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CONSULTING GROUP
NEW YORK · LONDON

MICHAEL AURIEMMA
President

December 8, 2008

Dear Sir or Madam:

***Fortune gives us nothing which we can really own. - Seneca***

The Romans believed in many gods. Fortune, the first born of Jupiter, was the goddess of fertility. Over time, the concept of fertility came to include money, advancement, and so on. When pictured on Roman coins, Fortune held a cornucopia in one hand – symbolizing her power to bestow favors. Many of us, whether or not we believe in Roman gods, have been blessed over the years with good fortune. We have succeeded in our careers, earned respectable livings, and been part of a fabulous and prosperous industry.

In Fortune's other hand was a rudder – symbolizing the fantastic speed with which she could alter our course. Fortune has played her hand in our community over the past year.

The philosopher Seneca defines "frustration" as when our wishes do not conform with reality. In his view, one can only obtain wisdom by learning to understand these conflicts and to control our reactions. Seneca's philosophy suggests that we best endure those frustrations for which we have prepared ourselves. How many of us saw the current financial crisis unfolding in time to truly prepare? How many of us foresaw the true depth of the crisis? More importantly, which of us can foretell what will unfold next?

I would argue that the future remains unclear. Certainly, there will be more deterioration, but how much, and for how long? Certainly, there will be a recovery, but how soon and how strong? Those answers are simply not available today. So what should we do? We need to accept uncertainty. We need to learn to survive, and indeed to thrive in a less predictable market.

Over the past year, we have encountered many individuals and institutions that seem to be seduced into inaction. They suffer from the "deer in the headlights" syndrome: I can't act. I can't launch new projects. I can't plan for the future.

The individuals and institutions that will survive this crisis and become stronger on the "other side" of it will be those that overcome this complacency. They will be those that understand the risks; that embrace the fact that the path will more likely change than remain the same. As such, they will design products, pricing strategies, alliances, etc. with flexibility in mind. They will invest in data and information, and will learn to operate in a new paradigm rather than wait for the storm to blow over.

We have begun to see signs of this new attitude in more (but by no means most) of our conversations with clients. We applaud those intrepid leaders who are willing to venture forward, and hope and trust they will be rewarded for their thoughtful actions. We stand ready to support and serve them in their quests.

As is our annual tradition, Auriemma Consulting Group (ACG) has prepared a report which discusses our view of the significant trends and issues shaping our industry. We discuss what is happening in the world, and how we are dealing with it from our New York and London offices. In a shift from tradition, we are making the report available online, rather than sending hard copies (an attempt to reshape our own activities, in light of market conditions, without sacrificing our goals).

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To access the report, please visit www.acg.net/letter.pdf. Feel free to share the document with your colleagues as you see fit. And, of course, if you would like a hard copy, please let me know. I can be reached, as always, by phone at 516-333-4800, or email at michael.auriemma@acg.net.

This has been a challenging year; 2009 will be better. We look forward to the possibility of navigating this storm at your side and to celebrating with you when it passes.

Sincerely,

Michael Auriemma

MJA/kt
Enclosure

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# ACG Annual Update

**December 8, 2008**

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## US OVERVIEW

Anyone who has ever constructed a financial model knows that they typically forecast three different scenarios: Best case, worst case, and expected case. It's safe to say that what we experienced in 2008, and what we expect in 2009, is the worst case.

Our industry is in its most serious crisis in nearly 30 years as we enter 2009. Card issuers and consumer lenders will be challenged like they haven't been in a generation. In 2008, delinquency and chargeoff rates rose sharply, largely the result of the depression in the housing market, where home foreclosures reached record levels. Many people who had relied on mortgage and home equity borrowing to supplement their incomes found those sources disappear as property values deteriorated and banks reined in borrowing limits.

Now consumer spending is falling and is expected to get even worse. Consumers who must carry a balance are borrowing more but paying back less. Our consumer research publication, Cardbeat®, found that among those cardholders who revolve, average balances increased 22% last year. Meanwhile, the payment rate fell more than three percentage points, to 17.4%. The rising unemployment rate just makes the situation even more dire. Lenders have been left holding the bag, and the bag is splitting on all sides.

While losses mount, borrowing costs have climbed. Banks have not been able to tap the securitization market, a main source of funding for card and consumer lenders, as buyers have left the market. Spreads have widened, and new issue volume has fallen sharply. As this market has proven to be unreliable, lenders have had to seek more expensive alternatives. We would not expect this situation to change until the capital markets return to something close to normal; even then, the high expected loss rates will make for a tough sell on a triple-A-rated security.

As if the credit crisis doesn't provide enough of a challenge, lenders will also have to deal with increasing legal and regulatory burdens. These will further impact revenues and make it harder for banks to respond through higher pricing and stricter cardholder terms. Proposed changes to "unfair and deceptive acts and practices" (UDAP) would prohibit lenders from raising interest rates on existing balances, among other things. Congress may also pass legislation that would regulate and possibly eliminate interchange fees.

Yet, it's important to keep in mind that today's economic environment might be even worse if not for some regulatory changes over the past few years that reined in bank's risk exposure. Three years ago, banking regulators worked with banks

## US OVERVIEW (Continued)

to raise minimum payments on credit card balances to prevent negative amortization situations and to change re-aging policies to more appropriately reflect the underlying risk of certain delinquent accounts.

