



Proactively managing a credit card business in the current downturn:  
Suggestions for credit card executives

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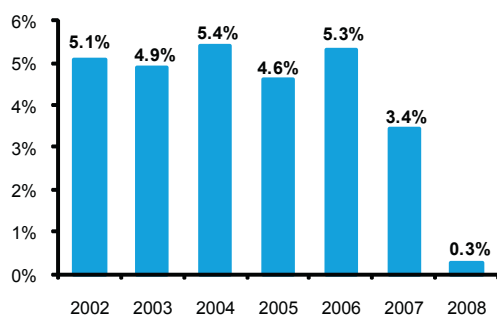
The credit card market is experiencing rising levels of delinquency and charge-off rates, which are expected to increase through 2009 and, perhaps, 2010. As the economy braces itself for another difficult year, many banks and credit card issuers are likely to face continued losses and may be considering action steps to potentially help navigate and proactively manage the current environment to minimize losses and better position the issuers for near-term growth following the ultimate return of an economic recovery.

## Recent return on assets trends

The credit card industry has been a profitable business in recent years. Industry-wide profits exceeded \$40 billion in 2007<sup>1</sup>, while the top three issuing banks experienced a healthy return on assets (ROA) consistently above 4.5 percent between 2002 and 2006 (see Exhibit 1). Credit card issuers have been able to maintain these healthy returns in the past thanks to high levels of consumer spending, low funding costs, and a generally benign credit loss environment.

### Exhibit 1

Top three credit card issuer return on assets



Source: Bank of America, JP Morgan Chase, and Citigroup respective 10-K reports

Yet, that trend for the top issuers is above the long-run historical averages for the industry. Exhibit 2 illustrates credit card issuer average profit and loss estimates over the life of the loan, including the effects of both expanding and contracting macroeconomic environments. The table includes the three elements of credit card revenue: interest

on account balance, fees (late, over-limit, annual service, etc.), and network interchange that are offset by the three sources of cost: funding, operating expenses, and credit charge-offs.

### Exhibit 2

Credit card industry lifetime average profit and loss estimates

(Units: Percent of assets)	
<b>Revenue</b>	
+ Interest	14-15 %
+ Fees	3-4 %
+ Interchange	< 1%
<b>Subtotal revenue</b>	<b>17-19%</b>
<b>Cost</b>	
- Cost of Funds	5-6 %
- Operating Expenses	4-5 %
- Charge-offs	6-7 %
<b>Subtotal cost</b>	<b>15-18%</b>
<b>Net pretax profit</b>	<b>2-3 %</b>

Source: David Lawrence and Arlene Solomon, *Managing a Consumer Lending Business*, 2002.

For the industry at large, net pretax returns on assets historically have averaged 2-3 percent – approximately half the ROA of the top three issuers in 2006.<sup>2</sup> While specific issuers will likely have different rates of return at any point in time given their individual differences in pricing, product mix, portfolio age, funding sources, distribution channel mix, and risk profile, a comparison of the average lifetime ROA of two to three percent to the average ROA of 4-5 percent for the top three issuers provides insight into how the top three issuers were able to generate better than historical average returns between 2002 and 2006. During this period, the cost of funds and charge-off rates averaged 3-4 percent and 4-5 percent, respectively, or 1-2 percent lower than their respective historical norms. The two factors combined have enhanced credit card issuers' profitability by 2-4 percent and have more than offset competition-driven slight decreases in industry-wide interest rates through the same period.

<sup>1</sup> "Exposing the Credit Card Fine Print," *Time*; Feb. 21, 2008.

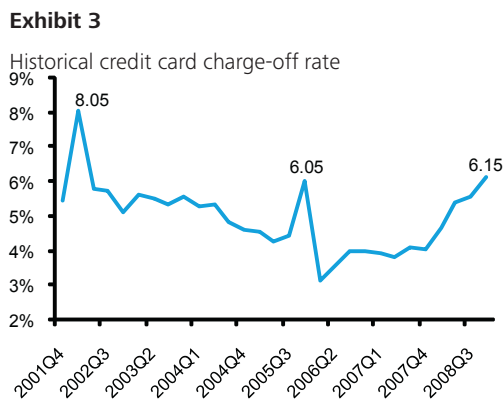
<sup>2</sup> <http://www.federalreserve.gov/fomc/fundsrate.htm>

