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Dear Friends,

If you invested in Bitcoin, Jamie Dimon thinks you must be “stupid” and Mark Cuban says you should be prepared to lose your money. Yet, the value of a Bitcoin is now fifteen times greater than it was at the start of the year. The stock market seemed over-heated at 18,000. Even more so at 20,000 and 22,000. Recently, it breached 24,000. So where should investors place their bets?

Retailers are struggling with brick and mortar. But when I took my daughter back-to-school shopping in September, I had to wait in line to get into the outlet mall’s parking lot. I then endured more lines for the dressing rooms and registers.

The US Congress seems ready to pass a tax bill which will help the rich. Or the middle class, depending on whom you ask. There are many other contradictions in politics (which I’ll choose to steer away from in this forum) regardless of whether, like most of our readers, you are in the US or the UK. Even in Zimbabwe… meet the new boss, same as the old boss (as The Who said in 1971).

What’s my point? Simply that the world is complex. It’s full of mixed messages, contradictions, and partisanship. Our own payments and lending industry is no different. This year’s letter looks at how that complexity has manifested itself for our clients over the course of 2017.

For example, US consumer confidence and stock markets are up, credit scores are at a record high, and unemployment is low. Yet, after a prolonged period of stability, US credit losses are on the rise. Of course, the UK market provides a stark contrast. Consumer confidence and the underlying economy are deteriorating, and wage growth is slow. While this escalates concerns about consumers’ ability to pay, the UK’s delinquency rates have been largely unaffected thus far, according to company reports and our proprietary benchmarking data.

So, why are US losses rising despite the positive market conditions? It’s easy to point to the recent uptick in new account growth and the subsequent (and expected) increase in early-stage delinquencies. Or, that non-prime borrowers have recently gained more access to credit. However, the current crop of newer vintages (accounts opened in 2014-2015) are performing worse than expected, according to many of our clients.

These losses don’t signal any existential threat to profitability for issuers in the near term, but our clients are taking the potential threat seriously. While none appear overly concerned about the credit outlook, most are diligently preparing for the possibility of continued deterioration.

The specter of rising losses is perhaps more ominous now that household debt has surpassed its pre-recession peak. For better or worse, the composition of that debt looks very different today than in 2008. Housing debt is down significantly, but auto debt is up dramatically, and student loans have tripled, leading to a raft of implications for the economic outlook.

In the auto lending arena, we are closely watching sub-prime lending. As dealers are pressured to sell more cars, in an era of ride sharing and a amidst a deluge of off-lease vehicles entering the marketplace, auto lenders are under similar pressure to approve more applicants. One result is longer loan terms, with some topping 96 months - a level that few believe is sustainable. The ability to balance sales goals and risk will be a major factor in separating the winners from the losers.

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Synthetic identity fraud (SIF) was another significant topic on our clients' radar this year. While EMV has successfully slashed counterfeiting, fraud losses (driven by card-not-present fraud) are higher than ever. With the amount of personal data available on the dark web (particularly in the wake of high-profile breaches, such as Equifax), fraudsters can create synthetic identities by combining real consumer data (such as Social Security numbers) with manufactured data (such as phony birthdates and names). This wreaks havoc on lenders in both fraud control and credit loss management.

As part of a recent study, Auriemma determined that up to 5% of charged-off credit card accounts could be linked to SIF. With the average unpaid debt totaling more than $15,000 per account, that equates to $6 billion, or 20%, in credit losses industry-wide. Issuers are banding together and fighting back, however. This year, Auriemma held its second workshop devoted to the subject. Our newly established working group will coordinate industry efforts to define, measure, and counteract this insidious trend.

As bad as the problem is in the US, I was interested to learn on a recent tour of UK card issuers, that SIF isn't making headlines in that market yet. While US issuers have been hamstrung by the inability to cross-check applications with Social Security numbers in a timely fashion, the UK has more effective screening processes at account acquisition. But we'll be closely watching the still-unknown implications of PSD2, which could create an opening for enterprising fraudsters.

