Missing Factors in the CFPB’s Analysis of Rising Credit Card Interest Rates

Francisco Covas and Gonzalo Fernandez Dionis | Sept. 15, 2022

A recent blog post published by the Consumer Financial Protection Bureau (CFPB) examined average credit card interest rates for borrowers that qualify as revolvers: borrowers that carry balances over multiple months. The spread of the average credit card interest rate relative to the prime rate went from 10 percent in 2017 to 13 percent at the onset of the COVID-19 pandemic. The CFPB post asserts that this increase cannot be explained by higher credit card loss rates or a rise in the share of credit card accounts with subprime scores. As a result, the blog post concludes that lack of competition in the credit card market could be a key factor in explaining rising average credit card interest rates for revolving accounts and credit card banks’ “outsized profits.”

This post shows that the CFPB’s analysis failed to account for several important factors that better explain the increased profitability of credit card banks during 2021 and the rise in interest rates of revolving credit card accounts during the period referenced in the CFPB’s post. First, we show that profits of credit card banks actually declined from 2011 to 2019, consistent with more competition in the credit card market. Furthermore, the increase in bank profitability in 2021 cited by the CFPB was largely driven by the adoption of a new accounting standard, combined with the decline in bank allowances for credit losses since their COVID-19 pandemic-era peak. It is somewhat surprising that the CFPB post did not recognize the accounting change.

An alternative explanation for the rise in the average credit card interest rate (relative to the prime rate) from 2017 on is that more fintech firms entered the broader market for consumer loans. According to a recent Federal Reserve Board report and several academic papers (see here and here), credit card borrowers have turned to personal loans—primarily from fintech lenders—to pay off credit card balances during the period of rising average interest rates on credit card loans. Also, the Federal Reserve’s Y-14M data show a sizable increase in the share of borrowers who pay their credit card balances in full each month during the same period, consistent with borrowers using personal loans to pay off credit card revolving balances.

Generally, all things being equal, increased competition should result in lower debt costs rather than higher costs, but all things are not equal here. Fintech loans are more likely to be available to consumers with higher credit scores. By cream skimming, fintechs have left banks with more risky customers who pay correspondingly higher interest rates. For instance, according to data from LendingClub, a popular fintech platform, loans used to pay off credit card balances have the lowest level of risk compared with loans for other purposes. This is consistent with fintech lenders being able to attract the most creditworthy credit card borrowers, lowering the average quality of the pool of households borrowing from banks.

As a result, the increase in interest rates of revolving credit card balances likely reflects a skew toward more financially constrained households that did not obtain loans to pay off credit card balances and therefore remained as revolvers.[1] Because these borrowers have higher probabilities of default, especially during an economic downturn, they are subject to a higher interest rate on their credit card balances, which would drive up the average interest rate for revolvers.

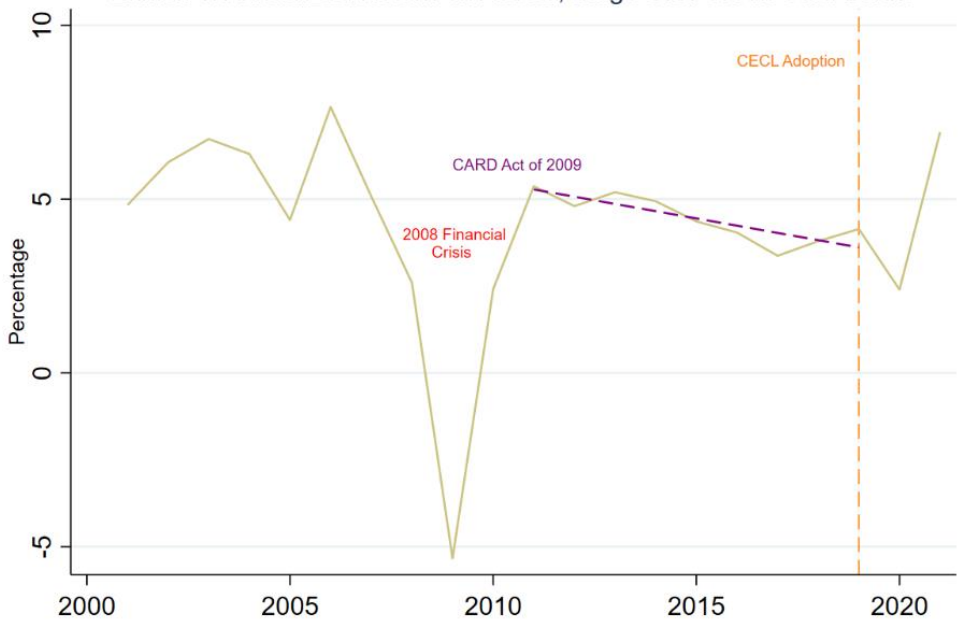
Profitability of Credit Card Banks

The main empirical finding of the CFPB post is that the interest rate on credit cards that assess interest each quarter rose between the second quarter of 2017 until the onset of the COVID-19 crisis.[2] This is the most relevant period, since during the pandemic average credit card interest rates were little changed on net. The CFPB post notes that interest rates moved higher despite the stability in the share of subprime credit card accounts. The CFPB post concludes that the increase in credit card interest rates can therefore only be explained by the lack of competition in the credit card market.

