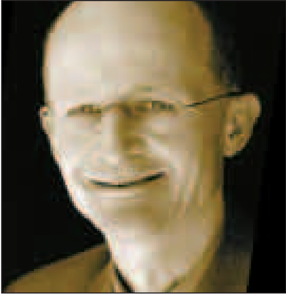
Options Abound for Post-Spinoff Discover



ERIC GROVER

There never was meaningful synergy between Discover and Morgan Stanley's brokerage, asset management, and investment businesses.

Having first reversed the decision by Phil Purcell, his predecessor, to spin off Discover, Morgan Stanley CEO John Mack changed his mind and now intends to cut it loose.

Soon the United States will have four independent, for-profit, public, general-purpose card payment networks: American Express, Discover, MasterCard, and Visa.

Discover is the runt. Its full-suite payment network is dwarfed by Visa, MasterCard, and Amex, and its card issuer must be counted as small relative to Gargantuas such as Bank of America, JPMorgan Chase, and Citigroup.

Once it is autonomous, what path should Discover take?

Under the hood, it has several businesses: a payment network, a card issuer, and a merchant acquirer. It can strengthen the payment network by sacrificing some or all of its merchant processing and card issuing business.

In the near term, Discover is likely to continue, with more tools and greater focus, on the path it has pursued for the last several years: trying to achieve acceptance parity with MasterCard and Visa in the United States, increase partner card issuance, enrich the payment network offer, and establish a more credible presence abroad, possibly with stepped up acquisitions.

Last year Discover was on a tear, striking acquiring relationships with First Data, Global Payments, RBS Lynk, Total System Services, Nova, and Transfirst, which among them reach 6.2 million merchant locations.

Astutely, Discover is trading acquiring revenue for network reach and, in some cases, ceding merchant relationships to acquirer partners. Within a few years it could well obtain U.S. acceptance parity with Visa and MasterCard.

Efforts to woo issuers have been less successful. Discover struck relationships with the retail finance specialists GE Consumer Finance and Alliance Data Systems. It is selling credit card rejects to HSBC's subprime business and CompuCredit, and it has a handful of small-bank issuers, providing principally prepaid products to the unbanked and underbanked.

Discover's U.S. card business competes with banks it courts as network customers. Selling it would eliminate the conflict and could facilitate network expansion abroad.

The best acquirer of Discover's card business would bring issuance and acceptance consideration in addition to cash.

For instance, Barclays and Royal Bank of Scotland aspire to build up their U.S. card businesses. Selling the card business to either company, or, better yet, to both, coupled with a partnership that brings Discover's issuance and acceptance abroad, could create compelling value. Barclaycard and RBS have huge consumer and merchant reach in the world's second-largest credit card market — Great Britain — and a host of smaller markets.

Discover has been enriching its product suite to compete better against the bank card networks. In 2005 it acquired Pulse, the No. 3 PIN debit network in the United States, expanding its offerings to include PIN and signature debit, credit, and prepaid cards. Now, going tit for tat with Visa and MasterCard, Discover has added reloading capabilities.

Interchange is a critical component of the network value proposition. In concert with broadening its offerings, Discover should improve its economics for issuers. It should push harder to close its interchange gap with MasterCard and Visa, enhancing its profitability for bank and retailer issuers, fueling rewards, and thereby increasing issuance and cardholder spending.

Being more attractive for issuers and cardholders than merchants is the best route to maximizing network value.

Discover is making headway in the world's largest and most competitive payments market. Nevertheless, that's insufficient. Its challenge abroad remains formidable. It does not have its own network. In its first foray offshore, in 1999, it issued MasterCard products in Britain.

To start addressing its lack of international acceptance, Discover forged a handful of reciprocal acceptance agreements, most notably with JCB and China UnionPay.

However, building payment networks is enormously difficult. One needs to establish critical mass on both sides of the network: acceptance and spending. Once established, however, the networks enjoy enormous operating leverage compared with credit card businesses.

Though relationships with global financial institutions and retailing behemoths such as Carrefour and Wal-Mart, with whom Discover already issues a hybrid card, would help, network mergers and acquisitions would give international expansion vital impetus.

