Navigator

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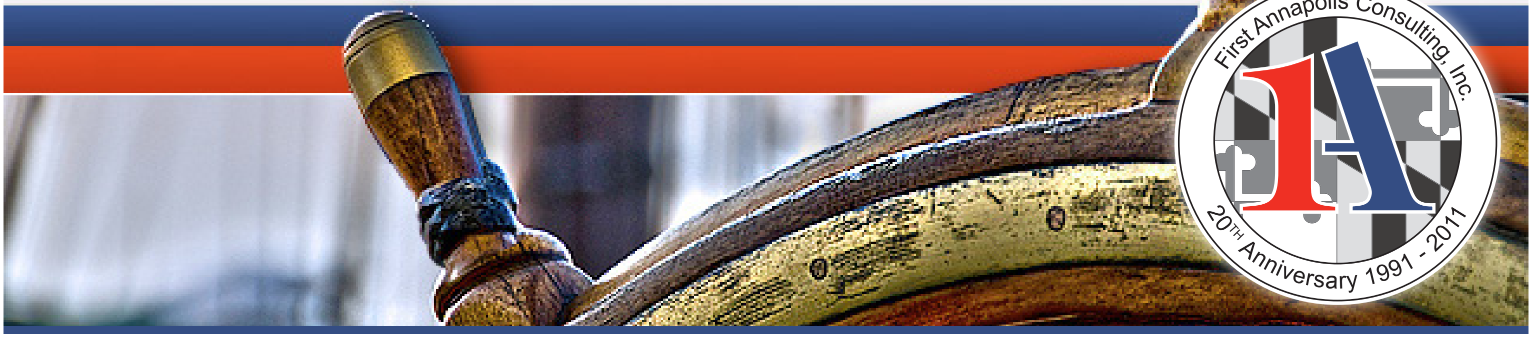

December 2011

Interview with Discover Networks' Kevin O'Donnell

Kevin O'Donnell is the Vice President of Credit Issuance for Discover Network, a business unit of Discover Financial Services, and is responsible for Discover Network's credit issuing partner management and business development. Kevin leads a team who oversee the relationships with Discover Network's credit issuing partners as well as business development activities with direct credit issuers, co-brand programs and group service providers (GSPs).

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Season's Greetings

Warmest Thoughts & Best Wishes For A Wonderful Holiday & A Happy New Year

First Annapolis Estimates Debit Growth

While the recent enactment of legislation regulating interchange fees has materially affected the profitability of debit for issuers, we expect debit volume growth in the U.S. to remain strong. First Annapolis developed its five year forecast for debit volume through discussions with issuers, analysis of market data, and internal analysis... More

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1. Discover has been quite active with a series of acquisitions and new products/ services. Can you provide some context on Discover's strategy as it relates to both issuing and network priorities?

In the last decade, Discover has transformed itself into one of the fastest growing global payments providers in the world. This growth has been spurred by both acquisition of the right companies and international strategic alliances.

The acquisition of PULSE, one of the nation's largest ATM/debit networks, and Diners Club International, a global payments network with acceptance in more than 185 countries, plus strategic alliances with UnionPay and JCB, have dramatically expanded our global acceptance footprint. Network to network agreements with BCcard, the largest network in Korea and DinaCard, the national Serbian payment card, have continued to increase our presence. Our global payment strategy will continue to expand our presence in other countries during the years to come.

As a provider of network services for both issuers and acquirers, Discover Network is one of the largest card networks in the United States, and over the past five years, has signed all of the top merchant acquirers, representing 97% of the total U.S. sales volume. Our comprehensive payments network supports multiple card products and billions of financial transactions each year. We expect our continued development of mobile commerce products and services like our contactless payments program, Discover® Zip®, will help to grow these alliances.

One of our strategic priorities is to add new partnerships to Discover Network. Discover Network currently includes over 30 partners now issuing Discover-branded cards through some of the biggest issuers in the industry: GE Capital Retail Bank, First National Bank of Omaha, Alliance Data Systems (ADS) and HSBC with leading retailers such as Wal-Mart and Sam's Club. We continue to enhance our relationship with other small to mid-sized market participants such as credit unions and community banks. We are a preferred partner of NAFCU Services, and a number of credit unions have begun issuing on the Discover Network this year.

