STANFORD
GRADUATE SCHOOL OF BUSINESS

CASE: SM-135
DATE: 12/17/04

# CAPITAL ONE FINANCIAL CORPORATION: SETTING AND SHAPING STRATEGY

*Eighty percent of strategy is figuring out where the world is going and 20 percent is figuring out what you're going to do in response. If you can figure out where the world is going, what you need to do usually becomes obvious. That's why we're always working backwards from end games at Capital One. The whole story of Capital One is about capitalizing on the inexorable evolution of consumer marketing.*

—Rich Fairbank, CEO Capital One[1]

At the end of 2000, Richard Fairbank, chairman and chief executive officer of Capital One Financial Corporation, waited in a conference room for his senior managers at headquarters in Falls Church, Virginia. As he waited, he reflected on Capital One's 13-year history—a financial services company that had started in the credit card business in 1988 and had achieved great levels of financial and organizational success since its spin-off from Signet Bank in 1994. The company's return on average equity topped 25 percent since 1998, peaking at 26 percent in 2000. From the time of its IPO in 1994 to 2000, Capital One's stock had increased more than 1,000 percent (adjusting for splits) while the S&P 500 had increased just under 300 percent. The number of customer accounts had grown to over 40 million. The company had also expanded its presence to international markets such as the U.K. and Canada, as well as expanded its product line beyond credit cards to auto finance and several other areas. Moreover, the industry had recognized Capital One in many ways. The company was regularly mentioned in industry magazines, such as *Forbes,* as one of the 100 fastest-growing companies, ranking as the 241st largest company in the U.S. by *Business Week.* Five magazines, including *ComputerWorld* and *Fortune,* had ranked Capital One as one of the best places to work.

Capital One had revolutionized the credit card industry with its innovative test-and-learn philosophy dubbed its "Information-Based Strategy" or IBS. IBS leveraged the power of

[1] Interview with Rich Fairbank. Subsequent quotes are from this interview unless otherwise noted.

Victoria Chang prepared this case under the supervision of Professor Garth Saloner as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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information, technology, testing, and smart people to bring customized solutions to consumers and transform "one-size-fits-all" industries. IBS integrated the traditionally separate functions of marketing, credit risk management and information technology into one flexible decision-making structure that enabled Capital One to offer financial services tailored to fit each customer's individual needs and risk profile. The company's competitive advantage lay with its IBS strategy, unlike American Express whose competitive advantage was brand, Citibank, economies of scale, or MBNA, links with affinity groups. Using IBS, Fairbank wanted to "mass customize the company's products by building massive databases of consumer information and by transforming our entire company into a scientific testing laboratory. Through mass customization…we can deliver the right product to the right customer at the right time and at the right price."[2] True, IBS involved "building sophisticated models and information systems," but it also involved the employment of "incredibly talented people and a flexible culture to identify, develop, and market credit card or other products and services to satisfy the demands of a competitive and ever-changing marketplace."[3] In fact, IBS pervaded all of the technology and business activities at Capital One including customer solicitations, account management, credit line management, pricing strategies, usage stimulation, collections, recoveries, and account and balance retention, as well as recruiting and associate (employee) performance management. In essence, IBS served as the company's strategy to improve its operations, and permeated every aspect of Capital One.

As members of Fairbank's senior management team strode into the conference room, he reflected on Capital One's history and successes, as well as its challenges. He had always been focused on constantly reinventing the company, and himself as a leader, to meet the demands of a rapidly growing business in a highly competitive environment. The original information-based strategy had served the company well, but Fairbank knew it was vital to critically examine how the information-based strategy had performed throughout the various phases of the company's history, and whether the strategy positioned the company for success in the future. He didn't want to get trapped in his own conventional wisdom. He wanted to make sure that the people, culture, strategy and organization were aligned to meet the tough challenges the company inevitably would face as it continued on its journey. Finally, Fairbank did not want to rest on his laurels while other financial companies continued to imitate Capital One's successes. He was committed to growing Capital One into a strong, diversified consumer financial services company, while preserving its strengths in marketing, credit risk management and innovation. He wanted to know, "Was traditional IBS enough to propel Capital One to its destination or did the company need to adapt its strategy to continue on its trajectory?"

## EARLY CREDIT CARD INDUSTRY

By 1986, more than 55 percent of all families possessed a credit card offered by banks—more than three times the number in 1970. The number of participating banks had also grown from 71 percent to 90 percent. By 1987, nearly 4,000 banks offered credit cards.[4] Since many of the "easy" customers had been signed up by banks already, banks shifted their focus to signing up the remaining customers and stealing share from each other. Banks continued to market through

[2] Capital One Financial Corporation Annual Report, 1997, p. 3.
[3] Capital One Financial Corporation 10-K, December 31, 2003, p. 3.
[4] Christopher H. Paige, "Capital One Financial Corporation," *Harvard Business School Case Study,* NT 700-124, April 24, 2000, p. 3.

affinity programs (marketing based on strategic alliances with other organizations that bring mutual benefits to both organizations) and other innovative marketing programs. They also began to target different segments of the credit card market from the low-end market to the more lucrative high-end market (e.g. the American Express Gold Card). Major banks included Citibank, Chase, Bank of America, and First Chicago. Other smaller players included Discover and American Express. Sears Roebuck & Co. had introduced the Discover Card in 1985, thus completing the group of the four major brands—American Express, Discover, MasterCard, and Visa. They each operated payment card systems which each contained a distinct set of computers and rules for processing transactions, seeking verification, getting approval, transferring funds, and capturing billing information.

During this time, bank issuers solicited new customers through retail branches or through direct mailings within the area where the retail branches were located. National players marketed through national direct mail campaigns. To determine creditworthiness, issuers used simple metrics such as debt-income ratios and credit scores. Moreover, they all charged the same APR of 19.8 percent for all customers. A $20 annual fee was also standard in the industry ($40 annual fee for gold card users). Banks didn't distinguish between the credit risks presented by individual customers and, therefore, all customers paid the same prevailing rates for credit cards. As a result, lower risk customers, in effect, subsidized higher risk customers and customers with poor (or no) credit histories found it virtually impossible to get a credit card since banks were unable to price for the higher risk.

**THE IDEA**

Rich Fairbank graduated first in his class (Ford Scholar) from the Stanford Graduate School of Business with an MBA in 1981. On entering Stanford, however, he was not the typical student. He had always enjoyed working with children and had serendipitously entered into management when a recreation agency in California recruited him to run the agency. When he graduated, he joined Strategic Planning Associates (SPA), which later became Mercer Management, spending a total of seven years in consulting, working on a variety of different projects in different industries. Over time, he became increasingly interested in how information and technology were changing the world of consumer marketing and the power of smart problem-solving to optimize performance at companies. Based on his consulting experience, Fairbank began to see "patterns across different industries" and generated a few deep beliefs that would shape his thinking: 1) industry structure is a key determinant of the fortunes of a company and 2) "when the world changes, often the last people to know are the ones that are most deeply involved in the old way," he explained. "The story of Capital One is the power of an objective ignorant view of the world from someone who really didn't know anything about the credit card business. I think that sometimes when the world is ripe for a change, the less you know, the less you have to separate conventional wisdom from real wisdom."

Eventually, Fairbank began consulting to banks, conceiving of the strategy for Capital One in a very short period of time. He said: "My belief is that 80 percent of strategy is about figuring out where the world is going and 20 percent is about figuring actually what a company is going to do in response to that. I think most companies view strategy as, 'What am I going to do?' I would argue that having a list of things that you're going to do is not strategy." While analyzing the

credit card industry, Fairbank had several observations: "First, the fact that everyone had the same price (same APR and annual fees) for credit cards in a risk-based business was strange. It was clear that credit cards would be a very profitable business if people actually paid you back. Underlying the strong profitability in this business was a massively steep gradient of customer profitability. And, if you could de-average that underlying profitability gradient (because you lose your shirt when people don't pay you back), you could build a profitable business. Secondly, credit cards were a profoundly rich information business because, with the information revolution, there was a huge amount of information that could be acquired about the customers externally. Since every interaction that credit card customers had with a company could be recorded and captured in terms of data, there would be a huge amount of information that could be obtained from prospects and customers. Finally, the industry lends itself to massive scientific testing because it has millions of customers and a very flexible product where the terms and nature of the product can be individualized and the channel of marketing was direct marketing where literally a unique offer could be made to every single customer." Fairbank envisioned an end game of "mass customization." Fairbank believed that if a company could build an information-based capability and test ways to "smash the price of credit," it could beat Citibank and other competitors. The fact that credit cards weren't physical products also meant that they could more easily be customized. Fairbank dubbed his strategy the "information-based strategy" or IBS. He called his realization a "religious conversion" and, after that point, he embarked on determining how to start such a company within such an entrenched massive-scale industry. He decided that getting a bank to "sponsor" his idea would be the way to succeed.

