Recent Trends in the Profitability of Credit Card Banks

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CREDIT card lending has traditionally been a highly profitable line of business for banks Increased competitive pressures in recent years, however, have prompted many card issuers to reduce interest rates, lower or waive annual membership fees, provide program enhancements, and offer rebate programs to make their plans more attractive Despite these developments, the profitability of "credit card banks," or banks specializing in credit card operations,[1] not only remains high relative to the rest of the banking industry but also continues to grow

This article analyzes recent trends in credit card bank profitability and the factors underlying them Evaluating the trends only in the aggregate, however, would ignore some interesting differences in profitability between two distinct groups of institutions. The first group consists of credit card banks owned by bank holding companies (BHCs), a relatively well-established market segment. The second group comprises credit card banks owned by nonbank firms, a more recent and fast-growing component of the credit card market

The article finds that despite growing competition from nonbank-owned credit card issuers, the return on assets of the more "traditional" issuers—those owned by BHCs—increased significantly over 1992-93 and continues to exceed that of nonbank-owned credit card banks. BHC-owned institutions have proved more profitable than their nonbank-owned counterparts largely because better asset quality trends in recent years have enabled them to maintain a lower level of provisions for loan losses

Aggregate Profitability Trends of Credit Card Banks

The profitability of credit card banks can be measured as an average annual return on assets Chart 1 traces the weighted average return on assets over the years 1989 to 1994 for all credit card banks with total assets of $200 million or more.[2] The data through 1993 measure the returns as of year-end; the 1994 return is estimated by annualizing first-quarter figures. The chart shows that the average return on assets for credit card banks has been relatively high over the years examined. As a point of contrast, whereas the average return for credit card banks ranged from 1 9 percent to 3.4 percent during the 1989-93 period, all other U S. commercial banks within the same asset size category had an average return on assets ranging from 0 4 percent to 1.1 percent in the same period.

Chart 1 also reveals that the average return on assets for credit card banks has been steadily increasing since 1991 This rising trend in profitability is particularly notable given that the spread between card issuers' lending rates and their funding costs has been shrinking since early 1992 Comparing the average credit card rate of U.S card issuers[3] with the one-year Treasury note rate—a conservative benchmark for issuers' cost of funds—indicates that, overall, issuers' margins decreased from 14 1 percent in February 1992 to 12.7 percent in February 1994. Although both lending rates and funding costs fell over this period, the decline in lending rates exceeded the decline in funding costs, resulting in a contraction in the overall funding margin.

Profitability at BHC-owned and Nonbank-owned Credit Card Banks

The aggregate trends presented in Chart 1 conceal some notable differences between the levels of profitability exhibited by BHC-owned credit card banks and those observed for nonbank-owned credit card banks. Such differences are of particular interest since these two groups are direct competitors in the credit card business.

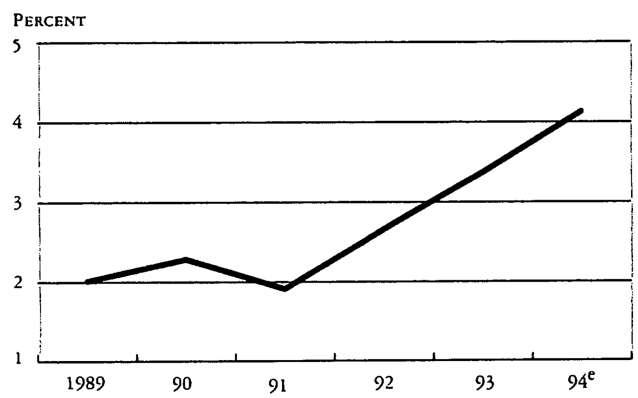
Increased competition from nonbank-owned issuers is a recent and important development in the credit card market Although the Bank Holding Company Act of 1956 prohibited nonbank companies from owning banks, in the early 1980s several nonfinancial firms found that they could conduct credit card business by acquiring so-called nonbank banks. Since nonbank banks limit their operations to either deposit taking or lending, they did not legally meet the Bank Holding Company Act's definition of a "bank" as an institution that engages in both activities, and thus were not subject to the act's restrictions on bank ownership. The Competitive Equality Banking Act of 1987 addressed this exception by amending the definition of a "bank" and banning new nonbank bank charters. However, the 1987 act exempted credit card banks and a few other special purpose banks from the new definition of a "bank " Thus, since 1987, the number of nonbank-owned commercial banks that specialize in credit card lending has surged.[4]

