

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM



Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions

Submitted to the Congress pursuant to section 8 of the Fair Credit and Charge Card Disclosure Act of 1988

June 2006

Section 8 of the Fair Credit and Charge Card Disclosure Act of 1988 directs the Federal Reserve Board to transmit annually to the Congress a report about the profitability of credit card operations of depository institutions.¹ This is the sixteenth report. The analysis here is based to a great extent on information from the Consolidated Reports of Condition and Income (Call Report) and two Federal Reserve surveys, the Quarterly Report of Credit Card Interest Rates and the Survey of Terms of Credit Card Plans.

Call Report Data

Every insured commercial bank files a Call Report each quarter with its federal supervisory agency. The Call Report provides a comprehensive balance sheet and income statement for each bank; however, it does not allocate all expenses or attribute all revenues to specific product lines, such as credit cards. Nevertheless, the data may be used to assess the profitability of credit card activities by analyzing the earnings of those banks established primarily to issue and service credit card accounts. These specialized banks are referred to here as "credit card banks."

For purposes of this report, credit card banks are defined by two criteria: (1) the bulk of their assets are loans to individuals (consumer lending), and (2) 90 percent or more of their consumer lending involves credit cards or related plans. Given this definition, it can reasonably be assumed that the profitability of these banks primarily reflects returns from their credit card operations.

The first credit card banks were chartered in the early 1980s, and the vast majority have been in operation only since the mid-1980s. To provide a more reliable picture of the year-to-year changes in the profitability of the credit card operations of card issuers, this report limits its focus to credit card banks having at least \$200 million in assets. Most of these institutions have been in continuous operation for several years, particularly those with assets exceeding \$1 billion, and are well beyond the initial phase of their operations.

As of December 31, 2005, sixteen banks with assets exceeding \$200 million met the definition of a credit card bank. At that time, these banks accounted for approximately 65.5 percent of outstanding credit card balances on the books of commercial banks or in pools underlying securities backed by credit card balances.

1. P.L. 100-583, 102 Stat. 2960 (1988). The 2000 report covering 1999 data was not prepared as a consequence of the Federal Reports Elimination and Sunset Act. The report was subsequently reinstated by law.

In 2005, credit card banks with assets in excess of \$200 million reported net earnings before taxes of 2.85 percent of outstanding balances adjusted for credit card-backed securitization.² As table 1 shows, returns for large credit card banks decreased 70 basis points or 20 percent from 2004. This rate of return is about the same rate as in 1998, but lower than in the years since then. The rate of return in 2005 compares favorably with returns experienced during the mid 1990s after 1994.

Table 1. Return on assets, large U.S. credit card banks, 1986–2005
(Percent)

Year	Earnings	Year	Earnings
1986	3.45	1996	2.14
1987	3.33	1997	2.13
1988	2.78	1998	2.87
1989	2.83	1999	3.34
1990	3.10	2000	3.14
1991	2.57	2001	3.24
1992	3.13	2002	3.28
1993	4.06	2003	3.66
1994	3.98	2004	3.55
1995	2.71	2005	2.85

NOTE: Credit card banks are commercial banks with average managed assets (loans to individuals including securitizations) greater than or equal to 200 million dollars with minimum 50 percent of assets in consumer lending and 90 percent of consumer lending in the form of revolving credit. Profitability of credit card banks is measured as net pre-tax income as a percentage of average quarterly outstanding balances.

SOURCE: Reports of Condition and Income, 1986-2005.

2. Calculations are adjusted for securitizations because earnings as reported on the Call Report reflect revenues and expenses from outstandings both on the books of the institutions and in off-balance-sheet pools backing securities.

Although profitability for the large credit card banks has risen and fallen over the years, credit card earnings have been consistently higher than returns on all commercial bank activities.³ For example, for all commercial banks, the average return on all assets, before taxes and extraordinary items, was 1.94 percent in 2005, well below the returns on credit card activities in that year.⁴

One difficulty that arises in assessing changes in profitability over time is that the sample of credit card banks changes somewhat from one year to the next. Thus, overall changes in profit rates from year to year reflect both real changes in activity and changes in the sample. To evaluate the effects of sample changes, the profitability of the specific banks included in the 2005 sample was examined over the period from 1986 to 2005 as well. Although the level of reported profitability for the constant panel of banks is somewhat different from that shown in table 1, the intertemporal pattern of profitability remains essentially as shown in the table. For 2005, returns for the constant sample decreased about 21 percent from the 2004 level.