Fairbank decided to recruit fellow SPA consultant, Nigel Morris, to help launch the IBS concept and find a sponsor. Morris had joined SPA from the London Business School. Fairbank planned to pitch banks on the concept of using an information-based strategy to build a card portfolio, tailoring each product to a market niche. Fairbank met with the heads of credit card divisions or the CEOs of between 20 to 25 card issuers, often enlisting support from Morris on the whirlwind tour. He pitched a combination of the scientific testing of product and pricing features and the use of behavioral and actuarial principles in the data mining of consumers, as well as innovative ideas regarding credit scoring, underwriting, and collections. Fairbank recalled the mentality of the banks he pitched: "Every issuer had the same price for everybody. That's a ridiculous notion. It's as if the auto insurance industry had the same price for 16-year olds as they had for 46-year olds."[5] Unfortunately, all of the banks turned them down, and some more violently than others—one bank CEO threatened to throw Fairbank out of the window if he ever again recommended a business with charge-off rates over 1 percent. Half of the companies claimed that they had an information-based strategy in place because they used computers and information, while the other half said they could not implement such a plan. "Some said it would cause too much internal difficulty, that they would have to realign the firm," said Fairbank. "For many of them, that was a very correct assessment. Creating a culture of constantly challenging ideas and introducing the complexity of mass customization can mean profound changes in an organization."[6]

Finally, after a year of pitching unsuccessfully, in 1988, Richmond, Virginia-based Signet Bank agreed to hire Fairbank and Morris to implement the mass-customization strategy. At the time,

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[5] Burney Simpson, "The Entrepreneur as Chief Executive," *Credit Card Management,* August 1998, p. 72.
[6] Ibid.

Signet was a mid-size, regional bank with approximately 1 million customers and $1 billion in managed loans. Moreover, Signet's credit card division had not solicited any customers directly, but rather received its leads from another company. Fairbank and Morris agreed to accept the job offers, as long as they could have control not only of the credit card division's strategy, marketing and credit functions, but also the information technology functions (which resided in corporate)—functions critical to the success of IBS. Fairbank also negotiated a new form of compensation—he and certain other executives would receive a significant share of the net present value (NPV)[7] of any new accounts generated. Signet agreed and Fairbank and Morris joined Signet in October 1989. They proceeded to hire a small team of young business analysts from top universities.

Within Signet, Fairbank's team worked for several years to build a database, testing hundreds of approaches to new products. Unfortunately, the initial testing was disastrous—Signet's charge-off rate[8] grew from 2 percent (among the industry's best) to 6 percent. Meanwhile, Signet, along with many other banks, faced problems in its real estate loan portfolio and the company's stock was plummeting rapidly. Recruiting talent into a small Southern bank was also challenging according to Fairbank: "We were recruiting head-to-head against McKinsey and Morgan Stanley. One of our biggest challenges was getting Signet to agree to pay new hires freshly graduated from the top schools what their veteran vice presidents were paid." All of these factors made the environment a very challenging one for the entrepreneurial team.

Fairbank's goal was to "smash the price of credit." In late 1991, after conducting 200 tests, the company finally hit pay dirt when it launched a low introductory-rate, balance-transfer test. Under the test, consumers could transfer their credit card balances to a Signet account with a 9.9 percent APR—a rate half that of industry standards. The results were beyond anyone's expectations: "We identified the most attractive customers of our competitors. We said, 'Sign your name and we'll do all the work.' It was explosively successful," recalled Fairbank.[9] In 1992, Signet rolled out the balance-transfer product nationwide. The response and credit performance were "amazing," said Fairbank. At the time, it was a "radical theology to be pricing credit cards below the rates charged on secured loans," he said. Within three years, Signet's credit card business grew to approximately 5 million customers and $7 billion in managed loans. Fairbank said: "Signet was in its darkest days and we were four years into our journey without producing tangible results. When we looked at our results for the balance-transfer test, it was like looking into Fort Knox. We were able to make substantial profit at half price rates. It was good timing because I think that it was a matter of days or weeks or, at most, months before our venture would have been shut down." Remarkably, the business went from near death to hiring a 100-person team in a week to execute the successful balance transfer product and drive the growth of Signet's business.

Because of its explosive growth, the credit card division's revenues and profits began to overtake the rest of the bank by 1994. Signet decided to spin-off its credit card business as Capital One

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[7] Entails calculation of expected free cash flows that result out of the investment, subtraction/discount for the cost of capital (interest rate to adjust for time and risk) to get the present value. From that, the initial investments are subtracted to get the net present value.

[8] Charge-off rates for any category of loan are defined as the flow of a bank's net charge-offs (gross charge-offs minus recoveries) during a quarter divided by the average level of its loans outstanding over that quarter.

[9] Simpson, op. cit.

Financial Corporation in order to fully realize the division's potential value. Fairbank became chairman and chief executive officer of Capital One, and Morris took over as president, after the initial public offering in 1994. Signet subsequently became a part of First Union Corporation. At that time of the spin-off, Capital One's goal was "to become a dominant player in the U.S. credit card industry," according to Fairbank.[10]

Steve Mugford, head of strategy at Capital One, discussed the "incumbent's dilemma," facing Capital One's competitors at the time: "With the emergence of direct marketing and information technology, combined with the price umbrella that was created by legacy competitors in a sleepy credit card industry, there was an opportunity for Capital One to de-average a lot of what was going on in the industry in a way that was difficult for the competition to respond to. Using technology to identify the most profitable prospects, and direct mail to contact them one at a time, we priced to the individual. Add on the fact that our competitors had a profitable franchise based on their existing pricing strategies and were reluctant to re-price their whole portfolios to respond to us, and you have a classic incumbent's dilemma."[11] Fairbank added: "The Citibanks, Chases, and Bank of Americas made a very fateful decision, which was to go for a year and a half without responding to our balance transfer product. So we just went at full speed right after the best customers of the biggest banks in America."

According to Fairbank: "Two critical elements converged that enabled the emergence of the big, national monoline lenders, like Capital One, that specialized in particular lending businesses. The power of mass customization and direct marketing liberated Capital One, and subsequently other monolines, to crush the cost of credit and build national lending businesses. And the rise of the capital markets provided the necessary fuel for growth. Banks typically relied on deposits to provide funding for their lending businesses. Capital One wasn't a traditional bank and didn't have deposits, so it had to get funding somewhere else. The capital markets provided a vehicle for pooling our receivables and selling them to the public, which allowed us to get the funding we needed to grow our credit card business. Without this funding, it would have been virtually impossible to build Capital One. Of course, the capital markets can be fickle, so the very source of funding that provided great thrust to our company also could have made it vulnerable if the market's appetite for our receivables had dried up."

FirstUSA was the first bank to mimic Capital One's strategy and it eventually became a large player in the credit card industry as well. Other "monolines" followed suit in the 1990s and achieved similar success both in the credit card and other lending businesses.

## AN INFORMATION-BASED STRATEGY[12]

### Fundamentals of IBS

As mentioned previously, because Capital One wanted to be able to deliver "the right product to the right customer at the right price," it had to understand two things about each potential

[10] Simpson, op. cit.
[11] Interview with Steve Mugford. Subsequent quotes are from this interview unless otherwise noted.
[12] This section was mostly written by Michael Rierson for Professor James Lattan for an unpublished case study. The author has taken the liberty of editing the section.

customer: the individual's *creditworthiness* (essentially, the likelihood of the individual making payment) and his or her *responsiveness* (the likelihood of the individual choosing the offer). Capital One's information-based strategy involved collecting data on individual prospects and using the data to model creditworthiness and responsiveness.

Slight variations in response rates and credit performance could significantly affect the economics of credit card marketing. Although the numbers varied widely depending on the offer, average response rates were typically in the vicinity of 0.5 to 2.5 percent. If the average cost of acquisition was $50 per customer at a response rate of 2 percent, then it doubled to $100 per customer as the response rate dropped to 1 percent, severely limiting potential profitability. An even greater threat was embedded in the lending decision. Each time a loan was made, there was a risk of default. The magnitude of a default made for a very asymmetrical profit structure: a large number of relatively small revenue streams could quickly be wiped out by a single default. Under-predicting risk could lead to devastating losses.

Capital One used both external and internal data to determine the risk profile of a potential customer. External credit bureaus offered a set of common information to credit issuers. From mortgages and auto loans to credit cards, loan payment and usage information was submitted to credit bureaus. Using an algorithm developed by the Fair Isaac Company (FICO), credit bureaus summarized each customer's credit history in a single metric of credit worthiness—the FICO score. The score took into account any negative information such as past bankruptcies and delinquencies or late payments; the score did not factor in race, religion, sex, marital status, or age. FICO scores ranged from about 350 to 850. A score above 700 was considered excellent, and usually made it possible for the applicant to obtain the most favorable credit terms. Although the information was useful in predicting credit risk, it posed one obvious problem—every competitor had access to the same information.

Bureau FICO scores also posed another problem. The score was designed to predict the creditworthiness of an individual chosen at random from the population. Capital One realized that the individuals who responded to the company's credit offers were not necessarily representative of all people with the same FICO score. In fact, compared to non-respondents, respondents were systematically more likely to be credit hungry (and hence riskier) than FICO predictions would indicate. The phenomenon was known as "adverse selection." To manage adverse selection, Capital One analysts ran tests varying message strategy, price, credit line, product features, and acquisition channel while holding FICO scores constant. In each case, they found that the respondents to different offers exhibited different levels of riskiness despite having the same FICO score. In one test, for example, using a second channel to make the same credit offer to a different set of prospects (holding FICO scores constant) resulted in a level of charge-offs twice as high as the first channel. In this way, the analysts learned which combinations of marketing activities led to the best outcomes. Capital One used the results of these tests to adjust its offers accordingly, before rolling them out nationally. In order to complement publicly available data, Capital One began to accumulate a wealth of private information.

