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 2010

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 twentieth 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, 2009, 16 banks with assets exceeding $200 million met the definition of a credit card bank. At that time, these banks accounted for approximately 76 percent of outstanding credit card balances on the books of commercial banks or in pools underlying securities backed by credit card balances. Taken as a group, the average credit card related assets for the 16 credit card banks over the course of 2009 was virtually unchanged from 2008.

In 2009, credit card banks with assets in excess of $200 million reported net earnings before taxes and extraordinary items of -0.46 percent of outstanding balances adjusted for credit card-backed securitization.[2] This is the first time credit card banks as a group experienced

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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.

[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.

negative net earnings since this report series was initiated. Losses among the credit card issuing banks were driven primarily by the poor performance of the largest card issuers.

As Table 1 shows, returns for large credit card banks fell 189 basis points from 2008. More broadly, the 2009 rate of return is well below the average rate of return of 2.88 percent since 1986. The decline in net earnings can be traced primarily to a continuing deterioration in credit quality; credit card delinquencies which have been rising since 2007, increased sharply in 2009 and along with them provisions for loan losses and chargeoffs.[3]

Table 1. Return on assets, large U.S. credit card banks, 1986–2009
(Percent)

Year	Return	Year	Return
1986	3.45	1998	2.87
1987	3.33	1999	3.34
1988	2.78	2000	3.14
1989	2.83	2001	3.24
1990	3.10	2002	3.28
1991	2.57	2003	3.66
1992	3.13	2004	3.55
1993	4.06	2005	2.85
1994	3.98	2006	3.34
1995	2.71	2007	2.75
1996	2.14	2008	1.43
1997	2.13	2009	-0.46

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, 1986-2009.

[3] Both chargeoff and delinquency rates began to increase notably beginning around the middle of 2007. As of June 2007 the chargeoff rate stood at 3.80 percent and the delinquency rate was 3.99 percent. Credit card delinquencies rose from 5.68 percent of outstanding balances as of the end of 2008 to 6.40 percent at the end of 2009. Chargeoffs rose from 6.37 percent to 9.50 percent over the same time period. Refer to www.federalreserve.gov/releases/chargeoff/chgallsa.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] 2009 stands out because earnings at credit card banks were notably lower than for all commercial banks. For all commercial banks, the average return on all assets, before taxes and extraordinary items, was 0.12 percent in 2009, up 9 basis points from the 2008 level and substantially higher than the negative returns experienced by the large credit card banks in 2009.[5]

One difficulty that arises in assessing changes in the profitability of credit card activities 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 2009 the level of reported profitability for the constant panel of banks is the same as that shown in Table 1.

Changes from 2008 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 2009 panel.[6] Interest income increased marginally and interest expense fell sharply over 2008 levels with net interest income increasing 90 basis points or 17 percent. Both noninterest income and noninterest expenses fell over 2008 levels; on net, noninterest income declined 144 basis points from 2008 levels. Much of the fall in average returns for credit card banks from 2008 to 2009 resulted from increased provisions for loan losses. Provisions for loan losses increased about 120 basis points or about one third from 2008 levels. Net chargeoffs increased about 235 basis points or about 77 percent over the 2008 level.

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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 cardholder profiles, and consequently the profitability of these diversified institutions may differ from that of the large, specialized issuers.

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, "Developments in the Pricing of Credit Card Services," *Federal Reserve Bulletin*, vol. 78, no. 9 (September 1992), pp. 652-666.

[5] Refer to Seung Jung Lee and Jonathan D. Rose (forthcoming), "Profits and Balance Sheet Developments at U.S. Commercial Banks in 2009," *Federal Reserve Bulletin*, www.federalreserve.gov/pubs/bulletin/default.htm.

[6] For another assessment of changes in credit card revenues and expenses, see Kate Fitzgerald, (May 2010) "An Industry At A LOSS," *PaymentsSource*, vol. 23, no. 4, pp. 16-18. The author reports the industry experienced losses in 2009. Profitability estimates for 2009 are also provided in *The Nilson Report*. It is reported that the three largest issuers all lost money in 2009 and other large issuers experienced significant declines in profitability. Refer to *The Nilson Report*, March 2010, Issue 944.

