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Developments in the Landscape for Consumer Credit and Payments

Remarks by

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Good afternoon. I am delighted to be here for the 10th anniversary of the establishment of the Payment Cards Center at the Federal Reserve Bank of Philadelphia. I would especially like to recognize Bob Hunt, director of the center, and his staff as well as the leadership of the Philadelphia Fed for providing such an outstanding forum for research, policy, and industry discussion in the important area of consumer credit and payments.

I plan to set the stage for this conference by focusing on three topics that are of particular interest to the Federal Reserve: changes in consumer credit, changes in the use of payment methods, and regulatory developments that affect both consumer credit and payments. I'll finish with some comments about the future of consumer payments.

Changes in Consumer Credit

During the recent financial crisis, the Federal Reserve and other policymakers throughout the government took unprecedented actions to mitigate the fallout from severely distressed market conditions and support the flow of credit to consumers and businesses. Nonetheless, the level of credit outstanding for households has been very slow to rebound and remains lower than it was at the onset of the crisis. The reasons for the slow rebound are, without a doubt, complex and multidimensional. Still, it is worthwhile to examine the data and try to understand why credit growth is not more robust.

For this forum, I have chosen to focus my discussion on factors affecting the overall movements in credit card debt. The bulk of revolving credit in the United States today is held in the form of credit card debt. As the financial crisis developed in late 2008, the aggregate amount of credit card debt outstanding began to fall. Revolving

credit has dropped every month since that time and is currently about 15 percent lower than it was at the time of the Lehman Brothers Holdings bankruptcy. Although our economy has experienced other long episodes in which revolving credit growth has slowed, we have never seen such a prolonged period of outright decline.

As overall consumer spending weakened significantly over the course of the recession and the early stages of the recovery, a proportionate decline in revolving credit used to finance purchases might actually have been expected. However, the decrease in revolving credit appeared to outpace the contemporaneous decline in spending during the recession, and, so far in the recovery, revolving credit has continued to decrease even as spending has turned up. This suggests that there are factors at work other than cyclical spending weakness. Within this context, it is helpful to consider the three main reasons that net borrowing--that is, the change in credit outstanding--can decrease: First, households can charge less on their revolving accounts; second, households can pay off a larger share of their balances each month; or third, households can default on (or lenders can charge off) their existing balances.

Taking the three factors in reverse order, consider first the role of cardholder defaults. As the economy weakened in 2008 and 2009, an increasing number of households found it difficult to pay their credit card bills on time. With nearly 10 percent of the workforce unemployed and many more underemployed, a significant number of households experienced sharply reduced incomes. Weakness in the housing market also contributed to financial strains, as many households could no longer easily tap into home

equity to consolidate their card debt and lower their monthly payments.[1] In this adverse economic environment, it is perhaps not surprising that the charge-off rate on credit cards more than doubled from about 4 percent in 2007 to more than 9 percent in 2009. The rate of charge-offs has since declined from its peak but remains elevated. All told, we estimate that the rise in charge-offs can account for about one-third of the net decline in revolving credit growth from 2007 to 2009.

Another possible explanation for the decline in outstanding balances might be that households, in an effort to repair their balance sheets *or* bring down their debt burdens, have begun paying down their credit card balances faster than usual. But, on the whole, the data do not indicate that faster paydown is a significant factor. Historically, households tend to repay their credit card balances at a faster rate during good economic times and tend to slow this rate when economic activity is weak. And, over the past several years, this tendency appears to have held up. In 2006, the rate of credit card repayment was well above its long-run trend, probably reflecting strong incomes as well as ample home equity that could be tapped to pay off more expensive card debt. However, beginning in 2007, as housing markets weakened and unemployment climbed, households began to pay off their card debt at a significantly slower pace--a trend that extended into 2008 and 2009 as the economic downturn worsened. All told, the drop in the payoff rate has been more pronounced than in the recessions of 1990-91 and 2000-01. More recently, however, this trend has reversed, and as of August 2010, the repayment rate had risen to a more typical level. While this increase likely reflects a gradual improvement in the ability of cardholders to repay their debt, it could also be attributed to

[1] On average since 2003, about half of the respondents to the Thomson Reuters/University of Michigan Surveys of Consumers who took cash out during a mortgage refinancing have reported using the funds to pay down other debt.

a shift in the composition of cardholders in bank portfolios toward more creditworthy borrowers as charged-off accounts were replaced with new accounts underwritten using stricter criteria. The bottom line is that accelerated payment rates on existing balances do not seem to have contributed importantly to the drop in credit card debt outstanding over the past couple of years.

