Issue 6 – Winter 2012

HORIZON

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Welcome to *Horizon*℠

Happy New Year and welcome to *Horizon*. The past year brought some good news for Discover® credit card issuers, ending with positive growth in overall credit card spending, according to estimates by Mercator Advisory Group. Be sure to read more of their predictions for the 2012 credit market in this issue.

As we look forward to the increased interest in both cobrand cards and debit, we visited with Megan Bramlette from Auriemma Consulting Group. We know you'll want to check out her analysis and also get an in-depth view of the Washington legislative and regulatory environment from our own Ray Messina.

The cost of fraud is a concern for all of us, so we take a look at the status of payment card fraud in the U.S. and some of the enhanced technology being used to combat it.

It promises to be an exciting year and we're looking forward to sharing it with you. Thanks again for your continued support.

Sincerely,

Kevin O'Donnell
Group Executive, Credit Issuance

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The Paradox of Spending Growth

By Ken Paterson, Director, Credit Advisory Service, V.P. Research Operations, Mercator Advisory Group

2011 turned out to be a positive year for credit card spending among bank-issued credit cards, and average spending growth for the year came in at about 8 percent. This spending growth appears to be concentrated among the affluent, low-risk consumers most targeted by issuers over the course of the recession. Perhaps to no surprise, these affluent consumers, especially those with good credit histories, are more likely to say their use of credit cards is increasing or holding steady, according to our CustomerMonitor consumer survey for 2011. Those with average or damaged credit histories are far more likely to say they are trying to make less use of credit cards.

As we project growth scenarios for credit cards going forward, this paradox weighs on our outlook. While we are finally seeing a relatively healthy rebound in credit card spending, how long can that trend continue without strong net growth in accounts? At some point, continued volume growth will require a broader-based expansion in accounts.

Another driver of spending, consumers' willingness to revolve card purchases, remains muted. Again, an important segment of our survey respondents continues to indicate that they are favoring debit and cash spending in order to avoid growing their revolving balances, a situation little changed since the depths of the recession in 2009. As the Federal Reserve's G19 statistic on Consumer Revolving Credit Outstanding confirms, industry outstandings have yet to show a real growth since 2008, and are down an estimated 3.4 percent (annualized) through August of 2011. We see no upturn in consumers' willingness to borrow on the horizon, as economic headwinds continue to take a toll on consumer sentiment.

For 2012, spending growth in the range of 7–8 percent appears likely, but is likely to plateau without significant net growth in accounts on file. Net account growth in 2012 is likely to be an anemic 1–2 percent for banks, a level that could jeopardize future spending growth.

Wishing For a Durbin Bounce

As credit card issuers launched enhanced rewards programs, spending incentives, and attractive balance transfer offers in 2011, concurrent with reductions in debit rewards and announced increases in debit-related fees, speculation has increased that consumers will move their spend from debit to credit. While there may be some marginal shift to credit among affluent debit users who found value in now-discontinued debit rewards, a significant shift from debit to credit spending is unlikely. Consumers who find value in the spending control of debit appear unlikely to trust themselves with credit at this time. Also, fewer consumers now hold general purpose and private label credit cards than did before the recession, further constraining their ability to shift spending.

Will there be a Durbin-driven bounce toward credit? We feel that consumers are more likely to bounce to a new DDA provider if they feel the need, in order to continue their debit-based spending discipline.

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Can Co-Brand Cards Fill the Gap Created by the Declining Value of Checking and Debit Card Accounts?

By Megan Bramlette, Director, Auriemma Consulting Group

Over the past several years, debit cards have enjoyed a steadily increasing market share, in comparison to credit cards. Notably, debit cards became the primary payment tool among the mass-affluent population (consumers that had historically used credit cards), who relied on their debit cards in an increasing fashion as a way to limit their temptation to spend. Consumers in this population also saw debit cards as

a high-value payments product (due to their wide acceptance and their low cost), particularly as the interest rates associated with their credit cards increased as a result of the economic crisis. Debit cards allowed consumers to avoid over-extending themselves financially, without worrying about having to pay interest or fees for the privilege of doing so.