**Executing IBS**

Capital One ran numerous tests to collect information on existing customers. Fairbank described the type of testing used by Capital One to optimize customer retention: "A classic test for Capital One is to randomize all the people who are calling the retention department saying, 'I'm out of here!' To respond appropriately requires some knowledge of who's bluffing and who's not, as well as some knowledge about which customers we'd like to keep. To get this information, we perform a test with (for the sake of simplicity) three different actions across three randomized groups of people. Group 1, we call their bluff and close their account. Group 2, we match their (allegedly) better offer. And Group 3, we meet them halfway. Then, we collect lots and lots of information on what the responses to these offers are, and build statistical models to link these results to the data we have on these people. So now, when somebody calls Capital One—instantaneously—we make an actuarial calculation of the customer's lifetime NPV and assess the customer's likely responses. Right on the screen, the customer service representative sees an instant recommendation, such as to negotiate the APR down to 7.9 percent. That's all instantaneous, totally customized, and … that's only one test!"[13]

In 1997 alone, Capital One conducted over 13,000 different tests and, by 2000, that number was in the tens of thousands. The data that Capital One collected was of high integrity and highly actionable due to the nature of direct marketing. Each piece of mail was targeted to a specific recipient. Capital One then recorded every aspect of every interaction—Did the recipients respond? If so, how did they use their cards? Did they carry balances? Did they default on their loans? Multiple product variations were tested, and each time customer response to the new stimulus was measured. In time, Capital One acquired significant information about the drivers of customer behavior.

Combining the public information from the credit bureaus with the company's own private data, Capital One created a proprietary database vital to its information-based strategy. Using the results of Universe tests, or tests to the general population, Capital One created statistical models to predict customer behavior. These models leveraged not only population characteristics, but also how product design and other features could minimize adverse selection. As a result, Capital One harnessed the predictive power of specific variables to make risk predictions that greatly outperformed FICO. The combination of this model with a response model allowed Capital One to market products to that optimal combination of creditworthy and credit-hungry customers.

The process for collecting information was also important. In any test, there existed an important trade-off between the information gained from the test and the cost of the test. Capital One incorporated statistical design into every one of its tests. Each test typically was only large enough to get a meaningfully significant statistical result. Tests were sized so that the result allowed the business to improve its strategies while managing costs. The large numbers of consumers in the credit card market enabled this testing to be successful. The credit card population of the U.S. was amply large to allow for statistically significant reads, even as customer segmentation became increasingly fine. Each test was also designed so that analysts could control every factor. Isolation of variables allowed for decisions to be made on each variable, rather than as a set. Understanding the independent effects of individual variables created the ability to better postulate the impact of combining multiple features that had been

[13] Richard Fairbank, as quoted in "Capital One Financial Corporation" (HBS Case 9-700-124).

evaluated separately. This modularization of knowledge resulted in improved testing and quicker development time by focusing efforts on high potential tests.

Over time, Capital One's testing became increasingly sophisticated. By employing statistical experimental design, Capital One increased the amount of testing it could accomplish using a fixed set of names (and marketing costs). Essentially, multiple tests were embedded into one in a way that allowed for reads of all the primary comparisons as well as the interactions. In such a manner, multiple variations were tested to screen for the optimal combination. When combined with iterative testing, this created the ability to find the best product offering rapidly and inexpensively. Generating information from testing became increasingly pervasive at Capital One. Testing dictated whether a customer service representative or a voice-response unit (VRU) should receive an incoming phone call. The color of a solicitation envelope was determined by empirical evidence, rather than by the opinion of a focus group.

At its heart, credit card profitability was about risk management. The asymmetry of credit card economics made accurate forecasting critical. Here, Capital One had two competitive advantages. The superior risk management models allowed Capital One to make better credit decisions about each prospect. This risk management then empowered Capital One to offer better products than its competitors, thereby attracting the lowest risk applicants. The cumulative effect of these forces allowed Capital One to carve out a super-prime market segment that received the lowest rates in the nation. Applying risk management across the risk spectrum, Capital One became an industry leader at maintaining low loss rates.

By virtue of its approach to testing, Capital One had a great ability to react to a dynamic competitive landscape. Often, Capital One's testing prowess made it first to market with a winning product. As competitors copied Capital One's strategy, it became increasingly important to understand how much of a first-mover advantage the company retained. Combining current response rates with a historic understanding of risk, Capital One was able to make accurate risk assessments on each set of accounts. If Capital One was not first to market, its testing efficiency and history helped close the gap swiftly enough to nullify its competitor's potential first-mover advantage.

Capital One's testing rigor even helped it be the first to exit a market. By virtue of its tracking capabilities, Capital One was able to determine when profits on a once-profitable product had eroded. This was the case with balance transfers. Capital One had pioneered the product, using it to attract revolvers (customers who maintained a credit balance and paid finance charges every month). But as competitors followed suit, "teaser hoppers" (customers who shifted their balances to a new card as soon as the introductory interest rate expired) began to destroy the product economics. Capital One watched this change and was able to shift its strategy to more profitable offerings. In the mid-1990s, competitors, such as Advanta, that had claimed to have strategies similar to Capital One failed to manage customer creditworthiness resulting in increased consumer bankruptcies and charge-offs.[14]

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[14] Advanta issued credit cards with low "teaser" rates and long introductory periods. The customers Advanta booked turned out to be riskier leading to increased delinquencies and defaults. Advanta ultimately sold its credit card business in the wake of bad loans on low introductory rate products and skyrocketing charge-offs.

## The Culture of IBS: Empowered Entrepreneurs and a Rigorous Culture

Scientific testing brought more to Capital One than just superior models and rigorous forecasting. The use of empirical evidence created a market environment within the company. Even a junior analyst could make an assessment of whether a better product had been found. The low cost of testing allowed this same analyst to investigate new opportunities. These features of IBS enabled the decentralization of decision-making. By providing any individual the power to create change, Capital One created an army of entrepreneurs. Mugford elaborated: "There was potential for very junior people to act autonomously, get out in the market with tests, and get the data they needed to drive company-changing initiatives. There was a sense of potential and empowerment that extended way down into the organization that was intoxicating. In a culture that rewards data and fact-based decision making, hierarchy is less important than facts. It was often the most junior people in the room who were closest to the data and therefore in a position to drive the agenda. Rich Fairbank referred to our decision-making process as a competition of ideas, not people. Ultimately, what's most distinct about Capital One is our culture. A lot of competitors sound similar to us, but few actually do what we do. Unless you actually have a combination of the right culture and the right business, it doesn't work."

Peter Schnall, chief credit officer, echoed Fairbank's earlier comments about the benefits of management not having credit card experience: "In the early days, we were unusual among credit card companies because we didn't have a lot of employees who were from the credit card industry. For example, I didn't have any credit card industry background and found myself running account acquisitions for the fastest growing credit card company in the U.S., and this is true for almost our entire management team. We were inexperienced, but it turned out to be a huge benefit because it allowed us to think about the business unconstrained by conventional wisdom." Fairbank further explained: "Our lack of experience helped us take an objective look at the credit card business. From the beginning, however, we always compensated for our inexperience by hardwiring conservative assumptions about the economy and credit performance into all of our product decisions."[15]

### CUSTOMER SEGMENTS

Due to the competitive credit card market in the early 1990s, Capital One shifted away from the saturated prime-middle market to the super-prime (low risk consumers that used cards primarily for convenience and generally paid off their balances in full each month) and the sub-prime segments (higher risk consumers that tended to carry revolving balances) of the market. Capital One adopted one system that supported two separate applications of the same approach to manage the different target markets. In the super-prime market, Capital One offered "near affinity" cards, including heritage cards (e.g. Polish-American and Japanese-American cards), professional cards and hobby-related cards. Capital One did not have to share its revenues because Capital One cards were generically targeted at the passions and interests of its customers, rather than depending on formal arrangements with affinity organizations. The company also offered the super-prime market incentives for using credit cards including a "cash-

[15] Interview with Peter Schnall. Subsequent quotes are from this interview unless otherwise noted.

back" program and an airline miles program in which mileage could be used on any airline with no blackout periods.

## ORGANIZATION

Capital One had historically been organized in a functional manner. As CEO, Fairbank ultimately was responsible for all of the functions and operations of the company. Functions with P&L or marketing and analysis responsibilities generally were supervised directly by Fairbank. Morris, who reported to Fairbank, typically had responsibility for managing operational functions, such as IT and Card Ops (call centers, customer service, etc.), as well as international expansion efforts.

### Marketing and Analysis

The M&A organization had responsibility for marketing and credit risk, which involved determining which offers to send to which customers. Traditionally, M&A was the only functional area at Capital One with P&L responsibility. In general, M&A employees included business analysts who drove the business strategies, project managers who worked closely with the business analysts to implement the strategy, statisticians who built statistical models and methods for implementing marketing strategies, and data analysts who served as the interface between the data and the business analyst. To best support Capital One's test-and-learn approach to business, the Marketing and Analysis (M&A) department worked closely with specialists from Management Information Systems (MIS) and Operations (Ops). These latter two teams were responsible for executing test and rollout changes. The former, MIS, was responsible for programming the computer systems; the latter, Ops, managed the facilities that were used to execute mailings and deliver customer service.

