New frontiers in credit card segmentation: Tapping unmet consumer needs

Credit card issuers have traditionally targeted consumers by using information about their behaviors and demographics. Behaviors are often based on credit bureau reports on how a person spends and pays over time; customers are typically categorized as *transactors, revolvers* or *subprime*. Demographics are derived from census reports and other non-financial databases and cover facts such as income, age and geography. This model has served the industry well for decades, enabling it to offer three main card types—*rewards, low-rate* and *subprime*—to cater to different users.

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However, with the dramatic decline in acquisitions over the past five years, issuers competing in similar segments with similar products are finding it hard to differentiate themselves: The total number of accounts at top issuers has declined by an average of 4 percent over the past five years according to *The Nilson Report*. The result is a race to attract new accounts. Some issuers have offered as much as $400 to customers signing up for a new card, and the top five U.S. issuers are spending over $100 million a year on advertising campaigns. But as switching incentives rise, profit margins inevitably fall.

Issuers do have an alternative: they can maintain a profit margin and generate demand for their product by providing only the benefits that customers value. The challenge for issuers is aligning the right value proposition with the right consumers. The question is: how do issuers develop a suite of credit cards that fulfill customers' needs more precisely without piling on features that add needless complexity or are not valued by users? The answer lies in a more nuanced and powerful approach to customer segmentation—one that can, by extension, be adopted across a range of consumer finance products and markets.

This approach has already been used successfully for two recent credit card launches in the U.S., as well as one in Brazil, where a

large issuer identified three distinct customer segments and shaped an integrated approach to the design of new products, messages and channels; the bank expects to see new accounts grow by 2 to 5 percent as it rolls out the cards in the coming months.

A new twist on needs-based segmentation

Attempting to develop a deeper and more rounded view of consumers is nothing new. Institutions have long sought closer connections with customers, but have struggled with limited data and arm's-length interactions. However, the two-way communications opened up by online and mobile channels enable today's issuers to capture much more information about each customer, information that can be used to execute a sophisticated needs-based segmentation. (See previous article, "Digital banking: Winning the beachhead," for more on leveraging customer behavior data for more advanced segmentation.) By connecting data on how people spend, save, shop and travel, banks can bridge the gaps between business lines, enhance their customer knowledge and improve cross-selling. To do so, they need to have the right message and product available in the right channel when a potential customer comes looking. This is the new frontier of segmentation, channel and product strategy.

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Targeting customers more precisely through smarter segmentation is easy to agree with but much more challenging to pull off. The secret lies in a hybrid approach that segments customers primarily by their needs and attitudes—exposing the underlying reasons why customers use their credit cards—but also takes into account a small number of financial behaviors (see sidebar, pages 14 and 15). Adding these measures to the mix provides further representation of underlying needs and makes the segments easier to score in an issuer's database. Armed with this segmentation, card issuers can not only craft better value propositions but also identify groups that are not well served by current offers.

Fine-tuning offers to meet distinct customer needs

McKinsey's Global Concepts Consumer Life Survey provides an example of how adding financial behaviors into the mix results in segmentation that is more sharply differentiated:

Segment 1: Prosperous and content

People in this segment keep their finances in order, use credit cards for 59 percent of their purchases and love rewards; they *dislike* revolving debt. They look for convenience and minimum effort, preferring to "set it and forget it" rather than get closely involved with banks or card issuers. This is the wealthiest segment in the McKinsey segmentation, with an average of $503,000 in household financial assets, five times the average for credit card holders. It also has the highest concentration of premium network card users at 17 percent, twice the average.

Getting a card into this segment's wallet involves offering rewards. To differentiate their

card, issuers should position it not merely as a spending instrument but as a tool that facilitates financial success through ease of use. For instance, if a credit card could offer a means of steering a large purchase straight into a low-rate installment loan, it could meet this segment's occasional borrowing needs without the stigma or higher interest rates associated with revolving credit.

Acquiring and keeping *deal chasers* calls for a balancing act, as they see themselves as pitted against issuers in a win-or-lose game. Always striving to borrow at the lowest cost, they try to steal the bait from issuers' traps without triggering fees or higher rates through mishaps or oversights.

