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MICHAEL AURIEMMA
President

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Dear Friends:

This year, Auriemma Consulting Group (ACG) celebrated its 25th anniversary. For a quarter of a century we've been proud to be advisors, practitioners, and proponents of what used to be known simply as ''the credit card business". That business has grown significantly and diversified into today's global electronic payments industry. Our firm has grown as well, maintaining our deep roots in the credit card world while branching out into all aspects of consumer lending worldwide. Eighteen years ago, I started sending an annual letter to our clients and friends reviewing the events of the preceding year, and though there have been growing pains along the way, the overall picture has always been one of dynamism, development, and opportunity.

This year is different.

We've never seen a year like this, when the entire global business of lending to consumers was shaken to its core. We've seen bad years for banks, but never on this scale. The mortgage and auto finance businesses were on the front lines of the crisis. Then, as the crisis spread, the credit card industry, already reeling under an avalanche of bad debt, became the focus of public outrage. This, in part, prompted legislative mandates in the U.S., Canada, and the U.K. that will fundamentally alter pricing strategies, risk management practices, and revenue streams for years to come.

Within the broad landscape of payments and lending, the former suffered "a mere flesh wound", while the latter is fighting for survival. You won't be surprised that we've got some pretty strong opinions about how we arrived here and how we get ourselves out of this mess. I don't propose to cover it all in a letter. But what I can do is zero in on some of the stress points and key drivers---some of them common to all consumer finance, some specific to credit cards---and share a few observations and insights about what may happen next.

Credit Losses

The single biggest story for consumer finance in 2009 is of course bad debt: both its magnitude, and the rapidity with which losses mounted. Our secured lending clients have some different concerns than credit card issuers. The specifics vary across the markets we cover, from the U.S. to the U.K. and other European and Asian markets. Nevertheless, there are some striking convergences in the challenges facing Collections and Recovery operations in general.

First and foremost is the tremendous increase in volume. Lenders have had to double or triple their Collections staff in short order, with predictable problems in hiring, training, and managing. Many lenders have transferred staff from their Customer Service units where lower transaction volume and fewer new customers have created some excess capacity. A growing number of lenders have taken it further, experimenting with blended call centers staffed with agents who can handle multiple functions. With or without these blended units, we have observed a growing trend toward sharing customer information across organizational lines, and consolidating Collections and Recovery operations across lines of business into a single unit reporting to one executive. ACG believes that this momentum toward a holistic approach will continue, although it will take some time for systems and organizational silos to be fully integrated. Many banks have professed for years to be striving toward the goal of customer relationship management, but the present crisis has created a sense of urgency that is accelerating the transformation.

Most of the enormous increase in bad debt is attributed to changes in the macroeconomic environment rather than in the way people think and act. Risk scores that predicted willingness and ability to pay were not predicated on the dramatic loss of asset value and sharp increases in unemployment and underemployment that we're experiencing now. Nevertheless, the consequences are confronting lenders with qualitative as well as quantitative challenges.

Risk managers didn't expect to see high credit scores among their delinquent ranks, and prime customers were equally shocked to find themselves in that state. A great deal of collections, recovery, and loss mitigation strategies have been based on time-tested approaches to the delinquent customer, who was likely to have had previous experience with paying bills late and could be counted on to act in predictable ways. The "new" delinquents, in contrast, behave differently. They're likely to have kept their payments current right up to the end, and kept their increasingly precarious status a secret. They're difficult to reach, with a wider range of tools to help them avoid unwanted contacts. Once found, they often have a highly combative attitude about their unpaid debts and the causes of their predicaments.

Whether the consumer is an "old" or "new" delinquent, an attitude of "it's not my fault" has been cultivated by factors including legislative hearings on the excesses of predatory lenders, media coverage of the huge amounts of taxpayer money lent to keep banks solvent, and advertising for credit counseling and debt settlement firms. Indeed, the message is that consumers should be aggressive in negotiating loan modification terms or a settlement amount.

ACG has helped clients develop a range of responses. Establishing which clients respond better to SMS messages rather than calls to a landline, for example, has the dual benefit of cutting costs and demonstrating responsiveness to consumer preferences. Several lenders have found that some first-time delinquents are more comfortable with self-service options than with speaking to agents. Best-in-class organizations cite this learning as an example of the benefits of an integrated approach to contact channel management, both inbound and outbound.