Changes from 2005 in overall returns to credit card operations can be better understood by reviewing how individual expense and revenue items changed among the credit card banks in the 2005 panel.⁵ Both interest income and expense rose, approximately offsetting one another. Much of the decrease in average return resulted from increasing operating expenses. Provisions for loan losses and chargeoffs both increased moderately. Net interest margin decreased less than 1 percent in 2005, but non interest operating expenses increased about 9 percent. Chargeoffs increased about 8 percent.

3. This report focuses on the profitability of large credit card banks, although many other banks engage in credit card lending without specializing in this activity. Reliable information on the profitability of the credit card activities of these other banks is not available, although their cost structures, pricing behavior, and consequently their profitability may differ from that of the large, specialized issuers. The relatively high returns of credit card banks are not surprising, since one would expect that monoline institutions or those focused heavily on only one activity, such as credit card banks, would need to earn higher returns to compensate for the greater risks of holding an undiversified (by credit line) portfolio.

In earlier annual reports on credit card profitability, information from the Federal Reserve's Functional Cost Analysis (FCA) Program was used to measure the profitability of the credit card activities of smaller credit card issuers. These data tended to show credit card activities were less profitable for smaller issuers than for larger ones. The FCA program was discontinued in the year 2000. For further discussion, see Glenn B. Canner and Charles A. Lueckert, "Developments in the Pricing of Credit Card Services," *Federal Reserve Bulletin*, vol. 78, no. 9 (September 1992), pp. 652-666.

4. See Elizabeth Klee and Gretchen Weinbach, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 2005," *Federal Reserve Bulletin* (Spring quarter, 2006).

5. For another assessment of changes in credit card revenues and expenses, see Jeffrey Green, "C&P's 2006 Bank Card Profitability Study and Annual Report," *Cards and Payments*, May 2006, pp. 31-32.

General Discussion

Thousands of firms offer bank cards to consumers.⁶ Prior to the early 1990s, card issuers competed primarily by waiving annual fees and providing credit card program enhancements. Since then, however, interest-rate competition has played a much more prominent role. Many credit card issuers, including nearly all of the largest issuers, have lowered interest rates on many of their accounts below the 18 to 19 percent levels commonly maintained through most of the 1980s and early 1990s. Credit card interest rates in general have become more responsive to issuers' costs of funds in recent years as more issuers have tied their interest rates directly to one of several indexes that move with market rates. (Currently, most large card issuers tie their interest rates on their largest credit card plans to an index, most often the prime rate.) Some issuers have segmented their cardholder bases according to risk characteristics, offering reduced rates to existing customers who have good payment records while imposing relatively high rates on higher-risk or late-paying cardholders. Moreover, many issuers have attempted to gain or maintain market share by offering very low, temporary rates on balances rolled over from competing firms. Trends in credit card pricing are discussed in more detail below.

Over the past several years, competition has led to substantial shifts in market shares among the industry's largest firms. Most of the larger issuers have grown by acquiring credit card portfolios from smaller issuers or by merging with other firms. In addition, several of the more rapidly growing firms in recent years appear to have attracted market share by offering comparatively low-rate cards and attractive balance transfer programs. Others have gained market share through co-branding and associated rebate strategies, typically combined with waivers of annual fees.⁷

Aggressive competition for new customers during 2005 was at least partly the cause of a 5 percent increase from 2004 in the number of VISA and MasterCard in circulation, to a total of 595.2 million.⁸ The number of credit cards per cardholder increased to an estimated 4.95 credit cards per person. While the number of cards in circulation continued to grow from 2004 to 2005, the rate of growth remains moderate, consistent with the view that the market is becoming relatively saturated.

