New Regulations and the Consumer Credit Card Market

Prepared for the Conference on The New Landscape for Consumer Credit and Payments

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Presentation Roadmap

- Key changes to credit card rules
- Past credit card pricing practices
- Possible issuer responses to new rules
- Economic conditions are having an effect
- Techniques to evaluate regulatory effects
- Outcomes: Economic conditions or regulation (or both)
- Concluding thoughts

Regulation and the New Rules of the Road

- Regulation of the **consumer** credit card market has changed significantly

- Rules address:
  - The content and timing of the disclosures
  - Alter key aspects of credit arrangements including marketing, underwriting and pricing

- Rules affect:
  - Issuer costs and revenues
  - Transparency and certainty of account terms
  - Certain consumers more than others
  - Issuers will respond in both foreseeable and unforeseeable ways
  - By altering the price and availability of credit card debt, the rules will likely alter the types and quantity of credit used by consumers

Sources of the New Credit Card Rules

- New rules emerged from two sources:
  - The Federal Reserve under its authority to:
    - Implement the Truth-in Lending Act (TILA)
    - Prohibit Unfair and Deceptive Acts or Practices (UDAP)
    - Rules adopted December 2008; Effective date July 1, 2010
  - The Congress through new legislation
    - The Credit Card Accountability Responsibility and Disclosure Act of 2009 (the CARD Act)
    - Effective in stages (August 2009, and February and August 2010)

Key Changes to Credit Card Rules

- **Restrictions on the changes in interest rates and advanced notice requirements**
- **Limits on Penalty Fees**
- Allocation of Payments (highest rate first)
- Restrictions on Fees for Cards with Low Credit Limits (subprime cards)
- Issuance of Cards to Minors
- Must Consider Ability to Pay

Key Interest Rate Rules

- Cannot increase interest rates on **existing balances** except in limited circumstances including:
  - Delinquency of at least 60 days
  - Variable rate plan
  - Expiration of promotional rate lasting at least 6 months
- Can increase interest rates on **new transactions** except
  - During first year (unless account meets above exceptions)
  - After first year, issuer must provide 45 day notice
- No restrictions on the level of interest rates at the time the account is established or for new charges

Amount of Penalty Fees

- Fees for late or returned payment, or over the credit limit must be reasonable and proportional to the violation
  - Rule:
    - Prohibits issuers from charging a penalty fee of more than $25 unless:
      - Repeat violation during next 6 billing cycles (then fee may be $35)
      - The issuer shows a higher fee represents a reasonable proportion of the costs incurred as a result of violation
    - Prohibits issuers from charging fees that exceed the dollar amount associated with the violation
    - Prevents issuers from charging multiple fees based on a single late payment or other violation

Past Credit Card Pricing Practices

- Interest Rate Setting Practices
  - In the past issuers could raise rates at their own discretion on both new **and** existing balances
  - Rate setting constrained by competition and consumer response
  - Various risk-based “penalty” triggers were used:
    - On-account behaviors
      - Late payments, over limit, payments returned for insufficient funds, changes in account use
    - Off-account behaviors (referred to as “universal default”)
      - Delinquency on other debts
    - Other risk indicators
      - Change in credit score

New Rules Will Have an Effect

- Interest rate related rules
  - Industry comment letter on *proposed* rule restricting repricing suggested that lost interest yield on credit card portfolios measured against accounts that revolve would be about 1.64 percentage points or about $12 billion
  - Effect likely larger under the final 60-day late repricing rule
  - Board staff did not independently assess the industry data so cannot be completely confident in precision

- Penalty fee related rules
  - Penalty fees generated about $10 billion in 2009 for Visa and MasterCard issuers
  - Safe harbor $25 limit would reduce revenue; perhaps by one third

Some Possible Issuer Responses to Restrictions on Repricing

- Higher interest rates for wider group of customers
- Increase existing non-penalty fees; add new fees
- More risk sensitive marketing and solicitations
- Tighter credit standards at time of application
- Tighter credit standards during account reviews
- Reduce (reward) benefits or enhancements
- Reduce incidence of waivers of penalty fees
- Raise required minimum payment amounts
- Expand access to populations not covered by rules (small businesses or professional groups)

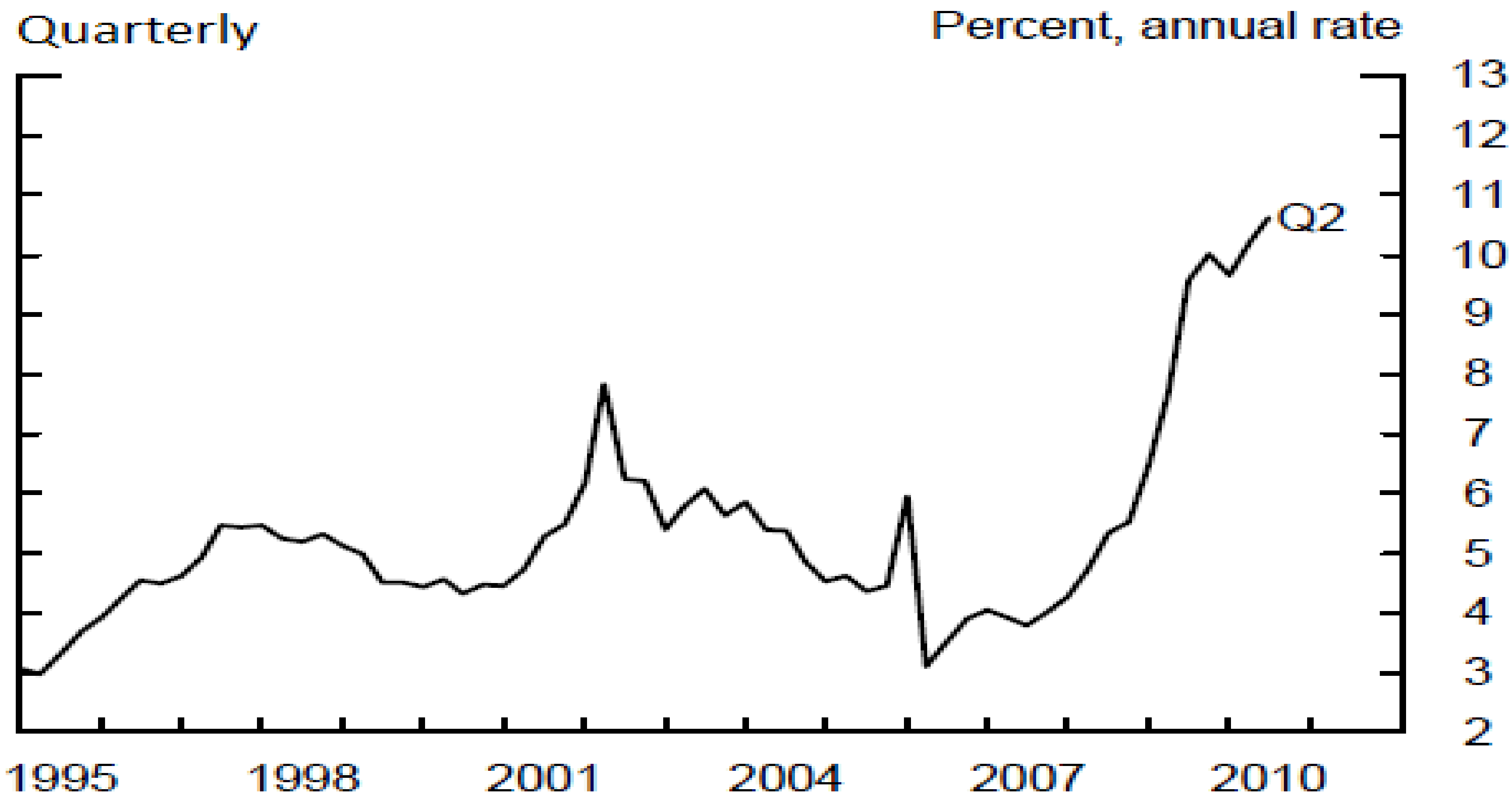
Economic Conditions are Having an Effect