Finally, consumers have been charging less on their credit cards. According to industry statistics, the amount of money charged on credit cards for purchases or cash advances fell around 10 percent between the third quarter of 2008 and the first quarter of 2010. This slowdown in new charges could be the result of a variety of factors. The significant overall drop in consumption during the recession no doubt cut into the demand for credit, as households simply opted to spend less than in the past. When they did spend, they may have been less willing to borrow to fund consumption given their experiences during the financial crisis, expectations for weaker economic conditions, and continued uncertainty about job prospects. Indeed, consumer preferences toward debt do appear to have shifted. Preliminary data from the 2007-09 Panel Survey of Consumer Finances (SCF) show a modest increase--from 35 percent in 2007 to more than 40 percent in 2009--in the share of households that believed that buying things on credit was a "bad idea." Further, those households whose views about buying on credit became more negative between 2007 and 2009 reported reducing their charges substantially more than other households. Consumers also appear to be seeking less new credit: Applications for new credit accounts, as recorded in data from the national credit bureaus, remain significantly lower than were observed for most of the past decade.

Credit supply factors have also likely contributed to the decline in overall credit card outstanding balances. Households may have charged less because they had less credit available. In the SCF panel, about 44 percent of households with credit card debt in 2007 experienced a reduction in their credit limits by 2009. Data from the national credit bureaus indicate that credit lines peaked in the third quarter of 2008 and continued to fall over the course of 2009 and 2010. The average dollar value of combined credit lines available to cardholders fell from a high near $26,000 per cardholder in late 2008 to around $21,000 per cardholder by the third quarter of 2010, a decline of about 20 percent. Moreover, SCF data indicate that changes in credit limits are indeed related to credit card spending: Among households whose credit limit declined, SCF data show that the median amount of monthly new charges fell from $200 in 2007 to $50 in 2009, while among households whose credit limit did not decline, the median amount of new charges rose from $150 to $200. Although this relationship is not necessarily causal, credit line restrictions have likely played at least some role in the reduction in credit card borrowing.

Looking further at the supply side of credit card debt, card lenders did report retrenching during the financial crisis. According to the Federal Reserve Board's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), large fractions of banks tightened standards and terms on new and existing credit card accounts throughout 2008 and 2009.[2] In recent months, however, some banks reported having eased standards somewhat. In the most recent survey, published in October 2010, about two-thirds of banks thought that credit standards for prime borrowers on credit card loans and other consumer loans either were at their longer-run averages or would return

[2] Results of the SLOOS are available on the Board's website at www.federalreserve.gov/boarddocs/SnLoanSurvey.

to them over the next two years. In contrast, for nonprime borrowers, more than half of the respondents thought that standards would remain tighter through at least 2013 or would not return to longer-run norms for the foreseeable future.

In addition to reductions in existing credit lines, new credit card account solicitations also fell considerably during the recession. By early 2009, offers to households for new credit cards had dropped to around one-fifth of their count in 2006. Card solicitations have turned up over the course of 2010, but they remain well below their pre-crisis levels. In addition, consistent with the SLOOS, the data on credit card offers show that solicitations to borrowers with lower credit scores are rebounding more slowly than those to borrowers with higher scores.

Interest rates may have caused some households to reduce their credit card usage even if unused credit lines remained available. Although credit card interest rates declined in line with broader interest rates early in the financial crisis, card rates diverged from the broader rate environment by reversing this decline during 2009. Some of the rate increase likely reflects a rise in charge-offs, which increases card issuers' costs of providing credit. However, the divergence from rates on other forms of credit that also experienced higher charge-offs indicates that a portion of the increase may have been in anticipation of regulatory changes, which I will discuss a bit later, that will restrict some card issuers' ability to reprice credit.

Overall, then, the available data lead me to conclude that, in large part, the decline in revolving consumer credit outstanding is due to a combination of higher charge-offs, tighter credit, and less consumer willingness to take on debt, but probably not to widespread increases in discretionary paydowns of existing debt.

Although households account for the vast majority of credit card loans and credit card spending in our economy, the market for small business credit cards has grown considerably over the past 10 to 15 years. After checking accounts, credit cards are the second-most-common financial product used by small businesses. Small business cards are structured to cater to business needs with features, pricing, and underwriting unique to their typical usage. Issuers provide several services specifically for small businesses, such as employee cards with customizable spending limits and detailed spending statements each month or quarter. Also, small business cards often have higher credit limits than personal cards to facilitate the higher spending needs of small businesses.

Small businesses are noticeably less likely than households to carry a balance on their cards. As of the end of 2009, 83 percent of small businesses used credit cards. Of those using credit cards, 64 percent used small business cards and 41 percent used personal cards. Despite the widespread *use* of credit cards, only a minority of small businesses--18 percent--reported *borrowing* on credit cards. In comparison, nearly one-half of households reported carrying a balance on their credit cards.[3] Thus, although most small businesses appear to use credit cards for transactions purposes, and perhaps as a source of short-term credit, the data suggest that only a small fraction of them rely on credit cards as a source of longer-term credit. Yet even if firms do not carry a balance, reductions in the size of their credit card lines may strain their cash flow and force them to cut spending or require them to use more expensive forms of short-term credit, such as trade finance.