Segment 2: Deal chasers

With average revolving debt of $3,802—twice the average—these cardholders move their balances around to chase the best transfer rates. This segment is the most likely to have a cobranded card (24 percent compared with 17 percent overall) and to pay an annual fee for a reward card (19 percent compared with 13 percent). *Deal chasers* are highly involved with financial products and are nearly as satisfied with their financial situation as the *prosperous and content* segment (34 and 37 percent respectively, compared with 20 percent overall), and rank second in both income ($65,000 median) and financial assets ($150,000). Despite carrying higher debt, they are confident about managing it and view the economic outlook as positive. They use online banking frequently, with half making online transactions three times a week.

Acquiring and keeping these customers calls for a balancing act, as they see themselves as pitted against issuers in a win-or-lose game. Always striving to borrow at the lowest cost, they try to steal the bait from issuers' traps without triggering fees or higher rates through mishaps or oversights. To build fidelity, issuers could foster a sense of partnership rather than competition by making these customers feel they are getting the best deal and occasionally satisfying their appetite for a great new offer; all, of course, while ensuring the product remains profitable. A big sign-up or annual bonus can be justified, for instance, if a customer is likely to spend heavily and fund the offer through interchange revenue.

Segment 3: Financially stressed

People in this segment carry heavy credit card debt—nearly four times the average, at $7,453—and consider themselves unable to control their spending or stick to a budget. Some are chronic spendthrifts; others are mired in circumstances that force them to borrow on credit cards to pay for essentials. They seldom shop around for better places to put their outstanding balances and doubt they will ever get out from under their burden of debt. They expect financial trouble for themselves and the wider economy. This is the poorest among the segments, with just a quarter of the financial assets (a mean of $44,000) of the average cardholder.

Credit plays a crucial role in satisfying this group's day-to-day needs: keeping a roof over their head, paying for their daily commute, keeping a prescription filled. This is not a sustainable path, but they are unable

McKinsey's U.S. Consumer Financial Life Survey

McKinsey's Consumer Financial Life Survey is an ongoing survey taken three times a year since 2009. Since the survey began, 24,000 U.S. consumers have taken the 30-minute self-administered interview. Topics explored include financial behaviors, preferences and motivations, with an emphasis on payments.

The data from the survey were used to create a needs-based segmentation of U.S. credit card holders that yields a more comprehensive picture than traditional demographic- and behaviors-based segmentations (Exhibit A).

The five groups identified by the segmentation are distinguished by members' economic circumstances, household money management style and reasons for using credit cards on various purchasing occasions. In addition to needs and attitudes, the segmentation takes into account certain spending behaviors that can be identified from customer data—namely, the volume of household expenditure, the proportion spent on credit cards and the proportion of revolving debt to income—in order to score customers and prospects more accurately into segments. Notably, these behaviors correspond to underlying needs that can be addressed by a credit card product.

Since needs-based segmentation does not divide customers into profitable and unprofitable groups, issuers must also evaluate indicators of profitability to determine whether and how to execute on each needs segment. Exhibit A lists spending behaviors typically used for this purpose. Looking at combinations of these traits at an individual level enables issuers to spot not only clearly profitable customers but also "diamonds in the rough" who are financially desirable yet overlooked by competitors.

In Exhibit B we see sharp differences between segments for certain attitudes and behaviors. The green bars indicate higher-than-average intensity of a given attitude or behavior; red bars indicate lower than average intensity. For example, the *prosperous and content* segment scores very low on the trait "Avoid credit cards for day-to-day purchases" because members of this segment use credit cards as often as possible; *recovering credit users,* on the other hand, score high on the trait because they avoid using cards more than other segments do.

