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Industry Surveys
Financial Services: Diversified

Erik Oja, Financials Sector Equity Analyst

DECEMBER 2014

Current Environment 1

Industry Profile 8

Industry Trends 10

How the Industry Operates 21

Key Industry Ratios and Statistics 31

How to Analyze a Financial Services Company 34

Glossary 37

Industry References 39

Comparative Company Analysis 40

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CONTACTS:

INQUIRIES & CLIENT SUPPORT
800.523.4534
clientsupport@
standardandpoors.com

SALES
877.219.1247
wealth@spcapitaliq.com

MEDIA
Michael Privitera
212.438.6679
michael.privitera@spcapitaliq.com

S&P CAPITAL IQ
55 Water Street
New York, NY 10041

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Natural Gas Distribution
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55 Water Street, New York, NY 10041

CLIENT SUPPORT: 1-800-523-4534

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CURRENT ENVIRONMENT

Consumer lenders are benefiting from gathering US economic strength

Since July 2014, when the last *Survey* was published, the US economy has continued to blossom with improving jobs data, strong credit quality, and consumer confidence indicators at high levels. These factors serve as a catalyst for the diversified banks and consumer banks industries to thrive.

Latest jobs data show that total nonfarm payroll employment increased by 214,000 in October 2014—a level in line with the average monthly gain of 222,000 in the prior 12 months. The increase in October marks the ninth month in a row with employment rates above 200,000—the longest stretch since 1994. Meanwhile, unemployment edged down to 5.8%, a six-year low, which signals a strengthening economy. The jobless rate has dropped by 0.8 percentage points since January 2014, while the current rate is a marked improvement from 7.2% in October 2013.

The US mid-term elections resulted in both the House and the Senate landing under Republican control. The finance industry is among the industries expected to benefit from said control. One of the industries that the new majority can possibly tap is the reform of government-sponsored entities (GSE), such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), particularly in terms of capitalization that may benefit the housing industry. Meanwhile, according to a survey conducted by ConvergEx, a global brokerage firm, 88% of respondents believe that the finance industry will benefit from the Republican win, as regulations, previously spearheaded by the Democrats, have hurt the banks' return on capital.

Since hitting a low in February 2009, US consumer confidence, as measured by the Conference Board, has generally improved. Confidence has risen in a seesaw pattern, from a reading of 25.3 during the darkest periods of the financial crisis, to the current level of 88.7 in November 2014. The only major downtrend posted from February 2009 was in October 2011, driven by the European banking crisis, downbeat US economic indicators, and a falling stock market. The Conference Board's questionnaires cover a sample of 5,000 households and emphasize labor conditions.

This *Industry Survey* focuses on two related but distinct areas of operation: diversified financial services and consumer finance operations. Included in the former are the largest banks in the US—JPMorgan Chase & Co., Bank of America Corp., Citigroup Inc., Wells Fargo & Co., and US Bancorp. Given that they are major competitors in the consumer finance industry, we touch on them in this *Survey;* however*,* for more details about their operations, see the *Banking* and *Thrifts & Mortgage Finance* issues of *Industry Surveys*.

The major companies that characterize the consumer finance industry are American Express Co., Discover Financial Services, and Capital One Financial Corp. We also include Visa Inc. and MasterCard Inc., as they operate card networks that are major competitors to American Express and Discover. We note, however, that under S&P's Global Industry Classification Standard (GICS) methodology, Visa and MasterCard are classified under the Information Technology sector in the Data Processing & Outsourced Services sub-industry because they are business-to-business companies that do not lend money.

Credit card companies invested significantly in marketing during the past few years to attract new customers, boost name recognition, and gain market share. They also took windfall credit improvement as an opportunity to invest in their future within the mobile payments space. We continue to look for top-line improvements from all credit card–focused companies, as management's time is free to focus on growth initiatives.

Lastly, while auto lending and consumer credit remain strong, tougher underwriting and mortgage standards together with heavy debt loads hold back home mortgages and home buying.

KEY CAPITAL RATIOS— THIRD QUARTER 2014 (In percent)		
COMPANY	TIER 1 COMMON CAPITAL RATIO	TANGIBLE COMMON EQUITY / RISK WEIGHTED ASSETS
CONSUMER FINANCE		
American Express	13.60	12.80
Capital One	12.73	9.56
Discover	14.80	14.66
OTHER DIVERSIFIED FINANCIAL SERVICES		
Bank Of America	12.00	7.22
Citigroup	12.97	13.58
JP Morgan	10.20	9.87

Source: Company reports.

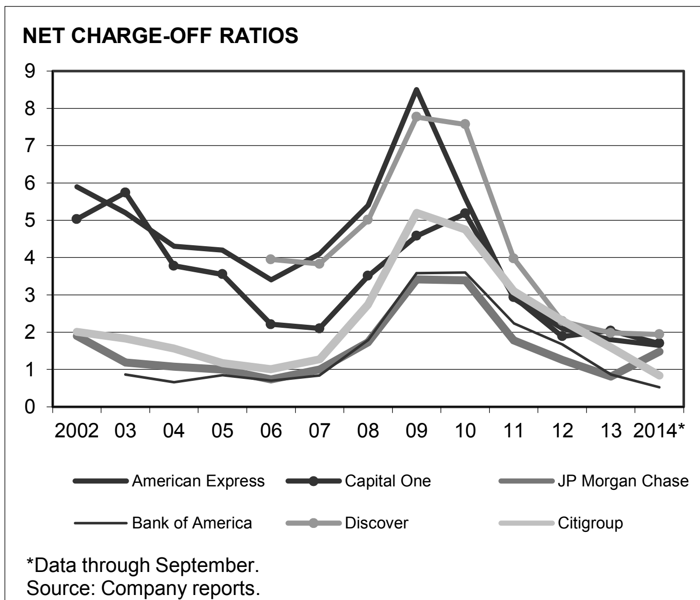
STRONG CREDIT QUALITY

Credit quality (measured by delinquencies and net charge-offs) improved significantly and continuously from 2009 through the third quarter of 2014, as consumers managed their personal debt balances.

Credit card credit quality is continuously improving

In the third quarter of 2014, data from the Federal Reserve Board show that the credit card delinquency rate (non-seasonally adjusted) for the top 100 banks in the US declined to 2.2%, compared with its peak of 6.7% in the first quarter of 2009. Meanwhile, the credit card charge-off rate (non-seasonally adjusted) fell to 2.9% in the third quarter of 2014, from its peak of 11.1% in the second quarter of 2010.

The major credit card issuers have seen their delinquency and net charge-off rates plunge to historic lows as consumers and households pare back debt. American Express' net write-off rate (for principal and fees on loans) in the US card division fell to around 1.7% in the third quarter of 2014, compared with its 10.0% peak in the second quarter of 2009. Discover Financial's credit card net charge-off rate was 1.9% in the third quarter of 2014, from a peak of 8.5% in the first quarter of fiscal 2010 (ended February 2010). Lastly, Capital One Financial's domestic credit card net charge-off ratio fell to 1.7% in the third quarter of 2014, from the recorded peak of 10.5% in the first quarter of 2010. We expect that delinquencies and charge-offs will rise from these historically low levels as companies look to grow their businesses, and we project a return of typical seasonal trends.



*Data through September.
Source: Company reports.

US auto lending remains strong

We expect lending requirements in the US to loosen and competition to pick up as the automotive delinquency rate continues to improve after the crisis. Statistics from Experian, a global data and analytical services company, show that auto finance lenders have been granting longer-term loans to the market, causing no overheating in the near term. Loan-to-value ratios remain relatively stable. In our view, competition has picked up, as auto lending continues to offer more attractive returns than other asset classes (such as commercial loans).

According to Experian, the 30-day delinquency rate was a healthy 2.39% as of the second quarter of 2014, versus 2.38% recorded in the second quarter of 2013, and 2.52% in the same period in 2012. Credit requirements have loosened slightly over the past several years—in order to grow their business, lenders are now charging lower interest rates, allowing longer payback periods, and taking more risks than they were in 2009–2011. In our view, this is in response to improved loan repayments by borrowers. According to Experian's "State of the Automotive Finance Market" report, the average credit score required for a new car loan was 711 in the second quarter of 2014 (644 for a used car), versus the peak score of 736 in the same quarter of 2009 (651 for a used car in the second quarter of 2010). The average amount financed for new cars in the second quarter of 2014 was $27,429, up 3.4% from $26,526 in the second quarter of 2013. For used cars, the average amount financed was up 1.9% to $18,258, from $17,913 in the second quarter of 2013. According to Experian, the average interest rate was 4.6% for new cars and 8.8% for used cars in

the second quarter of 2014, compared with 4.6% and 8.6%, respectively, a year earlier. In the second quarter of 2014, the average loan term was 66 months for new cars and 61 months for used cars.

The outlook for the auto loan industry remains strong. In October 2014, J.D. Power and Associates and LMC Automotive forecast that US auto volumes would grow 0.7% in 2014, totaling 13.6 million vehicles, due to overall better economic conditions and increasing consumer adoption of long-term financing that make monthly payments affordable.

Student loan trends still on the rise

According to the latest Federal Reserve Bank of New York's "Household Debt and Credit Report" (August 2014), student loans (including federal and private student loan balances) increased by $124 billion as of June 2014 from a year ago.

Student loan balances amounted to $1.1 trillion in as of June 30, 2014, with 10.9% delinquency by 90 days or more. New direct subsidized and unsubsidized loans for undergraduate students that originated in July 2014 carried a 4.66% interest rate, while direct unsubsidized loans for graduate students were at 6.21%.

For private student loans, Discover Financial Services has seen significantly better student loan credit performance than its industry peers, which in our view is because it requires cosigners for the students. The company also focuses on four-year and not-for-profit schools, requires school certification for all borrowers, and directly disburses funds to schools. In the third quarter of 2014, Discover's net charge-off ratio for student loans was 1.14%, versus 2.3% for private student loans at Navient Corp. (a spin-off company of SLM Corp.).

Home mortgages held back by tougher underwriting standards

New home sales increased to a six-year high in September 2014, to a seasonally adjusted annual rate (SAAR) of 467,000 units—the highest reading since July 2008. Meanwhile, existing home sales rose in October 2014 to a SAAR of 5.26 million, for the second straight month, and above its year-ago level—for the first time since October 2013. Further, as evidenced by the S&P/Case-Shiller US 20-City Composite Home Price Index, house prices gained 5.6% year over year in August 2014. The index is up 29.5% from the March 2012 lows.

While the housing market continues to improve as reflected by the above indicators, tougher underwriting and mortgage standards, as well as heavy debt loads, still hold back home mortgages and home buying from surging ahead. Mortgage lending is covered in depth in our *Thrifts and Mortgage Industry Survey*, while the US home industry is covered in our *Homebuilding Industry Survey*.

MASSIVE DATA BREACHES

As credit card and electronic payments have been widely utilized in the recent years for executing transactions, security has always been an important issue, particularly, as massive data breaches were reported year after year. In August and September 2014, JPMorgan and Home Depot experienced massive data hacking that compromised the information of millions of its customers.

In mid-August 2014, JP Morgan reported that its data from 76 million households had been breached—equivalent to 65% of total US households, and seven million small businesses. According to JP Morgan's SEC filing in October 2014, the hacked information consisted primarily of customer contact information such as names, addresses, phone numbers and email addresses, as well as internal JP Morgan information about customers. However, according to the report, highly classified information remained safe.

Similarly, in September 2014, Home Depot announced a breach in their payment data systems affecting more than 56 million households. The brick-and-mortar stores in the US and Canada have been affected, while stores in Mexico were spared. The company is investigating transactions from April 2014 to assess the full impact of the breach, and it assured that there is no evidence that debit PIN numbers were hacked. In order to protect the consumers who used payment cards in their 2014 transactions at Home Depot, the company offered free identity protections services, which include credit monitoring.

MOBILE PAYMENTS

In the past two years, the adoption of mobile payments has been widespread. In our view, while some players are motivated by the revenue potential, gaining access to the rich data captured by payment systems is more attractive for all players. Below we discuss several major transactions.

◆ **Discover/PayPal.** In August 2012, PayPal (owned by eBay) announced an agreement with Discover to expand its reach to more than seven million merchant locations across the US that already had an existing relationship with Discover; the agreement took effect in spring 2013. This combination, in our view, has strong growth potential, and it will be a formidable player in the mobile payments game. We also think that the PayPal relationship adds value for Discover, particularly on the international side.

According to our estimate, Discover/PayPal's combined annual spend in 2013 was around $200 billion. American Express had a head start among its peers, with $952 billion total spending in 2013, and it disclosed that it saw $130 billion online spent in 2012 (compared with PayPal's $145 billion). The high penetration of offline merchant relationships favors the more established networks, such as American Express, Visa, and MasterCard.

PayPal has entered several partnerships to extend the reach of its payment services. Uber Technologies Inc. forged a partnership with PayPal in November 2013 to support the payment services of its popular mobile-booking application in the US, France, Germany, Italy, and the Netherlands. In the February 2014 Mobile Congress, Samsung announced that a biometric identification system for payments using PayPal would be incorporated on its latest flagship phone, the Galaxy S5. In May 2014, PayPal entered a strategic relationship with MyCheck, a checkout technology, to enable real-time restaurant payment solutions from consumer mobile devices.

In September 2014, PayPal announced the acceptance of Bitcoin, a software-based online-payment system, for digital goods transactions of merchants. Through partnerships with BitPay, Coinbase, and GoCoin, PayPal will let its merchant participants accept Bitcoin in their transactions. According to PayPal, this will be available in North America for the moment. Meanwhile on November 3, 2014, PayPal announced a mobile app deal with Burger King for a payment service expected to rollout early next year in more than 13,000 Burger King outlets. On November 10, 2014, Corethree, a leader in mobile booking and ticketing solutions in the UK, announced that its m-ticketing solutions now include PayPal payments. The deal is expected to show excellent reach, as PayPal has over 19 million active accounts in the UK. Lastly, Alibaba Group Holding Ltd, an e-commerce company, plans to work with PayPal to expand its payments options.

◆ **Merchant Customer Exchange (MCX).** A group of merchants formed MCX in August 2012 to offer a versatile mobile commerce platform (through an application) to smartphone-enabled consumers. The original partners included in the group were major retailers including 7-Eleven Inc., CVS Caremark Corp., Darden Restaurants, Lowe's Companies Inc., Publix Super Markets Inc., Sears Holdings, Target Corp., and Wal-Mart Stores Inc. As of May 2014, total member merchants reached 59. New partners include ExxonMobil, Giant Eagle, Kum & Go, and Rite Aid Corp. In our view, this was a strategic move on the part of the retailers to build negotiating power on fees, to gain competitive insight, and to enhance custom marketing capabilities.

In February 2014, MCX added Paydiant Inc.'s cloud-based and white-label platform to allow its member merchants to use the application programming interface (API) to provide complete mobile wallet capabilities into their own iPhone and Android applications.

The platform would equate to a private-label store card, of which we think that American Express stands out from the other networks. Due to its closed loop and strong direct merchant relationships, American Express has been able to provide extensive feedback to clients historically, and it has been a key partner to retailers through targeted marketing and membership rewards.

In September 2014, MCX announced that its payments, loyalty, and offers platform will be called "CurrentC," and that it is expected to be rolled out in 110,000 merchant locations across US in 2015. In

October 2014, MCX announced that it is open in supporting both NFC and Bluetooth Low Energy for payments as well as conversion of credit card issuers for its CurrentC mobile wallet. MCX suffered a data breach on the email addresses of some of its CurrentC pilot program participants in October 2014; however, the company assured that many of the email addresses are dummy accounts used for testing purposes only.

◆ **Bluebird.** In October 2012, American Express and Wal-Mart Stores Inc. forged a partnership to launch Bluebird, a prepaid general-purpose debit-style card targeted to lower-income shoppers who may not have bank accounts. Consumers can sign up online by downloading the mobile application, or they can purchase a $5 kit at Wal-Mart. After successful registration, the prepaid card is sent to the consumer. Bluebird cards can be used not just at Wal-Mart stores, but also at outlets where American Express cards are accepted.

This card competes with the traditional checking account, due to its compelling low-fee structure: no annual or monthly fees, no overdraft fee, no minimum balance requirement, no charge to replace a lost or stolen card, no fees for bill pay, and the funds never expire. In addition, no credit check is required to use this card. Customers who choose to set up direct deposit can avoid the $2 fee for using 22,000 MoneyPass ATMs. Further, customers can deposit money by taking pictures of checks or by going to cashiers at 4,000 Wal-Mart stores (this number of “branches” would place Wal-Mart around the No. 4 position among the largest US banks). Bluebird cards also have features traditionally associated with credit cards, and for customers that demonstrate a long-term record of creditworthy behavior, American Express will likely offer traditional credit cards in the future.

In March 2013, Wal-Mart added Federal Deposit Insurance Corporation (FDIC) insurance to Bluebird accounts; paper check writing was rolled out in mid-2013. The company does not publish routine updates on the number of its Bluebird accounts. Most recent available data (as of February 2013) show that there were more than 575,000 accounts.

In October 2014, American Express and Walmart launched “Get 2X” for Walmart’s Savings Catcher, an online tool that compares prices of eligible items purchased at Walmart to the advertised prices of the identical items at top retailers. According to the press release, if Savings Catcher finds an advertised price lower than the price of an identical item in Walmart, customer can get the difference on a Walmart Rewards e-Gift Card or a Bluebird Account to be spent exclusively at Walmart stores or its website.

◆ **Apple Pay.** On September 9, 2014, Apple Inc. announced its plan to launch Apple Pay, a mobile payment system that works with iPhone 6 and iPhone 6 Plus through a groundbreaking NFC antenna design, a dedicated chip called the “Secure Element,” and the security of “Touch ID.” Current users with iTunes Store account can easily setup their credit and debit card on file, while Apple Pay will also work with Apple Watch, extending the reach of the payment system to over 200 million owners of iPhone 5, iPhone 5c, and iPhone 5s worldwide.

Apple Pay supports credit cards and debit cards from American Express, MasterCard, and Visa, representing 83% of credit card purchase volume in the US, according to Apple. Aside from the 258 Apple retail stores in the US, many of the nation’s leading retailers will support Apple Pay, including Bloomingdale’s, Disney Store, Walt Disney World Resort, Duane Reade, Macy’s, McDonald’s, Sephora, Staples, Subway, Walgreens, and Whole Foods Market. In addition, Apple Watch can be utilized at over 220,000 merchant locations across the US that are contactless payment enabled. Consumers can also make purchases using Apple Pay through applications in the App Store.

According to the company, Apple Pay offers enhanced security and privacy through its Secure Element feature. When a credit or debit card is added to Apple Pay, the actual card number will not be stored on the device nor on Apple servers. In addition, the payment system will not to collect the user’s purchase history and when the iPhone is lost or stolen, customers can use “Find My iPhone” to suspend payments quickly from the device.

Apple Pay was launched on October 20, 2014. The company reported one million credit card activations within 72 hours of availability.