Over the past few years, nonbank-owned issuers have gained substantial market share at the expense of more traditional BHC-owned issuers Among the top twenty-five credit card issuers (ranked on the basis of total credit card loans outstanding at the credit card subsidiaries of BHCs, thrifts, and nonbank diversified financial services companies), the share of outstandings held by nonbank-owned issuers grew from approximately 24 percent in 1991 to 37 percent in 1993 (Chart 2). In part, this trend reflects the recent entry into the credit card market of firms like AT&T, General Electric Capital Corporation, First USA, ADVANTA Corporation, and Ford Motor Company. The number of such nonbank-owned institutions figuring among the twenty-five largest issuers rose significantly around this time, increasing from five in 1990 to ten in 1993. In addition to making entry-related gains, nonbank-owned issuers have also captured market share through increased lending, both by originating credit card loans themselves and by acquiring the credit card portfolios of other issuers.

Decomposing the data for all credit card banks reveals a difference in the general level of profitability of the BHC-owned and nonbank-owned subsets. Chart 3 adds to the aggregate trend shown in Chart 1 two more series depicting the profitability trends of these subsets of the credit card bank population [5] Despite the competitive challenges posed by nonbank-owned issuers, the average return on assets for

Chart 1

AGGREGATE TRENDS IN CREDIT CARD BANK PROFITABILITY

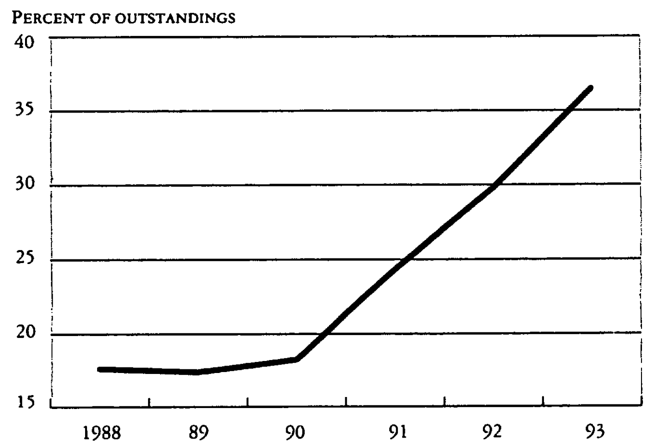


Source Federal Financial Institutions Examination Council, Reports of Condition and Income

Notes Chart shows the weighted average return on assets for all credit card banks with total assets of $200 million or more The data through 1993 measure the returns as of year-end, the 1994 return is estimated by annualizing first-quarter figures

Chart 2

MARKET SHARE OF NONBANK CREDIT CARD ISSUERS



Source *American Banker*

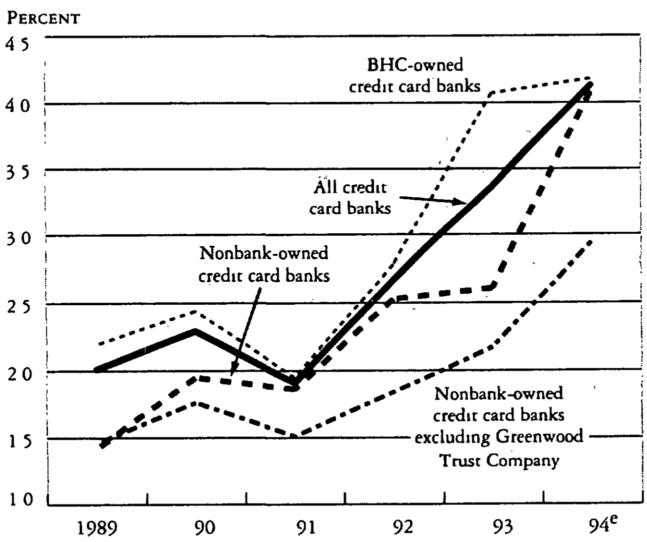
Notes Market share figures are based on the total credit card loans outstanding at the commercial bank and thrift subsidiaries of the top twenty-five credit card issuers The data for 1991-93 include securitized credit card loan figures derived from the Reports of Condition and Income Banks began reporting securitization figures in the September 1991 Call Reports

