AURIEMMA CONSULTING GROUP, INC.
CONSULTANTS TO THE
CONSUMER FINANCIAL SERVICES INDUSTRY

MICHAEL AURIEMMA
PRESIDENT

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Dear Sir or Madam:

My head hurts!

This has been a challenging year for the card industry. It seems we are beset on all sides by opportunities and threats, including mergers, legal and regulatory actions, consumer and merchant outcries, and of course competitive pressures.

Within the industry, issuers continue to adjust pricing levers and product enhancements to meet consumer demands in an effort to eke out market share and profitability growth. The biggest gains, however, have come from mergers and acquisitions. Issuers continue to do battle in an arena that is fiercely competitive, in spite of claims from outsiders that the credit card market is non-competitive. The distribution of market share among leading issuers alone suggests there is more competition in our business than in many other industries.

Over the past 15 years, as annual fees disappeared and interest rates fell into the single digits, issuers protected margins by bolstering late, overlimit, and other fees. Now, as these have come under attack, there seems to be a trend brewing to curtail them as well. With significant pressure on interchange, no sign of abatement in the teaser rate department, and increasing minimum payment requirements, it is difficult to imagine how we will generate future profits at historical levels.

I will admit too, that the interchange debate confuses me. With several "dyed-in-the-wool" retailers on our team, you can imagine that our lunchroom conversations are quite spirited! Some contend that retailers have a wonderful opportunity to accept plastic with virtually no risk, for only a small percent of sales. The counter is that interchange is out of line with issuer costs and risks. Of course, that leads to the old cost-based versus value-based pricing debate (one which, by the way, is not unfamiliar to consultants!). The cost-based contingent believes that debit usage replaces check payments. Since checks can be deposited for a few pennies, so too should debit transactions. The value-based advocates meanwhile, cannot understand why the price of accepting credit and debit ought to be different, despite court rulings. The value to the retailer is the same. Australia has already fallen victim to the cost-based approach, and the consumer seems to be suffering. The UK appears headed down the same path, but the market is fighting valiantly to maintain the current structure. I'm not sure that this debate will ever be resolved in Westbury!

So, how has the industry responded to all of this adversity? Well, MasterCard has announced plans to float an IPO, while Visa will restructure the make-up of its board. Each hopes that these moves will add to both the real and perceived level of independence of their governance. The potential certainly exists, but time will tell whether these strategies facilitate the ability of the associations to evolve the payments systems while balancing the interests of banks, merchants, consumers, regulators, and shareholders.

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Issuers have continued to consolidate, with MBNA, Metris, and Providian all either merging or announcing sales in the last six months. UK issuers continue to show strong interest in expanding their presence in the US. And it appears that "what was old, is new again," as combining card and retail presence appears to be back in favor. Washington Mutual's purchase of Providian and Wachovia's re-entry announcement being further indications of this trend. It seems branches are re-emerging as an effective and viable source of new account acquisition. We think Bank of America and Wells Fargo have known this all along!

While we sometimes lament the lack of innovation in the card business, this past year saw the launch (or at least the test) of several interesting developments. Among those is Capital One's product which eschews interest rates for flat fees depending on balance tiers. Bank of America's Keep the Change program is another that springs to mind. But, perhaps the most ambitious attempt at market changing innovation is RFID, led by Chase's Blink. This is the first attempt at a significant advancement in functionality since the brief rise and fall of smart cards in the US. Will RFID succeed where chips failed? It seems to have a head start, in that the basic product offers the advantage of speed and convenience for both consumers and retailers. Will that be enough? It is hard to tell. Perhaps it depends on the ability for the product to continue to add functionality. While the smart card seemed to have limitless potential, it never really made it off the starting blocks in the US, despite mass issuance in the UK. RFID has a nice early advantage, but will need to show promise in the months to come if it is to prove more than a fad.

