

MasterCard Payments Update  
Q2 2008

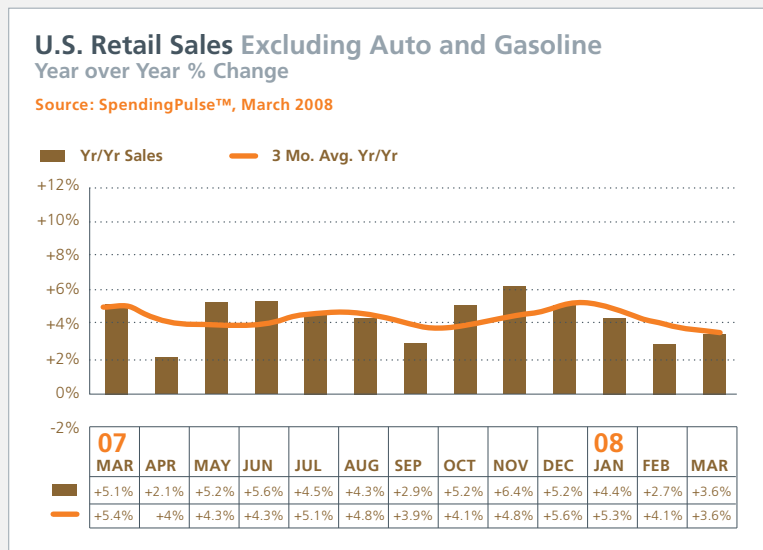
# Making the Most of an Economic Downturn



**The daily headlines look discouraging—deteriorating home values, a declining U.S. dollar, economic stagnation, and substantial write-downs by some of the world’s premier financial institutions. Consumer spending growth has slowed, however, it has not turned. According to SpendingPulse™ data<sup>1</sup>, U.S. retail sales were up 3.6% in March of this year (excluding auto and gasoline), versus 5.1% growth in March of 2007.**

While consumer spending hasn’t dried up, it has entered a new phase—a phase of *value spending* versus consumers’ more confident spending style of years gone by. In an economic slowdown, consumers

benefits—both near- and long-term—by helping consumers realize better value in their purchasing and by helping them gain better control of their money.



We’re pleased to share our first edition of *MasterCard Payments Update*. It’s all about the topic that many of our financial institutions regard as front and center: managing their business through an economic downturn. The following pages contain actionable strategies that you can use during this period of consumer retrenchment to enhance cardholder relationships, achieve new business efficiencies, and drive your business’s future profitability.

In this issue, we begin with an overview of altered consumer spending patterns and attitudes during periods of slower economic growth. We then outline several key strategies financial institutions are

seek to hold on to their money through tighter budgeting and spending. They will delay high-ticket discretionary purchases and look for more economical choices. Proprietary consumer research confirms that consumers are making tradeoffs—vacationing for only one week instead of two, putting off bigger purchases, and parents cutting spending on themselves, but to allow their children. Likewise, we see consumers cutting back on trips to expensive restaurants and opting for casual dining instead.

If history is a guide, some financial institutions will emerge from this period stronger than ever—namely, those that take advantage of this period to build and strengthen customer relationships while paring costs and laying the groundwork for greater profitability in the future. The key to surviving and making the most of the current down cycle is to recognize that merchants and financial institutions can reap important

considering for maintaining revenues and lowering costs, while being conscious of the impact on operations. The most important of these strategies:

- Motivate profitable behaviors by targeting your best opportunities and employing proven marketing tactics
- Drive card usage among key segments that continue to spend, such as the affluent and small business
- Manage risk appropriately by reviewing and refining procedures and practices
- Manage costs by minimizing potential fraud and streamlined processing

<sup>1</sup>SpendingPulse reports on national retail sales and is based on aggregate sales activity in the MasterCard payments network, coupled with estimates for all other payment forms, including cash and check. MasterCard SpendingPulse does not represent MasterCard financial performance. SpendingPulse is provided by MasterCard Advisors, the professional services arm of MasterCard Worldwide.

## Consumer Spending Tightens



“MasterCard’s most recent SpendingPulse data shows that consumers are, indeed, cutting back on discretionary purchases and shifting their spending to non-discretionary sectors.”

