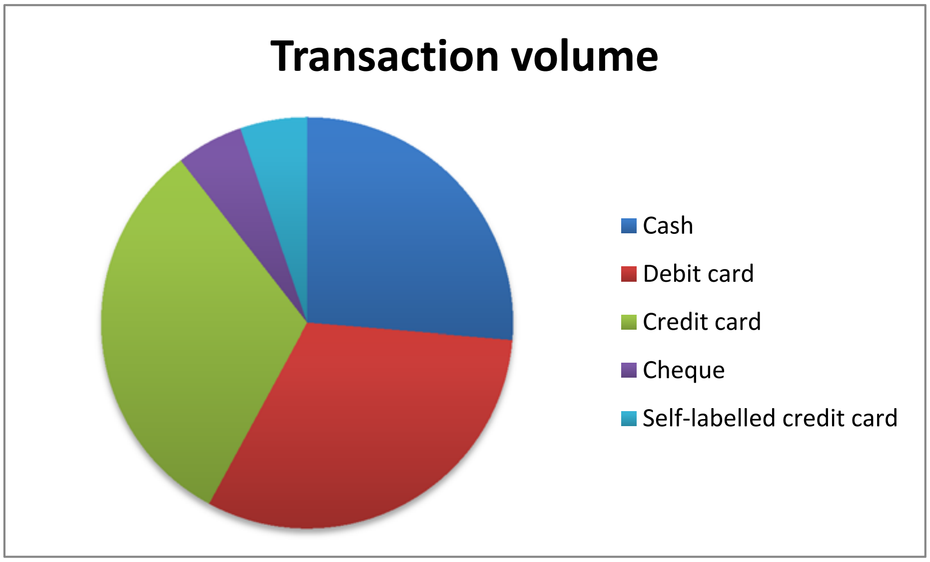
Profit at Visa Inc. rose 28 per cent to $314 million US in its most recent quarter.

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]

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 -

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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

$.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.

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

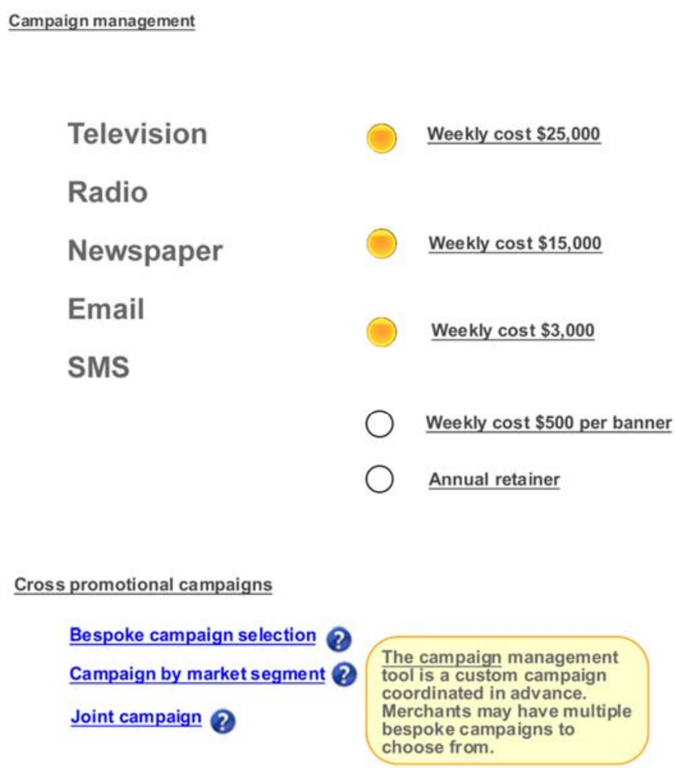

Figure 4 Campaign management dashboard

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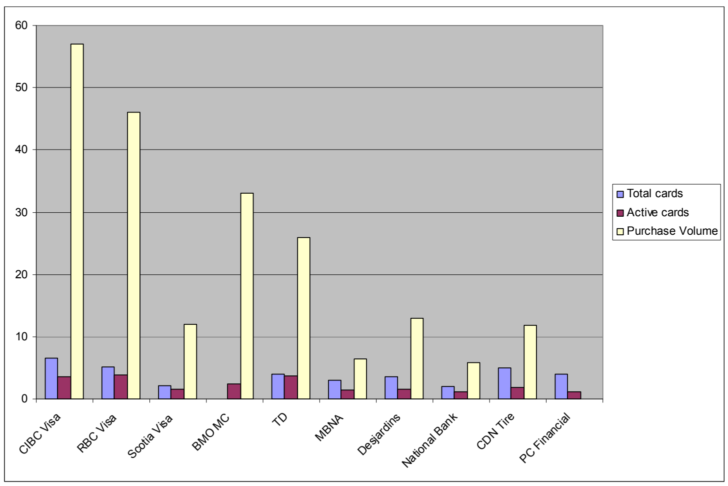
[61] Courtney Rubin, Inc.com, October 5, 2010 merchants win the right to offer discounts and show swipe fees to consumers related to card transactions, merchants pay $35 billion a year in fees to credit card companies, according to the Justice Department.

[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.

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:

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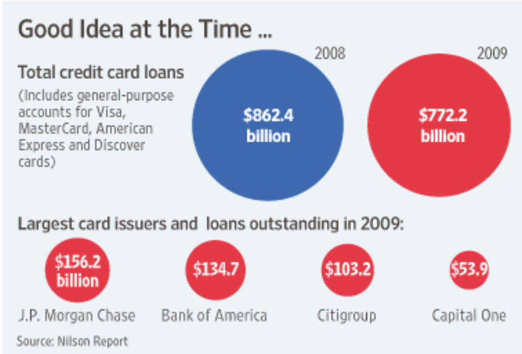
[65] Competition Commission, Store Cards Market Investigation, The Stationery Office, 2007

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



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."

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

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

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]

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

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 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 crisis 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 crisis.	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 crisis 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 crisis, 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 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.

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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.

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