- Charge-off rates
- Interest rate spreads
- Profitability
- Card holding and delinquencies
- Composition of borrowers in arrears

Economic Conditions are Having an Effect

- Charge-off rates have soared since 2008

Charge-off Rate for Credit Card Issuers

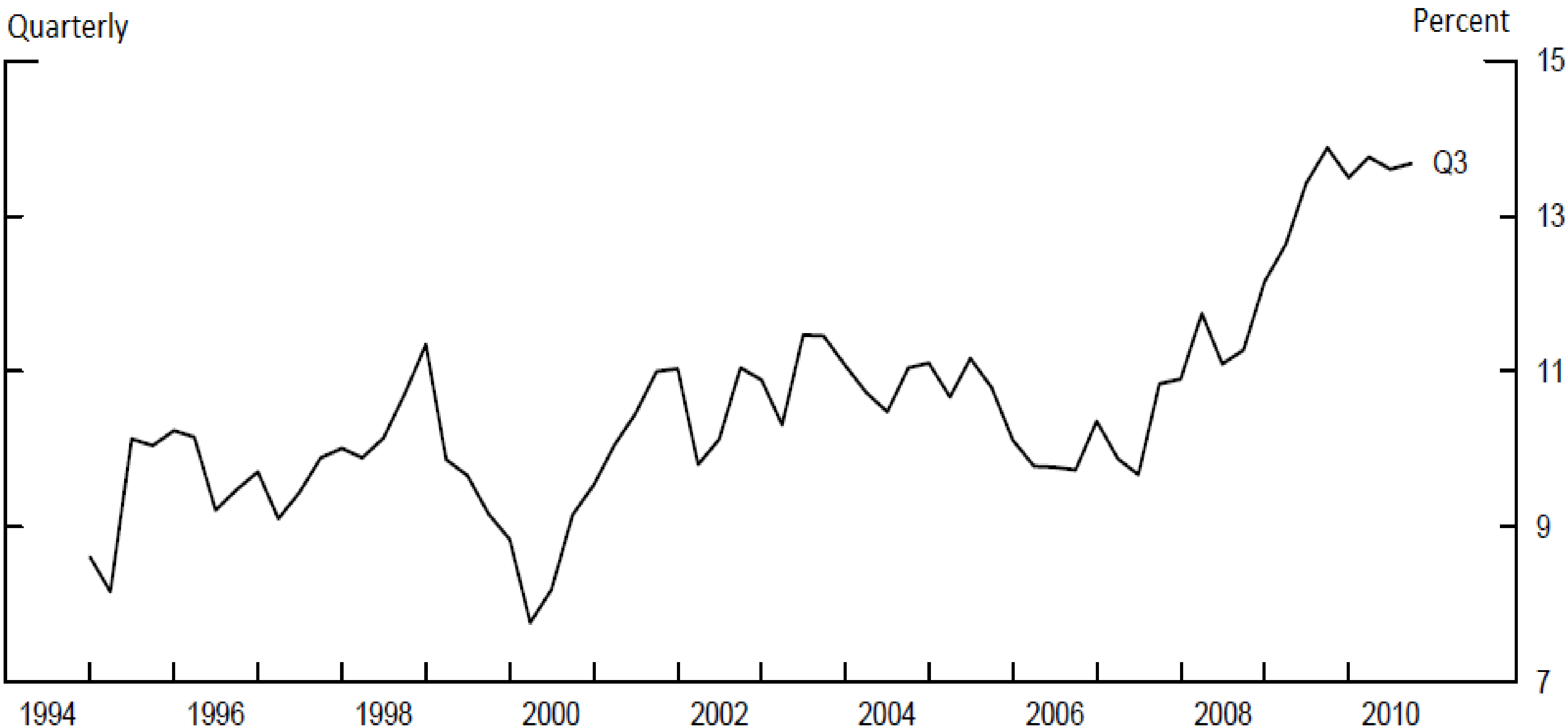


Source: Call Report.

Economic Conditions are Having an Effect

- Interest rate spreads have widened

Credit Card Interest Rate Spreads for Credit Cards Assessed Interest
(Spread over 2-year Treasury)