The strategy in the M&A function had always been to utilize the company's IBS strategy to drive growth in businesses where the company saw opportunities. Rob Alexander, senior vice president, Marketing and Analysis, noted: "We're unique in the card business in that we actually bring together both marketing and credit risk into one organization, which is important, because we believe that where you really find the value is in the tradeoffs around marketing and credit. In a typical bank, the credit department is off on its own setting policy, and the marketing group is off trying to market the best it can within that policy. Other companies keep these two organizations separate because if they're together, it's a little bit of the fox guarding the henhouse if you don't have good controls and discipline, because the way the credit card business works is that you make a lot of decisions in the present, and you live with the consequences of those decisions for years to come. So if you're a marketer and your incentive is to grow the business, it's easier to grow if you take on more and more risk. But we at Capital One gain a lot from putting credit and marketing together because our decision-making is so deeply-rooted in NPV and good quantitative decision-making."[16]

### People Strategy and Human Resources

[16] Interview with Rob Alexander. Subsequent quotes are from this interview unless otherwise noted.

Recruiting the best people was a key part of Capital One's IBS strategy, according to Fairbank: "Our company has always been about hiring the absolute best people and giving them an opportunity to be great. Recruiting great people is the highest leverage thing you can do in business. We go to unbelievable lengths to identify the best person to fill every job at Capital One. We scour the world for "great athletes" who, even if they don't know a lot about what we do, have the potential to be top-notch business leaders. In the early years, I personally spent 10 to 20 hours a week recruiting. I feel so strongly about this principle that the number one job of every line manager in our company is not credit risk management or product development or operations—it's recruiting and empowering great people. This may sound trite since everyone claims that people are their most valuable assets, but very few really walk the talk. Attracting the best talent is one of the most talked about, but least delivered on, things in business. Most executives spend 1 percent of their time recruiting and 75 percent of their time managing their recruiting mistakes. It's a classic management mistake. We've tried to turn that ratio on its head because, in the long run, it's the best expenditure of time you can make."

Alexander emphasized that the company positioned itself as a "technology company" and "anti-bank," differentiating itself from the sleepier banks by focusing on empowerment, entrepreneurialism, and technology. Fairbank modeled Capital One's recruiting strategy after the rigorous model of top management consulting firms such as McKinsey, Bain, and BCG. Alexander said: "Rich and Nigel really believed in the importance of hiring the smartest people and recruiting has always been our biggest competitive advantage. Thus our strategy was to go to the best schools with a strong recruiting pitch. We also had a strong compensation approach, which has been traditionally very equity-based." Alexander cited people as a competitive advantage for Capital One, but emphasized the importance of a "system:" "It starts with the people, but it's also about the various elements of the system that make up our information-based strategy and how we ultimately make business decisions and pursue opportunities, and I think it's how all these things work together that really make a difference. Smart people with an analytical orientation make quantitative data-driven decisions that are sound in their approach, and are supported by the right infrastructure and management processes, all combined with a senior executive team that really values analytics and infrastructure. Thus all of this creates a system that is a competitive advantage. But it's really rooted in smart people. We've never had unique technology that any other card issuer didn't or couldn't have."

Specifically, the recruiting process required all job applicants ranging from statisticians to MBAs to office managers, to take a number of tests before they were hired. Recruiting talent involved analytical testing for cognitive skills, EQ skills (emotional intelligence) testing for non-cognitive skills, managerial skills assessment that tested experiences in management, behavioral interviewing, and case studies (similar to case studies that McKinsey and Microsoft conduct, which measure logical thinking and problem-solving skills). Management and senior executive hires faced as many as 15 interviews in some cases.

In terms of performance management, all associates had their performance formally evaluated every six months by their bosses, peers, and direct reports. Associates were then rated and their performance was calibrated against their peers. Even Fairbank conducted a 360-degree feedback process on his own performance. Fairbank commented: "Feedback and development are at the core of our approach to managing talent. Associates are constantly provided with feedback so

that they can take a hard, honest look at their own performance and how they can improve. Associates are also expected to define their own developmental goals and aspirations – in essence a game plan for acquiring the skills and experiences they need – and to take personal responsibility for their own development. The company supports their development by making huge investments in providing training, new opportunities and coaching. Declaring development objectives, providing constant feedback and investing in our associates has proven to be a devastatingly good formula for driving performance."

The compensation philosophy of Capital One also was deeply rooted in finding and motivating the best talent. Capital One targeted 75th percentile total pay relative to the companies it recruited against, but the compensation was heavily weighted towards cash bonuses and long-term equity incentives that aligned employees with the long-term goals of the company (and its shareholders) and that were driven by individual and company performance. Fairbank believed that entrepreneurs must "have significant skin in the game," and that the alignment of performance and compensation was fundamental to the company's culture. Fairbank felt so strongly about this principle that he ultimately forfeited his salary and received compensation packages consisting entirely of stock option grants, most of which vested only if the company met stringent performance hurdles and delivered value only if the stock appreciated. "Capital One's people strategy and compensation philosophy have provided a competitive advantage and differentiated us from traditional banks," said Fairbank. "Our focus on people and performance has been one of the core, enduring values of Capital One since its inception."

## Information Technology

Over time, Capital One's testing culture became more and more complex, causing increasing amounts of pressure on the company's IT infrastructure. In fact, the IT group grew 15 to 20 percent per year in terms of people throughout the 1990s. Alexander said: "Our innovation at the company put tremendous demands on our IT organization. The organization dramatically staffed up, costs escalated, and it was increasingly difficult to develop an integrated system designed around a vision." Specifically, the M&A organization was architected on a project-basis, thus "each programmer would be the lead architect for a specific M&A-driven project and as a result, our systems became increasingly complex and duplicative in certain areas," said Gregor Bailer, CIO, beginning in 2001.[17] "After one project was completed, when we did a new project, we had a lot of things to check when we implemented a new feature because the wires crossed."

## Operations

The operations function at Capital One created lists of potential customers, created and mailed direct mail pieces or telemarketing scripts, handled incoming card applications and processing, managed billing, payment, collections and recoveries, and customer service in general, and handled fraud prevention, detection, and recovery. In the mid-1990s, the operations function within the credit card business was perceived as "good at getting things done," according to Schnall: "Operations did a good job executing, but our processes and culture made it hard for them to add the value that they might have."

[17] Interview with Gregor Bailer. Subsequent quotes are from this interview unless otherwise noted.

## Finance, Accounting, and Planning Administration

The finance function handled interest rate risk management, treasury management, and business planning. Traditionally, the CFOs within the various credit card product areas at Capital One reported directly to the heads of M&A. "One of the challenges of the Finance organization was forecasting because of the rapid pace of change and growth at Capital One," said Miles Reidy, head of financial planning.[18]

## Corporate Governance and Risk Management Functions

Certain staff functions relating to the company's reputation, governance and risk management had always been centralized. The functions included legal activities, compliance activities, community relations, internal and external communications, investor relations, brand advertising, and the audit group (which technically reported to the company's board of directors).

## GROWTH AND EXPANSION—APPLYING IBS AND INNOVATION

Capital One's IBS strategy was never just about credit cards: "Credit cards were at the forefront of where I believed the world was headed with respect to the use of information and direct marketing," said Fairbank. "Building a national credit card business created a platform for further expansion and diversification into new businesses and markets. The need for Capital One to diversify was not obvious. Other monolines were busy trying to create larger versions of themselves. But, I believed we needed to diversify for both offensive and defensive reasons: offensively, to leverage our strategy and position ourselves for continued growth and, defensively, to mitigate the risk inherent in being in a single lending business. It wasn't an easy sell to Wall Street that we wanted to diversify because, even if investors like the destination you're heading toward, they discount you along your journey because they're not sure you're going to get there. However, you have to make those bold moves from a position of strength and at a time when you don't have to because, if you wait until you hit a wall to take action, it's usually way too late."

In 1995, as the company passed the $10 billion milestone in managed loans, Capital One began expanding internationally into the U.K. and Canada, as well as testing in Continental Europe (by 2001, international revenue accounted for 10 percent of total revenue). "The U.K. and Canada were clearly successes," Fairbank said. "But, some of our forays into Continental Europe, where people use credit cards very differently than we do, haven't worked as well. The country infrastructures, availability of information, marketing channels, and consumer usage patterns are all different. I think we ran around with a Capital One hammer looking for Capital One nails instead of really working backwards from meeting markets where they are and how they work, and over time, then adapting them. Through experiences like these, I have developed a deep appreciation of how hard it is to change consumer behavior."

Following the successful implementation of IBS to credit cards, in the mid-1990s, Capital One tried to apply its IBS strategy to different types of businesses beyond cards. Fairbank noted: "We looked for businesses that had good industry structure that would lend themselves to direct

[18] Interview with Miles Reidy. Subsequent quotes are from this interview unless otherwise noted.

marketing and information-based strategies. Continued product innovation and expansion into new business lines was essential for our long-term growth." Fairbank had referred to product innovation as a "Golden Gate" effort, in reference to the practice of painting the famous bridge—once it was finished being painted, it needed to be painted again. Similarly, he believed that product innovation was a process that needed to begin again as soon as it was finished in order to ensure the company's survival. The innovation process at Capital One was designed to operate much like a seed-level venture capital market. Winners out of the Golden Gate process competed for staffing and funding based on the strength and promise of their respective business cases. In keeping with Capital One's experience in creating a platform for optimization from scratch in the credit card business, these efforts were typically oriented around custom-built operational platforms.

