

Capital One: Directions for Expansion

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Introduction

As the first entrant into the customized credit card market, Capital One experienced enormous growth and profitability during its first several years as a public company. However, as the custom-rate credit card has reached maturity, the industry has become rivalrous and populous. Thus, to maintain profitability, Capital One must look outside its original niche for avenues of expansion. Recent acquisitions indicate that it is entering the full service and local branch banking market. **We consider the question of whether Capital One should enter full service banking, and what other directions it might consider for expansion.** An analysis of the intense concentration and rivalry in this industry, combined with the lack of a good “fit” with Capital One’s core strategy, suggests that such entry is unwise *unless it complements a broader expansion strategy*. We explore how Capital One can enter the car insurance and life insurance industries and provide a full range of financial services using the strengths it has built up. We also discuss a different direction for expansion focused on the idea that has carried Capital One this far: namely, exploiting information about consumers in novel ways. In particular, we suggest using the data the company has about its customers to tailor all of Capital One’s advertising specifically to their needs.

Should Capital One Expand?

Early Profitability

Capital One experienced spectacular profits and growth during its first six years in the credit card lending industry. It grew at an average annual rate of 46%, and its stock price increased more than 1000%, compared to a 300% increase in the S&P 500 index [1]. The company made a profit of over \$400M in 2000 [2].

A major reason for this early profitability was Capital One’s first-mover advantage in the customized credit card market. Pioneering an Information Based Strategy (IBS), they collected immense amounts of data relating to consumers’ financial histories that allowed them to predict, with high accuracy, the probability of defaults. They could thus offer a customized rate to each

customer, and often this rate was lower than the industry standard 19.8%, even for customers with imperfect credit. Capital One thus positioned itself ideally to take full advantage of the growth phase of customized credit cards. During this period, their competitors, who had initially shunned the IBS when it was proposed to them, scrambled to catch up while Capital One made a great deal of money on its informational advantage [1].

Rivalry in the Credit Card Industry

Today, the customized credit card appears to be reaching maturity. Every major bank offers multiple cards with interest rates custom-tailored to applicants. The drive to offer lower rates constitutes the main price competition in this industry.

The nature of this competition is somewhat complex. The minimal, so-called prime rate (currently 5.75%) is offered by banks to the most creditworthy customers — businesses and individuals with excellent credit ratings [3]. The rate is the same across all major banks; moreover, the banks even change it in unison. However, these trustworthy customers are certainly not the cash cows of the industry, since they accumulate relatively little debt and, moreover, pay low interest rates on it.

There is much more variability in the rates offered to sub-prime customers, who, on average, accumulate more debt and pay more interest. Banks certainly compete on the rates they offer to these customers, since these can, other things being equal, determine which bank a customer borrows from. After all, small differences in interest rates can make a huge difference over time to a single consumer with considerable credit card debt. As discussed above, in the first few years after entering the lending market, Capital One's intensive IBS allowed it to offer better rates at lower risk to itself for such consumers, since it had better estimates than many of its competitors on the probable future behavior of the customers. More recently, many other banks have perfected information-intensive techniques [4]. While Capital One has enjoyed a first-mover incumbent advantage, this has been eroding as the stores of information accumulated by its competitors grow to match its own.

Bargaining Power: Suppliers

Additional insights into profit-eroding pressures can be gleaned by analyzing Capital One's suppliers and buyers. Key suppliers of information for Capital One are the credit bureaus.

Capital One uses this information in its IBS to tailor products to specific people. In particular, the company uses information furnished by the credit bureaus to precisely estimate the risk of defaults and to issue credit at optimal interest rates given a customer's risk characteristics. Three credit bureaus dominate the industry: Equifax, Experian and TransUnion [5]. Since there are so few, they have some bargaining power. In particular, since each has some valuable information about some customers not held by the others, credit card issuers would probably tolerate some price increases to continue obtaining this information.

Capital One also needs large sources of funds to pay for the purchases its customers make ahead of time. Often, these sources are outside investors who buy the debt as an investment. Offering savings accounts can also provide this income. The company's current interest rate on savings of 3.15% is higher than the national average by 2.14% [6]. This seems to indicate that they are eager to get more deposits in order to fund their debt.