**Michael McNamara**  
Managing Director of  
MasterCard Advisors’  
SpendingPulse

“MasterCard’s most recent SpendingPulse data shows that consumers are, indeed, cutting back on discretionary purchases and shifting their spending to non-discretionary sectors,” says SpendingPulse manager Michael McNamara. We have seen these behaviors before. McNamara recalls that some card portfolios performed fairly well in 2001—the last recession—as consumers shifted more of their payments from cash to cards.

The first thing that consumers try to do when the economy looks threatening is to tighten up on spending by seeking better bargains—by buying their favorite brands in bulk, for example. Only if this tactic fails to generate sufficient savings do they start making more significant trade-offs. They are *most willing* to trade off convenience, indulgence, and novelty—going without innovation, the latest style, or an impulse item, for example. They are *least willing* to forgo quality, durability, service, and what they perceive to be basic necessities.

Current research from Yankelovich validates that income is the biggest factor driving consumer concerns about the economy. As income levels increase, the level of anxiety typically decreases. This correlates directly with spending, as the vast majority of lower-income consumers—between two-thirds and three-quarters of them—have made or plan to make spending cuts. This trend is not evident among higher-income consumers.<sup>2</sup>

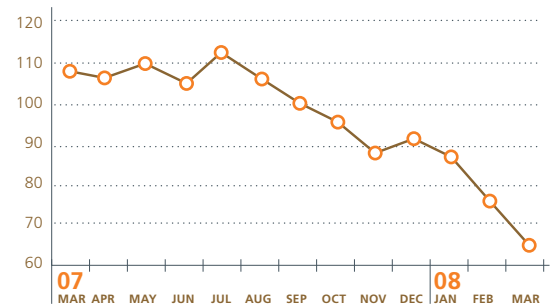
### Consumer Spending Overview

There’s no question that consumers have been losing confidence in the economy. Last summer, The Conference Board Consumer Confidence Index was above 100; it is now at 64.5—a five-year low. Job offerings are down, as is The Conference Board’s Help-Wanted Advertising Index, which was at 19 in March of this year, compared with 29 in March 2007.<sup>3</sup> Conference Board labor economist Ken Goldstein tells us that “businesses are cautious about investing and hiring, and they are not going to invest if they don’t have to.” The lack of job growth sours consumer attitudes and causes businesses to retrench further. The good news is that consumers do have money to spend; the bad news is that they’re not spending it as readily.

MasterCard’s SpendingPulse infers that there are key drivers affecting consumers’ retail spending, which have been trending downward. Among them: wage growth, which hasn’t kept pace with inflationary pressures; rising energy costs; declining home values and the inability of homeowners to further leverage their equity; and diminished consumer confidence. In addition, it will take a number of months for the Fed’s interest rate cuts to affect the general economy.

### Consumer Confidence Index

Source: The Conference Board, March 2008



Specific areas that historically are more recession-resistant include:

- Debit spending, which tends to be more concentrated in such recession-resistant non-discretionary areas as gasoline, food, personal care, and drug stores
- Non-discretionary areas such as gasoline and food will probably continue to see increased year-to-year dollar sales growth rates, driven in part by price inflation
- Food sales may also get a mild boost as consumers cut back on restaurant meals

<sup>2</sup> Yankelovich, *Dollars & Consumer Sense*, 2008.

<sup>3</sup> The Conference Board, March 2008.

## Spending Varies by Region

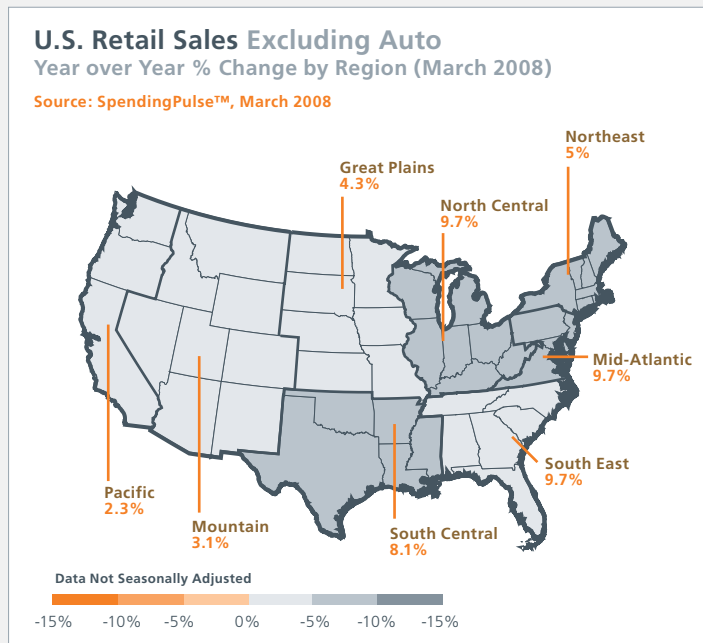
In March 2008, the unadjusted rate of spending growth in every region rose by 5.3% over the same month a year earlier. SpendingPulse data shows, however, that spending growth rates varied considerably from region to region.