BHC-owned credit card banks was 4.1 percent in 1993, almost double the level reported by nonbank-owned credit card banks. Moreover, the returns of BHC-owned institutions grew by 1 3 percentage points from 1992 to 1993, a larger rise than the increase exhibited by nonbank-owned issuers. First-quarter 1994 results suggest that the average return on assets for BHC-owned credit card banks remains higher than that for nonbank-owned institutions.

Chart 3 includes a fourth series describing the returns of all nonbank-owned credit card banks except the Greenwood Trust Company, a sizable institution that largely drives the results of this subset. This series demonstrates that although the average returns of nonbank-owned credit card banks appear to have increased substantially from the end of 1993 (and by more than the increase exhibited by BHC-owned credit card banks), most of this trend is actually attributable to a marked increase in the returns of Greenwood Trust Company[6] If Greenwood Trust Company is excluded, the average return on assets of the nonbank-owned subset in 1994 drops from 4 1 percent to 2.9 percent.

Chart 3

Subsample Trends in Credit Card Bank Profitability



Source: Federal Financial Institutions Examination Council, Reports of Condition and Income

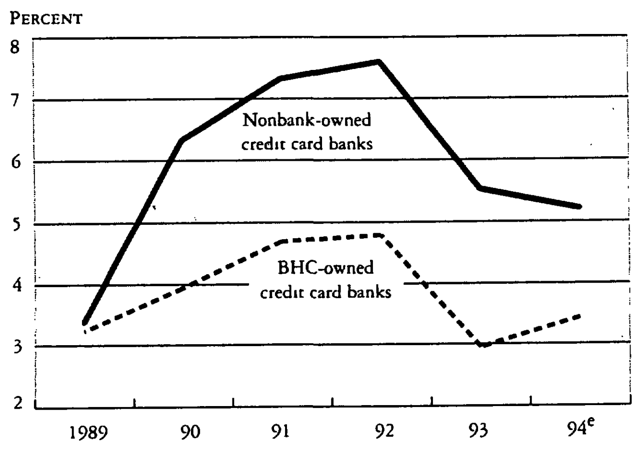
Notes Chart shows the weighted average return on assets for all credit card banks with total assets of $200 million or more The data through 1993 measure the returns as of year-end, the 1994 return is estimated by annualizing first-quarter figures Most of the increase in returns exhibited by nonbank-owned credit card banks from 1993 to 1994 was driven by Greenwood Trust Company, the second largest institution within this subset in terms of assets A series has been added to show the return on assets for nonbank-owned credit card banks excluding Greenwood Trust Company

The primary factor driving the higher level of profitability exhibited by the BHC-owned segment has been a significantly lower level of provisions for loan losses relative to the nonbank-owned subset Chart 4 tracks provisions as a percent of total loans from 1989 to 1994 for both BHC-owned credit card banks and nonbank-owned credit card banks. Although the ratio of provisions to loans has followed a similar trend at both subsets, peaking in 1992 and subsequently falling, this ratio has consistently been higher at the nonbank-owned subset in the time period examined In 1993, the provisions ratios of BHC-owned credit card banks and of their nonbank-owned counterparts were 2.9 percent and 5.5 percent, respectively. First-quarter data for 1994 indicate that provisioning remains significantly higher at the nonbank-owned subset.

Underlying the provisioning behavior of BHC-owned credit card banks in recent years are more favorable loan quality and loan loss trends. The BHC-owned subset has faced a smaller percentage of past-due loans and net charge-offs relative to total loans than have nonbank-owned credit card banks since 1991 (see table on next page). One possible

Chart 4

Provisions as a Percentage of Total Loans at BHC-owned Credit Card Banks and at Nonbank-owned Credit Card Banks



Source Federal Financial Institutions Examination Council, Reports of Condition and Income

Notes The data through 1993 measure provisions as of year-end, the 1994 value is estimated by annualizing first-quarter figures reason for the more severe credit quality problems of the nonbank-owned issuers is that in pursuit of market share, these institutions may have marketed their credit card accounts more aggressively by, for example, offering better terms Consequently, they may be attracting a greater proportion of high-credit-risk customers than are BHC-owned issuers.