Additionally, Discover seeks to be a leading direct bank and payments company. Discover's successful expansion into direct banking since 2007 includes private student lending, personal loans, and direct-to-consumer savings products, such as CDs and money market accounts. In 2010, Discover purchased the student lending division of Citigroup –The Student Loan Corporation – making Discover America's third largest student loan provider.

2. What is the value proposition that Discover offers to banks and merchant partners?

The Discover brand is known for rewards, customer satisfaction and loyalty. We challenge the status quo by truly putting our customers and their goals first. Our overall company philosophy of delivering the best in everything we do demonstrates our commitment to helping our issuers and merchant partners to achieve their goals.

Discover is focused on providing both products and services that exceed our clients' expectations. We know that we must be fast and flexible to succeed. We believe that both our issuers and our merchant partners would say that we have a proven track record of rising to meet challenges. Our banks and merchant partners know that when they offer Discover cards the value is real.

At Discover we bring together all of our network resources to help our clients achieve success – from relationship management, operations, and product development, to marketing and merchant relations. Our unique collaborative approach and commitment to our partners continues to drive our business.

3. What should potential partners know about Discover as an issuing or network option?

Again, the Discover brand has come to stand for rewards, service and value and that is exactly the value proposition that we present to our partners.

Discover supports a full range of Credit, Debit, and Prepaid products. We also provide customer-centric tools and programs designed to drive loyalty and increase transaction volume, boasting such differentiated products as Cash Over and the Personal Financial Management Suite, which includes Spend Analyzer and Paydown Planner. Our industry-leading fraud prevention, award-winning customer service, innovative product development, and client marketing practices are among the best in the payments industry and set us apart from our competitors.

Our heritage and history of success has given us a very strong foundation for the future. We believe that Discover, in addition to being a unique brand, is also the right fit for any size partner and brings the best of both worlds to our clients – the resources and capabilities of a large experienced enterprise, with the mindset and nimbleness of a small, entrepreneurial company.

4. Can you provide an update on Discover's product offering beyond credit?

Beyond credit, Discover owns PULSE, one of the nation's largest ATM/ debit networks and offers a broad range of Prepaid solutions as well. But beyond traditional plastic, Discover has been actively building industry leading capabilities with emerging technologies - both at the POS and in virtual environments. The fundamental criteria driving these capabilities is that we must shape and deliver value to all stakeholders - including merchants, issuers, acquirers, hardware/software manufacturers and, most importantly, consumers.

We have already launched award-winning mobile applications – like SWAGG™, and our in-market contactless devices through Discover® Zip® are leading the way in contactless payment solutions. We are also currently testing real-time and location-based services to provide merchant offers to cardholders – when and how they want to receive them. The opportunity to create real value for our issuing community is huge, and all of us will benefit from that.

Discover will continue to develop a roadmap that creates real value, at the right time, and where the consumer is still "King". This is how we ensure that we are leveraging emerging solutions correctly.

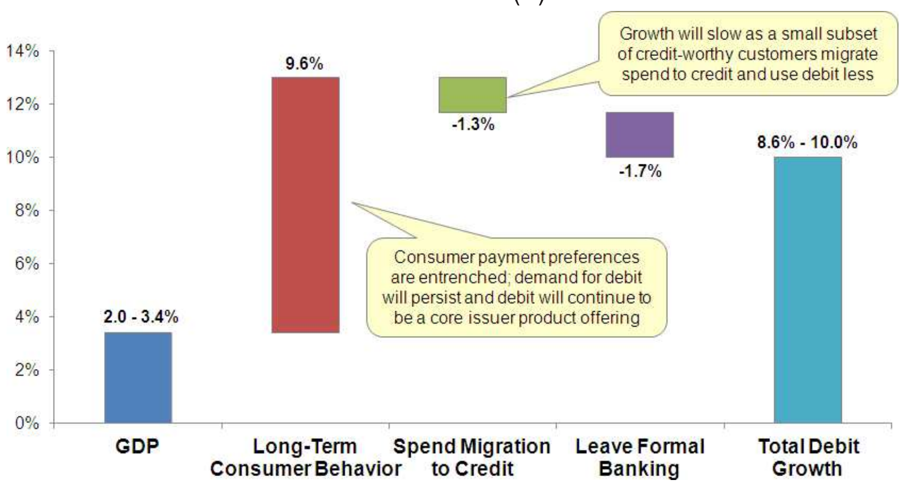
First Annapolis Estimates Debit Growth

By the Deposit Access Team

While the recent enactment of legislation regulating interchange fees has materially affected the profitability of debit for issuers, we expect debit volume growth in the U.S. to remain strong. First Annapolis developed its five year forecast for debit volume through discussions with issuers, analysis of market data, and internal analysis, and concludes that debit transaction volume will reach up to 76 billion by 2016, an 8.6% - 10% annual growth rate. This growth rate represents a slight deceleration compared to the last five years, but reinforces that debit will continue to be a core product offering and popular payment channel among consumers.