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 $866 billion in outstanding balances on their revolving accounts as of the end of 2009, down about 9.6 percent from 2008.[8] The decline in outstanding from 2008 to 2009 reflects the financial crisis that emerged in 2008 and the ensuing recession that saw consumers reduce spending and creditors tighten credit availability.

Until 2009, credit card outstandings had grown every year since 1968, the date the Federal Reserve's series on outstanding revolving credit card began.[9] Consumers use their cards for purposes of borrowing and because they serve as a convenient payment device and standby line of credit for unforeseen expenses. As a source of credit, credit card loans have substituted for borrowing that previously might have taken place using other loan products such as closed-end installment loans and personal lines of credit. As a convenient payment device, 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.

Prior to the early 1990s, card issuers competed primarily by waiving annual fees and providing credit card program enhancements such as airline mileage programs or other travel-related benefits. Since then interest rate competition has played a more prominent role, although for some market segments enhancements, particularly "reward" programs, are especially important in gaining market acceptance.[10]

Until the recent financial crisis, many credit card issuers, including nearly all of the largest issuers, had lowered interest rates on the majority of their accounts below the 18 to 19 percent levels commonly maintained through most of the 1980s and early 1990s. More generally, credit card interest rates 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. Recent changes in credit card rules (discussed below) that restrict the ability of card issuers to change interest rates on outstanding balances will induce more issuers to convert from fixed-rate to variable-rate plans.

Issuers segment their cardholder bases according to risk characteristics, offering more attractive rates to existing customers who have good payment records while imposing relatively

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[7] Currently, over 5,000 depository institutions including commercial banks, credit unions and savings institutions, issue VISA and MasterCard credit cards and independently set the terms and conditions on their plans. Many thousands of other institutions act as agents for card-issuing institutions. In addition to the firms issuing cards through the VISA and MasterCard networks, two other large 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

[9] Refer to the G 19 http://www.federalreserve.gov/Releases/g19/current/

[10] Refer to report to the Congress, "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," Government Accountability Office, GAO-06-929, April 21, 2006; available at www.gao.gov.

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.

In the recent economic downturn card issuers have aggressively reviewed interest rates and credit limits and have reduced limits on millions of accounts, particularly accounts that were inactive or those little used by cardholders.[11] Issuers have also closed many of these accounts as well as accounts that have become delinquent. In the current economic environment, inactive or little used accounts pose considerable risk of loss while offering little potential for profit as cardholders can draw on these accounts if they encounter financial distress. Trends in credit card pricing are discussed in more detail below.

The U.S. general purpose bank credit card market is dominated by VISA and MasterCard labeled cards that combined accounted for an estimated 473 million cards in 2009 down from about 565 million in 2008.[12] In addition, American Express and Discover Card Services provided another 103 million general purpose cards to consumers in 2009 down 7 percent from 2008. Reflecting the effects of the recession, the combined total of charge volume and cash advances using credit cards fell about 13 percent from the $2.174 trillion level in 2008.

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, mailings have fallen off sharply. Mail solicitations fell to only 3.8 billion in 2008.[13] The effects of the weak economic environment led to a further decline in solicitations in 2009 as card issuers sent 1.9 billion mailings during the year. Industry data suggest however that the retrenchment in mailings may have begun to ease some over the course of 2009 as prospects for economic recovery improved. For example, industry data related to mailings focused on the acquisition of new credit card accounts showed a nearly 50 percent increase from the third to the fourth quarter of 2009.[14]

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.

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[11] A review of a sample of credit records by the Federal Reserve found that about 10 percent of active general purpose bank credit cards experienced a line reduction from June 30, 2007 to December 31, 2008.

[12] Source: *The Nilson Report*, February 2010 issue 942.

[13] Source: Discussions with staff at Synovate Mail Monitor, mailmonitor.synovate.com/news.asp.

[14] Refer to report "Q4 2009 U. S. Consumer Acquisition Credit Card Overview", prepared by Mintel International Group, www.comperemedia.com. A sharp expansion in mailings from the third to the fourth quarter of 2009 was also reported by Synovate Mail Monitor February 2010. Refer to "Credit Card Offers Make a Comeback to U.S. Households," http://mailmonitor.synovate.com/news.asp

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.[15] 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. Today card issuers offer a broad range of card plans with differing rates depending on credit risk and consumer usage patterns. Moreover, as noted, 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 and the current downturn and new credit card rules spurred changes in pricing in 2009. In most plans, an issuer establishes a rate of interest for customers of a given risk profile, 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 reflecting the higher credit risk revealed by the new behavior. Issuers also consider the cardholder's performance on other credit accounts including those with other issuers when establishing rates. Recently adopted regulations limit the ability of card issuers to reprice outstanding balances for cardholders that have not fallen well behind on the payments on their accounts but will continue to provide issuers with considerable pricing flexibility regarding new balances.

