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Dear Friends:

The first year of the new decade has brought about big changes, both in our company and in the payments and lending industries that we serve. It's been an exciting time for Auriemma Consulting Group (ACG): three new senior leaders, new product offerings, new markets supported, and a brand new company headquarters in the Financial District of Manhattan, topping the list of headlines.

It's been an eventful year in cards and consumer finance as well, although not all of the excitement has been positive! Even so, the mood today is markedly different than it was twelve months ago, when our clients were largely in fire-fight mode. As 2010 draws to a close, bankers and lenders are stopping to catch their breath, dust themselves off, and ask "Now what?"

It is refreshing to hear talk of the desire and appetite for revenue growth finally starting to balance out the pervasive cost cutting talks of the last 24 months. And, even the discussions on the expense side of the equation are focused on doing the right things to improve effectiveness, not just around how to cut costs. While the mood is more optimistic than we've heard in a long while, it is still quite cautious. I've likened the atmosphere to a bunch of people crawling on their stomachs across what they know is thin ice. But, at least it is forward progress!

For every person we talk to that is optimistic about the near term economy, we talk to someone else who is still bearish. Even that, though, marks a positive swing in consensus over the past six months. One thing that everyone seems to agree upon is that the road to recovery is not going to be a straight line. We are in for a bumpy ride. With the future so unclear, ACG is often called on by clients and the business press to give our insights as to how the industry and consumers will react to the enormous changes of the last two years. As I've done for nearly two decades in this annual letter, I'd like to share some thoughts gleaned from ACG's myriad touchpoints, including consulting projects, industry roundtables, and consumer research, focusing on which of these changes are cyclical, and which represent enduring structural shifts.

Using Credit: Demand Side

By any measure, US and UK consumer finance has contracted sharply, a function of both supply and demand. Let's look first at the demand side: borrowing is down and savings rates are up. In part this is a textbook response to recession, and we can expect that when the overall economy improves significantly, spending and borrowing levels will rise. But we also see some fundamental shifts on the consumer side that will persist long after the recovery.

One long-term change is in the choice of payment products. Consumers have been putting less on their credit cards, in both the absolute and the relative sense: spending less money overall, and allocating a smaller percentage of that spend to credit cards. Debit cards, which came relatively late to the US market, were gaining in popularity even before the recession, and their growth was spurred even further by the credit crunch.

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We expect that debit cards will continue to gain share as they have in Western Europe. Demography is on their side: they are particularly favored by younger consumers. They also suffer less of an image problem than credit cards. Respondents to our monthly Cardbeat® survey tell us that debit cards are a better financial management tool than credit cards precisely because they do **not** extend credit. Regardless of whether that makes sense logically, it represents an overwhelming customer sentiment that must be addressed. So while sales volume and outstandings of credit cards will undoubtedly rise as the economy recovers, their share of the payment market is likely to remain flat at best, and over the long term, the US will probably look more like Canada and Europe where debit cards are the default and credit cards the exception.

Another obvious demographic trend shaping the future of payments is the comfort with and appetite for technology among younger consumers. I recently watched a young woman use her iPhone to transfer money into her checking account while standing at the register so she could use her debit card for that purchase. The new Starbucks mobile pre-paid app is all the rage among the associates at ACG. At 46 years old, I'm reminded how old I am (regardless of how young I feel) everyday when I read about new technology in our market. I've come to accept that by the time I hear about a cool new app, there are already two newer ones taking its place. In our efforts to stay fresh, it's good that I'm now "one of the old guys" in the office!

Stepping back from payments, and looking at consumer finance overall, we believe that attitudes toward borrowing and repayment have also changed substantially. We saw early signs of this more than a decade ago, as bankers were fretting over the ease with which consumers could and would declare bankruptcy. In research we conducted then, we began to hear borrowers talking about bankruptcy as a financial management tool, rather than as the last resort of the desperate. That attitude has continued to proliferate, spreading to auto finance and ultimately manifesting itself today in the concept of "strategic default" of underwater mortgages. The suddenness and severity of the downturn chipped away at the ability of risk-management tools to predict *ability* to repay; now the second core attribute, *willingness* to pay, has come to be seen not as a moral obligation but as a negotiable calculation.

