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.

Financing Source	Amount Available	Description
Committed bank lines of credit CTC_PresNew_Inside02	$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

Table 1, CTFS financial report 2008

The trend of merchants growing their financial services is outlined in a report by Packaged Facts. Packaged Facts predicts private-label card purchase volume to grow at a compound annual rate (CAGR) of 4% through 2015 due to modest increases in new-account and new-program development, and overall increases in total retail sales. In terms of receivables, this means U.S. private-label card programs will grow at a CAGR of 6 percent through 2015 to top the $129 billion level, as consumers gain the confidence to carry moderately higher balances. “However, we expect that portfolios will continue to have a higher percentage of accountholders that pay off the balances each month rather than revolve balances,” Packaged Facts said.

Explaining the mechanics and structure of the growth in merchant led financial services appears logical. However, given the liquidity risks, understanding why merchants want to grow this area requires an understanding of the benefits of rewards to a merchant’s bottom line.

To explain the loyalty effect, there only a few examples to rival pioneering Tesco. Tesco used loyalty programs to displace Sainsbury and become the leader in the UK grocery industry. Tesco’s program, called ‘Clubcard’ set the loyalty standard worldwide as evidenced by the fact that its proponents are the brains behind programs like CTFS, Kroger and Canada’s Metro as well as other internationally recognized brands. One point to be taken from Tesco’s experience is that in order for Tesco to be successful it first had to pour billions into its rewards program. The next section explains why Tesco risked this money and how merchants quantify the returns on this investment (ROI).

Establishing reward ROI

Rewards are part of merchant's DNA, and the following section explores why this is. The purpose of including this section being to clarify why rewards are an essential component of long-term profits for merchants, despite being a cost center for a traditional bank.[1]

This section is extracted from [my book on Mobile Payments, Merchants Guide to Credit and Loyalty Transformation](), and is included to demonstrate why rewards are important to merchants. It responds to the question of: *why a merchant like Tesco was willing to invest billions into its reward program?*

Rewards 101

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 / a reward ROI.

Regarding point 1, typically merchant programs offer a base level of shared rewards. Successful programs also offer a signing incentive for new accounts. In order to ensure member engagement, most programs that work long-term also offer ongoing promotions. These comprise the costs.

A point to note with regard to reward costs to Canadian merchants is merchant discount fees averaging about 1.56%. This fact is an incentive for merchants to promote transactions on their own branded cards, because in this case most of this cost reverts to them.

This latter point, however, would be moot if it could not be proven that offering rewards eventually leads to profit. The methodology I used to establish reward ROI is based on several studies, especially research by Christophe Benavent[2] focused on the grocery vertical; for the convenience store vertical I looked to Dr. Yuping Liu, a professor at Old Dominion University.[3]

These studies were selected because they are based on transactional data and tracked consumers over several years. The Benavent study, for example, 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;[4]

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

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

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

[4] Christophe Benavent ET Lars Myers, Analysis of the Efficiency of Loyalty Programs: a Case Study, 2002; Benavent, C. Crié D (2000); "**Analyse de l'efficacité des cartes de fidélité, une étude de cas**" in Volle " Recherche

- 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. Profiling that can be achieved by merchants through enhanced credit scoring. 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 result 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%.[5]

Therefore, assuming the following:

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

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.

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

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.[6] 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.[7] 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 weeks for an additional cost of 0.5% of sales during the 4 weeks of the promotion.

Nectar's metrics as well as other reward related studies are sophisticated, but, in my opinion, the measurement of reward impact on 'same-store sales' is simpler and more telling. I.e. lift and shopping frequency should actually reflected in increased same store sales: the challenge is testing for this. Therefore, my approach in looking at this metric was to find comparables and factor out variables that could skew results. For example, oil prices can have significant impact for a convenience store if fuel prices rise.

In order to optimize results I chose comparable merchants from a variety of verticals. In each vertical, one merchant offered loyalty, while the other did not. I further refined this to track data starting from when merchants first introduced loyalty programs: i.e. Kroger in 2008 and Home Depot 2003. The results are shown on the table that follows.

Kroger US versus Super Value US

Kroger US			Super Value US	
2010	+2.1%			-6.8%

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

[7] [7] John Deighton, Harvard Business School December 5, 2005

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%

As shown in the preceding tables showing same-store-sales data, rewards pay; especially in the first years following the launch of a new program. Obviously, this study presents a simplified sample, and it does not account for other factors that can influence same-store sales (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) yet, based on the data, it is apparent that rewards have had an measurable impact on same-store-sales for the merchants evaluated.

Conclusion

Merchants need rewards in order to grow sales and merchants are expanding their financial services, especially with respect to credit backed loyalty. To achieve their goals, some UK merchants are extending their financial services to include current accounts. A possible motivation for this being to provide a secure funding source. This means structural change: in the past, UK merchants like Tesco and Sainsbury partnered with banks, but now they are going it alone.

This contrasts with the approach taken by some U.S. merchants such as, Target and CTFS. These merchants have opted instead to reduce some of their liquidity risk by selling their receivables to TD and Scotiabank.

The different approach between the Canada/U.S. and the UK may be attributed to strong Canadian bank balance sheets and also regulatory pressure in the UK forcing UK banks to shed profitable but high risk assets.

Scotia's recent acquisition of 20% of CTFS' portfolio resulted in a ratings walloping by Moody's. This could in turn mean higher capital costs for the bank resulting in lower net interest margins. Based on this, further funding alliances between Canadian merchants and banks seem unlikely.

Therefore, the question that comes to mind for me is, "Which Canadian merchant will be the first to introduce peer-2-peer lending to fund its receivables?"