> In 2021, large credit card banks reported an annualized return on assets of near 7 percent—the highest level since at least 2000.

This statement has two flaws. First, 2021 is not the highest level of annualized return on assets since at least 2000. According to data from the Federal Reserve, the highest level occurred in 2006, with a level of 7.7 percent. But more importantly, the statement fails to acknowledge that the accounting standard for establishing the allowance for credit losses changed in 2020. That change had a significant effect on banks' reported profits, even holding revenue and expense constant.

Exhibit 1: Annualized Return on Assets, Large U.S. Credit Card Banks



Source: Federal Reserve Board, Profitability of Credit Card Operations of Depository Institutions (July 2022).

[1] The CFPB post shows the share of credit accounts with subprime scores was roughly constant between 2017 and 2019. If the most creditworthy revolvers received a personal loan from a fintech lender to pay off their credit card debt, they would move from revolvers to transactors. The share of credit card accounts with subprime credit scores would therefore remain unchanged.

[2] The rate for accounts assessed interest is the annualized ratio of total finance charges at all reporting banks to the total average daily balances against which the finance charges were assessed (which excludes accounts for which no finance charges were assessed).

Exhibit 1 presents the annualized return on assets of large credit card banks from 2001 to 2021 (from Table 1 data in the Fed's July 2022 report). Between 2011 and 2019, the profitability of credit card banks declined steadily. This decline is consistent with the regulatory limits on certain types of credit card fees introduced with the 2009 Credit Card Accountability Responsibility and Disclosure Act, and from increased competition in the credit card market. For instance, Agarwal et al. (2014) estimate that regulatory limits on credit card fees reduced overall borrowing costs by an annualized 1.6 percent of average daily balances.

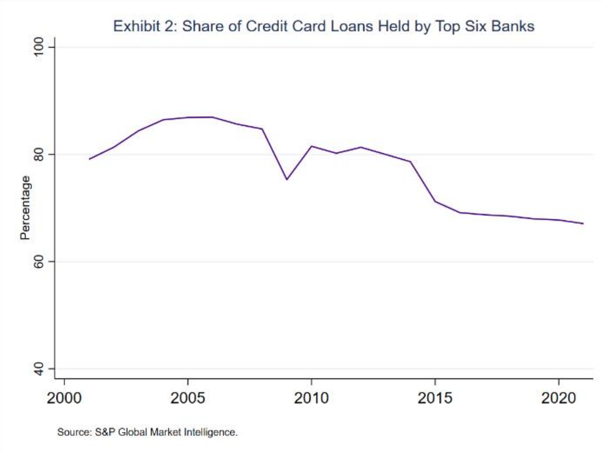
A drop in the profitability of credit card banks in 2020 was followed by a sharp increase in 2021. The explanation for the increase in the profits of credit card banks in 2021 is the passing of the COVID-19 crisis, combined with a change in accounting rules, also known as the current expected credit loss (CECL) standard. Under the CECL standard, a bank sets its allowance for credit losses equal to the current expected credit losses on outstanding loans over their entire remaining lives. At the onset of the pandemic, banks built their allowance for credit losses in anticipation of future losses, which caused bank profitability to fall. However, those losses failed to materialize due to the strong fiscal response to the pandemic that reduced defaults on credit card loans. As a result, the release of allowances for credit losses in late 2020 and in 2021 boosted the profitability of credit card banks. Indeed, this phenomenon is well explained in the Fed's credit card report on page 3:

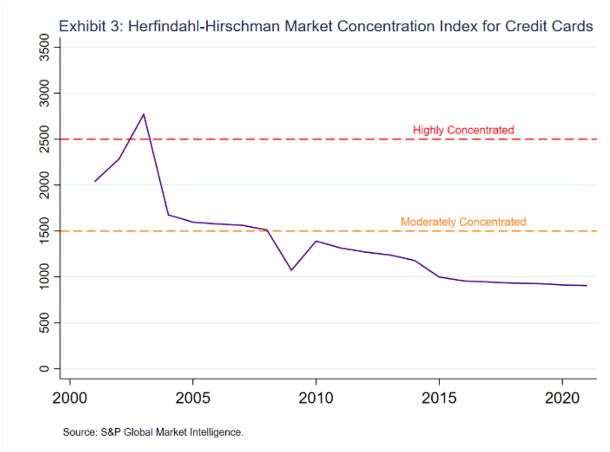
> The large increase in profitability in 2021 reflected several changes in expense and revenue items. First, the majority of the increase resulted from changes in provisioning for loan losses. As discussed in the 2020 report, after drastically expanding provision at the early stages of the COVID-19 pandemic to prepare for large potential credit losses, banks shrank their provisioning toward the end of 2020 as anticipated losses did not materialize. That trend continued in 2021 as provision fell to a historically low rate and supported a strong rebound in profitability.

