Credit Card Processing: Insourced or Outsourced?

A Comparative Study

White Paper

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CO-OP FINANCIAL SERVICES

www.co-opfs.org

EXECUTIVE SUMMARY

If crisis represents opportunity, then opportunities abound for credit unions interested in starting or growing their credit card programs. Although credit cards are a mature – and proven – product, never before has such a confluence of change rocked the industry.

Between the Credit CARD Act of 2009 and the credit crunch, the bank bailout and the ensuing shakeout on rates and fees, consumers find themselves feeling unsteady about their credit card companies. Many are open to new alternatives as they seek to replace decreased credit lines, start new or repair credit histories, or seek out more favorable rates or terms in a changed credit landscape.

Credit unions, too, have seen unprecedented changes in their ability to generate revenue. With debit card interchange under attack and traditional lending hamstrung by regulation, credit card revenue has taken on new importance.

CO-OP Financial Services remains committed to helping its member credit unions develop new revenue streams while increasing member loyalty. Credit unions have a unique role to play in the credit card industry. By providing members with consumer-friendly products and services – while strengthening their own financial positions – credit unions can create win-win propositions.

Now is an excellent time for credit unions to think about growing and nurturing their credit card portfolios. Yet, taking advantage of an opportunity means more than simply taking action. Running an effective credit card program – especially in this age of regulation and scrutiny – takes strategy and foresight. By choosing the best option for card processing – setting up an internally-driven pass-through program or an externally-fueled outsourced option – credit unions can leverage their individual strengths to grow revenue, diversify their product lines and build member relationships.

Overview: Credit Programs in an Era of Shaken Assumptions

Our nation is still recovering from the most profound recession in recent history. It's not just that our economy has suffered – with 8.4 million jobs lost since December 2007, record high mortgage foreclosures and loan delinquencies, government budgets in crisis and a for-profit banking industry in disarray. Our very way of life has changed. As CUNA's E-Scan reports, "Middle class families have suffered losses to their jobs, health insurance, savings, pensions and the value of their homes."

Long-held assumptions have been shaken to the core. Homeownership and access to credit were the foundations of financial security for average consumers. Now, even homeowners untouched by foreclosure have seen their equity dwindle or even disappear. Even responsible consumers have had their credit lines cut. A FICO survey found that 14 percent of the U.S. credit population saw a reduction in their credit lines between April 2009 and October 2009. Of these, four percent had a risk trigger – a late payment, collection or adverse public record. But 10 percent had no such risk trigger. This group posted a pre-reduction average FICO score of 757 and had low utilization ratios.

Credit unions have struggled right along with their members. While dealing with unprecedented loan losses and an increasingly difficult lending environment, they've taken on new industry-wide challenges. Legislation reducing debit card interchange income threatens credit union revenue. Compliance with new regulations such as the CARD Act restricts credit unions' ability to keep accounts profitable. Add in the ongoing challenge of NCUA assessments, and these are trying times indeed.

Credit card accounts are not a silver bullet. However, along with signature and PIN debit, they offer a raft of potential opportunities for credit unions to take better advantage of their credit/debit portfolios as revenue streams. These include:

- Interchange revenue that is not affected by current legislation.
- The opportunity to add an adjustable-rate loan product as a hedge against rising costs and/or fluctuating interest rates.
- A way to reach out to credit-worthy prospective members.
- Increased wallet share and loyalty for existing members; credit cards are a sticky and brand-able product.
- Cross-sell opportunities created by access to usage data and monthly communications via statements.
- New inroads to underserved consumers, including potentially secured card products for new credit users and the newly credit impaired. Visa estimates the total underserved market to be about 80 million consumers.
- The "halo effect," in which members feel good about belonging to an organization that provides fair products.
- Emotional attachment. Robert D. Manning, author of *Credit Card Nation*, notes that consumers hold their first-time card accounts for an average of 15 years.

That said, creating a successful credit card program is not as simple as passing out the plastic. Credit industry expert Tim Kolk, owner of TRK Advisors in Peterborough, New Hampshire, estimates that one in five credit union credit card programs is unprofitable. Though he is decidedly bullish on card programs, he also urges credit unions to proceed with care and a sound business plan. By learning as much as possible about current underwriting standards, structuring rates for continuing profits, reviewing "perks" such as reward programs, and finding the right vendors and processing options, credit unions can maximize their individual strengths – and build for the future.