Since the second half of 2007, the market environment has provided a less favorable scenario for credit card issuers and the top three issuer ROAs (Exhibit 2) declined markedly to 3 percent in 2007, and 0.3 percent in 2008. More recently, events in the secondary credit markets have increased the cost of funds for all the issuers and, particularly, for monoline issuers that have traditionally relied on securitization as the primary source of finance. Even for credit card issuers with a substantial bank branch presence, the overall competition for deposits has driven up funding costs even while the Federal Reserve's short-term interest rates and consequent funding costs have declined.<sup>3</sup>

In addition, future rates of returns may decline further as proposed new accounting changes to FASB Statement No. 140 guidelines transfer off-balance-sheet securitized assets back to the credit card issuers' balance sheets. Citigroup estimates that such an accounting change will return \$98.2 billion to its balance sheet and may depress its 2008 fourth-quarter ROA by 50 percent from 0.08 percent to 0.04 percent.<sup>4</sup>

**Charge-off rates rising**

Credit card charge-off rates also have risen consistently following general declines in the overall macroeconomic environment. Exhibit 3 provides a snapshot of the historical trends in the net credit card charge-off rates by the credit card lines of business from the top 100 banks in the U.S. in the last seven years.



Source: U.S. Bureau of Labor Statistics – www.bls.gov

There has been a clear upward trend in credit card charge-off rates from 2007 to the first quarter of 2009, and this trend may continue to rise in the near future as rising unemployment rates and falling house prices reduce

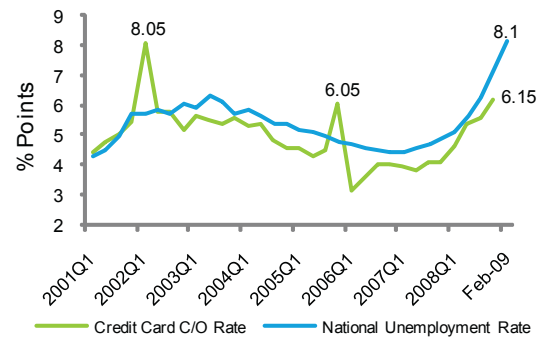
<sup>3</sup> <http://www.federalreserve.gov/fomc/fundsrate.htm>  
<sup>4</sup> "Accounting Rule Change May Block Capital for Credit-Card Issuers," *Wall Street Journal*, March 27, 2009.

cardholders' ability to finance their purchases. Indeed, consumers are experiencing various aspects of the current economic climate; rising unemployment rates, falling house values, and deteriorating retirement accounts. These factors could impose downward pressures on new purchases, as well as the cardholders' ability to pay existing balances.

The overall charge-off rate for credit cards has increased 50 percent from 4.06 percent in the fourth quarter of 2007 to 6.15 percent as of the fourth quarter of 2008. While there has been a deterioration in credit card loan performance, first-quarter 2009 levels actually remain close to historical 20-year credit card charge-off averages (6-6.5 percent) and are lower than the high losses last seen in 2001 (8.05 percent). Note that the temporary peak in charge-offs seen in the fourth quarter of 2005 was primarily due to changes in bankruptcy laws taking effect then and is not indicative of fundamental modifications in macro or issuer-specific risk profiles.

**Exhibit 4**

Historical unemployment rate and credit card charge-off rate



Source: U.S. Bureau of Labor Statistics – www.bls.gov

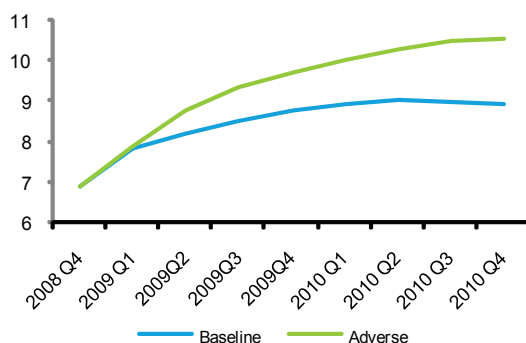
Industry-wide and nationally, credit card charge-offs have historically exhibited a reasonably close relationship with the overall unemployment rate (see Exhibit 4). There are two likely reasons for the unemployment and credit card charge-off association. First, cash from income is the primary and, usually, the only source of repayment on existing balances as the unsecured nature of the product generally precludes secondary sources of repayment, such as collateral. If the cardholder is unemployed, there is often no other source of repayment. Secondly, cardholders often settle credit card bills after meeting mortgage loan, utility payment, and auto loan obligations. In addition, there is some anecdotal market evidence suggesting cardholders now utilize their credit cards as essential means of financing everyday necessities like groceries and fuel. Still, we believe that the historical association between unemployment and credit card charge-off rates will likely remain largely intact.