[3] See the Federal Reserve Board's Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses (May 2010) at http://www.federalreserve.gov/pubs/reports_other.htm.

Changes in the Use of Payment Instruments

Consumer credit pricing and availability also appear to affect consumer preferences for different payment methods. When consumers decide how to pay for their purchases, they may have a variety of payment options to choose from, including cash, checks, debit cards, credit cards, prepaid cards, and even, increasingly, their mobile phones. The Federal Reserve has tracked changes in consumers' use of payment instruments in a number of studies over the past decade. These studies cast an interesting light on the effects that weakened economic conditions have had on the mix of payments.

The number of checks processed in the United States has been declining since the late 1990s, as consumers, businesses, and governments have shifted away from checks and toward electronic payment methods. The annual number of checks dropped from more than 40 billion in 2000 to 30 billion in 2006, and we expect the data for 2009 to show continued declines.

At the same time, the use of debit and credit cards has risen. Debit card payments, in particular, have grown remarkably: Between 2000 and 2008, the number of debit card transactions grew at an annual rate of more than 17 percent, while the value of debit card transactions grew 15 percent per year. Credit card transactions have grown at a slower pace than debit card transactions over the same period--about 2 percent per year in number and roughly 5 percent per year in value. For smaller-value payments, both types of cards, but especially debit cards, have served as substitutes for checks and, very likely, cash. Although the nature of cash makes direct measurement of aggregate cash payments difficult, we can infer a trend in usage from changes in the level of small-denomination currency that is most frequently used in cash payments. The amount of

small-denomination domestic currency in circulation has been steadily declining since the 1970s, leading us to believe that cash payments have similarly declined.

Most interestingly, the recent period of economic weakness appears to have caused some consumers to shift away from credit cards not only as a source of credit but also as a method of payment. As I said earlier, between late 2008 and early 2010, the value of credit card purchases declined 10 percent. In comparison, although the rate of growth in debit card use slowed during the recession, debit card transactions did not decline in either volume or value.

This shift from credit to debit makes sense from the perspective of the consumer. If credit is tight and consumption is contracting, consumers who are reluctant or unable to increase their debt levels can use debit cards to pay for current expenses out of current, rather than future, income. In addition, for individuals with existing credit card balances, interest must be paid on new purchases as well as on previous balances. Those individuals might seek to avoid interest charges on new purchases by using debit cards. This incentive is even stronger in the presence of higher credit card interest rates. Finally, some consumers might use debit cards to track their spending in real time when budgets are tight.

Regulatory Changes in Consumer Credit and Payments

In addition to the economic recession and recovery, the regulations governing consumer payment and credit products changed significantly in the past few years. So it is especially difficult to separate the effects of economic conditions from regulatory effects on credit and debit card usage.

In December 2008, the Federal Reserve issued rules that introduced new consumer protections and revised the disclosures that consumers receive in connection with their credit card accounts. Then, in May 2009, the Congress enacted the Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act, which contained additional provisions regarding credit cards and gift cards. Collectively, these rules have comprehensively overhauled the regulatory regime that applies to credit cards.

In large part, these reforms developed in response to concerns about the growing complexity of the products offered to consumers and concerns that consumers could not accurately assess the costs associated with their credit cards. To address these concerns, the Federal Reserve used extensive consumer testing to develop new disclosures to be provided with credit card solicitations and in periodic statements. These disclosures highlight key account terms and attempt to improve consumers' understanding of the costs associated with using their cards. The resulting disclosure requirements establish a new baseline for transparency in the credit card industry. In addition, the new rules ban certain practices that increase the cost of credit in ways that cannot easily be disclosed to consumers, such as double-cycle billing. The new rules also generally prohibit card issuers from increasing interest rates applied to existing balances and require issuers to provide adequate notice of higher rates to be applied to future balances.

It is too early to draw conclusions about the ultimate impact of these changes because many of the new requirements have been in effect only since earlier this year. For example, card issuers appear to have changed their credit card pricing and underwriting models as their ability to use penalty pricing has been reduced. And some of the reduction in new account solicitations may also be due in part to the regulatory

changes. But, in light of the concurrent changes in charge-off rates, economic conditions, and regulatory requirements, it is hard to separate the relative effects of each.