INDUSTRY OUTLOOK

Consumer Finance

In our view, the Consumer Finance sub-industry will outperform the broader Financials sector in the next twelve months, due to relatively less capital markets exposure, relatively more transparent business models, and dynamic and compelling growth strategies that should blossom as the economy improves.

Our fundamental outlook for the consumer finance sub-industry is positive, as we think companies are well positioned to capture the rewards of an improving economic environment. Due to tight underwriting standards employed through the downturn, a dramatic improvement in credit quality began in 2011 and continued through 2014. In our view, overall credit quality trends will be stable in 2014 and 2015, and we expect spending to grow at a faster rate than consumer loans. While the industry is now under a higher level of regulatory scrutiny, in our view, companies will act prudently. With credit at historically strong levels, we expect management's time to be focused on strategic growth initiatives.

Of the consumer loans offered by companies in this sub-industry, the biggest emphasis is on credit cards, as auto finance and private student loans are relatively smaller markets. The US credit card industry is relatively mature, but its players are accustomed to competition, and are balancing account growth, margin, and expenses. These companies are sophisticated information-rich marketers and are expected to develop innovative new products. The most significant area of development is in mobile payments, which brings new industry competitors.

We forecast a slight gain in receivables and loans in 2014 and think that companies will continue to modestly loosen credit standards over the next couple of years. Industry receivables growth and discount revenues for the card networks will likely continue to be moderate due to the cautious attitude toward debt and lackluster spending. We think receivables growth and spending should pick up as consumer confidence and employment levels improve. For the longer term, pricing pressure and competition will remain intense, and we expect the larger consumer finance companies to continue to look for new niches.

Year to date through September 5, 2014, the S&P 1500 Consumer Finance Index was up 3.5% versus an 8.2% rise in the S&P 1500 Index. However, this follows a robust 2013 performance of the S&P Consumer Finance Index 46%, along with a rise of 30% in the S&P 1500 Index.

Other diversified financial services companies

The S&P Diversified Banks sub-industry includes the four largest US banks by asset size as well as the largest Canadian banks. We have a positive fundamental outlook on this sub-industry, despite legal challenges, lower mortgage banking revenues, and equity and fixed-income trading headwinds for the US-based members of this sub-industry. For the US banks in this group, we see legal costs subsiding, easier trading revenue comparisons with the weak second half of 2013, and high capital levels leading to increased returns to excess capital to shareholders.

Second-quarter 2014 profits for the US banks in this group fell 6.2% from a year earlier, affected by declining mortgage banking and trading revenues. Quarterly net revenues were down 3.1% from a year earlier, as noninterest income fell 6% from the prior year and net interest income was flat a year ago. In the second quarter, loans held for investment rose 2.1% from a year ago, in line with the 2.2% rise of 2013, and the median net interest margin for the group fell just 0.01% from a year ago. With the Federal Reserve ending its mortgage bond buying programs, we see interest margins rising slowly, going forward.

The next 12 months for the US banks in this group will likely depend on the growth of the US economy, housing prices, the length of the low interest rate environment, regulatory costs, and capital demands. For the US banks in this group, we expect a 3% decrease in net income in 2014 (following a 23% increase in 2013, a 26% rise in 2012, and a 49% increase in 2011), on flat net revenues. However, we anticipate continuing credit quality improvements leading to lower loan loss provisions, and we see noninterest expenses falling. For 2015, we see flat growth, on a 3% revenue increase.

These banks are well capitalized, in our view, with an average Tier 1 Basel I capital-to-risk-weighted assets ratio of 10.9% at June 30, well above regulatory minimums. These banks have increased returns of “excess” capital, following the annual “stress test” results released each March.

Year to date through September 5, the S&P 1500 Diversified Banks Index was up 7.5%, beating a 6.5% increase in the S&P 1500 Financials, but lower than the 8.2% increase in the S&P 1500 Index. ■

INDUSTRY PROFILE

Diverse industry in an improving environment

We generally define consumer finance companies as those included in the S&P Consumer Finance Index. The major players of the index—American Express Co., Capital One Financial Corp., and Discover Financial Services—offer a wide variety of products and services, including various consumer lending products (such as automobile loans, home-equity loans, and credit cards, insurance, debit cards, and securities and investment products).

CREDIT CARD COMPANIES' MAJOR BUSINESS LINES

CAPITAL ONE	DISCOVER	AMERICAN EXPRESS
Credit Card Business	**Direct Banking**	**Global Network & Merchant Services**
Domestic credit card	Discover Card branded credit cards	Global payments network processes &
International credit card	Personal loans	settles card transactions
Domestic installment loans	Student loans	Partners with third party banks and
	Prepaid cards	institutions to issue cards
Consumer Banking	Other consumer loans	Network Card License (NCL)
Auto finance	Deposits–direct & brokered	Sign up merchants & settle; provide
Home loans	Fee products– identity protection,	marketing services
Other retail	payment protection, wallet protection,	
	credit score tracker, extended	**US Card Services**
Commercial Banking	warranties	Credit card
Commercial and multifamily real estate		Charge card
Middle Market	**Payment Services**	Deposits
Specialty lending	PULSE–ATM, debit, and EFT network	Consumer Travel Network
Small-ticket commercial real estate	Diners Club–global payments network	Special Services & Fee Business–
	Third Party issuers on Discover Network	Membership Rewards Global Assist
Non Bank Activities		hotline, protection plans (purchases,
Capital One Agency LLC–insurance		returns, event tickets, fraud),
agency		travel insurance (car rental loss &
Capital One Investment Services LLC–		damage, flight, baggage, roadside
broker-dealer		assistance), emergency card
Capital One Southcoast Capital–		replacement, advance ticket sales,
broker-dealer		CreditSecure, credit score & reports,
ING Direct Investment–broker-dealer		identity theft assistance, ID Protect
Asset Management–registered		Platinum Office program, online money
investment advisor		manager exclusive access to
		cardmember events
		International Card Services
		Co-brand credit cards
		Global Commercial Services
		Expense management services
		Corporate cards
		Corporate meeting cards
		Global business travel
		Global corporate payment services
		Corporate purchasing card
		vPayment - virtual payments
		Buyer-Initiated Payments (BIP)–
		electronic automated payments
		Supplier relations
		Meetings & events spending services
		Advisory services
		Enterprise Growth Group
		Serve–mobile payments application
		Online & mobile fee-based services
		Global payment options–global prepaid
		& gift cards
		American Express Publishing

Source: Company reports & S&P Capital IQ

Historically, the consumer finance companies placed the greatest emphasis on credit loans and/or consumer loans. However, given the advantages of scale for efficiency, access to deposit funding and capital, the division between banks and consumer finance companies is no longer as clear as it once was. Meanwhile, major diversified finance companies now have banking subsidiaries and/or are banks focused on consumers.

TOP 20 US-BASED BANK HOLDING COMPANIES BY ASSETS
(In billions of dollars)

	TOTAL ASSETS		
	9/30/2013	9/30/2014	% CHG.
1. JPMorgan Chase & Co.	2,463	2,527	2.6
2. Bank of America Corporation	2,127	2,124	(0.1)
3. Citigroup Inc.	1,900	1,883	(0.9)
4. Wells Fargo & Company	1,488	1,637	10.0
5. Goldman Sachs	923	869	(5.9)
6. Morgan Stanley	832	814	(2.2)
7. U.S. Bancorp	361	391	8.5
8. The Bank of New York Mellon Corporation	372	386	3.9
9. The PNC Financial Services Group, Inc.	309	334	8.4
10. Capital One Financial Corporation	290	300	3.6
11. State Street Corporation	217	275	26.6
12. BB&T Corporation	181	187	3.3
13. SunTrust Banks, Inc.	172	187	8.8
14. HSBC USA	187	175	(6.6)
15. American Express Company	150	154	2.5
16. Ally Financial	151	149	(0.9)
17. Fifth Third Bancorp	126	134	6.8
18. Regions Financial Corporation	117	119	2.0
19. Northern Trust Corporation	96	111	15.8
20. KeyCorp.	91	90	(1.0)
Total	12,551	12,847	2.4

Source: S&P Capital IQ Compustat.

The consumer finance industry is harder to quantify in terms of its size and scope than the banking industry. Like traditional banks, consumer finance companies record interest income and fees from lending products, establish reserves for potential credit losses, and generally compete aggressively with each other. However, consumer finance companies tend to be less diversified, and they usually focus on relatively higher-margin (and higher-risk) consumer businesses.

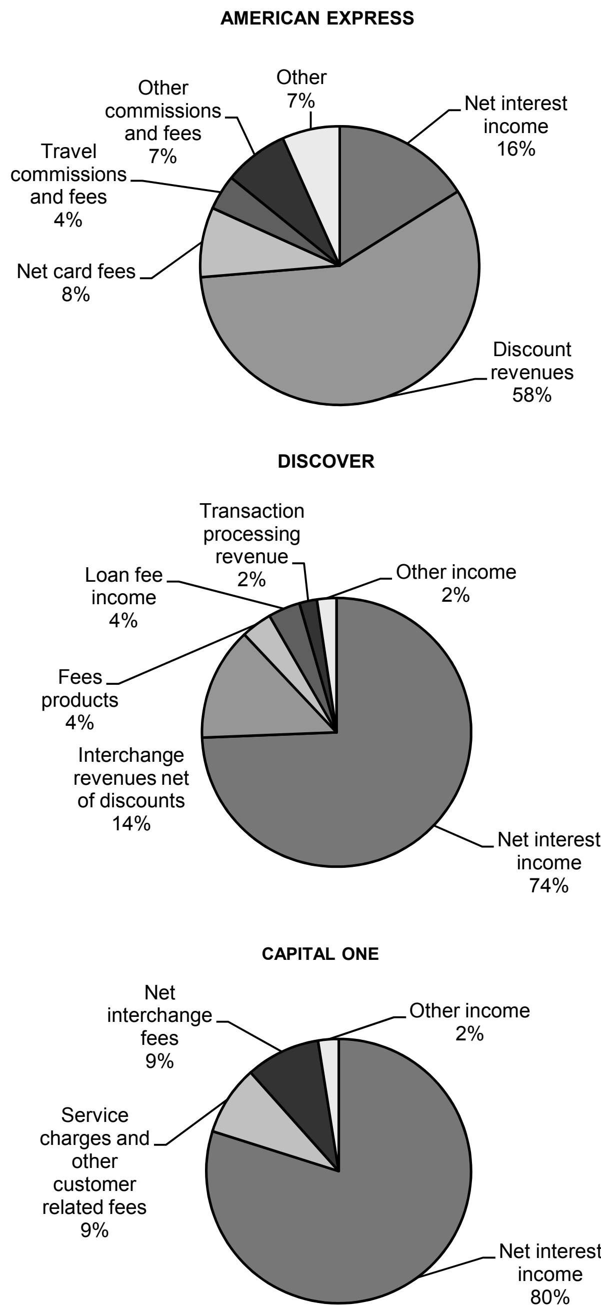
Mostly unregulated in the past, the consumer finance companies, like banks, are now subject to a wide range of regulations, depending on the company's product offerings. Most are regulated by the Federal Reserve Board (Fed) and the Consumer Financial Protection Bureau (CFPB), while some of these companies' subsidiaries are also insured by the Federal Deposit Insurance Corporation (FDIC) and, therefore, are subject to the agency's regulatory capital requirements. (For a more detailed discussion, see the "Regulation" heading in the "How the Industry Operates" section of this *Survey*.) The FDIC maintains and distributes aggregate industry data, making a comparative analysis easy to conduct.

Consumer finance companies historically operated in disjointed niche markets; however, due to consolidation and exchange of assets, bigger players emerged, while many monoline companies have disappeared. Trade publications *Specialty Finance* and the *Nilson Report* cover the specialty finance and consumer payment systems industries, respectively.

The landscape of the consumer finance industry has changed dramatically from the mid-1990s, as securitization provided ease of access to capital for small companies focused on market niches. This spurred many companies into growing too fast. Further, accounting rules at the time were inadequate for the new business models. Underwriters found that in practice, assumptions in securitizations were not easy to predict. While securitizations were structured as "bankruptcy remote" and were off–balance sheet, if a company's securitization experienced higher losses than expected, it could prevent the company from securitizing more assets. Companies generally securitized assets quarterly to fund new loan originations. If a company could no longer securitize, it could face a liquidity crisis and demise. Consumer finance experienced its first bubble long before the dot.com bubble burst, but the industry was so small in the 1990s that it did not cause global shocks to the system.

Payment processors

Third-party technology providers, or payment processors, facilitate consumer and business payments through their network of banks, merchants, and acceptance locations across the globe. These platforms support payments at relatively low marginal cost due to economies of scale. Payment processors include some of the largest companies in the processing services space. Some of the best-known participants in the space have invested billions to support market acceptance of their services across thousands (and, in some



cases, millions) of locations globally. We include credit and debit card networks such as Visa and MasterCard in this category. They compete with other network providers, including American Express and Discover. Other vendors include reloadable prepaid card services providers Green Dot Corp. and NetSpend Corp. (a unit of Total System Services Inc., a payments processing and services company). Many payment processors serve the financial services industry, but some vendors have extended their services to individuals who are underserved or not served by the banking industry. The continuous rising costs and the limited ability to price for risk or garner other revenue streams faced by traditional providers make this segment a growing market for the payment processors.

We think payment processors are among the primary beneficiaries of the secular shift to electronic payment methods from the existing paper-based payment forms, including cash and checks. We expect this shift to continue, despite more onerous regulation. The recovery in the global economy has spurred cross-border interest: under-penetrated markets with limited payment infrastructure, such as India, are viewed as avenues of growth for these vendors to expand their scope overseas. Many payment processors operate under long-term contracts and have significant recurring revenue streams, though we think competition remains intense.

INDUSTRY TRENDS

Global governments have infused capital and implemented subsidy programs to get world markets back on track, in response to the credit crisis that emerged in 2007–2009. In some cases, the crisis hastened the consolidation and globalization already occurring in the financial service industry. Currently, financial markets and their participants face more regulations; however, with the industry's tremendously improved credit profile, company managements appear to have stopped licking their wounds and are more focused on shaping the future of the industry through mobile payments. While we refer to the concept as mobile payment, it is really the integration of online and offline platforms and mobile that will transform the appearance of network payment systems.

While many companies loosened lending standards, particularly in 2005 and 2006—a time when the economy was strong, housing prices were rising, and interest rates were low—the precipitous decline in home prices and the increase in delinquencies and foreclosures caused these firms to reevaluate their lending standards. Starting in the spring of 2007, as delinquencies climbed, companies raised lending standards, albeit from very low levels. As a result, delinquencies and consumer bankruptcies that peaked in 2010 have improved dramatically since 2011.

THE TECHNOLOGICAL ARMS RACE: MOBILE PAYMENTS

According to *Bank Technology News*, an industry trade publication, the 50-year-old magnetic stripe-dominated payment system is headed to the museum, replaced by a standard that links mobile, web, point-of-sale, and contactless payments—simply put, mobile payments. This area is the hottest topic in the consumer finance industry today. Its development is potentially game changing, and a new set of competitors is likely to emerge.

The prevalence of mobile financial services in the US was discussed in the Fed's March 2014 (latest available) "Consumers and Mobile Financial Services" report. According to the 2013 survey, 87% of the US adult population has a mobile phone, and 51% of all smartphone users had used mobile banking in the past 12 months. This translates to 28% for mobile users and 48% for smartphone users. Meanwhile, the use of mobile phones for point-of-sale payments has experienced substantial growth in recent years—increasing threefold between 2011 and 2012, and again between 2012 (6%) and 2013 (17%).

The game will be played on a global scale, and the opportunity appears to be substantial. There are nearly five billion mobile phone users worldwide, and seven out of 10 people worldwide have a mobile phone, while only half the world's households have bank accounts. Nearly 174 million people—and about 72% mobile market penetration—owned smartphones as of the three months ending September 2014, according to comScore, a digital marketing company. We expect mobile payments to gain exposure. According to a June 2014 report from Juniper Research Ltd., a UK-based global wireless-communications research firm, the value of mobile commerce transactions conducted via mobile handsets and tablets are forecast to exceed $4.7 trillion by 2019, up from $2.5 trillion estimated for 2014. In terms of users, in a November 2014 report by Juniper Research, more than two billion mobile phone or tablet users are estimated to make some form of mobile commerce transaction by the end of 2017, up from an estimated 1.6 billion in 2014.

Some of the activities that we see in the mobile strategy include the following: developing merchant acceptance of the new technology; creating apps and encouraging consumers to use them through advertising, coupons, and rewards; integrating mobile, online, and traditional payments; and creating and insuring security.

Taking online mobile payments requires several key components that typically include a smartphone, data plan, financial account, financial payment platform, a mobile application that works on a variety of operating systems, lending capabilities, merchant and consumer relationships, and security/trust. Mobile payments can be executed a number of ways: email, text message, near field communication (NFC) technology (among other new technologies discussed later in this section), and through a "dongle" such as Square (or 40 other versions). What the winning method will be remains to be seen, though we think that ultimately there will be multiple winners rather than the historical one-size-fits-all magnetic stripe.

Alongside cards, cash, and online-payment services such as PayPal, several payment options have emerged to make transactions effortless and convenient to consumers. One of the most-used digital payment applications in the US is Starbucks Corp.'s mobile application, which enables about 10 million customers to pay for their coffee and registers about five million transactions per week. Square Inc. allows consumers and merchants to accept offline debit and credit cards in store with its Square Register. Google currently offers Google Wallet, a mobile payment system through an application, while Amazon recently set up a service to allow its customers to transfer money. Facebook has also expressed interest in the field.

The emergence of online-payment services and other methods of payment is of great concern to the banking industry. According to the November 2013 study by Accenture, a global management consulting and

technology company, by 2020 US banks could lose 35% of their market share to new competitors, ranging from small payment firms to Internet giants like Google. Some banks are already gearing up, and placing bets on the future of digital commerce. For instance, JPMorgan Chase plans to introduce a digital wallet later this year. Apple Inc. launched Apple Pay on October 20, 2014 and has seen wide acceptance from its users with around one million credit card activations within 72 hours of availability of the system.

The players

Major competitors—such as MasterCard (with Google Inc.), American Express, Visa, and Discover/PayPal (eBay Inc.)—are busy loading their ammunition.

◆ **MasterCard.** For more than a decade, MasterCard has pioneered the technology that has turned mobile phones into devices for making payments across the global network. The company has been in partnerships with companies to enable consumers to purchase goods and services via their mobile phones. In conjunction with Citigroup and Google, MasterCard was one of the first to mass-market Google Wallet (a digital wallet app). In a deal between retail giant Wal-Mart and MasterCard Inc. in April 2014, the retailer's credit card portfolio will soon carry MasterCard Inc.'s logo, ending a nine-year relationship with Discover Financial Services. Wal-Mart's Sam's Club co-branded credit card was transitioned in June. Moreover, in May 2014, an agreement was sealed with PULSE, a Discovery Financial Services company, to allow financial institutions that issue EMV (Europay, MasterCard, and Visa) debit cards participating in both the MasterCard and PULSE networks to use MasterCard's common debit solutions. In July 2014, MasterCard completed the acquisition of Pinpoint Pty. Ltd., Australia's leading provider of loyalty and rewards services to financial institutions. The acquisition marks the company's initiative in strengthening its offerings to benefit cardholders across the Asia-Pacific region.