Know Your Options: Pass-Through or Full Outsourcing

While it's only one piece of the puzzle, choosing the right processing option can affect the success of your credit card program. Though there is no "one size fits all" choice, finding the right fit for your organization will minimize expense, optimize profits and allow your program to reach its greatest potential.

All About Outsourcing

The first option is, in many ways, the most simple. Outsourcing your card program means turning over most of its vital functioning to an outside vendor. Although your credit union underwrites and carries credit card loan receivables, all processing (including posting), card production, statement generation and servicing are typically delivered by the processor.

On the upside, going fully outsourced means less investment up front. Your core processing capacity isn't an issue, since everything resides on the vendor's host system. Additional hardware and software requirements should be minimal, if any. Although someone at your credit union will need to be responsible for managing your card program, much of the legwork is done for you, and you will not have to hire or train service staff to handle customer inquiries. Provided you choose the right vendor (more on that later), operations should be robust and your access to service and technology cutting-edge. High-volume providers offer economies of scale, so even though you pay more for your services than with pass-through, your overall costs may still be lower.

Pass-Through Potential

Pass-through is just as it sounds – a limited-service, self-managed option for credit unions that want to retain internal control. With pass-through, the credit union's host platform is the system of record for credit card accounts. The credit union typically handles all transaction authorization and posting, along with back room services such as cardholder member servicing, statement generation, payment processing and collections.

If this sounds like more work (and more resources), it is. The tradeoff is greater control and potentially lower costs. The credit union maintains access to cardholder data, manages all promotions and program changes, runs its own analytics and handles its own member service. If these areas are strengths for your credit union – and/or you have the ability to make them strengths – then the more substantial startup resources associated with pass-through may be a worthwhile investment. With this option, your ongoing costs for processing are typically lower than with full outsourcing.

Pass-Through vs. Outsourcing At A Glance

Pass-Through	Fully Outsourced
Credit union's host platform is the system of record for credit accounts.	The processor's platform is the system of record.
Member accounts and records reside at the credit union.	Member account data is kept on the processor's system.
Compliance – including compliance with CARD act payment regulations – is the responsibility of the credit union.	Processor assumes responsibility for staying up-to-date on and implementing all compliance-driven changes.

Pass-Through	Fully Outsourced
Credit union handles all member inquiries related to credit cards.	Member credit card inquiries can be handled by processor's service team.
Credit union generates statements, allowing for the creation of integrated statements for multiple accounts. Credit union retains the ability to market in tandem with credit-card related communications.	Processor platforms provide flexibility and credit union-defined criteria to drive automatic statement messages and inserts.
The credit union reviews host platform credit module to ensure program requirements are met. Fees for software module and on-going maintenance fees apply. The host provider typically supports the installation and card program conversion when necessary. The credit union pays project costs for the latter.	Credit union's core system is unaffected; startup costs for technology are minimal if any.
Creating programs and features that suit member needs is up to the credit union.	Processor offers standard packages.

Which is the Right Choice?

Deciding between pass-through and outsourcing is an individual process. Neither option is "better" than the other. Rather, it depends on the philosophy and style of your credit union, the resources you have (and can acquire) to put toward this project, and your goals and objectives for your credit card program.

First, consider your style. "Credit unions that feel strongly that they want to serve their own members, no matter what, are going to prefer pass-through," says Jennifer Kerry, Vice President, Credit Issuer Processing, CO-OP Financial Services. "They want to be the first point of contact when their members need something. These credit unions have a particular sales and service philosophy that goes along with providing as many services – and retaining as much control – as possible."

Part and parcel of this philosophy is a commitment to grow capacity. Your organization will have to field member inquiries, process data, generate statements and manage collections. Credit unions that favor pass-through might also excel at using cardholder information to build relationships. For them, direct access to integrated cardholder information is invaluable.

Of course, choosing full outsourcing doesn't indicate a lack of sales and service excellence. Sometimes the best available option is to use outside resources in order to provide 24/7 member service or a fully-compliant payment posting system. If the operational challenges of developing, managing and marketing a credit card program seem overwhelming, outsourcing can reduce the load while still ensuring a quality program.

Next, investigate your resources. Not all core processing systems offer the credit card modules needed to implement a pass-through program. If yours doesn't – and your credit union is not in the market for a new core processing platform – your decision may be made for you.

Also consider your human resources. Do you have someone on staff to manage your credit card program? Both fully outscourced and pass-through processors offer portfolio consulting services, but you will need an on-staff program manager in either case. Is your service staff prepared to handle questions related to credit cards? Do you have the capacity to process – and make intelligent use of – the data you'll generate? If not, are you able to hire the manpower you need?