Just as the channels for communication are being more carefully managed, so too is the dialogue itself. We noted that customer service agents are being seconded to Collections. Even Marketing is being brought into the effort. Teams which had previously applied their knowledge of consumer behavior to customer acquisition are being tapped to develop strategies to contact and engage these delinquents in a constructive approach to improving collection results, and equally important, maintaining a relationship with customers that may once again be profitable when the economy recovers.

Some of the new tools available to Collections and Recovery are creating their own challenges. Models that predict delinquency probability on current accounts are very new but hold the tantalizing promise of identifying those customers who are most likely to default, thereby allowing the lender to take pre-emptive action. But because these customers are current on their accounts, the dialogue is somewhat constrained. Some customers welcome the opportunity for a constructive conversation, but others take offense at the suggestion that they may be heading for trouble. Lenders, especially those who are committed to a relationship model across multiple products, are still in the early stages of determining how to use this potentially powerful tool, and where to house it in the organization.

For collections and recovery agencies, the surge in volumes has been a mixed blessing. Some have been so overloaded with volume, and are posting such meager returns as they compete with other, better-resourced creditors and agencies, that they have gone out of business. Others that have carefully invested in technology and processes to become more efficient are succeeding. At the same time, issuers that relied heavily on a strategy of selling bad debt are finding it difficult to find buyers willing to pay even a fraction of 2007 prices. Lenders that use diverse strategies---working some accounts, placing others with an agency, warehousing or selling others---are coping better than those that relied solely on one approach.

Consumer Behavior

We see it in industry statistics, and we hear it from respondents to our U.S. and U.K. Cardbeat® surveys: consumers are spending less on their credit cards. Behind those lower sales volumes, though, are a number of complex interactions. In absolute terms, consumers are indeed spending less, as retail sales volume will attest. If this were a “normal’’ recession we’d expect to see it bounce back as the overall economy improves.

But consumers are telling us that they’ve also changed their thinking about how they pay for purchases. While debit card volume has grown steadily over the years, there’s been a sharp uptick in volume diverted from credit cards. Some people have no choice because their credit lines were decreased or closed altogether, but a lot of it is deliberate. Consumers say that they are using debit cards more often precisely because the product doesn’t allow them to borrow. Debit cards are enjoying an improved public image, with many respondents telling us that they perceive the product as superior to credit cards for helping them manage their finances. That may change, as debit card overdraft fees draw more critical scrutiny. Trying to avoid a replay of the credit card situation, several big players have scrambled to proactively change their overdraft policies before legislators force them to do so. If the industry can dodge that bullet, debit card share growth appears likely to continue, benefiting from the vilification of credit cards and a generational shift as younger consumers, accustomed to using debit rather than cash, assume a larger share of the market.

Increasingly, consumers say that they put a purchase on their credit card only if they specifically intend to revolve. If that behavior persists, it would point to the return of credit cards as a vehicle specifically for borrowing. The U.S. landscape may look more like the U.K. and Canada a decade ago, where debit cards were well-established and revolve rates on credit cards were exceptionally high. Although such portfolios carry additional risk, revolvers have traditionally been the engines of profitability when appropriately priced and managed. We expect to see more card products that are specifically designed for revolvers, with competitive APRs but no reward programs and, perhaps, no grace period. In fact, “no grace” cards have already been introduced in the U.K.

But what about the transactors that pumped so much volume through the system? Reward programs get most of the credit for motivating cardholders to put as much spending as possible on their cards, encouraged by tiering and threshold promotions. Transactors brought interchange income, diluted risk by swelling the receivables denominator, and even helped the industry increase merchant acceptance. In return, they got a free ride. That era is coming to an end. The reward programs these consumers have come to take for granted will still be there, but they will be much less rich and/or they will carry a fee. High-spending affluent customers will have a tempting array of products, as more issuers compete for the “spend-centric’’ business that American Express staked out. Indeed we’ve already seen Visa and MasterCard-branded charge cards come to market. Programs that already have annual fees, like airline co-brands, will be less affected, but cash-back and generic points-based rewards will be far less accessible for low-volume customers. Plus, if interchange levels are systematically reduced, all bets are off.