The North Central region led the nation in unadjusted year over year comparisons, with a 9.7% increase over March 2007. The region recorded five consecutive months of double-digit growth through February and has exceeded the national average for eleven straight months. The Pacific Coast region again trailed all other regions in unadjusted year/year comparisons, with only 2.3% growth over March of 2007—the seventh straight month that the Pacific region has lagged the rest of the nation.



“When you’re trying to manage costs and extract maximum value from your customers, that’s the time you want to put analytics capabilities to good use—to identify and quantify your best opportunity segments.”

**Jack Wilson**  
Global Solutions Leader,  
MasterCard Advisors



What does this mean for you? Regional spending variations can help financial institutions decide where to invest and where to cut expenses—where to expand your retail footprint and where to put the brakes on growth, or even reduce your footprint. Timely, comprehensive data on spending trends can also help you prioritize marketing investments by identifying consumer spending opportunities by region and/or category. Aligning your activation and usage activities to help capitalize on these trends will maximize ROI.

### Action Point One:

## Motivate Profitable Behaviors

Analytics, working in tandem with marketing, play a critical role in identifying and targeting your best opportunities. You’ll make the most of your limited marketing dollars by motivating profitable behaviors. For example, motivating customers to use your cards in the top ten categories of spend—which include transportation, food, restaurants, entertainment, and personal care products—can move your card to the top of consumer wallets. Behavioral analytics lets you identify those consumers with the highest propensity to respond to your offers.

PortfolioAnalytics, MasterCard’s business intelligence portal, provides secure, Web-based access to your account information via our transaction data warehouse, where you can analyze 24 months of cardholder spend data. Using PortfolioAnalytics, you can identify populations of cardholders who are *not* actively spending in the top ten categories with your card and execute targeted campaigns to stimulate spend. In addition, PortfolioAnalytics has a campaign management tool, so you can track cardholder behavior before, during, and after the campaign and fine-tune all of its elements to improve the success of future campaigns.

Expanding usage is another way to motivate profitable behavior. As consumers increasingly turn to credit and debit cards to pay their monthly bills, recurring payments represent a way for financial institutions to offer their customers greater convenience. When customers use cards for bill payment EBP or set up recurring payments through the merchant, we’ve seen a lift in spend in non-bill payment categories. In a campaign MasterCard recently conducted with three issuers, cardholders were credited \$5 for each recurring payment they signed up for during the promotional period. Two of these financial institutions saw a double-digit lift over control cells in both recurring and non-recurring payment transactions—evidence that recurring payments increase overall spend, not just bill payments.

Another tactic for getting the most profit from your customer relationships is to keep in mind that cardholders have different needs at different stages of their lives. As your customers move through these stages, it is important to tailor your value proposition to remain relevant to their changing priorities. To meet these needs, and your business goals, MasterCard has enhanced both its authorization and clearing applications to support specialized processing at the individual account level.

This capability, called Account Level Management (ALM), enables true life-cycle management because you can move a cardholder up—upgrade a Platinum MasterCard® cardholder to a World MasterCard card, for example—or move them down or sideways to best fit their needs. ALM's Product Graduation feature makes it easy to migrate cardholders to different card programs without changing their account numbers—a tremendous convenience for end users who have established recurring payments. ALM also reduces much of the complexity and expense of migrating cardholders to new products, making it easier for issuers to increase interchange revenue by converting non-rewards card portfolios to higher-tiered product platforms.

