AURIEMMA
CONSULTING GROUP
NEW YORK · LONDON

MICHAEL AURIEMMA
President

November 2012

Dear Friends:

Every year since 1992, I've sent our clients and industry colleagues a letter reflecting on the year's events and sharing an update on the happenings at our firm.

I'm delighted to be writing this, my 21st annual letter, and particularly to be able to do so from my office, after more than a week in exile from our lower Manhattan headquarters. I've spoken in previous letters about "the perfect storm" of the financial crisis, but Hurricane Sandy was no metaphor! Auriemma Consulting Group had never closed even for a day due to weather: there were always a few intrepid souls who managed to slog their way in. But, in a total power blackout (no electric, heat, phone, cell, or internet service), with water running through the streets, and no mass transit, even a 34th floor office was no place to be. In the immediate aftermath of the storm, we found ourselves with no way to communicate amongst ourselves or with clients. Fortunately, we were able to rescue and relocate our server within a few days. Our employees worked as best they could from home (or friends', relatives', church, Starbucks, police stations, and elsewhere) to make sure that no important deadline was missed.

All of our staff and their families made it through safely, although many sustained damage to their homes. Some (including my family) are still without power as I write this. I want to thank all of our clients for your concern and good wishes, and publicly thank the many ACGers who spent their days volunteering to help those who were even more devastated by the storm and their nights answering emails and providing business continuity.

We're excited to "Occupy Wall Street" once again! With that, let's turn to our regularly scheduled programming…

Imagine that in the darkest days of the financial crisis, a visitor from the future had appeared to announce that four years hence credit card delinquencies would be at their lowest point since 1994, the cost of funds would be similarly at historic lows, consumer confidence would be rising, and pricing would be higher than it had been for some time. Well, it's 2012, and it's all true. So where's the party?

While these numbers sound good, bankers continue to be preoccupied with risk. The difference is that it's now operational rather than credit risk that keeps them up at night. The Comptroller of the Currency called the current environment "extraordinary," saying that it was the first time in 30 years that OCC examiners have seen operational risk eclipse credit risk as a safety and soundness challenge. Auriemma Consulting Group (ACG) has been advising the industry for 28 years now, and never before have we seen such levels of anxiety about the potential of losses due to the failure of people, processes, reputation, or external events.

120 BROADWAY
SUITE 3401
NEW YORK, NY 10271

212.323.7000 | TELEPHONE
212.323.7015 | FACSIMILE

WWW.ACG.NET

Within that broad definition of operational risk, compliance risk is a major source of concern for most of the industries we serve. The Consumer Financial Protection Bureau is up and running strong, despite the fact that it's still got hundreds of vacancies to fill. The goals of the new agency are laudable, and it's hard to deny that mistakes were made during the bubble years before the financial crisis. But many of our clients tell us that they've had to spend huge chunks of time teaching new CFPB hires exactly how their business works, and scramble to find office space to house large teams of regulators settling in for protracted visits. While this absorbs massive amounts of time and money that could be put to more productive use, there is something to be said for the opportunity to educate your examiners. And there are some hopeful signs, like the recent decision to revise the "ability to pay" requirement so that non-working spouses can get credit in their own names.

Similarly, reputational risk has a chilling effect. Irate customers armed with social media can make a seemingly minor misstep metastasize into headline news. Financial institutions are struggling to monitor and respond to every criticism posted on Facebook or tweeted to followers. The difficulty of calculating the potential impact of a PR disaster, coupled with the CFPB's requirement to track and report on the resolution of every complaint, has made banks hesitate to challenge even the most specious claims.

All of these risks increase the cost of doing business, even as the rollout (just delayed as we go to press) of Basel III rules raise the table stakes. In the credit card world, capital requirements will go from 10% to 13% or more, and it must come from the most expensive source: common equity. ROE declines as the denominator grows, despite the fact that the industry's ROA is returning to pre-recession levels.