Regulation and Legislation

The reverberations of UDAP and the Credit CARD Act will be felt for years to come, both in the U.S. and in other markets like the U.K. and Canada that are modeling regulations based on them. With our Compliance and Accounting roundtables, pro bono workshops conducted with Morrison & Foerster, and specific consulting engagements, ACG has been actively involved in helping issuers work through the changes they will have to make and the impact on product design, statements, disclosures, operations, and financials. On the secured side of the business, the Home Affordable Modification Program (HAMP) presents mortgage lenders with similar uncertainties.

Clearly, credit card P&Ls are going to look quite different going forward. The contribution from penalty fees will be sharply reduced, leaving interest income and, perhaps, annual fees to make up the shortfall. The restrictions on re-pricing will put upward pressure on initial APRs, and teaser rates will become much less common. This is not all bad news for lenders who have had to compete with ‘’irrational’’ pricing and devote resources to the cat-and-mouse game of managing rate surfers. Average APRs will rise, and price competition will take place within a much narrower band.

The requirement for enhanced disclosures will increase consumer awareness of the cost of borrowing, and will reinforce the tendency we noted earlier for credit cards to be seen as lending rather than payment instruments. We also expect the average number of cards in the wallet to decline. Issuers will continue to reduce their exposure by decreasing unused lines, and testing the waters with inactivity fees. Opinion is sharply divided (in our own shop as well as in the industry) about whether “no annual fee” will continue as the market standard. Many high-value cards for affluent customers already have annual fees, but the picture is less clear for the mass market. While the P&L for this segment suggests that annual fees are inevitable, there’s no doubt that issuers will experience significant attrition in response, and the fear of driving away the most creditworthy customers who have a choice creates a sort of prisoner’s dilemma for issuers waiting and hoping for the competition to be the first to do it. Some banks in both the U.S. and the U.K. have begun testing annual fees for inactive customers, and low-volume transactors might be next.

The burdens of compliance have led some observers to predict that small banks will be forced out of the card issuing market. We tend to disagree. Most small issuers outsource the operational functions that will be most affected. It’s the big processors who must devote considerable resources to implementing new regulatory requirements. Moreover, many of the practices that have been prohibited were employed primarily by the largest and most sophisticated issuers. Small banks tended to shy away from these tactics. As this letter goes to press, small banks in the U.S. have been granted a major concession by lawmakers, who agreed to exempt banks with less than $10 billion in assets from additional oversight by the new federal consumer finance agency. And small banks are less tarnished in the public eye. In July of this year, we reported in the U.S. edition of Cardbeat that that while only 25% of respondents considered “national banks’’ to be trustworthy, twice as many said that they trust credit unions (51%) and local banks (47%). The top three issuers will still control the lion’s share of the market, but right now small lenders have a golden opportunity to grab market share and grow their business. We believe that this will be the same in the U.K.

Co-branding and Private Label

When a bank sneezes, its partners catch a cold. Issuers trying to claw their way back to profitability are taking a hard look at their co-brand and private label programs, as well as the financial models behind them. In some cases issuers are deciding that they can no longer afford the deals they signed. A number of programs are being offered for sale, and ACG is aware of many difficult contract renegotiations that are currently taking place.

Partners have grown used to getting revenue in return for providing access to their customer base and contributions to usage-based rewards. With spending down, profits erased by high loan losses, and little appetite to acquire new accounts, the value contributed by the partner is less evident, and the cost of the revenue-sharing more painful. All partnerships are not created equal, and some sectors are under more strain than others. Retailers are hard-hit for the same reasons issuers are, and banks’ reactions of decreasing lines, raising APRs, and dramatically lowering approval rates impact store purchase volume negatively at a time when they can least afford it. Retailers are left with few alternatives, as most sold off their private label businesses over the last few years, raising much-needed cash but also losing the people and skills that would allow them to support the business with a captive finance facility. Airline and hotel programs are in somewhat less dire straits. Although business travel volume is down, loan losses are much lower, and customer metrics in the T&E cards sector have remained more stable than in ‘’pure’’ consumer programs.