It seems inappropriate to call prepaid cards "innovative," although there is certainly innovation in prepaid applications. A whole new host of issuers, processors, and vendors are emerging to satisfy this market. It is hard to engage in a conversation about the card market these days without the subject turning to prepaid. Unfortunately (or perhaps fortunately for consultants), more questions than answers remain at this point. The most common and important of those being simply, "Can I make money on prepaid?" Of course, we have an opinion on the matter. But to paraphrase the CIA "we could tell you, but then we'd have to bill you!"

Debit cards are another product which have certainly made great strides over the past few years. In our last annual letter we announced that debit had officially outpaced credit spending globally. Debit spending is now in the lead in terms of the number of transactions in the US as well. We are not surprised by debit's growth in certain markets (e.g. quick serve restaurants and online bill pay) but we are occasionally shocked by the magnitude of the findings. Recently, for example, a cable provider told us that nearly two-thirds of its recurring payments made on plastic were debit, not credit. That is amazing. After decades of trying, it seems debit is finally stepping out of the shadow of checking accounts and becoming a viable, stand-alone product.

So, if that is what the industry is up to, you may be wondering how ACG has spent its year.

As you may have heard, an ever expanding portion of our time is devoted to our Industry Roundtables practice. We continue to secure our status as the premier source for independent, accurate, and actionable benchmark studies. This year we conducted over 70 benchmark studies on topics as broad ranging as payment trends, customer service sales rates, collector "right party contact" rates, Hurricane Katrina response policies, and the effectiveness of alternate marketing channels.

More Industry Roundtables are being formed as we speak. In fact, we expect groups in Compliance, Human Resources, Debit Card Marketing, Retail Bank Fraud, and Auto Lending Origination to be launched over the next several months. Additional groups are being planned for the balance of 2006, and we welcome your suggestions on topics of interest.

We can also now be considered one of the industry's leading experts in best practices across most functional disciplines. Our knowledge in areas such as customer service, collections, portfolio management, and fraud prevention have led to some exciting and challenging assignments. Two of our favorite examples include redesigning an issuer's approach to assigning credit lines at acquisition, and developing the business case for adopting a new workflow system. Given the industry's continuing shift to ever larger portfolios, even modest changes in policies and procedures can have a significant impact on the bottom line. We are proud to have been trusted to help issuers design and implement rational operating models in their attempt to gain or maintain competitive advantage.

Process management is a natural offshoot to our work. As such, two of our recent hires have significant Six Sigma experience. Whether or not you buy into a prescribed methodology like Six Sigma, it is hard to contend that a disciplined approach to business management isn't beneficial. We would be thrilled to engage your team in a discussion about setting up process and policy reviews, and determining metrics for your organization to ensure mission critical issues are being properly addressed.

Since the prepaid card market is so rife with open questions, the team of consultants we assigned to this market have become quite busy. While they learn more each day, they have already set about educating industry players, assisting in product design initiatives, and rationalizing operating platform decisions.

It goes without saying that we continue to work on a wide variety of alliance development assignments. Mirroring industry activity, much of our work has focused on retail programs. It is interesting to note that a large percentage of our recent assignments have been helping issuers to understand, compete for, and win deals. It is exciting to use our skills on that side of the table in an effort to balance winning with creating rational ventures.

Our Knowledge Management (née Competitive Intelligence team) has expanded to provide additional in-house capabilities which will allow us to better serve our clients. In addition to a variety of client specific assignments, the unit has covered several interesting topics in recent issues of Cardbeat®, including RFID, prepaid cards, effectiveness of credit card TV advertising, and consumer valuation of rewards programs. Our Knowledge Management team is a competitive bunch that loves a good challenge. Next time you need insight into a complex issue, give them a chance to show off.

Yes. It is a challenging marketplace. But, as we step back, it doesn't take long to realize that those challenges make it an absolutely fascinating environment in which to work. Most of the players in the business have stepped up, met those challenges, and continued to thrive. It's no wonder that the folks at ACG wake up every morning eager to go to work on behalf of our clients.

What a thrill! Thank you for giving us the opportunity to participate for another year.

Sincerely,

Michael Auriemma

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