However, recent announcements from major consumer banks regarding checking account fees and the termination of debit card rewards programs have decreased the perceived value of these products in the eyes of the customer, many of whom have indicated that they would cease using their debit card if the value of the product decreases. In a recent issue of ACG's Debit Report, 31 percent of consumers with an annual household income exceeding $50,000 indicated that if their bank instituted a usage fee on their debit card or removed their rewards program they would revert to using a credit card. Just 17 percent of less affluent consumers would move to credit cards if the value of their debit cards decreased.

As lenders reduce the value associated with debit cards and checking accounts, we anticipate that value-seeking consumers may turn to co-brand credit cards as their primary form of payment. This will especially apply to those consumers in the mass-affluent population who are averse to paying fees for products that deliver nothing in return for usage. For this portion of the population, co-brand cards could be especially appealing as there is value passed along to the customer directly as a result of card usage. With debit rewards a thing of the past, it is possible that rewards-seeking former credit users (i.e., the mass-affluent population) return to credit cards. In particular, consumers seem unlikely to pay a substantial annual fee for a debit card when they could pay a smaller (or no!) annual fee for a co-brand credit card with a rich value proposition.

To be sure, some consumers will be wary of returning to credit cards, citing the spend controls that debit cards offer them as a primary reason for using the product. However, if lenders offer the spend management tools and reports that have historically been reserved for bank-branded products to their co-branded customers, the combination of increased value and the ability to monitor and control spending may be enough to encourage consumers to turn to co-brand credit cards as their primary payment product.

While it is possible that consumers will rely on cash increasingly as a result of reduced interest in debit products, the convenience of plastic could become too enticing for consumers to overlook when making their payments choices. As a result, we believe that the outlook for credit cards in 2012 is positive, and are particularly intrigued with the role that co-brand cards could play in a market environment marked by rapidly changing consumer preferences. ■

Auriemma Consulting Group (ACG) is a full-service management consulting firm serving the payments and lending industries since 1984. Megan Bramlette is a Director in the Partnerships practice.

The Paradox of Spending Growth *(continued from page 1)*

Opportunities Are Where You Find Them

Account origination opportunities in 2012 exist, but some may challenge the comfort levels of some issuers. These include:

- Broadening account solicitations to include non-prime and thin-file consumers who are just entering or re-entering the credit card market.
- Competing head-on in the race to offer attractive rewards at a reasonable program expense.
- Reminding consumers about the core values of the product, such as Reg Z-based consumer protections and the safety of separating payment accounts from deposit accounts.
- Stressing transparency of credit terms and education of cardholders on responsible credit management.

As we caution every year, the economy and consumers' economic sentiments trump all forecasts in the complex credit card marketplace. And the economic outlook for this year is not in itself bullish. But the recovery in card spending hints at the possibility of a credit card issuing recovery; the next move is up to issuers. ■

Washington Viewpoint

By Ray Messina, Asst. General Counsel and Vice President for Government Relations, Discover

The ink is barely dry on the initial set of regulations issued by the Federal Reserve to implement the Durbin amendment, but Senator Durbin and other proponents of interchange regulation are keeping up the heat.

Retailing trade associations cut short their victory lap on the enactment of the Durbin amendment to announce an "aggressive" campaign to pass legislation to regulate credit card interchange fees. So far, members of Congress have shown little interest in pursuing this effort. One senior House Democrat suggested that Congress would be more likely to repeal the Durbin amendment than to extend it to credit cards. Indeed, a bill repealing the Durbin amendment and voiding the Federal Reserve's interchange regulations was introduced by Reps. Chaffetz (R-UT) and Owens (D-NY).