We don't think human nature has changed, and we expect talk about the New Austerity will diminish when consumers begin to feel more secure, particularly about the job market. But just as the generation that lived through the Depression had distinctive attitudes towards money and savings that persisted long after the return of prosperity, consumers slogging through the current Great Recession may be permanently altered, especially as it drags on. In recent recessions and bear markets, like the dot-com crash of 2000 or the post- 9/11 downturn, we saw a dip in spending that recovered back to previous levels within a year or two. This time around, though, recovery won't mean bouncing back from a dip. Rather, we think the situation is more akin to having hit the "reset'' button. The recovery will have to begin from a new line on the graph.

Extending Credit: Supply Side

While changes in consumer behavior contributed to the dramatic $160B drop in total revolving credit balances since their peak in August 2008, the major driver was the write-off of billions of bad debt and the drawback of credit lines. The supply of credit, throttled back by lenders trying to staunch loan losses, has been further attenuated as a consequence of sweeping financial reform legislation.

Most of the massive changes in the regulatory environment for payment cards are now in place in the US, and in the many countries (including Canada and the UK) that instituted similar new rules. As we've helped clients through interpretation and implementation of the myriad complexities of the CARD and Dodd-Frank Acts in the US, ACG has found plenty to criticize in the new regulations. We don't deny that there were indeed some examples of practices that deserved to be restricted, but much of the new legislation prescribes highly specific rules written by legislators without a clear understanding of the complexities of the payments business. At times, you had to wonder what was more important: reform or sound-bites. By contrast, regulators in Canada, continental Europe, and the UK (led by BIS) seemed to put more weight on input from practitioners. Like it or not, however, the new regulatory environment will be with us for the foreseeable future.

At least credit card issuers have the benefit of knowing what they're up against. On the debit side of the house, uncertainty and suspense prevails. Even as debit sales volume now outstrips credit card volume, the fundamental profitability of the product weighs in the balance during the nine months the Durbin Amendment gave the Fed to decide on "reasonable and proportionate" rates for interchange. We won't know until the second quarter of 2011 just what those interchange rates will be, but there's little doubt that they're coming down. In the meantime, product development, innovation, and alliances are all largely stagnating as banks prepare for the worst case scenario.

The bipartisan support for these financial reforms demonstrates that one of the few things Democrats and Republicans could agree on was the desire to rein in the banks. In this environment the combined efforts of Washington, merchant coalitions, and the mainstream press have fanned the flames of consumer sentiment against the banks. For example, in the ongoing interchange debate, Cardbeat respondents generally support the idea of lowering the amount of interchange, even though most don't believe that merchants will pass the savings on by lowering prices. Even when they have nothing to gain themselves, in their current mood, consumers favor the idea of reducing the amounts banks can charge *anyone.* This supports what ACG has been advocating for years: our industry NEEDS a better voice. We are lacking a clear, consistent delivery of a message to counter balance the barrage of negativity we are forced to confront.

It's ironic that this all comes at a time when banks are increasingly focused on keeping their current customers happy. With little or no new customer acquisition in the past two years and many formerly profitable accounts now written off, banks are focused on retaining good customers. How to price, contact, and treat customers in this environment is incredibly challenging, but critically important. The winners will be the organizations that figure out and implement the best formula.

The combined effects of recession and regulation may in the long run prove to have been salutary in curbing excesses, but they have also throttled down the overall availability and affordability of credit, which may in turn be slowing recovery in the US. It's instructive to note the growth of investment in lending infrastructure and skills that are creating something of a boom in the Middle East and Asia, where governments are actively promoting a prudent approach to transformation into a credit economy. ACG expects that in the long run the infatuation with stringent regulatory approaches will swing back toward center – but not for quite awhile.

