ForeSight

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# In Search of a Profit:

# As Return on Credit Card Assets Continues to Slip, Issuers Must Position for 2018

Lower return on assets means a softening in revenue, profitability and shareholder return.

*The Federal Reserve Board's annual Report to Congress on Credit Card Profitability of Depository Institutions, June 2017, indicates the lowest return on assets rate in seven years. In this ForeSight report, Mercator Advisory Group recommends nine critical credit policy actions that issuers should consider in their business strategies*

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## Introduction

A fairly straightforward metric, return on assets (ROA) provides a look into the health of the credit card industry. By comparing net interest and noninterest revenue to outstanding assets, it results in a measure of the net revenue generated by outstanding credit risk.

This profit measure is one of three sections published in the Board of Governors of the Federal Reserve System's *Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions*.[i] The Federal Reserve began this annual report under the requirements of the Fair Credit and Charge Card Disclosure Act of 1988,[ii] the 2017 report, covering 2016, is the 27th since the mandate. The 1999 report, due in 2000, was not published because the Federal Reports Elimination and Sunset Act[iii] intended to reduce reporting burdens but was reinstated the following year.

The report draws on information from U.S. credit card banks that meet two criteria: First, over 50% of the bank's assets are derived from individuals. Second, 90% or more of the bank's consumer lending involves credit cards or related plans. Fourteen U.S. banks with assets exceeding $200 million met this standard as of December 31, 2016. These banks account for almost 50% of outstanding credit card balances at U.S. depository institutions.

The data stems from two reports that the Federal Reserve System requires all U.S. depository institutions to provide: the Consolidated Report of Condition and Income (Call Report)[iv] and the Quarterly Report of Credit Card Plans.[v]

Other information reported to Congress on credit card profitability includes a summary of income and expenses for U.S banks, a discussion on the credit card market and recent pricing trends. It is the ROA metric that focuses on the use of credit card assets to generate net income and expenses, using this simple metric:

$$\frac{[\text{Interest Income} - \text{Interest Expenses}] + [\text{Noninterest Income} - \text{Noninterest Expenses}]}{\text{Credit Card Portfolio Balances}}$$

In this formula, cardholder interest income, generated by rates assigned to individual accounts, subtracts the funding cost to support the balances. For example, in the case of either a $300 billion card issuer or a $500 million community bank issuer, assessed interest becomes the first element of the equation. The next element, interest expenses, represents the funding cost to support the lending. When a cardholder generates a charge on the account, the issuer must provide the funds necessary to fund the transaction, so the issuer may either use available funds or have access to lines of credit that might be from internal funding sources or external channels. The net of these two numbers, the amount charged to the cardholder and the amount charged to the lender for using those funds, is often referred to in industry parlance as the interest spread.


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Noninterest income, the next element, refers to all revenue components other than interest. This includes interchange income or merchant discount, plus cardholder revenue such as annual, punitive, and usage fees. Finally, noninterest expense, which includes every cost other than interest funding, is subtracted from noninterest income to yield the net noninterest income. Noninterest expense includes everything from acquisition costs to customer support, staff compensation, and credit losses. Deteriorating credit losses have a severe impact on credit card profitability.

Once net income has been determined by subtracting expenses from income for noninterest and interest revenue, the resulting number is simply compared to outstanding credit card balances. The percentage is the return on assets, or ROA. The outstanding assets upon which the ROA is based may vary, but it must be consistent to protect against variations that might occur by using a peak or valley in portfolio size. This creates a preference toward measuring against the annualized net receivable, which smooths out the portfolio value over a 12-month period to avoid shifts that can occur from increased cardholder spending during the winter holiday season, or increased payback, which often happens during tax refund season in early second quarter.

## Where the Industry Is Today

### Credit Card ROA Is Slipping, Losing Its Advantage over Total Retail Banking

Credit cards have typically been the most profitable retail banking revenue channel. In the early 2000s, ROA in the 6% and 7% range was common. The recession of 2009 was an aberration because all major credit card issuers lost money on their businesses due to high rates of charge-off. As a result, the metric became negative, calculated at –5.33%; the year before and after produced abnormally low results, at 2.6% and 2.41% for 2008 and 2010, respectively, as the economy began to sour and then recover. The more common result is in the range of 4% to 5%.


