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Dear Friends,

Well, this is a first. Since, 1992, I've sent out an annual letter recapping the year gone by and "predicting" what I saw for the year ahead. Typically, these letters are dated around Thanksgiving. Occasionally, they've not been finalized until December. Today, I'm sending the 2013 year-end letter in 2014!

If I think about the reasons for the delay, it is obvious that I was really busy for the last few months. Indeed, for the whole of 2013. I can't, however, point to any truly standout event that occupied my time. In fact, I kind of feel the same way about the industry we serve. Everyone was busy. Everyone had their head down and was working hard. Yet, there were no watershed moments. No sea change in products, competition, economy, consumer behavior, etc. Sure, some events that are largely attributable to prior years were finally resolved. And, some work done this year may prove pivotal in the future.

New products were launched, but unless they came from your institution or your nearest competitor, can you name a few? There were new entrants in several markets. Some even did quite well and beat their own expectations. But, did any of them really change the competitive landscape? There were new co-brand credit card launches. Our team even worked on some high-profile deals. But, how many of them were million-account plus programs like we used to see regularly? There was a lot of activity and commotion in the mobile space, but nothing that really took hold and changed the way consumers view financial services. There were no massive mergers, divestitures, or IPOs… although GE is slated to lead the way in 2014. While the regulators kept us all busy and on our toes, there wasn't any massive new regulation enacted in 2013. The economy was relatively stable… and even modestly improving.

So how did we all spend our time in 2013? Let's look back on the year and think a bit about where we might be headed next.

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Let's start with the banking industry, where US banks enjoyed record-high profits in the first two quarters of 2013. These pleasing results are largely attributable to the continued combination of cost of funds and loan losses being nearly as low as veteran consumer bankers have experienced in their careers.

When we zero in on the credit card business, portfolios are performing well but growth is slow. Credit card balances rose year-over-year for the first time in five years, but the increase was slight, and the FDIC characterized loan demand as "sluggish." While this may be true in the hotly contested prime segment of the market, we don't fully agree with that assessment. For the most part, great swathes of the population have been effectively cut off from credit:  students are persona non grata, people with thin files can't prove their ability to pay, and those with any dings in their past are passed over by many issuers who've lost the flexibility of re-pricing or who fear the reputational risk of being publicly pilloried by the optics of risk-based pricing. But, the few brave souls who do actively target the sub-prime market are seeing spectacular response rates to their acquisition campaigns. We are convinced that a significant opportunity exists to responsibly target and serve this audience.

Recovery has been slower in the UK:  all five major banks recorded a profit in the first half of 2013 for the first time since 2010, but return on equity is still at half pre-crisis levels. British banks face even more regulatory constraints than we have in the US, and with the supply of credit so constricted, many less affluent Britons are turning to payday lenders. With the sharp eye of the regulator now turning to this market, it is yet to be seen what will happen to this segment next.

The rebound of bank profitability is all the more impressive considering the enormous and still growing, cost of compliance. Bankers from both large and small institutions have described the crippling effects of the laborious processes they've been forced to incorporate to satisfy regulators. Perhaps there is some upside: even some vocal critics of the CFPB concede that the requirement to compile and track every consumer complaint enterprise-wide has, in some cases, led to better root cause analysis of processes and policies that create pain points. And there's been some payoff: Gallup reports that the banking industry qualifies for a Most Improved award in 2013, with an 18-point jump in its reputational rating, the biggest improvement in any of the 25 industries Gallup measures.

But it's come at a cost. In credit cards, worries about discretionary pricing and potential disparate impact make lenders shy away from any qualitative judgments or exception processes: instead of treating each customer as an individual, financial institutions are being forced into a one-size-fits-all model. Auto lenders are also cutting back on credit exceptions. But, lately, they are more likely to consider the payment history on similar collateralized obligations for applicants with less-than-perfect credit, thus allowing a controlled expansion into deeper buying. Mortgage lenders are facing a double whammy. The Qualified Mortgage Rule's ability-to-pay set 43% as the maximum permissible debt-to-income ratio, while the CFPB announced its intention to pursue practices as discriminatory even if they only unintentionally create a disparate impact on a protected class. It's not hard to imagine how these two mandates might collide.

The regulators, including the CFPB, obviously play an important role in protecting the banking system and protecting consumers from truly "unfair and deceptive" practices. Hopefully, we can strike the appropriate balance and meet those objectives without stifling banks' ability to operate, innovate, serve a broad spectrum of the population, and earn a profit in the meantime.

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Five years ago the industry was obsessed with credit risk; in the wake of reforms, attention turned to operational and regulatory risk. Now the talk is turning to interest rate risk. The dangers here are myriad: banks were already bracing for Basel III requirements to kick in; now many are seeing a drop in the value of their available-for-sale securities, driven by volatility in the bond market.