Direct mail solicitations continue to be the primary channel used for new account acquisition and account retention. The large number of direct mail solicitations in 2005 reached

6. Currently, over 6,000 depository institutions issue VISA and MasterCard credit cards and independently set the terms and conditions on their plans. Close to 10,000 other institutions act as agents for card-issuing institutions. In addition to the firms issuing cards through the VISA and MasterCard networks, two large nonbank firms, American Express Co. and Morgan Stanley Dean Witter and Co., issue independent general purpose credit cards to the public.

7. Under co-branding programs, the credit card bears the name of and is marketed to consumers of the co-branded product(s). Through use of the card, consumers typically accumulate "points" good for rebates on purchases of the co-branded product(s). One popular type of co-branding is with airline companies; in this case, "frequent-flier miles" are earned through credit card purchases.

8. Figures exclude other third party cards such as the Discover Card and American Express Optima card and debit cards. Source: *The Nilson Report*, Issue 851, February 2006.

a new record, surpassing the previous high from 2004, and demonstrates the continuing desire of card issuers to expand and retain their base of cardholders.⁹ An industry source indicated that in 2004, 71 percent of US households received an average of 5.7 offers per month.¹⁰ As in the recent past, credit card solicitations in 2005 heavily promoted low introductory interest rates for purchases and balance transfers. These solicitations are intended to generate new account relationships. However, many solicitations also focused on rewards, such as airline mileage credits and rebates. These solicitations are intended primarily to retain customer loyalty and fend off competition.

Recent Trends in Credit Card Pricing

Aside from questions about the profitability of credit card operations, considerable attention has been focused on credit card pricing and how it has changed in recent years. Analysis of the trends in credit card pricing in this report focuses on credit card interest rates because they are the most important component of the pricing of credit card services. Credit card pricing, however, involves other elements, including annual fees, fees for cash advances, rebates, minimum finance charges, over-the-limit fees, and late payment charges.¹¹ In addition, the length of the "interest-free" grace period, if any, can have an important influence on the amount of interest consumers pay when they use credit cards to generate revolving credit.

Over the past several years, pricing practices in the credit card market have changed significantly. Many card issuers that in the past offered programs with a single interest rate now offer a broad range of card plans with differing rates depending on credit risk and consumer usage patterns. Moreover, as noted, many issuers have also moved to variable-rate pricing that ties movements in their interest rates to a specified index such as the prime rate.

At present, the Federal Reserve collects information on credit card pricing through two surveys of credit card issuers. Because of the significant changes in the pricing of credit card services, the Federal Reserve initiated the Quarterly Report of Credit Card Interest Rates (FR 2835a) at the end of 1994. This survey collects information from a sample of credit card issuers on (1) the average nominal interest rate and (2) the average computed interest rate. The

9. An estimated 6.05 billion direct mail solicitations were sent by issuers during 2005, up 16 percent from 5.23 billion in 2004. The response rate on credit card solicitations in 2005 was estimated to be 0.3 percent, down slightly from 0.4 percent in 2004, but down sharply from an average of 2.4 percent over the period 1990 to 1993. Source: Synovate MailMonitor, <http://core.synovate.com/PR0406.asp>.

10. Source: Synovate Mail Monitor, March 2005, <http://core.Synovate.com/PR0305.asp>

11. In June 1996, the Supreme Court ruled that states may not regulate the fees charged by out-of-state credit card issuers. States have not been permitted to regulate the interest rates out-of-state banks charge. In making its decision, the Court supported the position previously adopted by the Comptroller of the Currency that a wide variety of bank charges, such as late fees, membership fees, and over-the-limit fees, are to be considered interest payments for this purpose. This ruling will likely ensure that banks will continue to price credit cards in multidimensional ways rather than pricing exclusively through interest rates. Source: Valerie Block, "Supreme Court Upholds Nationwide Card Charges," *American Banker*, June 4, 1996.

former is the simple average interest rate across all accounts; the latter is the average interest rate paid by those card users that incur finance charges. These two measures can differ because some cardholders are convenience users who pay off their balances during the interest-free grace period and therefore do not typically incur finance charges. Together, these two interest rate series provide a measure of credit card pricing. The Federal Reserve also collects detailed information on the pricing features of the largest credit card plan of a sample of issuers through the Survey of Terms of Credit Card Plans (FR 2572).¹²

