AURIEMMA CONSULTING GROUP
NEW YORK · LONDON

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November 2011

Dear Friends:

Once again I am sending, as I have every year since 1992, ACG's annual letter. This tradition started as a true year-end review, but over time it's been moved forward in the calendar so that it reaches you before the holiday frenzy begins.

One drawback of this change in timing, though, is that it's risky to characterize a year until it's over – especially this one. In the first quarter of 2011, the talk was of slow recovery: auto sales were up, card delinquencies were the lowest they'd been for a decade, and stock markets were climbing steadily, almost back to pre-Lehman Bros. levels. Two quarters later, both the DJIA and the FTSE plunged 15% after S&P downgraded US debt. With consumer confidence ebbing, the talk turned to double-dip recession. October saw the markets climbing nicely again, even in the face of the worsening Eurozone crisis. Alas, November (to date) has not been so kind! Daily swings of more than 100 points on the Dow have become the rule rather than the exception. It seems that the only consistent trend is volatility.

These wild mood swings reflect a sense on Wall Street – and on Main Street USA, and the UK High Street – that almost any scenario seems plausible. Could this be the long-awaited market bottom, the launching pad for markets to "climb the wall of worry"? Or could the sovereign debt crisis, combined with widespread unemployment in the US and Europe, presage even tougher times for the global economy? We don't pretend to have the answers to these questions – we're not macroeconomists (and from what I can tell, it wouldn't help if we were). But we can tell you about how these and other turbulent forces have been affecting consumers and companies in the markets we serve, and point out some of the ramifications. Looking back at ACG's track record of public prognostications, we're pleased to see that we've made a lot of good calls.

Any summary of the big financial services news stories of 2011 would have to include the furor over debit card interchange and fees, so let's use that as a jumping-off point. While some of the particulars are US-specific, we think there are clear parallels and lessons for our clients in other markets as well as other industries.

Unintended Consequences

If credit cards were, uncomfortably, in the media spotlight in 2009 and 2010, last year was debit cards' turn on center stage. For almost a decade, ACG has been talking about the likelihood of interchange reduction in the US. Finally, on October 1, 2011 the new debit card rates mandated by the Durbin Amendment went into effect. The unfolding of this story is a fascinating case study of our old friend, the law of unintended consequences.

Back in 1995, debit cards accounted for less than 1% of US card payments. By 2006, debit card volume was equal to credit card, and today debit claims about 2/3 of US card transactions. It was one of the few products that benefited from the economic downturn, as Americans, especially younger ones, transferred their plastic usage to a card that wouldn't allow them to overspend. All of this should have been good news for policymakers worried about consumer indebtedness.

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Starting in the mid-2000s, there was a cascade of legislation to regulate banks and card issuers, including Bankruptcy Reform, UDAP, FFIEC's re-age policy rules, the CARD Act, and Dodd-Frank. While ACG has been outspoken in opposing specific aspects of these regulations, we can at least agree with the stated goal of transparency and fairness to borrowers. But the Durbin amendment was an anomaly pasted on to a larger bill. No consumers were asking for interchange reduction; it was retailers who successfully pushed the amendment.

> *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.*
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> *ACG Annual Letter, 2008*

The tug-of-war between merchants and issuers over interchange has been going on for years. We number many retailers among our clients, and we've been happy to help them strategize ways to reduce their costs of card acceptance. And, we couldn't help but admire the political skill of National Federation of Retailers and their allies in achieving their goals. We objected, however, to the claim that the consumer would benefit from lower interchange. We predicted that merchants would not pass along savings, and that banks would first discontinue rewards on debit cards and then institute fees on the accounts – factors that would conspire to make debit cards less valuable to consumers in the end.

> *"Banks are all watching each other because there is a first-mover disadvantage … The first to institute debit/checking fees in a given market will experience the most scrutiny and possible attrition, along with negative press; as others follow, customers will have fewer places to move."*
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> *ACG Quoted in MarketWatch/WSJ Digital September 20, 2011*

As the October 1st implementation date neared, US banks prepared their response to the impending loss of $12B in revenue. Most began by discontinuing rewards on debit cards, warily approaching the problem of how to charge for what had long been free to customers. Finally, nine days after this story appeared, Bank of America announced its plan to charge most accounts a monthly fee of $5 for debit card purchase usage. At ACG, we were surprised at the format of the announced fee structure; in July 2011 our Debit Report survey reported that a fee based on debit card usage was the **most** objectionable way to charge, rated worse than simple annual fees on debit or checking.