Similarly, regulators worked with monoline credit card companies to mitigate their exposure to unsecured lending and to the securitization market for funding. Today, only a few, small monolines remain, the rest having become multiline bank holding companies or having been acquired by them. How much more precarious might their situations be right now had these moves to diversify their business not been made?

It's fortunate, too, that those deals were made when they were, and not during today's crisis atmosphere. MBNA, for example, is now fully integrated into Bank of America; Capital One has absorbed its commercial bank acquisitions (notwithstanding its recent Chevy Chase Bank acquisition). Washington Mutual's purchase of Providian several years ago no doubt will make its forced integration into JPMorgan Chase go that much smoother. It's quite possible that some of these former monolines, had they stayed independent, might not have been able to find a buyer in today's environment.

Similarly, if not for the public stock offerings of both MasterCard and Visa, now publicly traded independent entities, the situation for their member banks might be even worse. Thanks to stockholder capital, the two networks were able to absorb the combined $8 billion settlement with American Express and Discover, shielding their member banks from further financial damage. How long ago those court cases now seem in the light of today's even grimmer problems. It's extremely fortuitous that those events took place when they did, and are not still hanging over the industry. What's more, the independent Visa and MasterCard now provide a source of much needed funds for the banks, now that the banks are able to sell their shares in the two networks, each of whom has experienced dramatic growth in share price since their respective IPOs, despite the recent pullback in the stock market overall.

Despite the global crisis and financial markets shakeout, there remain areas of growth and opportunity in our business.

We're impressed by the growth of the alternate payments industry, particularly PayPal. In 2008, the eBay unit reached an important milestone, as its volume of transactions at other merchants exceeded those at its parent company. The eBay unit continues to grow by 25% in transaction volume annually, and stands to grow even larger following its acquisition of Bill Me Later. While still quite tiny, PayPal may soon expand into the brick-and-mortar retail world, challenging traditional payment methods.

## US OVERVIEW (Continued)

When will the improvement begin? We simply don't know. The recovery in the housing market will no doubt lead the way, but that market has yet to hit bottom. Perhaps now, with long-term mortgage rates starting to fall, people will begin buying again, lifting or at least putting a floor under home prices. But the unsecured consumer lending business, which trailed the housing market down, may not recover until well after home prices start to improve. Indeed, we haven't yet seen the credit tightening in the credit card market that we've already seen in residential mortgages and auto lending. We are perhaps only at the end of the beginning of what will likely be a long and painful period for the US consumer finance business.

We are confident, though, that even in markets as bad as this, opportunities will present themselves, and smart companies and managers will create their own opportunities. The credit card business is nothing if not resilient. The industry has been through tough times before, and lenders have always been able to adapt. These are tougher times than any of us have ever experienced. We are using ingenuity and flexibility to help clients manage through the crisis.

## THE UK PERSPECTIVE

Just as in the US, cards and payments organizations in the UK will be challenged in 2009 to do more with less and generate more revenue from existing customers. While the consumer credit crisis in the UK isn't as severe as in the US – at least not yet – payment processors, issuers and co-brand partners are watching developments closely in order to be prepared.

Lenders have become highly risk averse, and new investment is limited. Generating new originations has become very much a secondary consideration. However, ACG believes that opportunities to differentiate still exist. Perhaps now is the time to start planning and challenge existing and established paradigms.

Given the attention to retaining good existing customers, ACG believes issuers should be more heavily focused on customer service and stronger value propositions than ever before. Not only will this resonate with customers but also with the regulatory authorities, who have a powerful role to play in the shaping of the industry going forward. They should also consider more aggressive targeted rewards offers to increase spending, which retailers expect to be very poor in 2009.

One of the battlegrounds in 2009 will be share of wallet. The gauntlet has been thrown down to the industry to develop an innovative, game-breaking proposition. There are a number of different propositions that are beginning to emerge, but one consistent theme is that the consumer is going to be better rewarded for good behavior.

With interest income and payment protection insurance (PPI) premiums likely to be under pressure, issuers are going to need a fundamental review of their cross-selling strategy. ACG finds it ironic that just as PPI has been under its fiercest criticism, the need for the product has never been greater.

We are also seeing a surge in interest to exploit the potential growth in prepaid cards. While the commercial model is still evolving, companies need to look at how prepaid cards can complement credit offerings. They also need to explore potential new segments, such as the underserved and overseas markets. Much of this drive is being led by the retailer community.

It's also only a matter of time before retailers begin to look at de-coupled debit. While the product has had some difficulty taking off in the US, de-coupled debit could be an exciting opportunity for UK retailers with strong brands looking for ancillary income streams.

Despite the hype, contactless cards are not catching on with UK consumers as much as issuers and networks would like us to believe. According to the UK version of our Cardbeat publication, only 3% of UK consumers hold contactless

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## THE UK PERSPECTIVE (Continued)

cards. Rewards and APRs, as opposed to the convenience of technology, are still the prime motivating factors for consumers in choosing which card they use. Feedback from retailers also suggests that contactless technology is failing to meet expectations. McDonalds reports very low usage at its restaurants and has had problems with equipment. Boots, the UK pharmacy chain, said bank card transactions cost it significantly more each year than cash. Banks and payments networks may need to lower long-term merchant service fees to attract merchants.

