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201 Boston Post Road West, Suite 301 | Marlborough, MA 01752
www.mercatoradvisorygroup.com |phone 1-781-419-1700 |email: info@mercatoradvisorygroup.com

2020 Outlook: U.S. Credit Cards

Happy days are here again as U.S. credit card issuers reverse the downward trend in their profitability as the next decade begins.

Low unemployment helped control credit loss expenses and increased credit card interest spreads improved revenue in 2019. Expect both factors to have a positive impact on the credit card industry in 2020. This Mercator Advisory Group outlook on credit cards for 2020 identifies 12 trends that will influence U.S. issuers' revenue, risk, the market, and product growth.

by Brian Riley,
Director, Credit Advisory Service

Strong Results Will Continue Through 2020

U.S. credit card issuers' profits will remain healthy as the next decade begins. Momentum from improved return on assets (ROA), which rebounded in 2018, will build from broader interest rate margins and stable collection performance.

The *Wall Street Journal* noted an interesting event in consumer credit interest rates: The prime rate fell, but counterintuitively, the average interest rate charged by lenders rose. "Lenders tacked on an average margin of 11.72 percentage points on interest-charging cards in August, up from 10.60 points two years before.[i]" The increase in interest rate spreads came at a good time. While interest rates declined 50 basis points, from 5.5% on January 1, 2019, to 5.0% in September 2019, increased margins caused little disruption to new credit card accounts.

Instead of interest rates ranges that might be prime plus 9.99% to 15.99%, credit card issuers often raised the high end of the spectrum and left the low field in place, perhaps offering 9.99% to 24.99% depending on credit quality. With the prime rate decreasing slightly, the change was of little consequence to the consumer. For credit card stockholders, this increased net interest income by 46 basis points in 2018 and should follow through as 2019 closes. We believe this positive swing will continue in 2020 and remain close to 10% of total assets.

On the expense side of the equation, credit losses continue to be reliable with year-end volumes at 3.59% ending 2019 and continuing through 2020, assuming that unemployment remains steady. Unemployment has been 4% or less throughout 2019. As of September 2019, unemployment in the United States was 3.5%, a 50-year low last seen in December 1969.[ii]

In 2020, 12 significant trends will have an impact on the U.S. credit card industry and its revenue, ensuring continued success for credit cards in this market.

Twelve Trends That Will Affect Credit Cards in 2020

2020 is a presidential election year in the United States, and as candidates jockey for position in the primaries and general elections, perspectives on credit cards have come to the forefront with some candidates promising to intervene on credit card interest rates,[iii] blockchain and cryptocurrency,[iv] and consumer bankruptcy reform.[v] The subject of credit card interchange has not appeared, nor have sweeping changes of the type experienced with the Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), which followed the 2008 financial crisis.[vi] However, the Republican Party may choose to unravel many of the controls and protections found in Dodd-Frank.[vii]

Politics aside, 12 industry trends will affect the credit card business in 2020. Listed in ***Table 1***, these range from new accounting standards to the changing consumer and industry consolidation.

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Table 1. Twelve trends will influence U.S. credit card performance in 2020.

12 Game-Changing Trends Affecting Credit Cards	
1	Current Expected Credit Loss (CECL) mandate is in place for large, not small, issuers
2	The U.S. economy is overdue for a downturn.
3	Shifting demographics: With millennials growing up, keep an eye on Gen Z.
4	As installment loans gain scale, issuers need to react.
5	Near Field Communication (NFC) is ready for prime time.
6	Good news, bad news for people on the fringes of credit.
7	Interest rate spreads at record high levels will likely continue.
8	ABS market has slowed but is still strong.
9	Rewards continue to play a role but are generating less excitement.
10	Apple Card will not alter the playing field but will force issuers to react.
11	Transacting in harmony: the Click-to-Pay brand alliance.
12	Mergers take form: FIS–/Worldpay, Fiserv–/First Data, TSYS–/Global Payments.