The acquisition of Hibernia is going to provide Capital One a source of funding. At the end of 2004, Hibernia had \$17.4 billion in deposits. This amount is almost 25% of Capital One total loan amount for 2004 [7].

Bargaining Power: Buyers

Credit card holders are Capital One's main buyers. The majority of the company's products are aimed at consumers with some emphasis on small businesses. Capital One recruits many of its consumers, which now number 48 million, through mass mailing of applications, obtaining addresses from marketing agencies. These buyers have some bargaining power in adjusting the prices of the product. For example, a buyer who has a high interest rate can bargain to have the rate lowered by saying that he could go to a different company¹. Since this threat is often plausible, Capital One must keep its rates competitive to avoid customer flight.

Borrowers for auto purchases are another group of Capital One's buyers. Over the last 9 years, the company has gone from 100% credit card customers to 61% credit card customers and 13% auto loan customers (the rest consists of international operations). Capital One also uses its IBS with its auto loan customers to provide the best rates for the particular risk characteristics of individual buyers.

¹ We investigated this by calling a credit card company, and succeeded in using this "bargaining" approach to get an interest rate lowered by three points.

Eroding Profits

Between 1997 and 2001, Capital One's profits grew at a slower pace than they did during the previous five years, nearing a standstill [8,9,10,11,12]. This is almost certainly attributable to the pressures discussed above. If the trend were to continue, Capital One would soon find itself losing the stellar profits that characterized its first decade. Thus, to remain profitable, Capital One must look to expand significantly beyond its original niche.

Should Capital One Expand into Full Service Banking?

Capital One has recently announced its plans to acquire Hibernia, a large regional brick and mortar bank in Louisiana and East Texas. It has also begun offering banking services such as savings accounts on its website. This strongly suggests that the company is entering the full service banking industry.

What does this industry look like today, and how rivalrous is it? Insight on this issue can be gained using a five forces analysis. This analysis reveals that concentration in many market segments as well as interest rate competition are significant issues. Let us first look at the high end, service-wise, of the market. Some banks, like Citibank, differentiate themselves with a high level of service and pride themselves on extensive websites, free automatic bill-paying, online transfers of money to other institutions and helpful customer assistance. These banks offer interest rates on savings that are very low compared to the best available, since they spend a great deal on service. Thus, many customers use a bank like Citibank for their checking account, and keep a relatively small amount of money in it. At the other end of the spectrum, bare-bones banks like ING Direct provide stellar interest rates but almost no service, allowing them to keep expenditures low. For this reason, many customers use them for large, long-term but still liquid savings. On this end of the axis, there is fierce competition to offer the highest interest rate. Thus, an entrant would have to deal with a very crowded market and the threat of an "interest rate war". In fact, buyers have "bargaining power" in the sense that they can easily move to a rival bank that offers better rates or service, forcing an entrant to keep (roughly) up with the best service and/or best rates in the industry. (Typically, consumers would not actually bargain. Their threat to leave is implicit.) The rivalry is exacerbated by the fact that different banks are highly

substitutable, since they perform essentially the same services in a fairly standard way. There are some switching costs associated with moving funds, such as filling out forms, but these seem to be mild enough that they would not deter customers from moving funds if much better service or rates are available. Barriers to entry do not appear to be a significant issue, since a sizeable financial institution like Capital One already has essentially all the large-scale infrastructure to offer banking services, and individual branch banks are easy to acquire.

It is important to note that in the checking and savings markets there is little room for Capital One to leverage its informational muscle. The rates offered are essentially uniform and do not depend on the customers to whom they are offered, so Capital One cannot outdo its competitors by being better at guessing the optimal rate, as it had done in the lending business. In other words, there is a poor “fit” between the things which Capital One currently does well and the industry it seems to want to enter. Competing with companies like Bank of America, Citibank, MBNA, ING Direct, etc., would put Capital One into an unfamiliar industry in which its central secret is no longer applicable.

Given the highly rivalrous and concentrated nature of the full-service banking market and the lack of a clear “fit” of such services with Capital One’s strengths, the entry which Capital One is beginning seems to be unwise *as a primary focus*, since it seems very difficult to make a profit from these activities alone. However, as we will now argue, checking and savings accounts might make sense as complements to a full range of financial services.

