BBVA Research

Credit cards: trends, profitability and outlook

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14 September 2017

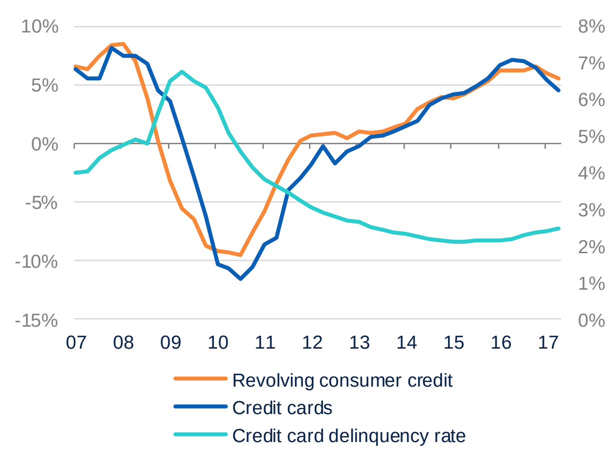
- **Credit card debt continues expanding at a solid pace, while fundamentals remain favorable**
- **Credit cards can be more profitable than other banking operations but also riskier**
- **We expect credit card debt growth to moderate**
- **Competition will intensify, particularly on rewards, incentives and benefits**

Revolving consumer credit, of which 97% is credit card debt, has finally surpassed the levels reached before the Great Recession.[1] This happened after a continuous expansion that started in the first half of 2011, when revolving consumer credit bottomed out. However, strong lending growth can sometimes result in increased risk. In the second half of 2015, delinquency rates began a slight upward trend, contributing to a slowdown in credit card debt growth in 2017 (Figure 1). This brief looks at recent trends in the credit card business and discusses future developments.

Credit card debt and household leverage

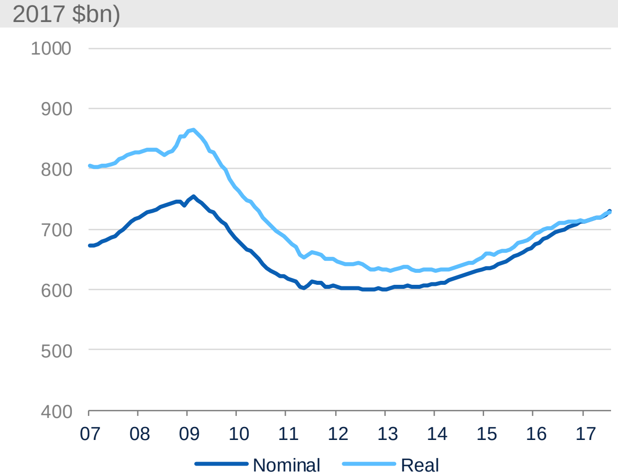
While in nominal terms outstanding credit card debt has surpassed the levels reached in the previous credit cycle, it is still 16% lower in real terms compared to its peak in February 2009 (Figure 2). Moreover, it is around 25% lower in real per-adult terms (Figure 3). These trends are consistent with the developments in other types of household debt and the overall deleverage process that followed the Great Recession (Figure 4), amid a new regulatory environment intended to reduce systemic risk but that probably also resulted in more moderate loan growth.

Figure 1. Credit card debt outstanding and delinquencies (YoY % change and %)



Source: BBVA Research and FRB

Figure 2. Commercial bank credit card lending ($bn and 2017 $bn)

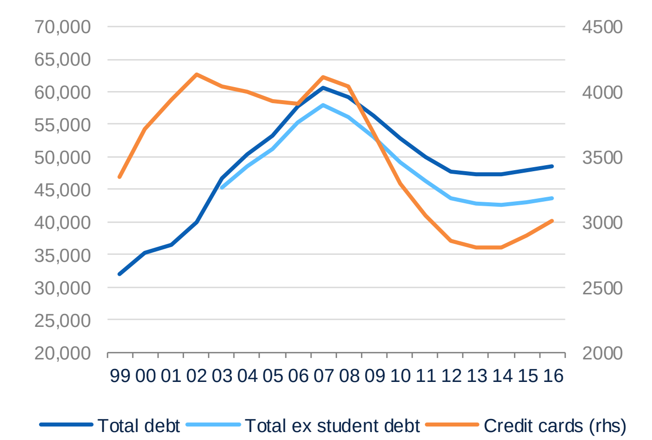


Source: BBVA Research and FRB

1: The remaining share includes overdraft plans on checking accounts and other loans without a fixed repayment schedule

