

VIEWPOINT

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2018 OUTLOOK: CREDIT

2018 will be a year for credit card issuers to tighten up lending and build on existing customer relationships as account delinquency begins to rise.

Credit card account volumes and revolving debt in the United States are back to peak levels. Concurrently, past due accounts are beginning to increase. In 2018, issuers should solidify their portfolios, grow organically, and prepare their portfolios for emerging payment opportunities.

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2018: The Healing Process Over, It's Time to Protect the Balance Sheet

It took almost nine years, but the Great Recession is in the rearview mirror for the U.S. credit card business. The economy is now relatively stable, with inflation comfortably below 2%, unemployment trending toward a record 3.9%, and low-stress rates for consumer households and their payment responsibilities.

Fast growth often comes at a price, though, as many issuers begin to feel the pains of increased collection volume. Write-offs of bad debt as a percentage of annualized receivables hit a low of 2.92% in 2015 but bounced upward to 3.47% in 2016. The percentage will close at 4.01% in 2017, 50 basis points above the ideal portfolio standard of 3.50%. Mercator Advisory Group projects the metric will rise to 4.50% in 2018. While the recession peak of 10.54% credit loss dwarfs our expectation for 2018, Mercator Advisory Group notes that the deterioration will have an impact on both non-interest revenue and interest revenue streams. The loss rate is critical because it represents credit losses measured as a percentage of total receivables, an item that causes operating expense.

Total open accounts, outstanding revolving debt, and contingent liability are three other vital metrics that also increased in 2017. The U.S. market, with its 129 million households, will have 477 million branded credit cards at year end 2017, within 1% of the pre-recession peak. 2018 will see this number rise to 488 million, with an average of nearly four cards per household.

Revolving debt, the amount left on credit cards and carried from month to month, ends 2017 at \$1.011 trillion, nearly \$160 billion over the 2011 trough and slightly larger than the pre-recession high of \$1.004 trillion. Finally, open credit lines, often referred to in industry parlance as contingent liability, rose to \$3.52 trillion in 2017, only \$10 billion lower than the pre-recession peak, but nearly \$1 trillion higher than in 2010, when the metric stood at \$2.66 trillion, as issuers proactively cut credit lines to avoid incremental loss.

While the pace of lending offers credit card issuers an opportunity to increase interest income, it comes at a time when the industry feels the pain from the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the CARD Act), which limited the industry's "dynamic repricing" of accounts. That is to say, issuers could no longer reprice accounts when they anticipated credit risk as result of deteriorating creditworthiness in any of a consumer's open accounts indicated by credit bureau scores based on that consumer's behavior. Nor could they reprice an account when the cardholder's transacting habits suggested risk of nonpayment. Coupled with the regulatory constraints on interest income were mandates that decreased non-interest income, such as the assessment of fees, the use of revenue enhancements like credit insurance, and the rate and frequency of punitive fees.

Return on assets (ROA) for credit card portfolios, which compares total income to the total value of receivables, continued to fall. In 2014, the industry ROA was 4.94%. The number slid to 4.36% in 2015, then to 4.04% in 2016. Mercator Advisory Group projects that the metric will tumble again in 2017, to 3.76%, and then again in 2018, to 3.49%.

Credit card bank ROA continues to outperform retail banking ROA by multiples. However, the gap is lessening. In 2014, when the credit card banks delivered a 4.94% ROA, commercial banks yielded only 1.23% ROA. According to Mercator Advisory Group's projections, 2018 will see 3.76% for credit cards while retail bank ROA performance will climb to 1.37%.

How Mercator's 2017 Predictions Fared

In December 2016, Mercator Advisory Group published a series of predictions for 2017 for credit cards in the United States in the report titled *2017 Outlook: Credit*. These are summarized in Table 1. In retrospect, we find the results for 2017 were generally on target with our predictions, at least directionally, except for one item that we should either have tied to a specific industry metric or provided with some measurable anchor.

The estimate for revenue was within two basis points of the result for 2017, and our projection of declining non-interest revenue was consistent with the 41 basis point drop that occurred. Risk management expectations were also consistent, as evidenced by a three-year trend in account deterioration to write-off. Our projection of card-not-present (CNP) fraud as a persistent threat was in line with a frequently expressed perception in the industry, although Visa noted earlier in 2017¹ that there has been no increase in CNP fraud.