Collections and Recoveries is the area in most demand in our consulting practice in the UK. We are helping lenders develop solutions for pre-delinquency activity, finding the right balance between regulatory compliance and best commercial practices, and general operational and performance improvement. In 2008, we added three new Industry Roundtables in the UK – Recoveries, Financial Reporting, and Compliance – and plan to launch a Sales & Service forum in 2009.

ACG's International practice is managed out of its growing London office, which is now headed by Matt Simester, formerly a senior executive at Barclaycard and a 20-year veteran of the financial services industry. Since the office's opening in 2006, the scope and scale of client assignments have testified to the importance of having local market expertise allied with international best practices as the cards and payments industry operates more and more on a global scale.

## COLLECTIONS AND RECOVERIES

As 2008 nears an end, lenders and borrowers are suffering through one of the worst and tightest credit environments ever, certainly since the late 1980s and early 1990s. But as the unemployment rate only recently has begun to spike, it's likely 2009 will be even worse.

But the worsening delinquency and net charge-off numbers are only part of the story. Consumer behavior and attitudes toward debt repayment have changed dramatically. Lenders must be prepared to be able to respond.

Delinquency rates are up across all lines of consumer finance. Lenders are seeing loans become uncollectible at much earlier stages, as well. Customers 60 to 90 days delinquent now have a much higher propensity to charge-off than in past years. More troubling, a large number of consumers are rolling straight through delinquency without making a payment. Similarly, as we note in the Auto Lending section of this report, lenders are seeing a rising volume of voluntary repossessions, with about a quarter of them from borrowers who were still current on their loans.

Personal bankruptcy rates are climbing despite the passage of the federal bankruptcy reform act, which was designed to make filing tougher for consumers. After an initial drop in filings following passage of the act, bankruptcies are rising sharply again. In the first half of 2008, personal filings were up nearly 30% over the same period of 2007 and at about 75% of pre-reform act volumes. At the same time, more and more of these customers are defaulting on loans and moving to chargeoff without filing for bankruptcy. We are now in a situation where collectors are contacting borrowers who are willing to pay but simply can't.

These developments have put tremendous pressure on account collectability, challenging lenders to reconsider their approaches, from strategy development to collector scripts. In turn, this raises questions about settlement criteria, general productivity, development of new tools, and even new contact strategies such as "pre-delinquency" collecting. We have been following the pre-delinquency movement for many years. One of the more obvious risks of applying collection strategies to current accounts is making sure that you are contacting more of the people who really are going to turn delinquent while not alienating good customers.

Another trend we have seen is the drop in telephone contact rates. Although the telephone remains the mainstay of any collections department, customer contact rates have been plummeting since mid-2006. Customers have become savvier, knowledgeable of the regulations, and influenced by the debt settlement advertising blanketing the airwaves. In response, lenders have adapted by being more creative in other channels, such as internet portals, email, text messaging, field agents, or letters. ACG has always encouraged outside-the-box thinking and

**COLLECTIONS AND RECOVERIES (Continued)**

has continually stressed the importance of the Internet as a channel that should be pursued. When we first began discussing it, fewer than 5% of our clients used the Internet for collections. Now more than 30% have internet collections capabilities, and that figure is growing.

In addition to changes in technology, some lenders have tried novel motivational tactics to try to establish customer contact, such as offering gift cards, phone cards, or gas cards to get customers to call. Some lenders have gone as far as offering to match customer payments as a way to improve contact and repayment volumes.

Not surprisingly, in this environment, recovery rates have also deteriorated.

Asset sale prices continue to slide. Prices for contractual paper have declined by more than 50% since the beginning of 2008 and continue to fall. Lenders may need to rethink the cash flow addiction of selling charged-off loans and, at least temporarily, diversify by either using in-house recoveries or collection agencies.

Even as prices have dropped, we expect to see an increase in loan portfolio sales over the next 12 months as lenders look to shed more of their bad assets as a means to raise cash. In recent months, we've seen unique ventures spring up outside the traditional collection agencies to buy distressed debt and other portfolios. These new ventures include hedge funds looking for opportunistic investments. Some of these new players have engaged ACG to help evaluate portfolios and broker portfolio sales.

Clearly, the profile of a delinquent customer has changed, as have the types of treatment strategies lenders need to mitigate loss. This is an area where ACG is helping clients understand and adapt to the changes. Our Knowledge Management team can provide detailed studies on consumer behavior and motivation, the first step in knowing what you're up against. Our seven collection and recovery roundtables across credit card, mortgage, and auto lending in the US, UK, and Canada provide industry benchmarking, yielding insight into lender productivity and effectiveness. Our benchmark studies, combined with our best practice meetings, drill down to the underlying business drivers that are shaping this new credit environment. For example, our recovery benchmark studies provide industry liquidation rates which can be used by management to understand how the various recovery channels are performing. As a result, our clients have the data and information they require to react quickly.

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## COMPLIANCE AND REGULATIONS

The card industry is on the cusp of a regulatory and legislative overhaul that will have a major affect on issuer finances and in how they deal with their customers.

One of the most impactful changes is contained in a bill passed by the House Judiciary Committee last summer that, if enacted into law, would essentially regulate, if not eliminate, interchange fees. With their finances already squeezed by loan losses and decreases in new loan volumes, banks are more dependent on interchange than ever. The pain would also be acutely felt in the debit card arena, a relatively low-margin product with fewer revenue sources compared to credit cards.