Finally, recent U.S. Treasury projections have forecast unemployment rates that run from 7 percent in the fourth quarter of 2008 and may reach 9 percent a year later or as high as 10.5 percent in 2010, according to the Treasury's "baseline" and "more adverse" scenarios of unemployment through 2010, which is based on consensus economists' estimates. (See Exhibit 5.) Given this association, it is likely that credit card charge-off rates will increase further and potentially exceed the 8 percent charge-off rates recorded in 2001.

As the credit card industry focuses its attention on lessening the impact of these potential credit losses,

**Exhibit 5**

Unemployment projections (2008-2010)



Source: Supervisory Capital Assessment Program, United States Treasury, February 25, 2009

executives may consider taking steps focused on proactively managing portfolios, refining and focusing underwriting standards, enhancing early warning and proactive risk reporting, improving predictive powers of key models, and focusing on flexible and effective default management.

**Effective proactive portfolio management**

Portfolio management is an integrated function that combines traditional marketing, finance, and risk management activities to accelerate risk-appropriate balance growth (via behavior scoring and limit management) and profits (via behavior scoring and pricing) while limiting the overall portfolio and segment-specific risk levels of existing cardholders. Successful portfolio management typically requires an effective, analytically driven approach to risk-return trade-offs in pricing and limit management, as well as increasing the share of existing account holders' spend and credit card balances with compelling offers.

Credit card portfolio managers have many tools available designed with the goal to achieve profitable growth and limit losses of existing accounts. Commonly used portfolio approaches include changing fees and interest rates, modifying credit lines, renewing or canceling existing accounts, altering rewards offers, as well as specific marketing offers of one-time balance transfers or special pricing deals.

Credit card portfolio managers may have to apply these tools in innovative ways in today's difficult market conditions. There is an added premium on retaining and growing the share of credit card purchases of existing "good" customers while identifying and limiting losses from "bad," or those likely to migrate to "bad," customers. Inevitably, losses will increase as markets deteriorate further, but effective portfolio management may partially offset those losses through deepening existing credit card relationships with those remaining attractive accounts and by early proactive management of deteriorating accounts.

**Action: Use nontraditional factors to identify accounts likely to deteriorate**

Recent market trends indicate that credit card issuers have been aggressive in lowering credit lines, raising interest rates, and canceling or forgoing renewal of accounts that have shown direct signs of stress (i.e., increased delinquencies, lower dollar rates of repayment, etc.). Many of these credit card issuers have managed through economic troughs in early 2000 or before, and have experience in containing portfolio losses.

However, the current market may be different from prior recessions because the expected depth and duration of the economic decline may be more intense and longer than previous downturns and may produce significantly higher rates of unemployment. Past market contractions have indicated the effectiveness of taking action at early signs of account stress. Existing behavior scoring systems track and monitor portfolio account delinquencies and pay-down rates, as well as "off-us" (i.e., credit not with the credit card issuer) credit usage and delinquencies in borrowers' total credit profiles. Selectively increasing interest rates (within regulatory guidelines) and pursuing risk-appropriate limiting of "open-to-buy" amounts for those credit profiles that show deterioration in behavior scores should continue to be applied.

Increasingly, today's credit card environment appears quite different from past recessions and may require consideration of additional prudential steps. Past economic declines from cyclical business causes have traditionally led to increases in unemployment and credit card charge-offs, but with only modest increases in home foreclosure rates and housing price declines that were localized to small geographic areas. Thus, credit card charge-off rates generally preceded undetected or only marginal increases in home foreclosure rates and home price declines.