ALM supports increased spend and retention while optimizing portfolio yield. It's not just about up-sell, but right-sell. We recognize that some cardholders are not profitable because they don't spend enough to cover the costs of customer service, rewards, and other benefits on their current card. Moving them to a product that still meets their needs but is more cost effective for issuers is a great way to optimize your portfolio.

## Action Point Two: **Drive Card Usage**

### Affluent Segment

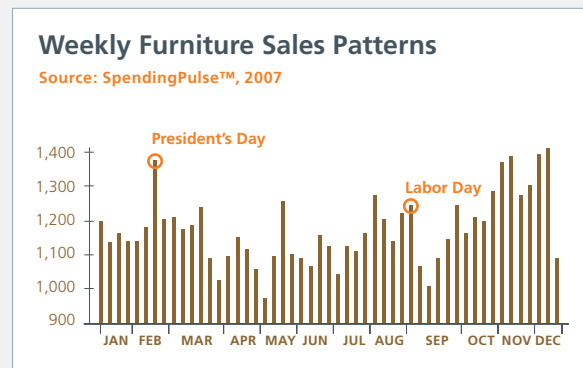
As many consumers retrench, focus on segments most likely to continue to spend. Affluent consumers are less likely to stop spending during softer economic times, and feel less anxious about the economy, reports Yankelovich.<sup>4</sup> That makes them the right target for usage stimulation activities.

To preserve profitability and capture the maximum number of transactions in discretionary categories, consider those spending patterns that occur yearly, regardless of the macroeconomic environment. With SpendingPulse as a guide, you'll discover recurring spending patterns such as the Massachusetts

tax holiday that occurs each August, providing a compelling focal point for issuer acquisition and usage programs. Likewise, merchants experience predictable surges in sales. For example, furniture purchases peak around President's Day and Labor Day, and large increases in spending on jewelry at Valentine's Day, Mother's Day, and the holidays in November and December.

SpendingPulse data for March 2008 shows that the following were the leading sectors that month:<sup>5</sup>

- eCommerce: 12.3%
- Men's Apparel: 5.4%
- Full-service Restaurants: 3.1%
- Electronics and Appliances: 2.8%
- Hotels: 2.2%



Affluent consumers are also continuing to travel and vacation in this down cycle, but they will seek ways to economize. MasterCard has recently launched a travel program designed to boost incremental spend in such travel-related categories as retail, gas, and restaurants. We are building awareness of the program through TV, online, and print advertising, while also promoting in-market spend with local placements. A full spectrum of travel-related offers and ideas is available on priceless.com, and this content can be syndicated to our partners' sites. In addition to our brand campaigns, MasterCard has a comprehensive schedule of promotions and marketing initiatives designed to augment your portfolio marketing plans and incent profitable spending behaviors.

### Domestic Travelers

17% of U.S. Population	36 Million
Median Age	42
Median HH Income	\$115,000
College Degree	53%
Children in HH	52%

Source: 2006 Simmons Adult Full Year Study  
 2006 MRI Double base

<sup>4</sup> Yankelovich, *Dollars & Consumer Sense*, 2008.

<sup>5</sup> SpendingPulse, March 2008.

## Business Segment

Rain or shine, small businesses have to keep buying gasoline, vehicle maintenance supplies, equipment, and other business necessities. Indeed, analysts predict that U.S. small business card usage will grow from \$348.5 billion in 2006 to \$740.2 billion in 2010.<sup>6</sup> MasterCard's Easy Savings loyalty program gives rebates to your cardholders when they shop at participating merchants. The program is designed to boost volume in T&E, office supplies, telecom, business services, computer and related spend, as well as shipping. Issuers pay nothing for merchant-funded Easy Savings rebates, and it can support key business drivers, including higher spend, higher average ticket, and decreased attrition.



"The last major mortgage crisis, in the late 1980s taught us that locking the door on consumers is a mistake. Instead, it's important to remind ourselves that not all customers are alike."

**Rick Openshaw**  
Vice President Risk  
Management/Credit  
MasterCard Advisors

## Action Point Three:

# Manage Risk Appropriately

We've long observed that during economic downturns, issuers often become overly conservative in managing their risk. For instance in acquisition efforts, many financial institutions reduce the number of direct mail campaigns in favor of more branch and cross-sell efforts. Issuers may also raise their underwriting scores. Portfolio management measures include cutbacks on credit line increases, focusing more on line decreases that mitigate exposure by decreasing open-to-buy amounts. Inactive accounts are also closed in order to further reduce exposure.