Should the bill be signed into law, consumers could find themselves having to pay to use their credit and debit cards, either through the reinstatement of annual fees, the elimination of grace periods or some other kind of user surcharge. Alternately, rewards, now common on debit as well as credit cards, might have to be scaled back dramatically. It might be instructive for US legislators to study the negative impact on consumers when the Australian banking authority interceded in the free market and regulated interchange. In that case, there is no evidence that lowering interchange fees led to merchants lowering prices to consumers. And yet, those merchants were allowed to impose a credit card usage surcharge.

Another transformational change regarding “unfair and deceptive acts and practices” (UDAP) – being driven by both Congressional and regulatory bodies – would prohibit lenders from raising interest rates on existing credit card balances, among other things. If fully implemented, this measure stands to cost banks a lot of money. In addition, in order for issuers to comply with the proposed changes and attempt to maintain returns at or near current levels, there may be some unintended negative consequences for consumers. Issuers may respond by restricting credit to certain segments, eliminating promotional incentives, or possibly raising initial interest rate and fee offers.

At this point, most of the card industry has already eliminated the practice of universal default, another UDAP target. ACG has to wonder why issuers are permitted to consider a consumer’s borrowing and payment history before approving a new credit application, but not permitted to use that same information once the lending decision has been made. We believe this restricts the tools issuers have to manage portfolio risk. Certainly, that can’t be what banking regulators want to impose. In response, issuers will be resourceful and find new ways to identify cardholders’ ability to repay by considering buying behavior, payment patterns, and even where they shop.

On the bright side – if we can call it that – the dismal economic climate might actually work in lenders’ favor on the regulatory front. With lenders already under enormous financial pressure from loan losses and trying to avert failure,

## COMPLIANCE AND REGULATIONS (Continued)

regulators might be more inclined to be sympathetic and ease up on banks' requirements and prolong the implementation date of these rules. While this won't put off full implementation forever, it would give banks at least some of the breathing space they're going to need.

As if the legal and regulatory challenges aren't enough, lenders will also face potentially more restrictive accounting rules that will make it tougher to operate. The Financial Accounting Standards Board (FASB) is considering significant changes to FAS 140, which would force companies to hold on their balance sheets securitized assets that right now they are permitted to keep off the books. While FASB has deferred the issue for now, it may be implemented in 2010.

ACG is attempting to help our clients remain as informed as possible in order to prepare for the coming industry transformation. We are currently focusing on these issues in our compliance forum and industry briefings. In partnership with Morrison and Foerster, we will be hosting several briefings in early 2009 to help the industry understand and interpret the final rule changes as well as facilitate the discussion on implications of how business will be affected. We are also using our accounting policy and financial reporting forums in the US and UK to help clients manage through these challenging times. Through a variety of avenues, we are helping issuers anticipate, understand, and prepare for this new, more highly regulated environment.

## OPERATIONS

Despite the difficult environment we will face in 2009, businesses still need to continue to operate and serve their customers in order to stay afloat. Just about all organizations will be working with fewer resources and fewer investment dollars while delicately balancing customer loyalty, quality, and retention. But historical trends, data, and operating models are not reliable anymore as a guide to help companies stay ahead of the curve. Companies will need new ways to face the challenges that come their way.

ACG's Industry Roundtables and Benchmarking practice has evolved to meet the unprecedented challenges that companies witnessed in 2008 and will continue to do so in 2009. Every company faces a variety of decisions that need to be made when serving its customers. Our Industry Roundtables are forums where members can learn to validate, adjust, refine, or, if need be, completely overhaul their operating approach given the current conditions. Some of the challenges that we addressed in 2008:

**Card Reissuance**: Lenders continue to be plagued by data compromises, both small and large. Every company has its own approach to deal with them. If an account has been involved in a compromise, a lender must carefully weigh many variables before deciding whether it's necessary to issue a new account or monitor the existing account's behavior. That decision requires a delicate balance between the cost of the reissuance, loss management, marketing, customer satisfaction, and brand image. Our Industry Roundtables allow lenders to formally and informally discuss each scenario and gather supporting benchmark data to help determine the best solution for their organizations.

**Offshoring**: Over the past few years, the industry view of offshoring operational functions has been evolving as issuers balance human and financial resources and customer satisfaction. Reducing expenses has become paramount at many banks. As a result, there is a renewed interest to offshore and outsource more activities. But even the strongest proponents of offshoring recognize that it is not always the best solution for every function. While some choose an offshore model, others look at alternatives such as improved technology in the IVR, improved routing capabilities, Internet self-service models, low-cost domestic locations, work-at-home reps, or even satellite offices.

There is no industry standard, no right or wrong way to handle any of these issues. Each organization has its own level of tolerance for what is acceptable from an expense as well as a customer satisfaction point of view. By discussing these issues and learning how their industry peers handle them – and measuring the results through benchmarking – ACG roundtable members learn what works and what doesn't. They receive as much information as possible to help them make smart decisions appropriate for their organization.

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## OPERATIONS (Continued)

ACG tries to facilitate learning by helping clients understand the risks and rewards of the decisions they make.

These discussions not only help companies make smarter decisions, but they short-cut the process, enabling expense reductions. For example, in one ACG roundtable, we created a Technology Matrix for our members to use. With this matrix, members gain insight into what technologies are being used, how they are used, the pros and cons of each, and points of contact. While individual companies must do their own testing and due diligence, they can get a better idea from their discussions with peers about what technologies might work best in their organizations.