George Overholser, former head of strategy and new business development (and a Stanford GSB graduate), expanded on the Golden Gate concept and launched the "Growth Opportunities" (or GO) teams in 1994. These teams reported to Fairbank and were staffed with top consulting talent from both within Capital One and from outside (each GO team member had to do a six-month rotation in the credit card business first). The GO teams investigated and tested more than 50 potential opportunities in 1996 and early 1997. The group fluctuated in size from 30 to 200 people, depending on the life stages of particular GO projects. Teams used a venture capital model to explore product categories as diverse as cellular phone service, auto insurance, life insurance, travel, flowers, home equity loans, rent guarantees, and computer reselling. The GO team spawned businesses and spun them out of the GO group to stand on their own.

Eventually, the GO team dissolved as Capital One shifted from an incubator approach to more of an acquisition approach. Overholser said: "For a long time, we were seeking to reinvent industries from the outside. We were hoping that the power of IBS would forgive the lack of experience in these new industries. What we learned as time went on was that IBS wasn't strong enough to overcome a basic lack of experience, and in 1998 we started to use the acquisition approach as opposed to the skunk works approach. Our way of entering new businesses still involves a test-and-learn approach, but before the major testing starts, we make certain that we've entered the new industry on its own terms."[19]

### Telecommunications: America One

In 1996, Capital One decided to expand into the wireless telecommunications business, naming its venture America One. America One resold blocks of cellular calling time to consumers. Fairbank called a cellular phone "a credit card with an antenna." Mugford explained: "The thought was that a cellular phone is a physical phone, but in addition, the actual calling plan was a virtual good that is made up of different terms, features, and pricing that you could mass-customize. In addition, we thought we could direct market the phones, taking out the cost of the physical stores. Because there was so much cellular capacity we thought we could buy access capacity on existing players' networks relatively cheaply and resell it, repackage it, and thus not be fully integrated into the phone business." For example, Capital One developed a direct marketing relationship with Sprint PCS to test the viability of offering Sprint's wireless services to Capital One prospects.

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[19] Interview with George Overholser. Subsequent quotes are from this interview unless otherwise noted.

However, in August 2000, Capital One abandoned its five-year attempt to build a business for selling wireless phone service. "We pulled out of that business and we learned some valuable lessons," recalled Fairbank. "We should have seen that the industry was on the verge of collapse. We were in the wrong place at the wrong time and were just too small." The company shut down the operations in March 2001, shifting the 370 employees to other parts of Capital One. Mugford discussed the lessons from the America One experience: "We learned that no matter how elegant our strategic reasoning, at some level if you don't have a viable going concern, it's difficult to separate the success or failure of tests from the effects of being totally sub scale. We spent a lot of time trying to do basic things like putting a billing system in place, for example, as opposed to trying to think about clever IBS strategies. In addition, we were trying to sell customers phones through direct mail when the rest of the industry wasn't direct. We found that changing customer behavior was a profoundly difficult thing to do. We were trying to get customers to sign up for these things in a way that was totally untested and unproven in the marketplace. On top of that, the actual cellular industry was structurally challenged with high fixed costs and massive over-supply. The supply-demand imbalance led to an over-emphasis by Wall Street on first mover advantage and irrational valuations driven by pure customer growth versus profitability and the value of the customer. This in turn led to cutthroat pricing behavior by the incumbents , which deflated the pricing umbrella we sought to de-average like we did in credit cards. We had so many strikes against us that we were doomed to fail."

**Auto Finance: Summit Acceptance Corporation**

While Capital One ultimately pulled out of the wireless business, there was a silver lining to the experience. Fairbank explained: "I've always deeply believed that we need to be a learning company. Success often blinds you. Failure gives you feedback right between the eyes. We have been powered by the lessons we learned through some of our failures, most notably in America One and Continental Europe. First, we learned that we had to enter a new business with threshold scale infrastructure. It's hard to compete if we're busy building everything from scratch. Second, we had to meet customers where they were. We can't immediately try to change customer behavior by, for example, forcing customers to take a product directly when they're used to getting it through a different channel. This led us to the strategy of acquiring threshold scale businesses where we get infrastructure, a viable business model and a management team. We could then focus on turbocharging the business with the unique skills that Capital One brought to the table. After we had threshold scale and were positioned to meet customers where they were, we could begin working on adapting customer behavior from a solid footing."

Following America One, Capital One decided to focus on financial services and expansion through acquisitions. Fairbank planned to expand into other financial services businesses through the acquisition of what he called "growth platforms" or successful companies with accomplished management teams with at least threshold operating scale: "Our strategy is to acquire these companies and work with them and scale their businesses, bringing in our information expertise," commented Fairbank. On July 1, 1998, Capital One acquired Dallas, Texas-based Summit Acceptance Corporation, an auto financing company operating in 26 states

that focused on the sub-prime market. Capital One acquired this business to test the applicability of IBS to the auto finance business. Fairbank believed that IBS would allow the company to successfully understand the market and credit risks in the auto finance industry. He said: "We didn't know anything about auto finance, but it looked like an industry that was trapped in the past in the sense that a consumer had to go in and spend a couple hours at an auto dealership getting financing in a face-to-face environment, while we were already pre-approving unsecured loans, many of them at the prices of secured auto loans. Why couldn't we leverage all the apparatus, the information, the customer base, and the knowledge that we have and go out and transform the auto finance industry to bring pre-approved offers to auto buyers so they wouldn't have to go into the dealership empty-handed?"

Dave Lawson, CEO and president of Capital One Auto Finance and prior head of Summit Acceptance Corporation, recalled Capital One's decision-making process: "When Capital One was assessing Summit, they liked the fact that we were using our own customized credit models to make credit decisions versus other companies who were using the standard FICO score and human decision-making."[20] Overholser said: "We hoped to overlay IBS on Summit to see how much competitive advantage we could develop." He acknowledged that there were some initial concerns: "We felt that having an intermediary in the form of car dealers was potentially fundamentally incompatible with an IBS approach. We actually discovered that our IBS methodologies were more adaptable than we thought. We found ways to drive scientific decision-making in that environment, and we also learned from Dave Lawson and the auto business other things that we didn't know before, such as how to manage our costs very rigorously, for example." Fairbank commented: "It's important to understand how we applied our lessons learned from prior experiences in this case. We bought a threshold scale infrastructure with a strong management team, especially Lawson, which allowed us to hit the ground running. Everyone in the industry marketed auto loans through dealers, so we were also able to meet customers where they were—in the dealerships—to provide loans initially. This solid foundation allowed us to begin leveraging IBS in auto lending without having to reinvent the wheel as we expanded into the direct marketing of auto loans."

### Other Business Segments

Other business segment successes included installment loans and small business lending: "Installment loans were just like credit cards, except they were just a closed-end loan instead of a revolving loan," noted Fairbank. "Like credit cards in the early days, installment loans typically were transacted out of bank branches. We believed that we could market them directly on a national scale like we marketed credit cards. This business was tailor-made for Capital One since our IBS and marketing skills could be used to bring pre-approved installment loans directly to customers. Using IBS, we have been able to offer some of the nation's lowest prices for installment loans. We've also had a lot of success going into small business lending, which is a segment that's right on the cusp of commercial and consumer banking. Small business lending was a logical place to extend IBS within financial services."

## DEVELOPING A BRAND

[20] Interview with Dave Lawson. Subsequent quotes are from this interview unless otherwise noted.

In 1998, Bill McDonald joined Capital One as executive vice president of Brand. The impetus to hire McDonald stemmed from Fairbank's desire to develop a brand that would support a diversified company "We cheated in that we didn't initially build a brand," noted Fairbank. "We were very fortunate to ride on the backs of two of the world's biggest brands—VISA and MasterCard. But we got what we paid for in the sense that we became one of the biggest companies nobody had ever heard of. We made a fateful choice to go out and build a brand and that decision was internally controversial. But ultimately, we knew that beyond credit cards, we didn't have any legs." Fairbank believed that Capital One, Citibank, and Chase would be able to break away from the pack, while Wachovia and SunTrusts as well as others would be left behind because investing in brand would be very expensive: "Building a strong brand requires a large, sustained financial investment and businesses with national scale to make it worthwhile. Because of the massive number of customers, the credit card business is the perfect platform for building a brand. Companies lacking a national credit card business likely will find the table stakes for brand advertising too expensive."

Capital One planned to utilize its brand to drive response in its card business and its emerging diversified businesses, as well as to support the Internet and other marketing channels where "brand is so central," said Fairbank. "I've always believed that, in time, direct businesses will gravitate from an outbound model—where you target the customers—to an inbound customer channel where you pull customers in through your brand and advertising. The Internet is an example of this dynamic. The Internet isn't about outbound marketing due to the privacy laws. Instead, it's about having people come to you." McDonald elaborated on Capital One's brand positioning: "Our brand research showed that consumers wanted great value without the hassle and so everything we did trued north to what consumers wanted."[21] He and his team developed advertising strategies and measured brand recognition, in addition to developing the slogan: "What's in your wallet?" The brand organization achieved significant successes, but its greatest challenge was cultural, according to McDonald: "We essentially created two marketing departments. We had the M&A quantitative gurus and the traditional brand marketers. We're slowly evolving to act as one marketing team."