Table 1: Mercator Advisory Group's Predictions for U.S. Credit Cards in 2017 vs. Results

	What We Predicted	What Happened	How We Did
Continued Revenue Decline	<ul style="list-style-type: none"> Decline in non-interest income Falling credit card ROA 	<ul style="list-style-type: none"> Total non-interest income fell 41 basis points. ROA predicted 12/16: 3.74% projected 12/17: 3.76% 	A+
Risk Management Issues	<ul style="list-style-type: none"> Collection deterioration CNP fraud 	<ul style="list-style-type: none"> 2017 projection indicates third year of a trend in deterioration of collections, from 2.92% in 2016 to 4.01% in 2017. No major industry indication of rise in CNP fraud. 	A
Environmental Factors	<ul style="list-style-type: none"> Interest rate increase Inflation increase 	<ul style="list-style-type: none"> Prime rate predicted 12/16: 3.75% projected 12/17: 4.50% Inflation increased from 1% to 2%. 	A
Product Features	<ul style="list-style-type: none"> Ubiquity of EMV cards and acceptance at merchant POS. Mobile payments gaining scale. 	<ul style="list-style-type: none"> Reissuance of cards with EMV chip complete; some areas of merchant resistance. Normal growth, no major shifts. 	A
Controls	<ul style="list-style-type: none"> Expansion of account-level controls Regulatory mandates Deep data integration 	<ul style="list-style-type: none"> Amped-up issuer strategies for secondary cards Pro-industry shift regarding class action suits; executive shift at CFPB. Objective not specific enough. 	B
Market Developments	<ul style="list-style-type: none"> Product enhancements Enhanced scoring 	<ul style="list-style-type: none"> The year of premium credit cards. Some developments with alternative scoring models, no significant movement. 	B

Source: Mercator Advisory Group

Our prediction on the maturing EMV strategy was on point although some merchants still are not running entirely with EMV chip card acceptance; they remain vulnerable to the liability shift until their process is fully functional. Mobile payments grew steadily, and a 20% compounded annual growth rate is in line with many industry estimates.

The weakest predictions concern the control functions. While many issuers now include bonuses for secondary cards, there is no reliable metric to anchor this item. Similarly, our expectation of deepened data integration throughout the credit cycle is likely correct but not specific enough to earn an “A” in this self-assessment. While the observation for regulatory mandates was on the mark with the change on class action legal suits versus mediation and single suits, the result rated a “B-.” In the final category, premium travel reward cards brought attention to the market. However, we anticipate that 2018 will bring changes to this card segment as issuers assess the value of enhanced rewards and high annual fees. We expected additional shift in scoring models, but what ensued was the removal of public record data from credit reporting agencies. Public record data will no longer be reported on credit bureau reports although they are available through LexisNexis Risk Solutions. For a full view of last year’s predictions report, see [2017 Outlook: Credit](#).

2018 requires issuers to be cautious. New account acquisitions are a mainstay in the credit card business, where issuers must cover voluntary and involuntary attrition rates, which typically range between 6% and 12%, demanding similar growth just to maintain portfolio ballast. Caution is the order of the day; issuers should grow organically and strategically. Risk-sensitive, conservative growth strategies should be in place as well as credit policies that allow accounts to season, foster sound credit management, and generate growth in both the credit card portfolio and other retail banking products. For a comprehensive view of loss rates, return on assets, portfolio growth, and delinquency, see the recently released Mercator Advisory Group report titled [The Credit Card Data Book: 12 Significant Indicators](#).

2018 Outlook: Cautious Optimism

Four environmental factors will affect credit cards in 2018: (1) the continued digitalization of payments, (2) risk management, (3) regulatory influences, and (4) portfolio segmentation. The payments industry continues to undergo rapid change in payment forms, innovation at the point of sale, and technical innovations that will continue to displace cash.

Digitalization of Payments Continues

Payment digitalization affects the issuer’s ability to service the customer through online access, payment acceptance, and any channel access. U.S. credit card issuers completed the reissuance of the entire base in 2016. With charge-back policies in force for the least compliant party between merchant and issuer, the migration to EMV chip-based cards is fully functional in the market. The U.S. market resisted “smart cards” for decades, which in effect allowed European and Asian markets to set digital standards through common network ventures by

American Express, Discover, Mastercard, and Visa. The U.S. market is now on par, however, and industry concerns about global interoperability mostly are over.

