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 2009

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 nineteenth 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 or mono-lined 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; few were in operation prior to 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, 2008, 18 banks with assets exceeding $200 million met the definition of a credit card bank. At that time, these banks accounted for approximately 77 percent of outstanding credit card balances on the books of commercial banks or in pools underlying securities backed by credit card balances.

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[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 2008, credit card banks with assets in excess of $200 million reported net earnings before taxes of 1.43 percent of outstanding balances adjusted for credit card-backed securitization.[2] As Table 1 shows, returns for large credit card banks fell 132 basis points or nearly 48 percent from 2007. The 2008 rate of return is very low by historic standards; well below the average rate of return of 3.03 percent since 1986. Much of the decline in net earnings can be traced to deterioration in credit quality; credit card delinquencies rose sharply in 2008 and along with them provisions for loan losses and chargeoffs.[3]

Although large credit card banks as a group experienced positive returns for 2008 taken as a whole, issuers experienced losses in the fourth quarter of the year as credit quality problems grew. Despite an increase in outstanding balances, year-to-date income fell about 4 percent from the end of September to the end of December 2008.

Table 1. Return on assets, large U.S. credit card banks, 1986–2008
(Percent)

Year	Return	Year	Return
1986	3.45	1997	2.13
1987	3.33	1998	2.87
1988	2.78	1999	3.34
1989	2.83	2000	3.14
1990	3.10	2001	3.24
1991	2.57	2002	3.28
1992	3.13	2003	3.66
1993	4.06	2004	3.55
1994	3.98	2005	2.85
1995	2.71	2006	3.34
1996	2.14	2007	2.75
		2008	1.43

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, 1986-2008.

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2. Calculations are adjusted for credit card backed 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.

3. For example, credit card delinquencies rose from 4.54 percent of outstanding balances as of the end of 2007 to 5.56 percent at the end of 2008. Refer to www.federalreserve.gov/releases/chargeoff/delallsa.htm.

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.[4] For example, for all commercial banks, the average return on all assets, before taxes and extraordinary items, was .04 percent in 2008, down about 137 basis points or 97 percent from the 2007 level.[5]

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 primarily because of mergers and acquisitions. 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 sample each year was also examined for the prior year. For 2008 the level of reported profitability for the constant panel of banks is the same as that shown in Table 1.

Changes from 2007 in overall returns to credit card operations can be better understood by reviewing how individual expense and revenue items changed relative to assets among the credit card banks in the 2008 panel.[6] Both interest income and interest expense fell over 2007 levels with net interest income increasing 66 basis points or 15 percent because interest expenses fell more sharply than interest income. Both noninterest income and noninterest expenses also fell over 2007 levels; on net, noninterest income declined 27 basis points or 19 percent from 2007 levels. Much of the fall in average returns for credit card banks from 2007 to 2008 resulted

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4. 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. The cost structures, pricing behavior, and consequently the profitability of these diversified institutions 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. Luckett, ADevelopments in the Pricing of Credit Card Services,@ *Federal Reserve Bulletin*, vol. 78, no. 9 (September 1992), pp. 652-666.

5. Refer to Morten L. Bech and Tara Rice (forthcoming), "Profits and Balance Sheet Developments at U.S. Commercial Banks in 2008," *Federal Reserve Bulletin*, www.federalreserve.gov/pubs/bulletin/default.htm.

6. For another assessment of changes in credit card revenues and expenses, see Jeffrey Green, (May 2009) AC&P's 2009 Bank Card Profitability Study and Annual Report,@ *Cards and Payments*, vol. 22, no. 5, pp. 22-24. The authors also report the profitability of credit card activities declined from 2007 to 2008 but not to the same extent as found in this report.

from increased provisions for loan losses and chargeoffs. Provisions for loan losses increased 165 basis points or 84 percent from 2007 levels. Net chargeoffs increased 106 basis points or 53 percent over the 2007 level.

General Discussion

Thousands of firms offer bank cards to consumers and consumers use their cards extensively.[7] The Federal Reserve's G. 19 Consumer Credit report indicates that consumers carried a total of about $960 billion in outstanding balances on their revolving accounts as of the end of 2008.[8] Credit card outstandings have grown over the years as consumers have chosen to use such products both for purposes of borrowing and because they serve as a convenient payment device and standby line of credit for unforeseen expenses. As such, a portion of the outstandings reflects primarily convenience use that consumers intend to repay within the standard interest-rate grace period offered by most card issuers. As a source of credit, one reason for the growth in credit card outstandings over time is that credit card loans have substituted for borrowing using other loan products such as closed-end installment loans and personal lines of credit

Prior to the early 1990s, card issuers competed primarily by waiving annual fees and providing credit card program enhancements such as airline mileage programs. 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. Moreover, credit card interest rates in general have become more responsive to issuers' costs of funds in recent years as more issuers have tied the interest rates on their plans directly to one of several indexes that move with market rates.