Source: Mercator Advisory Group

Current Expected Credit Loss (CECL) Mandate in Place for Large, Not Small, Issuers

Current Expected Credit Loss, a conservative regulatory shift intended to ensure accurate loss reporting, initially scheduled for implementation by all banks on January 1, 2020, has been pared down to include only large banks until 2023. The Financial Accounting Standards Board (FASB), the organization responsible for defining generally accepted account standards (GAAP), voted in October 2019[viii] to delay implementation because of "significant challenges of complying with one of the most sweeping accounting changes."[ix]

The delay affects many community banks and most credit unions. The Credit Union National Association (CUNA), the industry group that represents 5,800 credit unions and their 104 million members, noted that the new accounting standard is too harsh: "However, CUNA's longstanding position has been and continues to be that application of CECL to credit unions is inappropriate, and that implementation of the new standard will create compliance challenges, as well as alter the financial standing of credit unions."[x]

For now, top issuers such as American Express, Bank of America, Chase, Citi, Discover, and Wells Fargo will be responsible for compliance. Many top issuers used 2019 to squirrel away funds in advance of this shift on the

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Allowance for Loan and Lease Losses (ALLL) line on their balance sheets. Chase, for example, anticipated a 35% increase in reserve requirements and increased its reserves by $5 billion in early 2019.[xi]

Expect large issuers to move toward compliance quickly, with a sigh of relief from middle market and small issuers. In either case, keep a keen eye on the economy.

The U.S. Economy Is Overdue for a Downturn

People are working, gas prices are low, and inflation is in check in the U.S. Most important to credit card managers, people are paying their bills on time. However, the economic cycle consists of four stages: expansion, peak, contraction, and trough. As of July 2019, the U.S. economy had surpassed the longest recorded expansion since 1854.[xii] As we begin 2020, the cycle will represent 126 consecutive months of economic growth and the market will be one month closer to contraction.

The credit card industry relies on low unemployment and stable household budgets, so when the downturn begins, expect to see a rapid deterioration in credit quality, a reduction in spending on durable goods, and an increase in revolving debt.

In 2019, all top banks passed the Dodd-Frank Stress Test requirements[xiii] without difficulty, indicating that failure would be unlikely under severely adverse scenarios, which in the current definitions means a 6-point increase in unemployment, a 50% drop in stock values, and a 25% drop in home values. Where credit card firms need to focus is on contingency, overflow, and diversion, which means credit policies must protect the balance sheet with strategies to score delinquency, triage resources, and have third-party partnerships in place to handle volume increases. Preparing plans for double and triple collection volume is a prudent way to protect bankcard assets. Managing contingent liability, the value of open credit lines, which is now at record levels near $4 trillion, is another.

Shifting Demographics: With Millennials Growing Up, Keep an Eye on Gen Z

Visa identified a shift in cardholder demographics[xiv] three years ago that every credit manager should understand because it sets the stage for the coming decade. New data drawn from the U.S. decennial Census will be compiled in 2020, as required by Article 1, Section 2 of the United States Constitution.[xv] However, the trend forecast by Visa is likely to continue.

In 2025, millennials will represent 75% of the workforce and 46% of U.S. income. Baby Boomers, the generation that grew up as the credit card business formed, are aging into retirement or transacting rather than revolving. Next up will be Generation Z.

Millennials grew up with computers, and many use broadband internet and mobile devices. They also grew up during the recession, experienced the influences of the Credit Card Responsibility Accountability and Disclosure Act (CARD Act), and now carry the burdens of student loans. Many studies indicate that members of Gen Z, the next

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age cohort, are native to technology, maintain a digital profile, and have more explicit expectations about how they want their money handled.

In any case, the peak age for household debt is the 40–49 years of age, the cohort that currently has $3.49 trillion in total household debt, compared to the cohorts aged 18–29, with $0.92 trillion debt; 30–39, with $2.88 trillion debt, and 60+ with $3.32 trillion debt.