With reissuance came an upgrade in point-of-sale (POS) devices to make them capable of handling digital interactions with customers. This step up was necessary the 10 million terminals deployed in the United States to facilitate the industry's move payment card acceptance by means of swiping a magnetic stripe (mag stripe) card to the EMV chip cards' more secure bi-synchronous transaction that interacts with the merchant processing host. Networks already report decreased counterfeit card fraud, quicker POS acceptance, and more secure processing. As the process of EMV card acceptance matures, there is a foundation for more interaction between customer, merchant, and issuer at the point of sale. A late 2017 development was the announcement by three major payment networks that many future transactions would no longer require the cardholder's signature because of the networks' increased confidence in EMV chips. The change is concurrent with the growth of third-party mobile payment models such as the so-called universal payment applications like Apple Pay, Android Pay, and Chase Pay and single-merchant payment applications like Walmart Pay. Technical variations allow the payment model either to interact directly with the face-to-face payment acceptance device as in the case of Apple Pay or to emulate the workings of Near Field Communication (NFC) technology for "contactless payment" by means of host card emulation (HCE), which digitally mimics the traditional card interaction.

Payment wallets, used typically for online transactions, met less success than the Pay models, but they have the opportunity to grow by offering benefits to the consumers who use them. A legacy card-on-file model offered at Amazon.com permits consumers to securely store account numbers so they can select their tender option during checkout. In contrast to wallet options, the Amazon function simply links to the online retail platform and can now interact with virtual assistants such as Amazon Alexa.

Traditional retailers continue the complex shift to the e-commerce channel, as we see with Wal-Mart's acquisition of Jet.com and Target's acquisition of digital provider Shipt. It will be interesting to see how these two retailers unfold their payment options. As they shift from the purely physical format of brick-and-mortar stores to the virtual venue of online sales, they will need to choose among three formats: use the card-on-file model, develop their pay model, or align to Chase Pay type options.

As digitalization affects the point of sale, developments also occurs on the account issuing side, notably in the way credit card issuing firms source new accounts. The legacy mode of booking new accounts through direct mail now results in fewer new accounts than sourcing new accounts through digital methods. Top U.S. issuer Chase reports that 77% of its customers came through digital channels.ⁱⁱ This represents a disruption to the legacy direct mail marketing model. Direct mailings in the United States, which required 4 billion pieces in 2014, have response rates of only 75 basis points, and acquisition by this mode is expensive. In contrast, the online acquisition model enables issuers to create synergies with acquisition and marketing budgets that more efficiently facilitate prospective cardmembers. Other opportunities include more and less costly customer interactions at the issuer's website, faster plastics distribution, and customer self-service options.

As digitalization continues and online payments continue to grow from their 12% share of total retail sales, credit cards will further displace cash, but the process calls for increased scrutiny of customers, merchants, and transactions.

Risk Management Is Key

While making it easier to transact, successful issuers must continue to ensure that control tools protect the balance sheet from criminals who will find vulnerabilities. New cardholder entry points create more access points for criminals to attack the payments system. Preventive tools such as EMV tighten the physical point of sale, but when the card is not physically tendered, the controls offer limited benefit. Tokenized payment options such as the revised version of 3D Secure 2.0 (3DS2), which will take effect in 2018, will provide online merchants with an additional layer of security through authentication. Bridging both the EMV card and 3DS2 end-to-end tokenization scheme are foundational offerings by FICO with behavioral controls found in FICO's Falcon product, and by ACI Worldwide, with its Proactive Risk Manager. Issuers on platform service providers such as First Data, FIS, Fiserv, and TSYS will find customized fraud prevention tools that easily link to their product support tools.

In contrast to the risk of fraud, credit risk for issuers comes from cardholders' inability to pay their debt in a timely manner. As issuers rebuild their portfolios after severe write-offs during the recession, the accounts are less seasoned, particularly since nearly half of the accounts at many issuers are less than three years old. With increased collection volumes, looser underwriting standards and lending strategies, and aggressive credit lines, issuers must not only tune their credit policies but also look to external sources such as LexisNexis Risk Solutions to enhance their reconnaissance of customers and gain a full understanding of account-level risk.

Regulatory Trends: Here and There

Three significant regulatory conditions are on the horizon for 2018: changes at the Consumer Financial Protection Bureau (CFPB), the European Union's revised Payment Services Directive (PSD2), and global regulatory trends. CFPB, spawned by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, shifted U.S. regulatory focus from safety and soundness of the financial system to a consumer protection role. During its tenure, CFPB identified certain shortcomings in credit card industry practices ranging from unfair and deceptive practices to predatory pricing for punitive fees. With the exit of the CFPB's first director, Richard Cordray, in November 2017 and the appointment of a successor under the current presidential administration, the CFPB will likely shift to a more creditor-friendly environment in U.S. markets.