The right vendor can provide what you need without the capital outlay required to hire and train staff or upgrade your technology significantly. This final element of resource availability – capital – may also play a role in your decision-making. Fully outsourcing represents a higher ongoing expense, while pass-through may call for a higher initial investment and/or larger ongoing investment in internal resources but with less money going out the door. Is conserving capital a consideration right now? Is so, outsourcing may be for you.

Finally, match your objectives with your options. Is yours the kind of credit union that easily adopts new technology? Is IT one of your core strengths? Do you pride yourself on using member data to cross sell, plugging the information you glean into innovative promotions? Is your service team formidable? Answering "yes" to these questions makes you a good candidate for pass-through.

On the other hand, if your priority is offering members a quality credit card option without straining your staff, IT and other resources – and if beefing up your core systems and piling on an additional data load doesn't sound like you – then outsourcing may be your best option. Finding a way to provide your members with a fully-functioning card program while staying within your reasonable IT/marketing boundaries is also an example of great service.

Selecting the Right Vendor

The vendor you choose to handle credit card processing will become your partner in starting, running and growing your card program. To that end, your vendor is either an asset or a hindrance. Whatever you envision your card program to become – a low-impact product you provide as a member convenience or a driving force behind future growth – you need a vendor that is flexible, consultative and responsive.

Credit card consultant Tim Kolk believes vendor selection should take place early in the planning process. "Choosing a vendor is one of the first things you should do," says Kolk. "If you start looking at marketing or services before you choose a vendor, you're going in the wrong order."

How do you choose? Naturally, price is an issue – and since Kolk identifies profitability as essential to any card program, he considers price to be worth a solid 25 to 50 percent of the decision. However, he also believes that other factors weigh heavily. These include:

- Relationship support.
- System functionality.
- Access to information.
- System – and company – stability.

When it’s time to compare pricing, be as specific as possible – and get details in writing. “Before credit unions put out an RFP, they need to evaluate exactly what they want their proposed program to look like,” says Kolk. “Issuers need to recognize that putting together a proposal is a fairly onerous process for vendors, and if your RFP isn’t clear then the proposals will not be comparable. Then you’ll have to go back for revisions, everyone will get frustrated and you increase the chances that you aren’t making an accurate comparison.”

As an example, one vendor’s pass-through pricing may include fraud scoring and detection. If a competing vendor’s proposal doesn’t include this service, you need to consider the cost of providing it independently.

“It’s very difficult to get apples to apples comparisons, although there’s enough competition in this business that when you do, there are usually functionality and relationship factors that can overcome small price differences,” says Kolk.

More significant is the level and scope of services provided. Will the vendor provide adequate support through the startup process? Will you have access to what Kolk describes as the “atomic level of detail” needed to analyze your accounts and mange your relationships? Are you able to lower processing costs by expanding your relationship with an existing vendor? Visualize what you would like your partnership to look like, then determine which vendor is most likely to provide it.

Case Studies: Two Paths to Success

Six years ago, Community Financial Credit Union in Bloomfield, Colorado, sold its credit card portfolio. Now it’s working to build a new one – this time with the help of CO-OP Financial Services pass-through credit card processing services. As a client of CO-OP’s new program, Community Financial CU has been active not only in shaping its own systems, but also CO-OP’s understanding of what this market demands.

Chief Lending Officer Jeremy Pinard is delighted to be expanding Community Financial CU’s credit card offerings. “There’s an intangible value to offering your members credit cards. You become an important part of their financial lives,” says Pinard.

In the true spirit of pass-through, Community Financial CU is looking to innovate with its card program. “We want to implement unique card programs that we can bring quickly to the market, and we sought a processing partner that’s as committed to these goals as we are,” says Pinard.

Community Financial CU also wants to offer its members overdraft protection via their credit cards. They’re interested in promoting a single account package that includes integrated savings, checking, credit, debit and overdraft. These options aren’t commonly available using a fully-outsourced option – precisely why this credit union has chosen pass-through.

“There’s going to be more work and more responsibility with this option,” says Pinard, “but I value the extra input I can get on the front end.” Also, Pinard is glad to have his members’ data in house. “I probably get an offer from Bank of America once a month,” he says. “I don’t want to turn that marketing opportunity over to another company. With pass-through, we have control.”