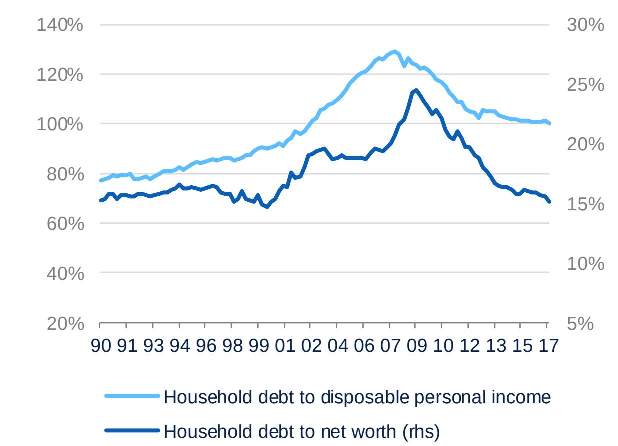
As a result, despite the gradual decrease in credit card portfolio quality over the last two years, the delinquency rate at 2.5% is still significantly lower than its historical average of 4.3%. In addition to healthy households' balance sheets, this development was also supported by solid employment gains and low interest rates.

Figure 3. Real household debt per adult (2Q17 $)



Source: BBVA Research, FRBNY and BLS

Figure 4. Household leverage (ratios %)



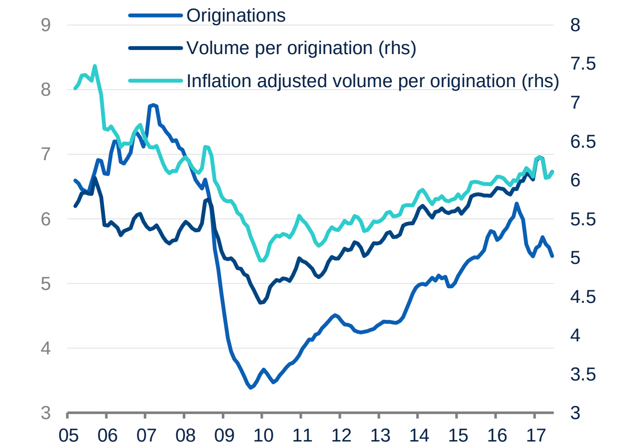
Source: BBVA Research, FRBNY and BLS

Credit card originations

Since 2009, the number of new credit cards originated per month increased consistently, reaching almost 7 million in July 2016. This peak was nonetheless lower than the 8 million reached back in 2006. In addition to total originations being lower in the current cycle, they look even more modest when taking into consideration the 11% increase in adult population between 2006 and 2016. Furthermore, the inflation-adjusted average volume per origination during the current cycle peaked at a level that is almost 20% below the previous expansion (Figure 5), providing another evidence of higher risk aversion of credit card lenders during the current cycle.

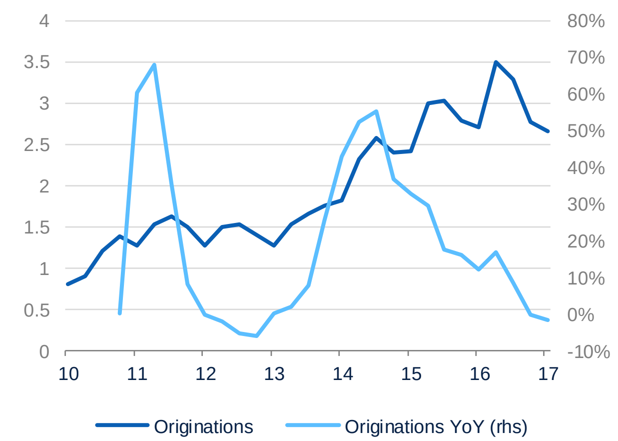
Most recently, originations have slowed down to 5.4 million in June 2017, which is slightly lower than the 2005-2017 average of 5.6 million per month, suggesting that originations have likely plateaued. This is to a great extent result of the sustained pullback from the subprime segment (Figure 6), which in turn is the result of the uptick in delinquencies. In 1Q17, subprime originations dipped below 2.7 million for the first time in two years and contracted for the second straight quarter for the first time since 2012. Considering that the share of lower credit quality borrowers in total originations is higher than in 2005 and 2010 (Figure 7), the slowdown in the subprime market has had a bigger impact than in previous cycles. Therefore, a limited increase in the subprime segment going forward will most likely constrain the pace of total originations.