◆ **American Express.** In 2011, American Express disclosed that it had established a $100 million fund aimed at expanding digital commerce. The company very quietly rolled out its Serve app in late 2011, and it has partnered with companies that reach three-quarters of the adult population through relationships with Verizon, Sprint, and Ticketmaster. The telecom companies plan to pre-install the Serve app as they roll out new phones.

In October 2012, American Express and Wal-Mart Stores Inc. entered into a partnership to launch a prepaid debit card called Bluebird (as discussed in the "Current Environment" section of this *Survey*.) We think the card has significant potential for growth due to its low and no-fee characteristics that make it a viable competitor to traditional checking accounts.

In February 2013, American Express introduced a "Tweet to pay" service, where American Express cardholders can synchronize their cards to their Twitter accounts and take part in new discounts and offers posted on Twitter by tweeting.

Wells Fargo, in coordination with American Express, launched new credit cards in May 2014—Propel 365 and Propel World—that offer accelerated rewards on travel and everyday purchases, with bonuses for Wells Fargo consumers, and that are accepted in all American Express networks.

In October 2014, American Express announced its availability for Apple Pay, a payment system by Apple that utilizes iPhone 6, iPhone 6 Plus, iPad Air 2, and iPad mini 3. In November 2014, American Express launched a new website that provides enhanced financial clarity, a simplified payment experience, and new account insights for the cardholders. In the same month, the company announced the launch of the American Express Token Service, a suite of solutions designed to enable its card-issuing processors, partners, and merchants to create a safe online and mobile payments environment for consumers. With the Token Service, the traditional account numbers are replaced by unique tokens that will be utilized to complete payment transactions online in a mobile application or in stores with NFC-enabled device.

◆ **Visa.** This company is also expanding its digital wallet strategy. Visa is working with technology firm Monitise to significantly enhance Visa's issuer processing platform, Visa DPS. The platform offers mobile services that are fully managed by Visa and accessed by any mobile device, any mobile channel, and with any eligible debit, credit, or prepaid account. Other services include mobile check deposit and mobile (NFC)

payments. In 2012, Visa and Visa Europe announced that NFC-enabled smartphones from Samsung Electronics, LG Electronics, and Research In Motion (currently BlackBerry) have been certified for use with Visa payWave, which is Visa's mobile application for point-of-sale payments. In March 2014, Visa Inc. together with PULSE announced an agreement to enable financial institutions that issue EMV debit cards on both the Visa and PULSE networks to use Visa's common debit solution. In June 2014, Visa announced that the company is preparing consumer-friendly standards for prepaid debit cards, such as monthly fees. The company expects that the special designation, which has not yet been named by the firm, to be offered before the end of 2014.

◆ **PayPal.** Owned by eBay, PayPal is a formidable competitor with a considerable account base and early-mover competitive advantage. PayPal has a mobile application for consumers and, in March 2012, it introduced one for a business called PayPal Here. The PayPal Here app can accept card payments through the phone's camera as well as through a mobile card reader similar to Square; merchants pay a similar 2.7% transaction fee for US debit and credit cards (there are no fees for check acceptance), while an additional 1% is charged for non-US cards. In August 2012, PayPal announced an agreement with Discover Financial Services to bring PayPal to more than seven million merchant locations across the US that already had an existing relationship with Discover; service began in spring 2013. PayPal recently forged several partnerships to expand the reach of its mobile payment service (as discussed in the "Current Environment" section of this *Survey*.)

The technologies

◆ **Near field communication (NFC).** Certifying smartphones to use NFC technology paves the way for mobile device makers, mobile operators, and retailers to partner with financial institutions. NFC technology is a short-range communications standard that enables mobile phones to securely transmit payment information to a contactless payment terminal. In practice, the early systems appear to work like zapping a contact from one Palm Pilot to another. The user prepares to make payment, sends the signal while holding the device close to the terminal. The range is very short, limiting the ability of someone in the vicinity to pick it up. Further, it has security protection to prevent repeat transactions.

◆ **Europay, MasterCard, and Visa (EMV).** One of the new credit card technologies expected to be widely adopted in US in the near future is EMV, a technology widely used in Europe. Compared with the current magnetic stripe in most credit cards, EMV provides a safer way of authenticating credit card transactions through its personal identification number (PIN) and chip features that employ cryptography and a range of other security measures to defend against card fraud. According to the October 2014 report of Juniper Research, new mobile payment systems, such as Apple Pay, as well as the increasing adaptation of NFC solutions utilizing HCE within the banking sector here and abroad, will spur the number of NFC users from the existing 101 million this year, to around 516 million mobile users by the end of 2019.

According to the report by Javelin Strategy & Research, by the end of 2015, about 166 million EMV credit cards (29% of all credit cards), and 105 million EMV debit and prepaid cards (17% of all debit and prepaid cards) will be in circulation within the US. By the end of 2018, the total is forecast to reach 96% for credit cards and 98% for debit and prepaid cards.

◆ **Beacon.** Beacon is a Bluetooth low-energy (BLE) device that enables hands-free payment, identity management, and customer analytics. This technology broadcasts signals that can be picked by compatible or smart devices. Currently employed by PayPal, Beacon is expected to affect how businesses manage identity, payments, and customer engagement.

◆ **Host card emulation (HCE) and cloud-based payments.** HCE is a technology currently employed by Visa and MasterCard that enables NFC application on an Android device to emulate a smart card—letting users pay with their smartphones, while permitting financial institutions to host payment accounts in a secure, virtual cloud. The new HCE technology will allow storage of user payment information in the cloud rather than in mobile phone hardware. The Android HCE feature is expected to be widely available to the market given the prevalence of the Android operating system among consumer electronics. According to the latest figures released by the International Data Corp., 84.7% of smartphones sold in the second quarter of 2014 run on the Android.

Meanwhile, Merchant Customer Exchange (MCX) recently added Paydiant's cloud-based platform to its mobile commerce infrastructure (as discussed in the "Current Environment" section of this *Survey*.)

Merchant acceptance, terminals, and point-of-sale hurdle

One of the key aspects of success for a network is merchant acceptance. A high level of merchant acceptance provides an initial competitive advantage to existing network providers.

A challenge that has media attention is the cost of upgrading point-of-sale terminals to take mobile payments. For instance, according to the National Retail Federation, industrywide, it will cost retailers between $25 billion and $30 billion to switch over to chip-and-PIN technology. However, we think this is a lesser challenge than is portrayed by the headlines, as network providers can specify changes that coincide with a natural upgrade schedule. According to VeriFone Systems, which holds about five million terminal systems (about 60%–70% of the seven million to eight million terminal systems in the US market), the typical terminal upgrade has fallen to an average of five years. The company estimates that another three to four million locations with only a cash register or restaurant system will need customer-facing devices.

Five years is not far off in our view. New terminals are expected to run existing electronic payment methods, as well as NFC and EMV. The new terminals are also expected to cooperate with Card networks from Visa (payWave), MasterCard (PayPass), Discover (Zip), and American Express (ExpressPay), as well as Wallets from Google, ISIS (ISIS Mobile Commerce is an AT&T Mobility, T-Mobile USA, and Verizon Wireless joint venture), PayPal (eBay), GROUPON, Facebook, and more.

In its October 2013 investor presentation, VeriFone projected that fraud liability will shift in 2015 to US merchants that do not accept EMV (cards enabled with chips) payments, causing a re-terminalization of the market and a 50% increase in the market for point-of-sale terminal systems. ABI Research, a technology-market intelligence company, forecasts that the installed base of mobile point-of-sale (mPOS) devices is set to make up to 46% of all point-of-sale terminals by 2019.

"Mobile retailing" is cheaper for store merchants

An alternative to traditional terminals is "mobile retailing," where merchants can make sales outside of the typical cash register environment. At the Apple Store, for example, a traditional cashier can process payments, or the customers may opt to process themselves through iPhone or iPad to avoid waiting in line. Meanwhile, Starbucks launched an application that enables its customers to pay for their coffee. VeriFone, which offers mobile retailing through the mobile retail software applications it acquired through the purchase of GlobalBay Mobile Technologies in November 2011, estimates that mobile point-of-sale is one-half to one-third the cost of the traditional cash register point-of-sale system for the merchant. The company's PAYware Mobile Enterprise (PwME) device is a small attachment that fits around iPads, iPhones, and other devices to securely take all forms of payment through credit, debit, PIN entry, NFC, and barcode scan.

Security

US payments law is fragmented, and the degree of protection that consumers have depends on whether their mobile payment accounts link to a debit card, credit card, a prepaid card, or another form of payment. While it is still too early to know how things play out, we suspect that linkage of a traditional credit card will likely be the most protected way to use a mobile account: credit card issuers and networks have sophisticated fraud detection strategies, and they have shown commitment to the customer relationship as many purchases have moved online. Given the lack of clear regulation, prepaid accounts are likely to be the least secure method of mobile payment, at least initially.

According to *American Banker*, financial policymakers are starting to turn their attention to the issue of mobile payments because currently there is no clear regulator. The Electronic Fund Transfer Act (EFTA) regulates electronic transactions; for mobile payments linked to a card or other credit account, the Truth in Lending Act (TILA) applies. Both fall under the Consumer Financial Protection Bureau (CFPB). However, making a payment using text messaging via a mobile network provider would not fall under banking laws, so there will likely need to be more coordination with the Federal Communications Commission.

In March 2014, the consumer finance industry's major players, MasterCard and Visa, announced the formation of a new cross-industry group focused on enhancing payment system security. The initial focus is intended to be on EMV chip technology in order to keep pace with the expectations of consumers, retailers, and financial institutions. It will be composed of a diverse group of participants in the payments system, including banks, credit unions, acquirers, retailers, point-of-sale device manufacturers, and industry trade groups.

Consumer behavior changing

A challenge in conversion to mobile payments is changing customers' habits. We think that development of easy-to-use and widely accepted secure payments will ultimately spur usage, but first, we expect companies to provide coupons, discounts, or points to get consumers to try out mobile payments and ensure a high success rate. It could start as simply as using a coupon to Starbucks from a network provider: soon the user finds no need to carry a wallet on the 10-minute daily coffee break. While some people use credit cards only to purchase big-ticket items, others, especially younger people, increasingly view them as a daily purchase vehicle. We think that retailers are helping to accelerate the conversion to mobile transactions through their apps, which include digital versions of their store frequent shopper cards. For instance, the rewards cards for Sephora and Walgreens are available in Apple's Passbook (on OS 6 and more advanced operating systems), while other retailers such as CVS make such cards accessible through their own apps.

The role of prepaid accounts

In our view, the potential for mobile wallets and prepaid accounts is significant, as it is a logical way to bank the unbanked, especially in countries with less developed banking systems. No credit score or credit bureau infrastructure is necessary to provide recommendations as to an individual payment history or potential credit quality. Thus, anyone with a smartphone or Internet connection and a few cents cash could potentially load up his mobile wallet by creating a prepaid account.

FEDERAL REGULATIONS

Since 2008, the US government has played a key role in stabilizing the economy and banking system. In February 2009, the Treasury put forth the Financial Stability Plan, designed to attack the credit crisis on all fronts. Part of the plan provided for a stress test (formally called the Supervisory Capital Assessment Program, or SCAP) for the larger banks to ensure that they have enough capital in case the economy worsens. The stress tests, first administered in April 2009, represented a major positive turning point for the banking sector. We outline below some of the more important initiatives the government launched.

Credit Card Accountability Responsibility and Disclosure Act (CARD) Act of 2009

In 2009, President Obama signed the CARD Act into law. All of the included provisions have now taken effect. With this law, Congress and the White House took aim at controversial credit card practices, from higher interest rates on past balances to fees for paying by phone or online. The following is a summary of what companies can and cannot do under this new law:

- Cannot treat payments as late unless consumers have a reasonable amount of time to make the payment (at least three weeks before due date)
- Must allocate minimum payments to balances with the highest rate first
- Cannot raise interest rates from the opening amount unless: the rate was variable-rate or introductory, with the increase disclosed; it is a year after the account opened and 45 days' notice is given; or a minimum payment is received 30 days after due date
- Cannot use double-cycle billing, *i.e.*, calculating interest based on a prior month's balance in addition to the current month, even if the prior month's balance had been paid.

Banks and credit card companies began changing their practices to comply even before the law took effect, mitigating its impact on their revenues. Many banks switched customers to variable rates from fixed-rates, so banks can raise rates more easily. Banks also cut rewards programs and added annual fees to cards that previously had none. We saw an impact on results of the big credit card issuers through reduced fee income; however, we think the bulk of the impact from regulatory change is behind us.

Regulation E

Under separate legislation, changes have been made to Regulation E that required customers to opt-in for overdraft coverage and one-time debit card transactions. Regulation E provides guidelines for electronic funds transfer and electronic debit cards. The latest amendment was made effective in October 28, 2013.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

In July 2010, President Obama signed the bill into law, and it affects almost every aspect of the financial services industry. Below we highlight some of the major provisions of this financial regulatory reform legislation.

◆ **Debit fee regulation.** The Durbin Amendment to the Dodd-Frank Act, which directed the Fed to regulate interchange fees, went into effect on October 1, 2011. The amendment capped debit interchange fees (the prices banks charge to merchants for their customers' use of debit cards) at 21 cents plus 0.05% of the transaction, with the possibility of an additional cent in certain cases. It reduced average swipe fees by almost 50%. However, financial services companies and banks with assets of under $10 billion were exempt. According to American Banker, several banks terminated their debit card reward programs in order to cut costs.

In July 2013, the District Court in Washington released a court opinion urging the lowering of fees set by the Fed for debit card transactions. However, a recent May 2014 ruling by the United States Appeals Court for the District of Columbia overturned this opinion, upholding the current fees banks collect from retailers for debit card transactions.

◆ **The Consumer Financial Protection Bureau (CFPB).** The Dodd-Frank Act established the CFPB as an agency of the Federal Reserve Board. The CFPB supervises and regulates consumer financial laws and products, including credit cards, mortgage loans, student loans, and auto loans. The goal is to provide fair, sustainable, and transparent financial products for consumers. In January 2012, President Obama appointed Richard Cordray as the first director of the CFPB. The former Ohio attorney general has a reputation as a tough regulator. He came to national prominence by challenging Bank of America's 2008 takeover of Merrill Lynch, and filing an antitrust claim against American International Group. In 2010, he sued lender Ally Financial after its subsidiary, GMAC, was found to have "rubber-stamped" foreclosure documents. He also went after Bank of America, Citigroup, JPMorgan Chase, and other big banks over "robo-signing" activities.

In 2012, the CFPB collected civil penalties from two defendants—Capital One Bank and Discover—totaling $32.0 million. In fiscal 2013, penalties from eleven defendants amounting to $49.5 million were collected. One notable example is when American Express was penalized over alleged illegal card practices in December 2013. American Express agreed to refund $59.5 million to 335,000 customers and pay an additional $9.6 million in civil penalties to CFPB, $3.6 million in fines to the FDIC, and $3 million in fines to the Office of the Comptroller of the Currency (OCC). According to the *Fall 2014 Supervisory Highlights* of the CFPB, recent enforcement actions for the year include GE Capital Retail Bank, ACE Cash Express, US Bank, Flagstar Bank, and Manufacturers and Traders Trust Company (M&T Bank), resulting in the relief of approximately $308 million to more than 1.2 million consumers, due to illegal practices related to credit cards, payday loans, mortgage servicing, and checking accounts.

◆ **The Financial Stability Oversight Council (FSOC).** To avoid having financial services providers that are "too big to fail" (following the collapse of Lehman Brothers and the bailout of American International Group Inc. and Citigroup Inc.), the Dodd-Frank Act states that the US government will not cover the cost of liquidation or support a failing financial company.

The Act created the FSOC and the Office of Financial Research (OFR) agencies under the Treasury Department. The FSOC was given the authority to monitor, review, and respond to any systemic risks to the US financial system. While the OFR supports the FSOC and other agencies, its primary responsibility is data collection, and research and analysis, for monitoring risk in the financial system. In addition, an orderly liquidation process and a liquidation fund (funded by the financial companies themselves, not the US government) was created for all financial services companies.

The Financial Stability Board, an international organization that monitors and makes recommendations about the global financial system, came up with a list of 29 "global systemically important financial institutions," eight of which are headquartered in the US, while nine insurers were identified as "globally systematically important insurers," of which three are headquartered in the US. The report indicated that government officials and regulators are likely to save the behemoths if such a need arises again. Thus, by raising the standards and strength of major financial institutions, the government hopes to avoid other rescues in the future.

CAPITAL REQUIREMENTS CHANGING TO ALIGN WITH BASEL STANDARDS

To meet the day-to-day obligations, banks must have capital on hand. In its most basic form, capital is shareholders' equity, calculated by taking the difference between assets (loans, investments, cash, real estate, and intangible assets), and liabilities (deposits and borrowings, mainly).

Using the international Basel standards—the common name for capital guidelines issued by the Bank for International Settlements (BIS) in Basel, Switzerland—the Federal Reserve System has established two basic measures of regulatory capital adequacy with which US bank holding companies must comply: a risk-based measure and a leverage measure. These ratios are as follows:

- **Tier 1 capital ratio—**calculated by dividing Tier 1 capital by risk-weighted assets.
- **Total capital (Tier 1 and Tier 2) ratio—**calculated by dividing total capital (Tier 1 plus Tier 2 capital) by risk-weighted assets.
- **Leverage ratio—**calculated by dividing Tier 1 capital by average total consolidated assets.

The first two ratios are risk-based standards. These measures take into account differences in risk profiles among banks. Assets both on and off the balance sheet are assigned to risk categories, and different weightings are applied. Tier 1 capital is generally made up of common equity, certain preferred stock, plus retained earnings, less goodwill and other intangible assets. Theoretically, it is the most solid type of capital. US regulators consider a Tier 1 capital ratio of around 6% to be well capitalized.

The second ratio is the total capital ratio. The minimum ratio of total capital to risk-weighted assets should be around 8% to be considered adequately capitalized. At least half of total capital must consist of Tier 1 capital. A bank or financial services company with total capital ratio of 10.0% is generally considered well capitalized.

International Basel II capital standards historically allowed the largest banks to use internal models to calculate their asset risks to determine their own capital levels. During the height of the recent financial crisis, many banks found they did not have the capital levels necessary to withstand the losses on loans and securities that proved to be much riskier than their models had suggested.

We therefore see a more rigorous approach in Basel III capital standards. While the Basel III capital rules will continue to rely on banks' risk models, the international committee has narrowed the definition of what counts as capital, and how much capital needs to be held for certain riskier assets.

The third ratio is the leverage ratio. The Fed's guidelines for bank holding companies is to provide for a 4% minimum ratio of Tier 1 capital to average assets, less goodwill and certain intangible assets. Bank holding companies making acquisitions are expected to maintain capital positions substantially above the minimum supervisory level. To meet the regulatory requirement to be classified as well capitalized, the financial institution must have a leverage ratio of at least 5%.