Today issuers segment 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. Card issuers also closely monitor payment and charge volumes and adjust credit limits accordingly both to allow increased borrowing capacity as warranted and to limit credit risk. Many issuers have attempted to gain or maintain market share by offering very low, temporary rates on balances rolled over from competing firms or to select current customers and by offering a wide variety of enhancements. Trends in credit card pricing are discussed in more detail below.

[7.] 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 Discover Financial Services, issue independent general purpose credit cards to the public.

[8.] Refer to www.federalreserve.gov/releases/g19/Current/

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 including, in some cases, larger competitors. 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 rebates combined with waivers of annual fees.[9]

The U.S. the general purpose credit card market is dominated by VISA and MasterCard labeled cards that combined accounted for an estimated 565 million cards in 2008 down about 6 percent from 2007.[10] In addition, American Express and Discover provided another 111 million general purpose cards to consumers in 2008 up slightly from 2007.

Direct mail solicitations continue to be the primary channel used for new account acquisition and account retention. After reaching an all-time high in 2005 of 6.05 billion direct mail solicitations, direct mailings fell off in 2006 to 5.8 billion, fell further to 5.2 billion in 2007 and to 3.8 billion in 2008.[11] The sharp decline in mailings from 2007 to 2008 likely reflects the effects of the weaker economic environment, rising unemployment and increased credit risk among current and prospective card holders. Part of the decline in activity may also reflect the effects of funding issues as problems in the market for credit card-backed securitizations emerged in 2008 and may have reduced the ability of card issuers to fund outstandings at attractive rates.

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.[12] In addition, the

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[9.] 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 Apoints@ good for rebates on purchases of the co-branded product(s). One popular type of co-branding is with airline companies; in this case, Afrequent-flier miles@ are earned through credit card purchases.

[10.] Source: *The Nilson Report*, April 2009, Issue 924.

[11.] Source: Synovate Mail Monitor, “US credit card mail volume declined to 3.8 billion in 2008 Other projections don’t accurately reflect extent of cut back” January 9, 2008, refer to http://mailmonitor.synovate.com/news.asp.

[12.] 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

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, currently offer a broad range of card plans with differing rates depending on credit risk and consumer usage patterns. Moreover, as noted, many issuers have moved to variable-rate pricing that ties movements in their interest rates to a specified index such as the prime rate.

As noted, risk-based pricing has become a central element of most credit card plan pricing regimes. In most plans, an issuer establishes a rate of interest, if the consumer borrows and pays within the terms of the plan that rate applies. If the borrower fails to meet the plan requirements, for example, the borrower pays late or goes over their credit limit, the issuer may reprice the account, including any outstanding balances, reflecting the higher credit risk revealed by the new behavior. Some issuers also apply “universal default” to reprice accounts, although some large issuers have discontinued this practice in the past year.[13]

In recent months, many issuers have responded to rising delinquencies and higher chargeoffs on their credit card plans by both repricng accounts and reducing credit limits. In some cases the repricing and credit limit changes have affected account holders that were in good standing, not just those that had failed to make payments as scheduled. Recently adopted regulations will limit the ability of card issuers to reprice outstanding balances but will continue to provide issuers with considerable pricing flexibility regarding new balances (see discussion below, the new rules take effect in July 2010).

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 former is the simple average interest rate posted 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

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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, ASupreme Court Upholds Nationwide Card Charges,@ *American Banker*, June 4, 1996.

13. Universal default is the practice of repricing an account based on a wide variety of factors, some not directly related to the credit card account subject to the repricing. For example, paying late on other credit accounts, or a change in a consumer’s credit score.

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 data are made available to the public each quarter in the Federal Reserve Statistical Release *G.19 Consumer Credit.* 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).[14]

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).[15] Since early 1998, credit card interest rates have fluctuated between 12.78 and 15.85 percent.

It is important to note that while average rates paid by consumers have moved in a relatively narrow band over the past several years, interest rates charged vary considerably across credit card plans and borrowers reflecting the various features of the plans and the risk profile of the card holders served. For 2008, credit card interest rates averaged 13.57 percent for those incurring finance charges, down about 110 basis points from the 2007 average.[16] It should be noted that although, on average, credit card interest rates fell for those paying interest, data from FR 2835 for the first quarter of 2009 show an increase in rates likely reflecting repricing in response to rising delinquencies and chargeoffs (data not shown in table 2).

