The digital transformation of merchant credit

Merchant credit – lending to consumers through retailers – is more important than ever for banks, retailers and their customers. After the financial crisis, banks pulled back on other forms of consumer lending, especially to mass-market and emerging middle-class customers. Now, both lenders and retailers are recognizing that having strong credit capabilities at the point of sale has tremendous value for both customers and the bottom line.

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Traditionally, retailers and their bank partners have been primary sources of credit for their customers because they have had to be; customers with imperfect or limited credit histories still need access to credit to buy the items they want. Without it, consumers often turn to lower-cost, lower-quality products that provide less value to both them and the retailer. To offset the credit risk posed by providing mass-market merchant credit, lenders have relied on higher interest rates, while retailers have mitigated their exposure with the income from increased sales.

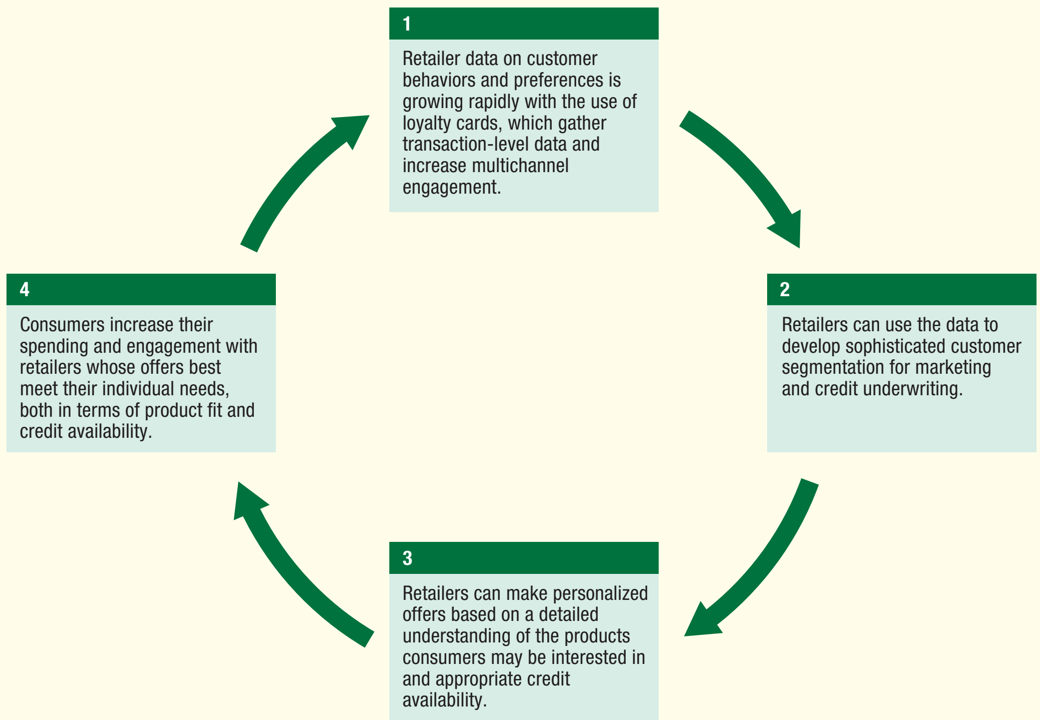
Today, however, merchant credit is undergoing a transformation driven by digital technology; the growing amount of data on customers' shopping habits and preferences; and by digital channels that foster engagement and enable the delivery of new credit offers for higher-priced items. In a virtuous cycle, consumers' redemption of these offers yields more data, leads to more engagement and more spending, and ultimately helps consumers get the items they want, when they want them (Exhibit 1, page 4).

As promising as it is, the digital transformation of merchant credit also poses challenges. Lenders and their retailer partners must develop new capabilities and negotiate how data is shared. Some customers will likely object to retailers' use of their purchase data, at least until a new set of norms develops around the use of such data.

These challenges are not insurmountable, however, and are worth addressing, because the prospects for digital capabilities represent value for customers, merchants and their financial partners.

Exhibit 1

A virtuous cycle is driving the digital transformation of merchant credit



Source: McKinsey analysis

New data sources, better analysis

An increasing number of brick-and-mortar retailers in both developed and developing countries are introducing loyalty platforms that capture transaction-level data. In addition, some retailers' IT systems allow them to link transactions back to the debit or credit cards their customers use, and some banks are starting to share transaction data securely with retailer partners. Online retailers, who often require customers to log in when they shop, are awash in data from which they can infer their customers' behaviors and preferences.

To transform this data into profits, shopping behavior has to be matched with financial services data. For example, linking specific customers' shopping data to their bank accounts and past credit performance allows merchant-lenders to estimate the customers' income and thus their ability to repay a loan, as well as their likelihood to repay.