European credit card markets are undergoing more severe change, and it is likely that several changes will bleed over to the U.S. market in the short term. While mandates such as the move toward faster payments will primarily affect debit and retail banking more than credit cards, requirements for open banking access, the creation of third-party roles to access data, and the "one leg in" governance of non-European banking participants will have both short-term and long-term effects. As has been the experience of the global payment card markets with respect to regulation of interchange, it is common to see one jurisdiction effect change and then actions migrate to other markets. Access to banking services through application programming interfaces (APIs) will likely take hold in the

U.S. market first, as evidenced by some of the significant players such as ACI Worldwide. Open access by third parties to account-level data will likely be more cautious in the U.S. market, which can wait and see if risks rise or the access provides worthwhile to the financial services in European markets. The one-leg-in mandate now under PSD2 requires issuers in any country that operates in the European Union to conform to specific account access standards, which will inevitably accelerate compliance issues for U.S. credit card issuers.

Regulatory events in other markets beyond Europe may also affect the U.S. market, including tighter interchange control in Asia, price controls in Latin America, and cost-based interchange accounting in Australia.

Portfolio Segmentation

Segmentation will continue as the U.S. card market addresses growth opportunities, but it is likely that issuers will be more conservative. Expect to see issuers refining general purpose cards to address the four account segments described below:

Small Business Credit Cards. This \$500 billion spend category, once dominated by American Express, now faces competition from most top-tier issuers and several middle-market players. While many of the features overlap, issuers of network-branded cards face a problem in that many small business owners use their personal credit cards rather than a business-specific card. One advantage of using consumer cards is that they offer better protections than do small business cards. The consumer cards receive protection under Regulation E for fraud risk, Regulation Z for Truth in Lending, and the CARD Act for pricing. The challenge for issuers is to modify existing strategies to improve the credit card's value proposition for customers through better rewards, stable pricing, and product enhancements.

Millennial Customers. The next generation of credit cardholders, now plagued with student loan debt that exceeds total revolving credit card debt, has not followed their parents' fondness for credit cards. Instead of embracing credit card debt as a means to accelerate purchasing and improve life-style, Millennials have been less interested in traditional credit card lending. Issuers such as American Express, Bank of America, Chase, and Citi are actively developing card products and features desirable to this segment and follow the patterns of better digital engagement.

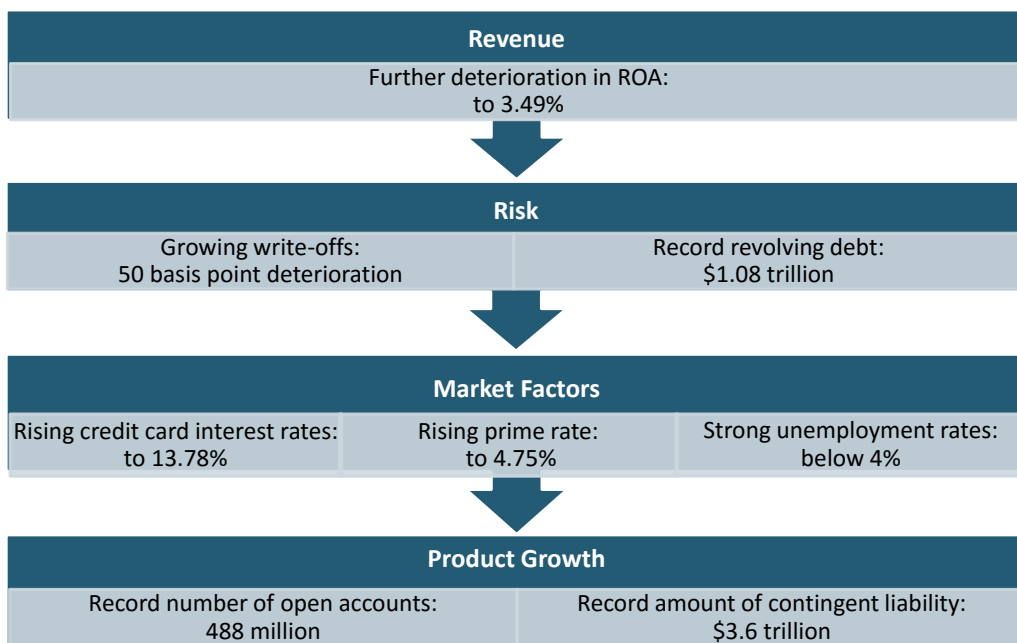
The Underserved and Unbanked Market. The secured credit card, a 40-year-old industry development, will likely find increased activity during 2018 as issuers look for additional service niches. The market today, which Mercator Advisory Group estimates at 1 million cardholders, now has offerings by most significant issuers. With continued success of prepaid accounts, which can accept direct deposit of payroll and that mitigate operational risk through balance controls, expect to see increased activity during 2018 as issuers expand the product as a banking option for down-market borrowers. Pricing challenges will persist as deposit accounts offer limited possibilities for earning interest and cardholders often struggle to build the deposit account. Capital One is particularly active in the secured market and provides a novel approach. After five months of reliable payment activity, the secured account will be reviewed with a credit line that is greater the depository account. This change allows the cardholder to enjoy a real credit relationship.