As a result, the spike in bank profitability in 2021 was an anomaly likely driven by the adoption of CECL and the massive fiscal support from the U.S. government during the pandemic that suppressed defaults on credit card loans. Moreover, the increase in credit card interest rates started in 2017, and there was no discernible effect on the profitability of credit card banks around that period.

Competition Trends in the Credit Card Market

The consumer finance literature has established that the degree of competition in credit card lending is an important driver of profitability. Although the credit card market is still thought by some to be highly concentrated, the share of credit card loans originated by the largest lenders has declined significantly over the past 15 years. As shown in Exhibit 2, the share of credit card loans held by the top six banks declined from about 80 percent in 2011 to 67 percent in 2021.





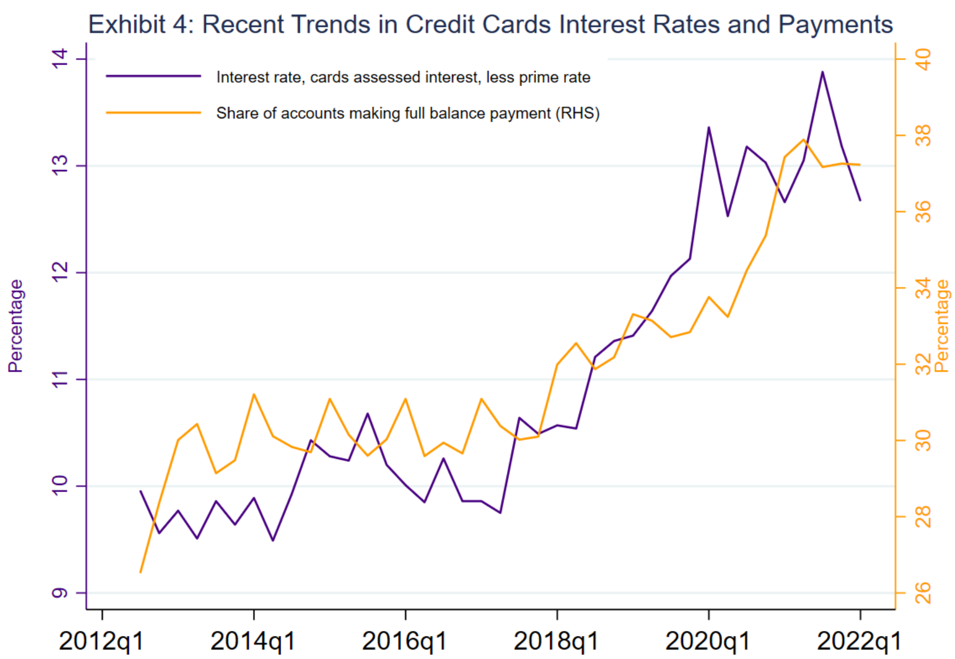
Likewise, the Herfindahl-Hirschman Index (HHI), a commonly accepted measure of market concentration, reflects a similar downward trend and has been below the "moderately concentrated" limit set by the Department of Justice for some time (Exhibit 3).

As a result, the increase in credit card interest rates after 2017 cannot be explained by a decline in competition in the credit card market.

Increased Competition from Fintech Lenders

The most likely explanation for higher credit card interest rates after 2017 is because of increased competition in the broader consumer loan market. During the period of rising average credit card interest rates, fintech lenders attracted some of the most creditworthy credit card borrowers away from banks by offering attractive terms on personal loans to pay off credit card debt. As these credit card borrowers moved from being revolvers to transactors, the average interest rate of the remaining card balances increased. Only the most creditworthy borrowers were able to refinance their credit card debt with personal loans, leaving less creditworthy consumers as revolvers subject to relatively higher interest rates, thereby increasing the average interest rate for revolvers.

This explanation is corroborated by the most recent Fed report on credit card profitability, which noted the recent trend of credit card borrowers relying on personal loans—typically from Fintech lenders—to pay off credit card balances and to consolidate debt. Several academic papers have used LendingClub data to demonstrate the importance of this trend. For instance, Jagtiani et al. (2020) show that credit card repayment and debt consolidation account for 80 percent of all loans originated in the LendingClub platform between 2007 and 2018. Moreover, both Jagtiani et al. (2020) and Đurović (2017) report that installment loans used to pay off credit debt or to consolidate debt are less likely to default than loans for other purposes.