Figure 5. Credit card originations (3M MA, mn., K $ and June 2017 K $)



Source: BBVA Research, CFPB and BLS

Figure 6. Subprime originations (mn. and YoY % change)

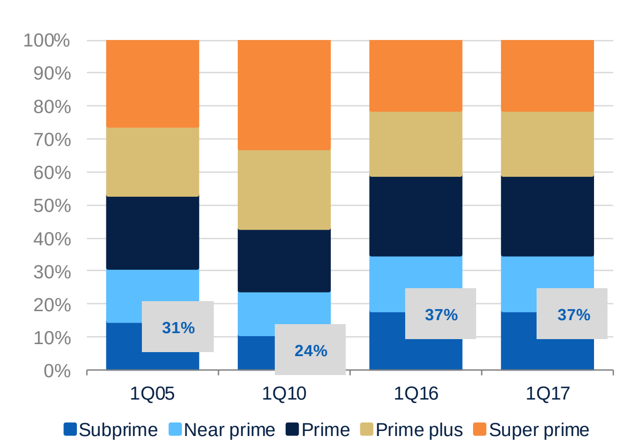


Source: BBVA Research and TransUnion

Credit card lending growth

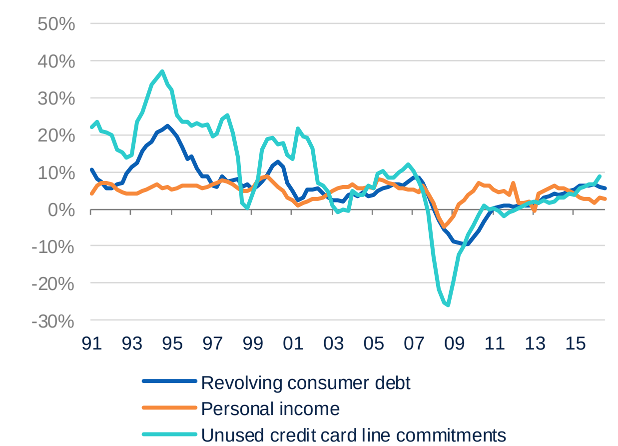
Despite the pullback in subprime originations, the pace of outstanding credit card debt growth remains strong. In 2Q17, the year-over-year growth was 5.6%, slightly lower than 6.6% in 4Q16. Nonetheless, outstanding credit card debt at FDIC-supervised commercial banks has decelerated more abruptly, from 7.3% in 3Q16 to 3.5% in 2Q17. This is explained in part by weaker growth of real disposable income since 2016, as well as the pullback of lenders from the subprime segment. This is evidenced by the continued and even intensified increase of unused commitments at commercial banks, resulting from increased credit lines for more creditworthy clients (Figure 8). When looking at historical trends, this pattern seems like a prelude to the next cyclical stage of the credit card business, which is expected to be characterized by intensified competition for clients in lower credit risk tiers.

Figure 7. Credit cards originated by risk tier (%)



Source: BBVA Research and TransUnion

Figure 8. Credit card lending growth (% YoY change)



Source: BBVA Research FRB and BEA

Business conditions

According to our analysis, there are three explanations for the recent slowdown in originations and lending growth, which is occurring amid solid overall economic and financial conditions, lower relative exposure to credit card debt than in previous cycles, and significantly lower delinquencies: regulation, demographics and lagged effects from the subprime mortgage crisis.

In terms of regulation, the changes that were introduced in the wake of the Great Recession have likely limited lenders' growth avenues, particularly the increased oversight by existing regulators and the newly established Consumer Financial Protection Bureau. The most significant regulatory changes since the Great Recession include the "ability to pay" requirement – that limits opening of new credit-lines or increasing existing ones –, restrictions on risk-based re-pricing and fees, and a ban on opening credit lines for younger customers without co-signer or financial means test.[2] In regards to demographics, population ageing, the retirement of Baby Boomers and the rise of Millennials result in less spending on credit cards as the lower purchasing power of younger workers cannot fully offset the deleveraging of retirees. Last but not least, the increased cautiousness of some lenders may be related to memory effects from the subprime mortgage crisis, as they try to avoid some of the same mistakes that led to overly relaxed credit standards and unsustainable leverage ratios.