In Asia, Discover might look to acquire China UnionPay — if it can be bought. Mature Western European markets, however, offer more realistic near-term M&A opportunities to establish a beachhead abroad.

The Single Euro Payment Area initiative by the European Commission and the European Central Bank imperils continental national debit programs. Some of the programs have banded together in the EuroAlliance, aiming to develop a pan-European network to compete with MasterCard and Visa. Like the United States, Europe would benefit from more vigorous payments competition and could support more than two networks.

Discover could acquire and cobble together Euro Alliance national networks such as PagoBancomat, Bancomat, Multibanco, Euro 6000, Electronic Cash, and Deutsches Geldautomaten-System and the nonmembers ServiRed, 4B, and BNP's proprietary multinational credit network, Carte Aurore, et al.

Under pressure from the European Commission, Visa and MasterCard reduced interchange. MasterCard will lower the interchange rate for Maestro in SEPA to a paltry 0.12% and 3 euro cents per transaction for large merchants. In the European Union, Visa is completely, and MasterCard substantially, bank controlled. Both are therefore likely to continue to be treated like public utilities by regulators, with interchange consequently kept artificially low. This is an invitation for a third or fourth network to distinguish itself with higher interchange to woo issuers and spur use, producing a third pan-European card payment program, something the European Central Bank and the European Commission say they want.

Discover is stepping up its game in the United States. By a strategic sale of its credit card business, targeted network acquisitions, and a more hawkish interchange policy, it can strengthen its U.S. network business and establish a credible international payment network.

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Long-Term Rewards of HSAs Worth Challenges

BY JAMES VAN DYKE

Health-care relationships have arrived with a thunder in the financial services industry, in the form of health savings accounts.

Will financial services executives enhance customer relationships and balance sheets through these accounts, or will the problematic patterns of the health-care industry infect bankers' profitable and loyal relationships?

As with every vital yet uncertain strategy, quantitative research and rigorous analytical planning are critical to success.

HSAs were created by the Medicare bill signed by President Bush on Dec. 1, 2003. Combined with a qualifying high-deductible health plan, they are intended to contain spiraling medical costs and expand insurance coverage. HSAs help individuals save for qualified medical expenses on a tax-free basis. Balances are portable and build from year to year.

Enhancements signed into law on Dec. 20, 2006, make the accounts more enticing to both consumers and employers.

The legislation increased the maximum annual contributions to $2,850 for individuals and $5,650 for families. Additionally, it eliminated the requirement that annual contributions not exceed the annual deductibles of the health plans to which the accounts are linked. The law also allowed people who join a high-deductible health plan to contribute the full year's maximum, regardless of when they join.

A five-year provision allows employers to make one-time transfers of funds from flexible spending or health reimbursement accounts to employee HSAs.

All the provisions are intended to spur consumer interest and enhance the value of opening HSAs. Banks should certainly take heed. Must leading financial institutions include HSAs in their plans? Absolutely. Will the accounts hit adoption and profitability goals in ways similar to other large consumer offerings? Absolutely not, the data says.

Consumers are not ready for the accounts, and when they are ready they will expect offerings to come from the wrong places, or in forms that traditional providers won't be prepared to offer. Some demographic groups that would benefit strongly from HSAs show the least enthusiasm for using them.

Making matters worse, the financial gains won't likely materialize in the form or time frame that bank and payment executives expect. Nevertheless, the rewards will be worth it, if the "sick market characteristics" of the health-care industry ca navigated.

Financial providers' foray into HSAs could result in a jur of complexity, higher costs, and missed expectations, yet opportunity is simply too important to pass up. Succes diversification into medical information/transaction proces will yield high-end dividends far into the future.

Not since the creation of IRAs has an opportunity like been set before the banking industry. Therefore, institut must be willing to jump in with both feet.

The financial services industry is unsurpassed at hel consumers and businesses manage complex and uncer assets and transactions. On the surface, HSAs seem like a fect fit for bankers, yet the rescuers need to be careful they a drowned by those they are trying to save.

HSAs are not a casual undertaking; their essential na requires a type of commitment that is not for the fain heart. Divergent areas of expertise — medical, privacy, c pliance, tax, and payment processing — must be caref coordinated with consumer preference data to formula successful strategy.