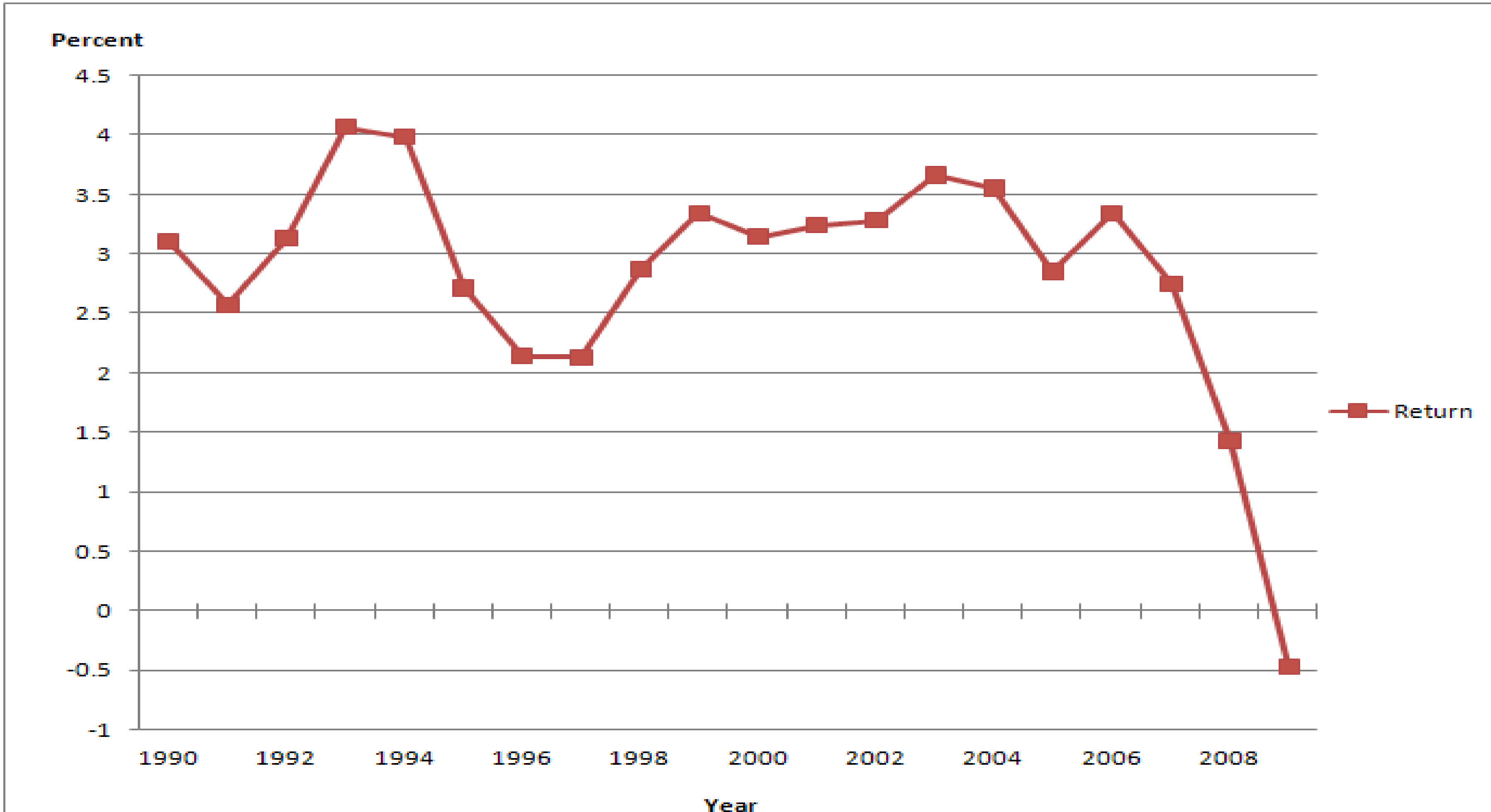
Source: Federal Reserve Board of Governors

Economic Conditions are Having an Effect

- Profitability has fallen since 2006
- Negative returns in 2009
- 2010 is a work in progress

Profitability of Large U.S. Credit Card Banks, 1990-2009

Return on Assets

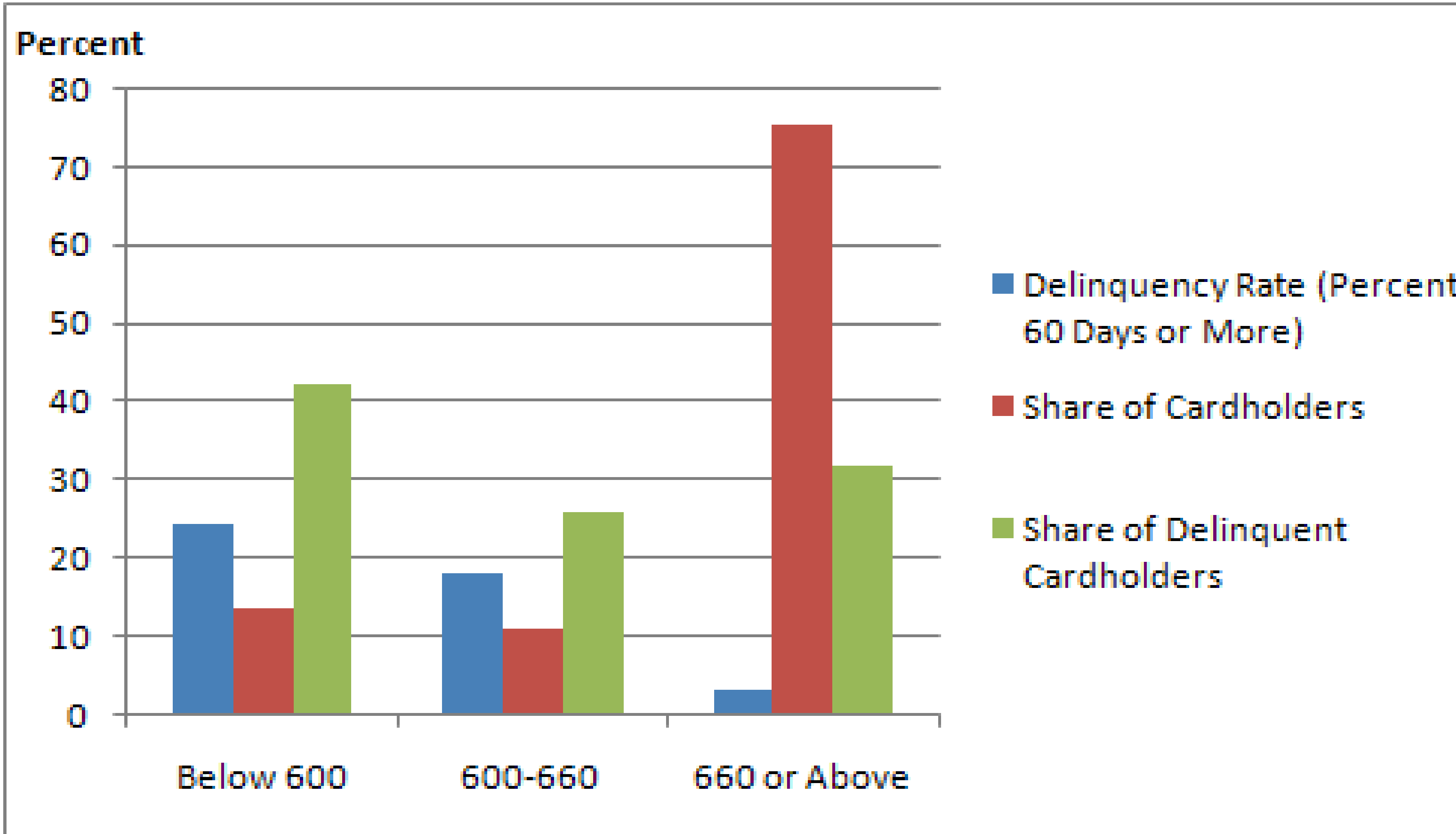


Source: Federal Reserve Board of Governors

Economic Conditions are Having an Effect

- Most bank credit cards are held by individuals with higher credit risk scores
- Delinquency rates are much higher for individuals with lower credit risk scores
- Delinquencies disproportionately from lower credit risk score groups