As the industry confronts unprecedented challenges in the months and years ahead, with little guidance from history, it will be more important than ever for managers to meet and talk with their peers about the similar issues facing them. By doing so, they are better prepared to meet each new crisis as it presents itself.

## KNOWLEDGE MANAGEMENT

Going forward, there will be more significant pressure on banks and financial institutions to increase revenue to offset the dramatic rise in both losses and cost of funds. Companies will need to think differently and better substantiate their decisions in 2009 if they are going to be one of the survivors. Several organizations have recently launched new initiatives to help them survive – and prosper – during the current downturn. Here are just some of the new ideas ACG found notable:

- Launching new products and augmenting existing ones. For example, MasterCard rolled out MasterCard IPS, a platform that processes debit and prepaid card transactions and going forward may also process credit cards.
- Offering existing customers more of the company's products. Even prior to their merger, both Washington Mutual and JPMorgan Chase had put much more emphasis on selling credit cards into their retail customer base.
- Building infrastructure around profitable niche areas, especially those relatively insulated from economic downturns and with fewer competitors. The partnership between CardPartner Inc. and UMB Financial Corp. has moved into a previously unserved space, serving the needs of very small affinity groups.
- Partnering with other firms that can provide access to new areas of business. PayPal bought Bill Me Later, the other major player in alternate payments, decreasing its reliance on parent eBay.
- Expanding into new markets. ACG helped a bank investigate merchant categories that had not yet been penetrated by co-branded programs.
- Learning new business methods to perform more efficiently. A company hired ACG to document best practices for retention and activation marketing in both credit and debit cards.

We think there's even more that can be done. ACG recently helped a retailer that was considering the launch of a small business credit card to expand its product offerings. We provided the company with a competitive overview of the business and industry best practices for a successful start. A non-bank entity considering a charter for an industrial loan corporation retained us to evaluate whether the timing for such an application was right. Following our analysis, the company decided to move forward and its application for an ILC is currently pending. On behalf of a multinational bank, we did a competitive analysis of the consumer credit market in Portugal, with a particular emphasis on how credit cards are being marketed through various channels. These were all exciting initiatives that enabled our clients to engage in new activities with more intelligence and assurance, and we expect companies to require this sort of rigorous analysis even more often next year.

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## KNOWLEDGE MANAGEMENT (Continued)

Our Knowledge Management team brings a varied background of expertise, including best practices in card operations, customer service, risk management, marketing, competitive and business intelligence, strategic planning and new product development. These areas will be important elements in the thought process as companies venture forward and evaluate new business opportunities in a treacherous environment.

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## CONSUMER BEHAVIOR

Perhaps now more than ever, understanding the drivers of consumer behavior will be critical to business success. Cardbeat, ACG's flagship market research service, which begins its 15th year of publication in 2009, provides subscribers with up-to-date, reliable data about what consumers are thinking, how they behave, and what motivates them to use their credit cards.

Our subscribers are clearly focused on investigating the drivers of card value in the eyes of consumers, with attention to how these propositions can support portfolio profitability. Though the topics covered in Cardbeat have a history of being diverse, a primary theme in the subjects covered over the past 12 months has been identifying low-cost ways for issuers to add value to their customers. Our clients are commissioning topics and questions in the survey that reflect these priorities, and they are requesting customized data sets and analysis of our results.

The topics covered in the US edition of Cardbeat during 2008 included reward program valuation, mobile banking, fee services, core card benefits, and integrating retail banking with credit card strategies, among many others. Some findings that helped subscribers revisit or shape their strategies include:

- In the US, the percentage of consumers who carry a balance remained stable, but the average balance carried by revolvers increased 22%. At the same time, the payment rate continued to fall to a low of 17.4% in August, down more than three percentage points from 20.6% one year earlier. Consumers are borrowing more and paying back less. With the unemployment rate rising and forecast to exceed 8% in 2009, we can expect these trends to continue.
- About two-thirds of US consumers carry a reward card, a rate that has remained largely unchanged for the past two years. However, when we compared the results of a recent Cardbeat survey about the value of reward programs with one from 2006, we found that most reward cardholders think that their cards' value propositions are less valuable than they thought they were two years ago. This was particularly the case with airline reward cards, where consumers have reacted negatively toward the increase in mileage redemption fees, fewer available reward seats, and the introduction of more fee-based services. Airline reward cards have long been seen as "can't miss" propositions. Now they, along with all other consumer propositions, will need to be revisited.
- Consumers currently see the ability to use their mobile phones to manage their credit card as an unnecessary benefit. But data collected in Cardbeat indicated that, among younger consumers, there is a strong appetite for time-saving technology, especially when it leverages mobile phones. This group in particular seems well-poised to adopt mobile services as their primary banking channel in the next 5-7 years, with the mass market following soon thereafter.

## CONSUMER BEHAVIOR (Continued)

Subscribers to the UK edition of Cardbeat, now two years old, are likewise driving the topic agenda for the product in a way that allows them to obtain market-relevant data in a timely and cost-effective manner. In 2008, the topics our UK subscribers requested also indicated a focus on boosting portfolio profitability, albeit primarily through back-office operations.