As Installment Loans Gain Scale, Issuers Need to React

Recent market analysis by the rating firm DBRS and TransUnionxvi indicates that fintech companies now have a larger share of personal loan balances than banks. The shift occurred in late 2016. Today, fintechs are accountable for 40% of personal loan balances, and banks are accountable for below 30%. Virtual lenders such as Goldman Sachs offer consumer debt loan consolidation. Specialized companies, including Affirm, provide point-of-sale financing. Marketplace lenders such as Prosper and Lending Club, which focus on peer-to-peer lending, pose a multiple-front challenge for credit card issuers.

Several top credit card issuers are actively addressing the market, among them American Express, Chase, Citi, and Discover. Banks of all sizes and shapes should consider a strategy relevant to their market.

Near Field Communication (NFC) Is Ready for Prime Time

Contactless payments cards pioneered in 2003, but acceptance at the point of sale (POS) was not standard until the United States began to convert to EMV cards in 2015. Today, almost 80% of top retailers are certified to accept contactless card payments. U.S. cardholders have been slow to embrace the payment form despite rapid take-up in similar markets such as Canada and the United Kingdom. The Federal Reserve reports that 63% of cardholders in the U.K. across all age demographics make contactless payments. In Canada, a market 10% the size of the United States, contactless card usage surged from 215 million transactions valued at C$9.7 billion in 2012 to 3.2 billion valued at C$104.2 in 2017. This represents a shift from about 2% of all point-of-sale (POS) transactions to 29%.

The Federal Reserve points out three lessons learned:

- Broad adoption will not occur unless issuers and merchants make physical changes in cards and devices.
- Educating consumers and merchants about NFC is critical.
- There must be a smooth fall-back position if the process fails or hits limits (C$100 in Canada or £30 in the U.K.).

As happened in the rollout of chip-based EMV cards, it appears that top issuers are leading the charge. Citi experimented with NFC stickers in some markets six years ago[xvii] but is back to traditional NFC forms with its extensive Costco portfolio. Chase announced that it plans to convert 100 million cards in 2019, and Bank of America is poised to reissue over 4 million cards.[xviii]

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Two significant drivers for NFC transactions are mass transit applications[xix] and as a countermeasure to QR codes. Quick Response (QR) codes, which have highly penetrated developing markets such as ASEAN, China, India, and Latin America, challenge the NFC model because they operate on mobile devices rather than dedicated POS acceptance terminals. As a result, many new ecosystems have formed outside the realm of payment networks, such as Alipay (China), Paytm (India), and Mercado Libre (Latin America). NFC is a defensive play in this arena.

Good News, Bad News for People on the Fringes of Credit

Twenty-five percent, or about 30 million, of U.S. households are underbanked or unbanked.[xx] The credit card industry seeks to embrace new ways to book accounts by using new scoring models such as FICO's UltraFICO[xxi] or products such as Petal Card that are based on social indicators,[xxii] But these have yet to be tested in a declining economic cycle. Card issuers certainly have responsibilities to lend fairly,[xxiii] but stockholders have a right to ensure that their investments yield an appropriate return without undue risk.

With the likelihood of an economic downturn within the next year, testing new pockets of marginally qualified cardholders should probably be deferred. Secured cards offer opportunities for both borrowers and lenders, and the recent development by Synchrony and Amazon of a secured private label credit card[xxiv] can also help.

Interest Rate Spreads at Record High Levels Will Likely Continue

Despite a decrease in the prime rate, credit card interest rates increased as issuers raised the top of their ranges in anticipation of deterioration in credit quality. Although credit quality did not deteriorate measurably, card issuers now have a built-in shield against erosion. With approximately 130 million new bookings between 2018 and 2019 and another 65 million new accounts anticipated for 2020, 37.5% of the U.S. portfolio of 480 million credit cards will operate with these higher spreads.

ABS Market Has Slowed but Is Still Strong

Asset-backed securitizations in the United States in 2019 have run slightly behind securitizations in 2018, most likely because of increased interest spread by top issuers, but Fitch Ratings, a leading rating agency, reports reliable operational results due to healthy employment trends.[xxv] The overall expectation for continued reliable charge-off will likely continue through 2020. Substantial credit card interest spreads are the most likely driver behind the slowdown, and Mercator Advisory Group's perspective is that volumes will likely increase, with potentially more attractive terms, in 2020.