Where to Expand?

There are several areas having a surprising number of synergies and complementarities with what Capital One already does well. Exploiting these synergies, we argue, would take it into the auto insurance and life insurance industries, with a focus on so-called high risk customers underserved by the current leaders in these fields. This would position the company to provide a full range of financial services to this market segment, and checking and savings would fit well as complementary services.

Auto Insurance

Recall that Capital One made huge profits in credit cards by aiming at subprime (high risk) borrowers and offering them interest rates that were not low, but certainly less bad than the

ones those customers could get anywhere else. The company did this by knowing more than anyone else about the customer's probability of default. Whereas their competitors in the 1980's panicked and gave all subprime customers the worst rate, Capital One realized that there were gradations of risk in the subprime market, and that those gradations could be exploited.

Along the same lines, Capital One can offer car insurance to the *seriously* underserved high risk driver market; after all, many of the currently leading auto insurance companies are unable to offer high risk drivers any insurance at all; (the gory details are discussed below). In fact, there are significant complementarities between such activities and things that the company already does well. In particular, one of the factors that determines the premium for a high risk driver is his or her credit history. Since statistics show that customers with poor credit file more auto insurance claims, many insurance companies already use a basic credit report as one factor in setting the premium [13]. However, they often suffer from the same "panic" problem that credit card lenders did in the 1980's — seeing bad credit, and having little information about its details, they panic and deny insurance or set unaffordable premiums. Capital One, on the other hand, has much more extensive knowledge about almost everyone's credit history than a basic credit report or rating can provide. As before, the company can study the impact of different degrees of bad credit by statistically examining how attributes of credit history affect the risk of an accident; (before, it did the same thing with the risk of a default). Doing this would give them much more nuanced estimates of the risk of a given driver. It would almost certainly turn out that the current leaders are overcharging some drivers in view of the risk those people actually pose. That is, one could charge those drivers lower premiums and still pay out less in claims than one takes in, in the long term. This situation creates an inefficiency. By estimating risk more precisely and individually than competitors, Capital One can correct this and offer premiums much less bad than the ones currently available to so-called bad drivers, thus winning this huge and potentially very profitable market.

How huge? The California Department of Insurance conducted a study that reports the estimated rate of uninsured vehicles in the state as 28.1%. This reflects that a significant percentage of people are breaking the law by owning an uninsured vehicle [14]. Another study revealed that one of the main reasons for owning an uninsured vehicle was not being able to afford insurance [15]. The study also showed that it was largely poor (less than \$20,000 per year in income) minorities (Hispanics and African Americans) who have uninsured vehicles. This

shows that there is a large market for auto insurance that current companies have not yet been able to reach because they have been unable to provide affordable premiums.

Moreover, a study by the National Association of Insurance Commissioners (NAIC) reports that New Jersey residents pay the highest average auto insurance premium in the country, namely \$1,182.54. The cheapest state, Iowa, has an average premium of \$596.44 [16]. This demonstrates that companies charge much higher premiums in highly urban, densely populated states than highly rural, sparsely populated ones. Many of the poorer residents in the more rural parts of the high-premium states cannot afford such high premiums and also don't frequently drive in the riskier urban areas. Though Capital One's expertise with credit reports is no longer relevant, their philosophy of using precise statistical analysis to find out which customers are being overcharged due to a high-risk classification could be quite powerful in winning a large segment of the market in states like New Jersey.

Life Insurance

It is natural to consider applying a similar philosophy to life insurance. Many traditional insurers charge high-risk customers — smokers, older patients, etc. — very high premiums; these are high enough, in fact, to render life insurance unaffordable for many consumers. Unlike the situation in car insurance, though, life insurers do *not* suffer from the “panic” problems that Capital One can exploit so lucratively in other markets. In fact, these insurers typically have a great deal of information about prospective buyers and do a good job of predicting average claim rates. Life insurance is a fairly old business, after all. Nevertheless, the philosophy of using slightly better information to make slightly better predictions and undercut competitors is still applicable. In particular, the sort of detailed statistical analysis that Capital One does well can reveal correlations between purchasing/borrowing behavior — about which Capital One has troves of proprietary information — and longevity, which can be judged from publicly available government records. For instance, borrowers whose bills reveal that they regularly shop at health food and athletic stores are likely to be healthier, on average — even if they are older, and can no longer get affordable insurance from the standard providers. Capital One can send targeted offers for life insurance to these customers, and those offers would be more affordable than the ones available from the leading providers, who don't know about the healthy shopping habits. Capital One would thus win those customers and become their provider of life insurance. If this entry is