Delinquency Rate of Bank Cardholders **Current** as of 2008 Q4; Performance Measured as of 2010 Q3

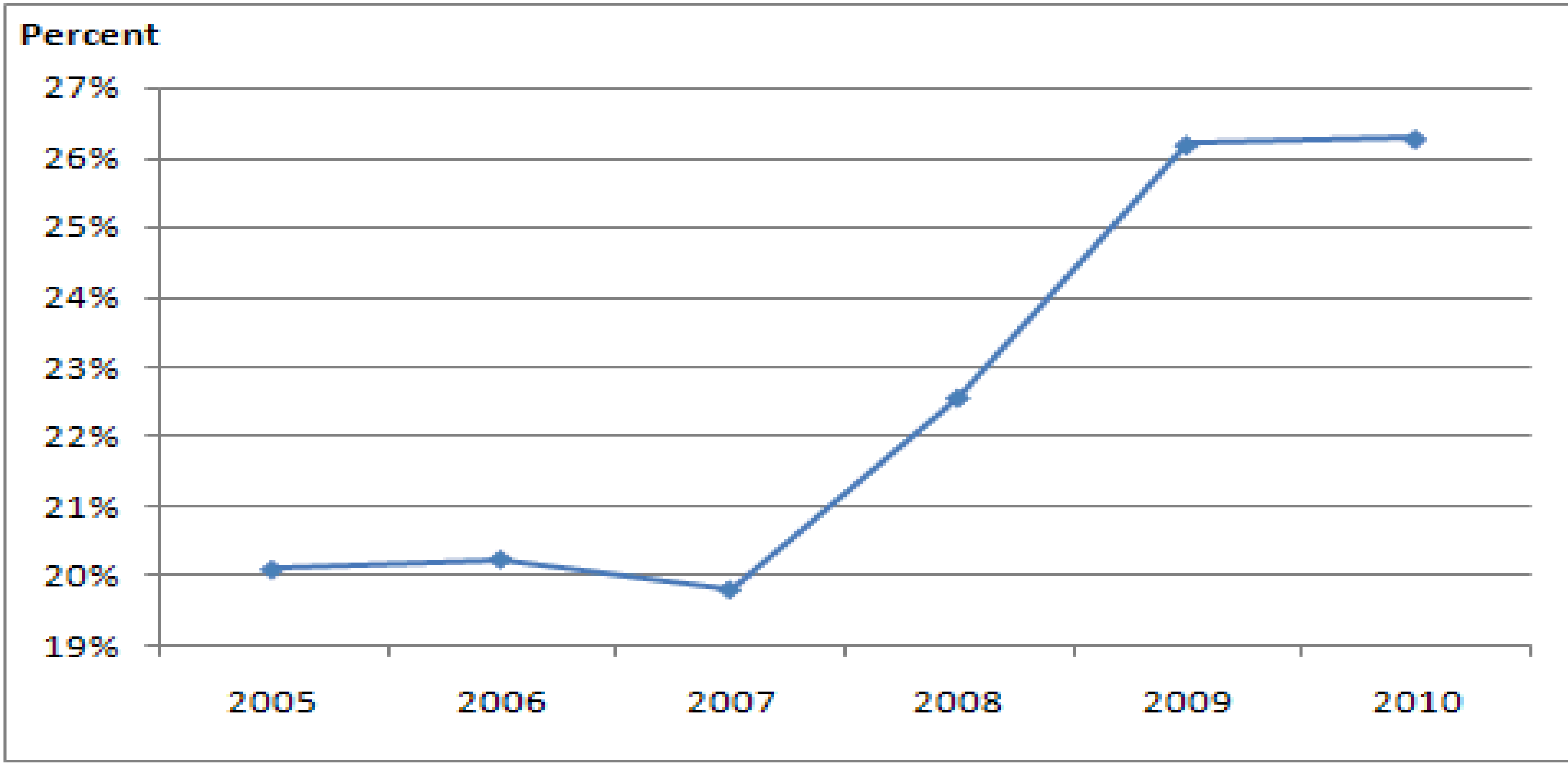


Source: Author's calculations, based on the FRBNY Consumer Credit Panel
Note: Cardholders current at year end, 60 days or more delinquent by 2010 Q3.

Economic Conditions are Having an Effect

- Higher risk score population has accounted for growing share of delinquencies

Share of Bank Cardholders 60 Days or More Delinquent with Credit Risk Scores Above 660



Source: Author's calculations, based on the FRBNY Consumer Credit Panel

Note: Proportion of bank cardholders that became 60 days or more delinquent that were current one year earlier and had credit risk scores of 660 or more at that time.

Issuer Responses: Economic Conditions or Regulation

- Considerable overlap in the timing of economic downturn and credit card rulemaking
  - Board’s proposal on credit cards -- June 2007
  - Economic downturn late 2007
- Issuers respond to deteriorating economic conditions
- Issuers respond to rule changes
- Distinguishing changes in pricing or availability arising from changes in the economic environment as opposed to regulation is difficult
  - Observed outcomes reflect both supply and demand conditions and both are influenced by economic conditions and regulations

Distinguishing Responses to New Rules from Changes due to Economic Circumstances

- Techniques used to evaluate effects of new regulations:
  - Survey affected firms about responses to rules. Ask about:
    - Changes in anticipation of new rules
    - Changes due to new rules
    - Ask about changes in underwriting, pricing, marketing, volume of activity, revenues, expenses and profitability
  - Different forms of "natural experiments"
    - Before and After studies (example; event studies)
    - Margin analysis (example; effects of the CRA along the threshold)
    - Coverage-based evaluations (example; effects of state predatory lending laws or state restrictions on payday lending)
  - True experimental design
    - Issuers tests; applying different policies to subsets of customers or potential customers

Distinguishing Responses to New Rules from Changes due to Economic Circumstances (cont.)