In mid-November, Senator Durbin launched an effort of his own to address interchange fees on credit transactions. In a Senate floor speech, he called on the largest credit card issuers to disclose, on consumers' monthly billing statements, the amount of the interchange fee paid by merchants on each transaction. He did not explain why he feels consumers would benefit from learning about a small fee paid by someone else. It is unclear if Senator Durbin intends to turn this idea into a proposed legislative mandate, or if he will ask the Consumer Financial Protection Bureau to issue a regulation requiring the disclosure. (At the very least, a CFPB rule requiring, in effect, that monthly bills double in length would seem to run counter to the Bureau's interest in simplifying and shortening consumer disclosures.)

Another retail trade group effort has taken the form of a lawsuit against the Federal Reserve challenging the Board's interchange regulation as inadequate and inconsistent with the requirements of the Dodd-Frank Act. The obligation of courts to generally defer to regulatory agency expertise makes this lawsuit an uphill battle, and the Board is likely to ask the court to resolve the case through procedural motions. But the suit could also drag on for a long time, particularly if the court were to agree with the plaintiffs and send the rule back to the Federal Reserve, with judicial guidance, for another look at whether fees permitted under the initial regulations are too generous.

Also in November, Senator Durbin added language to a committee report on an appropriation bill that directs the Federal Trade Commission to study the impact of the Federal Reserve's debit fee regulation on smaller financial institutions, and whether larger banks and debit networks have conspired to harm smaller institutions. This part of the study would presumably be conducted by the FTC's Bureau of Competition. There is no comparable House provision (and opposition exists to adding one), and it is not clear at this writing if the provision will become part of the final bill.

A certain amount of congressional "issue fatigue" on interchange, a curtailed election-year legislative agenda in 2012, and Republican control since 2010 of the House of Representatives reduce the odds of further congressional involvement in interchange regulation. Still, the anti-bank sentiment in Washington and throughout the country has not abated, so the political danger of further legislation cannot be ignored. ■

Is the U.S. the Next Destination for Payment Card Fraud?

By Thomas A. Layman and Vinod Zalpuri, Global Vision Group

In 2010, total global fraud on payment cards resulted in over $6.25 billion in losses to all stakeholders. The good news is that although this "cost of doing business" is large, the incidence of fraud when measured as a percent of total purchase volume has steadily declined from the early 1990s. As the graph on the next page indicates, global fraud dropped to around 6.5 cents per US$1000 in 2008, less than half of that reported in the mid-1990s. This declining trend is due to increased investment in and sophisticated use of fraud detection, mitigation and avoidance policies and technologies. Unfortunately, however, the trend at the aggregate level tends to mask other trends that occur at the product, geographic and fraud type level. For example, the graph shows that decreased fraud rates associated with lost and stolen cards accounted for most all of the decline in overall fraud during the last decade. By comparison, other types of fraud, including counterfeit, fraudulent and unauthorized use, especially in card-not-present (CNP) environments such as MOTO and internet e-commerce, have either increased or remained steady during this same period.[1]

Enhanced use of technology to block and/or remove sensitive data from a transaction continues to evolve and vary by market and product. When stronger security emerges on cards in one area or product, the fraud doesn't just go away. It moves. This migration of fraud is most apparent when compared to variations in the the use of technologies, such as EMV chip.

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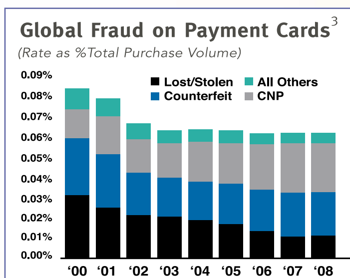
Is the U.S. the Next Destination for Payment Card Fraud? *(continued from page 3)*

According to the U.K. Cards Association, face-to-face card fraud at U.K. merchants fell by nearly 70 percent after the widespread introduction of EMV at the Point of Sale (POS) in 2004. During this same period, however, the CNP fraud rate rose by 50 percent and now represents 62 percent of all fraud in the country.[2] Similar experiences have been noted in other countries such as France, Australia and more recently in Canada.