We all know what happened next. Rarely has a bank fee been headline news before. BAC's announcement set off a firestorm of outrage with mainstream media, politicians, and grass-roots bloggers vying to find the most vituperative description. The depth of public rancor became a story in its own right. Chase, SunTrust, and others that had been testing various fee structures hastily distanced themselves and announced that they would not charge for debit card use. And finally, after a month of intense backlash, BAC announced that it was rescinding its decision and dropping the fee.

Occupy Wall Street

While there are some that give the Occupy Wall Street movement (now known as OWS) credit for getting BAC to back down from its fee, I would disagree. However you feel, though, what year-end letter would be complete without some reference to OWS? I'm particularly intrigued by one major element of the movement.

To be honest it often seems that our industry lacks a common voice that is necessary to stave off issues. We don't often develop and communicate the case for our actions. Perhaps if we did, the severity of actions against us could be reduced.

ACG Annual Letter 2007

The protesters on our doorsteps (ACG's New York office is across the street from the now infamous Zuccotti Park and our London office is not far from St Paul's), should be a powerful lesson to bankers. While we have repeatedly failed to effectively communicate the value of our products to consumers and regulators, an incoherent bunch of rag-tag demonstrators has made their "message" a rallying cry around the world in under two months.

But these protesters and others who think the banks are all-powerful are giving the sector too much credit, in our opinion. We are convinced that our lack of a clear and consistent "voice" has led to burdensome regulation and significant marketing challenges. Despite years of advanced warning, the banking industry has not been able to educate the public about the costs and benefits of electronic payments. It's not surprising that, after years of relying on "free'' as their primary marketing strategy, banks are finding it hard to convince customers that these valuable services are worth paying for. We fear that the industry has not really taken this message to heart, as we watch the proliferation of 0% rate offers on credit cards. What message does that send to our customers and prospects?

The New Guard

Fortunately, not all 20-something year olds are sleeping in tents in public parks! As a wider demographic, though, Millennials are having a rather significant impact on the products and marketing efforts banks must deliver to remain relevant and growing. I know some of you believe these "new attitudes" to be just another passing fad. We're not convinced. In fact, quite the opposite. Today's youth grew up in a different environment than most of the readers of this letter. They have formed very different opinions about and relationships with financial products and the companies that provide them… not to mention their relationship with their mobile phones! I've suggested to clients recently that they "take a Millennial to lunch". You'll be surprised what you learn… or at least what you hear (you still may not learn). Whether or not you believe the market research, meeting and getting to know this demographic set proves that they think and behave differently than what we are accustomed to. The conclusion then is that we need to develop products differently, communicate differently, and change our ideas about who and what the competition is.

…And the Rest!

Three pages in, and still so many topics to cover. Let's switch to bullet points and hit the highlights!

- Operationally, Collections had been lenders' focus for the last three years. This year, Customer Service and Customer Experience have caught and maybe surpassed Collections as the hot topic. In every industry we serve… Retail Banking, Cards, Auto Finance, Mortgage, and Investment Services, Customer Service is center stage. A growing number of clients are using automated web crawlers, Facebook, and other tools to monitor and develop their reputations. The objective is simple… protect the customer relationship we tried so hard, and spent so much to build in the first place. In fact, even Collections departments are upping their Customer Experience game in order to ensure the possibility of maintaining the relationship if and when the customer's financial situation improves.

- Speaking of customer relationships, the banking industry has renewed its focus on increasing the number of products it sells to each household. Banks are disposing of assets that aren't held by their "core" customer. Regional banks are getting out of agent relationships and taking a primary role with their customers. There is a trend under way of reorganizing around customer segments and integrating systems and operational platforms. Organizations are getting better at measuring profitability across product lines. There is a lot of work to be done, and a lot of blind alleys to be avoided, but we believe the benefits are achievable.