In mid-September 2010, the Basel III committee announced preliminary guidelines that require 4.5% common equity capital to risk-weighted assets, plus a 2.5% "conservation buffer," totaling 7.0%. When Basel III fully kicks in, up to another 2.5% of common equity may be required during economic boom times, to build for down cycles (the countercyclical buffer). These requirements are being phased in through at least 2018. The long phase-in period, in our view, is an acknowledgement that the new rules are relatively complicated. For instance, the Basel III guidelines are over 600 pages long, compared with the 30-page Basel I released in 1998.

In addition, as part of the Dodd-Frank Act, banks have five years to phase out the inclusion of trust-preferred securities in Tier 1 capital calculations. Trust-preferred securities are hybrid securities that possess the characteristics of both subordinated debt and preferred stock and were historically a significant source of capital for many regional banks.

It is clear that most US banks entered the 2007–2009 financial crisis with capital levels that were much too low. However, given the deleveraging that financial institutions have undertaken, we think that most large US diversified financials and banks are now relatively well capitalized.

GLOBAL GROWTH

As competition in domestic markets intensified, financial services companies of all stripes have built businesses overseas. Most companies begin with operations in developed Europe, and move into Latin America and Asia as they grow. Other services offered abroad vary widely, as companies grapple with different regulatory standards and cultural preferences; there is also a lack of third-party credit bureaus in developing and emerging countries to monitor and track individuals credit histories.

According to the 2014 World Payments Report (WPR) from Capgemini Consulting, one of the world's largest consulting, outsourcing, and professional services companies, and The Royal Bank of Scotland (RBS), although the volume of non-cash payments are largely recorded from mature markets, developing markets post higher growth rates than their developed counterparts. According to the report, non-cash payments in the developing markets and developed countries were estimated to grow 20.2% and 5.6%, respectively in 2013.

Credit card companies have generally concentrated on developed markets such as Canada and the United Kingdom, where cultural attitudes toward credit are most in tune with those of the US. As these markets have also matured, some companies have expanded to other markets. However, the lack of credit bureaus (as mentioned above) limits unsecured lending to some extent. Therefore, we see the prepaid card market as having higher growth potential.

For many diversified financial services companies, cross selling has been a part of their operations for many years. In recent years, however, it has taken on greater importance. Firms are trying to raise revenues by improving their communication capabilities and rewarding employees for building relationships across business lines through platform integration. Customer lists can be better matched so the company can know its customers better, make faster decisions, and increase its cross selling efforts through more tailored offers.

In our view, financial companies will continue to expand internationally in order to benefit from faster-growing emerging markets, through stand-alone expansion, joint ventures, and partnerships with current market participants. Given a relatively mature market in the US, we expect continued international expansion over the longer term, and especially when global economic growth picks up. To take advantage of these opportunities, firms must have an expertise and sufficient capital. A presence in international markets (through current customers and/or a physical presence) and brand recognition are important as well.

Major banks have increased their focus on the Asia-Pacific region, including China pre-crisis. Expansion slowed during the crisis as banks needed to raise capital levels. Highly capitalized companies have a greater ability to sustain losses in new markets. With capital levels more constrained post-crisis, and Basel III being phased in, we think companies are proceeding with expansion plans more cautiously.

Continued focus on less developed markets

Pre-crisis, several major US and international banks expanded into developing and frontier markets such as China, Russia, India, and Latin America. Over the next several years, we look for a growing presence of the industry players in these markets that offer strong potential for diversification and growth. In some cases, larger firms have distinct advantages, such as an existing client base that could be cross-sold. They may also have a physical presence or relationships in neighboring regions. Familiarity with regulations, market demographics, and cultural preferences can make it easier to grow a business and less risky.

INDUSTRY CONSOLIDATION WAS DRIVEN BY FINANCIAL CRISIS

During the late 1990s and in the early part of the 2000s, the financial services industry underwent rapid consolidation due to easing of regulatory barriers, the search for higher margins, and economies of scale. Deterioration in capital levels due to turmoil in the credit markets prevented some of the big banks, such as Citigroup, from completing large acquisitions.

The easing of regulatory barriers began in the late 1980s, when rule changes by the Federal Reserve Board allowed banks to generate up to 5% of their revenues from securities underwriting. (The percentage was subsequently increased to 10% and then to 25%.) The passage of the Gramm-Leach-Bliley Act in November 1999 eliminated the prohibition against commercial banks owning brokerage firms (which had been mandated by the Glass-Steagall Act of 1933), by allowing the three largest segments of the financial services industry—commercial banks, investment banks, and insurance companies—to enter into one another's businesses.

The reform did not cause an avalanche of mergers—largely because loopholes in previous laws already permitted much cross-industry activity. After moderate acquisition activity in 2005, the next two years saw several large deals, such as Capital One Financial Corp.'s acquisition of North Fork Bancorp. Inc. in December 2006. Market turbulence in late 2007 nearly halted merger and acquisition (M&A) activity.

However, the financial crisis in 2008 and 2009 led to the failure or fire sale of several large US financial institutions. These actions increased the concentration of the US banking system above pre-crisis levels. Four banking behemoths (JPMorgan Chase, Bank of America, Wells Fargo, and Citigroup), with assets of over $1 trillion each, now dominate the US financial system. Three of these US banks significantly grew their assets by acquiring weakened competitors during the crisis. In March 2008, JPMorgan Chase & Co. acquired Bear Stearns & Co. Inc.; in September, in the depths of the financial crisis, it acquired Washington Mutual, with government assistance. Bank of America Corp. expanded with the purchases of Countrywide Financial Corp. (July 2008) and Merrill Lynch & Co. Inc. (January 2009), while Wells Fargo purchased Wachovia Corp. (October 2008).

Recent acquisitions and spin-offs

In February 2012, Capital One Financial Corp. completed the acquisition of ING Direct USA from ING Groep, making Capital One the sixth-largest bank by deposits in the US. Capital One paid $6.2 billion in cash and $2.8 billion in stock. ING Groep received a 9.9% stake in Capital One as part of the deal. We think Capital One got a good price on a crown jewel, as we think that ING Groep sold the profitable business to repay loans to the Dutch government from its bailout in 2008.

On May 1, 2012, Capital One acquired the US credit card business of HSBC Holdings Plc. The HSBC US credit card portfolio included general-purpose and private-label cards with approximately $28.2 billion credit card receivables and $0.6 billion in other net assets. Capital One paid a $2.5 billion (or 8.68%) premium to par value of all receivables. The close of the purchase by Capital One essentially unseated American Express' position as the fourth largest credit card lender in the US.

We expect future small-scale acquisitions of lending portfolios or niche businesses to be more common than huge, transformational deals, as companies strive to add size and new product offerings to their organizations. The nature of the financial services industry offers advantages to larger companies, which may find it easier and less expensive to access capital. Large companies also are likely to have the resources to take advantage of growth opportunities in international markets. While the upheaval in the credit markets may change some of the dynamics of future deals, we think companies will find it more important than ever to have a diversified business model.

Apart from acquisitions, several spin-offs and initial public offerings (IPOs) occurred in the first part of the year. Spanish lender, Banco Santander S.A., took its US consumer finance arm, Santander Consumer USA Holdings Inc., public last January 2014. Spinning off parts of its foreign subsidiaries is said to be a core strategy of Santander in the wake of the financial crisis, with selling stakes in its Brazilian, Chilean, Polish, and Mexican arms. Meanwhile, General Electric Co. filed a statement with the Securities and Exchange Commission in March 2014 for IPO of its North American retail finance unit, Synchrony Financial. The firm

is forecast to be the largest issuer of private-label credit cards in the US, ahead of Citigroup and Capital One Financial Group, valued at around $20 billion.

Finally, as of May 1, 2014, Navient Corp., the education-loan arm of SLM Corp., started to operate independently from the latter, which will continue its consumer banking operation. In September 2014, eBay announced the spin-off of PayPal as an independent publicly traded company in 2015, subject to customary conditions. According to the announcement, the spin-off optimally positions both companies in terms of capitalizing in the rapidly changing global commerce and payments landscape.

SLOW BUT POSITIVE LOAN GROWTH FOR CREDIT CARD ISSUERS

For many of the credit card industry's strongest players, loan growth declined during the Great Recession. In 2009 and 2010, due to a tightening of credit standards, consumer interest in paying down debt, and cutbacks in cards issued, loan growth declined, year over year. Pre-recession, annual growth rates ranged between 5% and 8% reflecting industry maturation as growth rates were in the high-double-digit area as the industry blossomed in the 1990s.

Credit card receivables of the largest credit card loan portfolios posted mixed results in the first quarter of 2014 compared with the same period a year before. Major consumer finance-focused company balances grew from - 10.6% to 6.4%, while traditional banks recorded balance growth ranging from -0.8% to 23.5%. In the first quarter of 2014, Discover Financial Services and American Express posted positive growth of 4.6% and 2.4%, respectively, compared with the year before. Meanwhile, Capital One Financial posted a 10.6% decline in its credit card portfolio.

LARGEST CREDIT CARD LOAN PORTFOLIOS*
(Ranked by outstanding debt as of March 31, 2014)

	CREDIT CARD DEBT --------- (MIL. $) ---------	
ISSUER	3/31/2013	3/31/2014
Citigroup	138,935	139,393
JPMorgan Chase	111,061	110,831
Bank of America	100,817	99,979
Capital One Financial	79,543	71,092
General Electric Capital	53,750	57,192
American Express	53,680	54,971
Discover Financial Services	48,449	50,682
Wells Fargo	24,131	26,073
U.S. Bancorp	16,234	17,134
Barclays	13,670	16,879

*Largest global portfolio for US-based companies.
Source: American Banker

In our view, there are several reasons for diverging loan growth trends and loan growth appetite. First, the consumer finance companies generally now have higher margins and relatively lower leverage than banks with more commercial lending and traditional banking businesses, and less risk from sovereign debt issues in Europe. Also the industry made a calculated effort to reduce leverage and risk to meet the requirements of (and to pass) the Fed stress tests. Memories of severe credit challenges are still vividly strong for both management teams and consumers. Consumers are still relatively risk adverse to building debt.

Credit card loan growth could benefit as the economic environment and employment levels improve, although we think that the unsecured credit card industry is relatively mature.

Co-branding, sponsorships maintain strength

In a co-branding arrangement between a credit card company and another company such as a retailer, hotel, or airline, the partner's name and logo appear on the credit card. Such arrangements allow credit card companies to cross-sell other products, encourage credit use, and reach new customers. Issuers also have developed sponsor relationships with colleges, universities, and professional organizations. The lender provides the funds, typically embossing the logo or insignia of the endorsing organization on the card, while the organization provides the customer list. Thus, card members are encouraged to use the card to show support for the endorsing organization, which may receive a small percentage of the sales proceeds charged with the card.

Reward programs encourage credit card use, and loyalty

Most card issuers offer reward programs through which purchasers accumulate points that they can redeem for various goods, such as travel benefits or free flights on airlines. Issuers devised these programs to encourage loyalty among customers and to boost credit card usage for items typically paid by cash or check. Research

has shown that customers with reward cards tend to be more loyal/more likely to remain with the issuer for a longer period. As saturation of the credit card market rose, loyalty programs became increasingly important. Further, during the 2008–2009 credit crisis, it was shown that charge-offs from reward-oriented customers of credit card companies held up better than from other customers. The main challenges from running rewards programs are the increasingly competitive environment and the high costs of enhancing and maintaining the program.

EFFICIENCY, SAFETY BOOST TRANSACTION VOLUME

Improved technology has spurred much of the growth in transaction volume by facilitating faster, cheaper transactions. In fact, some retailers prefer credit or debit card transactions to checks. Credit and debit transactions provide electronic records of all purchases. Compared with cash transactions, they are generally less susceptible to miscalculations or other human errors. The downside, though, is that they are costlier to merchants than cash transactions due to interchange fees.

Many purchases, such as those made through catalog phone orders, are difficult to make without credit cards. Increased consumer shopping over the Internet has further multiplied transaction volumes. Financially astute consumers have discovered that paying for purchases after the credit card bill arrives—typically weeks after purchases were made—lets them keep cash in the bank longer, earning more interest for themselves.

The relative safety of using credit cards compared with cash and checks has boosted industry volume growth in recent years. Although credit cards are not immune to theft or fraud, issuers generally limit consumers' liability for unauthorized use of their credit cards. Finally, the ability to travel without having to carry cash for all transactions makes credit cards particularly useful for vacation and business travelers; for the latter group, credit cards also aid in record keeping.

The Durbin Amendment to the Dodd-Frank Act directed the Fed to regulate interchange fees, so we do see more scrutiny over transaction fees and expect further focus on pricing by regulators over the next few years.

HOW THE INDUSTRY OPERATES

The consumer finance industry comprises companies that operate in many disparate businesses. The three major consumer finance companies have origins in the credit card industry, American Express, Capital One, and Discover all provide credit cards and other consumer-related products to their customers. American Express and Discover also operate their own payment networks that compete with large global payments companies Visa and MasterCard. Capital One is the most similar to a traditional bank of the three, although it is more focused on the direct-to-consumer approach (while primarily a credit card lender, it is a top deposit taking institution in the US, it bought ING Direct, and has a substantial auto finance business). Discover is also developing its direct banking business. Discover's biggest business is credit card lending and it has been growing its private student loan business. In 2012, it began mortgage originations and, in the summer of 2013, it entered the home-equity loan business.

The diversified consumer finance companies that originally defined the consumer finance industry were Texas-based Associates First Capital (bought out by Citigroup in 2000), Illinois-based Household International Inc. (purchased by HSBC in 2002 for $15 billion), and Beneficial Corp. (purchased by Household International in 1998 for about $8.6 billion). They primarily offered unsecured personal loans, home-equity loans, private label and general-purpose credit cards, and auto finance. Another major player was Green Tree Financial, which made its mark in manufactured housing and motor home loans. Green Tree was bought out by a major life insurer, Conseco, for about $7 billion in 1998; lack of extensive due diligence on the acquisition lead to Conseco's 2002 Chapter 11 bankruptcy (the third largest US bankruptcy at the time).

The consumer finance industry came into its own as securitization gave access to capital to small companies that focused their efforts on market niches, rather than trying to meet the borrowing needs of all people. Numerous niche players focused on credit cards, home equity, and auto finance went public in the early

1990s. However, many of these companies behaved like cowboys in the Wild West or kids in the candy store with a $10 allowance. Access to capital was easy, non-banks were essentially unregulated, and the urge to grow lured many companies into growing too fast. Further, accounting rules were not prepared for the new business models. Many companies used gains on sale of securitized assets for current period earnings.

However, history shows us that assumptions in securitizations were not so easy to predict. Moreover, there were surprises: home equity was originally considered safer than auto finance loans, yet in practice predicting prepayments added more risk than expected. Securitizations were structured as "bankruptcy remote" and were off–balance sheet; yet if a company's securitization experienced higher losses than expected, it could prevent the company from securitizing more assets. Companies generally securitized assets quarterly to fund new loan originations. If a company could no longer securitize, it could face a liquidity crisis and a quick demise.

Consumer finance experienced its first bubble long before the dot.com bubble burst, but back then, the industry was relatively small and independent, and therefore did not cause global shocks to the system or affect the stability of the global financial system. While many small monoline players have gone bankrupt, others were bought out by banks in search of growth. The strongest have emerged as not only survivors, but also as visionary industry leaders of tomorrow's financial service and payment systems arena.

The landscape of the consumer finance industry has changed dramatically from the mid-1990s. We define consumer finance companies as those included in the S&P Consumer Finance Index. The players that make up the largest piece of the index include American Express, Capital One, and Discover Financial Services. They offer a wide variety of products and services, including various consumer lending products (primarily credit cards, automobile loans, home-equity loans and, to a lesser extent, traditional banking products, insurance, debit cards, and securities and investment products). American Express and Discover run payment networks that compete primarily with Visa and MasterCard.

The division between banks and consumer finance companies is no longer as clear as it once was. To add to the confusion major consumer finance companies have banking subsidiaries. Many of the niche businesses are now operated by major banks. This is a result of banks' desire to grow in higher-margin businesses and their history of having better access to funds through deposits and other forms of capital. Thus, the consumer finance companies compete with major diversified banks, primarily Citigroup, JP Morgan Chase, Wells Fargo, and Bank of America.

For greater insight into peers in the diversified financials and bank sectors, essentially the financial conglomerates, see the *Banking; Insurance: Life & Health; Insurance: Property-Casualty*; and *Investment Services* issues of *Industry Surveys*.

CREDIT CARD INDUSTRY

The credit card industry can be divided into two categories. First, the card issuers (which include essentially all the banks) are the providers of revolving loans. The second group, the credit card network providers, includes companies such as Visa, MasterCard, American Express, and Discover. American Express and Discover are both card issuers and lenders. On the other hand, Visa and MasterCard are solely card network operators and are classified by S&P as technology companies, according to the GICS methodology. We include them in this section in order to have a more complete view of the industry.

According to the US Census Bureau's Statistical Abstract of 2012 (which quotes data from the trade publication *Nilson Report*), the number of credit cards reached a peak of 1.5 billion in 2008 (with 176 million cardholders). However, owing to the recession, the number of credit cards dropped to around 1.2 billion in 2009 (and 156 million cardholders). Due to debt consolidation trends, we estimate that the current number of credit cards is modestly below the 2009 level.

General-purpose credit card purchase volumes increased to $2.4 trillion in 2013 from $1.9 trillion during the recession in 2009 and $1.24 trillion in 2000. Historically, Visa has led the category, accounting for around 40%–45% of the purchase volumes, followed by American Express and MasterCard (each

generating about a quarter of the volume), leaving Discover as the smallest card network with around 5%–6% of the market.

According to the February 2014 *Nilson Report*, JPMorgan Chase accounted for 17.2% of general-purpose credit card outstanding in 2013, followed by Bank of America (13.8%), American Express (12.1%), Citibank (11.8%), and Capital One (9.3%). Revolving credit peaked at $1 trillion in 2008, according to the Fed; however, US consumers have been paying down debt following the Great Recession and the most recent G19 release on November 7, 2014 showed that as of the end of September 2014, revolving credit outstanding was $881.8 billion.

The companies with the largest credit card portfolios as of March 2014 included Citibank, JPMorgan Chase, Bank of America, Capital One, General Electric Capital, American Express, and Discover Financial.

According to the June 2011 "Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions" from the Federal Reserve Board on credit card profitability, the credit card industry has witnessed considerable changes in pricing practices adopted by the credit card issuers. Lenders now offer a wide range of plans customized to suit the credit risk and usage requirements of credit card customers and, therefore, have started charging different rates. The Fed report pointed out that credit card annual percentage rates (APRs) were stable for over 20 years during the 1980s and 1990s. In 1991, the typical APR was 18%. Since 1998, credit card interest rates have been in the range of 13% to 16%. In 2013, credit card interest rates averaged 12%, while as of the third quarter of 2014, interest rates averaged 11.8%, according to the Federal Reserve Board.