Retailers and issuers can go a step further by combining consumer purchase data with social network information and other non-traditional, digital data sources to assess credit risk and offer customized credit products. When effectively analyzed and deployed, this data allows both merchants and issuers to decide whether to offer installment, private-label or co-branded cards to those customers. A retailer-bank partnership in Latin America identified "unbanked" and "underbanked" consumers as a priority growth segment. The challenge was to devise a lending model that would meet these customers' needs while also incorporating sustainable economics and satisfying the conservative risk standards of a traditional retail bank. The retailer focused on the mass market, and most of its customers did not have formal credit relationships. The bank and retailer worked to create a new credit-scoring system – based on transaction patterns linked to the retailer's loyalty cards – for customers lacking a formal credit history.

South Africa's Edcon, a leading clothing, footwear and textiles retailer, formed its own financial services company to provide banking and insurance products to its 4.2 million accountholders. Using what it claims is the largest consumer database in the country, Edcon cross-sells banking products such as private-label store cards, co-branded personal loans, home loans and store-branded MasterCards to its customers, as well as credit account protection plans and auto and home insurance.

To date, retailers rather than issuers have been most aggressive in harnessing mobile technology to improve customers' experience, but issuers can capitalize on mobile opportunities, too.

New ways to engage

Along with new data sources and advanced analytics, ubiquitous connectivity – primarily through mobile devices – is the other major force enabling the digital transformation of merchant credit.

Until recently, only online retailers could deliver personalized shopping experiences to consumers. A consumer's Amazon or Netflix home page, for example, is customized, but when customers visit a typical brick-and-mortar store their experience is the same whether they are a 60-year-old retiree or a 20-year-old student, since traditional retailers must generally take a one-size-fits-all approach.

Now, however, traditional retailers can begin to compete with their online peers' customized experience, thanks to the proliferation of smart phones and shopping apps. This capability is critical because it provides a delivery mechanism for credit-related offers and yields valuable data about customers.

In Latin America, two leading retailers with strong loyalty programs, supermarket chain Exito in Colombia and department store chain Falabella in Chile, are pushing the customer-engagement envelope even further by launching their own mobile virtual network operations using existing mobile networks. Through these virtual networks, the two retailers will use their extensive loyalty database to present customized, digital offers to customers.

To date, retailers rather than issuers have been most aggressive in harnessing mobile technology to improve customers' experience, but issuers can capitalize on mobile opportunities, too. American Express, for example, makes special offers available to its cardholders through its mobile apps, working with its network of retailer partners. Especially in more fragmented retail markets, a lender could include digital offers linked to credit as part of the set of capabilities they bring to their retailer partners.

Richer value propositions

While merchants and issuers can use consumer data to offer credit to consumers, they can also help consumers make online purchasing decisions by maintaining continuous, tailored engagement throughout the decision process (Exhibit 2). For example, consumers can receive tailored offers that combine credit and product discounts. A bank-retailer partnership in Brazil uses the online retailer's database to pre-approve customers and make offers at the point of checkout. In this scenario, the retailer sends information on registered customers to the bank for credit pre-approval analysis. If the client is pre-approved, she receives an exclusive online offer (e.g., a credit card plus a discount on that day's purchase) while on the Web site. Customers who accept the offer pay for their purchase with the new card, which is then sent to them within one to two weeks.

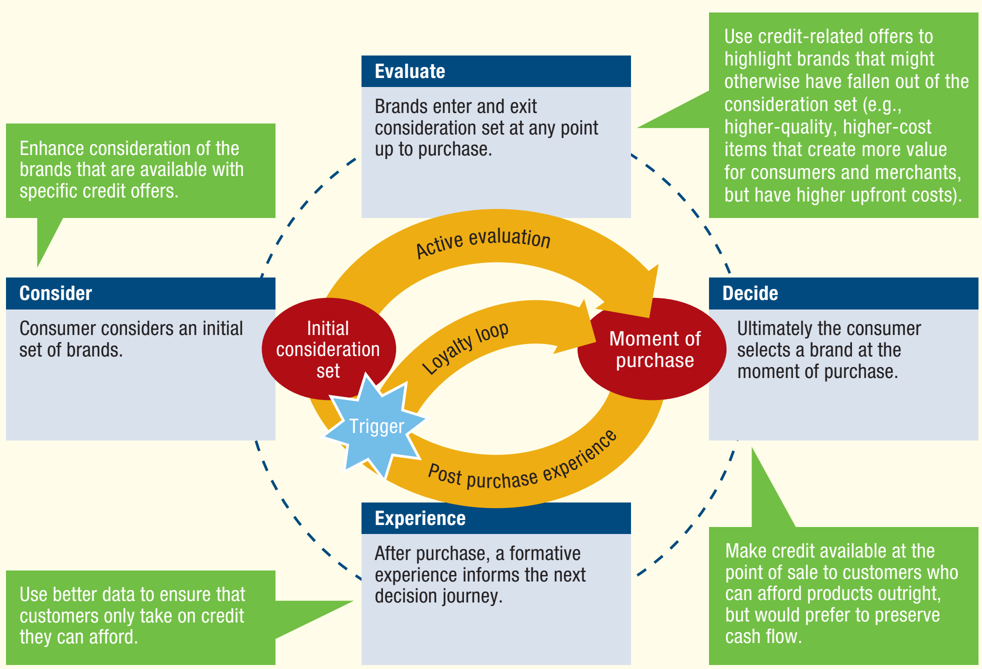
Online merchants: Seizing an opportunity

