



# Uncharted Waters

## Managing the U.S. Credit Card Business in the New Era of Responsibility

By Kevin Mellyn

**D**uring the past 25 years, the world enjoyed the longest economic expansion in recorded history. In the process, over one billion new consumers worldwide escaped poverty and joined the global market economy. In advanced economies like the United States, a newly prosperous segment of mass affluent consumers arose, spurring an unprecedented boom in affordable luxury goods and services that further drove consumer spending.

The financial services industry—especially investment banks that created truly global capital markets—was the key driver of this quarter century of growth. The global financial market fueled a vast increase in the availability of credit to rising numbers of people and enterprises at ever more attractive terms. The bank credit card business, which really took off in the early 1980s, played a big role in making revolving credit a convenient part of daily life.

Where did all this credit come from? It depended almost entirely on a new

and untested financial innovation: the securitization of credit. This financial alchemy turned consumer loans and mortgages into highly rated bonds that fed the growing ranks of institutional investors worldwide. Consumers, whose real incomes remained flat throughout this period, began to use easy credit as a substitute for income. Increasingly, they spent money they didn't have. Household debt in the United States rose from less than 40 percent of disposable income in 1952 to 133 percent in 2007.<sup>1</sup> The savings rate fell effectively to zero as consumers bet on the appreciating value

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of their houses and financial assets to provide for retirement.

At the same time, U.S. household consumption exceeded 70 percent of gross domestic product. Not only was this high by historical and global norms (the comparable figures for other rich countries tend to be below 60 percent), it fueled export-driven growth in China and other emerging countries. These countries, especially China, were effectively financing America's shopping spree by funding financial sector debt that supported the exploding lending for consumption.

### THE AGE OF LEVERAGE COMES TO AN END

The upward expansion of credit suddenly fell to earth last year. What we are seeing is not a cyclical recession, but a systemic crisis of the global financial system. Starting with the bursting of a housing bubble in the U.S., it has spread across the globe and across asset classes at lightning speed. The global economy faces a long and painful process of wringing excess leverage and bad assets out of the system and getting sound credit flowing again, a process that has just begun.

Household balance sheets have been devastated and will have to be rebuilt. Meanwhile economic activity and employment will continue to contract until confidence in our credit markets is restored. This will clearly take time, despite the unprecedented efforts of governments worldwide to prop up the

financial system and threatened industries with capital and liquidity. It is too early to know if these efforts will work.

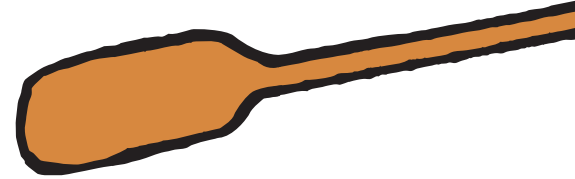
How will this derailment of the global economy affect the financial industry in general and credit card issuers in particular? While no one can predict the future outcome of current events, issuers should prepare themselves for the most likely scenarios to stay competitive. At a minimum, there are two potential scenarios issuers might consider, with many possible outcomes in between:

#### Scenario I: Back to Business as Usual After a Short Downturn

This downturn may be similar to past ones, with the economy rebounding in 18 to 24 months. Certainly, politicians here and abroad are intent on getting credit flowing to consumers again. If this comes to pass, consumer spending will gradually return and thus restore economic activity and employment. In such a scenario, the issuers who were able to continue providing credit profitably to viable customers during the crunch will increase their market share and emerge as winners.

#### Scenario II: Welcome to the Economy 2.0

On the other hand, we may be in for a protracted global recession that leads to major structural changes in the banking and card industries when it ends. If the current crisis is indeed a sea change for the business of credit, we can expect cautious consumers to embrace savings and reduce spending



(see "Responsible Spending Is the 'New Normal'" in this issue), as the banking industry further consolidates and regulators and governments contemplate greater oversight of the card industry. If so, credit card issuers cannot assume that the business models that worked before 2008 will continue to work. Rather, issuers will likely need to provide cardholders with greater budgetary control over their spending. The issuer's business model in the Economy 2.0 might well incorporate these assumptions:

- With less discretionary income, consumers will reduce spending
- Value-conscious consumers will retain only one or two credit cards
- Consolidation among issuers will intensify competition
- Regulations and legislation will change the revenue/risk dynamic for issuers

#### PLOTTING YOUR COURSE

Credit card issuers, alas, cannot wait on events or hope for the best. Instead, they need to do two things simultaneously:

First, for as long as the storm lasts, issuers need to keep bailing water and plugging the leaks that will continue to spring in their current businesses and card portfolios. How effectively they do this matters a lot. Adversity sorts out winners and losers. While all lenders

thrive in boom times, history shows that only the best-managed banks gain strength and market share during tough markets like this. Even after prolonged depressions—like that of 1873–1894 in the UK, 1930–1942 in the U.S., and the 1990s in Japan—strong banks that took advantage of these disruptions emerged even stronger, while many of their competitors ceased to exist.

Second, even while fighting the day-to-day battle for survival, issuers should prepare themselves for success in whatever new era of more responsible credit card use will follow. This means they need

to think through their business models from the ground up. A key tool in doing this is scenario planning. The objective of scenario planning is not to predict the future. Rather, it is to describe a range of plausible future business environments and anticipate what it will take to thrive in any of them.

The card-based payment system is a highly adaptable platform that can support many types of profitable retail banking models. The prudent course is to think through in detail—and prepare for—what a profitable cards business might look like in either of these scenarios, or others that suggest themselves. If you create flexible business

models—perhaps more focused on household cash management, savings, and control over spending than on revolving credit balances—there is plenty of opportunity for renewed growth and profit when the economy recovers. ●

1 Niall Ferguson, “Wall Street Lays Another Egg,” *Vanity Fair*, December 2008.



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