Rewards Continue to Play a Role but Are Generating Less Excitement

As long as U.S. interchange remains a nonissue in the market, credit cards will continue to be table stakes for credit card issuers. More than 65% of credit card programs provide rewards with cash values that tie to transactions; merchant-driven offers sometimes enhance these programs for additional benefit. Apple Card presents an interesting spin with its daily settlement of rewards although the card is not competitive except for purchases with Apple itself or a few brand partners, such as Uber. Apple Card is thus more of a store card than a true general

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purpose rewards card. The average daily settlement on credit card rewards posted to the account will be less than $2.00.

Apple Card Will Not Alter the Playing Field but Will Force Issuers to React

Apple Pay floundered, as did other mobile payment wallets (although it has rebounded in our latest customer survey), but it advanced credit card industry thinking on two-factor authentication, an embedded secure element, and cryptographic functionality. Apple's first attempt at a payment card, co-branded with Barclaycard, was of little consequence. The latest launch, with Goldman Sachs, is more akin to a standard credit card in its fees and limits. With a high-tech launch in Cupertino, California, Apple announced that the card was "Created by Apple, Not a Bank,"[xxvi] much to the chagrin of its credit card sponsor, Goldman Sachs Bank USA, Salt Lake City Branch.[xxvii]

While not every feature was unique to Apple, the product brings some ideas on improving the user experience that bank card issuers should note. The reward structure is worse than those of leading credit cards such as Chase Freedom, Citi Rewards, Discover It, or Capital One Quicksilver, but daily rewards settlement drives engagement. The streamlined application process, combined with instant delivery of a live account number, emphasizes the importance of both digital delivery and the user experience. The card rewards the user for using it with Apple Pay, raising the rewards rate to 2% (to the dismay of those who ordered the fancy titanium version, which pays only 1%). The card should not cause top issuers to tremble, but it is a wake-up call regarding the importance of managing the user experience.

Transacting in Harmony: The Click-to-Pay Brand Alliance

To replace the long-awaited revision for 3-D Secure and to improve the user experience at the online point of sale, American Express, Discover, Mastercard, and Visa launched a new interface based on a common standard designed by EMVco called Secure Remote Commerce (SRC). The feature provides an interoperable checkout that promises to be secure and straightforward. According to a joint press announcement[xxviii] by the four major U.S.-based networks, top payment processors including Adyen, Authorize.Net, CyberSource (a subsidiary of Visa), FIS, Global Payments, Mastercard Payment Gateway Services, and Stripe now offer the function to merchants. The offering replaces Masterpass and Visa Checkout.

Click-to-Pay can improve the payment card user experience, which still is hampered by uneven encryption, sluggish user interfaces, and card-not-present fraud. The initiative promises to provide a consistent checkout experience without requiring multiple log-ins or additional overhead. Finding a better solution for e-commerce solutions is essential particularly as sales transactions continue to grow. In the second quarter of 2019, e-commerce was estimated by the U.S. Department of Census at $1.4 trillion, or nearly 11% of retail sales. This increase was 13.3% higher than the same prior year.[xxix]

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Mergers Take Form: FIS–Worldpay, Fiserv–First Data, TSYS–Global Payments

January 2019 began with Fiserv acquiring First Data (for $22 billion), followed by Fidelity Information Services buying Worldpay (for $34 billion), then the $21 billion merger of TSYS and Global Payments. The coming year will require each of the combined firms to create synergies with their most robust processes and best technologies. Challenges will exist for all of the firms as they drive down expenses and push for higher revenue to justify the cost of their new businesses. A ripple effect will occur as the new organizations contend with client preferences and conflicts. Bank of America,[xxx] for example, announced it is severing its long-term relationship with First Data in a Securities and Exchange Commission filing that mentioned a $2 billion impairment charge.