successful, Capital One could offer life insurance to all of its customers. In cases where it had no additional useful information to estimate risk better than competitors, it would offer standard premiums and be on par with the rest of the industry. In cases where CapitalOne could use financial information to make better risk estimates, it could make better decisions about premiums than its competitors. While life insurance would probably not be a cash cow for the company, there would be a group of customers (the ones to whom Capital One offers low premiums based on “good” purchasing histories) who would find it to be a unique deal unavailable elsewhere. Since few companies own as much financial information as Capital One has collected through the IBS, essentially nobody else would offer those customers premiums as low. This would create a very strong lock-in effect. Since the various financial services the company provides are complementary, this would probably increase the usage of Capital One’s other services by those customers. Finally, even Capital One customers who don’t get especially good premiums from Capital One’s life insurance business might like to get a more typical policy from the company anyway; the extra value keeping them in would come from the complementarities associated with having many financial services under the same roof, as discussed below.

Exploiting Complementarities with a Full Suite:

Checking, Savings, and Beyond

Entering the car insurance and life insurance industries, in addition to Capital One’s extant credit card, mortgage, and car loan businesses, would put it in the position of covering much of the spectrum of financial services most Americans use. A first and obvious step to encourage customers to explore all of the company’s offerings would be consolidating accounts from multiple branches into one easy-to-use package. Once this is done, adding basic checking, savings, investment, and tax planning services would create a very attractive financial services suite for customers who first find Capital One because the company provides affordable services for high-risk borrowers or drivers. In the first chapter, we saw why entry into the checking/savings/etc. industry would be difficult on its own, as a primary focus. But as part of a suite of services offered to people who already have several relationships with the company, such offerings could be much more successful. The key extra value which would make them viable would come from the *complementarities* with Capital One’s other services. These

complementarities, in turn, arise from the convenience of only having to provide various information once (instead of redundantly to different companies), receiving fewer statements, having a central customer service contact, etc.

A Different Direction: Advertising

An idea for expansion that is not directly related to the theme developed above is using targeted advertising techniques to direct all the many promotional materials Capital One sends its customers.

A typical credit card bill contains a lot of material. The current practice of Bank of America and American Express, for example, is to enclose two pieces of “promotional coupons” along with the statement. One is typically part of the bill (Exhibit 1), whereas the other is attached to the small payment envelope (Exhibit 2). Capital One has a similar arrangement. If one wants to make a payment, one must detach the coupon from the payment envelope first. The coupons that are enclosed usually promote large nationwide businesses such as T-Mobile or Hertz. The coupons that are enclosed with the payment envelope are typically claimed to be rewards and offer wallets or DVDs at reasonable prices. Currently, there is very little variety in these promotions – while the coupons enclosed with, say, a student account and platinum account differ, the coupons enclosed with all the student accounts are the same, as a telephone discussion with the customer service department revealed [17].

Unlike Bank of America and American Express, Capital One is also responsible for a third type of promotion – direct mailings from third party companies. Unless the customers opt out, they receive mailings that are separate from Capital One statements [5]. As was confirmed with the Customer Relations Department of Capital One, these direct mailings also do not depend on specific details about customers [17].

This practice is rather surprising, for Capital One has immense amounts of information about its customers, both from their personal details and purchasing behavior. We believe that Capital One should use its IBS system to target particular groups of customers with promotions tailored to their interests and habits. This targeting should be implemented across all the advertising – the small amount in the statement along with the direct mail.