There's an obvious danger in being overly cautious, even at times like these: It can mean missed opportunities. "The last major mortgage crisis in the late 1980s taught us that locking the door on consumers is a mistake," warns MasterCard Advisors' Rick Openshaw. Remember that not all customers are alike. Use analytics to see which of your consumer segments are impacted more by an economic down cycle and which are impacted less. If your portfolio is intelligently segmented and balanced, your business should be able to proactively manage any losses generally associated with a down cycle. In our experience at MasterCard, issuers who carefully analyze spending patterns and transaction data and who know how to use segmentation can successfully grow their portfolios, even in the worst of times. As a first step, review your forecasting methods. MasterCard's Portfolio Performance Forecasting tool (PPF) can help you analyze 25 months of your own historical data and then apply external economic data to spot key trends and issues that your business needs to address. Using PPF, for example, you might

spot a bad credit line increase program that was implemented nine months earlier, or you might spot a change in prescreen criteria that needs adjustment.

A second step is to improve your loss forecasting. Here's an example: One of our major card issuers recently sought to improve the accuracy of its bad debt provisioning models while reintroducing credit line increases without escalating risk and delinquency. This issuer believed that historical increases in bad debts had been primarily driven by increasing card balances on the part of high-risk customers.

MasterCard Advisors used PPF to analyze the bank's portfolio and learned that, while credit line increases in 2005 accounted for 37% of its more than \$8 million in bad debt balances, three other factors lay behind the bulk of the remaining 63%. Nearly one-third (31%) or \$2.5 million of the bad debt came from accelerating the classification of bad debt; \$1.4 million came from changes in bankruptcy law; and \$1.1 million occurred because the bank had outsourced its collections.

MasterCard's analysis provided this bank with deeper insight into its declining portfolio performance, and our strategic recommendations helped the bank add line increases for accounts most likely to utilize them—and all of this while controlling risk through enhanced segmentation and new behavioral models. Because of its improved loss projections, the bank found it could confidently reduce loss reserves; freeing up more funds that could be shifted into marketing for new customer acquisitions. Finally, as a result of instituting appropriate risk management tools based on its key business issues, the bank was able to reduce collection balance rolls. It instituted new collection models to boost recovery rates and achieved a 15% improvement in first-contact resolution rates.

<sup>6</sup> Packaged Facts, *Corporate Credit Cards in the U.S.*, March 2007.

**Action Point Four:**

## Focus on Cost Management

Use periods of economic downturn to reduce operating costs while optimizing portfolio performance. Diminishing fraud is a proven way to reduce your cost of doing business. Until recently, incidents of PIN fraud were less common, but as occurrences of data compromise have grown more frequent, fraudsters have stolen multiple card numbers and PINs at a time. They then create duplicate cards to make purchases or, more often, withdraw cash at ATMs, which increases costs for issuers while angering consumers and creating negative perceptions of card security.

Neural networks can catch fraud in real time, but can be cost prohibitive—because the cure is more expensive than the problem. Absent a neural network, issuers are left with inadequate PIN debit protection and are losing more than their fair share to fraud.

MasterCard offers Debit Monitoring System (DMS) as a very cost-effective solution for PIN fraud. It enables you to load your entire portfolio of PIN transactions into this rules-based data mining tool to analyze fraud over a predetermined time period. One MasterCard issuer that chose to invest \$150,000 to implement DMS saved about \$1.4 million in fraud on their debit portfolio over twelve months.

The MasterCard debit solution also benefits issuers that *do* use neural networks. For while a neural network can identify individual fraudulent transactions, it may not allow an issuer to see its entire portfolio. A retail bank that was experiencing a series of low-value transactions at one particular merchant did not grasp the severity of the problem until it loaded its entire debit portfolio on the DMS. The bank then realized they weren't just experiencing a few of these transactions, but that they had up to dozens a day. In this instance, fraudsters were testing stolen cards before they attempted to use them for larger purchases.