Home mortgage defaults and housing price declines are nationally widespread today and have been increasing since the second half of 2007. With home mortgage defaults preceding both rising unemployment rates, which began in earnest in the second half of 2008, and recent increases in credit card charge-offs, credit card portfolio managers should, therefore, consider prioritizing additional steps that may be effective due to the unique nature of the current economic stress:

- Consider non-credit card-related indicators of risk that could be relevant today but are not commonly captured in existing behavior scoring systems. For example, large, nonconforming hybrid mortgages originated in 2006 or 2007 have shown above-average rates of foreclosure. Cardholders with such mortgages could be reviewed for potential modifications to the pricing and limits of their credit cards to better reflect the underlying risks.
- Contemplate credit line adjustments and/or pricing changes for mortgage holders who have recently sought loan modifications to reduce monthly payments, which could be signs of rising cash flow concerns.

**Action: Utilize integrated approach to market to existing customers**

Average costs to acquire a new account in the industry can vary from \$50 to \$200 with an average cost of approximately \$90 for prime (FICO > 660) customers, depending on the distribution channel utilized (bank branches cost less and direct mail cost more).<sup>5</sup> Most newly acquired customers could also require many months of “seasoning” for them to become profitable after accounting for common incentives such as balance transfer offers and low introductory interest rates. It is generally more cost effective, therefore, to retain “good” accounts and grow the portfolio’s balance and profitability by targeting those customers to use their credit cards more rather than by aggressively acquiring new accounts.

The current market conditions of high credit losses and defaults have also precluded many large issuers from aggressively marketing to existing account holders. This could be an opportunity for some of the smaller issuers to build balances with existing customers. Major credit card issuers have been cautious to grow their receivables balance for good reason – loss avoidance. A selective, prudential approach using current market situation-specific drivers of risk may allow increased risk differentiation to more effectively target existing customers for cautious growth.

For example, many credit card issuers utilize multiple channels, such as bank branches, direct mail, telephone solicitations, etc., to acquire new accounts. Industry data

suggest that accounts from some channels may be more risky than others (i.e., have higher rates of default). In general, accounts that have multiple relationships (such as checking or mortgages) with the same issuer have been known to display markedly lower risk profiles than credit card only accounts. In most cases, credit card issuers either don’t have access to such an integrated risk approach or a single view of the customer’s multiple relationships to measure a holistic view of risk and consider multirelationships accounts with the same risk assumptions as those with only a credit card account. Consider for growth, therefore:

- Existing cardholders that have multiple relationships beyond credit cards (e.g., checking) and, after verification and testing, drive growth via expanded credit lines or lower pricing using a risk-based approach.
- Marketing noncredit card products (e.g., checking, auto loans, etc.) to current cardholders. This may expand existing relationships and may decrease risks for those same cardholders.

**Refine and focus underwriting standards**

The objectives of acquisition underwriting are simply to maximize the acceptance of profitable customers with meaningful credit lines and risk-appropriate pricing, while excluding high-risk and most-likely-to-default customers. Today’s stressed environment does not change these objectives, but rather places even greater emphasis on the underwriting ability to disaggregate the “good” population from the “bad” given the heightened competition for the former and greater loss potential from the latter.

While the natural tendency and the temptation may be to discontinue or severely limit the new account acquisition process given the current market environment, there may actually be a greater need for the acquisition function to generate new accounts to help offset higher losses in the portfolio, as well as the normal expected customer “churns” with better customers that can generate replacement income and reposition the issuer for long-term growth. A segmented approach that raises underwriting standards and decreases credit card approval rates, while concurrently targeting those remaining “good” customers with more aggressive officers, may be a superior alternative. This method can provide the advantage of reducing the overall risk profile even as more profitable customers are added to the portfolio for future growth.



<sup>5</sup> “Maximizing Card Rewards,” CNNMoney, August 10, 2006; David Lawrence and Arlene Solomon, *Managing a Consumer Lending Business*, 2002.