Topics covered in the UK in 2008 included attrition and dormancy drivers, credit card fees, and consumer borrowing habits. Some particularly interesting findings were published in our study on credit card fees; we found that UK credit card users place a premium on low-cost borrowing options, and are even willing to sacrifice rewards in exchange for a fee-free card.

In the highly competitive UK market, it is crucial to regularly monitor consumer perception of brand strength at a detailed level since the similarity in product offerings from issuer to issuer can cloud a traditional head-to-head brand analysis from a competitive intelligence perspective. In 2008 we introduced our proprietary Issuer Brand Index (IBI) to the UK market. The IBI, which has been published in the US for 10 years, gives our subscribers a regular update on the strength of their brand in comparison to their competitors, broken out by components like card usage, brand awareness, brand quality and other characteristics.

It seems certain that 2009 will be a year filled with questions: What products should lenders offer to customers who are over-burdened by financial pressures? Will the credit crisis mean that debit card market share will continue to grow at the expense of credit cards? How can lenders trim expenses? We plan to answer these questions (and more) in Cardbeat in the coming year. Topics planned for 2009 include the impact of the credit crunch on consumer spending and borrowing habits, online account servicing, a comparison of debit and credit card rewards, and card activation.

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## ALLIANCE DEVELOPMENT

The co-branding environment has changed dramatically in the past six months. As recently as last summer, many, perhaps most, people in the card business took co-branded programs for granted. Yes, everyone agreed that some deals were underperforming and that budgets would be tighter and under more scrutiny, but most were confident the majority of programs would survive in the end.

Since then, however, ACG believes there has been a transformation in thinking. The old way of doing business, where some portfolios performed well and others did not, is no longer going to be acceptable. Everything--from financial performance to marketing support dollars to the consumer value proposition--will be scrutinized. While co-branding remains an important strategy, some programs have not met their original expectations, either for merchant partners or their issuers. In the past, these programs might have been allowed to continue. Now, the law of the jungle--the survival of the fittest--will be the key determinant in whether many existing deals will continue to survive, and which new deals will get done.

Tough negotiations lie ahead for both card issuers and their partners. Existing contracts will need to be revisited if they are going to be supported. Value proposition rewards to the consumer remain compelling in many programs, but need to evolve to better reflect current consumer attitudes. With so many people worried about their jobs and staying current on their mortgages, we would argue that more practical rewards and cash back may become more compelling, although airline miles and other higher end offers will continue to have a loyal constituency.

The number of bank mergers caused by the global financial meltdown--Wells/Wachovia, JPMorgan Chase/Washington Mutual, to name two--may create openings for other banks, should the original issuers make a strategic decision to limit the number or type of deals they have and let go of programs that don't measure up. More likely, the shrinking number of large banks - and their own worries about survival--means the competition for issuers will be tougher than ever. In the future, banks will only tolerate successful (read profitable) programs and will allow the underperforming deals to wither.

ACG is optimistic that some new deals will still be able to get done. Indeed, several de novo programs are in the making and might reach the market soon, including from a major hotel chain, a major entertainment company, and a big media house. Toyota recently announced a new launch. However, constructing new deals will require greater strategic vision and will be done under a microscope. The deals that are going to be completed MUST be win-win for both partners. What's more, as virtually all banks tighten their underwriting

## ALLIANCE DEVELOPMENT (Continued)

policies, any new deals will likely focus on the higher end of the credit spectrum for the foreseeable future.

Co-branders are going to need expert advice during this period. For existing programs, an annual "checkup" will be critical to make sure the program is performing to the satisfaction of both partners. ACG can assist established brand partners and issuers through contract renewals and renegotiations, as well as assisting new entrants into the market. ACG is positioned to help companies in both the US and in foreign markets, from our New York and London offices.

Outside the US, co-branding remains an opportunity for issuers and their merchant partners, in both Europe and beyond. Although the UK market is well-established, co-branding is less developed in continental Europe. The most notable new market is France, where Carte Bancaire's long-standing restrictions against co-branding were finally dropped this year. Other areas of emerging growth for co-branding and loyalty coalitions include Central and Eastern European markets such as Poland, Romania, Hungary and Turkey (the third-largest credit card market in Europe after the UK and Spain).

Many of these markets have developed unique and innovative adaptations for local conditions. For example, in several Eastern European markets like the Czech Republic, cardholders who shop in the partner's retail stores can stop at a cash desk in the store and receive an immediate cash rebate on purchases. Turkish banks in particular have taken advantage of chip technology to develop sophisticated loyalty programs. Another huge center of growth, of course, is China, where ACG has worked on assisting new entrants to the card market as well as on the development of popular co-brand and reward programs.

This will be the most difficult and challenging period for co-branders and their issuer partners since our founding. At the same time, the co-brand credit card product is too valuable to fail, and will eventually thrive once this crisis period is over.

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## AUTO LENDING

The automobile market is in the midst of its greatest crisis in memory. In turn, lenders are suffering tremendously. Sales of new vehicles are down sharply as consumers, often fearful of losing their jobs, hold off on major purchases. Delinquency and loss rates on auto loans continue to increase. Yet at the same time, lenders need to figure out how to get credit to creditworthy customers without taking on even more risk.

