Alpen Bank:
Launching the Credit Card in Romania

Introduction

In September 2006, Gregory Carle sat pensively at his desk at Alpen Bank's corporate headquarters in Zurich. The previous evening he and the senior management team had enjoyed themselves dining late above the picturesque Limmat Valley, but now it was time to focus his attention on the task at hand. As Alpen's country manager for Romania, Carle was contemplating a credit card launch in the Romania market, which he would pursue if he could be confident that it would add €5 million of annual profit to the Consumer Bank segment within two years (see **Exhibit 1** for a summary of the financial performance of the Consumer Bank segment of Alpen Bank in Romania).

Carle had been with Alpen since 1992, when he joined the bank's global marketing group. His appointment in 2000 to country manager for Romania coincided with the bank's opening its first branch in the capital city of Bucharest. Since then, Carle had overseen the opening of 14 additional branches in Romania, with Alpen Bank developing a reputation for excellence in serving affluent clientele. In addition to basic deposit, checking, and personal loan services, customers had access to a wealth management program composed of financial planning and investment products.

The idea of a credit card for Romanian consumers was not new. Historically, Alpen management had balked at launching a card business due to low per-capita income levels, a poorly developed infrastructure of point-of-sale terminals, and the population's inexperience with consumer credit. The country's imminent entry into the European Union had led to a reassessment of this decision. However, Richard Tschumperlin, head of the bank's International Consumer Businesses and Carle's boss, remained skeptical that it was time for Alpen to introduce a card business:

> I'm not sure there is enough of a market there. Are there enough households with enough money? How much would it cost us to build a customer base? We have been very successful

building a profitable banking business for the wealthy—over 200,000 customers in a country with just 7.7 million households, which is great penetration. I worry that pursuing this credit card idea would be a risky distraction.

Unlike Tschumperlin, Carle believed a credit card business would be an important growth vehicle, but he was aware of the skepticism within the Zurich headquarters. Certainly, he had to consider the financial and reputational costs of any missteps. He would need convincing analysis to win support from the Zurich team. If he recommended a "go" for the decision, he had to articulate a compelling business strategy with clear product positioning and a strong economic case.

Credit Card Industry Background

The credit card industry comprises four key parties that work together to provide card transaction services: networks or card associations, merchant acquirers, merchants, and card issuers:

> ***Networks/card associations*** are the backbone of the payment system and enable transactions to be cleared by connecting merchants, merchant acquirers, and card issuers. Visa and MasterCard are the two most extensive networks and set the operating rules by which all parties in the system abide.
>
> ***Merchant acquirers*** are the distribution and sales arm of the payments industry and are frequently affiliated with banks. They sign up ***merchants*** for card acceptance and provide the support that merchants require to process card transactions: point-of-sale terminals, data transmission, payment authorization, and payment settlement.
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> ***Merchants*** are the restaurants, retailers, gas stations, etc., that accept cards.
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> ***Card issuers*** are typically banks, and they own the relationship with the cardholders themselves. Issuers authorize payments and bill cardholders. As members of the Visa/MasterCard associations, banks must abide by card-logo design standards, but it is left to their discretion to decide on branding, positioning, pricing, and loyalty programs.

Revenue in the card payments industry is determined by transaction volume. A percentage of every transaction, called the "merchant discount," is taken and split among the merchant acquirer, network association, and card issuer. Hence merchant acquirers seek to sign up attractive merchants with frequent transactions and high "per-ticket" spending, while Visa and MasterCard encourage customers to use their cards for every purchase.[1] Similarly, card issuers benefit from the amount spent by the cardholder, receiving a portion of the merchant discount known as "interchange." Merchants, on the other hand, tend to prefer cash except when card acceptance will encourage their customers to spend more (see **Exhibit 2** for a representation of a typical transaction cycle).

In addition to interchange revenue, card issuers—the role under consideration by Alpen Bank—also generate revenue by charging annual fees, penalty fees, and interest income. Interest income is charged to cardholders who do not pay off their full balance each month, but instead use their credit cards for "revolving" financing. Card issuers profit from having such "revolver" customers and may attract customers by offering temporary low-interest financing. However, the potential profit of "revolvers" must be managed against the risk of default, which can be significant and costly, particularly during economic downturns.[2]

Romanian Credit Card Market

In the early 2000s, the executive team in Zurich felt that Romania lacked credit-card growth potential relative to other emerging markets. Consumer spending was largely cash-based, and merchant acceptance of card payments was low. Furthermore, the Romanian consumer lacked experience in managing credit. This made it difficult to determine credit limits and set interest rates that would attract customers, yet fully protect Alpen Bank from default risk. Carle described the conditions the bank faced:

> In 2000, Romania was just emerging from a very tough three-year recession. Average per-capita income was just 3,500 RON [approximately €1,700]. It was true that the middle class was growing, but it was very small, and less than half of the population was urban. We discussed it with the Zurich team, but decided our efforts were better spent developing the branch banking business and building an upscale customer base than in building a credit card business.