McDonald's brand crusade went beyond developing a powerful identity for Capital One. Fairbank and McDonald both knew that the brand promise could never truly be successful unless the company was prepared to deliver on that promise with its customers. Fairbank noted: "McDonald is a great advertising executive and the ads are the most visible part of what he does. But, equally important are the efforts he and our business line executives embarked on to ensure that our products and services lived up to the brand promise and actually delivered great value without the hassle. Without the internal commitment to deliver on that promise, our advertising ultimately rings hollow."

## REFLECTIONS

By 2000, Capital One had accomplished a lot and appeared well-positioned for the future. It had gone from a small company to a leading credit card issuer in the United States. In many ways, Capital One was responsible for breaking price barriers and "democratizing credit" by providing credit to customers who found it impossible to borrow money under the old, monolithic regime.

[21] Interview with Bill Mcdonald. Subsequent quotes are from this interview unless otherwise noted.

The company was enjoying strong growth and delivering record profits. The diversification efforts were gaining traction in new business lines and geographies. Efforts to build a brand were starting to take hold and become a part of the culture. The company continued to attract and retain great people and they were delivering results.

Despite all of the success they had enjoyed, Fairbank was determined not to get stuck in their own conventional wisdom. In the spirit of being a learning company, he was compelled to examine the past to assess what they had done right and, perhaps more importantly, what they could have improved on along the way. He was also determined to make sure that Capital One was always working backwards from an end game, rather than incrementally moving ahead from where it was today. He wanted to make sure that Capital One had a compelling vision for the future and that he and his management team were making the right decisions today to stay several moves ahead in the chess game and win in their businesses.

IBS had been successful, but not without its limitations. As his senior management team joined the meeting to assess the company's strategy, Fairbank asked himself: "Was traditional IBS enough to propel Capital One to his destination or did the company need to adapt its strategy to continue on its trajectory?"

**Case Discussion Questions:**

1. Identify the different phases in Capital One’s history and identify the strategy in each of these phases.

2. Identify the company’s key functional strategies and how they support/fail to support the company’s overall strategy and objectives.

3. Write a one-sentence statement that summarizes Capital One’s initial strategy. (Refer to SS&P Chapter 2 in doing this).

4. Evaluate Capital One’s strategy at different phases within its history.

5. Was the company’s strategy well-suited to the competitive environment that it faced? Why or why not?

6. What strategic issues faced Capital One at key phases within its history?

7. What should Capital One’s future concerns be and how might the company overcome some of those challenges?

**Exhibit 1**
**Top 30 Banks in Credit Card Operations, December 1998**
**Credit Card Loans (thousands)**

| Rank | Institution | Credit Card Loans | Total Loans |
|---|---|---|---|
| 1 | Citibank South Dakota, Sioux Falls | 12,107,130 | 12,805,721 |
| 2 | Chase Manhattan Bank, Wilmington DE | 6,732,513 | 6,766,014 |
| 3 | Greenwood Trust Co, DE | 5,908,337 | 5,922,133 |
| 4 | Citibank Nevada, Las Vegas | 5,765,860 | 5,791,185 |
| 5 | Bank of America, SF | 4,844,000 | 59,444,000 |
| 6 | American Express Centurion Bank, DE | 3,818,234 | 4,491,234 |
| 7 | FCC National Bank, DE | 2,997,421 | 2,983,863 |
| 8 | Wells Fargo Bank, SF | 2,720,496 | 35,780,803 |
| 9 | Bank of New York, DE | 2,686,463 | 3,241,419 |
| 10 | Manufacturers Hanover Trust, NY | 2,117,000 | 37,736,600 |
| 11 | Citibank, New York | 1,668,000 | 99,756,001 |
| 12 | First Deposit National Bank, NH | 1,468,469 | 1,490,822 |
| 13 | Maryland Bank, DE | 1,428,573 | 1,471,639 |
| 14 | Citibank, MD | 1,303,955 | 1,388,121 |
| 15 | Lomes Bank, DE | 1,240,063 | 1,272,005 |
| 16 | Security Pacific National Bank, LA | 1,218,816 | 32,863,318 |
| **17** | **Signet Bank, DE** | **1,203,328** | **4,287,535** |
| 18 | CoreStates Bank of Delaware, DE | 1,179,685 | 1,179,685 |
| 19 | First National Bank, WA | 1,150,980 | 8,823,123 |
| 20 | Household Bank, CA | 1,068,858 | 1,068,858 |
| 21 | Michigan National Bank, MI | 1,024,599 | 6,294,279 |
| 22 | First Interstate Bank of California, LA | 966,152 | 13,472,076 |
| 23 | First National Bank, GA | 875,543 | 5,034,592 |
| 24 | Chemical Bank, NY | 842,351 | 8,876,038 |
| 25 | Chemical Bank, NY | 823,000 | 26,736,000 |
| 26 | BancOhio National Bank, OH | 747,832 | 3,730,411 |
| 27 | Marine Midland Bank, DE | 735,618 | 2,031,680 |
| 28 | Mellon Bank, DE | 705,438 | 1,055,633 |
| 29 | Sovran Bank, VA | 699,110 | 8,473,140 |
| 30 | Marine Midland Bank, NY | 670,629 | 18,142,542 |

Source: American Banker Association Yearbook, 1987-1990.

**Exhibit 1 (cont'd)**
**Top 30 Banks in Credit Card Operations, December 1998**
**Gross Credit Card Interest Revenue (thousands)**

| Rank | Institution | Credit Card Loans |
|---|---|---|
| 1 | Citibank South Dakota, Sioux Falls | 1,904,858 |
| 2 | Chase Manhattan Bank, Wilmington DE | 966,891 |
| 3 | Bank of America, SF | 787,000 |
| 4 | Citibank Nevada, Las Vegas | 785,986 |
| 5 | Greenwood Trust Co, DE | 775,034 |
| 6 | Security Pacific National Bank, LA | 485,921 |
| 7 | American Express Centurion Bank, DE | 430,448 |
| 8 | Wells Fargo Bank, SF | 414,577 |
| 9 | FCC National Bank, DE | 411,769 |
| 10 | Manufacturers Hanover Trust, NY | 391,000 |
| 11 | Bank of New York, DE | 318,240 |
| 12 | Citibank, New York | 298,000 |
| 13 | First Deposit National Bank, NH | 239,812 |
| 14 | Maryland Bank, DE | 233,698 |
| 15 | Chemical Bank, NY | 225,000 |
| 16 | Lomes Bank, DE | 192,248 |
| 17 | First National Bank, WA | 187,729 |
| 18 | Citibank, MD | 176,555 |
| 19 | Michigan National Bank, MI | 174,289 |
| **20** | **Signet Bank, DE** | **169,832** |
| 21 | First Interstate Bank of California, LA | 168,161 |
| 22 | Household Bank, CA | 166,986 |
| 23 | CoreStates Bank of Delaware, DE | 157,811 |
| 24 | First National Bank, GA | 148,970 |
| 25 | BancOhio National Bank, OH | 145,336 |
| 26 | Marine Midland Bank, DE | 136,734 |
| 27 | Marine Midland Bank, NY | 116,920 |
| 28 | Mellon Bank, DE | 101,417 |
| 29 | Chemical Bank, NY | 100,353 |
| 30 | Sovran Bank, VA | 95,738 |

Source: American Banker Association Yearbook, 1987-1990.

## Exhibit 1 (cont'd)
## Top 30 Banks in Credit Card Operations, December 1998
## Net Card Related Chargeoffs (thousands)

| Rank | Institution | Credit Card Loans |
|---|---|---|
| 1 | Citibank South Dakota, Sioux Falls | 537,097 |
| 2 | Chase Manhattan Bank, Wilmington DE | 202,803 |
| 3 | Greenwood Trust Co, DE | 147,184 |
| 4 | Manufacturers Hanover Trust, NY | 136,000 |
| 5 | Citibank Nevada, Las Vegas | 126,606 |
| 6 | American Express Centurion Bank, DE | 118,821 |
| 7 | Bank of America, SF | 95,000 |
| 8 | Wells Fargo Bank, SF | 83,496 |
| 9 | FCC National Bank, DE | 81,729 |
| 10 | Bank of New York, DE | 71,628 |
| 11 | BancOhio National Bank, OH | 60,848 |
| 12 | Household Bank, CA | 54,025 |
| 13 | Lomes Bank, DE | 48,256 |
| 14 | Citibank, MD | 44,696 |
| 15 | Michigan National Bank, MI | 39,416 |
| 16 | Chemical Bank, NY | 39,000 |
| 17 | Marine Midland Bank, DE | 37,382 |
| **18** | **Signet Bank, DE** | **33,272** |
| 19 | Security Pacific National Bank, LA | 31,574 |
| 20 | Maryland Bank, DE | 30,476 |
| 21 | First Deposit National Bank, NH | 28,963 |
| 22 | First Interstate Bank of California, LA | 27,455 |
| 23 | First National Bank, WA | 24,347 |
| 24 | First National Bank, GA | 23,682 |
| 25 | CoreStates Bank of Delaware, DE | 23,272 |
| 26 | Mellon Bank, DE | 18,145 |
| 27 | Chemical Bank, NY | 17,131 |
| 28 | Citibank, New York | 16,000 |
| 29 | Sovran Bank, VA | 13,602 |
| 30 | Marine Midland Bank, NY | 7,351 |

Source: American Banker Association Yearbook, 1987-1990.