## Related Concerns:

If you find this piece of interest and would like to explore this issue further, possible proprietary project work could be done to examine questions like these:

Which data and analytic approaches can help address account underwriting?

How can we evaluate infrastructure weaknesses to limit risk?

What are the most profitable strategies to capitalize on the current account acquisition environment?

How can we best invest in collections and recoveries infrastructure?

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Experience since 2014 has been steadily declining as the ROA fell from 4.94% to the most recently published rate of 4.04%. Mercator Advisory Group expects the ROA to continue its downward trajectory through 2018, when we forecast the ROA at 3.49%, less than half the peak reported for 2008, when credit card banks achieved a 7.65% return. Figure 1 illustrates performance for the past three years and projects results for 2017 and 2018.

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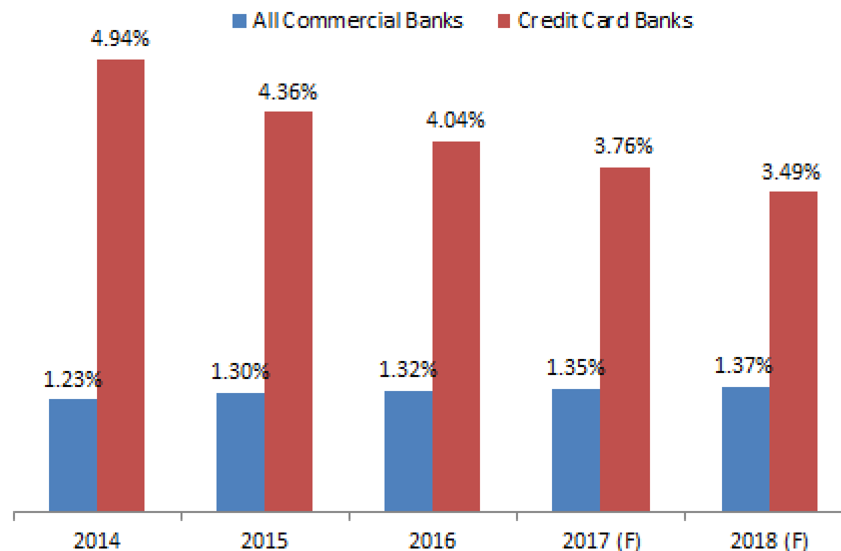
**Figure 1: Return on Assets, U.S. Credit Card Banks vs. All U.S. Commercial Banks, 2014–2018(F)**




*Source: Mercator Advisory Group analysis of Federal Reserve data*

Another concern for card issuers and industry investors is that as credit card ROA is declining, the overall commercial bank ROA is rising. This is in contrast to 2014, when credit card banks generated a 4.94% return on assets, four times the 1.23% returned by banks overall during the same period. In 2016, credit cards delivered 4.04% ROA, a result that was 306% of the 1.32% commercial bank ROA, a margin decrease of nearly 25%. Mercator Advisory Group expects the downward trend of credit card bank ROA to continue through 2018, when we anticipate it will fall to 3.49% while commercial bank ROA will continue to improve. At that point, the ROA advantage for credit card banks over commercial banks will be a scant 249%.

## The Devil Is in the Details

Table 1 reconciles the credit card ROA for 2016 and compares the line item to the prior year and commercial banks. Total interest income was 10.13%, representing the net result of interest charged and transacting accounts that did not generate interest charges because they paid in full within their interest period. Subtracted from this is the funding cost[vi] of 1.06%, returning a net of 9.07%. Compared to the prior year, which was 0.85%, or 85 basis points (bp) lower, 2016 saw incremental funding expense of 21 bp. In contrast, commercial bank total interest income was substantially lower, reflecting the less secured credit and lending structures backed by some assets such as mortgages or auto lending.

In this case, while commercial banks delivered a total interest income of only 2.62%, their funding costs were lower, nearly 80% less than those of credit card banks, at 0.29%.