We all know that interest rates have been deliberately pushed down by central banks, and that sooner or later they are going to rise; it's not news. So it's particularly striking to look back at events, and non-events, in 2013. What happened in May? Nothing: Ben Bernanke made a comment about when the Fed's bond-buying program might end (which, he said, was not likely to be soon). The mere mention of an eventual end to quantitative easing caused the biggest single move in interest rates since 1962. The yield on the benchmark 10-year Treasury note jumped one full percentage point, a 62% increase in borrowing costs for the Federal government -- and also for mortgage borrowers. Home sales plunged, refinancing dropped precipitously, and major lenders like Wells Fargo and Bank of America wasted no time in laying off big chunks of their mortgage staffers. Ironically, when the shoe finally dropped in December with a very gentle introduction of tapering, stock markets responded with cheerful indifference, closing at record highs. Since the Fed took pains to couple the announcement of its $10B reduction in QE3 with the assurance that short-terms rates will remain near zero until unemployment drops below 6.5%, lenders and borrowers alike can relax their vigilance about one source of uncertainty in 2014.

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Over on the debit side of the house, things were looking pretty good at the start of last year. However reluctantly, issuers had come to terms with the new economics of the post-Durbin world. Slowly, through trials and testing, issuers were experimenting with ways to place a value on the services they offer with deposit accounts and debit cards. And then, on July 31st, Judge Leon dropped a bombshell of a ruling, tossing out the Fed's rule capping debit card transaction fees at 24 cents and suggesting that a seven-to-12 cent cap would be more in line with the Durbin Amendment's intent. In the ensuing chaos, the merchant coalition plaintiffs somewhat surprisingly supported the Fed's request for a stay while it awaits a review by the Court of Appeals, which probably holds things constant for another six months at least. But the chill is palpable as banks and credit unions look at their 2014 business plans and try to decide whether to proceed with BAU in the interim, or make contingency plans for a 50% or greater cut in revenue.

Interchange was not the only shocker in this ruling. EMV migration plans for debit cards were already mired in the struggle to settle on an Application ID standard for two unaffiliated networks, as required by the Durbin Amendment; Judge Leon's ruling would extend that requirement to both PIN and signature networks, a further complication that's caused debit issuers to place most EMV conversion plans on hold until the appeals process has run its course.

Ah, EMV… for how long have we been talking about this? Our London staff watches in bemusement, contrasting their organized migration and consumer education process with the lack of process, consistent vision, or even uniform acknowledgement of a need by US execs. While US pundits often point to the differences between US and International markets as the reason EMV is not as much of a "slam dunk" here, UK experts are convinced they are witnessing a slow-moving train wreck in the US. Only some of our US clients are undergoing comprehensive efforts to comply, and they are doing so reluctantly: they see the cost of implementing EMV outweighing the potential reduction in fraud, particularly since EMV does little to address CNP fraud. And the cost of conversion includes not just the more expensive card, but critically, the impact on customer service centers.

Most US credit card issuers are opting for Chip and signature, despite the fact that PIN authentication is more secure, to make the transition seamless for customers. But with debit cards still mired in the unaffiliated network issue, it will be difficult to coordinate migration of both cards, a source of particular frustration to banks that have been putting enormous effort into breaking down product silos and presenting "one face" to the customer. The date for the liability shift is set for October 2015, and since most are planning to issue the new cards as part of their overall 3-year reissuance cycle, they should be 1/3 of the way through by now, which is clearly not the case. Anticipating the need for consumer education and likely increases in customer service volume, no one wants to be first. At the other end of scale is the likelihood that fraudsters worldwide will concentrate on the dwindling number of mag-stripe cards, so no one wants to be last, either.

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Proponents of EMV, notably Visa, touted the technology's link to NFC as a mobile-commerce enabler. But NFC is looking increasingly DOA. For the last few years we kept hearing rumors that Apple's next iPhone would be NFC-enabled---it's not. Both Isis and Google Wallet, despite participation by heavy hitters, have failed to gain significant traction. While NFC has done well in transit systems, the need to invest in new POS systems to accommodate it has been a stumbling block for merchants, many of whom see more potential in the QR code + cloud approach reportedly favored by MCX, the merchant coalition that collectively accounts for roughly a trillion dollars in annual sales. Once again, retailers are showing more cohesion and focus than card issuers are, just as they did with Durbin. The debit card interchange battle was fought in Congress and the courts, but the struggle to define the shape and economics of mobile payments is a race to woo the consumer, and merchants have most of the leverage to do so.