The delinquency rate for credit card issuers has been declining and recently reached historically low levels. According to data from the Federal Reserve Board, delinquency rates dropped from a peak of 6.46% in the third quarter of 2009 to 2.71% in the fourth quarter of 2012 and to 2.18% in the second quarter of 2014, among the lowest levels since the Federal Reserve Board began publishing data in Q1 1991. This improvement was primarily due to the stringent credit standards that the banks have followed since 2009 due to the recession. However, these figures are not sustainable in the long run and we can expect that credit card issuers will loosen their credit standards as the competition increases.

AUTO FINANCE

According to Experian Automotive (Experian), a market research firm, the US auto loan market totaled $839 billion in total outstanding loans as of the second quarter of 2014, an 11.7% increase from the same period a year ago. The market is competitive, with four different categories of players engaged in automotive financing: retail banks, finance companies specialized in auto finance, captives of original equipment manufacturers (OEMs), and credit unions. According to Experian, banks had the largest share of outstanding auto loans (35.6% at the end of the second quarter of 2014), followed by captives (26.6%), credit unions (22.8%), and finance companies (15.0%).

In terms of individual players, Wells Fargo, the largest player among banks in automotive financing, had the largest market share (5.8%) of all vehicle loans in the industry in the second quarter of 2014. Ally Financial Inc. (formerly GMAC), an auto finance company, had the second largest market share of 5.0%, followed by Capital One with 4.3%. Other major retail banks with significant auto finance assets were JPMorgan (4.27%) and Bank of America (1.3%). Among captive finance companies, Toyota Financial Services was the largest player, with a 4.1% market share. Ford Motor Credit and American Honda Finance were ranked sixth and seventh in the list of top auto lenders in the second quarter of 2014.

The auto loan sector grew strongly in the first 10 months of 2014, driven by 5.6% growth in new car sales amounting to a SAAR of 16.4 million vehicles—the seventh month of the year in which the SAAR was in the range of 16.0-16.9 million.

According to Experian, 53.8% of used cars are bought by financing, while 85.0% of new cars bought through the same mode. Wells Fargo is the market leader in financing used cars, with around a 6.9% market share at the end of the second quarter of 2014, followed by Ally Financial, Capital One, with 4.2% share each, and

JPMorgan with an approximately 3.1% share. Following the recent economic crises, auto financers have focused on the risk profile of the borrowers and primarily extended loans to prime borrowers.

STUDENT LOANS

Outstanding student debt in the US totaled approximately $1.2 trillion, according to the CFPB. These loans help students pay for university tuition, books, and living expenses, and generally have lower rates of interest and deferred schedules of repayments. The market is divided into two categories: Federal Loans, issued directly by the federal government, and Private Loans, issued by banks and other financial institutions. According to the Annual Report of the CFPB Student Loan Ombudsman, federal lending controls the majority of the student loans. According to the CFPB, 92.2% of the $1.2 trillion outstanding are federal loans, and just 7.8% are financed by the private sector.

SLM Corp. (also known as Sallie Mae) was the largest private lender of student loans in the US in 2012, with a student loan portfolio of $163 billion at year-end. This was primarily made up of federal loans, while private student loans represented $37 billion of the portfolio. As of December 31, 2013, SLM had a student loan portfolio of $142 billion, of which $38 billion represented private student loans. In comparison, Discover Financial held just $8 billion in private student loans in 2013.

In May 2013, SLM announced its plan to split into two publicly traded companies within the next 12 months. Operating independently since May 1, 2014, Navient Corp. currently manages the company's portfolios of federally guaranteed (FFELP) and private education loans, as well as most related servicing and collection activities. Meanwhile, the private education-loan origination and servicing businesses, including Sallie Mae Bank and the private education loans it currently holds, will operate separately under the Sallie Mae brand. While Sallie Mae Bank is expected to start with a smaller portfolio of loans, we expect to see growth in private student loans.

Navient Corp. replaced SLM Corp. in the S&P 500 GICS Consumer Finance Sub-Industry index, while SLM joined the S&P MidCap 400 GICS Consumer Finance Sub-Industry index, effective after close of trading on April 30, 2014.

Federal vs. private student loans

For students that qualify, there are a number of benefits to getting a federal student loan. Unlike private student loans, the interest rate charged by the federal government is fixed, with the rate resetting each July 1 for the following year. For loans disbursed between July 1, 2014, and June 30, 2015, the subsidized rate is 4.66% for undergraduate loans and 6.21% for graduate student loans.

In addition to a fixed interest rate, federal loans have repayment plan options. The standard 10-year repayment period has the highest monthly payment, but accumulates the least interest. Other options include longer repayment periods (which lower the monthly payment, but cost more in interest) and income-based repayment terms. Flexible repayment terms are beneficial during times of financial distress. Federal loans also have more lenient terms than private loans in other respects; for example, federal loans are not considered to be in default until the borrower misses payments for nine months. Default conditions for private loans depend on the lender's contract and can be as strict as only one missed payment.

Private lenders controlled the student loan market until 1965, when the federal government began guaranteeing private student loans provided by banks and nonprofit lenders through the Federal Family Education Loan (FFEL) program. In 1990, direct lending by the federal government started gaining share, but remained relatively subdued until 2010, when the FFEL program was eliminated (all government guaranteed loans are now made as direct loans). Following the US government decision, many US banks pulled out of the student lending business. According to American Banker, US Bancorp stopped accepting student loan applications in March 2012 and JPMorgan Chase limited its student lending to existing customers beginning July 2012.

Discover Financial Services, Sallie Mae (and its new spin-off, Navient Corp.), SunTrust, Citizens Bank, and PNC Financial Services Group, Inc. all provide private student loans. Private student loans are often used to

supplement federal loans to help meet the total cost of education. The best interest rates on private student loans (and the loans most likely to be approved) are typically on applications with cosigners, assuming both credit histories are healthy. Lenders require school acceptance letters or current registration to approve a loan.

Private lending has historically been less attractive to students due to higher interest rates, lower flexibility in repayment terms, floating interest rates and little consumer protection. Floating interest rates can increase during the life of the loan depending on the fluctuation of prime rates and LIBOR. Interest charged by private lenders varies according to the credit profile of borrowers. In addition, many private lenders, such as Discover and Sallie Mae, may require the student to have a co-signer guarantee the loan. We also note that higher education loans are typically not dischargeable in bankruptcy, according to Sallie Mae.

COMPETITIVE LANDSCAPE

In the early 1990s, the consumer finance industry was fragmented. The fragmentation and lure of high margins and easy financing led to rapid growth of niche businesses. The rapid growth and higher margins, as well as the liquidity crisis suffered by highly leveraged companies, led to consolidation. Today, large players generally dominate the industry.

Scale advantages

The nature of the financial services industry tends to favor large companies given the advantages of scale for efficiency, cost of capital, and access to capital. Larger companies, which typically offer many different products, leverage their distribution systems to get the most products to the greatest amount of people in the most efficient manner. It is also easier for them to advertise widely and generate name recognition.

Access to low-cost financing can be a key advantage in the financial services business: Larger firms can generally secure financing for their operations at a lower cost than their smaller peers can.

Barriers to entry

New heavy regulation, high competition, and ability to access capital provide barriers to entry for the consumer finance industry today. The consumer finance industry initially blossomed with low barriers to entry, namely, little regulation and easy access to capital through securitization in the 1990s. In addition, the Gramm-Leach-Bliley Act of 1999 eliminated the Glass-Steagall Act barriers and allowed investment banks, insurance companies, and commercial banks to enter each other's businesses. However, more recent accounting changes for off–balance sheet financing, significantly greater regulatory oversight, and consolidation now characterize a high barrier to entry industry.

Competition

Due to the commodity-like nature of most financial services products, competition is intense. Even unique companies face competition from companies that offer acceptable, if not exact, substitutes. In addition, because financial products cannot be copyright or patented, companies that successfully introduce new products soon face competition. That said, consumer finance providers engage in risk-based pricing to obtain attractive returns over the long term (rather than setting prices, or APRs and fees, so high that only the most desperate borrowers take the cards and, shortly thereafter, run up their balances to the maximum, then default).

Pricing: the interest rates that customers pay

According to Bankrate.com, an aggregator of financial rate information, the national average credit card interest rate for a balance transfer card, cash-back card, and rewards card was in the area of 15.7% as of November 20, 2014. Although short-term promotional rates can be as low as 0%, such teaser rates are less prevalent now than in years past due to tighter lending standards. According to the FDIC's *Quarterly Banking Profile*, the cost of funds averaged 2.4% for credit card companies and 2.2% for consumer lenders from 2002 through the end of 2012; for 2013, the cost of funding on earning assets was 0.72% for credit card banks. For the first half of 2014, the annualized cost of funds was 0.66% for credit card companies and 0.45% for consumer lenders. APRs charged, in contrast, have varied widely (8%–30%) by product and over the period.

Lending rates offered by consumer finance companies are usually competitive with those offered by banks, as the two often vie for the same customers. Because some consumer finance companies specialize in less lending segments than the typical bank, they may be more familiar with the associated risks and thus sometimes offer more attractive rates than banks.

Before making a loan, consumer finance companies investigate the creditworthiness of the potential customer. The credit extension process tends to be highly automated. Many firms have proprietary credit scoring models that determine the creditworthiness of applicants. Companies work in conjunction with independent credit rating agencies, such as Equifax Inc., Experian Information Solutions Inc. (formerly TRW Information Services) or TransUnion LLC, which issue reports of borrowers' credit histories and paying habits. Financial services companies use this information—along with other data, such as employment history, income level, value of designated collateral, and current debt servicing requirements—to attempt to gauge an individual borrower's ability and willingness to repay a loan. Firms often employ credit analysts who can override decisions made by a company's scoring system after receiving further information from applicants. For instance, those with a shorter credit history (typically youth, new immigrants) or poor credit history (those who have been late payers, missed payments or have bankruptcy in their credit profile) tend to pay higher interest rates and fees than people with an established record of timely debt payment.

The interest rate charged is determined by factors that affect the loan's riskiness: the loan's duration, whether its rate is fixed or variable, whether the loan is secured or unsecured, the life of the item being financed, and the borrower's creditworthiness.

◆ **Loan duration.** Other things being equal, loans made on a short-term basis carry lower interest rates because lenders can more reliably gauge economic conditions and their impact on interest rates over a briefer time span. Long-term loans typically carry higher interest rates to cover the greater potential risks associated with the uncertainty of distant future economic events.

◆ **Fixed- or variable-rate.** The interest rate on a loan can be either fixed or variable. For a fixed-rate loan, the interest rate remains unchanged throughout a loan's life. For a variable-rate loan, in contrast, the interest rate is adjusted over time as the lender's costs fluctuate. For lenders, fixed-rate loans are riskier and thus carry higher interest rates at the date of issue, because lenders cannot raise rates when their funding costs rise. Loans made at variable interest rates carry lower initial interest charges, as they are usually linked to a base interest rate and, therefore, they offer the lender protection from higher interest rates.

◆ **Secured or unsecured.** Whether a loan is secured or unsecured is another paramount factor in determining its risk. Secured loans typically hold a home or other tangible asset as collateral; a lien is placed on the property until the loan is repaid. Unsecured lending offers no such protection to the lender, and thus carries higher associated risk. From the lender's point of view, the difference between the two is the likelihood that the loan obligation will be satisfied through alternative means if the loan is not repaid.

When a borrower defaults on a secured loan, the lender repossesses the asset, which may be sold to pay the loan obligation. Because of this collateral, secured loans are perceived as less risky and, therefore, they carry lower associated interest rates. The greater risk inherent in unsecured loans means that borrowers pay higher interest rates. Using a credit card to make purchases or cash withdrawals—two common forms of unsecured loans—incurs some of the highest interest rates of all lending. Although temporary teaser rates can be as low as 0%, interest rates on credit card loans can be as high as 20% or more.

◆ **The life of the item being financed.** In the case of a secured loan, the financed item's durability is another factor determining interest rates and loan terms. In general, the longer the projected life of the item, the further one can extend payments, and the lower the associated interest rate will be.

Assets that are expected to have long life spans (homes, large appliances, or other durable goods) may qualify the borrower for lower interest rates, as the item probably will not need to be replaced within the duration of the loan. Conversely, lenders are not likely to make a 10-year loan on an item expected to last

five years. Automobile loans, for example, typically extend no more than five or six years for new models and three or four years for used vehicles.

◆ **Customer credit rating.** The borrower's creditworthiness—based on his or her financial profile and past record of making timely loan payments—will affect the interest rate at which a lender is willing to lend money. A good credit history is attractive to financial services companies, which may offer such borrowers reduced interest rates. Borrowers' income and debt levels also affect the interest rates they are charged. An individual whose debt levels are high as a percentage of income might have trouble repaying a loan.

Attractive lending spreads

Consumer finance companies tend to have wider spreads than banks have, and credit card companies have wider spreads than other consumer lenders. For instance, in the first half of 2014, bank credit cards enjoyed a yield on earning assets of 10.01% and a net interest margin of 9.35%, versus 3.82% and 3.37%, respectively, for consumer lenders, and 3.52% and 3.16% for all FDIC-insured institutions (see the FDIC's *Quarterly Banking Profile* for more details). Commercial banks' net interest margins are typically lower than consumer finance companies due to their wider variety of business and greater proportion of lower-risk secured lending.

Although consumer finance companies generally enjoy greater latitude in pricing their products and services, there are limits. Although, some states, for example, have usury ceilings (a maximum allowable interest rate that financial institutions can charge). In most cases, however, this rate is higher than 10% and can range from about 8% to 30%. In cases where allowed rates do not adequately compensate for the risks involved, financial services companies can elect not to participate—declining credit to individuals or not actively soliciting their business.

FUNDING COSTS

Diversified financial services companies with lending operations are similarly influenced by changing interest rates. Interest rates affect the profitability of diversified financial services and consumer finance companies by influencing the demand for credit, the cost of funds, and the amount of charge-offs. Lower interest rates cut borrowing costs, boosting demand for the industry's products. As interest rates fall, the cost of the funds that companies use to make loans also falls, and lending spreads tend to widen. Finally, low interest rates typically fuel economic (and thus job) growth, and lower unemployment rates often result in higher credit quality. When interest rates rise, the opposite occurs. The cost of borrowing goes up, so consumers may forgo purchases. The cost of funding loans also rises, putting pressure on spreads, and job growth slows, which may ultimately lead to credit quality problems.

Securitization provides lower-cost funding

Consumer finance companies are some of the biggest issuers of asset-backed securities. Beginning around 1994, securitization of finance receivables became a popular financing mechanism as it can offer lower-cost funding than a company's own corporate credit would provide, as loans are pooled and used to secure debt. In these transactions, a lender typically pools various finance receivables, structures them as asset-backed securities, and sells them in the public securities market.

The securitization and sale of certain loans, and the use of loans as collateral in asset-backed financing arrangements, are important sources of liquidity for financial services firms. Together with credit syndications and loan sales, securitizations help these companies manage exposures to a single borrower, industry, product type, or other concentration. Until the latter part of 2008, when the securitization markets virtually came to a standstill, most large financial services companies were active participants in the asset-backed securities market.

As loan receivables are securitized, the company's on–balance-sheet funding needs are reduced by the value of loans securitized. The company often continues to service the accounts, for which it receives a fee. Funds received from securitizations sold in the public market are typically invested in money-market instruments and investment securities, which are available whenever the company needs to fund loan growth.

During the revolving period of the securitization (generally 24 to 108 months), no principal payments are made to the security holders. Payments received on the accounts are used to pay interest to the holders and to purchase new loan receivables generated by the accounts so that the principal dollar amount remains unchanged. Once the revolving period ends, principal payments are allocated for distribution to holders.

In June 2009, the Financial Accounting Standards Board (FASB) issued new standards aimed at changing the way banks account for securitizations and off–balance-sheet special-purpose entities through Statements 166 and 167. Both Statements were effective at the start of a company's first fiscal year beginning after 2009, or January 1, 2010.

- Statement 166 is a revision to Statement No. 140 and will require more information about the transfer of financial assets, including securitization transactions, with a particularly focus on whether companies have continuing exposure to the risks related to the transferred assets.
- Statement 167 is a revision to FASB Interpretation No. 46(R) and changes how a company determines when an entity that is not sufficiently capitalized or is not controlled through voting should be consolidated. Among the determinants of whether a company is required to consolidate an entity are the entity's purpose and design, and its capacity to direct these activities. In our view, the new standards have made analyzing consumer finance companies easier and financial statements reflective of the true trends of the business.

Companies that lend tend to have highly leveraged balance sheets. The degree of leverage within actual businesses varies and often is determined by the companies' business and regulatory statutes. The equity-to-assets ratio is one measure used to determine indebtedness. For example, at September 30, 2014, Capital One had common shareholders' equity of $43.8 billion and total assets of $300.2 billion, for an equity-to-assets ratio of about 14.8%.

REGULATION

The US financial services industry is highly regulated. Their role is vital as countries around the world are tightly linked through financial services and electronic trading. Given that the business focuses on money (lending, investing, borrowing, or some combination thereof), heavy regulation is not surprising. What is surprising is that for many years the consumer finance industry was unregulated. In the wake of the 2007–09 financial crisis, the government focused on protecting the consumer through new legislation (including the CARD Act of 2009) and government agencies (the new CFPB), discussed in the "Industry Trends" and "Current Environment" sections of this *Survey*.

In general, most financial regulations mandate various consumer protection and capital adequacy measures. Consumer protection measures are designed to safeguard consumers from predatory lending practices and fraud. Capital adequacy measures are designed to ensure the viability of the financial services industry under different economic scenarios.

Given their diverse nature, consumer finance companies are subject to a wide range of regulations by numerous regulatory agencies; specific regulators vary based on the company's product offerings. The Federal Reserve Board and the CFPB regulate most, while some of these companies' subsidiaries are also insured by the FDIC and, therefore, subject to the agency's regulatory capital requirements. State and local regulators, including state banking and insurance regulators, also oversee the industry, while companies with international operations must conform to regulations in their host countries. Companies with non-US operations are also subject to the rules of foreign jurisdictions; this includes all the major players (American Express, Capital One, and Discover Financial Services). In addition, they must adhere to federal privacy laws governing the collection and use of customer information by financial institutions. Other regulations concern telemarketing, money laundering, and terrorism. Specific regulatory information can be found in a company's annual reports, 10-Ks and 10-Qs.

◆ **Consumer protection laws.** The most important US laws and their main provisions are as follows:

- The TILA of 1968: requires extensive disclosure of the terms on which credit is granted

- The Fair Credit Reporting Act of 1970: regulates use by creditors of consumer credit reports and credit prescreening practices, and requires certain disclosures when a credit application is rejected
- The Fair Credit Billing Act of 1974: regulates how billing inquiries are handled and specifies certain billing requirements
- The Equal Credit Opportunity Act of 1974: generally prohibits discrimination in the granting and handling of credit
- The Electronic Funds Transfer Act of 1978: also known as Regulation E, regulates disclosures and settlement of transactions for electronic funds transfers, including those at ATMs
- The Fair Credit and Charge Card Disclosure Act of 1988: mandates certain disclosures on credit and charge card applications.