However, the macroeconomic trends during the first half of the decade were encouraging. Rapid economic growth and rising incomes, particularly among the emerging middle- and upper-middle class, had dramatically increased total disposable income. An independent consumer behavior study indicated that over one-third of Romanian households were likely to purchase branded imports from the EU rather than lower-priced domestic products, and in Bucharest there was growing interest in luxury goods.

Consumers were also increasingly likely to use cards instead of cash. In 2006, total financial cards, including both debit and credit cards, grew by 35% over the prior year, and there were an estimated 9.5 million cards in circulation in Romania. In addition, the infrastructure required for a payments system was rapidly developing, and by 2006 Romania had approximately 8,000 ATMs and 150,000 point-of-sale terminals for card transactions. Even with such growth, the market remained underpenetrated relative to other central and eastern European countries (see **Exhibit 3** for cards-per-household data).

The vast majority of cards in circulation were debit cards, and many cardholders used their cards exclusively for cash withdrawals, rather than the purchases needed to drive up revenue for card issuers. However, Carle and his team believed the Romanian market was poised for further growth in financial cards overall, and in credit cards specifically. Indeed, competing Romanian banks had been marketing credit cards for several years already. Actual usage rates of the cards remained quite low, since many merchants still required cash only, but it was evident that other banks were bullish on the prospects of a Romanian credit card business (see **Exhibit 4** for data on card issuances from competing banks).

Credit Card Positioning and Economics

In addition to determining whether to enter the credit card market at all, Carle had to make a recommendation on the positioning of Alpen Bank's credit card. Clearly, only a subset of the 18.6

million adults in Romania would actually want and qualify for a credit card. Alpen Bank's existing customer base was affluent and was likely an easier segment to target, but Carle was unsure whether a credit card business could be viable without marketing to the broader middle class (see **Exhibit 5** for income distribution data). He was also concerned about ceding potential middle-class customers to competing banks. The other leading banks in Romania had tiered offerings, with both standard and premium cards. Carle commented:

> Today's middle class may become the affluent customers of tomorrow. We have seen in other emerging markets that credit cards tend to be "stickier" than in developed countries—consumers are less likely to switch from one credit card to another. Do we need to build a credit card business that targets the middle class and is easier to quality for? Does that fit with Alpen Bank's premium image?

Income inequality was increasing in Romania, and the top 10% of households by income had nearly 24% of the wealth. These potential customers had net incomes of at least €500 per month and were typically active, career-oriented professionals who were increasingly conscious of their image and sought goods and services that matched their status. These customers were the most attractive for credit card issuers. They were less price-sensitive about annual fees and more likely to be experienced with low levels of consumer debt. They were also likely to use their cards with greater frequency and for higher-average tickets, and premium cards carried by the affluent could command higher interchange rates.[3]

Middle-class households that were potential credit card customers earned over €200 monthly. They were a mix of young professionals and families that valued quality, but were more willing to compromise and make price-driven decisions. While many were interested in having credit cards, Alpen Bank's experience in other emerging markets showed that actual card utilization was significantly lower for middle-class customers than for the affluent. Carle suspected that the relatively low utilization rate of credit cards in circulation in Romania was due to middle-class customers. Serving them could mean lower interest income and interchange for the banks.

Credit card revenue would be derived from several streams: joining/annual fees, penalty fees for late payments, interest payments, and interchange. Several country managers in the Asia-Pacific region had chosen to waive the joining fee entirely when launching their credit card business, but Carle believe that the premium image of Alpen Bank in Romania would allow for joining and annual fees without significantly hurting customer acquisition and retention. In fact, he felt that a product targeting the affluent segments could have an above-average annual fee without hurting uptake. Using Alpen Bank's experience in Poland, Bulgaria, and the Czech Republic as a guide, Carle's team modeled the net revenue impact of the potential credit card business (see **Table A** for estimated revenue by cardholder).

Table A Net Revenue Impact Estimates, 2007

	Revenue per Cardholder			
Segment	**Annual Income (€)**	**Interest Revenue (€)**	**Other Revenue (€)**	**Annual Revenue (€)**
Middle Class	3,000-4,500	37.13	23.50	60.63
Affluent	4,500-6,000	86.63	36.75	123.38
Most Affluent	6,000+	148.50	61.25	209.75

Note: "Other revenue" includes fees and interchange.