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**Table 1: Return on Assets: Individual Components Compared to Total Income**

| | Credit card banks in 2016 | Credit card banks in 2015 | All commercial banks in 2016 |
|---|---|---|---|
| Total interest income | 10.13% | 9.53% | 2.62% |
| Total interest expenses | 1.06% | 0.85% | 0.29% |
| Net interest income | 9.07% | 8.68% | 2.33% |
| | | | |
| Total noninterest income | 4.01% | 4.41% | 1.47% |
| Total noninterest expenses | 6.08% | 6.34% | 2.24% |
| Net noninterest income | -2.07% | -1.92% | -0.77% |
| | | | |
| Provisions for loan losses | 2.96% | 2.39% | 0.24% |
| | | | |
| Return on Assets | 4.04% | 4.36% | 1.32% |

*Source: Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report)*

Two takeaways on interest income: Net interest income for credit card banks increased from 8.68% in 2015 to 9.07% in 2016 as income and expenses gained 60 bp and 21 bp respectively, and the credit card income rate was 386% of commercial bank income rate and consistent with the net income rate at a 389% variance.

Deterioration is evident in the noninterest income components, primarily due to constraints of the Credit Card. Accountability Responsibility and Disclosure Act of 2009 (CARD Act),[vii] which eliminated numerous junk fees, shallow product features like credit insurance, and similar practices. At the top level, total noninterest income fell by 10%, from 4.41% to 4.01%, resulting in net noninterest income of –2.07%. In the case of both commercial banks and credit card banks, net noninterest income is now a substantial drain on total income. As reward features bloat payment operating expenses, credit card issuers end up in an arms race with overly generous reward offers that pay bonuses of 1–5% of volume on specified purchase categories and directly affect revenue, as the issuers attempt to shift spending volume with incentives that benefit the most profitable cardholders but not the entire base.

The long-term concern is straightforward. It is not that credit cards may be priced too high. Does the industry have to increase cardholder costs through annual fees, or cut costs by offering fewer rewards, to achieve an attractive profit margin and reflect the real cost of business operation? More analysis of this topic is presented in the recent Mercator Advisory Group report *Premium Travel Reward Credit Cards: High Profile but Unsustainable*, released in July.


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The Loan Loss Provision, the amount set aside by credit card issuers to cover charge-offs, surged from 2.39% in 2015 to 2.96% in 2017, more than 10 times the rate of all commercial banks. Early indications are that this metric will end 2017 at 4% or higher, suggesting additional stress on the ROA metric, as illustrated in the projections for 2017 and 2018 in Figure 1. As a result, we see the credit card ROA metric at its current level of only 4.04%.

# Prepare for 2018 Before It Is Too Late

## Credit Policy Plays a Vital Role

The recent Mercator Advisory research report titled *U.S. Credit Card Debt: Circle the Wagons and Fortify* (released in June 2017) discussed credit risk that is imminent as a result of rapid account build-up, aggressive lending, and credit quality deterioration. The question of diminished ROA is broader and requires action from credit policy and executive management for strategic rather than tactical results.

## Recommended Actions

Mercator Advisory Group recommends that credit policy and business executives focus on the following nine important action items to directly improve credit card ROA.

1. **Treat the credit card as a "profit center of one."** Credit card accounts should be able to stand on their own, without relying on the expectation that other banking relationships can offset any revenue shortfall. Profitability scores pave the way for managing to account-level revenue management, but supplemental tools such as FICO Blaze Advisor and SAS Analytic Solutions can drive analytics to the next level. For example, they can help the issuer generate incremental income by automating credit line decreases for accounts that are not using routinely available spend limits or by increasing the credit line for "revolvers," cardholders who don't pay the balance in full each month. While the opportunity to cross-sell products and services may add value, it is of little consequence to the credit card profit center if the card account does not generate sufficient revenue. The credit card should stand on its own as a single profit center. It should not be a loss leader for other banking accounts with the expectation that a credit card account will instantly draw revenue from other banking products.