### **Action: Focus underwriting on key loss and profitability drivers**

There may be an industry-wide propensity in underwriting to become more risk averse, making issuers more selective when deciding to whom they will lend. This can be appropriate; however, the existing market conditions may also provide an opportunity for issuers to “cherry-pick” borrowers and develop a profitable portfolio in the long term. Credit card issuers should consider:

- Being more conservative in their cut-off decision standards by improving the underlying criteria and assumptions given the current and near-term market environment.
- Recalibrating and reconfirming, as necessary, factors that drive underwriting decisions, such as company threshold loss rates, marketing offer response trends, and credit card usage, as well as future credit loss rates where appropriate.

It is often the combination of risk-based pricing and line assignment approaches that help drive loss and profitability performance in the market place. The goal is to assign an optimal combination of the two factors to ensure high activation and utilization of credit cards, as well as to build balances on the credit product while limiting loss balance. Attractive pricing generally leads to higher activation rates, and a competitive credit line assignment can lead to quick balance buildup on the credit product. An overly aggressive pricing strategy or extremely high credit line assignment, however, can lead to an adverse selection, i.e., a portfolio mix bias to those higher risk customers unable to attain better pricing elsewhere and/or high balances at the time of default.

In anticipation of market declines, pricing and credit limit setting can be more selective rather than uniformly conservative for customers who have exceeded cut-off standards and accepted credit card offers. While unemployment and spending levels may continue to deteriorate, the majority of cardholders may still be gainfully employed and may continue to use their credit cards for purchases. It could be possible to acquire those customers with very attractive offers and build the portfolio even while the overall market is in a decline. Consider, as an example, using a larger set of pricing and credit limit tiers to appropriately reward “performing” customers. Using a risk-based approach, the pricing and credit line assignment options can be maintained at a constant level for the majority for recent customers; however, older and “performing” cardholders could be rewarded with more attractive offer combinations in pricing, rewards, and credit limits. Because many issuers apply Net Present Value (NPV) models to selectively target and set pricing/credit limit standards, this implies simultaneously targeting higher NPVs for customers close to cutoff requirements, while decreasing (perhaps to  $NPV \approx 0$ ) pricing/limit standards for those with the very best credit standards.

### **Early warning and proactive risk reporting**

Credit card executives have traditionally tracked and monitored their portfolio performance to identify both opportunities for growth and weaknesses from credit losses. Delinquency tracking, vintage assessment, and spend/usage cohorting are all common reporting elements, among many others, that provide insights into the performance of the portfolio.

Given the depth of the current economic decline, as well as the pace of changes that are driving the declines, there is an increased need for credit card executives to assess the performance of their portfolios and make decisions to mitigate any potential risks that may be developing. Executives may ask themselves:

- How are the declines in home values affecting my cardholders?
- Are the declines in FICO scores biased in any particular geographic area, credit card vintage, or credit card product?
- How will the increases in anticipated unemployment affect the credit card accounts?

Consider that effective reporting relies on factors applicable to any credit card issuer, including data management, information delivery, and reporting design. Data management encompasses an understanding of the underlying data integrity and/or quality (accurate, complete and timely), while being accessible and efficient. Information delivery highlights an understanding of the issuer’s culture of “push versus pull” and “paper versus electronic” delivery. Lastly, an effective reporting design emphasizes the specific needs of the audience and delivering actionable information, which enables future requirements to be added easily.

### **Action: Define appropriate new KRIs and monitor frequently**

Credit card issuers should consider identifying key risk indicators (KRIs) that can provide effective early signs of potential deterioration in the portfolio. Traditional KRIs, such as delinquency and FICO migrations, should continue to be monitored as risk indicators, but issuers should also consider augmenting these measures with additional metrics or combination of metrics that may provide increased visibility to early signs of potential declines.

For example, tracking a combination of FICO score declines in geographic areas that have significant home price depreciation for adjustable rate mortgage holders could be early indicators of possible weakness (combining FICO score limits with geographical locations and percentage house price declines creates a new variable). Another combination could seek to identify for those same FICO-home price-ARM combinations, account holders who have rapidly consumed their available credit lines as an indication of potential credit deterioration.

Take into account the most effective means of monitoring and reporting these and other potential KRIs with regard to data management, information delivery, and reporting design. Efficient and timely usage of the factors can provide insights to answer critical board and executive management questions and provide early warnings of portfolio deterioration.