Figure 1: U.S. Debit Transaction Volume Forecast

2012 – 2016 (B)



Source: World Bank, CBO, Federal Reserve, First Annapolis Consulting estimates and analysis.

The First Annapolis forecast of debit growth is primarily driven by the continuation of the long-term secular shift of consumer payment volumes from paper forms to cards, and the continued adoption of debit by younger consumers. Coupled with the government-forecast GDP growth, of up to 3.4% annually, we would expect debit growth of approximately 13%, close to recent past performance. However, two Durbin-related forces will likely depress those rates. First, a portion of current debit spend will likely shift from debit to credit, as consumers are presented with attractive value propositions for credit-interchange qualified products. We do not anticipate issuers extending these offers deeply into their debit customer portfolios, but the practice may constrain growth by up to 1.3% over the forecast period.

Second, we expect Durbin-related deposit account repricing to force a subset of underbanked households out of traditional banking products and into other channels. The resulting shift from debit to other payment forms will result in another 1.7% annual reduction in debit growth.

Taken together, First Annapolis expects that these factors, plus a direct outgrowth of the Durbin regulations, are likely to slow debit growth by as much 3% over the next five years. However, this hiccup will not displace debit as a core product offering or a preferred payment method.

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The Early Read on Holiday Retail Sales Is Mixed

By Steven Le

As is the case every holiday season, all industry eyes are on retail sales and recent National Retail Federation forecasts point to a 3.8% increase over 2010. While standard retail sales metrics remain top of mind, the full picture is far more complex. The way that customers purchase is becoming as important as how much and what they purchase. To name a few of the most notable developments, e-commerce now manifests itself in different forms (e.g., PC, tablet, smartphone), comparison shopping technology is proliferating, social media is the rage, and promotions are intense.

The early read on holiday retail sales offers a partial view into some of these dynamics. As Table 1 indicates, retailers that skew to the affluent demographic have posted higher sales results thus far. This is not a surprise given the fact that the U.S. unemployment rate is still hovering around 9% driving a disparity across the purchasing power of demographic segments. Those retailers catering to the mass market have had more varied sales performance which will fuel heavy promotions as the holidays approach.

Table 2 highlights some “factoids” that track the online and mobile channel, offering an early glimpse into this year’s consumer holiday purchasing behaviors. E-commerce is experiencing significant growth

Table 1: November Same-Store Sales Growth for Select Retailers

Retailer	Growth
Saks	9.3%
Costco	9.0%
Limited Brands	7.0%
The Buckle	6.9%
Nordstrom	5.6%
Ross	5.0%
Macy's	4.8%
The TJX Companies	4.0%
Dillards	3.0%
Stage Stores	2.3%
Target	1.8%
Banana Republic N.A.	0.0%
Wet Seal	-1.8%
JCPenney	-2.0%
Gap N.A.	-2.0%
Talbot's	-4.0%
Stein Mart	-4.6%
Kohl's	-6.2%
Old Navy N.A.	-7.0%

Source: Merchant Press Releases.

with consumers engaging via the mobile channel in meaningful ways. Mobile traffic increased 14.3% on Black Friday (versus 2010) as consumers rely on mobile devices to research products, stores, etc. Social network discussions were up over 100% as consumers shared tips on inventory, parking, and shopping deals. There are many different opinions on the evolution of mobile payments, but it is clear that mobile devices are influencing shopping behaviors and the pace of change is alarming.