High Spend, High-Value Travel Customers. Card issuers will continue to address this market with rewards. In 2017, top issuers battled for the market, armed with expensive product features and well-funded reward programs offset by an annual fee between \$450 and \$550. There is some evidence of cardholders’ sticker shock at time of renewal of the annual fee, but the potential spend for this group is likely to keep the full-featured credit card offering alive albeit with revised features. It is likely that issuers will hone their strategy on this group in 2018 if attrition becomes an operational concern.

Predictions for 2018

In addition to the environmental expectations, we base our predictions for 2018 on specific metrics that tie to eight of the measures detailed in the Mercator Advisory Group’s report [The Credit Card Data Book: 12 Significant Indicators](#), cited earlier. These metrics (shown in Figure 1) met the criterion of being specific and measurable rather than general statements about the credit card industry. Each metric appears in a Federal Reserve report or is regularly published by the U.S. Bureau of Labor Statistics.

Figure 1: Mercator Advisory Group’s Credit Card Industry Predictions for 2018



Source: Mercator Advisory Group

Revenue will continue to deteriorate in the U.S. credit card industry. Interest income is protected in this market because virtually all U.S. credit card issuers index their interest rates to the Federal Reserve’s prime rate. We expect this number to continue to fall as non-interest income deteriorates, although this decrease is indicative of a market shift rather than weak management by credit card companies.

Write-offs will continue to rise, in part because of the “burn-off” of weak recent account bookings and aggressive lending over the past three years. Revolving debt will swell to a new high point of \$1.08 trillion.

As the U.S. prime rate is increased, credit card interest will follow. We expect to see at least another 50 basis points added, bringing the reported market rate closer to 14%. A saving grace for credit card portfolio management will be continued low unemployment, likely in the 4% range.

Product growth will continue in the U.S. market, gaining no more than 11 million net new accounts, bringing the outstanding number of credit cards up to 488 million credit card accounts. Finally, contingent liability, the total value of open credit lines for the whole market, will set a new record, ending 2018 at \$3.6 trillion.

What These Predictions Mean for Market Participants

Credit card issuers of all sizes should recognize the risks and opportunities for rapid growth and ensure that they have adequate process controls in place. They should also address the various vintages of their portfolios to isolate risk and expand financial relationships and anticipate increasing shift toward the digital transaction. If card account debt repayments do deteriorate and delinquency rise as expected, operational capacity will need to edge up and technology enhancements must ensue.

From vendors’ perspective, opportunities indeed exist for enhancing data, portfolio analytics, and developments in payment technologies that support acceptance at the point of sale, fraud mitigation, and enhanced collection platforms.

2018 U.S. Credit Cards: Plenty of Opportunities, Plenty of Risks

2018 will be a year of opportunity for issuers. It should be a year in which to take advantage of recent growth, allowing credit card accounts to mature, season, and stabilize. Lending should be conservative if U.S. regulators push for safety and soundness of the financial system rather than consumer protections. Digitalization of payments continues, but issuers should be wary of new channels that create incremental portfolio risk. Increased revenue is typically a business requirement, and in this coming year, issuers should focus on the portfolios they have today and grow them organically with the customer base to better address customers’ card needs and their broader banking requirements.

Endnotes

ⁱ <https://www.csoonline.com/article/3166584/security/javelin-visa-offer-different-takes-on-whether-card-fraud-is-moving-online.html>

ⁱⁱ https://www.jpmorganchase.com/corporate/investor-relations/document/ccb_investor_day_2017.pdf



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