This practice could result in highly relevant advertising being aimed at consumers, for the amount of information contained about a consumer’s needs and preferences in credit card bills

alone is huge. For example, someone who pays \$37.53 for a T-mobile account probably incurred overage charges on one of the plans with a smaller number of default minutes. A promotion from Verizon offering an upgrade to their similarly priced plan with more free minutes and fewer overage charges would be appropriate. Someone who pays \$39.99 with Verizon is not using all the minutes and should receive a promotion for the \$29.99 plan from T-mobile. A person who has been renting a car from Enterprise in his hometown for the past two weeks has probably been in an accident and would be more responsive to promotions for new automobiles or car repair. In most cases, it would even be possible to use other purchases to surmise what sort of car the customer might like to buy — people who shop at wilderness stores would probably prefer an SUV, whereas those who frequent high-fashion boutiques would usually be more receptive to an advertisement for a coupe convertible. Advertisers could now be charged more for promotions sent directly to those most likely to be interested in them.

Indeed, given that the credit card issuers already burden customers with promotional materials, it is not clear why they promote wallets and flashlights to all of their customers without regard to the purchases the customers make. We believe that across-the-board targeted advertising would be a very good source of revenue Capital One. Moreover, since many of its car insurance customers under the model above would be able to get reasonably priced service only from Capital One, they have less freedom to leave, even if they don't particularly enjoy targeted advertising. Finally, and conveniently, the company's bigger competitors, such as Citibank, would probably be somewhat leery of entering targeted advertising; such a move might endanger their hard-won reputations as trusted names in other markets by making them look opportunistic or intrusive.

The Ramifications of Targeted Advertising: A Public Relations Nightmare?

But, of course, seeming invasive is a problem for Capital One too. Before implementing this advertising strategy, the company would have to seriously consider whether the public relations costs justify the policy. Some customers may object to being “spied on” for advertising purposes. Certainly, such concerns surfaced when Google released a beta version of Gmail, its first product in the free email industry, which targets advertisements based on the semantic content of user emails [18]. Some people even refuse to use Gmail for this reason. Capital One


would have to develop a comprehensive plan to avoid negative PR and to prevent consumer flight.

We believe such a plan can be quite successful, and Capital One could use it to make losses from targeted advertising sufficiently small that the associated profits would dwarf them.

- First, experts agree that the relatively mild blowback from Google’s “spying” can be attributed to their forthrightness about how their service targets advertising [18]. Capital One should do the same thing, sending a simple, straightforward letter to all customers introducing the new policy.
- This letter, and an accompanying media campaign, should emphasize the value of targeted advertising for consumers. (The ad blitz should be funny and memorable; Capital One has been successful at creating amusing and memorable advertising in the past [2].) Consumers should get the following messages:
 - All credit card companies already send unsolicited advertisements; we just send you ones you’ll find most useful, instead of hocking wallets and flashlights.
 - The smaller, precisely chosen audiences allow advertisers to offer more generous promotions and discounts, which is good for you. (This should be proved at the time of roll-out with maximally generous promotion: for instance, a \$100 discount coupon at Dell for frequent computer buyers.)
 - No humans look at your purchasing patterns; only computers do. (This feels less invasive.)
- After all these mitigating factors have been explained, customers should still have the clear opportunity to opt out of all targeted advertising. Many experts believe Google’s targeting was so well-received because Google has such a good corporate image [18]. On the other hand, Gmail offers no opt-out option, since it is completely advertiser-supported. Capital One could make up for its relatively less strong reputation by offering customers exactly the same service, if they ask for it, as they had before the changeover. However, given the truly valuable aspects of targeted advertising for the customer, only very privacy sensitive customers would probably opt out.

Exhibits

Exhibit 1



**Redeem Your
VIP Thank-You
Certificate**

**DON'T LET YOUR
CERTIFICATE EXPIRE.**
Redeem now for your VIP
Thank You. Detach and return
certificate in this American
Express® reply envelope.
Expires: June 15, 2005

VIP THANK-YOU CERTIFICATE ORDER FORM

Yes! Redeem my certificate now for my favorite DVD movies for just \$9.97 each billed to my American Express® Card account. Best of all just \$3.95 covers shipping and handling for all my selections. There's no club to join!

Expiration Date	Maximum Thank-You Value	
06/15/05	\$62.00	

- -
Please enter your American Express® Card account number above (required).

Your Name 6VF*

Street Address P.O. Box/Apt. No.