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Table 2: Thanksgiving Weekend 2011 Statistics

Black Friday 2011 Statistics[1]
Black Friday online sales grew 24.3% year-over-year.
Mobile traffic made up 14.3% of total online traffic (vs. 5.6% in 2010).
Mobile sales made up 9.8% of total online sales (vs. 3.2% in 2010).
iPad conversion rates reached 4.6% (vs. 2.8% for all mobile devices).
Social network referrals generated 0.53% of all online sales.
In online sales, winning categories included department stores (59% y-o-y growth), home goods (48.8%), apparel (47.2%), and health & beauty (34.2%).
Of these categories, department stores exhibited the highest shopping cart abandonment rate at 76.3%.
Cyber Monday 2011 Statistics[2]
Cyber Monday online sales grew 33% year-over-year.
Mobile traffic made up 10.8% of total online traffic (vs. 3.9% in 2010).
Mobile sales made up 6.6% of total online sales (vs. 2.3% in 2010).
iPad conversion rates reached 5.2%.
In online sales, winning categories included home goods (68.4% y-o-y growth), department stores (60.0%), apparel (33.9%), and health & beauty (23.0%).
Other Statistics[3]
Thursday-Friday sales by dollar volume grew 6.3% year-over-year; transaction volume grew 7.3%.
Electronic/Appliance retailers came out on top with 12.0% dollar volume growth, whereas General Merchandise Stores was the only category to experience negative growth at -2.6%.
Retailer average ticket over Thanksgiving weekend decreased 0.9% year-over-year.

Source: [1] IBM Benchmark Black Friday Report 2011. [2] IBM Benchmark Cyber Monday Report 2011. [3] First Data SpendTrend Special Edition: Black Friday.

Green Dot Makes Significant Strategic Move

By Bob Rohr

Green Dot has much to be thankful for this holiday season, as the Federal Reserve Board approved the company's bid to purchase Bonneville Bancorp. Green Dot is expected to close on the Provo, Utah bank acquisition by year end, ending the company's year and a half-long quest to obtain regulatory approval. The deal, worth $15.7MM, represents a significant milestone in the prepaid industry and a major strategic move for Green Dot.

The Board's approval marks the first time the Fed has allowed a prepaid card program manager to buy a bank as well as a rare occurrence of a non-financial institution obtaining a bank charter. Fed Gov. Elizabeth Duke dissented in the 4-1 vote, arguing that the deal was too risky given Green Dot's reliance on revenue from a single product (prepaid cards) and a single partner (Wal-Mart). To address these concerns, Green Dot pledged to maintain a Tier 1 leverage ratio of 15% for five years and to balance customer deposits on cards with equal levels of cash. Deposit and funds management will be critical for the stabilization and success of the bank; if effectively managed, the Green Dot deal may serve as the blueprint for more non-financial institutions seeking bank charters.

Green Dot will be regulated by the San Francisco Fed and the Utah Department of Financial Institutions after conversion to a bank holding company. While the introduction of such regulatory scrutiny may not be appealing now, it may be in Green Dot's best interest down the road. As the Consumer Financial Protection Bureau gains steam, and once a bureau head is confirmed by the Senate, the CFPB will have direct oversight of all non-banks with a keen focus on "alternative" financial services providers such as check cashers, payday lenders, and prepaid card providers, as well as banks with more than $10 billion in assets. As a bank holding company with less than $10 billion in assets, Green Dot will avoid some oversight from the CFPB, though it will still be subject to general prepaid industry guidelines. While being under the watchful eye of federal and state banking regulators may not be a welcome change, it is plausible that Green Dot would prefer this structure over being regulated by another entity.

Prepaid program manager margins have come under attack recently from two angles. Increased competition has placed downward pressure on cardholder fees and correspondingly on program managers' bottom lines. Compounding the problem, other prepaid value chain participants erode the program manager's margins through additional revenue sharing demands and servicing fees. Vertical integration has been a common trend in the prepaid market and has largely been at the program manager's expense. Retailers managing their own programs, processors adding program management capabilities, and financial institutions self-managing the delivery of their programs are all examples of vertical integration at the expense of the program manager. Green Dot's acquisition effectively counters the integration trend, with the potential to replace several links in its own value chain, reduce issuance costs, and improve operating margins while achieving a high degree of strategic flexibility. For Green Dot, a program manager who must currently balance the needs of sponsors, processors, distribution partners, and networks, obtaining a bank charter is a competitive coup.