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 cardholders 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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[15] 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.

An assessment of the fees charged by credit card issuers is provided in "Credit Cards: Increased complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, Report 06-929, September 12, 2006. Refer to www.gao.gov.

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).[16]

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).[17] 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 2009, credit card interest rates averaged 14.31 percent for those incurring finance charges, up 74 basis points from the 2008 average.[18] The increase in rates reflects repricing in response to rising delinquencies and chargeoffs; it may also be driven in part by repricing in anticipation of regulatory restrictions.

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 2010 (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 2010, the proportion was 67 percent.

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[16] 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 www.federalreserve.gov/creditcard/survey.html

[17] 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).

[18] 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.

One consequence of the shift to variable-rate pricing is that credit card rates respond more quickly to changes in market interest rates. New regulations limiting the circumstances in which card issuers may reprice outstanding balances create incentives for issuers to continue to migrate to variable-rate pricing (see discussion below). Data from the *Survey of Terms of Credit Card Plans* finds that the proportion of issuers reporting variable-rate pricing increased from 61 percent in January 2009 to 67 percent in January 2010.

Recent Regulatory and Legislative Actions

Credit card related lending has been the focus of regulatory and legislative activity over the past year or so. The new rules affect a variety of business practices and will result in changes to the pricing, marketing and underwriting of credit cards and ultimately to their use by consumers.

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.[19] The rules prohibiting certain credit card practices were adopted under the Federal Trade Commission Act, and were issued concurrently with substantially similar rules by the Office of Thrift Supervision and the National Credit Union Administration.

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.

On May 22, 2009 the "Credit Card Accountability Responsibility and Disclosure Act of 2009" (referred to here as the Card Act) was enacted by the Congress 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. The Card Act ensures advanced notification of changes in key credit terms and establishes rules regarding repricing of outstanding balances; requires allocation of payments above the minimum to balances that are assessed the highest interest rate first; limits the imposition of certain fees; establishes rules for cardholders to "opt-in" if they wish to have their issuer allow a transaction to be paid if the payment exceeds their credit limit; requires disclosure of the consequences of only making required payments; places limitations on extending credit cards to those under the age of 21; establishes a requirement that issuers must consider the consumer's ability to make the required

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

payments under the terms of a credit card plan before issuing a card or increasing a credit limit; and restricts fees on so-called “subprime” credit cards. Rules regarding advanced notice and the amount of time a cardholder has to make payments took effect in August 2009. Most of the other rules that implement the provisions of the Card Act took effect on February 22, 2010.[20] Additional rule making is ongoing, including provisions that ensure that so-called “penalty” fees (fees for late payments and for exceeding credit limits) are reasonable and proportional.

[20] Refer to www.federalreserve.gov/consumerinfo/wyntk/creditcardrules.htm

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 1994–2009

(Percent)

Year	Interest rate	Year	Quarter	Interest rate
1974	17.20	1999	February	14.73
1975	17.16		May	14.94
1976	17.05		August	14.79
1977	16.88		November	14.77
1978	17.03			
1979	17.03	2000	February	14.32
1980	17.31		May	14.74
1981	17.78		August	15.35
1982	18.51		November	15.23
1983	18.78			
1984	18.77	2001	February	14.61
1985	18.69		May	14.63
1986	18.26		August	14.64
1987	17.92		November	13.88
1988	17.78			
1989	18.02	2002	February	12.98
1990	18.17		May	13.34
1991	18.23		August	13.26
1992	17.78		November	12.78
1993	16.83			
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			
1999	14.81	2004	February	12.41
2000	14.91		May	12.93
2001	14.44		August	13.60
2002	13.09		November	13.92
2003	12.92			
2004	13.21	2005	February	14.13
2005	14.54		May	14.81
2006	14.73		August	14.75
2007	14.68		November	14.48
2008	13.57			
2009	14.31	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
		2009	February	13.54
			May	14.43
			August	14.90
			November	14.37

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.