2. **Leverage technology partners.** Payment service providers (PSPs) such as FIS, First Data, Fiserv, and TSYS operated in the cloud long before the buzzword existed. The companies exist to provide their client companies with tools that level the playing field dominated by top issuers who can manage their own on-premise software and develop their own leading technologies. As an example, the development of remote deposit capture was pioneered by several large banks, but within a few short months, PSPs had similar processes open to all. A common point of failure we often see in the PSP relationship is that user-banks do not exploit the full potential of the relationship and fail to master the available tools. The rapid development of application programming interfaces (API), discussed in the Mercator Advisory Group research report *Payment Services Directive 2: Worldwide Industry Implications*, released in April 2017, explains how the evolution of application program interfaces will make payment tools even easier to implement.


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3. **Follow your mission.** It is easy to get excited about the payments industry. The economy relies on its success, new technologies develop rapidly, and digital payments will bring continued success. Community banks and credit unions should keep focused on their mission to serve (and defend) their local markets and members, delivering a value proposition with leaner costs and better pricing. Global leaders in the industry will likely drive innovation because they dominate both the issuing and merchant sides of the business, but smaller institutions will find quick relief by focusing and nurturing their local markets with a home-court advantage.

4. **Target business metrics.** Business reporting should be concise and accurate, consolidated into a dashboard-like review of key elements germain to each operational function. They should cascade through each management level and focus on relevent production, risk, and expense functions that represent the business unit's contribution to controlling expense, containing risk and achieving customer satisfaction. Many organizations get lost in cumbersome historic metrics which should be reconsidered in favor of better focused management controls.

5. **Follow, don't lead.** It is often fulfilling to be first to market, but a fast follower often incurs less cost and achieves shorter implementation time and easier integration. Watching market developments and working with established partners will provide equal footing for payment technologies. Unless your business is ready to spend millions in development and licensing costs, it is probably more effective to go with the offering of your service provider or a properly vetted vendor.

6. **Manage pricing.** Constraints from the CARD Act limit dynamic pricing, so it is essential to set pricing according to risk during underwriting. Fees should be reviewed against the market to ensure that they are intentionally in or out of the equation. For example, travel cards should likely waive foreign exchange fees and most accounts should have punitive collection fees. Retrospective audits should be mandated to ensure that new account bookings will both match the market and meet the issuer's revenue requirements. Watch unused credit lines to avoid unnecessary contingent liability from customers who might use large lines

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when a financial crisis occurs; then temper the lines to match card usage patterns. Accounts that do not offer commensurate revenue potential should not be carried in the hopes that they will consume $10,000 lines of credit.

7. **Deepen relationships with households.** The profit center of one, which began this list, is essential, but controlled strategies should be in place to widen and deepen the relationship to maximize customer revenue for other lending products within the credit card function and through the retail bank as appropriate. Linkages should be in place to ensure the customer profile is within appropriate credit tolerances.

Improving the return on assets requires a business focus that, on one hand, protects net income revenue streams through funding and pricing, and on the other hand, focuses on operational expenses ranging from acquisitions to pricing and risk management.

## Conclusions

Credit cards will continue to offer profit opportunities, but the golden days have likely passed, at least for this credit cycle. Credit policy management has a critical role to ensure that payment businesses can operate efficiently. It is far more important to focus on profitability than size of the portfolio, and card managers must focus on account-level details rather than simply building up large portfolios that fail to produce steady, less risky returns.

### Endnotes

[i] https://www.federalreserve.gov/publications/files/ccprofit2017.pdf

[ii] https://www.congress.gov/bill/100th-congress/house-bill/515

[iii] https://www.govtrack.us/congress/bills/104/s790

[iv] https://www.fdic.gov/news/news/financial/2017/fil17015.html

[v] https://www.federalreserve.gov/reportforms/forms/FR_2835a20150831_f.pdf

[vi] https://www.jpmorganchase.com/corporate/About-JPMC/historical-prime-rate.htm

[vii] https://www.ftc.gov/sites/default/files/documents/statutes/credit-card-accountability-responsibility-and-disclosure-act-2009-credit-card-act/credit-card-pub-l-111-24_0.pdf



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