- Surveys of issuers can provide insight but have limits
  - Reasons for changes are not mutually exclusive so difficult for respondents to apportion change to causal factor

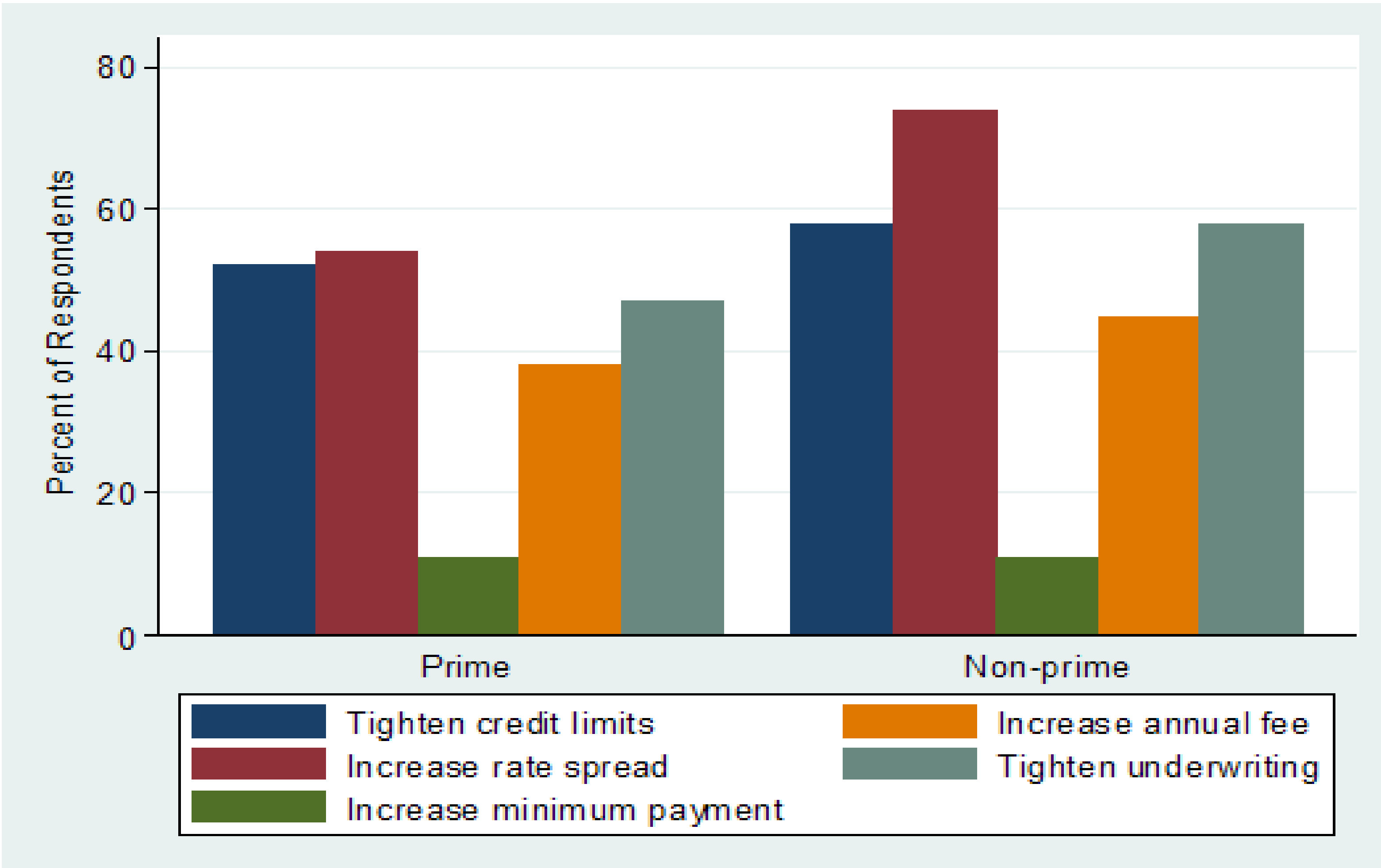
- Other approaches face difficulties:
  - The rule writing process extended over a long period
    - Issuers could have begun responding at any point and in different ways depending on customer base and business strategies

  - All issuers of consumer cards subject to the same rules regardless of location

Distinguishing Responses to New Rules from Changes due to Economic Circumstances (cont.)

- Three approaches considered:
  - First: Surveys of issuer's practices – before and after
  - Second: Examine activity in market segment not covered
    - Focus on small business credit card data reported under the CRA
    - Observe effect of economic conditions on origination volume
    - Observe variation between states experiencing high distress from those experiencing mild distress
  - Third: Difference in differences
    - Use consumer credit record data to examine outcomes
    - If differences in outcomes are tied primarily to differences in economic conditions, then observe variation between states experiencing high distress from those experiencing mild distress
    - If differences in outcomes are minimal, rule changes may be key