The Fed's approval of Green Dot's bank charter is a historic moment for the company and the prepaid industry at large. The implications extend beyond Green Dot and its immediate partners, as industry players will be watching closely to see the effects on pricing, value chain economics, and most importantly, bank management. A successfully managed bank will bring legitimacy to the Fed's decision, and may serve as the Fed's new precedent in granting bank charters to non-financial institutions.

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Merchant Acquiring and The Internet: In Search of New Merchants

By Chris Sanson and Marc Abbey

Among the various lead sources that acquirers utilize to drive new merchant accounts, one of the more dynamic and less understood is internet search. Nearly every ISO and acquirer generates some level of business through internet searches, be it through aggressive advertising campaigns or more passive organic approaches that drive traffic to the acquirer's homepage. We set out to quantify the market opportunity presented by internet searches, and to examine how this opportunity has changed over time.

There are primarily two means by which an acquirer generates leads through the internet - paid search and organic search. In paid search, the acquirer actively enables search keywords on a search engine such as Google, and pays a per-click fee each time a Google user clicks on the acquirer's ad. In organic search, the acquirer designs its websites in such a way that it hopes to drive search users to its sites without the assistance of paid advertising.

In order to estimate the market opportunity presented by internet search, we used Google AdWords to approximate the total number of merchant-services related searches that occur in a given month in the U.S. At first blush, the numbers are staggering. By our count, there are over 13 million searches for merchant services-related terms every month on the internet.

Keyword	Avg. Monthly Google Search Volume
"Card Services"	550,000
"Credit Card Payment"	368,000
"Credit Card Accepting"	33,100
"Credit Card Machine"	74,000
"Credit Card Processing"	165,000
"Merchant Services"	165,000
"Merchant Account"	246,000
Other Related Keywords*	6,898,900
Total (Google)	*8,500,000*
x Google Market Share	*~66%*
= Total (All Search Engines)	*12,900,000*

*Compilation of ~250 related keywords using Google-suggested related search terms

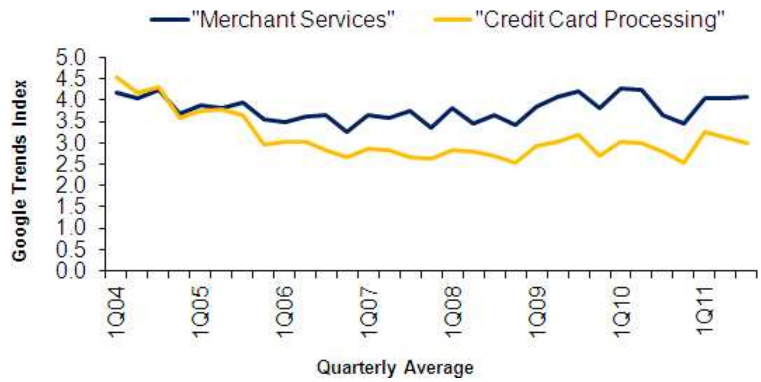
While 13 million sounds like a large figure, most of those searches will never become true leads. Using assumptions we generated from synthesizing third party research about the internet search market as a whole, we attempted to translate the number of monthly searches into actual leads and, ultimately, signed accounts. The results are impressive but not so stratospheric:

	Organic Search	Paid Search
Monthly Searches	13 million	13 million
x Click Thru Rate	6%	2.5%
x Lead Conversion Rate	4%	8%
x Close Rate	25%	25%
= Monthly Production	7,800	6,500
Annual Equivalent	93,600	78,000

Assuming about 20% of the ~8 million merchants in the U.S. make a buying decision every year, the combined annual number of merchant accounts generated through internet leads represents about 10% of all new merchant accounts in a given year.

How has this proportion changed over time? Counterintuitive to us, at least, it appears that internet traffic for key merchant services search keywords has been steady to decreasing over the last seven years. Compound annual growth rates, as measured by first quarter results, have declined by 0.5% and 4.7% for "Merchant Services" and "Credit Card Processing," respectively.