- Many of the factors already discussed, including banks' desire to get closer to their customers, shifting consumer behavior and priorities, reductions to interchange, and others, such as Durbin's mandate of non-exclusivity for signature versus PIN networks, have conspired to put many corporate alliances into a new light. As a result, we've seen a sharp uptick in contract renegotiations for service providers and partners all over the payments and lending landscape. For the past two years, many financial institutions held off or executed temporary contract renewals while waiting for the dust to settle. Now they are taking a hard look at overall vendor servicing costs, technological capability of partners, ability to consolidate and access customer information, the balance of risk and reward in marketing relationships, and so on. Despite the upheaval this is causing among the buyers and sellers of services, overall this slew of renegotiations seems to be creating significantly healthier, more stable, and better balanced relationships. We are confident the hard work will pay off.

- As already alluded to, the new focus on customer relationships is causing the portfolio sale market to open up again as well. This is particularly true in the cards business where BAC is selling (or has sold) non-relationship based portfolios in the US, Canada, and the UK. Barclaycard has purchased "non-strategic" assets from Citi and others in the UK. HSBC, of course, is in the process of selling a segment of its branches, and its massive $30B card portfolio. Capital One, the anticipated buyer of HSBC's cards, is also attempting to buy ING's $80B direct deposit portfolio. Meanwhile, Citi has completed the sale of countless billions worth of assets (auto, student loan, mortgage) from its Citi Holdings unit. Discover and American Express have both been on buying sprees, though neither has bought any card assets yet. The good news is that in addition to many of these assets finding new, more appropriate homes, the purchase prices seem to be reasonable. While sellers are getting a fair price, buyers do not appear to be overpaying.

- Another financial topic which we see emerging is a focus on Risk Weighted Assets (RWA). We've now seen banks across the board raise capital to meet new regulations. But as they worked through the process of raising and managing regulatory capital, there will be renewed attention to asset risk weighting. We think that what we've seen so far on the RWA front is just the beginning. 2012 should see a focus on RWA as never before, since it may be the last way for banks to influence the amount of capital needed for Basel III.

- Throughout 2011, we heard lots of noise and speculation around the advent of EMV in the US. Ironically, we wonder if the debit interchange reform mentioned earlier could actually inhibit our migration to this new standard. Merchants' organized efforts to reduce debit interchange could arguably be traced back to the Wal-Mart case of a decade ago, when the retail giant won the ability to steer consumers toward PIN rather than the more expensive signature. Now that the two authorization methods are equal in cost, signature may look more attractive to merchants: they have signature processing in place for accepting credit card transactions already, so why take on another process and buy more POS equipment to accept PIN transactions?

Issuers with affluent customers seem to be leading the way as they learn that international travelers are encountering acceptance problems with mag-stripe only cards. Several banks have stated that they are issuing Chip and PIN cards to international travelers, but despite my frequent trips to ACG's London offices, I haven't yet been offered one! Visa's announced plans to accelerate the migration to Chip include a liability shift for counterfeit fraud from issuer to acquirer, which may be the most powerful incentive of all.

Conclusion

Looking back, it seems that volatility has been the theme of 2011. But, maybe volatility isn't all bad… at least it's a sign of life.

I know we didn't cover all of the possible topics from the past year, and we certainly only scratched the surface of those we did cover. Hopefully, as in the past, this letter is just the starting point for our dialog in 2012. We'd welcome the opportunity to hear your thoughts about any of the topics we touched on in this letter, or others that you think are affecting the market or your institution specifically. We'd be pleased to come to your offices, invite you to visit to our Manhattan or London offices, or just talk on the phone.

Best wishes from all of us at ACG for a happy and prosperous (and more stable) 2012!

Michael Auriemma

p.s. I mentioned the protestors "outside my window". I feel compelled to also mention the other, more impressive sight out my window – the significant work on the rebuilding of the World Trade Center, and specifically the completion of the 9/11 Memorial. If you haven't been here to see it, I highly recommend the trip. The Memorial is a beautiful yet somber reminder of the tragic events that unfolded here ten years ago. You can't help but be moved by the fountains which are surrounded by the thousands of names of people that were lost. I can't wait until the full site is open for business in the coming years. Having this massive Memorial as part of the urban landscape will be an incredible reminder to us all.