While it may seem that the industry has been spinning its wheels for the last five years or so, with bold pronouncements every January that <u>this</u> will be the year that mobile payments <u>really</u> take off, we've actually learned quite a lot.

Starbucks aside (a closed-loop prepaid system), most of the mobile payments we hear actual consumers talking about are simply an extension of online commerce and pose no threat to the current paradigm. In our office, people love to avoid long lines by using their smartphones to buy tickets for the ferry or place pick-up orders at Chipotle. From the standpoint of the issuer, the challenge is to be the card chosen when the app is set up: once you're in, all those subsequent Amazon Prime or Seamless orders will go to that card---not unlike recurring billing. Once that habit is established, though, what if more merchants decide to steer the customer to replace the debit or credit card with an ACH number as Fresh Direct and others are already doing?

Decoupled debit, first introduced by Capital One in 2008, is experiencing a groundswell of interest among retailers. Target's Red card is probably the best-known, with its compelling 5% discount. Nordstrom's product offers the same loyalty points as their co-branded credit card. ACG believes that several other retailers will be introducing their own versions in the near future. These proprietary debit cards hearken back to the heyday of private-label cards (PLCC). Most consumers eventually tired of carrying multiple store-specific cards; however, as mobile wallets evolve from early efforts to create a proprietary instrument to current "agnostic" designs, they make it easy to carry many virtual PLCCs. Apps have been developed to automatically pick the payment card with the best value proposition for any specific transaction. Ironically, mobile may be both the future of payments and an enabler for the re-emergence of discarded product variations.

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I started this letter by suggesting that nothing truly significant happened in 2013. Of course, we did end the year with an event that can't go unmentioned. It seems that some low-life creeps hacked their way into the systems of Target and stole account information for up to 40 million consumers.

The situation has been discussed extensively. Be it in the press, over the dinner table, or on the conference call that ACG hosted for over 70 clients the day after the story broke, and doesn't need to be elaborated upon by me. Many questions still remain and the full impact is far from clear, however. For some time, we'll be debating topics including the industry's responsibility to protect customer data, the potential impact on EMV migration – including a renewed debate around Signature vs. PIN, the pros and cons of decoupled debit, customer experience (whether or not to re-issue, limit cash withdrawals, etc.), and regulatory scrutiny. All of these topics and more have strategic implications on many stakeholders in the payments ecosystem.

The thing that bothers me most, though, is how Target and the card issuers have been painted by the press and consumer advocates as the bad guys in this situation. Usually, when something is stolen, the "bad guy" is the criminal who took the item, not the party it was taken from!

Herein lies just the latest example of our industry's inability to properly tell its side of the story... whatever that story may be at the time.

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I can't conclude this letter without sharing some of the "family" news about our firm's growth and development.

- We recently launched our redesigned website (www.acg.net). The new website provides a streamlined user experience that includes: dedicated landing pages for ACG's lines of business; a topical News section that includes articles written by our Subject Matter Experts; a range of case studies; and more---including this and past years' Annual Letters.

- Our **Industry Roundtable** business continues to grow, with new groups, geographies, and functionality. The introduction of VIZOR, our new analytics platform, will help clients contextualize benchmark data and enable greater opportunities to customize reports to their specific needs.

- Demand for **Operations Consulting** has been driven, in large part, by lenders' desire to ensure operational compliance. ACG designed and launched its Collections Certification process to recognize lenders that excel in managing regulatory and compliance risk while simultaneously delivering superior collections performance. As a result, we evaluated and certified our first top-15 bank.

- ACG's **Partnerships** team has had a very busy year, supporting brand partners, issuers, processors, and networks around the world for both transactional and strategic consulting engagements. Although we played a role in some of the most significant deals of 2013, details of most of our current and recent engagements must remain confidential**.**

- Our **Corporate Finance** group is expecting to launch the ACG Card Index to track and forecast the health of the credit card industry. Drawing on both publicly available and our own proprietary data, our quarterly Index will consider profitability (of issuers and other major industry players), consumer sentiment, credit risk, and the regulatory environment. And of course we continue to provide strategic and transactional support to our clients, including advising on the sale of a major airline portfolio.

- Consumer research from our **Payment Insights** group has been featured in publications ranging from the Wall Street Journal and the Boston Globe to The American Banker and Payment Source. Market studies have covered topics as widely ranging as country market entry decisions, best practices in subprime lending, rewards optimization techniques, and prepaid product design.

As always, the team and I would welcome the opportunity to discuss these or any other topics---give us a call at 212.323.7000. In the meantime, best wishes from all of us at ACG for a happy, healthy, and prosperous 2014!

Michael Auriemma