### Improve predictive powers of key models

Credit card issuers use predictive models and automated decision criteria to assess, measure, and execute key actions on all accounts. Marketing initiatives to identify the most responsive new customers, new pricing offers to enhance credit card balance spend by existing customers, as well as the risk disaggregation of “bad” accounts in the portfolio are all actions derived from usage of scoring-type models, among many others.

It is, therefore, important to verify that these marketing and underwriting models maintain their predictive powers in order to protect the issuer from unduly large losses, to enable a segregated acquisition strategy, or to implement the integrated portfolio marketing initiatives described above.

#### Action: Review and update key models

Given rapidly changing market conditions, credit card issuers should consider revisiting the models (e.g., application/behavior scoring, marketing offer response rate, credit card usage, and collection default risk and recovery models) from an analytical and theoretical perspective to determine that the models are appropriately rank-ordering accounts and to assess appropriate usage of these models. Some models may need to be refreshed using updated data from existing data sources to retain their predictive capabilities, while others may need to be rebuilt with data from data sources not previously used.

For example, some models use many years’ worth of base accounts (more for risk models and less for marketing response-type models) and their historical performance as the basis to build the models. The models that were designed and built in 2008 may contain account histories from 2007, 2006, or possibly even earlier. The underlying population of accounts at that time was likely quite different from today’s existing customers with respect to their risk profile and their credit usage. A population stability test can be utilized to assess the basis of such underlying data discrepancies and could be applied to identify those models that require modifications or possibly a complete rebuild.

Lenders should also consider new characteristics that may be driving scorecard performance unique to the current environment. Consider, for example, home mortgage holders. Traditionally, home owners were viewed as more stable and less risky applicants compared to renters, and such applicants obtained higher credit scores along

with favorable pricing and creditlimit terms. In today’s high home foreclosure environment, such assumptions may no longer be valid, particularly for high-balance, nonconforming adjustable mortgage holders. Conversely, the recent macroeconomic data suggests selected industries, such as health care and the public sector, have maintained more stable employment levels than others, such as the construction or retail industries, and their future rates of credit card defaults may be correspondingly less. Credit card issuers should consider applicability of such nontraditional characteristics to assess the predictive powers of their underwriting models and discern profitable low-loss customers from other customers.

#### Flexible and effective default management

Default management is an important aspect of managing credit card portfolios. Credit card issuers have policies, tools, and organizations to manage delinquent accounts and to maximize collections on defaulted balances. An issuer with an effective default management capability can gain competitive advantages over its peers by being able to acquire higher risk customers, or as in the current environment, by being able to minimize losses as its overall portfolio risk quality deteriorates.

Collection strategies typically differ for early stage (i.e., 60/90 days or less delinquent) vs. late stage (i.e., 120 days or more delinquent) accounts. It is a common industry observation that the majority of the accounts in early-stage default tend to repay the balance with only a small portion of those customers transitioning to default. Thus, the early-stage collection strategy focuses on identifying and proactively managing those few customers who are most unlikely to pay back the balance. Conversely, the majority of those in late-stage default status often do not pay the balance due, and the late-stage collection strategy is to identify and manage those customers that are most likely to pay back.

The current credit environment does not alter the objectives of the two early- and late-stage collection strategies. However, it does provide greater emphasis on both the collection scoring models and policies to disaggregate appropriate populations to target, as well as on the organizational abilities to absorb what is likely to be a much greater volume of delinquent accounts to manage. Consider focusing on the early-stage strategy that allows collections departments to manage the telephone dialer ahead of other competitors who are also likely to solicit repayment on past due credits concurrently. Customers who receive multiple collections-related calls often pay those who call first before they pay others. Speed can matter. Consider also more flexibility for collections agents to accept partial payments or lower monthly payments to accommodate debtors who have temporary problems. Such cases may become more common as many homeowners seek modifications of existing mortgages via various government-sponsored programs.

## Contacts

For more information, contact:

### **JH Caldwell**

Partner  
Deloitte & Touche LLP  
+1 704 227 1444  
jacaldwell@deloitte.com

### **Kevin Huh**

Senior Manager  
Deloitte & Touche LLP  
+1 312 486 3907  
kehuh@deloitte.com

### **Amit Malik**

Manager  
Deloitte & Touche LLP  
+1 312 486 1965  
amimalik@deloitte.com

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