# Exhibit 2
# Capital One Financials
# (thousands)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|
| **Income Statement** | | | | | | |
| Revenues | $ 1,010,452 | $ 1,423,907 | $ 1,787,115 | $ 2,599,819 | $ 3,965,843 | $ 5,118,231 |
| Interest expense | 249,396 | 294,999 | 341,849 | 424,284 | 540,882 | 709,292 |
| Non-interest expense | 497,430 | 713,182 | 876,976 | 1,464,586 | 2,464,996 | 3,208,311 |
| Provision for credit losses | 65,895 | 167,246 | 262,837 | 267,028 | 382,948 | 440,628 |
| **Income before taxes** | 197,731 | 248,480 | 305,453 | 443,921 | 577,017 | 760,000 |
| Income taxes | 71,220 | 93,231 | 116,072 | 168,690 | 213,926 | 288,801 |
| **Net Income** | **$ 126,511** | **$ 155,267** | **$ 189,381** | **$ 275,231** | **$ 363,091** | **$ 471,200** |
| | | | | | | |
| **Balance Sheet** | | | | | | |
| Assets | | | | | | |
| Cash and equivalents | $ 407,460 | $ 78,976 | $ 64,223 | $ 38,367 | $ 333,261 | $ 564,302 |
| Fed funds sold | 465,000 | 450,000 | 173,500 | 261,800 | -- | -- |
| Investment securities | 413,016 | 865,001 | 1,242,670 | 1,796,787 | 1,856,421 | 1,949,242 |
| Loans held for sale | 400,000 | -- | -- | -- | -- | -- |
| Loans receivable less credit loss allowance | 2,449,679 | 4,225,402 | 4,678,687 | 5,926,111 | 9,571,549 | 10,080,078 |
| **Total Current Assets** | 4,135,155 | 5,619,379 | 6,159,080 | 8,023,065 | 11,761,231 | 12,593,622 |
| Property and equipment | 139,074 | 174,661 | 162,726 | 242,147 | 470,732 | 494,269 |
| Deferred tax asset due from securitization | 359,379 | 502,520 | 855,781 | 833,143 | 661,922 | 675,160 |
| Interest receivable | 55,573 | 78,590 | 51,883 | 52,917 | 64,637 | 72,717 |
| Other | 70,140 | 92,295 | 115,809 | 268,131 | 464,685 | 487,919 |
| **Total Assets** | **$ 4,759,321** | **$ 6,467,445** | **$ 7,078,279** | **$ 9,419,403** | **$ 13,423,207** | **$ 14,323,687** |
| | | | | | | |
| **Liabilities and Equity** | | | | | | |
| Current Liabilities | | | | | | |
| Deposits | $ 696,037 | $ 943,022 | $ 1,313,654 | $ 1,999,979 | $ 3,783,809 | $ 4,067,595 |
| Fed Funds purchased | 709,803 | -- | -- | -- | -- | -- |
| Bank facility | 100,000 | -- | -- | -- | -- | -- |
| Notes | 2,491,869 | 3,694,237 | 362,774 | 3,739,393 | 4,180,548 | 4,598,603 |
| Affiliate and Other Borrowings | | 830,979 | 796,112 | 1,644,279 | 2,780,466 | 2,989,001 |
| Interest payable | 73,931 | 80,362 | 68,448 | 91,637 | 116,405 | 125,135 |
| Other | 88,490 | 178,454 | 276,368 | 575,788 | 959,608 | 816,894 |
| **Total Liabilities** | 4,160,130 | 5,727,054 | 6,087,356 | 8,051,076 | 11,820,836 | 11,780,334 |
| Shareholder's Equity | 599,191 | 740,391 | 893,259 | 1,270,406 | 1,515,607 | 1,368,000 |
| **Total Equity** | 599,191 | 740,391 | 990,923 | 1,368,327 | 1,515,607 | 1,638,000 |
| **Total Liabilities and Equity** | **$ 4,759,321** | **$ 6,467,445** | **$ 7,078,279** | **$ 9,419,403** | **$ 13,336,443** | **$ 14,323,687** |

Source: Capital One.

**Exhibit 3**
**How Credit Cards Work**

Multiple parties were involved in every credit card transaction (Visa is used as an example here): 1) cardholder, 2) issuer: a financial institution such as Capital One that issued Visa cards and maintained a contract with cardholders for repayment, 3) merchant: an authorized acceptor of Visa cards for the payment of goods and services, 4) merchant bank: a financial institution that helped the merchant fulfill Visa card payments from customers, 5) Visa, whose members issued Visa cards and/or signed merchants to accept Visa, and 6) VisaNet: a network that acted as an authorization and clearing and settlement service to transfer payment information between parties which was run by Inovant, Visa's IT and processing subsidiary.[22]

Processing a Visa card transaction was a two-stage process. The first stage was called Authorization, where an electronic request was sent through various parties to either approve or decline the transaction. The next stages were Clearing and Settlement, where all parties settled their accounts and were paid. The Authorization stage included eight steps: 1) cardholder presents Visa card to pay for services, 2) merchant swipes Visa card, enters the dollar amount, and transmits an authorization request to the merchant bank, 3) merchant bank automatically sends the authorization request to VisaNet, 4) VisaNet routes the request to the cardholder's issuer, 5) issuer such as Capital One approves or declines the transaction, 6) VisaNet forwards Capital One's response to the merchant bank, 7) merchant bank forwards the response to the merchant, and 8) merchant receives the authorization response and completes the transaction accordingly.

The Clearing and Settlement stages followed with five additional steps: 9) merchant deposits the transaction receipt with the merchant bank, 10) merchant bank credits the merchant account and electronically submits the transaction to VisaNet for settlement, 11) VisaNet pays the merchant bank and debits the issuer account, then sends the transaction to the issuer, 12) issuer such as Capital One posts the transaction to the cardholder account and sends the cardholder a monthly statement, and 13) cardholder receives the statement and pays issuer usually on a monthly basis.[23] Cardholders did not have to pay the entire balance, but a minimum payment. Typically issuers charged cardholders an APR (annual percentage rate) on any outstanding balances plus late fees if cardholders failed to pay their minimum balances by the due date. Interest income constituted the majority of revenue for issuers such as Capital One.

The merchant received only about 98 percent of the purchase amount. The remaining two percent was called the "merchant discount," which was a fee paid to the merchant bank that handled transactions for the merchant. These banks then paid about 1.4 percent of the purchase amount to the credit card issuer, Capital One. That 1.4 percent was called the "interchange fee" and was set by Visa and MasterCard. Visa and MasterCard also charged its own interchange fee to merchant processors of 0.4 percent, which represented revenue for these associations. Merchant processors such as VisaNet charged a final interchange fee of 0.1 percent to merchants. Neither American Express nor Discover set interchange fees since they were both the issuer and the bank that handled transactions for the merchant.

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[22] Visa USA Website: http://usa.visa.com/business/merchants/guide_to_transaction_who.html.
[23] Visa USA Website: http://usa.visa.com/business/merchants/guide_to_transaction_how.html.

## Exhibit 4
## Basic Industry Background

### INDUSTRY EVOLUTION

### Rise of the "Monoline" Card Issuers

Monoline card issuers revolutionized the credit card industry. They were credit card issuers such as Capital One who engaged primarily in issuing credit cards. Some monoline banks such as MBNA were, however, were chartered as credit card banks, but they were still classified as monoline banks since credit cards were its primary businesses. Many of the monoline card issuers were spun out in the early to mid-1990s from larger banks. Prior to their arrival, consumers mostly received credit cards from their banks after going through a long application process. Consumers also received uniform and less favorable interest rates. The monoline card issuers disrupted the consumers' relationships with their banks, offered better terms, and marketed to consumers with a pre-approved application.

### Market Consolidation

Through their innovative strategies, monoline issuers captured market share and drove other smaller and less efficient players out of the market. Suffering from commercial real estate loan losses in the late 1980s, many large banks lost focus or withdrew from the credit card market. In fact, by the end of 2000, the top ten card issuers represented more than 80 percent of the total credit card market, compared to roughly a 60 percent share in 1994. Industry analysts believed that consolidation would continue, but would be from larger companies taking market share through internal growth rather than through acquisition due to the lack of smaller companies that would add to the portfolios of the larger companies.

### Slowing Growth

The credit card industry was estimated to have $492 million of total receivables outstanding at the end of 1999. The Federal Reserve estimated total consumer credit outstanding at June 30, 2000 of $1.5 trillion (43 percent revolving). Throughout the 1990s, credit card debt grew at 12 percent compound annual growth rate (CAGR) and total consumer debt grew at an 8-9 percent CAGR. The industry-wide growth rate had slowed down by the end of the 1990s. Growth in merchant credit card acceptance, higher credit lines, lower minimum monthly payments, and value-added services such as rewards programs and frequent flyer miles were the primary drivers of consumer debt.

However, industry analysts expected future growth to be more challenging. Analysts believed that the fact that the "easy" growth (easy acquisition of new cardholders and a decade of economic growth) had already happened, coupled with increasing risks such as credit quality and bankruptcy filings, would make credit card industry growth and risk management even more challenging. Credit costs had begun to dampen profitability and specifically, bankruptcies grew, leading to higher charge-offs and greater loss provisioning. Credit problems were driven by the decline of financial wealth due to the stock market correction, an increase in debt per person

(debt per person has steadily grown over the past 15 years and equaled slightly more than $49,000 per civilian employed at the end of the 1Q 2001), an increase in consumer debt as a percent of disposable income (in 1Q 2001, consumer debt as a percent of disposable income exceeded 100 percent), and an increasingly larger percentage of disposable personal income being eaten away by larger mortgages. The growing household debt levels would remain manageable only if consumers were able to keep their jobs. However, if unemployment continued to rise, bankruptcy filings would continue. Some blamed high bankruptcies on the increasing ease in which consumers could file for bankruptcies. Others blamed the credit card companies for making too much credit available to consumers with little credit history.