Are credit card issuers leaving money on the table? While it's good news that credit quality is up, these low losses come from cardholders who revolve less, even as other sources of revenue, from penalty fees and sales of ancillary products, have been regulated away. Venturing deeper into the risk pool would yield higher response rates, lower the cost of acquisition and generate more revenue from interest --- more than enough to offset higher losses for a well-run issuer, we believe. But with regulators signaling their new enthusiasm for eye-wateringly large fines, and corporate stewards feeling skittish about any danger of tarnishing the brand, these potential risks end up forestalling expansion that credit risk alone might well have justified.

In secured lending, our clients in auto finance have made that deeper dive, and sales are benefiting. Automakers are on track to sell almost 15 million cars and light trucks this year, at an annualized rate not seen since March 2008. That remarkable recovery is driven partly by pent-up demand from consumers who, having put off buying for the last few years, are now taking advantage of record-low interest rates and the return of zero-percent financing. Through mid-September 2012, 24.4% of used car sales and 11.5% of new vehicle sales went to subprime buyers. The business case is made easier as the high resale value of repossessed cars has meant that even when auto buyers default, lenders can recoup their losses---or even make a profit.

Meanwhile, mortgage lenders have reported their fair share of good news after a long dry spell. The percentage of delinquent mortgage loans fell to its lowest level since 2008; foreclosure inventories have grown leaner; and loans underwritten in the last several years continue to perform exceptionally well. The housing market recovery also appears to be gaining traction. Home sales are climbing, spurred by historically-low mortgage rates, and prices are rising.

Not all the news is sunny, though. Housing is still not serving as an engine to pull the economy out of recession. Where toxic subprime mortgages once dominated, today's backlog of nonperforming loans derives from borrowers struggling to recover financially. Mortgage lenders are probably the most compliance-obsessed of all our clients, as the increasing scope of regulatory oversight, onerous national mortgage servicing standards, and a tide of state-specific legislation have caused some to pull back on originations.

Back in the credit card world, three developments that have been discussed for the past few years are finally starting to get some traction: general-purpose reloadable prepaid (GPR) cards, the move to EMV chips, and, everybody's favorite, mobile payments.

- Prepaid: it's not just gift cards anymore. In fact, several of our retail banking clients are discontinuing their sale of gift cards after failing to see enough direct or indirect payback from the largely seasonal foot traffic in the branch. The big news on the consumer front is the groundswell of interest in general-purpose reloadable (GPR) cards. This year has seen a flurry of new product offerings, including major launches by Chase (Liquid) and a Walmart/Amex partnership (Bluebird). There are several reasons that the stars have aligned for this product. The major driver is the Durbin amendment, which slashed interchange on traditional DDA-based debit cards while prepaid continues to earn at credit-card rates. The loss of debit interchange revenue has led to an inexorable (and predictable) increase in checking-account costs and fees. Depending on their usage patterns, GPRs can deliver many or most of the same benefits as debit cards at less cost to the consumer. In addition, banks seeking to expand their customer bases without venturing into subprime lending are seeing GPR as a way to establish relationships with un- and under-banked consumers. Interestingly, many banks targeting this market report a surprising degree of take-up from their own customers, who are utilizing them as a way to bucket or segment their spending. The entry of heavily-marketed products like Bluebird may benefit the category overall, but its aggressive pricing may also decrease the attractiveness for many bank issuers.

- Earlier this year ACG conducted a series of interviews with executives at major US banks, retailers, and other payment organizations regarding their plans for EMV. Tapping the knowledge of ACG London staff with experience in the UK migration to Chip and PIN, we wanted to see how the US experience was going to play out. The contrast could hardly have been starker. While UK bankers described a coordinated effort that synchronized the transition across issuers, acquirers, networks (or schemes, as our British friends say) and consumers, the picture in the US is, quite frankly, characterized by indecision and disarray. Visa and MasterCard are divided in their preference for authentication methods (signature versus PIN); small and midsized retailers are unwilling to spend on requisite new POS infrastructure; many acquirers and processors, caught in the middle, are largely unprepared; and issuers are struggling to fashion a business case. We've heard from more than one exasperated client that for EMV to take root, someone needs to step in and orchestrate this extremely significant transformation of the payment system.