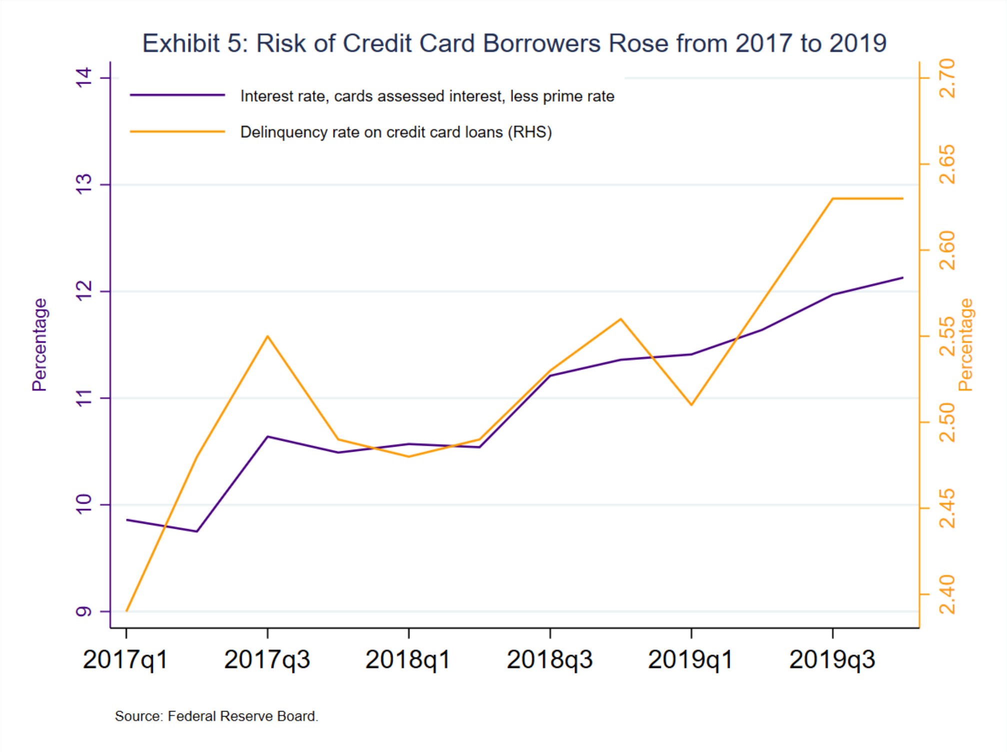
Source: Federal Reserve Board, Federal Reserve Bank of Philadelphia, FR Y-14M.

The overlap in recent trends in credit card interest rates (less the prime rate) and payments also offers supportive evidence that increased competition in the consumer loan market is driving the increase in the APR of credit card loans that revolve each month. As shown in Exhibit 4, the share of accounts making full balance payments each month closely matches the rise in the interest rate of credit card loans. More precisely, the share of transactor accounts increased from 30 percent in 2017 to 38 percent in 2021. Similarly, the interest rate on revolving accounts rose from about 10 percent to 13 percent over the same period. The increase in the share of accounts making full balance payment is consistent with borrowers relying on personal loans from Fintech lenders to pay off credit card balances.[3]

Consistent with a shift in credit card revolving balances toward riskier borrowers, Exhibit 5 shows a modest increase in the delinquency rate of credit card loans. Naturally, this increase is modest because it covers a period of strong economic growth and a declining unemployment rate. A recent post by Federal Reserve Board economists also analyzes the profitability of credit card banks during this period and finds that banks originated credit cards to riskier borrowers:

> . . . whereas NCM [net credit margin] was relatively flat before 2020, NCM excluding loan loss provisions was on an increasing trend, suggesting that banks originated credit cards to riskier borrowers who paid higher interest rates.

[3] One helpful addition to the FR Y-14M data published by the Federal Reserve Bank of Philadelphia is a time-series on the distribution of credit scores of revolving accounts.



Concluding Thoughts

Understanding recent trends in credit card usage and changes in credit card interest rates is important to determine if changes to the existing consumer regulations are needed. We would encourage the CFPB to conduct a deeper study on how recent trends related to credit card usage, such as debt consolidation and the emergence of buy-now-pay-later providers, are affecting the average interest rates on credit card loans, and adjust its analysis to reflect accounting effects. The analysis in this post indicates that the recent increase in credit card interest rates reflects originations of loans with higher risk rather than a lack of competition in the credit card market. Moreover, with fintech firms entering the broader consumer market, standard measures of credit card market concentration are understating the increase in competition for credit card loans.

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