◆ **Banking laws.** Because many consumer finance companies operate as bank holding companies, they are also subject to regulation by various federal bank regulatory agencies, specifically the Bank Holding Company Act of 1956 (BHCA). The BHCA prohibits bank holding companies from directly or indirectly acquiring or controlling more than 5% of the voting shares or substantially all of the assets of any company, including a bank, without the prior approval of the Fed. The BHCA generally prohibited bank holding companies from engaging in nonbanking activities, subject to certain exceptions, though many of these restrictions were relaxed with the passage of the Gramm-Leach-Bliley Act.

COSTS: CREDIT LOSSES

The practice of lending money sometimes results in extra costs to lenders, as when a customer stops repaying a loan. Naturally, lenders try to limit these types of losses. When the worst happens, however, these companies take other steps.

As with any other cost of doing business, consumer finance companies attempt to minimize their loan losses, while at the same time take on enough risk that they can grow their loan portfolio. Individual companies may set limits on what they perceive as acceptable levels of losses, depending on the type and duration of loans they make and the interest rates they charge.

Delinquencies, charge-offs, and default

Default occurs when the borrower has stopped servicing a debt obligation for a certain number of months. Credit managers generally determine the point at which default occurs once they have exhausted all methods of collecting on the obligation.

Delinquencies and charge-offs are generally higher during periods of adverse or recessionary economic conditions. These conditions may include rising unemployment, declining home values, and inflationary pressures, all of which can affect a borrower's ability to repay loans. At such times, financial services companies may limit the number and amount of loans they are willing to make. The ways they can do this include placing stricter standards on credit availability or charging higher interest rates to compensate for greater perceived risk.

In general, financial services companies that offer financing for a broad range of products have experienced a delinquency rate of around 2% on average over the last five years (for all insured institutions over the period of 2008–2013), which has continued in the third quarter of this year, based on the FDIC's *Quarterly Banking Profile*. However, the range varies widely based on the type of product and demographic and credit profile of the targeted customer. For instance, the credit card delinquency ratio for 30-89 days past due was 1.1% at the end of the second quarter of 2014, down from a near-term peak of 3.1% and a historical peak (back to 1984) of 3.4% in the third quarter of 1991, and the lowest rate seen since 1990. The delinquency ratio has historically fluctuated within the 2%–3% range. The net charge-off ratio in the second quarter of 2014 was 3.0%, a significant improvement from the peak of 13.2% in the first quarter of 2010 and the previous record of 7.7% in the first quarter of 2002. Historically, a more typical level for the net charge-off ratio had a range of about 3%–4%.

Loan loss provisions

Like banks, consumer finance companies must set aside funds, called reserves, for loan losses, in case customers do not repay their loans. Loan loss provisions appear on a firm's income statement, where they represent a charge taken against earnings to cover potential loan defaults. Provisions are based on management's assessment of current and expected lending conditions. The provision flows into the reserve for loan losses, which appears on the balance sheet as a contra account to loans. The reserve reconciliation is provided in the 10-Qs and 10-Ks and can usually be easily tracked. The reserve conciliation starts with ending reserves, adds provisions, subtracts charge-offs, adds recoveries, and ends with ending period reserves.

Unpaid loans are generally grouped according to the time that has elapsed since payment was to have been received: zero to 30 days; 30 to 90 days; or more than 90 days. After 30 days, loans are first categorized as delinquent; after 90 days, they are deemed uncollectible and are charged off. Charged-off loans are removed from the balance sheet and subtracted from the reserve for loan losses.

Types of bankruptcy

Bankruptcies generally cause lenders immediately to charge-off a customer's loan, since repayment is considered unlikely. Types of bankruptcy are described below. Individual consumers typically file under Chapter 7 or Chapter 13. Chapter 11 is typically used for business bankruptcies and restructuring.

◆ **Chapter 7.** This bankruptcy filing is essentially liquidation. It lets a debtor retain certain exempt property, while a trustee liquidates the debtor's remaining assets. The proceeds are distributed according to priorities set by the bankruptcy court.

◆ **Chapter 11.** This filing, known as reorganization, lets individuals reorganize their financial obligations, such as state or federal taxes, over an extended period of time.

◆ **Chapter 13.** This filing, generally referred to as the wage-earner chapter, is designed for individuals with regular income who wish to repay their debts but who are currently unable to do so. Under the supervision of the bankruptcy court, such individuals carry out a repayment plan in which their obligations to creditors are paid over an extended period.

Funding sources and margins

The mix of yields earned on assets and the rates paid for funding are of utmost importance to financial services firms. Like all firms, financial services companies try to maximize their profit from each sale—in this case, from each loan. They must seek the best available interest rates for funding, and also lend at the highest possible interest rates, and stay competitive.

To be successful, a financial services company must have access to funds at competitive interest rates, terms, and conditions. To obtain such funds, most firms turn to the global capital markets, by issuing commercial paper, medium-term notes, long-term debt, asset-backed securities, or equity (such as common or preferred stock). To a lesser extent, they also may offer customers limited deposit services.

OPERATING COSTS

Credit costs are typically the largest cost for consumer finance companies, followed by marketing, advertising, and distribution costs, and employee compensation. Other costs such as technology and occupancy/rent are meaningful, but a lesser factor for earnings.

Marketing and distribution

Because competition among lenders is usually intense, the costs of soliciting new business and retaining existing customers can be substantial. Response rates tend to be low, and competitors often try to lure customers away.

A company's marketing and advertising efforts often are geared toward the specific market segments where it has expertise or where it offers the most products and services at the most competitive prices. In this manner, a firm can maximize available resources in hopes of attracting the greatest number of customers.

Distribution channels often include media, direct mail, telemarketing, branch networks, event marketing, and retail relationships.

◆ **Media.** Companies promote their brands and products through advertising on their own websites, television, social networking websites, and more. Establishing a national brand name and trust is helpful to attracting customers. We note that consumers that seek credit are often more likely to be having credit difficulties, making the Internet a less productive way to source customers than it is for retailers.

◆ **Direct mail.** Direct mail involves the prescreening of credit rating databases for individuals with favorable credit criteria; they are mailed offers of lending products such as home-equity loans or credit cards. These mass mailings are inexpensive, but they also have a low success rate. Although direct mail is generally cheap, the volume is enormous, resulting in considerable outlays for postage and delivery charges.

◆ **Telemarketing.** These techniques often use the same financial criteria as direct mail in locating potential clients, but the process involves a representative calling the prospect directly. Telemarketing campaigns tend to be more expensive than direct mail campaigns. They are also more successful, and often can be used to reach existing customers to cross-sell ancillary products, such as insurance.

◆ **Branch networks.** Branch networks usually cover a geographic region, such as the Southeast or the Midwest, with offices located in high-traffic areas. This enables firms to leverage marketing and production efforts. At branch offices, walk-in customers may meet with financial representatives to find out about lending products or other offerings. This brick-and-mortar approach to business is costly, but also highly effective. Customers entering branch offices are already looking to borrow money, and the face-to-face contact makes it easier for financial representatives to close the deal. Branch networks are more common among banks than consumer finance companies as consumer finance companies and card networks have taken a more national approach.

◆ **Event marketing and event sponsorships.** Event marketing typically involves setting up booths, at sporting events or other well-attended activities, where product offerings are made. This kind of marketing has a fairly high success rate, reflecting the combination of face-to-face contact with customers and the use of promotional tie-ins, such as T-shirts and hats, which encourage people to apply for credit. Event sponsorship of a sport, concert, or other entertainment can also help reinforce a company's brand name.

◆ **Retail outlets.** Retail outlets often let financial services companies provide brochures or applications to customers, who may seek financial assistance in purchasing the items they want. This practice is common among electronics and appliance retailers, which sell high-cost consumer durable goods. This method is also helpful to the retailer, since sales of high-priced items could be limited if financing were not available.

Compensation costs

After interest expense, compensation costs—salaries, bonuses, profit sharing, payroll taxes, and benefits paid to or incurred for various employees—are the most significant expense item at most consumer finance companies. Large credit card issuers, such as Capital One, often employ thousands of part-time telemarketers to promote their products to customers, numerous credit underwriters to approve credit, and collection specialists to help speed up payments from late-paying customers and to help limit credit card loan defaults.

Technology costs

Given the industry's increasing reliance on technology, especially for computer-driven credit scoring and evaluation, it is not surprising that technology-related costs are often a sizable part of a firm's expenses.

KEY INDUSTRY RATIOS AND STATISTICS

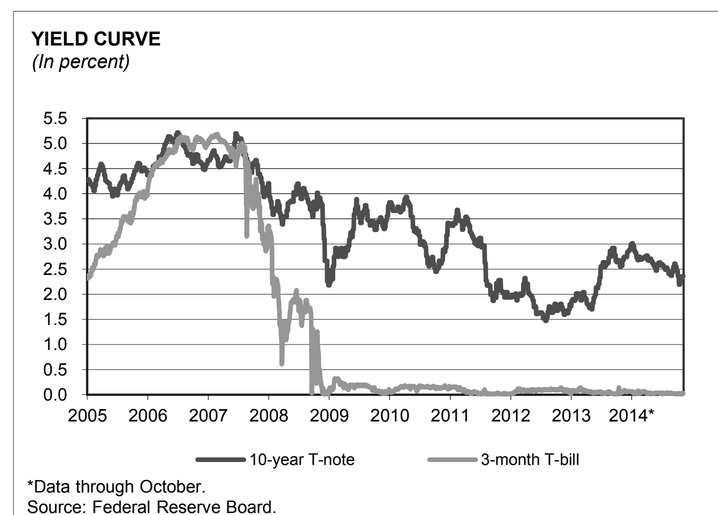
The following measures can be used to gauge the health of companies in the consumer finance industry. Like traditional banks, consumer finance companies record interest income and fees from lending products, establish reserves for potential credit losses, and generally compete aggressively with each other. However, they tend to be slightly less diverse and focus on relatively higher-margin (and, in some cases, higher-risk)

businesses. For companies with securities, insurance, or commercial banking operations, consult the *Industry Surveys* on those subjects for specific ratios and statistics affecting those lines of business.

◆ **Interest rates.** Interest rates are a key macroeconomic indicator of the financial services industry's overall performance. Because rates affect the ultimate cost of items to be financed, they may increase or diminish the demand for financial services companies' products. Analysts watch short- and long-term interest rates closely, as well as the relationship between those rates, which can be graphed and is referred to as the "yield curve." The chart plots interest rates and their maturities.

Short-term rates generally are represented by the federal funds rate and the discount rate. The Federal Reserve Board (the Fed), whose policy takes into account current economic conditions, influences the federal funds rate and directly controls the discount rate. For example, strong economic growth and/or employment activity, which can generate shortages in labor and goods and therefore cause higher inflation, may cause the Fed to raise its target for the federal funds rate, which, in turn, affects other interest rates.

Market forces determine long-term rates, commonly represented by the yield on the 10-year Treasury note. However, they are subject to the same factors as short-term rates: strong economic and employment conditions, by fueling inflation, can make them rise. Because they are subject to market forces rather than to regulation, long-term interest rates react more swiftly than short-term rates to daily economic developments. Thus, they can be viewed as a leading indicator for future interest rate levels and economic activity.



*Data through October.
Source: Federal Reserve Board.

When long-term rates decline but short-term rates do not, the difference between the two diminishes, and the yield curve begins to flatten. A flat yield curve is undesirable for the industry because it reduces the difference between the rates lenders must pay to borrow funds and what they can charge their customers. By reducing the spread, it cuts into their profit margins.

Declining interest rates tend to stimulate economic activity and the demand for borrowing. Rising interest rates tend to make loan payments less affordable, reduce loan demand, and generally result in higher delinquencies and charge-offs, thus weakening financial services firms' profits.

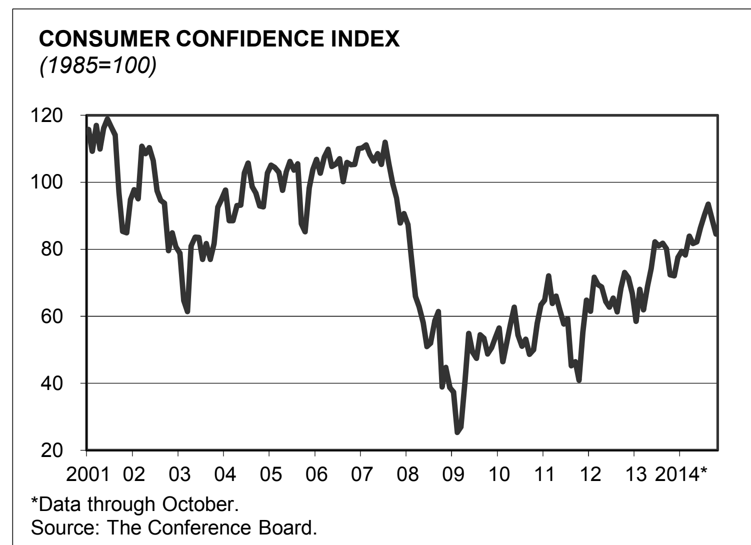
To anticipate the direction of interest rates, the analyst should evaluate the levels of domestic economic growth and inflation. Interest rates tend to rise when economic growth is strong, because healthy demand for borrowing makes lenders less willing to compromise on credit rates. A strong economy often means higher employment and consumer confidence levels; however, strong economic growth also may put upward pressure on inflation, as goods and services may be in short supply. Higher inflation limits individuals' purchasing power.

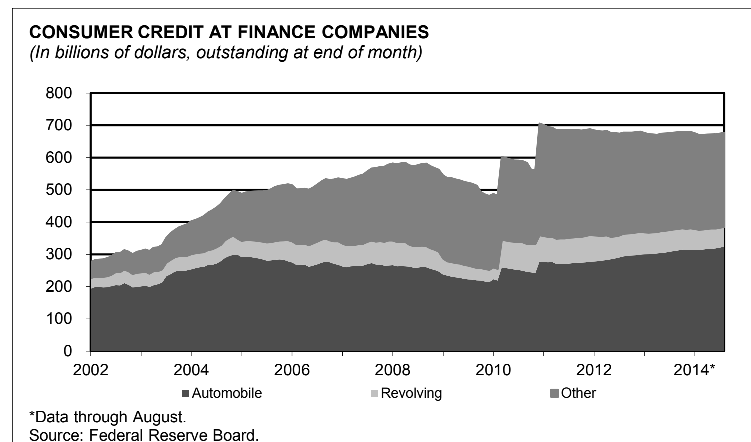
US interest rates continue to be well below their historical levels. As of May 6, 2014, the 10-year yield stood at 2.36%, while the three-month yield was 0.03%, resulting in a spread of 233 basis points. This compares positively with the average for 2013 of 228 basis points and 2012 of 172 basis points; it is down, however, from the 273 basis point average spread in 2011 and from the 308 basis point spread in 2010. Net interest income is usually about half the revenues of a major bank, and is dependent on interest rate spreads, growth of interest-earning assets, and level of nonperforming loans.

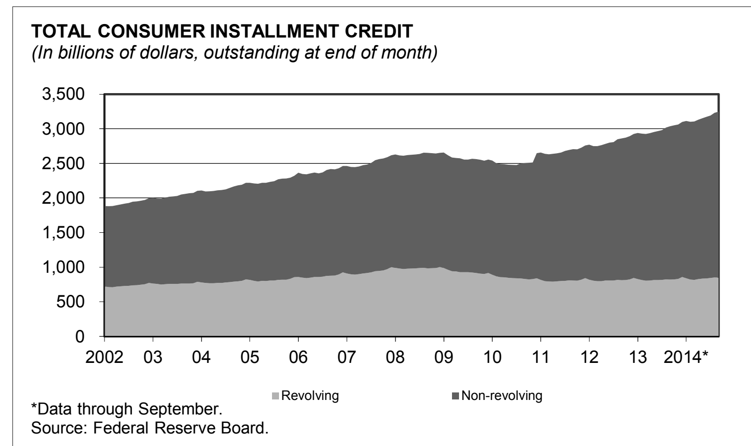
◆ **Personal consumption expenditures (PCE).** This is a measure of price changes in consumer goods and services. It consists of the actual and imputed expenditures of households including data pertaining to durables, nondurables, and services. PCE is included in the personal income report published by the Bureau of Economic Analysis of the Department of Commerce. The PCE is considered to be a fairly predictable report

that has little impact on the markets, but it is a measure commonly discussed by card networks such as Visa and MasterCard.

◆ **Unemployment rate.** Reported each month by the Bureau of Labor Statistics (part of the US Department of Labor), this is an important measure of employment and unemployment across the nation. Changes in the unemployment rate are meaningful to financial services companies as predictive measures of potential inflation (and hence of possibly rising interest rates) due to a tight labor market, or as an indicator of conceivably higher charge-offs and delinquencies due to rising unemployment. In October 2014, 5.8% of the US labor force was unemployed (seasonally adjusted); this compares with peak unemployment rates of 10.0% in October 2009 and 10.8% in November 1982, according to the Bureau of Labor Statistics.







◆ **Disposable personal income.** Reported each month by the Bureau of Economic Analysis (part of the US Department of Commerce), disposable personal income is a measure of inflation-adjusted income minus taxes. Changes in disposable personal income are important to financial services companies because they influence consumer spending and borrowing. Healthy rises in disposable personal income indicate a higher capacity to borrow and spend. Real disposable personal income growth has shown signs of recovery from the Great Recession: In September 2014, it was up 0.1% from the previous month, according to the Bureau of Economic Analysis. It increased 0.7% in 2013, 2.0% in 2012, 2.4% in 2011, and 2.1% in 2007, pre-credit crisis.

◆ **Consumer confidence index.** The consumer confidence index reflects US consumers' views on current and future business and economic trends, and the ways they expect to be affected by those trends. The Conference Board, a private research organization, which polls 5,000 representative US households to gauge consumer sentiment, compiles it monthly.

The survey has two components. One set of questions is concerned with consumers' appraisals of present conditions, the other with expectations for the future. The consumer confidence index combines

responses to those questions. Factors that influence the index include individuals' perceptions of employment availability and of their current and projected income levels.

Historically, the level of consumer confidence has been a good predictor of future borrowing and spending habits. People's expectations of future economic, employment, and income levels affect their ability to repay borrowed money and can be key in making purchase decisions. Consumer borrowing often moves in tandem with job growth and can be influenced by the direction of interest rates (lower rates may stimulate borrowing). In November 2014, the index stands at 88.7, according to the Conference Board.

◆ **Consumer credit.** The Fed reports consumer installment and revolving credit outstanding monthly. As of September 2014, consumer credit outstanding in the US totaled $3.3 trillion (seasonally adjusted), almost the same as at the end of 2013 and up from $2.9 trillion in 2012 and $2.8 trillion at the end of 2011. The accompanying chart, which shows consumer credit at finance companies, includes what appears to be anomalous data for 2010. This reflects revisions and methodology changes by the Federal Reserve. For details on these and other revisions, go to www.federalreserve.gov/releases/g19.