Credit card profitability

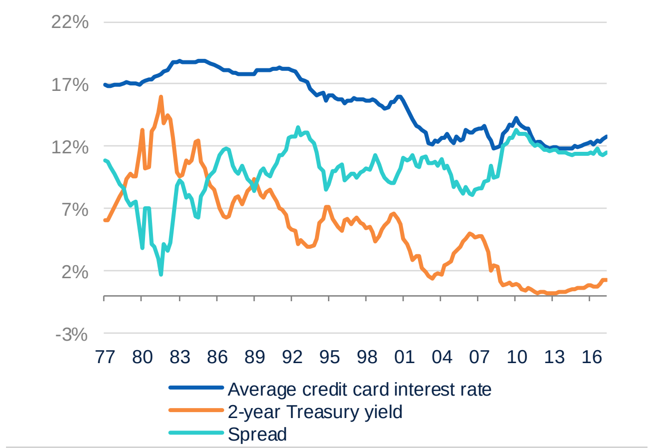
Credit card operations have been one of the most profitable lines of business for lenders for some time. The high spread between funding costs and credit card interest rates has remained persistent over the last 30 years and arguably even increased (Figure 9), despite ample competition in credit card issuance and multiple new entrants over the years. The difference between the profitability of credit cards and other banking operations has led some researchers to pose the question whether competition has failed to bring down interest rates.[3] However, other studies confirm that higher interest rates on credit cards are not related to limited market competition but to greater levels of risk relative to other banking activities backed or secured by collateral (Figure 10).

In fact, an investigation into the risk-adjusted returns of credit-card banks versus all commercial banks suggests that over the long term, credit card banks do not enjoy a significant advantage (Figure 11). Moreover, the stickiness of credit card interest rates is a reflection of the higher elasticity of the spread between credit card interest rates and funding costs to the dynamics of delinquencies compared to other credit products. This is a result of the nature of credit cards – unsecured credit lines that could be but are not necessarily used by the clients and that are at the same time payment vehicles. In essence, the spread increases when the economy deteriorates and funding costs decline in order to dis-incentivize borrowing by riskier clients and recuperate losses, while not affecting higher quality borrowers who usually do not carry large balances and are thus interest rate insensitive. The mechanism works the other way around during expansions (Figure 12).[4]

2: See CFR Part 1026 (sections 1026.51-1026.60) https://goo.gl/2BH5zb and McKinsey. (2011). *Designing a sustainable card model: The growth challenge*. https://goo.gl/VcLKBD
3: See Asubel, L. (1991). *The Failure of Competition in the Credit Card Market*. The American Economic Review, Volume 81, Number 1 (March 1991), 50–81.
4: For further information see Raskovich, A. and Froeb, L. (1992). *Has Competition Failed in the Credit Card Market?* U.S. Department of Justice, Antitrust Division, Economic Analysis Group Discussion Paper EAG 92-7

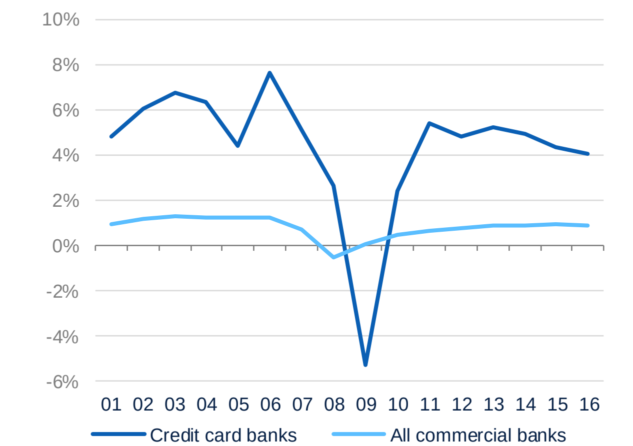
When all of this is taken into consideration, the concerns about the lack of competitiveness in the credit card market seem overblown. In fact, the market is characterized by participants that operate a high-risk business that requires elevated risk premiums. In addition, these players are not primarily competing through interest rates when dealing with prime borrowers but rather on product features such as points, rewards and benefits, which represents a cost that has increased significantly due to more stringent regulation and during the low interest rate environment.[5]

Figure 9. Interest rates (%)



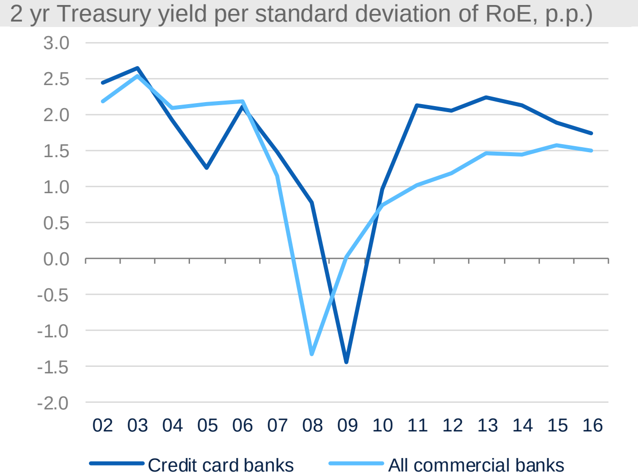
Source: BBVA Research and FRB

Figure 10. Return on average assets (%)