The Bottom Line

Third quarter results for the big issuing banks came in shortly before this letter went to press, with some cheerful news: revenues up, losses down. Cynics may note that the third quarter of 2009 was so abysmal that even mediocre performance looks good in comparison. Nevertheless, the double and triple-digit rises in profits, despite the impact of implementing the new regulations, underline how profoundly the loan loss line dominates the P&L. Lower write-offs went straight to the bottom line, and gradual declines in delinquency allowed banks to reduce loan loss provisions. Nevertheless, this big improvement takes Moody's charge-off index from its high point of 11.21% in March of this year down to 10.00% in September --- still staggeringly high in historical context, and an unwelcome drag on profitability for several quarters to come.

Unsecured lending is supposed to be inherently risky. The corollary was that secured lending was supposed to be less so. But it didn't really turn out that way for auto finance and mortgage lenders. The peculiarities of this recession have turned the recovery equation upside down: the most valuable assets are the most problematic. Even without the current foreclosure paperwork crisis, lenders who are on the receiving end of strategic defaults have bulging inventories of unwanted homes. Auto lenders, after particularly challenging years in 2008 and 2009 got a bit of good news with the continued uptick in used car prices and hence, recovery values. In the consumer payment hierarchy, primary credit card bills are now being paid first, to keep the account open, while mortgages incredibly shifted to number two and even worse if the loan exceeds the current market value of the house. There's a lot of quantitative analysis going on as risk managers reconstruct their scorecards in light of these new dynamics.

While we are disappointed by the particular catalysts that led to the change, we are pleased that our industry's focus is once again on profitability rather than growth for the sake of growth. It wasn't long ago that our clients were being grilled by Wall Street analysts about their growth rate: How many new accounts have you added? How much have you grown outstandings? Blue-chip banks were urged to emulate high-growth technology companies, many of whom first bought market share and then learned how to monetize it. Our clients often lamented that growing the profitability of their already huge customer bases would not be rewarded appropriately by shareholders.

As banks and lenders were persuaded to chase the next elusive new customer, the industry did whatever it took to grow: credit cards had teaser rates and free balcons, auto loans touted no-interest finance, rebates, and extended terms, while mortgages had balloon clauses, no-documentation loans, 100% financing, option ARMs with low rates for 2-3 years, you name it. And as long as the denominator of the equation, total outstandings, grew faster than the loan losses did, it worked. Until the proverbial perfect storm (credit crisis, recession, ballooning loan losses, and punitive regulation) hit …and then it didn't work anymore.

The focus is now clearly back on profitability, and some lenders are quite open about their willingness to shrink as a means to that end. Others are poised to scoop up bargains in portfolio sales and use economies of scale to achieve profitability. That's the thing about profitability: it's an equation, and you can get there in many ways, by tinkering and tweaking with all the different variables that go into the P&L. The new regulations have taken away some options and will reduce others, but there are still countless unique combinations of products and prices that can create that most sought-after result: black ink.

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At ACG we're responding to new market demands as well. Early next year we will launch a new research product which will provide the same detailed look at debit, prepaid, and charge card users and their financial behavior that Cardbeat has done for credit cards for 16 years. We continue to add Industry Roundtables dedicated to specific geographies and product sets, and the range, depth, and quality of our benchmarking studies is, we believe, unsurpassed. Our Financial Strategies team has been developing some rather creative (in a good way!) approaches to solving challenges such as the wide bid-ask spread in many potential portfolio transactions, the need to lower capital requirements, and the desire to mitigate risk. Those new structures have enabled lots of detailed conversations that we expect will beget some very interesting transactions in the new year.

We'd welcome the opportunity to hear your thoughts on any of the opinions we've expressed in this letter, and we extend an open invitation to visit us in our new headquarters in Manhattan, or in our London office.

Best wishes from all of us at ACG for a profitable 2011.

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