Mergers on the issuing side were less robust, with only one massive deal, which occurred in January 2019, when BB&T and SunTrust joined to create the sixth-largest bank in the United States

Predictions for 2020

These 12 trends identified above influence Mercator Advisory Group's forecasts for 2020, which focus on credit card revenue, risk, market factors, and product growth. Our expectations for the card business tie together eight business metrics, including credit card return on assets (ROA), credit card write-off, total revolving debt, interest rates, the prime rate (which drives most of U.S. credit card pricing), unemployment, open accounts, and contingent liability for credit card issuers.

We expect a slight improvement in ROA, with continued momentum on improved credit card interest spreads. Since reporting on the industry ROA lags calendar year end by six months, we assume that the turnaround trend on declining ROA, which fell from 4.94% in 2014 to 3.37% in 2017, then recovered in 2018 to 3.79% will advance slightly by 2019 year end and then taper. Many factors go into the ROA, which reconciles net interest revenue and net non-interest revenue versus the amount of outstanding credit card assets. Interest spreads highly influence the interest revenue line item and collection performance for the non-interest expense.

Our projection on write-offs is optimistic at 3.9%, which assumes stable employment at 4%. If unemployment deteriorates, it will directly affect credit card write-offs.

Revolving debt in the United States continues to tick up slightly. Contingent liability—the sum of all open credit lines—follows in tandem as new accounts open.

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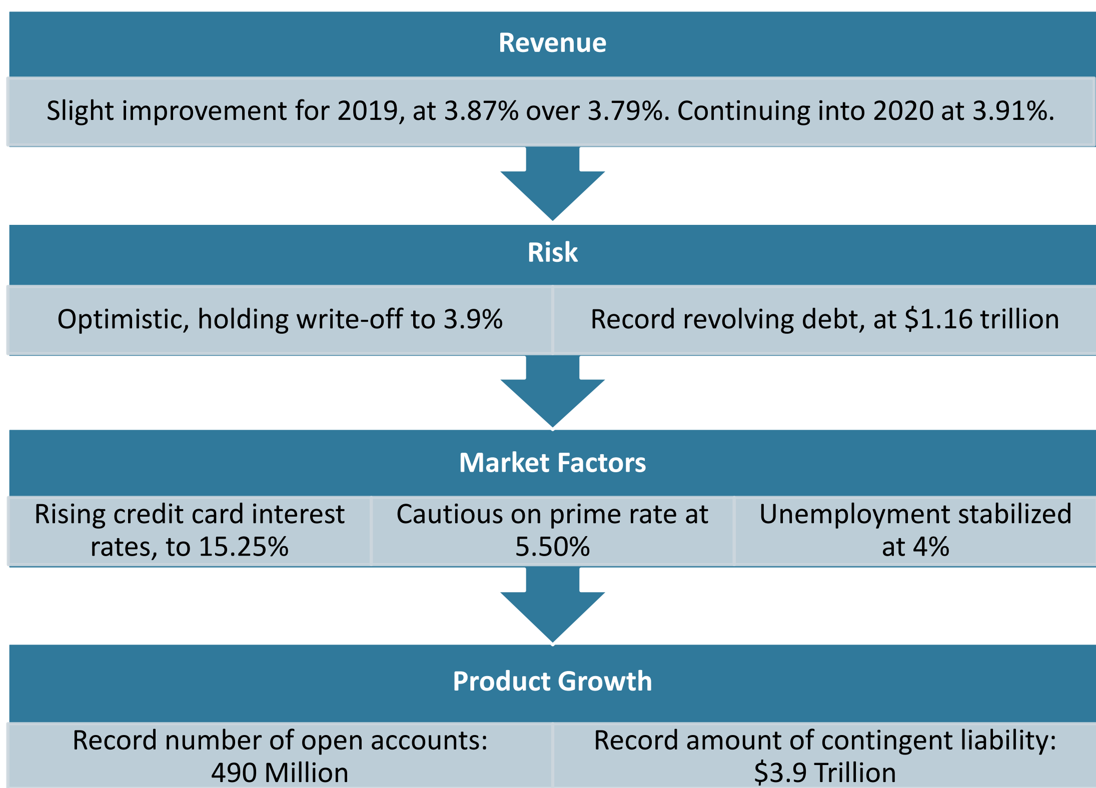
Figure 1: Mercator Advisory Group's 2020 credit card projections for U.S. credit cards



Source: Mercator Advisory Group

How Mercator's Predictions for 2019 Fared

The rapid rise of the interest spread along with better than anticipated collection results merit only a "C" in Mercator's self-appraisal for this revenue metric. The shift began to build in 2018[xxxi] and carried through to most of 2019 and leveled near the peak at 15.10% in August 2019. The trend will likely hold through 2020, and if collection risk management continues to be reliable, will likely ensure a slightly higher ROA in the coming year.