◆ **Delinquency trends.** Delinquency statistics are collected by the Federal Reserve Board, the FDIC, and other regulators.

◆ **Bankruptcy trends.** The number of US bankruptcy filings increases when consumers try to spend beyond their means. When a borrower declares bankruptcy, the lending company is forced to write off the loan as a loss. In addition, bankruptcy implies that an individual's ability to borrow is limited. The number of US bankruptcy filings is calculated quarterly by the Administrative Office of the US Courts and disseminated by the American Bankruptcy Institute.

HOW TO ANALYZE A FINANCIAL SERVICES COMPANY

This section discusses how to evaluate a financial services company. Although companies in this industry have different businesses mixes, certain quantitative factors can be used to compare all industry participants: revenue growth, profit margins, and return on equity. In contrast, loan growth, net interest margin, and credit quality measures pertain most specifically to those companies that provide loans. We recommend evaluating business mix, applicable quantitative measures from the list below, and valuation.

An analysis of a diversified financial services company begins with an assessment of the company's lines of business—the key factor differentiating the diverse companies in this group.

Lines of business

The consumer finance category includes a variety of different business models, most of which have roots in the credit card industry. Therefore, an analysis of any company in this industry segment must begin with an evaluation of what the company does, its products, and how it generates revenues. Companies with multiple business lines typically report revenue and profit contributions from different segments in their annual reports.

For example, Capital One has diverse business lines including consumer banking (retail deposits, mortgage, and auto finance), credit card, direct brokerage, and commercial banking. Meanwhile, American Express and Discover Financial Services compete partially with financial services providers (primarily other consumer finance companies and banks), but also the major network services providers Visa and MasterCard; these companies are technically part of the Information Technology sector of the GICS. Visa and MasterCard are business-to-business companies that do not lend money.

Quantitative measures

Although companies in this segment operate different types of businesses, many similar quantitative measures can be used to compare industry participants. Key measures of financial performance are loan growth, net interest margin, return on managed receivables, credit quality, and efficiency ratios. The two main drivers of a lender's earnings are net interest income and noninterest income.

When evaluating a consumer finance company's loan portfolio, it is important to look at it on a managed basis, which assumes that securitized loans that the company still services remain on the balance sheet. "Managed" metrics provide a more complete picture of a company's operating performance than "owned."

◆ **Revenue growth.** Analysts compare a firm's revenue growth with its historic growth rate and with that of its competitors. Is growth accelerating or decelerating? Is the company outperforming others in its markets, and, if so, why? Are there unique seasonal trends to consider? Determining what is behind the growth trends, such as acquisitions or new products, can provide insight into prospects for future growth. Note that with a lender, faster growth is not always better. If a company grows loans too rapidly, it may sacrifice credit quality. Revenues tracked by analysts are typically net of interest expense for diversified financials, and are typically referred to as total net revenues.

◆ **Loan growth.** To predict loan growth, it is important to understand the mix of a company's lending business. Given that loans are the biggest component of interest-earning assets, it is easy to see the relationship between loan growth and earnings growth. While some companies with higher-risk profiles might outgrow those with higher credit standards in certain periods, the group with stricter lending standards is inherently less risky and more likely to succeed over the long term. A lender that is growing too fast can lose control of credit quality and ultimately put itself out of business.

◆ **Net interest income.** Net interest income is driven by loan growth. Net interest income represents income on total interest-earning assets, less the interest expense on total interest-bearing liabilities.

◆ **Fee income (noninterest income).** Loan growth, add-on products, and/or credit quality (late payment fees or other penalties) drive fee income.

◆ **Net interest margin.** Net interest margin (net interest income divided by average interest-earning assets) indicates how much new profit can be expected from a given level of loan growth. For companies that have significant lending operations—banks, savings and loans, or consumer finance companies—this is a key profitability measure. Net interest margin trends are affected due to factors such as funding costs and business mix. Net interest margin may not fully reflect the risks that a company is taking, therefore, some analysts look at risk-adjusted net interest margin that accounts for net credit losses.

◆ **Return on assets (ROA).** For historical comparisons, it is best to use return on managed assets. Managed assets include a company's securitized loan portfolio; historically they were considered off-balance sheet assets.

◆ **Return on equity (ROE).** ROE (net income divided by average shareholders' equity) is a telling indicator of financial performance. It measures how efficiently a company uses shareholders' capital, or how much bang it gives shareholders for their buck. Not surprisingly, the ROEs of financial firms vary widely. Although ROE is a very useful tool for evaluating performance, it is not a perfect measure, as it is affected by leverage. All else being equal, the higher a company's level of debt as a percentage of its capital structure/the greater use of leverage, the greater the ROE.

◆ **Credit quality. O**ccasionally the individuals to whom financial services companies lend do not repay it. Therefore, lenders set aside reserves to offset the impact of future potential credit losses. Evaluating a firm's credit quality—its ability to withstand loan losses— over the course of several quarters or years is a key differentiating aspect among peers.

- **Delinquency ratio.** The delinquency ratio is calculated by dividing loans delinquent by end-of-period (managed) receivables. This represents the percentage of loans in a company's portfolio that are delinquent. Typically, a loan is termed delinquent if the payment is not received within 30 days of its due date.
- **Charge-off ratio.** Delinquent loans are typically determined uncollectible after no payment after 180 days and are considered losses and written off the balance sheet. You can calculate the net charge-off ratio or write-off rate by dividing charge-offs minus loan recoveries on balances previously charged off over average receivables in the period.

- **Reserve ratio.** Comparing a company's reserves for loan losses to total receivables can help determine whether it is adequately prepared for an unexpected deterioration in credit quality. We recommend assessing if a company's quarterly loan loss provisions are covering charge-offs; is the reserve level rising or falling and whether reserves are growing at a similar rate as loans.

◆ **Efficiency ratios.** Efficiency is measured by dividing expenses by revenues. Efficiencies typically improve as a firm grows in size, reflecting economies of scale. Companies generally strive to keep the growth rate of expenses below that of revenues.

◆ **Pretax and net margins.** Whether a company makes loans or not, you can evaluate the pretax margin and net margin. The ratios are typically calculated by dividing either the pretax income or net income by total net revenues. Companies with commodity-like, undifferentiated products tend to have lower pretax and net profit margins than companies that provide customers with proprietary products and value-added services.

◆ **Funding sources.** An examination of funding sources will reveal the relevant importance of a company's deposit taking and securitization activities. When a company securitizes pools of assets, it recognizes certain gains on its income statement. These sums recognized are based on assumptions made by the company about the loss trends and prepayment rates of the securitized assets. If the performance of the pool of assets diverges significantly from the company's expectations, the company may have to restate earnings or take a significant charge. In addition, securitization income can make a considerable contribution to net income. That said, the current securitization market is weak, as the credit markets remain relatively illiquid.

Valuation

The last step in analyzing a diversified financial services company consists of trying to determine whether its stock price reflects its true value. What price might the business garner in a private transaction? The valuation of a financial services company should reflect myriad factors, such as the quality of management, future business prospects, earnings volatility, and earnings history, to name a few.

◆ **Price-to-earnings ratio (P/E).** Among valuation methods, the P/E ratio is the most commonly used yardstick for consumer finance companies. All else being equal, companies that have superior earnings growth prospects will command higher P/E ratios. Analysts compare a firm's P/E ratio with the P/Es of its peers and with the P/E ratio of the broader market. The P/E ratios of diversified financial services companies vary widely. However, most financial services companies typically trade at a discount to the overall market because of the cyclical, interest-rate–sensitive nature of their business.

One useful technique is to estimate normalized earnings per share, and apply a multiple to it, based on longer-term historical trends. Normalized earnings per share can be estimated by forecasting the revenues based on an assumption of a moderate growth economic environment, with loan loss provisions that just cover net charge-offs, and expenses that are free of legacy legal and credit-related costs.

◆ **Price-to–tangible book value.** Tangible book value is typically common shareholders' equity less goodwill and/or other intangible assets. Alternatively, book value is calculated by taking total assets, minus goodwill and intangibles, minus total liabilities, minus preferred stock, all divided by shares outstanding. A key indicator of investors' perception of future value of a company is if the company trades above or below 1X its tangible book value per share and how that compares with peers. Differences in valuation can be explained by asset quality trends, growth, geographical mix, and/or quality of management. A financial services company that is deemed to have more solid credit quality and growth potential will generally trade at a relatively higher price/tangible book value than weaker peers. This measure is often applied when a company is in distress and when earnings are volatile. A company trading at a price that is at a discount to its book value per share is typically perceived as facing potential stress or in distress already.

◆ **Purchase price-to-managed receivables.** This measurement is typically used for mergers and acquisitions analysis. ■

GLOSSARY

Affinity card—A credit card sponsored by an organization (such as a nonprofit group or a university) and a card-issuing financial institution.

Asset-backed commercial paper—A short-term investment vehicle with a maturity that is typically between 90 and 180 days. A bank or other financial institution usually issues the security itself. The notes are backed by physical assets such as trade receivables, and are generally used for short-term financing needs.

Bankruptcy—Legal proceeding initiated when an individual or organization is unable to pay outstanding debts. Under US law, bankruptcy may be involuntary (when creditors petition to have a debtor judged insolvent) or voluntary (when the debtor brings the petition). In each case, the goal is to achieve an orderly and objective settlement of obligations.

Basis point—Unit measuring movements in interest rates or margins; it equals one one-hundredth of one percent (0.01%). Thus, 100 basis points equal one percentage point.

Captive finance company—A company (usually a wholly owned subsidiary) that finances consumer purchases from a parent company, such as Ford Motor Credit Co.

Collateralized debt obligation (CDO)—A type of asset-backed security and structured credit product. CDOs hold a portfolio of fixed-income assets and divide the credit risk among different tranches (*i.e.*, classes of bonds).

Credit—An amount of money that a financial institution extends, which the customer may borrow.

Credit bureau—An agency that tracks consumers' credit history, which it relays to credit grantors for a fee, including credit lines applied for and received, and timeliness of payment. The three major national credit bureaus are Equifax, Experian, and TransUnion.

Credit card—A plastic card issued by a bank, savings and loan, retailer, oil company, or other credit grantor that allows the consumer to obtain goods or services on credit, for which interest is charged. Most bank credit cards let consumers use their cards to obtain cash advances.

Credit limit—The maximum balance that a credit card customer is allowed to carry.

Credit rating—A formal evaluation of an individual's credit history and ability to repay obligations.

Debit card—A bank card that allows depositors to pay for the cost of goods and services directly from their checking accounts, electronically. Debit cards often combine the convenience of an automated teller machine (ATM) card and a general-purpose credit card; however, protection is more limited than for a credit card.

Debt consolidation—Managing consumer debts by combining them in a single loan from a financial institution. Usually results in a lower monthly payment extending over a longer period than the original loans, possibly at a higher interest rate.

Delinquency—A loan payment that is past due, typically by 30 or more days.

FICO score—A widely used measure developed by Fair Isaac & Co. to predict the likelihood that credit users will pay their bills based on an analysis of an individual's credit history compared with others, as well as historical performance. Scores range from 300 and 850.

Forbearance—A period when a creditor permits a debtor to temporarily suspend or reduce payment.

Interest rate sensitivity—The degree to which interest rate fluctuations affect an interest-earning asset or interest-bearing liability whose interest rates are adjustable within one year or less, according to maturity or contractual terms. Rate adjustments usually reflect changes in prevailing short-term money rates.

Managed receivables—The total amount of receivables (*i.e.*, credit card, mortgage, or other forms of loans), including both securitized receivables and receivables on a company's balance sheet.

Net charge-off—The portion of a loan that a financial services company is unlikely to collect and writes off as a bad debt expense; can be reduced by recoveries of payments for loans previously charged off.

Net interest income—Total interest revenues less total interest expenses.

Net interest margin—A measure of the profitability of a lending business, calculated as net interest income divided by average earning assets. Does not consider risks incurred.

Private-label credit card—A credit card issued under the name of a merchant, such as a department store. Merchants issue private-label cards, carrying their brand names, mainly to reinforce brand loyalty and to encourage spending.

Return on assets (ROA)—An indicator of operating efficiency, ROA is calculated by dividing net operating income by total average assets.

Return on equity (ROE)—A performance ratio, calculated as net operating income divided by total average equity.

Risk-adjusted margin—Operational measure that considers how much risk a company has taken on. Calculated as risk-adjusted revenue (net interest income plus noninterest income, less net charge-offs) divided by average managed receivables.

Secured loan—A note that, upon default, provides for pledged or mortgaged property or other collateral to be applied toward the payment of the debt.

Securitization—The process of pooling assets together and converting them into packages of securities collateralized by those assets. Asset-backed securities are sold into the secondary market as a funding source, but generally a piece is held by the issuer and following January 1, 2010 the entire portfolio of sold and unsold pieces are reflected on the issuers balance sheet.

Subprime borrower—A classification of borrowers with a deficient credit history. Although certain lenders define subprime using different measures, the most widely used form defines a subprime borrower as one with a FICO score below 620.

Unsecured loan—A credit agreement not backed by the pledge of specific collateral. The lender's only security is the credit user's signature and personal financial situation as demonstrated through the credit application.

Workout—When a lender agrees to accept less than is owed on a debt as full payment; may include forbearance. ■

INDUSTRY REFERENCES

PERIODICALS

ABA Banking Journal
http://www.aba.com/Pages/default.aspx
Monthly journal of the American Bankers Association; covers regulatory developments and compliance issues.

American Banker
http://www.americanbanker.com
Daily; news on a broad range of legislative, product, and financial developments affecting financial services companies.

The Conference Board Inc./
NFO's Consumer Confidence Survey
http://www.conference-board.org
Monthly; reports consumer confidence index levels.

Federal Reserve Bulletin
http://www.federalreserve.gov/pubs/bulletin/default.htm
Monthly; provides data and articles on financial and economic developments.

National Mortgage News
http://www.nationalmortgagenews.com
Weekly newspaper serving the mortgage industry, including mortgage bankers, commercial bankers, savings institutions, brokerage firms, insurance companies, and government enterprises. Provides news and analysis of the trends shaping the mortgage industry, including coverage of commercial lending, mortgage servicing, technology & e-commerce, default management, nonconforming lending, latest M&A developments, and exclusive industry rankings.

The Nilson Report
http://www.nilsonreport.com
Bimonthly; covers consumer payment systems worldwide.

GOVERNMENT AGENCIES

Federal Deposit Insurance Corporation (FDIC)
http://www.fdic.gov
Independent deposit insurance agency created by Congress to maintain stability and public confidence in the US banking system by identifying, monitoring, and addressing risks to insured depository institutions.

Federal Reserve System, Board of Governors
http://www.federalreserve.gov
Founded by Congress in 1913, the Fed supervises and regulates banks; maintains the stability of the financial system; conducts US monetary policy; and provides certain financial services to the US government, the public, financial institutions, and foreign official institutions.

US Bureau of Labor Statistics (BLS)
http://www.bls.gov
Principal fact-finding arm of the federal government in the broad fields of labor, economics, and statistics. Among its major programs are the consumer price index (CPI), the producer price index (PPI), the employment cost index, and the national compensation survey.

OTHER SOURCES

American Bankruptcy Institute (ABI)
http://www.abiworld.org
Founded in 1982, the ABI is a multidisciplinary, nonpartisan organization dedicated to research and education on insolvency matters; it is the largest such organization in the world. Membership includes more than 5,800 attorneys, bankers, judges, professors, turnaround specialists, accountants, and other bankruptcy professionals. It publishes information for both insolvency practitioners and the public.

Cardweb.com Inc.
http://www.cardweb.com
Online publisher of information about all types of payment cards, including credit, debit, smart, prepaid, ATM, loyalty, and phone cards. The organization is the offspring and online extension of RAM Research Group, a research firm covering the payment card industry, and serves hundreds of institutional clients in more than 30 countries.

COMPARATIVE COMPANY ANALYSIS

Ticker		Company	Yr. End	Operating Revenues (Million $) 2013	2012	2011	2010	2009	Net Income (Million $) 2013	2012	2011	2010	2009	Total Assets (Million $) 2013	2012	2011	2010	2009
CONSUMER FINANCE‡																		
AXP	[]	AMERICAN EXPRESS CO	DEC	34,932.0	33,808.0	32,282.0	30,242.0	26,519.0	5,359.0	4,482.0	4,899.0	4,057.0	2,137.0	153,375.0	153,140.0	153,337.0	147,042.0	124,088.0
COF	[]	CAPITAL ONE FINANCIAL CORP	DEC	24,176.0 A	23,177.0 A	18,525.0 A	18,939.0	15,885.2 A	4,392.0	3,734.0	3,253.0	3,050.0	986.6	297,048.0	312,918.0	206,019.0	197,503.0	169,646.4
CSH	§	CASH AMERICA INTL INC	DEC	1,797.2	1,801.1	1,540.6	1,293.3 A	1,120.4 A	142.5	107.5	136.0	115.5	96.7	2,081.7	1,818.3	1,674.2	1,427.2	1,269.7
DFS	[]	DISCOVER FINANCIAL SVCS INC	DEC	9,370.0 A	8,984.0	8,543.5	8,241.2	6,094.0	2,470.0	2,345.0	2,226.7	764.8	1,276.2	79,340.0	75,283.0	68,783.9	60,785.0	46,021.0
ECPG	§	ENCORE CAPITAL GROUP INC	DEC	773.4 A	559.3 A,C	467.4	381.3	316.4	77.0	78.6	61.0	49.1	33.0	2,685.3	1,171.3	812.5	736.5	595.2
EZPW	§	EZCORP INC -CL A	SEP	1,010.3 A,C	992.5 A	869.3	733.0	597.5 A	57.4	143.7	122.2	97.3	68.5	1,345.3	1,218.0	756.5	606.4	492.5
FCFS	§	FIRST CASH FINANCIAL SVCS	DEC	660.8 A,C	595.9 A,C	521.3 D	431.1 D	366.0 D	84.5	81.1	70.9	54.3	41.9	659.0	507.7	357.1	342.4	256.3
GDOT	§	GREEN DOT CORP	DEC	573.6	546.3	467.4 A	363.9	234.8	34.0	47.2	52.1	42.2	37.2	875.5	725.7	425.9	285.8	123.3
NAVI	[]	NAVIENT CORP	DEC	6,489.0 D	6,593.0	6,678.0	6,868.4	6,190.1 D	1,312.0	938.0	600.0	597.5	481.8	159,543.0	181,260.0	193,345.0	205,307.0	169,985.3
PRAA	§	PRA GROUP INC	DEC	735.1	592.8 A	458.9	372.7 A	281.1	175.3	126.6	100.8	73.5	44.3	1,601.2	1,289.0	1,071.1	995.9	794.4
SLM	†	SLM CORP	DEC	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
WRLD	§	WORLD ACCEPTANCE CORP/DE	# MAR	617.6	583.7	540.2	491.4	438.7	106.6	104.1	100.7	91.2	73.7	850.0	809.3	735.0	666.4	593.1
DIVERSIFIED BANKS‡																		
BAC	[]	BANK OF AMERICA CORP	DEC	101,697.0 F	99,708.0 F	129,913.0 F	134,194.0 F	150,450.0 F	11,431.0	4,188.0	1,446.0	-2,238.0	6,276.0	2,102,273.0	2,209,974.0	2,129,046.0	2,264,909.0	2,223,299.0
C	[]	CITIGROUP INC	DEC	92,543.0 D	96,997.0 D	102,587.0 D	111,465.0 D	104,159.0 D	13,403.0	7,690.0	10,955.0	10,622.0	(1,161.0)	1,880,382.0	1,864,660.0	1,873,878.0	1,913,902.0	1,856,646.0
CMA	[]	COMERICA INC	DEC	2,610.0	2,681.0	2,601.0	2,642.0	3,127.0	541.0	521.0	393.0	260.0	16.0	65,227.0	65,359.0	61,008.0	53,667.0	59,249.0
JPM	[]	JPMORGAN CHASE & CO	DEC	105,790.0 F	107,084.0 F	110,838.0 F	115,475.0 F	115,632.0 F	17,923.0	21,284.0	18,976.0	17,370.0	11,652.0	2,415,689.0	2,359,141.0	2,265,792.0	2,117,605.0	2,031,989.0
USB	[]	U S BANCORP	DEC	21,059.0	22,202.0	21,136.0	20,518.0	19,490.0	5,836.0	5,647.0	4,872.0	3,317.0	2,205.0	364,021.0	353,855.0	340,122.0	307,786.0	281,176.0
WFC	[]	WELLS FARGO & CO	DEC	88,069.0 F	91,247.0 F	87,444.0 F	93,249.0 F	98,636.0 F	21,878.0	18,897.0	15,869.0	12,362.0	12,275.0	1,527,015.0	1,422,968.0	1,313,867.0	1,258,128.0	1,243,646.0
OTHER COMPANIES RELEVANT TO INDUSTRY ANALYSIS																		
V	[]	VISA INC	SEP	11,778.0	10,421.0	9,188.0 A	8,065.0 A	6,911.0	4,980.0	2,144.0	3,650.0	2,966.0	2,353.0	35,956.0	40,013.0	34,760.0	33,408.0	32,281.0
MA	[]	MASTERCARD INC	DEC	8,346.0	7,391.0 A	6,714.0	5,539.0 A	5,098.7	3,116.0	2,759.0	1,906.0	1,846.0	1,462.5	14,242.0	12,462.0	10,693.0	8,837.0	7,470.3