City State ZIP

www.americanexpress.com

DVD MOVIE SELECTIONS
Enter code numbers below:

1. <input type="text"/> Y <input type="text"/>	6. <input type="text"/> Y <input type="text"/>
2. <input type="text"/> Y <input type="text"/>	7. <input type="text"/> Y <input type="text"/>
3. <input type="text"/> Y <input type="text"/>	8. <input type="text"/> Y <input type="text"/>
4. <input type="text"/> Y <input type="text"/>	9. <input type="text"/> Y <input type="text"/>
5. <input type="text"/> Y <input type="text"/>	10. <input type="text"/> Y <input type="text"/>

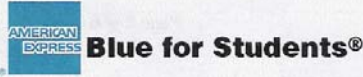
Claim your VIP Thank You before it expires!

Select up to 10 of your favorite DVDs for \$9.97 each – there's absolutely no club to join! Details above.

DVD Title	Code	DVD Title	Code	DVD Title	Code
A Beautiful Mind	Y42	Field of Dreams	YT3	Runaway Bride	YR9
A Few Good Men	Y75	Fried Green Tomatoes	YG8	Snow White	Y88
A Perfect Murder	YR8	Ghost	YR2	The Black Stallion	YA9
A River Runs Through It	Y65	Jerry Maguire	Y62	The Client	YT6
Air Force One	Y61	Kiss the Girls	YP6	The Fugitive	YQ3
Alfred Hitchcock: Collector's Edition	YH2	Legends of the Fall	Y69	The Natural	YT5
An Officer and a Gentleman	YR6	Les Misérables	YT8	The Perfect Storm	YE9
As Good as it Gets	Y78	Lucy: Queen of Comedy	Y57	The Pianist	YF6
Basic Instinct	YT7	Miss Congeniality	YQ5	The Second Jungle Book	Y60
Cinderella	Y82	Monty Python's Flying Circus	YT2	The Three Stooges Comedy Classics	Y56
Conspiracy Theory	YQ6	Ocean's Eleven	YQ2	Tomb Raider	YN4
Cool Hand Luke	YT1	Patch Adams	YT4	Trading Places	YR4
Dirty Dancing	YM6	Roman Holiday	YR5	Very Best of the Honeymooners	YE2

A typical payment envelope has a coupon attached to it offering putative rewards.

Exhibit 2



To manage your account online, visit americanexpress.com

Prepared For _____

Account Number _____

Closing Date **04/17/05**

Page 1 of 6

Previous Balance \$	Payment Activity \$	New Activity \$ inc. Adjustments and Finance Charges if any	New Balance \$	Minimum Amount Due \$
47.94	-47.94	+24.09	=24.09	15.00

Payment Due Date
05/12/05

Please refer to page 2
for important information
regarding your account

Credit Line Summary
on 04/17/05

Total Credit Line \$ _____


Available Credit Line \$ _____

Cash Advance Limit \$ _____

Available Cash Limit \$ _____

Are you concerned about managing your finances? Want help developing a monthly budget or spending plan? Visit our student Web site at www.americanexpress.com/student.

Contact us at www.americanexpress.com or call Customer Service at 1-888-BLUE-741.



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From April 4-May 31, 2005, take advantage of our special offers and rebates from top brands like KitchenAid® and Benjamin Moore®. And every day from May 10-May 23, the coolest home products and experiences are up for grabs at special Cardmember-only prices, including My Organized Home, a dream organizing package brought to you by REAL SIMPLE®. Check out www.mylifemycard.com/springhome.

Void where prohibited. Restrictions may apply. Actual items subject to change. Quantities on featured items are limited and will be sold on a first come, first served basis. See website for full terms and conditions.

Activity	Amount \$
03/22/05* COMPUTER PAYMENT RECEIVED - THANK _____	-47.94
<hr/>	
New Activity for _____	Amount \$
Card _____	
03/18/05 PAVILION PASADENA CA GROCERIES	18.11
03/24/05 PAVILION PASADENA CA GROCERIES	5.98
<hr/> Total of New Activity	<hr/> 24.09

American Express currently includes inline promotional messages, which are, however, not targeted at specific consumers.

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