Another opportunity to reduce costs is to consolidate all signature, PIN POS, and ATM transactions onto a single debit-processing network. Our powerful new

Integrated Processing Solution™ (IPS) substantially lowers the cost of debit transaction processing versus multiple processing platforms.

MasterCard built IPS with open systems technology and fully integrated it with our own world-class infrastructure. It greatly improves processing functionality, flexibility, and productivity, while also providing deeper insight into customer behavior for enhanced marketing effectiveness. "Many legacy systems are inefficient because of their multiple platforms, processes, and contact points, creating unnecessary costs and complexities," notes Candace DeBarger, MasterCard Vice President, Payment Processing Solutions. But IPS is a fully integrated system that supports signature- and PIN-based, as well as prepaid transactions—including card processing real-time fraud detection, ATM driving, program and card management and a Web portal with advanced workflow tools and back-office processing services.

IPS is also a gateway to MasterCard's analytic, marketing, and operations expertise that can help drive your profitability by:

- Developing propensity models that identify cardholders who are most likely to expand their debit usage beyond everyday spend categories
- Building an attrition model to improve retention of DDA customers
- Devising segmented marketing programs that enhance ROI
- Designing comprehensive rewards programs for your most valuable customers

Additionally, financial institutions increasingly look to innovation to help differentiate themselves from the competition. The IPS architecture is engineered for innovation and can assist banks and credit unions in bringing new payment products to market in a matter of weeks rather than months or even years. It does this through a more flexible, highly parameterized system and through scripting rather than coding.

### Call on MasterCard for Solutions to Your Most Important Challenges

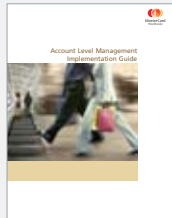
MasterCard offers expertise and experience in each of these categories. Call on us for help in addressing your most important business goals and challenges in this economic climate.

"Many legacy systems are inefficient because of their multiple platforms, processes, and contact points, creating unnecessary costs and complexities"

**Candace DeBarger**  
MasterCard Vice  
President, Payment  
Processing Solutions

**To learn more, contact your MasterCard account representative.**

## MasterCard solutions discussed in this Payments Update



**Account Level Management**  
Enhancements to MasterCard authorization and clearing applications to support specialized processing at the individual account level, which enables issuers to more closely align the economics of rewards programs

with cardholder value and to migrate cardholders to different card programs without changing the account number.



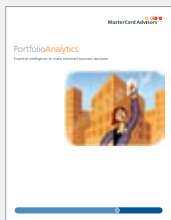
**Debit Monitoring System**  
This risk-scoring model uses predictive analytics to instantly detect potential PIN-based debit during authorization process at the POS or ATM. Online Fraud Monitor swiftly evaluates each authorization request, so you can immediately

decide to approve or deny a transaction.



**Integrated Processing Solution™**  
A suite of services that support signature- and PIN-based debit transactions—including card processing, real-time fraud detection, ATM driving, program and card management, a Web portal with advanced analytics

tools, and back office processing services.



**PortfolioAnalytics**  
A Web-based information portal that offers a multitude of business intelligence reports that enable issuers and acquirers to benchmark and optimize the performance of their marketing programs, reduce fraud and

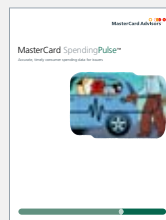
manage chargebacks, enhance cardholder and merchant relationships, and streamline operations.



### Portfolio Performance Forecasting

Portfolio Performance Forecasting uses advanced mathematical approaches to provide sophisticated, scenario-based modeling capabilities. This easy-to-use tool, accessed via a secure

Web gateway, enables managers to quickly and graphically view possible futures for portfolios, whether they are revolving lines (credit cards and lines of credit) or installment loans (auto, mortgages, home equity, or small business installments).



### SpendingPulse™

SpendingPulse draws on data from the extensive MasterCard network, along with estimates of cash and check payments, to translate retail sales information into valuable insights and strategies. By tracking industry data and performance,

analyzing trends, and providing guidance that identifies opportunities to capitalize on spending, SpendingPulse provides unbiased, accurate reports on retail sales, earlier than traditional sources, segmented by category.

### MasterCard payments experts who contributed to this Update:

**Candace DeBarger**, Vice President, Issuer Development, Payments Processing Solutions

**Ken Goldstein**, Economist, The Conference Board

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