Note: Data as originally reported. CAGR-Compound annual growth rate. ‡S&P 1500 index group. []Company included in the S&P 500. †Company included in the S&P MidCap 400. §Company included in the S&P SmallCap 600. #Of the following calendar year. **Not calculated; data for base year or end year not available. A - This year's data reflect an acquisition or merger. B - This year's data reflect a major merger resulting in the formation of a new company. C - This year's data reflect an accounting change. D - Data exclude discontinued operations. E - Includes excise taxes. F - Includes other (nonoperating) income. G - Includes sale of leased depts. H - Some or all data are not available, due to a fiscal year change.

Ticker		Company	Yr. End	Return on Revenues (%) 2013	2012	2011	2010	2009	Return on Assets (%) 2013	2012	2011	2010	2009	Return on Equity (%) 2013	2012	2011	2010	2009
CONSUMER FINANCE‡																		
AXP	[]	AMERICAN EXPRESS CO	DEC	15.3	13.3	15.2	13.4	8.1	3.5	2.9	3.3	3.0	1.5	27.9	23.8	28.0	26.5	14.0
COF	[]	CAPITAL ONE FINANCIAL CORP	DEC	18.2	16.1	17.6	16.1	6.2	1.4	1.4	1.6	1.7	0.3	10.6	10.6	11.6	11.5	1.7
CSH	§	CASH AMERICA INTL INC	DEC	7.9	6.0	8.8	8.9	8.6	7.3	6.2	8.8	8.6	7.9	13.7	11.3	16.0	15.7	15.4
DFS	[]	DISCOVER FINANCIAL SVCS INC	DEC	26.4	26.1	26.1	9.3	20.9	3.1	3.2	3.4	1.3	2.8	25.0	26.8	30.3	9.8	18.5
ECPG	§	ENCORE CAPITAL GROUP INC	DEC	10.0	14.0	13.0	12.9	10.4	4.0	7.9	7.9	7.4	5.8	15.8	20.2	18.1	18.0	15.1
EZPW	§	EZCORP INC -CL A	SEP	5.7	14.5	14.1	13.3	11.5	4.5	14.6	17.9	17.7	17.1	6.6	19.2	20.6	20.8	19.9
FCFS	§	FIRST CASH FINANCIAL SVCS	DEC	12.8	13.6	13.6	12.6	11.4	14.5	18.8	20.3	18.1	16.0	22.0	24.3	23.1	21.3	22.8
GDOT	§	GREEN DOT CORP	DEC	5.9	8.6	11.1	11.6	15.8	3.6	6.9	14.6	20.6	33.7	7.9	13.6	24.9	48.0	NA
NAVI	[]	NAVIENT CORP	DEC	20.2	14.2	9.0	8.7	7.8	0.8	0.5	0.3	0.3	0.2	27.0	20.0	12.8	12.6	9.3
PRAA	§	PRA GROUP INC	DEC	23.8	21.4	22.0	19.7	15.8	12.1	10.7	9.8	8.2	6.1	22.2	19.4	18.6	17.8	14.3
SLM	†	SLM CORP	DEC	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
WRLD	§	WORLD ACCEPTANCE CORP/DE	# MAR	17.3	17.8	18.6	18.6	16.8	12.8	13.5	14.4	14.5	13.1	31.6	26.5	23.4	22.1	21.9
DIVERSIFIED BANKS‡																		
BAC	[]	BANK OF AMERICA CORP	DEC	11.2	4.2	1.1	NM	4.2	0.5	0.1	0.0	NM	NM	4.6	1.3	0.0	NM	NM
C	[]	CITIGROUP INC	DEC	14.5	7.9	10.7	9.5	NM	0.7	0.4	0.6	0.6	NM	6.9	4.2	6.4	6.7	NM
CMA	[]	COMERICA INC	DEC	20.7	19.4	15.1	9.8	0.5	0.8	0.8	0.7	0.2	NM	7.7	7.5	6.2	2.6	NM
JPM	[]	JPMORGAN CHASE & CO	DEC	16.9	19.9	17.1	15.0	10.1	0.7	0.9	0.8	0.8	0.4	8.7	11.1	10.7	10.3	6.3
USB	[]	U S BANCORP	DEC	27.7	25.4	23.1	16.2	11.3	1.6	1.6	1.5	1.1	0.7	15.8	16.5	16.1	12.9	8.4
WFC	[]	WELLS FARGO & CO	DEC	24.8	20.7	18.1	13.3	12.4	1.4	1.3	1.2	0.9	0.6	13.9	13.1	12.1	10.5	9.3
OTHER COMPANIES RELEVANT TO INDUSTRY ANALYSIS																		
V	[]	VISA INC	SEP	42.3	20.6	39.7	36.8	34.0	13.1	5.7	10.7	9.0	7.0	18.3	7.9	14.2	12.3	10.6
MA	[]	MASTERCARD INC	DEC	37.3	37.3	28.4	33.3	28.7	23.3	23.8	19.5	22.6	21.0	43.3	43.2	34.4	42.4	53.9

Note: Data as originally reported. ‡S&P 1500 index group. []Company included in the S&P 500. †Company included in the S&P MidCap 400. §Company included in the S&P SmallCap 600. #Of the following calendar year.

Ticker		Company	Yr. End	Price / Earnings Ratio (High-Low) 2013	2012	2011	2010	2009	Dividend Payout Ratio (%) 2013	2012	2011	2010	2009	Dividend Yield (High-Low, %) 2013	2012	2011	2010	2009
CONSUMER FINANCE‡																		
AXP	[]	AMERICAN EXPRESS CO	DEC	18 - 12	16 - 12	13 - 10	15 - 11	27 - 6	18	20	18	21	46	1.5 - 0.9	1.6 - 1.3	1.7 - 1.3	2.0 - 1.5	7.4 - 1.7
COF	[]	CAPITAL ONE FINANCIAL CORP	DEC	10 - 7	9 - 7	8 - 5	7 - 5	43 - 8	13	3	3	3	53	1.9 - 1.2	0.5 - 0.3	0.6 - 0.4	0.6 - 0.4	6.7 - 1.2
CSH	§	CASH AMERICA INTL INC	DEC	11 - 7	14 - 9	14 - 8	11 - 8	11 - 4	3	4	3	4	4	0.4 - 0.3	0.4 - 0.3	0.4 - 0.2	0.5 - 0.3	1.2 - 0.4
DFS	[]	DISCOVER FINANCIAL SVCS INC	DEC	11 - 7	9 - 5	7 - 5	16 - 10	7 - 2	12	9	5	7	5	1.6 - 1.1	1.7 - 1.0	1.1 - 0.7	0.7 - 0.4	2.5 - 0.7
ECPG	§	ENCORE CAPITAL GROUP INC	DEC	17 - 9	10 - 7	13 - 8	12 - 7	14 - 2	0	0	0	0	0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0
EZPW	§	EZCORP INC -CL A	SEP	22 - 9	12 - 6	16 - 10	15 - 5	12 - 7	0	0	0	0	0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0
FCFS	§	FIRST CASH FINANCIAL SVCS	DEC	22 - 16	18 - 12	23 - 13	18 - 11	16 - 8	0	0	0	0	0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0
GDOT	§	GREEN DOT CORP	DEC	33 - 15	28 - 8	50 - 19	61 - 39	NA - NA	0	0	0	0	NA	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	NA - NA
NAVI	[]	NAVIENT CORP	DEC	9 - 6	9 - 7	15 - 10	13 - 9	18 - 4	20	26	27	0	0	3.6 - 2.2	3.9 - 2.8	2.7 - 1.8	0.0 - 0.0	0.0 - 0.0
PRAA	§	PRA GROUP INC	DEC	18 - 10	14 - 8	15 - 10	18 - 9	18 - 7	0	0	0	0	0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0
SLM	†	SLM CORP	DEC	NA - NA	NA - NA	NA - NA	NA - NA	NA - NA	NA	NA	NA	NA	NA	NA - NA	NA - NA	NA - NA	NA - NA	NA - NA
WRLD	§	WORLD ACCEPTANCE CORP/DE	# MAR	12 - 8	10 - 7	11 - 7	10 - 5	8 - 2	0	0	0	0	0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0	0.0 - 0.0
DIVERSIFIED BANKS‡																		
BAC	[]	BANK OF AMERICA CORP	DEC	17 - 12	45 - 22	NM - NM	NM - NM	NM - NM	4	15	400	NM	NM	0.4 - 0.3	0.7 - 0.3	0.8 - 0.3	0.4 - 0.2	1.6 - 0.2
C	[]	CITIGROUP INC	DEC	13 - 9	16 - 10	14 - 6	14 - 8	NM - NM	1	2	1	0	NM	0.1 - 0.1	0.2 - 0.1	0.1 - 0.1	0.0 - 0.0	1.0 - 0.1
CMA	[]	COMERICA INC	DEC	17 - 11	13 - 10	21 - 10	58 - 38	NM - NM	23	21	19	32	NM	2.2 - 1.4	2.1 - 1.6	1.9 - 0.9	0.8 - 0.5	1.7 - 0.6
JPM	[]	JPMORGAN CHASE & CO	DEC	13 - 10	9 - 6	11 - 6	12 - 9	21 - 7	31	22	18	5	24	3.1 - 2.3	3.7 - 2.5	2.9 - 1.7	0.6 - 0.4	3.5 - 1.1
USB	[]	U S BANCORP	DEC	14 - 11	12 - 10	12 - 8	16 - 12	26 - 8	29	27	20	11	21	2.8 - 2.2	2.9 - 2.2	2.5 - 1.7	1.0 - 0.7	2.5 - 0.8
WFC	[]	WELLS FARGO & CO	DEC	12 - 9	11 - 8	12 - 8	15 - 10	18 - 4	29	26	17	9	28	3.3 - 2.5	3.1 - 2.4	2.1 - 1.4	0.9 - 0.6	6.3 - 1.6
OTHER COMPANIES RELEVANT TO INDUSTRY ANALYSIS																		
V	[]	VISA INC	SEP	29 - 20	48 - 31	20 - 13	24 - 16	29 - 13	17	28	12	12	14	0.9 - 0.6	0.9 - 0.6	0.9 - 0.6	0.8 - 0.5	1.0 - 0.5
MA	[]	MASTERCARD INC	DEC	33 - 19	23 - 15	26 - 15	19 - 14	23 - 10	8	5	4	4	5	0.4 - 0.3	0.3 - 0.2	0.3 - 0.2	0.3 - 0.2	0.5 - 0.2

Note: Data as originally reported. ‡S&P 1500 index group. []Company included in the S&P 500. †Company included in the S&P MidCap 400. §Company included in the S&P SmallCap 600. #Of the following calendar year.

Ticker		Company	Yr. End	Earnings per Share ($) 2013	2012	2011	2010	2009	Tangible Book Value per Share ($) 2013	2012	2011	2010	2009	Share Price (High-Low, $) 2013	2012	2011	2010	2009
CONSUMER FINANCE‡																		
AXP	[]	AMERICAN EXPRESS CO	DEC	4.91	3.91	4.11	3.37	1.55	14.55	13.31	12.43	10.54	9.53	90.79 - 58.31	61.42 - 47.40	53.80 - 41.30	49.19 - 36.60	42.25 - 9.71
COF	[]	CAPITAL ONE FINANCIAL CORP	DEC	7.45	6.60	7.08	6.74	0.99	45.26	41.26	33.62	26.73	26.56	76.71 - 50.21	61.83 - 43.12	56.26 - 35.94	47.73 - 34.03	42.90 - 7.80
CSH	§	CASH AMERICA INTL INC	DEC	4.97	3.64	4.59	3.90	3.26	11.59	12.02	10.44	7.51	5.31	54.12 - 35.30	49.42 - 34.21	62.33 - 36.65	42.35 - 30.00	35.38 - 11.60
DFS	[]	DISCOVER FINANCIAL SVCS INC	DEC	4.97	4.47	4.06	1.23	2.42	20.71	17.56	14.75	11.04	12.57	56.20 - 37.24	42.08 - 23.75	27.92 - 18.31	19.45 - 12.11	17.35 - 4.73
ECPG	§	ENCORE CAPITAL GROUP INC	DEC	3.12	3.16	2.48	2.05	1.42	1.73	15.09	14.48	11.91	9.67	51.95 - 26.84	30.91 - 20.87	33.16 - 18.96	24.08 - 14.65	19.89 - 2.62
EZPW	§	EZCORP INC -CL A	SEP	1.07	2.82	2.45	1.98	1.45	7.91	8.24	9.43	7.84	6.15	24.06 - 9.85	33.38 - 16.57	38.66 - 25.30	28.75 - 10.07	17.72 - 9.50
FCFS	§	FIRST CASH FINANCIAL SVCS	DEC	2.91	2.81	2.31	1.79	1.42	5.63	6.39	8.14	7.11	4.76	64.06 - 47.56	49.64 - 33.27	52.18 - 29.71	32.06 - 19.82	22.89 - 11.26
GDOT	§	GREEN DOT CORP	DEC	0.80	1.15	1.30	1.06	0.93	9.85	8.25	6.83	3.95	0.91	26.61 - 12.31	32.49 - 9.05	65.00 - 24.94	65.10 - 41.13	NA - NA
NAVI	[]	NAVIENT CORP	DEC	2.94	1.93	1.13	1.08	0.71	10.84	8.94	8.18	7.45	5.62	26.81 - 16.57	17.99 - 12.85	17.11 - 10.91	13.96 - 9.85	12.43 - 3.11
PRAA	§	PRA GROUP INC	DEC	3.48	2.48	1.96	1.46	0.96	15.01	11.38	10.08	8.02	6.35	63.96 - 33.68	35.67 - 20.04	30.32 - 18.92	26.00 - 13.83	16.83 - 6.47
SLM	†	SLM CORP	DEC	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA - NA	NA - NA	NA - NA	NA - NA	NA - NA
WRLD	§	WORLD ACCEPTANCE CORP/DE	# MAR	9.36	8.04	6.75	5.76	4.52	29.00	29.24	29.34	27.41	22.38	107.98 - 72.12	79.11 - 57.03	74.48 - 50.12	55.24 - 31.56	37.42 - 10.31
DIVERSIFIED BANKS‡																		
BAC	[]	BANK OF AMERICA CORP	DEC	0.94	0.26	0.01	(0.37)	(0.29)	13.11	12.59	11.98	11.18	8.80	15.98 - 10.98	11.69 - 5.62	15.31 - 4.92	19.86 - 10.91	19.10 - 2.53
C	[]	CITIGROUP INC	DEC	4.27	2.56	3.69	3.70	(7.60)	54.41	50.57	48.88	43.00	39.23	53.68 - 40.28	40.18 - 24.61	51.50 - 21.40	50.70 - 31.10	75.85 - 9.70
CMA	[]	COMERICA INC	DEC	2.92	2.68	2.11	0.79	(0.80)	35.67	33.38	31.42	31.94	31.23	48.69 - 30.73	34.00 - 26.25	43.53 - 21.48	45.85 - 29.68	32.30 - 11.72
JPM	[]	JPMORGAN CHASE & CO	DEC	4.39	5.22	4.50	3.98	2.25	37.46	36.01	31.05	26.02	22.50	58.55 - 44.20	46.49 - 30.83	48.36 - 27.85	48.20 - 35.16	47.47 - 14.96
USB	[]	U S BANCORP	DEC	3.02	2.85	2.47	1.74	0.97	12.95	11.97	10.32	8.03	6.30	40.83 - 31.99	35.46 - 27.21	28.94 - 20.10	28.43 - 20.44	25.59 - 8.06
WFC	[]	WELLS FARGO & CO	DEC	3.95	3.40	2.85	2.23	1.76	20.33	19.00	15.52	12.73	9.44	45.64 - 34.43	36.60 - 27.94	34.25 - 22.58	34.25 - 23.02	31.53 - 7.80
OTHER COMPANIES RELEVANT TO INDUSTRY ANALYSIS																		
V	[]	VISA INC	SEP	7.62	3.18	5.18	4.02	3.11	6.02	6.77	4.85	2.87	2.82	222.72 - 153.93	152.51 - 98.33	103.45 - 67.51	97.19 - 64.90	89.69 - 41.78
MA	[]	MASTERCARD INC	DEC	2.57	2.20	1.49	1.41	1.12	4.76	4.18	3.30	3.05	2.14	83.94 - 50.10	49.86 - 33.63	38.50 - 21.93	26.99 - 19.10	25.90 - 11.71

Note: Data as originally reported. ‡S&P 1500 index group. []Company included in the S&P 500. †Company included in the S&P MidCap 400. §Company included in the S&P SmallCap 600. #Of the following calendar year.
J-This amount includes intangibles that cannot be identified.

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