One way to assess the effects of regulation alone might be to watch the relative developments in business credit cards in comparison to consumer credit cards. Credit cards issued primarily for business or commercial purposes generally are not governed by the consumer protections in the Truth in Lending Act or the amendments to that act in the 2009 Credit CARD Act. Some observers have already expressed concern that some card issuers may be marketing business and professional cards to consumers in an effort to sidestep new restrictions. At the same time, some business owners and professionals might find the higher credit line availability or other terms offered on business cards to be more attractive than using their personal cards for business expenses. The federal banking agencies have sufficient supervisory and enforcement authority to ensure that issuers market and issue business cards only to borrowers who they have legitimate reason to believe are using them for business purposes. Generally speaking, the card issuer is responsible for determining whether an account is intended to be used for business or personal purposes, and indeed, business card applications commonly request information necessary to make this determination. The detailed information requested may include, for example, the type of business, annual revenue, age of the firm, number of employees, and tax identification number. The answers to these questions help verify that the applicant owns a business, as well as gauge the creditworthiness of the business.

Aside from credit cards, the regulatory landscape is also changing for other payment products. The Federal Reserve has recently issued regulations that prohibit consumers from being automatically enrolled in overdraft programs for overdrafts created

by automated teller machine withdrawals and one-time debit card transactions. In addition, new disclosures are required to help consumers understand the associated costs before they choose to opt into overdraft coverage. We have also implemented new protections under the Credit CARD Act that restrict the fees and expiration dates that apply to gift cards.[4]

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Federal Reserve to develop standards for debit card interchange fees and the routing of debit card transactions. I am aware of the high level of interest in this topic, and I recognize the importance of the statute and its implementation for the future development of the payment card industry. However, we plan to issue a proposal for comment soon, so I will not comment on any specific elements at this time.

Just as credit card products have undergone change in response to the new credit card rules, new regulations affecting debit card overdrafts and interchange fees are likely to result in some changes in deposit product pricing and design. For example, depository institutions have stated that they are reconsidering their ability to offer free or low-cost checking accounts if losses due to lower revenue from overdraft or interchange fees materialize. As the pricing of checking accounts changes, financial institutions and consumers may turn to certain types of reloadable prepaid cards as checking account alternatives.

The Future of Consumer Credit and Payments

While the pace of the economic recovery and the effects of new consumer regulations are strongly influencing lender and consumer behavior, the evolution in the

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[4] For more information on the new rules concerning credit cards and other payment products, see the "What You Need to Know" publication series, available on the Board's website at www.federalreserve.gov/consumerinfo/wyntk.htm.

consumer credit and payments landscape in the years ahead will be equally shaped by technological innovation.

Innovative product and system design in the payment card marketplace continues to produce new electronic payment products. For example, a growing number of consumers are using prepaid cards. Preliminary estimates from the Federal Reserve Bank of Boston's 2009 Survey of Consumer Payment Choice indicate that about one-third of consumers sampled reported having a prepaid card of some type.

Offering functionality similar to credit and debit cards, prepaid cards include a variety of products targeted to different groups of customers, from general-purpose reloadable cards that may serve as deposit account substitutes for the unbanked or the underbanked to more-limited-purpose products, such as gift cards, teen spending cards, or mass transit cards. In addition, as an alternative to checks, employers issue payroll cards to employees and numerous government entities make payments and issue benefits on cards. And of course, the idea behind prepaid cards is not limited to being in card form; their function also may show up in the form of codes, stickers, cell phones, and chips embedded in any number of other devices, with payments transferring across the debit card interchange system or automated clearinghouse systems. Depending on the card type, the issuer, the purpose of issuance, the payment collection network, and the form of access, payments made using prepaid cards or other devices may be governed by different regulations and interchange fee restrictions. Consumers cannot be expected to know these differences. It will be important for regulators to monitor, over time, the effect of differences in regulation and pricing restrictions to ensure that consumers are adequately protected regardless of their payment method preferences.

Other emerging payment methods, such as mobile payments, also show potential for broad adoption in the United States. Earlier this year, the Federal Reserve Board hosted a forum on consumer protection and education issues associated with mobile payment methods. The Reserve Banks, including the Reserve Bank of Philadelphia through the efforts of the Payment Cards Center, have also been active in soliciting information from industry participants on the roles that various players are taking on in U.S. mobile payments and the forces that are affecting the rate of adoption by card issuers, merchants, networks, telecommunication firms, consumers, and others. As of yet, mobile payments do not represent a meaningful percentage of overall consumer payments in the United States, but the Federal Reserve remains engaged in monitoring the emergence of this product to ensure that adequate consumer protections are put in place as the technology is adopted more broadly in the marketplace.

Conclusion

In closing, I encourage you to continue to push forward on research and policy work in the area of consumer credit and payments. The landscape is changing rapidly and dramatically in response to economic, regulatory, and technological developments. You have some very interesting conversations ahead of you during this conference and quite challenging work for the foreseeable future as these markets continue to evolve. I wish you great success in your work, and I thank you for inviting me to participate in this conference.