Market Entry Costs

The costs for Alpen Bank to enter the market included investments in direct marketing, advertising, and support infrastructure. Carle knew that building a customer base would require a direct marketing plan with a multi-prong effort, each with its advantages and drawbacks:

> ***Direct mail*** could target credit card applications to the intended audience, resulting in a higher yield, but it tended to be more expensive than other methods.
>
> ***"Take-ones"*** were brochures offered via countertop displays at various retailers and offered a very broad reach. However, because this was made available to the general public, many applicants would not qualify for bank credit.
>
> ***Free-standing inserts (FSIs)*** were newspaper and magazine inserts or bind-ins that were inexpensive to circulate, but tended to have a very low response rate.
>
> ***Direct sales*** efforts through telemarketing enabled Alpen Bank to target both existing customers and high-potential new customers, but required considerable investment in each salesperson. Carle estimated he needed a team of 10 sales representatives, each making 25 calls per day.
>
> ***Branch cross-selling*** was a targeted sale to existing customers who entered a bank branch. This leveraged Alpen Bank's fixed costs and because it was a more personal sale, Carle expected the response rate to be much higher.

Carle hired a market research agency to estimate the rate at which prospects would respond to, and qualify for, a credit card given the marketing channel through which they were reached (see **Table B** for customer acquisition estimates).

Table B Customer Acquisition Estimates, Year 1 (All Customers)

	Unit Cost (€)	**Prospects Reached**	**Response Rate**	**Qualification Rate**
Direct Mail	0.50	2,500,000	3.0%	60.0%
Take One	0.10	2,000,000	2.5%	30.0%
FSIs	0.05	3,500,000	1.5%	30.0%
Direct Sales	€3000/rep	60,000	25.0%	60.0%
Branch Cross-Sell	1.00	50,000	50.0%	90.0%

… only with a more premium card would reduce the available direct-because these marketing efforts could not be targeted specifically at the affluent. Unlike the other marketing tools, take-ones and FSIs could not be targeted specifically at the affluent, so the agency anticipated that the qualification rate would be reduced by half. Based on conversion rates in other central and eastern European markets, the agency estimated that 85% of prospects who qualified for the credit card would convert into customers. Alpen Bank's experience in other central and eastern European markets was that using several direct marketing channels was necessary to build a customer base. Carle wondered whether it made sense to be aggressive and use all five avenues, or whether there were meaningful savings in being more selective. Direct mail, in particular, appeared to be quite expensive.

To complement the direct marketing program, Alpen would also need to invest in advertising. A €2 million budget could support targeted magazine advertisements and 30-second television spots on the major channels during the holidays—Christmas, Great Union Day (celebrating the union of Transylvania with Romania), and National Anthem Day. The magazine and television advertising would not only generate interest among prospective card applicants, but also help convert prospects already in the sales pipeline.

Beyond the customer acquisition and advertising costs, Alpen Bank needed to invest in an in-country infrastructure support, and incremental fixed overhead costs were substantial. Costs associated with new staff, computer systems, customer support, and other overhead costs were estimated at €5 million annually to support the first 50,000 customers. For every additional 50,000 customers, Carle would need to spend €750,000 per year for overhead. The direct variable costs associated with each cardholder included billing, loyalty program administration, collections, fraud, and loan default and were estimated at €20 per customer. With every additional 50,000 customers, economies of scale would reduce the direct costs by €2.50 per card.

The Decision

Carle had one week to prepare his presentation to Richard Tschumperlin on whether Alpen should launch a new credit card in the Romanian market. It was clear that the heart of the presentation would rest on his analysis of the economic opportunity. In order to win approval, he would need to demonstrate that generating €5 million in profit within two years was a realistic objective. What level of customer acquisition would be required to break-even, and how quickly would the business generate profit beyond break-even? How should the new card be positioned, particularly given its current upscale customer base? How would the credit card opportunity compare to focusing on the core business of banking services for the affluent? A compelling business case would need to address these issues for Alpen Bank to proceed with confidence.

Exhibit 1 Alpen Bank Romanian Consumer Segment Performance (€ millions)

	2003	2004	2005
Net revenue	66.0	82.0	87.5
Fees/commissions/insurance	4.0	6.9	13.1
Customer net revenue	70.0	88.9	100.6
Net credit losses	9.8	11.5	14.4
Credit collection	3.3	3.9	4.9
Total credit cycle	13.2	15.5	19.3
Delivery expense	47.0	54.5	57.9
Other revenue/(expense)	(4.9)	(5.5)	(6.7)
Earnings before tax	4.9	13.4	16.7
Customer liabilities (€M)	2,343	2,745	3,000
Customer assets (€M)	1,640	1,922	2,400
Average total assets (€M)	1,875	2,232	2,573
Full-time equivalent employees	564	611	705
Number of accounts (000)	209	256	297
Number of customers (000)	157	179	201
Number of branches	12	13	15