More and more consumers are requiring longer and longer loan terms so they can afford the monthly payments – more than 43% of new auto loans now have maturities of six years or more. Even Toyota found itself having to offer 0% financing nationwide to customers in order to move products, the first time it had done so in the US since the 9/11 terrorist attacks. GMAC announced it would stop making loans to borrowers with FICO scores below 700. Over the summer, Chrysler, among others, stopped leasing vehicles, after taking huge losses from sharply reduced values on returned vehicles, mostly gas-guzzling SUVs and trucks. HSBC Finance decided to exit the auto lending business altogether.

Lenders began seeing a growing number of borrowers voluntarily surrendering the keys to their cars – often shortly after they drove off with a new, less costly vehicle. What's more, about 25% of these "voluntary repos" were still current on their loans at the time they handed in the keys.

Bankruptcy for Chrysler, General Motors and Ford now looks like more and more of a possibility than ever, unless they can convince Washington to bail them out.

All aspects of the auto business, from manufacturing on down, are under pressure at the same time. Manufacturers and dealers can't sell cars because people are hesitant to buy them. And lenders, with very little margin for error, are reluctant to offer financing except to borrowers with the very highest credit scores. All lenders have tightened their underwriting criteria, which has limited the number of buyers eligible to purchase a vehicle. Home equity, which aided vehicle purchases in the past, is unavailable for a large population of consumers, as banks have reduced or closed available lines of credit in response to falling home values. It's conceivable, therefore, that the auto business won't recover until the housing market does.

ACG has increased its coverage of the auto lending market to assist lenders through this difficult period. We recently launched the Auto Servicing Roundtable and now cover originations, servicing, collections and recovery for captive and non-captive auto finance companies. Our work with industry

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## AUTO LENDING (Continued)

roundtables, benchmarking, and process effectiveness solidifies our position as a leading operational consulting firm for the lending industry.

Looking forward, crisis creates opportunity. While 2009 is predicted to be a difficult year, GMAC's pullback to only the most creditworthy borrowers and HSBC's exit from the market are but two events that point to opportunities for others ready, willing, and able to fill the gap. And, of course, market conditions can change. The recent drop in gasoline prices to the $2 per gallon range may make SUVs and light trucks an option for buyers again. That, in turn, would raise the value of lease returns on these vehicles, as well as the value of used cars.

But will a turnaround happen fast enough to save stressed automakers? The new year will no doubt prove to be a watershed year for this industry.

## DEBIT AND PREPAID CARDS

This year has been another good year for debit cards. Share of spend compared to credit cards continued to rise. MasterCard and Visa both reported double-digit growth in spending and transactions processed. And, the number of consumers receiving rewards on their debit cards continued to grow.

However, the debit arena is threatened by the proposed federal UDAP regulations, scheduled to take effect in January, and the possible regulation of interchange. One of the requirements of UDAP would allow consumers to opt out of overdraft fees caused by debit transactions. This could cause banks to respond by imposing more restrictive authorization rules, resulting in a greater number of declined transactions. These fee and interchange actions would have a particularly negative bearing on debit cards, which have a much thinner operating margin than credit cards and are thus more heavily dependent on fees and interchange revenue. Issuers must have sound strategies in the areas of expense control, rewards, and revenue opportunities in place and ready for implementation should this happen. ACG, through its consulting practice and debit card marketing roundtable, is actively helping to assist issuers to identify and implement solutions in these areas.

In the UK, consumer research indicates there may be a large potential market for a decoupled debit card offering, unlike in the US where the concept has failed to get off the ground. Over two-thirds of UK consumers questioned in a recent survey said they would be likely to apply for such a card. Many are drawn by the potential reward incentives provided through the card. The concept of decoupled debit in the UK and continental Europe has the potential to repeat what happened in the co-branded credit card industry, opening the door for retailers to extend their reach into the wallets of UK consumers.

Currently, the fastest growing segment under the debit umbrella are prepaid products. Prepaid cards are continuing to make inroads and are moving beyond simple plastic versions of gift certificates during the holidays.

While private label gift cards still dominate the prepaid market, network branded cards are growing rapidly as more consumers realize they can use them at virtually any merchant that accepts credit and debit cards. ACG has helped non-bank entities to find bank alliance partners to issue their prepaid cards.

The real explosion is in the variety of new applications in both reloadable and non-reloadable cards. An increasing number of employees are diverting discretionary dollars to these accounts. Health spending accounts are growing in popularity as medical costs increase; many employers are partially funding the HSA deductibles onto prepaid cards. Notably, Comerica Bank hopes to generate millions of direct-deposit Social Security accounts with the money

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## DEBIT AND PREPAID CARDS (Continued)

loaded onto prepaid cards. Some states pay unemployment and other benefits through prepaid cards. ACG believes that more creative uses for this versatile payment form will emerge.

ACG has applied its industry experience and insights gained through our prepaid card roundtable to assist our clients. We have helped companies better understand the market and make sound choices as to where they should best place their efforts. For example, ACG assisted a bank in determining what its strategy should be in the area of BIN sponsorships as well as selecting a processor. We believe the issue of whether to offer BIN sponsorships needs to be considered as a potential area of growth for banks in the years to come, as more non-bank entities look to monetize their customer base and issuers look to add new products and improve cross-sell opportunities.

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## ALTERNATE PAYMENTS

Over the last year, growth and consolidation among the alternate payment providers means that they're not so "alternate" anymore.