- For headline-grabbing, though, the undisputed Next Big Thing is clearly mobile payments. Hardly a day goes by without a breathless announcement of a new mobile wallet, payment coalition, or enabling device. In fact, I sometimes think there are more articles about mobile payments than there are consumers taking advantage of the technology! But it's huge, it's real, and it's coming: we don't dispute that. We think, however, that reports of the imminent disappearance of the plastic card are wildly exaggerated. We also think the emphasis on mobile *payments* is missing the point somewhat. ACG believes that our industry needs to be thinking instead in terms of mobile *commerce.* Aside from the gee-whiz cool factor, there's no truly compelling reason for consumers to want to pay with their phones rather than their cards. It's not more convenient in most cases; there are big questions about security; and everyone knows the frustration of a phone running out of power or getting dropped into a puddle of water. But as retailers become more and more creative with location-based marketing, the incorporation of payment into the total experience of shopping---letting consumers conduct research, use loyalty codes and coupons, receive GPS-based offers, make a payment, and store receipts, all on their smartphones---will usher in the brave new world. Even then, I'll still be holding on to my plastic cards for awhile!

It happens every year: so much to talk about, so little time! Having watched our Presidential candidates squabble over their allotted time, I'm loath to emulate them. Let me just mention a few of the other themes that have emerged in this turbulent year:

- Retailers, fresh from the success in pushing through Durbin, are continuing to play an ever-larger role in the dynamics of financial services. We touched on their role in determining the direction of EMV migration and mobile commerce. The recently-formed MCX coalition, collectively accounting for roughly one trillion (with a t!) in annual US sales, will have enormous influence. And products like the above-mentioned Bluebird confirm many observers' belief that Walmart, already licensed as a bank in Mexico and Canada, hasn't abandoned its interest in similar efforts in the US. They may not be alone. Target's self-issued debit card featuring a flat 5% discount on all in-store purchases has been a hit with customers. In the UK, Tesco and other High Street merchants are expanding their financial offerings. Banks in both the US and UK are near the bottom of all industries in public esteem, while Apple, which incidentally holds the credit-card account numbers of more than 140 million people, enjoys quasi-religious status.

- Finally, Millennial influence continues to grow. Their preference for debit over credit and their reliance on smartphones and social media has already impacted the industry significantly, but other unique aspects of this generation are lying in wait. Millennials have grown up in a digital, multi-channel, on-demand universe, turning to their social networks for advice and opinions when confronted with any decision, large or small. Sooner or later these young people will pay off their student debts and accumulate savings---to put where? In an uncertain and wildly fluctuating stock market? In zero-interest savings accounts? In real estate that they watched bring their parents down? All of our constituencies are going to have to figure out how to deal with this, the largest generation (outnumbering even Baby Boomers) as borrowers, investors, and even employees.

Of course, we can't close this letter without commenting on the Presidential election. Regardless of how you view the results, at least we can all be thankful that the seemingly interminable campaigns are over. As I've spoken to friends and colleagues in the last few weeks, it seems that one thing is clear. Everyone outside of Washington believes that the destructive partisanship on both sides needs to stop if our country is going to get back on track in a serious way. It's hard to say that either party is without fault, and it's harder to predict how they will break the cycle. In the meantime, we hope that next year's update isn't dominated by the impact of the fiscal cliff.

As always, the team and I would love to chat about these or any other issues. We can be reached at (212) 323-7000. In the meantime, best wishes from all of us at ACG for a happy, healthy, and prosperous 2013!

Michael Auriemma