Pinard says piloting a new program underscores the value of selecting a vendor you can work with. "CO-OP gets the big picture," says Pinard. "This is a cooperative and we're working on this project together. I've worked with vendors who aren't oriented that way and it makes the process much more difficult. It's not that we've had every little detail go our way, but when you're working with CO-OP, you feel like it's a joint venture."

Like Pinard, the eServices team at Mountain America Credit Union in West Jordan, Utah, is bullish on pass-through processing – only they've been running their credit card program this way for more than 25 years. "We think we've been able to service our members better with a program we control," says Tony Rasmussen, Senior Vice President of eServices, Mountain America. "We've been able to integrate card accounts with our online banking, which means members are able to see payments reflected right away online – they don't have to wait a day to see their payments post."

Also instantaneous: issuing live debit and credit cards to members who visit Mountain America branches to set up their accounts or need replacements. "Members can walk in and walk out with a live card," says Rasmussen. "That's been a huge benefit. They can literally walk out of our doors and across the street to a store where they can start using their cards." Because Mountain America has control of their card programs, they can implement benefits like these at their pleasure.

Offering strong core benefits is critical as well. "There is always a card out there that has a new feature yours doesn't have," says Todd Lindemann, Associate Vice President of Electronic and Card Services. "You watch TV and half the commercials you see are for Chase Sapphire or Capitol One. But we continue to have an advantage with the core product: our rates are lower, our fees are lower and our members know it's easy to do business with us."

Mountain America also makes sure their fraud detection services are state-of-the-art. "If you work with a vendor like CO-OP Financial Services, you can get help with areas like risk management that are difficult to implement on your own but are critically important to cardholders – even if you choose pass-through processing," says Rasmussen. "A good partner can really help you create a program that works."

Of course, pass-through processing isn't necessarily the right choice for every credit union. Since its implementation in the mid-1980s, the fully-outsourced credit card program at Coastal Federal Credit Union in Raleigh, North Carolina, has proven to be an unqualified success, working for both members and credit union alike.

"Back in the 80s, it was a really foreign thought to do your own processing," says Carlton Howard, Vice President, Coastal FCU. "Our old core systems really did not have the capacity to handle the data, so we chose full-service processing." In 25 years, times have changed. With more than $2 billion in assets, Coastal FCU certainly has the capacity to expand into internal card operations now. "But," says Howard, "like a cow, we follow the path of least resistance."

Put another way, Coastal FCU and its members are happy with their current system. Among Howard's concerns about switching to an internally-driven process is keeping up with service demands. "Even when you're doing everything right, you can expect a deluge of phone calls about credit cards," says Howard. "If you decline a member's transaction at a cash register, in public, you have committed a terrible act in your member's eyes. You had better be available to give them the right answers right away with a smile that's visible over the phone. Being there to handle questions 24/7 is a big part of handling plastic."

Even with full outsourcing, managing a card portfolio takes effort and insight. “You can’t manage your portfolio like you’re making rotisserie chicken – you can’t set it and forget it,” says Howard. “You need to work with a processor who’s concerned with the success of your program.”

Though Howard describes his experiences with full-service processing as a “sweet and sour proposition,” with good points and bad points, he’s happy to provide Coastal FCU’s members with credit card accounts at credit union standards. “People use their credit cards every day,” says Howard. “They may not drive the most revenue, but they might be the stickiest product we have.”

Conclusion

With the recent unprecedented changes in the ability of credit unions to generate revenue, now is an excellent time to offer your members credit card solutions. With two processing options available, this opportunity is open to a wide range of organizations. Credit unions that choose their options wisely can provide their members with a valuable, relationship-building product.

CO-OP Financial Services is now offering a pass-through processing system, available for implementation in January 2011. We look forward to helping our clients develop credit card programs that will strengthen their positions – and the financial lives of their members – for years to come. CO-OP Financial Services will also be launching a fully-outsourced option later in 2011.

“Credit unions are serious about finding ways to continue providing outstanding, customized service to their members while reducing their operating expenses,” says Stan Hollen, President/CEO, CO-OP Financial Services. “We’re equally serious about helping them accomplish this. By adding credit card processing to our business lines – tailored exclusively for credit unions – we become a single point of contact for debit and credit processing, surcharge-free ATM network and shared branching.”

CO-OP’S COMMITMENT TO YOU

We’re committed to giving you the tools, counsel and support you need to maximize profitability. Contact us to learn more about how CO-OP Financial Services benefits your credit union and your members.
Visit www.co-opfs.org or call (800) 782-9042, ext. 7140.

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