Figure 1: Search Frequency of Key Acquiring Terms

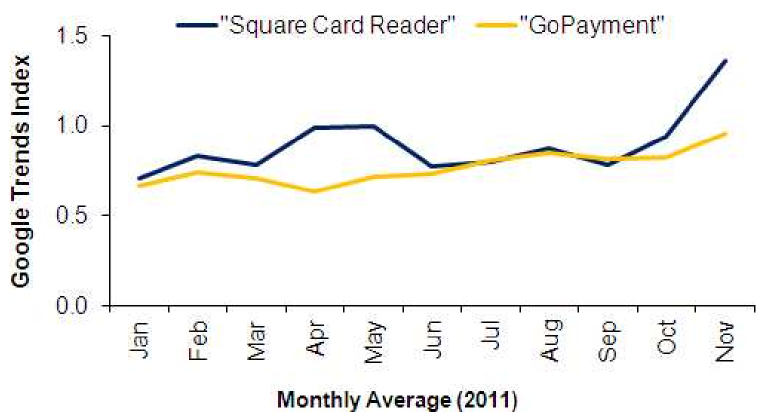


Source: Google Trends and First Annapolis Consulting analysis.

Though the propensity for merchants to buy through 'search' may be increasing in merchant services as it is in other consumer and business markets, there is not a great deal of evidence that search is on a rapid ascent as a lead source, as a general statement, at least as it relates to general search terms.

We did not observe this stagnant trend across the board. Searches for mobile-related acquiring terms have been on the rise in 2011. Twitter co-founder Jack Dorsey's Square card reader has been "trending" this year, as has Intuit's GoPayment device to a somewhat lesser extent. The search frequency for "Square Card Reader" has increased at a compounded monthly rate of 6.7% for the period Jan-Nov 2011. This equates to an annual growth rate of 118%. Similarly, search frequency for the term "GoPayment" has increased at a 3.6% monthly rate, equivalent to annual growth of 53%.

Figure 2: Search Frequency of Mobile Acquiring Terms



Source: Google Trends and First Annapolis Consulting analysis.

In the paid search and organic search world, the trends illustrated above may have interesting implications for acquirers that rely on search for lead generation. Acquirers selling a generic brick and mortar acquiring solution are competing with an increasing number of ISOs and specialty providers for a somewhat static number of unique impressions. In contrast, acquirers or quasi-acquirers selling uniquely branded mobile solutions are seeing a large uptick in impressions.

Having said all this, we do not expect this channel to lose its relevance any time soon. We do think, however, that acquirers will have to continue actively managing their internet lead businesses in order to stay ahead of the changing facets of the market.

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Why Building Balances Matter

By Matt Zalubowski

Credit card balance-building efforts are not new, but behavioral economics may provide further evidence as to why they are relevant. Credit card issuing banks earn the majority of their card revenue from charging interest. As a result, banks are motivated to build cardholder balances. This makes sense and basic arithmetic proves this point. Given a finite means to pay off a loan, the larger the loan, the longer the payoff and the greater the interest expense incurred by the cardholder. The importance of balance building efforts becomes more apparent when one considers on average Americans holds over three cards and combined balances exceed $6,000 (Experian 2011). Amongst these loans, which card balance does the average consumer pay off first? The answer is not exactly obvious, but what is, each bank would like their respective balance to be paid off last.

Normative economic behavior would anticipate each consumer take actions to lower their overall indebtedness as fast as possible. The best means to lower ones debt is to first pay off the largest loan being charged the highest interest rate. Interestingly enough, most cardholders do not approach paying off their credit card debt in this manner. Cardholders regularly practice what Behavioral Economists Moty Amar, Dan Ariely, Shaar Ayal, Cyhtia Cryder and Scott Rick refer to as "debt account aversion." Rather than pay off the most expensive credit card balance first, cardholders lower the number of loans outstanding.

While counter to economic theory, this practice is somewhat intuitive. Financial guru Dave Ramsey believes this method of setting smaller, attainable goals results in a "snowball method" for debt repayment. Ramsey argues success begets success, so a consumer that pays off a small loan is more likely to continue paying off one's other debts. While this practice may cost consumers more in the long run, consumers realize debt repayment is a timely and costly process. Paying off a large loan, regardless the interest rate, is daunting and provides little to no appreciable immediate benefit.

So what does this mean to banks issuing credit cards? Building balances matters, and the underlying psychology associated with managing multiple loans further demonstrates the larger the loan, the longer it will take the indebted to repay. Given the increase in credit card legislation, one is apt to call foul on banks taking actions to purposefully increase credit card balances. Such a judgment is hasty, for balance building is often facilitated by debt consolidation. By combining loans, a cardholder can no longer rely on debt account aversion to dictate loan repayment. With fewer loans outstanding, consumers will begin to pay off their larger and higher interest charging debts. Thus banks are earning additional interest revenue while subtly instructing their cardholders to better manage their credit card debt.