In both the US and UK, retail sales are soft, with thousands of store locations closing their doors. But private label and co-brand programs are thriving as the savviest retailers are using these products to drive loyalty. Although 2017 was expected to be a slow year for US co-brand and private label activity, we've seen a surge of de novo offerings from the likes of Porsche, IKEA, Uber, Jet.com, Verizon, and others. These new deals, combined with the largest pool of issuers competing for deals in recent memory, made the market frothy indeed.

Issuers, merchants, and networks all worried about the future of co-branding in the UK after interchange rates were slashed to 30 basis points. Certainly, some value props have since been watered down. But other programs became stronger than ever after partners reached new agreements that restructured economics and allowed for more creative and compelling rewards. Ironically, the threat to these programs has forced the survivors (read: winners) to focus on the fundamental reasons why co-branding makes sense in the first place.

During a recent assignment in Japan, we've also observed several interesting dichotomies throughout the APAC region. Japan is fascinatingly modern and technologically advanced, though mobile payments have not penetrated the geography. This is true despite their having spread like wildfire in China, thanks to major players like Alipay and WeChat Pay. The average Japanese consumer carries six cards in her wallet (including many co-brand cards), but virtually no consumers revolve, and cash is still widely used. The spend-centric Japanese market is poised for the right combination of players to tap into consumer needs.

Mobile payments continue to struggle in the US, too. Despite consumers being increasingly addicted to mobile devices, mobile payment adoption is declining from an already low base. Between Q2 and Q3 this year, mobile payment usage fell 5% among eligible consumers, according to our proprietary Mobile Pay Tracker research. Earlier, I mentioned mixed messages. Here's another one: of those who use mobile payments, roughly one-third cite security as a main attraction. A near-equal proportion of non-users say their main barrier to trying mobile payments is - you guessed it - uncertainty around security.

Clearly, it's imperative that wallet providers and card issuers beef up education and communication around the security of mobile payments. Consumers want assurance that they won't be responsible for fraudulent transactions, and they want proof that mobile payments are secure.

The regulatory environment remains an uncertain landscape. In the US, look no further than the speculation about the CFPB future leadership and regulatory scope now that Director Cordray is out. Certainly, the interim director will have a very different mindset than his predecessor, likely leading to a new direction for the Bureau. If pressure from the CFPB does subside though, we have no doubt that many state regulators will pick up the slack.

As always, our focus is on advocating for common-sense approaches and drawing attention to unintended consequences arising from regulation. For example, earlier this year, we wrote a comment letter on the continued effects of the CARD Act. While the Act has improved transparency in pricing and marketing, the regulation has also restricted access to credit and eroded the customer experience.

Europe is also gearing up for major regulatory initiatives as GDPR and PSD2 are scheduled to take effect early next year. While both regulatory initiatives share a common theme – putting the customer in control of personal data - the timing and scope of those changes create wrinkles for implementation. For example, PSD2 focuses on making customer data available to third parties, while GDPR is focused on a customer's rights to keep it private. Moreover, PSD2 is based on current data protection regulations which will be replaced with GDPR. Both regulations present major operational and IT infrastructure changes and will take up significant resources. It might all prove to be worthwhile, however, for innovative lenders that use these initiatives to improve customer value rather than focus exclusively on complying with regulations.

When so many indicators seem to contradict each other, we must prepare for the unexpected. Through our industry roundtables, consumer and market research, partnership support, and corporate finance strategies, the team at Auriemma is prepared to assist clients in achieving growth targets while fortifying defenses against wide ranging threats.

Meanwhile, Auriemma is undergoing its own transformation. You may have noticed that I referred to the company as Auriemma throughout this letter, as opposed to ACG, which was our preferred acronym for many years. This is step one in a complete re-branding exercise we've embarked upon to more accurately depict who we are as a firm today and moving forward. Look for a new website, logo, and more in 2018.

We hope you enjoyed our perspective on the mixed signals rampant in 2017. While this annual industry round-up is a long-standing tradition, we continuously issue press releases, research, and articles focused on the topics that matter most to the industry. To follow along, please join us on LinkedIn or Twitter. Or, do it the old-fashioned way - give us a call.

We'd be happy to schedule time with you and your team to explore any of these (or other) topics in greater depth. Contact us at feedback@acg.net to set up a meeting or provide your thoughts on this year's letter.

Regards,

Michael Auriemma