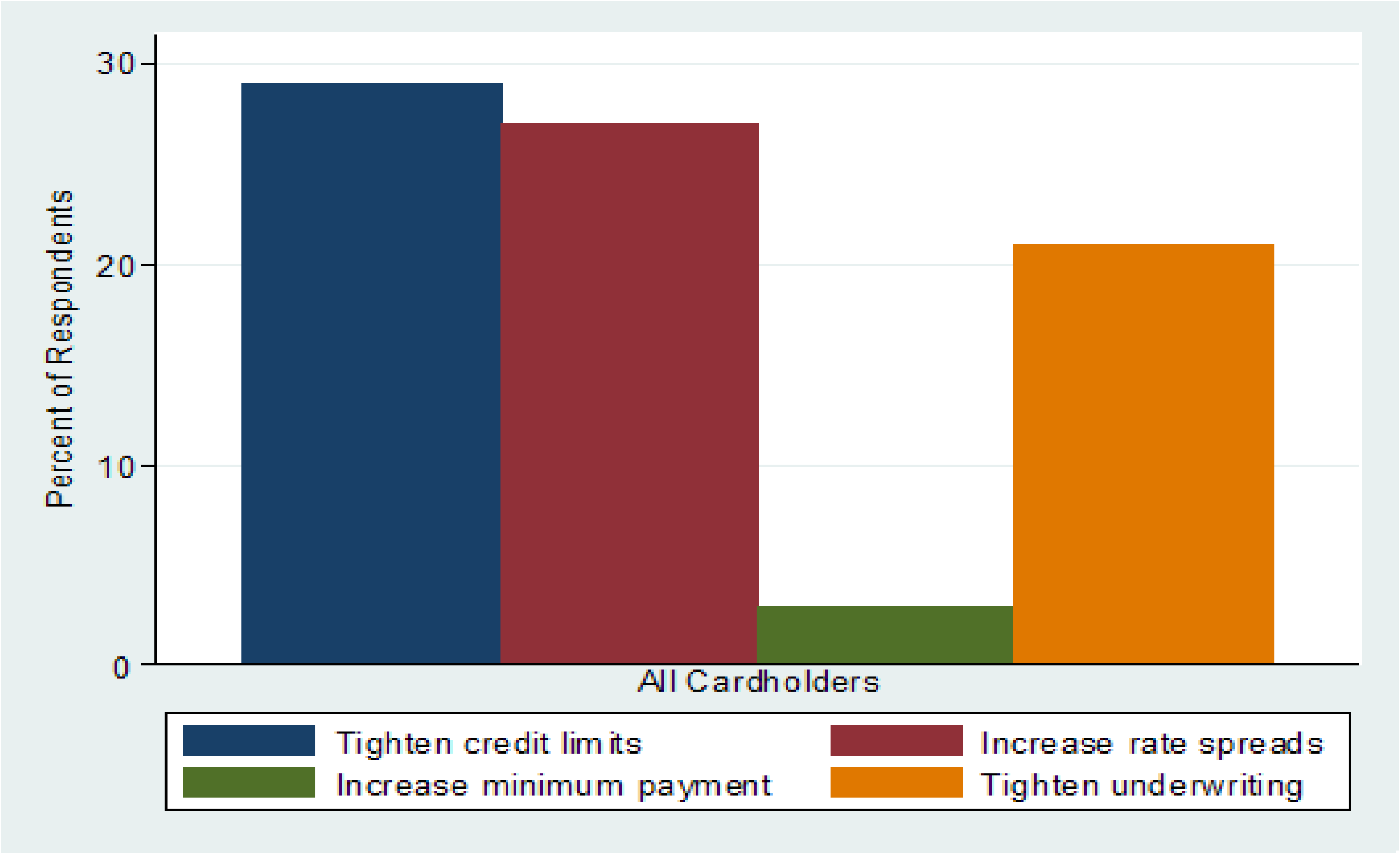
Anticipated Reactions by Credit Card Issuers to Credit Card Rules, October 2009



Question: "How do you expect the legislation will affect…."

Source: FRB, Senior Loan Officer Opinion Survey

Recent Actions by Credit Card Issuers, April 2010



Source: FRB, Senior Loan Officer Opinion Survey

Note: Responses pertain to actions in 3-month period before survey.

Small Business Credit Card Originations

(Number of Originations to Small Firms, Indexed to 2005)

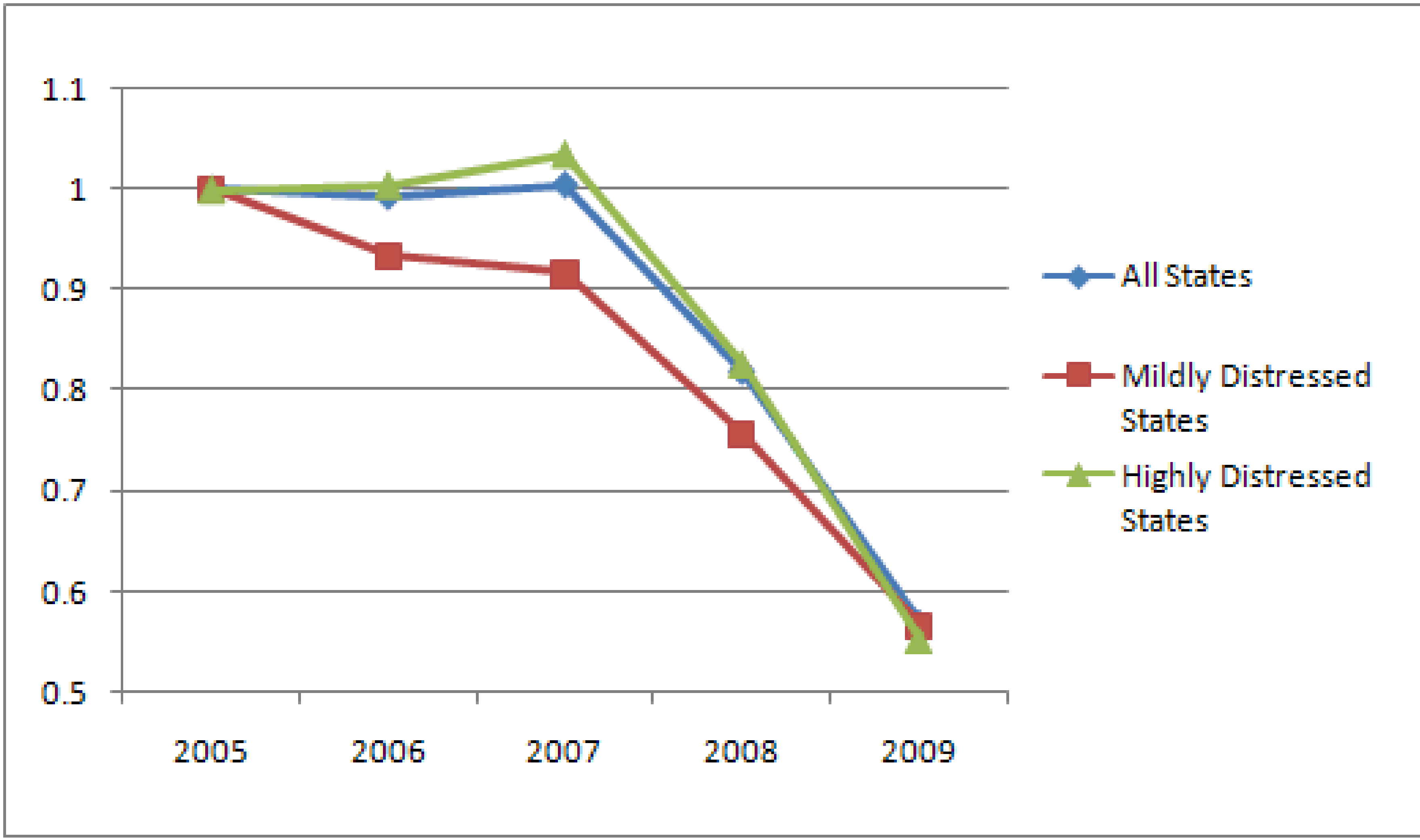
Source: FFIEC, CRA data, 2005-2009

Note: Data include reporters identified as credit card issuers.