PayPal has continued to show impressive growth of over 25% in the value of payments over last year. It also hit an important milestone, as its volume of transactions at other merchants exceeded those at parent company eBay. In particular, the company has had significant success with online retailers and airlines, and recently signed up Wal-Mart for online purchases.

The company will become an even bigger force with its recent announcement that it is acquiring Bill Me Later, the other major player in alternate payments. The combination of PayPal and Bill Me Later under the ownership of eBay has fueled speculation about how much more share of online transactions they can grab, and whether they have aspirations to expand into brick-and-mortar retail. We also note with interest a recent promotion that JPMorgan Chase sent to some of its cardholders, offering a $10 rebate for opening a PayPal account, funding it with a Chase card, and making a purchase online. The promotion is noteworthy because PayPal is being positioned as complementary to credit cards rather than as a competitor.

ACG has previously observed that there are three major forces driving the development of alternative payment schemes: first, the desire of merchants to minimize the amount of interchange they pay; second, consumers' concerns about security and privacy, especially for on-line purchases; and third, the desire to monetize new networks and technological infrastructure. It will be interesting to see how these forces play out in the changed economic landscape of 2009.

While alternate payment products like PayPal and Revolution Money attract merchants with lower costs, it will be more challenging for them to come up with an attention-grabbing value proposition that will increase the consumer base. Recent research from the UK version of our Cardbeat consumer research service showed a marked shift in consumer preferences away from reward programs and toward low fees and rates as drivers of credit card preference. We suspect that the message to consumers may shift from "rewards" to "discounts."

Consumers' current pessimism and disenchantment with credit providers in general might also offer an opportunity for these new schemes to position themselves as a new and better alternative to the increasingly maligned credit card. Card issuers, therefore, need to be prepared to respond to even more competitive products on the payments turf.

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## ALTERNATE PAYMENTS (Continued)

ACG's involvement with alternate payments has touched on all three stakeholders in this area: issuers, merchants, and consumers. We have produced white papers and educational workshops for issuer clients, and performed consumer research. On the partner side, ACG retail clients have engaged us to investigate the full range of payment strategies.

Just as television has evolved well beyond the three major broadcast networks to encompass hundreds of cable networks, we expect to see a continued proliferation of specialized payment options beyond the traditional major networks. While not all of these new alternate payment providers will obtain enough critical mass to be successful, enough will survive to make the payments field resemble the current television landscape.

## MOBILE BANKING

Although there has been a lot of discussion and interest in mobile banking in the US, ACG believes that there is some confusion in the market about what this actually means.

There is currently a fairly significant range of informational services available to consumers on their cell phones and mobile devices. These are generally adaptations of functions that are available as on-line banking, meaning the internet access function of the mobile phone simply mirrors what the consumer might do on a desktop or laptop at home. At that, only 8% of US consumers use their cell phones to do banking transactions and only 13% have even heard of the concept, according to the April edition of the US edition of Cardbeat. ACG believes, however, that with virtually all consumers having mobile devices, adoption will increase as issuers and merchants begin to roll out services.

True mobile payment functionality would allow the consumer to use the mobile phone instead of a plastic card. But implementation is still hung up in development, especially on the payments side, due to wrangles among the several players whose cooperation is required: banks, card networks, mobile phone service providers, manufacturers, and merchants. In the US, using cell phones to conduct banking is still a ways off due to different handsets, carriers, chipsets and a general lack of standardized technology.

By contrast, mobile banking is more advanced outside the US. There is more consistent, standardized technology for mobile phones overseas. Additionally, pricing in non-US markets makes texting more common among consumers than in the US, making cell phones more functional as a data transmission device. In the US, the mobile phone still is more commonly used for voice transmission, although that is changing, as younger, Generation Y consumers are much more frequent users of text messaging.

Many companies are trying different things to get more people to use their cell phones to conduct banking transactions. These include such things as fraud alerts, bank balance information, couponing, and product offers. Since consumers are rarely without their mobile devices, it is hoped that they will respond quickly to the alerts. For example, in a recent television commercial for the product, a woman is climbing a mountain when she receives an alert on her cell phone indicating that her checking account balance is low. She then speaks to someone at the bank over the phone and has them complete a transfer of funds enabling her to avert an overdraft.

Many of the big players in banking have been looking at ways to enter this market. Mobile Money, an alliance between Citigroup and SK Telecom, seeks to develop systems, services and infrastructure to provide mobile commerce

**MOBILE BANKING (Continued)**

services to many clients. This will allow many companies who do not have the capital to invest by themselves to enter the business on a pay-as-you-go basis, similar to the large credit card processor model. First Data took a novel approach to the use of mobile phones as a payment device and developed a sticker that is applied to the phone and acts like a contactless device. However, the device is currently limited to singular use accounts, allowing only one issuer or entity. Still, it is a first step to bridging the gap to full mobile payments. MasterCard's Mobile Partner Program, established in 2007 as a global online resource center, recently announced that more than 30 companies have joined the program.

These programs and products will help motivate consumers to try and use mobile devices at the POS, but it remains to be seen how many merchants will be willing to invest in the necessary infrastructure to accommodate this demand. Whichever mobile payments business models eventually win market acceptance, ACG clients will be actively involved in the process. By gaining insights through consumer research, competitive intelligence, and in-depth discussions at our industry roundtables, ACG is assisting its clients in where, how, and with whom to take advantage of this exciting new technology.