Online merchants remain far ahead when it comes to using customer data to provide more integrated, targeted credit offers. In China, for example, e-commerce giant Alibaba's immense trove of data enables it to analyze the spending habits and assess the creditworthiness of China's rapidly expanding middle class. Its Alifinance subsidiary has already established itself as a significant micro-lender to small businesses, based on data from Alibaba's flagship business-to-

Exhibit 2

Digitally enabled credit can be effective at every point in the consumer decision process

McKinsey's Consumer Decision Journey framework



Source: McKinsey analysis

business portal. Now the group has announced plans to offer its first-ever consumer finance product, "Pay by Credit," for users of Alipay. The service will evaluate and rank Alipay users (both merchants and consumers) before issuing them lines of credit accordingly. Alipay users shopping on Alibaba's consumer-to-consumer platform, Taobao (a site similar to eBay), and business-to-consumer platform, TMall, will be able to use the credit to pay for purchases just as they would with an ordinary credit card. Merchants who agree to use the service will incur a 1 percent service fee for credit payments.

To compete with their online peers, brick-and-mortar retailers and their financial partners must figure out how to use transaction data strategically.

In the U.S., PayPal's BillMeLater service enables online merchants of all kinds to offer consumers financing with a "six-months-same-as-cash" offer, after which interest starts to accrue. According to PayPal, merchants who integrate BillMeLater into their e-commerce sites see sales lifts of at least 20 percent.

Offline financial institutions and merchants: A chance to catch up

To compete with their online peers, brick-and-mortar retailers and their financial partners must figure out how to use transaction data strategically. To begin, they can take five steps to jumpstart the digital credit transformation:

1. Ensure loyalty programs collect transaction-level data (e.g., specific SKUs, quantities, and actual amount paid) that can be tied to individual customers and linked to financial partners' databases.
2. Retain customer purchase data over the long term. The further back the data goes, the more robust the underwriting and segmentation models.
3. Create digital communication channels that deliver individualized messages (e.g., apps for customers with smart phones, text messages for feature phones). Given low response rates, email is not enough.
4. To serve customers with varying risk and spending profiles individually, give them multiple options for using credit, such as co-branded or private-label credit cards and product-specific financing at the point of sale.
5. For merchants, consider offering a layaway program. A layaway option means a lot to cash-strapped, risk-averse customers, and can become a path to credit for those who lack a borrowing history. Moreover, layaway programs help to identify committed, responsible customers who may migrate to more traditional forms of credit over time.

Implications for stakeholders and business models

The implications of the digital transformation of merchant credit are significant for retailers, financial institutions and their customers. Digitally enabled credit offers can strengthen customer loyalty and boost retailers' return on investment in digital technology and big data analytics. Financial institutions can expand their focus on traditional credit card underwriting to include the use of nontraditional data, become more significant partners to retailers throughout consumers' purchasing decision process, and strategically increase lending.

Existing partnerships among retailers and financial institutions will likely need to be reconfigured to reflect the changing interactions between parties. For example, a retailer might move beyond sending banks basic customer information to include loyalty card and other information. Likewise, banks may use more of their existing data on customers (e.g., deposit information to estimate incomes) to help retailers improve their customer segmentation. Issuers may then be able to adjust their compensation or revenue-sharing models based on the value they add beyond traditional underwriting and risk-taking.

These new models will raise privacy concerns, and it will be incumbent on retailers and their financial partners to determine how much discretion to allow consumers over the use and transparency of their data. For mass-market customers in general, the primary result of adding nontraditional data such as utility bill payment histories to underwriting processes has been an increase in the number of approvals, as more customers become better understood. If that trend continues, explaining to customers how and why their data is being used becomes much easier.

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Customers need credit at the point of sale, and are demanding more engaging and customized shopping experiences. Retailers need better data to offer those customized experiences, and lenders need better and lower-risk ways to expand access to credit. The new proliferation of data, in combination with increasingly powerful digital technology for consumer engagement as well as credit and marketing analytics, has made it possible to satisfy nearly all of these needs.

There is tremendous potential in the digital transformation of merchant credit, but retailers and their financial partners must work together to fully realize it.

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