Overall, ACG expects that the number of co-branded and private label programs will shrink, mostly at the expense of small partners, and the economic construction of deals will shift. We expect to see less up-front money for partners, fewer guarantees, and more emphasis on profit-sharing.   ACG has extensive experience with renegotiations and portfolio migration. For the short term, those types of engagements will probably outnumber new alliance development projects. At the same time, with “big banks” in particular suffering from a dismal public image, the appeal of a strong partner brand will be enhanced, and partners who are willing to acknowledge and accommodate the changed landscape can reap significant rewards.

Portfolio Sales and Customer Acquisition

“If you find yourself in a hole, stop digging.” In 2009, banks took this adage to heart. Acquisition marketing slowed to a trickle, and portfolio purchases ground to a halt. A number of large portfolios that came onto the market as far back as 2008 have not found buyers, and the unsold inventory has been swelled by increased capital requirements. Some banks that had been aggressive purchasers are now trying to sell assets to shrink their balance sheet as part of their overall plan to rebuild their capital base. In many cases, these for-sale portfolios include an option for the buyer to extend an existing alliance, co-brand, or agent bank relationship. These third parties add complexity to the deal, but also present the opportunity to acquire an ongoing source of new account origination.

ACG is aware of nearly $20 billion of credit card receivables that have been offered for sale. Just as in the housing market, prospective buyers have felt no sense of urgency, offering lowball bids while waiting for signs of a bottom. Sellers have often clung to outdated notions of fair value. The recent sale of $1.3 billion from Citi Cards to US Bank is a hopeful sign that both sides were able to move enough to close the gap, and now that the ice has been broken, perhaps prospective buyers will come off the sidelines to take advantage of these historically low prices.

The market will also benefit as issuers regain some confidence in their ability to forecast. Before the financial crisis, lenders were accustomed to looking at the previous 12 months performance, adding some tweaks and management factors, and producing a reasonably good prediction of the following year’s results. Indeed, one of the strengths of the card business has been the stability engendered by the sheer numbers of customers and transactions. The velocity of change over the last year reduced issuers to focusing on the previous quarter for guidance. The unknowns of pending regulation further exacerbated this lack of predictive power, depressing portfolio sales, new deal creation, and acquisition marketing. As issuers digest the implications of the Credit CARD Act in the U.S., and other government intervention across international markets, and revise their P&Ls to reflect changes in cardholder behavior, they are regaining confidence in their projections.

The hiatus in customer acquisition, coupled with high attrition and reduced spending volume is shrinking the denominator of receivables, and loan losses as a percentage will remain high in 2010, even if the absolute volume of bad debt gets whittled down. However, we are hearing more about new acquisition marketing plans beginning to take shape and ramping up throughout next year, and competition for the individual cardholder will make the wholesale acquisition of consumer portfolios all the more attractive.

Back to the Future?

When ACG started up in 1984, most credit cards had annual fees, APRs were around 20% with relatively little price competition, and there were no balance transfers or teaser rates. Travel and entertainment was considered to be the province of charge cards, while retailers of all kinds issued their own private label cards. American Airlines, flush with the success of its innovative frequent flyer program, was mulling over ways to extend its reach, and American Express got tongues wagging with the introduction of the Platinum Card.

No, we're not predicting a return of all those things (nor of my shoebox-sized cell phone), but there are certain elements of the card business that may start to look a bit retro. Charge cards and installment loans are coming back into style, while teaser rates and penalty fees are fading. We expect to see more products designed to fit a specific need, and more explicit tradeoffs: low rates OR rewards, but not both. More people will carry cards from their main bank, and they may have fewer in their wallet. Credit will be tighter and more expensive, at least for the short run, and retailers will be more aggressive in offering low rates for major purchases. There will be fewer co-branded programs, but strong brand name partners will continue to be in demand, although they may need to share some of the risks as well as the rewards.

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"Whatever doesn't kill me makes me stronger." I don't think Nietzsche ever worked in consumer finance, but he had a point. Personally, I'd prefer a little less character-building drama next year, thank you. But I'm also excited to participate in our ever-resilient industry's response to these challenges. We'd love to hear your reactions to these thoughts. We thank you for the confidence you've shown in our advice and support over the last quarter-century. We look forward to the next!

Best Regards,

Michael Auriemma

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