Because information from the FR 2835a survey does not have an extended historical interest rate series for comparison purposes, this report on credit card profitability also presents data from the survey that preceded and was replaced by the FR 2835a, the Federal Reserve's Quarterly Report of Interest Rates on Selected Direct Consumer Installment Loans (FR 2835). Data from the FR 2835 indicate that credit card interest rates fell sharply from mid-1991 through early 1994 after being relatively stable for most of the previous twenty years, and fell again over the 1998-2003 period (table 2).¹³ Since early 1997, credit card interest rates have fluctuated between 12.78 and 15.85 percent. For 2005, credit card interest rates averaged 14.54 percent, the sixth consecutive year such rates have averaged below 15 percent. (It should be emphasized that the interest rates reported after August 1994 are based on the new survey and are not strictly comparable to the interest rates reported on the older survey.) The general decline in credit card interest rates from mid-1991 is the result of many factors, including greater competition on this aspect of credit card pricing. The decline in rates also reflects, in large measure, the sharp drop in credit card issuers' costs of funds during this period. In 2005, both interest income and interest expense increased somewhat.

Additional evidence on changes in credit card interest rates comes from the FR 2572. Although not precisely comparable from period-to-period because of changes in the sample of reporters, this statistical series reveals a general decline in credit card interest rates in recent years. For example, only 11 percent of the respondents reported interest rates below 16 percent on their largest credit card plan as of September 1991, but 78 percent did so as of January 2006 (the latest report available). In addition, the proportion of card issuers reporting that they utilize variable-rate pricing has also increased substantially since September 1991. As of September 1991, 23 percent of issuers used variable-rate pricing; as of January 2006, the proportion was 53 percent. The widespread use of variable-rate pricing suggests credit card rates are likely to respond relatively quickly to changes in market interest rates in the future.

12. The information in the FR 2572 survey is published twice a year by the Federal Reserve. Historically, the data were made available in a statistical release, the E.5 "Report of the Terms of Credit Card Plans." Beginning in 1995, the E.5 statistical release was discontinued and data are now available exclusively on the Board's web site at <http://www.federalreserve.gov/pubs/shop/survey.htm>.

13. For a comprehensive discussion of the factors that account for the levels and changes in credit card interest rates see, Glenn B. Canner and Charles A. Luckett, "Developments in the Pricing of Credit Card Services"; also U.S. General Accountability Office, *U.S. Credit Card Industry* (GAO/GGD-94-23, 1994).

Table 2. Average most common interest rate on credit card plans, 1974–August 1994, and the interest rate assessed on accounts incurring interest charges, November 1994–2005

(Percent)

Year	Interest rate	Year	Quarter	Interest rate
1974	17.20	1998	February	15.33
1975	17.16		May	15.62
1976	17.05		August	15.85
1977	16.88		November	15.72
1978	17.03	1999	February	14.73
1979	17.03		May	14.94
1980	17.31		August	14.79
1981	17.78		November	14.77
1982	18.51	2000	February	14.32
1983	18.78		May	14.74
1984	18.77		August	15.35
1985	18.69		November	15.23
1986	18.26	2001	February	14.61
1987	17.92		May	14.63
1988	17.78		August	14.64
1989	18.02		November	13.88
1990	18.17	2002	February	12.98
1991	18.23		May	13.34
1992	17.78		August	13.26
1993	16.83		November	12.78
1994	15.77	2003	February	12.85
1995	15.79		May	12.82
1996	15.50		August	13.11
1997	15.57		November	12.91
1998	15.59	2004	February	12.41
1999	14.81		May	12.93
2000	14.91		August	13.60
2001	14.44		November	13.92
2002	13.09	2005	February	14.13
2003	12.92		May	14.81
2004	13.21		August	14.75
2005	14.54		November	14.48

Note: Prior to November 1994 interest rates were those reported in the Quarterly Report of Interest Rates on Selected Direct Installment Loans. Beginning in November 1994 interest rates are those reported on the Quarterly Report of Credit Card Interest Rates for those credit card holders incurring interest charges.

Source: Board of Governors of the Federal Reserve System.