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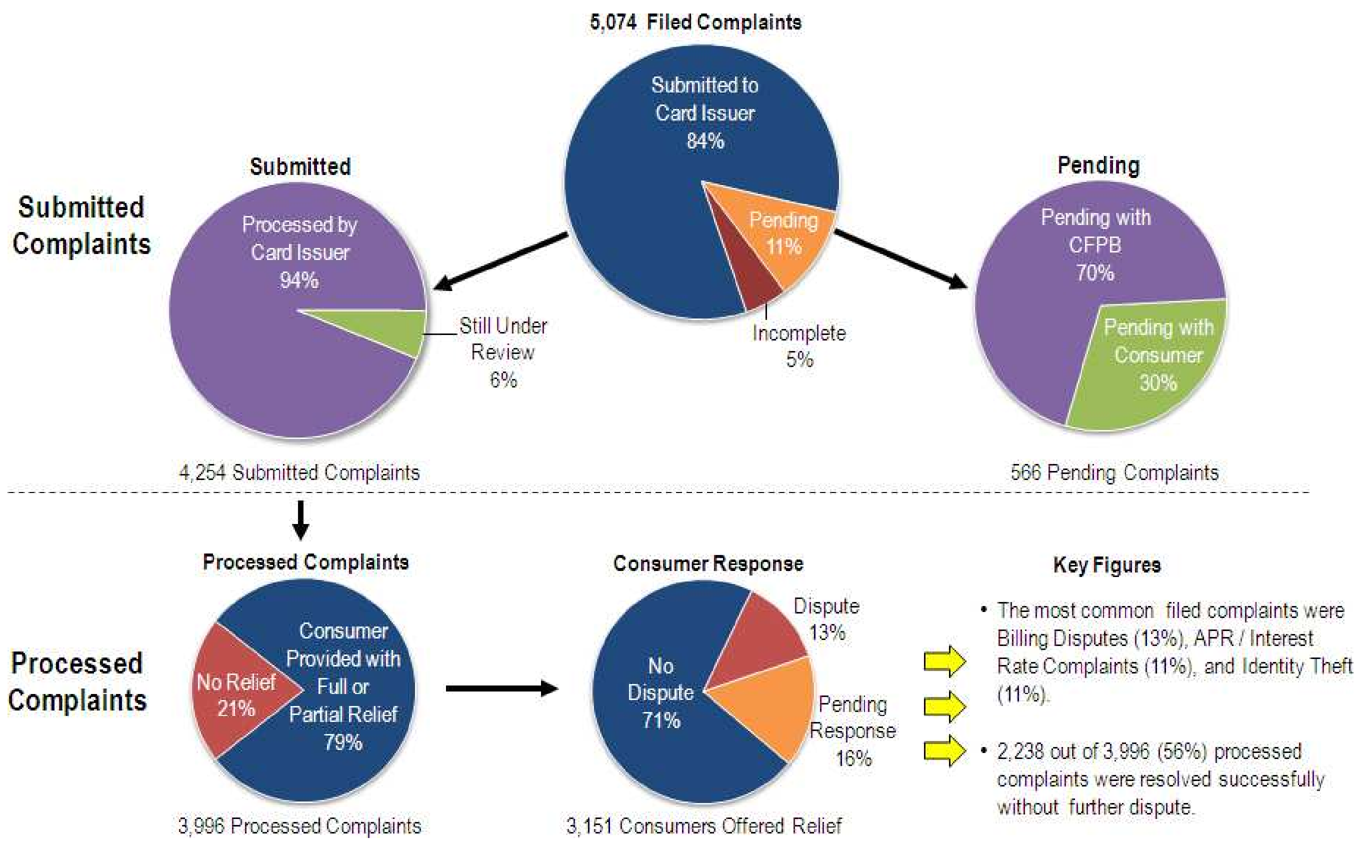
The CFPB Releases a Prototype Credit Card Agreement and New Study on Consumer Complaints

By Collin Bauer

The Consumer Financial Protection Bureau (CFPB) released a credit card agreement "prototype" on December 7th as part of its "Know Before You Owe" campaign to help consumers better understand the credit agreements offered by card issuers. The CFPB's prototype aims to provide a "short, clear, consistent, and consumer-friendly" suggestion for credit card issuers to use to simplify their Terms & Conditions. Incorporating the proposed template into credit card agreements is currently optional for issuers, and has been referred to by the CFPB as only a 'thought-starter". However, depending on the outcome

Figure 1: Interim Report on CFPB's Credit Card Complaint Data



Source: CFPB

of an upcoming pilot program for nearly 350,000 Pentagon Federal Credit Union cardholders, the CFPB could implement more formal requirements to card issuers in the future. The official CFPB press release and credit card agreement prototype can be found using the links at the bottom of this article.