Although an analysis of customer risk characteristics at BHC-owned and nonbank-owned credit card banks is beyond the scope of this article, some anecdotal evidence supports the idea that nonbank-owned issuers may be pursuing a more aggressive strategy to attract customers. For example, one set of market analysts (Liss and Rhei 1994) argues that "bank issuers are continuing to lose share to nonbank players [because] many banks continue to lack a differentiated consumer status with their cards"; in contrast, nonbank issuers such as ADVANTA, American Express, and Dean Witter, Discover and Company have "aggressive pricing/balance transfer/credit line product offerings " Other research (Canner and Luckett 1992) suggests that "nonbank firms have garnered significant market shares, in part by differentiating their plans by forgoing annual fees or by offering rebates on purchases or discounts on selected services " Finally, a recent Report to Congressional Requesters by the U.S. General Accounting Office (1994) contends that "nonbank entrants may be more comfortable than depository institutions with lower interest rates and earnings because their primary reason for issuing credit cards was to increase volume in their traditional lines of business."

In sum, notable differences in the levels of profitability at credit card banks exist on the basis of ownership structure A comparison along these lines suggests that growing competition from nonbank-owned issuers has not yet significantly curtailed the profitability of BHC-owned credit card banks, which has continued to rise over the past two years. As nonbank issuers evolve into more mature, established players in the credit card market, they may pose a more serious competitive threat to BHC-owned institutions.

Past-Due Loans and Net Charge-offs as a Percentage of Total Loans at Credit Card Banks

	Past-Due Loans		Net Charge-offs	
	Nonbank-owned (Percent)	BHC-owned (Percent)	Nonbank-owned (Percent)	BHC-owned (Percent)
1989	4.78	7.42	2.93	3.27
1990	5.25	6.68	4.42	3.60
1991	6.19	5.14	5.08	4.20
1992	5.17	4.23	6.05	4.47
1993	4.29	3.56	3.89	3.19
1994	4.18	3.34	3.49	3.40

Source Federal Financial Institutions Examination Council, Reports of Condition and Income

Note The 1994 past-due loan values are first-quarter figures The 1994 net charge-off values are estimated by annualizing first-quarter figures

Endnotes

1 This analysis defines a "credit card bank" as an institution allocating 90 percent or more of its total loan portfolio to credit card loans. Because the Federal Financial Institutions Examination Council's Reports of Condition and Income do not break out all expenses and revenues by specific product lines, this definition allows one to use the reports to assess the profitability of banks established primarily to issue and service credit card accounts

2 The returns are calculated using on-balance-sheet assets. The sample ranges in size from twenty-four to thirty credit card banks over the 1989–94 period

3 The average rate is reported in Federal Reserve Statistical Release G 19, a quarterly survey of the most common rates charged by a sample of commercial banks during the first week of each midquarter month

4 Before the passage of the Competitive Equality Banking Act, only twelve credit card banks (nonbank banks) were owned by nonbank firms

Note 4 continued

After the act was passed, the number of nonbank-owned credit card banks (commercial banks) roughly doubled, to twenty-six banks

5 The BHC-owned subset ranges in size from thirteen to seventeen institutions from 1989 to 1994. The nonbank-owned subset ranges in size from nine to seventeen institutions over the same period and includes both nonbank banks and commercial banks

6 Greenwood Trust Company is a $6 7 billion nonbank bank that issues the Discover Card for Dean Witter, Discover and Company and that alone accounts for roughly a quarter of the total loans held by the nonbank-owned credit card bank subset The increase in Greenwood Trust Company's return on assets from the end of 1993 to the first quarter of 1994 stemmed from a 72 6 percent rise in net income (driven primarily by an increase in noninterest income) and a 24.2 percent drop in total assets (reflecting a high volume of loans sold in the first quarter of 1994).

References

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