Table 2 summarizes the results.

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Table 2: Our 2019 predictions were strong, with one exception.

	What We Predicted	What Happened	How We Did
Revenue	• Continued deterioration in return on assets, to 3.03%	• ROA improved based on rising interest spreads and improved delinquency. Result: 3.79%.	C
Risk Management	• Increased write-offs, to 4.24% • Record revolving debt, at $1.10 trillion	• Latest numbers through Q2 show slight erosion to 3.74%. With seasonal variances, year should end short of 4%. • Through August 2019, $1.08 trillion. Should be on par.	A
Market Factors	• Increased credit card interest rates, to 15.25% • Rising prime rate, to 5.50% • Stable unemployment rates, at 4%	• 15.10%, through August 2019, in range • Prime rate, 3Q19: 5.00% • Unemployment at record low: 3.7%	A-
Product Growth	• Record number of open accounts: 480 million • Record amount of contingent liability: $3.8 trillion	• 475 million open accounts through Q3 2019 • Contingent liability: $3.8 trillion	A

Source: Mercator Advisory Group

All other metrics were strong and worthy of solid rankings, including write-off, revolving debt, interest rates, number of accounts, and contingent liability.

Conclusions: What These Predictions Mean for Market Participants

Return on assets, a comprehensive indicator of bankcard profitability, rebounded from its four-year decline in 2018 and will end 2019 with a modest but healthy increase. With increased spreads, and more than one-third of U.S. credit cards on the books less than three years, credit card issuers need to hone their credit policies and operations to adjust to a newer cardholder base. Economic indicators, such as employment, inflation, and growth, are stable, laying the groundwork for reliable performance as the next decade begins.

Click-to-Pay will help ease cardholder frustration at the point of sale, replacing 3DSecure. With the U.S. payment brands aligned to counteract card-not-present fraud, this will reduce friction at the point of sale. For physical transactions, the multibrand push for contactless creates synergies throughout the payment network.

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Card issuers need defensive plays for two critical business strategies: how to react to Apple Card and what to do about installment loans. Apple and Goldman Sachs certainly revitalize credit card rewards and reinforce their digital strategy with their daily points settlement. A countermeasure that emphasizes that consumers might be better off squirreling away their points until meaningful values accumulate would be one way to react. Another would be to slightly increase reward values, which would be hard for Apple and Goldman Sachs to contend with as they incur start-up expenses for the fledgling product.

Installment loans are a more challenging issue for banks. With small-value loans, strategies employing lower underwriting criteria can attract marginal businesses that might not qualify for credit cards. The result, as these accounts season, could be a mass of customers aligned with fintech companies rather than banks. For larger loans, such as debt consolidation, card issuers must be wary of customers who run up their credit card debt, then consolidate their balances, and subsequently run up the old card. Card issuers face a similar problem with balance transfers, where instead of extinguishing the balance, household debt increases.

Delaying CECL is positive for the industry until the next economic cycle begins. Healthy reserves, good credit quality, and passing marks on the Federal Reserve's stress-tests are reasons to believe that the accounting shift that grew from the Dodd-Frank Act may be draconian. But the number one issue as it relates to cards is the economy. U.S. credit cards rebounded from the declining ROA metric through increased interest spreads and better credit quality. When the economic downturn begins, positive moves on interest revenue and non-interest expense can be quickly washed away. That is the reason credit card issuers must make sure their infrastructure has depth.

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For more information about this report, please contact:

Brian Riley, Director, Credit Advisory Service
briley@mercatoradvisorygroup.com
1-781-419-1720

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