Originations include new accounts and increases in credit lines on existing accounts

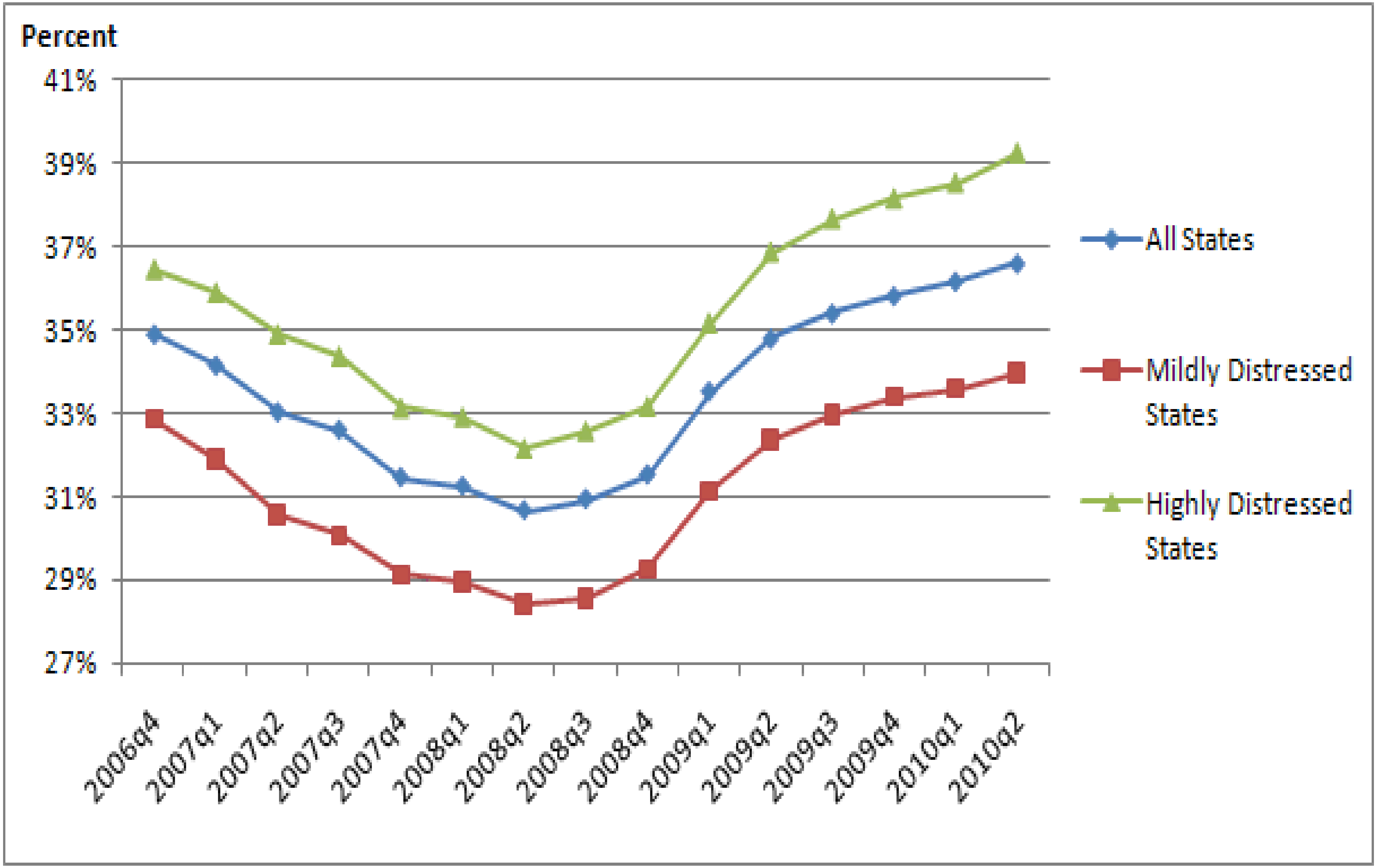
Number of Revolving Accounts Opened Within Last 6 Months

(Yearly Average, Indexed to 2005)



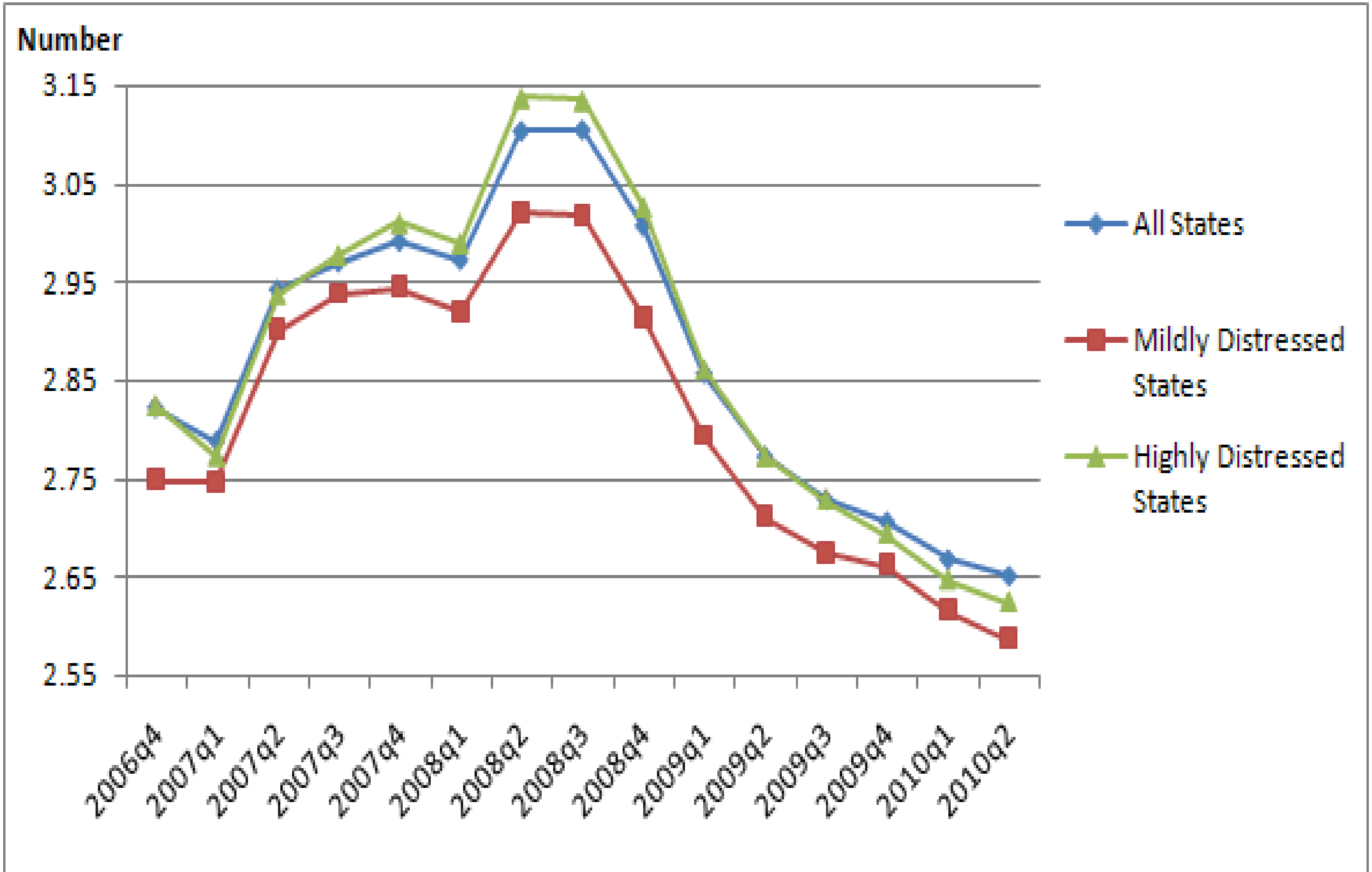
Source: Author's calculations, based on the FRBNY Consumer Credit Panel