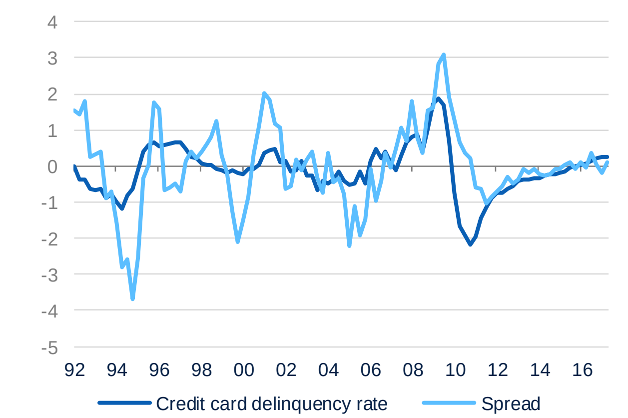
Source: BBVA Research and FRB

Figure 11. Risk-adjusted returns (Return on Equity above 2 yr Treasury yield per standard deviation of RoE, p.p.)



Source: BBVA Research

Figure 12. Credit card delinquency rate and interest rate spread (YoY change, p.p.)



Source: BBVA Research and FRB

5: BI Intelligence. (2007). *The credit card rewards explained: examining issuers' battle to attract and retain customers with perks*. and Wall Street Journal. *Banks hold best cards in rewards contest*. https://www.wsj.com/articles/banks-hold-best-cards-in-rewards-contest-1484148228

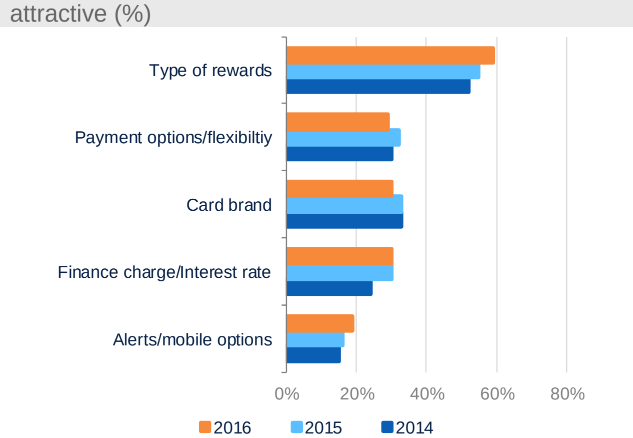
Credit card business outlook

The combination of lower household leverage and delinquency rates will support strong credit card business activity.[6] However, regulatory changes and greater risk aversion will move the needle in the opposite direction. On net, we expect credit card debt to continue expanding above nominal GDP growth, primarily supported by disposable income growth and job creation. In this environment, competition will become more aggressive for prime borrowers as lenders try to increase market share. At the same time, we expect some lenders to continue advancing new strategies and innovation to expand the market among less creditworthy borrowers.

According to our models, we expect commercial bank credit card growth to average between 3.5% and 4.5% over the 2017-2019 period compared to 6.5% in 2016. The slowdown in growth will ensure that delinquency rates remain low compared to historical standards, especially since households are in a much better financial position compared to previous credit cycles. This will result in a more stable environment relative to previous credit cycles.

With credit card interest rates remaining stable, if funding costs remain close to current rates, the low levels of loan loss provisions will provide opportunities to issuers to fund generous rewards programs. This will lead to an intensification of competition in the area of incentives such as sign-up bonuses and rewards, which consumers find most attractive (Figure 13), especially when they are in the form of cash back discounts (Figure 14).

Figure 13. Credit card features that consumers find attractive (%)



Source: BBVA Research and TSYS

Figure 14. Usefulness of rewards (%)

Source: BBVA Research and TSYS

In order for banks to be able to compete successfully in this environment, they will require sophisticated risk management capabilities. Robust data analytics and marketing capabilities will provide strong support to develop new risk management tools, reduce operating costs and improve customer targeting, segmentation, customer service and overall customer experience.

At the same time, the plastic credit card is already being replaced by mobile phone applications and wearable items such as a ring or a keychain that contain a chip and allow borrowers to make payments. Likewise, technologies that rely on retina or fingerprint scans will help enhance security measures. Undoubtedly, competition will not only be among credit card providers but also with payment providers and technology companies. For customers, new technologies and innovation will mean new opportunities and improved services, potentially at lower costs and under a more secured environment, in which the 50-year old plastic credit card is finally replaced by the digital credit card.

6: The minimum credit card delinquencies reached in the previous two credit cycles are 3.3% and 3.5% compared to 2.5% currently.

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