## MARKET SEGMENTS

The credit card market was segmented into super-prime, prime, sub-prime, and secured. Market segments were defined by FICO scores. FICO was a credit-scoring model that was used to predict potential consumer debt faults. The U.S. economy has become increasingly bifurcated, expanding the upper and lower income classes at the expense of the middle class. This bifurcation has led to the division of the credit card market into two segments—the high-income convenience users who paid off their balances each month or the “transactors” and the low-income “revolvers” who carried a balance each month and paid interest for those balances.

### Super-Prime and Prime

The super-prime and prime markets were the most mature segments of the market having the slowest growth and lowest expected profitability. Borrowers in this segment tended to use credit cards for convenience and tended not to carry revolving balances. This characteristic minimized the spread income potential that credit card companies could collect. Competition has virtually eliminated fees for this market segment, except for airline miles-based credit cards, which still charged annual fees.

### Sub-Prime Market

The sub-prime market had the greatest growth and profitability potential through higher fees, but it also carried the greatest risk for credit card issuers. Traditionally credit card issuers avoided the sub-prime market due to the high risk involved. SMR Research estimated that this market would triple in size in the next 3-5 years. Analysts also believed that few new competitors would enter the market due to the high charge-off rates (the creditor does not expect to collect the balance owed) typically associated with the segment.

### Secured

The secured segment is one step below the sub-prime market. This type of credit card was more of a debit card than a true credit card. The secured credit card required borrowers to deposit cash with the credit card issuer, who then issued the credit card company a card that allowed the borrower to use the card up to the deposited amount of cash.

### Small Business Market

Since the small business market was expected to grow rapidly, many credit card issuers seized the opportunity to service this market. American Express dominated this market, but other issuers such as MBNA developed affinity relationships with doctors, dentists, and attorneys. Industry analysts believed that even though the small business segment was an attractive one, it did not match the opportunity in the sub-prime segment both in terms of size and profits since small businesses would most likely be convenience users unwilling to pay high interest rates.

## KEY PLAYERS

### Single-Issuer Networks

Single-issuer networks accounted for approximately 27 percent of the dollar value of transactions on credit and charge cards in the U.S. in 1997. American Express was the largest issuer of credit cards in the U.S. based on dollar volume and its charge cards accounted for approximately 87 percent of its transaction volume. Novus (which issued Discover and Novus cards) issued only credit cards and was the fourth-largest issuer based on charge volume. Diners Club, operated by Citibank, was the third single-issuer network, but its transaction volume made up only 1 percent of total credit and charge card volume in 1997.

### Depository Institutions

Depository institutions included banks or credit unions that offered checking account services and other related services. They accounted for the largest portion of payment card charge volume at 45 percent of the top 50 issuers in 1997. Top players included Citibank, Chase Manhattan, First Chicago NBD, and U.S. Bankcorp. Most cardholders who used credit cards from depository institutions did not have banking relationships with the institutions.

### Monoline Banks

Monoline providers operated banks that typically took limited deposits, but whose primary business was issuing credit cards. Examples included Capital One, MBNA, First USA, and Advanta. MBNA bought lists of customers from affinity groups whom they deemed had a certain level of group creditworthiness.

### Nonbanks

Nonbanks included companies such as Household Bank, which issued the General Motors card. Another nonbank included AT&T Universal. Both GM and AT&T credit cards were closely managed by nonfinancial corporations. Nonbank credit card issuers accounted for 12 percent of the charge volume among the top 50 issuers in 1997.

## COMPETITION

In general, Capital One's competitors in the 1990s were not as good at the micro-segmentation of customers as Capital One, according to Reidy. "Our competitors had uniform blocks of customers, while our business model was to offer unique product structures to small groups of customers. Given the credit card market expanded dramatically in the 1990s, we were able to grab lots of little customer segments." Overholser said: "In the very early days, the competition didn't even know what was hitting them. We were small and direct marketing is very stealthy by nature. In the next phase, when the competition did wake up they found that they didn't have the skill set that it would require to strike back. They didn't have the computer systems, problem-solving, highly analytical work force, or culture of innovation. The third phase is that, in the credit card industry, the competitors were beginning to pick up some of the fact-based innovation approach at just about the same time that we were finding explosive growth in other industries that have not begun that process, such as the auto-finance industry." Although the credit card business was maturing, the auto finance business was much like the credit card business was in the 1990s where there was little segmentation in terms of pricing.

According to Catherine West, President of U.S. Card, who worked at FirstUSA prior to joining Capital One: "Until about 1996, none of our competitors fully appreciated the power of Capital One as of a competitor. We were under the radar screen. When we came into focus, CitiBank, Chase, BancOne and MBNA were all farther down the path in terms of size and culture. It's much harder to turn a big ship than a small craft. They found themselves, as I did while at FirstUSA, distracted with the growth of the business through either acquisitions or trying to compete on volume and cost-cutting. At that time, MBNA pursued the affinity play, FirstUSA went with some partnerships, but mostly aggressive growth with the low APRs, crunching their margins, and CitiBank pursued a massive low-cost strategy. Capital One came in with IBS, smart people, technology, and more flexibility." West acknowledged that competitors were using NPV as a decision-making tool, but explained why Capital One was successful: "Other competitors were sophisticated to a degree too. At FirstUSA, there were very brilliant credit people and strong marketing people who used NPV calculations to determine their direct-mail strategies, very similar to what we do at Capital One. The difference is that at Capital One, customer value, shareholder value, and NPV analysis is pervasive at all levels of the organization. Rich Fairbank is definitely a driver of that pervasiveness."

## REVENUE AND PROFITABILITY DRIVERS

Historically, credit card companies relied primarily on net interest income and interchange fees for revenue. However, over the past several years, credit card issuers have sought fee-based income such as late and overlimit fees and the sale of ancillary products such as credit insurance. Non-interest managed revenue contribution to total revenue increased from approximately 35 percent in 1998 to over 40 percent in 2001.

Credit card companies must set aside funds in case customers don't repay their loans—these funds are called reserves for loan losses. Provisions appeared on a company's income statement, where it represented a charge taken against earnings to cover potential loan defaults. The provision was added to the reserve for loan losses, which appeared on the balance sheet as a

contra-account to loans. If loans were deemed uncollectible, they were charged off and removed from the balance sheet, as well as subtracted from the reserve for loan losses. Industry analysts used the "risk-adjusted margin" (which incorporated net charge-off activity) in evaluating both revenue and profitability. The risk-adjusted margin decreased slightly in 2000 and 2001, but the composite average margin still remained well above historical levels.

Credit card companies also utilized a variety of financing tools in order to fund growth, such as securitization. In a securitization transaction, a lender typically pooled various finance receivables, structured them as asset-backed securities, and sold them in the public securities market (similar to a traditional bond with interest payments made monthly and principal paid in a single payment at maturity). This financing mechanism served as an important source for liquidity for credit card companies and helped them to manage exposures to a single borrower, industry, or product type. Funds from securitizations sold in the public market were usually invested in money markets until they were needed to fund loan growth. Banks and credit unions funded their loans through consumer deposits within local branches.

**Exhibit 5**
**Balance Sheet for Selected Credit Card Companies, 1998**
**(millions)**

| **As of December 31, 1998** | **Capital One** | **MBNA** | **Providian** | **American Express** |
|---|---|---|---|---|
| Managed loans | $ 17,395 | $ 59,641 | $ 13,245 | $ 18,200 |
| Less securitized loans | (11,238) | (46,173) | (7,504) | (3,000) |
| Owned loans | 6,157 | 13,468 | 5,741 | 15,200 |
| Loss reserve | (231) | (217) | (451) | (619) |
| Loans, net | 5,926 | 13,251 | 5,282 | 14,581 |
| Charge card receivables, net | -- | -- | -- | 19,176 |
| Cash and investments | 2,097 | 5,441 | 908 | 4,366 |
| Gain-on-sale asset, credit card only | 165 | 497 | 69 | n/a |
| Goodwill | 67 | 671 | 5 | n/a |
| Deferred tax assets | 101 | 54 | 306 | n/a |
| Other assets | 1,063 | 5,892 | 662 | 25,735 |
| Total assets | 9,419 | 25,806 | 7,231 | 44,682 |
| Deposits | 2,000 | 15,407 | 4,672 | 2,037 |
| Other debt | 5,384 | 7,170 | 872 | 28,023 |
| Deferred card fees | 156 | n/a | 335 | 770 |
| Deferred tax liability | -- | -- | -- | n/a |
| Preferred stock/capital securities | 98 | 86 | 160 | -- |
| Other liabilities | 512 | 752 | 389 | 8,936 |
| Total liabilities | 8,147 | 23,415 | 6,428 | 39,766 |
| Equity | 1,270 | 2,391 | 803 | 4,916 |

Source: Credit Card Industry Picture Book, Paine Webber, May 1999, p. 60.