Proportion of Individuals with No Bank Cards



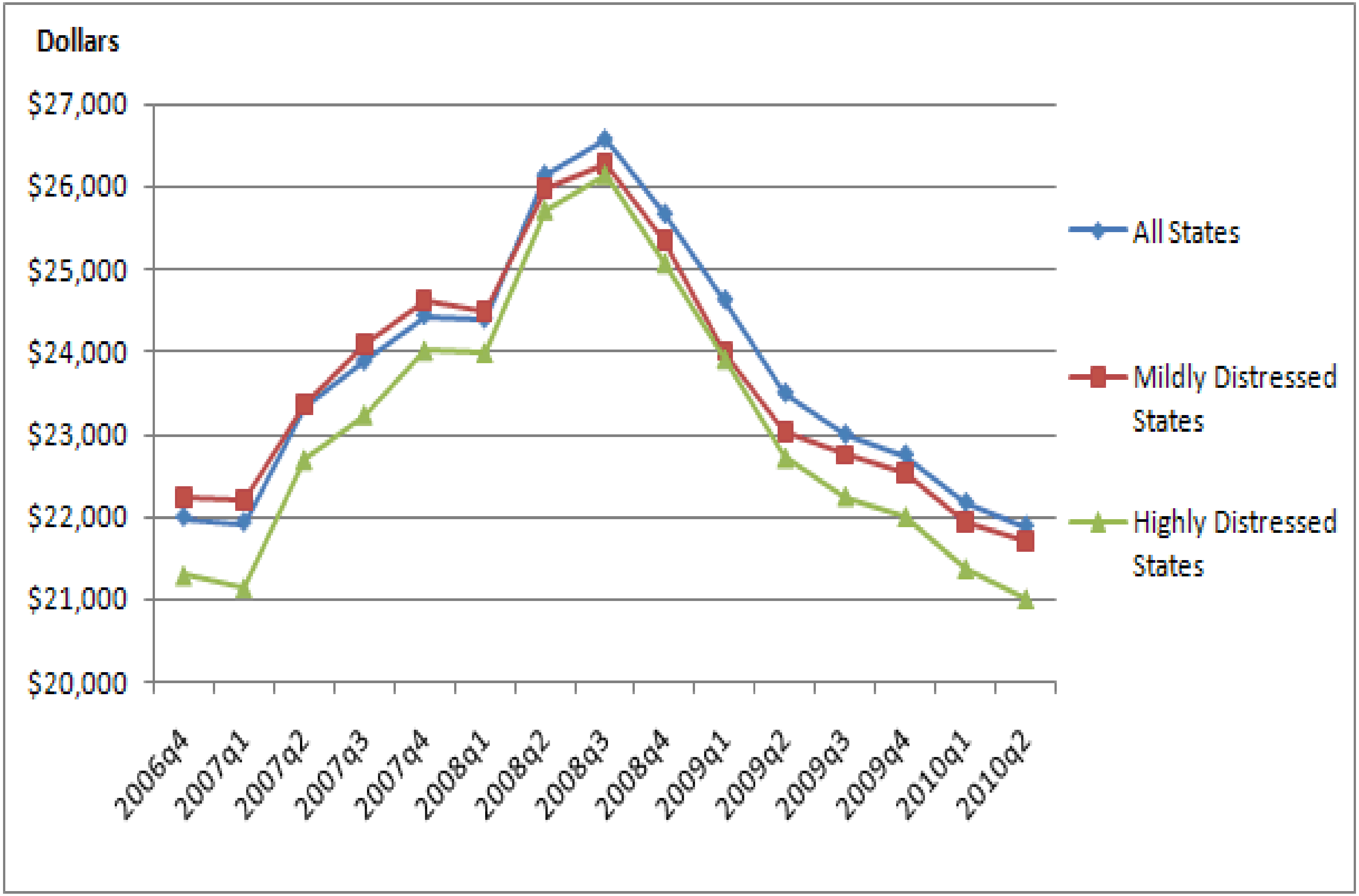
Source: Author's calculations, based on the FRBNY Consumer Credit Panel

Average Number of Bank Cards
(Per Cardholder)



Source: Author's calculations, based on the FRBNY Consumer Credit Panel

Average Total Credit Limit on Bank Cards



Source: Author's calculations, based on the FRBNY Consumer Credit Panel

Concluding Thoughts

- Changes are occurring, but disentangling economic from regulatory effects is challenging
- New credit card rules affect issuers and consumers
  - Issuers will alter pricing and seek to curtail costs (losses)
  - Some consumers will be affected more than others
    - Reduced access to credit cards
    - Smaller credit lines
    - Higher interest rates (wider spreads)
    - Higher and more fees
- More to come – Report to Congress will explore the effects of the rule in much more depth