Exhibit A

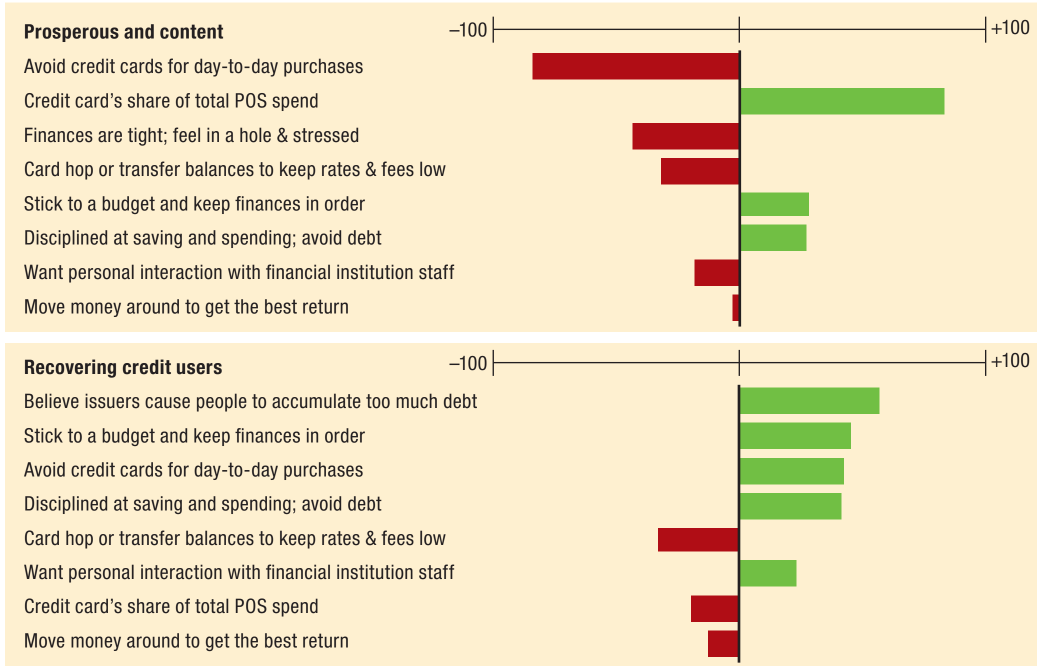
Profitability indicators should be considered in conjunction with needs segmentation

	Prosperous and content	Deal chasers	Financially stressed	Recovering credit users	Self-aware avoiders
Percent of U.S. credit card holders in segment	23%	18%	19%	22%	18%
Median annual household income	$85,000	$65,000	$45,000	$45,000	$55,000
Percent of segment with revolving credit card balance	29%	81%	93%	64%	64%
Mean credit card revolving balance per household	$890	$3,802	$7,453	$1,726	$1,969
Most-used instrument for POS payments	Credit	Debit	Debit	Debit	Cash
Share of credit card in POS spending	59%	24%	20%	11%	19%
Most-used credit card does not earn rewards	8%	37%	52%	45%	43%

Source: McKinsey/Global Concepts Consumer Financial Life Survey 2012–13

Exhibit B

Credit card segments display sharply different traits



Source: McKinsey/Global Concepts Consumer Financial Life Survey 2012–2013

to abandon it just yet. They value simplicity and transparency in fees, rates and terms, but their biggest need is for something that no credit card offers: a mechanism allowing them to impose their own spending limits. This would enable them to carry a credit card for larger purchases that take time to pay off without fearing they might be tempted to use it for non-essentials.

A limited array of features can be assembled in different combinations to create a unique value proposition for each segment.

Segment 4: Recovering credit users

These individuals have become avid budgeters who pride themselves on keeping their financial house in order, although they still revolve an average balance of $1,726. Wary of financial institutions, they avoid the stock market as too risky, fear their bank deposits are unsafe and blame issuers when consumers accumulate debts and fees they are unable to pay off. Cardholders in this segment avoid using credit cards for routine purchases and seldom respond to zero-percent teasers or high-reward offers. They prefer to deal with bank staff in person and are less likely than other segments to use online banking, with just 49 percent doing so.

This group's adversarial view of issuers suggests they need reassuring that they can use a credit card without stumbling into a "gotcha" fee or triggering a penalty rate. They need a product that helps them budget and manage their spending—for instance, by allowing them to define spending "buckets" for various merchant types with monthly limits (e.g., $200 at grocery stores, $80 at mass merchants and $150 at restaurants). As they approach one of these limits, a purchase could trigger an SMS text or email alert to warn them. An issuer could allay fears of triggering a penalty fee by adding a one-time "forgiveness voucher" to its card offer, and attract a greater share of spending by positioning the card as appropriate for everyday purchases. This is an active, engaged group that wants to control their spending and are looking to companies that can provide the necessary tools.