The CFPB also recently released the Interim Report on CFPB's Credit Card Complaint Data, their first-ever study on consumer credit card complaints. Published on November 30th, this report tracked over 5,000 consumer-reported credit card complaints submitted to the CFPB during the 3-month span from June 21st – October 21st. The most common claims filed by consumers were billing disputes (13%), APR or interest rate disputes (11%), and identity theft / fraud disputes (11%). After receiving disputes from consumers, the CFPB forwarded those claims to the respective credit card issuers for investigation. As shown in Figure 1, issuers were able to successfully resolve about 56% of all processed complaints. While this complaint system successfully identified recurring scams and helped obtain redress for fraudulent customers, the CFPB concluded that "many complaints show consumers struggling to understand the terms of credit cards and associated products like debt protection services"-an issue the CFPB aims to address in 2012.

Official CFPB Press Release
http://www.consumerfinance.gov/pressrelease/consumer-financial-protection-bureau-aims-to-simplify-credit-card-agreements/

CFPB Credit Card Agreement Prototype
http://www.consumerfinance.gov/assets/CFPB_card_agreement.pdf

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Payments Industry Stock Price Tracker

By Ryan Douglas

Figure 1 is the December Payments Industry Stock Price Tracker. The chart measures current stock prices and market caps (as of December 15, 2011) and changes over the last 30 days as well as year-to-date movements. Unless there is a rally in the second half of December, the stock market is on pace to finish slightly in the red for the 2011 calendar year. Despite a strong start to the year, the market took a significant hit at the end of July (10% drop from 7/25 to 8/5) following news of the European debt crisis, and the U.S. stock market has struggled to recover.

In summary:

- The bank sector experienced a loss of 6% in the past 30 days. Bank of America continues to be the major factor in the sector's negative performance; the stock price is down 62% since the beginning of 2011.
- The processor/acquirer sector performed slightly better than the market this month with a 1% loss; the sector is up 5% YTD.
- The networks also reflected a 1% loss over the last 30 days, but are up nearly 45% on the year.

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Figure 1: Monthly Average Stock Price Tracker

Companies	Dec. 15, 2011	30 Day Δ	YTD Δ	Current Market Cap ($Billions)
Acquirers / Processors				
TSYS	$19.21	-5%	10%	$3.87
Fiserv	$57.24	-2%	-7%	$8.05
Fidelity	$25.23	2%	-17%	$7.63
Global Payments	$44.01	-3%	-7%	$3.47
Heartland	$22.98	4%	46%	$0.94
Average	-	-1%	5%	-
Issuers				
American Express	$46.42	-7%	7%	$54.64
Bank of America	$5.26	-14%	-62%	$53.31
Capital One	$43.05	-1%	-11%	$19.80
Chase	$31.76	-3%	-29%	$121.80
Citi	$25.92	-7%	-46%	$75.90
Discover	$23.07	-7%	13%	$13.16
US Bank	$25.80	1%	-4%	$46.69
Average	-	-6%	-19%	-
Networks				
MasterCard	$359.21	-3%	52%	$45.92
Visa	$95.82	0%	38%	$79.07
Average	-	-1%	45%	-
Market Index				
S&P 500	$1,215.75	-3%	-5%	-

Source: Yahoo Finance, First Annapolis research and analysis.

Founded in 1991, First Annapolis is a specialized advisory firm focused on electronic payments. Our market coverage is international in scope with a primary focus on North America, Latin America, and Europe. First Annapolis is headquartered in the Baltimore / Washington, D.C. corridor and Europe is served through our office in Amsterdam. In total, we have over 70 professionals across our practice areas giving us one of the largest and strongest advisory teams focused exclusively on electronic payments.