Exhibit 2 Typical Credit Card Transaction Cycle

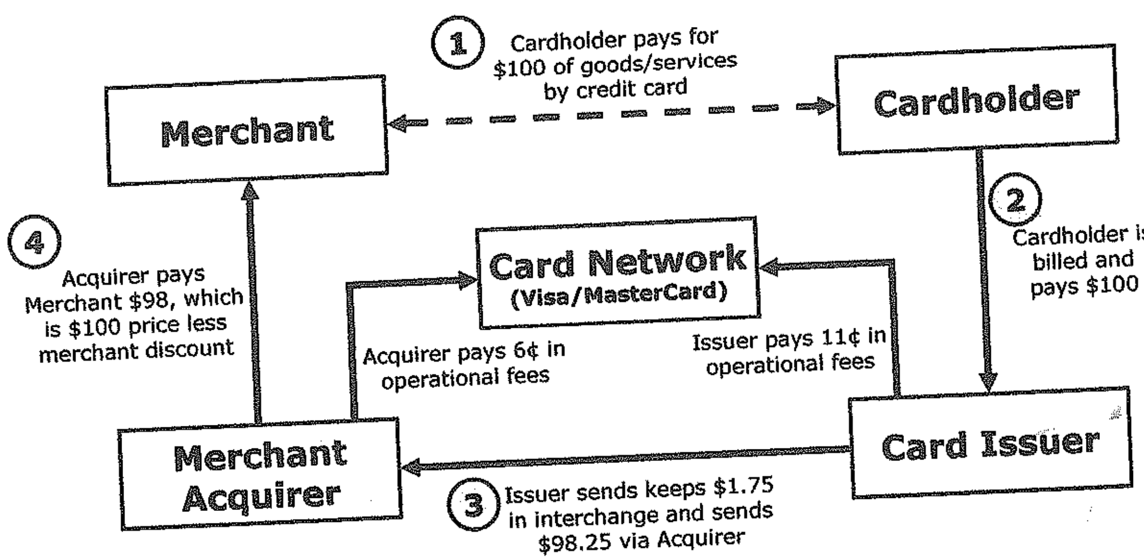

Exhibit 3 Cards per household in Central and Eastern Europe

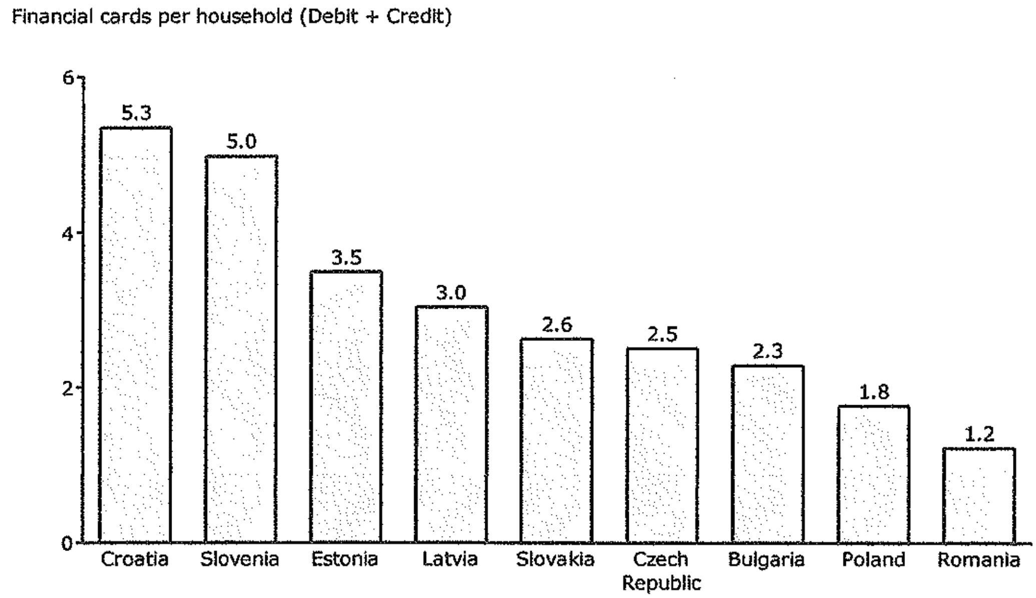

Exhibit 4 Credit Card Issuances, Romania (2006)

	Credit Cards	Credit Card Utilization
Romanian Commercial Bank (BCR)	180,000	10%
Raifeissen Bank	200,000	70%
Bancpost	29,000	6%
Romanian Bank for Development (BRD)	606,000	27%
Estimated total credit cards, Romania	1,710,000	20%

Exhibit 5 Distribution of Annual Income, Romania (2005)

Annual Income (€)	% of Population
<1,500	23.2%
1,500 - 2,000	11.9%
2,000 - 3,000	18.8%
3,000 - 4,500	18.2%
4,500 - 6,000	15.0%
6,000 - 7,000	6.6%
7,000 - 10,000	3.8%
10,000 - 15,000	1.2%
>15,000	1.3%