Segment 5: Self-aware avoiders

Like *recovering credit users*, members of this segment avoid using credit cards, although they blame themselves rather than issuers for their debt problems and worry about the damage they could do to themselves with a credit card. They use debit cards and cash for three-quarters of their POS purchases, but still carry an average revolving debt load of $1,969 per household. They are slightly better off than *recovering credit users*—and, for that matter, average cardholders—in terms of income and wealth.

Like the *financially stressed* segment, these consumers are likely to respond to simplicity and transparency in fees, rates and terms. Bolstering their confidence that they can use credit cards without mishap for certain purchases, particularly for short-term borrowing, will make a credit card more viable. Similarly, they would feel more in control if they could understand the payoff horizon for major purchases. Cards that could instantly calculate the scale and duration of monthly payments for a given purchase at the point of sale would better meet this group's needs.

Exhibit 1

Benefits can be bundled into distinct products to appeal to each segment

Benefits	Segments: Prosperous and content	Deal chasers	Financially stressed	Recovering credit users	Self-aware avoiders
Rewards	✓				
Balance transfer offers		✓			
Easy account management	✓				
Low fees and interest		✓			
Occasional special deals discounting or rewarding existing balances		✓			
Simple and transparent fees, rates and terms			✓	✓	✓
Self-imposed spending limits			✓	✓	
Budgeting within distinct purchase categories		✓		✓	
"Daily needs" positioning	✓			✓	
Avoidance of mishaps that trigger fees			✓		✓
Payoff horizon for each major purchase			✓		✓
Swipe to installment loan	✓				✓

Source: McKinsey Payments Practice; Global Concepts

A limited array of features can be assembled in different combinations to create a unique value proposition for each of these five segments (Exhibit 1). The first two—*prosperous and content* and *deal chasers*—are already well served by the market through reward offers and zero-percent balance transfer deals. However, the remaining three segments have no products designed specifically to meet their needs. Issuers seeking to expand their card offerings and tap growth in underserved segments would do well to target these groups with their particular needs (and associated risks) in mind.

Making it work

The first step for issuers is to reach alignment on their business objectives: what problem are they trying to solve with the segmentation, and how will they use the segmentation? When segmentation efforts fail, it is often because more energy has gone into deriving the segmentation than thinking through the implementation.

When an issuer's objective is to attract new customers and drive revenues and growth, it should use the segmentation to structure not just product design but the whole acquisition process from customer targeting to segment positioning to delivery. That means starting with a needs-based segment, developing a card with features to meet those needs and promoting it by explicitly communicating how the features satisfy the needs. The segmentation described above is well suited to helping issuers design value propositions with maximum appeal to distinct

consumer groups and frame how these propositions are delivered.

(If, however, an issuer is more concerned with revenue leakage, it could increase the ratio of behavioral to attitudinal measures so as to optimize scoring efficiency rather than needs-based differentiation among the customers it is trying to retain.)

Once objectives are set, deriving the segmentation is typically a two-part process combining qualitative research to uncover needs and attitudes and quantitative research to cluster and measure customers. Issuers should use professionally moderated qualitative research involving one-on-one interviews, focus groups or online groups to inform the design of the quantitative survey and bring segments to life. For survey purposes, issuers should recruit individuals from market panels as well as existing customers to help them understand how their customer base differs from the wider market and how they might increase share among particular segments. Issuers can also append their own data and create database proxies to help type the segments in their database.

By using such methods, some issuers have managed to increase their targeting ability within a segment by up to 100 percent.

Having derived the segmentation, an issuer must then hard-wire it into the business. To be effective, segmentation must become part of the rhythm of the organization, embedded in its planning, measurement, goals and incentives.

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By building a richer, deeper view of customer segments, financial institutions can sharpen their value proposition, integrate cards with other lending products, reduce channel confusion and clarify positioning and promotions. This approach helps to break down silos and rally business units around a common goal and a single company-wide view of the customer.

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