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 85 percent did so as of January 2009 (the most recent 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 2009, the

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[14.] 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 AReport 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.

[15.] 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, ADevelopments in the Pricing of Credit Card Services@; also U.S. General Accountability Office, *U.S. Credit Card Industry* (GAO/GGD-94-23, 1994).

[16.] 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.

proportion was 61 percent. The widespread use of variable-rate pricing suggests credit card rates are likely to respond relatively quickly to changes in market interest rates.

Recent Regulatory Actions

On December 18, 2008 the Federal Reserve Board approved regulatory changes to protect credit card users by prohibiting certain unfair acts or practices and improving the disclosures consumers receive in connection with credit card accounts and other revolving credit plans.[17] The rules prohibiting certain credit card practices were adopted under the Federal Trade Commission Act, and were issued concurrently with substantially similar final rules by the Office of Thrift Supervision and the National Credit Union Administration. The most substantive rule changes will:

1. Protect consumers from unexpected interest charges, including increases in the rate during the first year after account opening and increases in the rate charged on pre-existing credit card balances.
2. Forbid banks from imposing interest charges using the "two-cycle" billing method.
3. Require that consumers receive a reasonable amount of time to make their credit card payments.
4. Prohibit the use of payment allocation methods that unfairly maximize interest charges and make it more difficult for borrowers to benefit in full from low rate balance transfer programs and other similar promotions.
5. Address subprime credit cards by limiting the fees that reduce the amount of available credit.

The Federal Reserve Board also adopted rules to revise the disclosures consumers receive in connection with credit card accounts and other revolving credit plans to ensure that information is provided in a timely manner and in a form that is readily understandable. These rules amend Regulation Z (Truth in Lending). The final rules under Regulation Z require changes to the format, timing, and content requirements for credit card applications and solicitations and for the disclosures that consumers receive throughout the life of an open-end account.

The new rules for disclosures are intended to increase the transparency and fairness in how credit card (and deposit) accounts operate, thereby enhancing competition and empowering consumers to better manage their accounts and avoid unnecessary costs. The new rules are currently scheduled to take effect on July 1, 2010. Recent legislation (noted below) will alter implementation of some portions of these rules.

[17.] Refer to www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm

Recent Congressional Actions

On May 22, 2009 the "Credit Card Accountability Responsibility and Disclosure Act of 2009" was enacted to establish new protections for credit card users by prohibiting or limiting certain acts or practices and improving the disclosures consumers receive in connection with credit card accounts and other revolving credit plans. The legislation mirrors in many respects the Federal Reserve's recent changes to credit card rules but goes further in a number of areas including, rules regarding repricing of outstanding balances; allocation of payments above the minimum to balances that are assessed the highest interest rate first, imposition of certain fees, including over the limit charges and some types of fees on gift cards; disclosure of the consequences of only making required payments; limitations on extending credit cards to those under the age of 21; a requirement that issuers must consider the consumers ability to make the required payments under the terms of a credit card plan before issuing a card or increasing a credit limit; and restricting fees on subprime credit cards.

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 1994–2008

(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			
1979	17.03	1999	February	14.73
1980	17.31		May	14.94
1981	17.78		August	14.79
1982	18.51		November	14.77
1983	18.78			
1984	18.77	2000	February	14.32
1985	18.69		May	14.74
1986	18.26		August	15.35
1987	17.92		November	15.23
1988	17.78			
1989	18.02	2001	February	14.61
1990	18.17		May	14.63
1991	18.23		August	14.64
1992	17.78		November	13.88
1993	16.83			
1994	15.77	2002	February	12.98
1995	15.79		May	13.34
1996	15.50		August	13.26
1997	15.57		November	12.78
1998	15.59			
1999	14.81	2003	February	12.85
2000	14.91		May	12.82
2001	14.44		August	13.11
2002	13.09		November	12.91
2003	12.92			
2004	13.21	2004	February	12.41
2005	14.54		May	12.93
2006	14.73		August	13.60
2007	14.68		November	13.92
2008	13.57			
		2005	February	14.13
			May	14.81
			August	14.75
			November	14.48
		2006	February	14.38
			May	14.77
			August	14.67
			November	15.09
		2007	February	14.64
			May	14.47
			August	15.24
			November	14.35
		2008	February	13.77
			May	13.51
			August	13.64
			November	13.36

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.