EMV mitigates fraud on several fronts by verifying whether a POS terminal is legitimate, detecting a counterfeit card, and authenticating cardholders via dynamic authentication and cryptology. This can be enhanced with "two-factor" authentication of the cardholder by using personal PINs to verify the cardholder as well. For CNP transactions, use of Chip Authentication Programs using various software and hardware devices that can accept existing PINs or generate one-time passwords can further secure Internet-initiated payments.[3] Use of other techniques and technologies, such as virtual terminals and hosted pay pages (HPPs) where data are encrypted and stored in the "cloud," data masking and dynamic authorization are being implemented across various channels to better secure data and personal information.



Given that the largest payment market, the United States, is still dependent upon mag-stripe technology for conducting the vast majority of electronic transactions, the question naturally arises as to whether the U.S. is the next target for increased fraud. The main reasons for continued reliance on mag-stripe is the high cost to both re-issue cards and to upgrade or replace terminals that can support enhanced technologies.

Progress is being made however. A recent proprietary survey of a cross section of 30 U.S.-based card issuers by Global Vision Group found that 11 issuers have adopted EMV chip technology for issuing credit cards going forward. But of those adopters, only 10–20 percent of their respective portfolios will be upgraded by the end of 2012. Moreover, the vast majority will continue to rely only on cardholder signature rather than PINs for authentication at the POS. In the meantime, it is clear that the U.S. is a prime target for fraudsters, as evidenced by the jump in data breaches occurring within the U.S. This and the migration to mobile payments through virtual wallets, NFC chips and other technologies in both the virtual and real world will help accelerate the transition to adopt enhanced security measures and technology to protect all stakeholders across all electronic payment products and channels of use. ■

[1] The fraud category noted as "other" includes fraud types such as fraud committed through fraudulent applications to obtain a card, fraud committed on cards that were never received by the authorized cardholder (NRIs), and other miscellaneous fraud types.

[2] http://www.ukpayments.org.uk/resources_publications/key_facts_and_figures/card_fraud_facts_and_figures/-/page/645/

[3] Diner's Club International is now piloting such a product called "Protect Buy."

[4] Scotiabank Commercial Card Conference, 2010.

Did You Know?

FIS Adds Discover Network to Card Processing Capabilities

FIS, the world's largest provider of banking and payments technology, recently announced an agreement with Discover Financial Services to process cards that are accepted over the Discover® network. A leader in card processing, FIS offers fully integrated transaction processing solutions, providing a single point of authorization, transaction posting, settlement, reporting and access for all services. In addition to the newly added Discover cards, FIS currently supports card issuers for Visa,® MasterCard® and American Express® as well as domestic schemes and proprietary card brands.

The Discover network is a comprehensive and secure payments network. A business unit of Discover Financial Services, Discover Network markets and supports a full range of credit, debit and prepaid cards including the Discover Card. At least one in four U.S. households hold a Discover card. Further, Discover's U.S. card issuing business has more than $46 billion in receivables.

FIS provides card processing services for every aspect of card production and processing including activation, fraud management and value-add loyalty programs. In addition, FIS's solutions provide end-to-end processing support of consumer, commercial, small business and private-label card programs. Currently, FIS processes 70 million credit cards, 125 million debit cards and in excess of 180 million prepaid cards on a global basis. In the U.S. alone, FIS provides credit card processing for 3,000 financial institutions.

"FIS's comprehensive solutions will allow us to focus on what is most important to us—continuing to find ways to better serve our customers," said Kevin O'Donnell, Vice President of Card Issuance, Discover Network.

"Ongoing regulatory changes have made issuing cards increasingly difficult for financial institutions and frustrating for consumers," said Frank D'Angelo, Executive Vice President, FIS Payment Solutions Group. "By teaming with FIS, Discover Network broadens its network of processors, while providing increased customer satisfaction and loyalty to its issuers and cardholders alike." ■

About FIS—FIS (NYSE: FIS) is the world's largest global provider dedicated to banking and payments technologies. For more information about FIS, visit www.fisglobal.com.

The views of Mercator Advisory Group, Auriemma Consulting Group and Global Vision Group as expressed in this Newsletter do not necessarily reflect the views of Discover. We appreciate the contributions of these great authors.

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