

Higher bank costs are affecting low-income borrowers most

Equity Research

Low income borrowers affected most by higher bank costs

After analyzing the impact of higher capital requirements on loan growth in “Higher Capital Costs Hinder Loan Growth” (November 11, 2010), we turn to the consumer loan market where similar trends can be seen. Stiffer capital requirements, along with other regulatory measures that restrict banks’ income from certain products or prohibit banks from re-pricing existing credit risk, have raised the cost of consumer loans. Lower-income borrowers appear most negatively affected. The average credit card rates paid by these borrowers have soared far more than those paid by less risky borrowers, and these borrowers face more restricted access to credit, leaving many of them “under-banked” or “un-banked”.

The public sector is filling in for the private one

As US consumer credit has contracted, a substitution effect has occurred: the US government is the only lender who is expanding credit to consumers. In the mortgage market, the substitution effect has been more dramatic, with the GSEs accounting for over 90% of mortgage originations.

The rise of alternative payment networks

We expect prepaid card companies such as NetSpend (NTSP; Buy) and Green Dot (GDOT; Neutral) to benefit as customers are unable to get traditional banking services. In fact between 15 to 30% of pre-paid card customers are categorized as un-banked or under-banked by the FDIC.

A boon to dollar stores; a drag on big ticket (ex-autos)

Limited credit availability, among other factors, has caused lower-and middle-income consumers to “trade down” and delay purchases of big ticket items. A shift to dollar stores has, for instance, tempered Wal-Mart’s (WMT; Neutral) growth post the crisis. Further, mainstream durable goods retailers such as Best Buy (BBY; Neutral) and Sears (SHLD; Sell) have experienced subdued sales despite the economic recovery.

Captive financing arms drive a competitive advantage

Companies with captive financing arms could gain a competitive advantage by providing credit to customers who are unable to afford or access traditional bank credit. Ford (F; CL Buy) and auto retailer Carmax (KMX; Neutral) stand out as better positioned than their peers.

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Higher bank costs are affecting low-income borrowers most

As we wrote recently in “Higher Capital Costs Hinder Loan Growth,”¹ the global banking industry has faced higher regulatory capital requirements over the past 18 months, and further capital surcharges for systemically important financial firms may well be put in place.² In that report, we focused on the business loan market, where higher capital requirements have raised the cost of making loans. This change has, in turn, raised the costs faced by many corporate bank customers, particularly small and medium-sized businesses, and slowed loan growth. In this report, we turn our attention to the consumer loan market, where higher capital requirements and other regulatory measures have raised the price consumers – especially low-income borrowers – must pay for bank products.

Higher capital requirements reduce the amount of credit available

Higher capital requirements directly affect the amount of credit banks can extend. As capital requirements have risen, the amount of credit supplied by banks has contracted. Total managed loans – loans held by banks on their balance sheets, as well as in securitized form – have already declined by over 10% since peaking at over \$9 trillion in late 2008. They continue to decline at a rate of 1% to 4% per quarter³ – a trend quite contrary to the historical pattern, which normally sees loan growth returning within 50 weeks of the peak. This time, however, loan growth continues to decline more than 100 weeks past the peak.

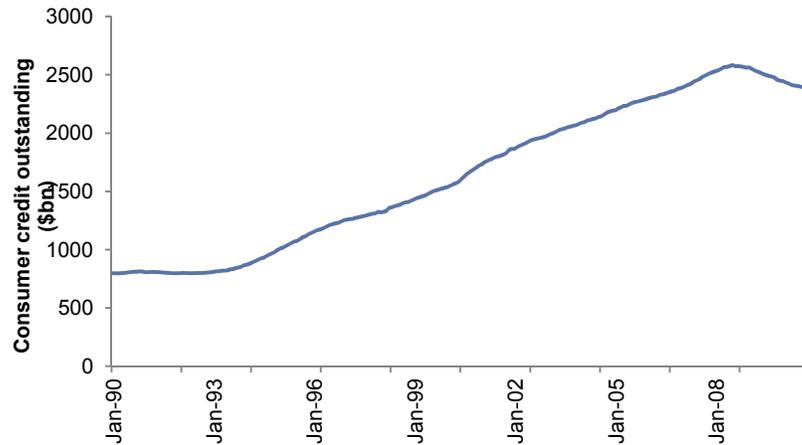
The contraction in US consumer credit has been particularly severe and has diverged sharply from the usual historical pattern. As we show in Exhibits 1 and 2, total US consumer credit has declined by 7% since peaking in mid-2008. Until the recent cycle, US consumer credit had not fallen in any year since at least the mid-1940s (when the data first became available). As we show in Exhibit 3, the contraction has been most pronounced in the revolving credit segment (e.g., credit cards), in which outstanding credit has fallen by nearly 20% since the peak. Net charge-offs in the revolving credit segment have been greater than in the non-revolving segment (e.g., student loans, automobile loans, etc.), which has declined by only 1% since the peak.

¹ “Higher Capital Hinders Loan Growth,” was published on November 11, 2010 by Richard Ramsden, Charles Himmelberg, David Greely and Anne Brennan.

² In the United States, the required minimum for tier one common capital has risen from the 4% required in the May 2009 US Treasury “stress test” to the 7% level announced by the Basel Committee in September 2010. The effective minimum continues to rise, with recent capital raises by European banks as well as requirements set by Swiss regulators pointing to nearly 10% as the new standard. In addition, there may be as-yet unspecified capital charges for financial firms that are determined to be systemically important.

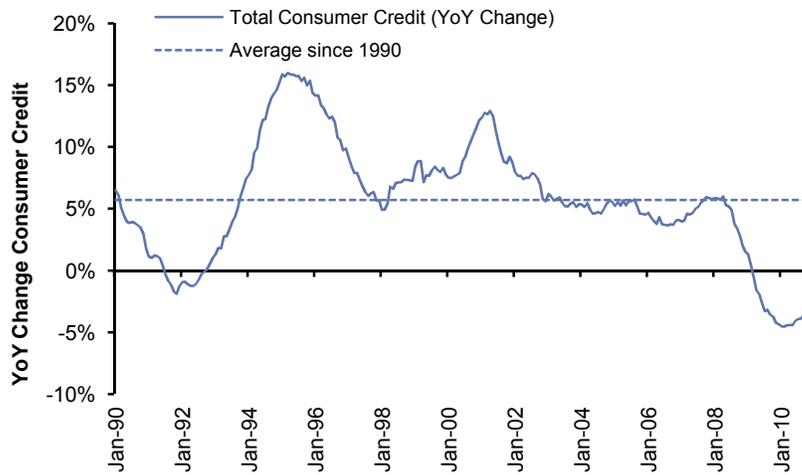
³ Of the \$1 trillion reduction in loans that has occurred thus far, C&I loans and credit card loans accounted for \$380 billion, with net charge-offs (the net value of loans that are deemed unlikely to be repaid) accounting for another \$300 billion. Within the net charge-off category, the bulk of the reductions have come from loans that are secured by one-to-four family properties and from consumer loans, especially credit card loans.

Exhibit 1: Total US consumer credit has declined by 7% since mid-2008



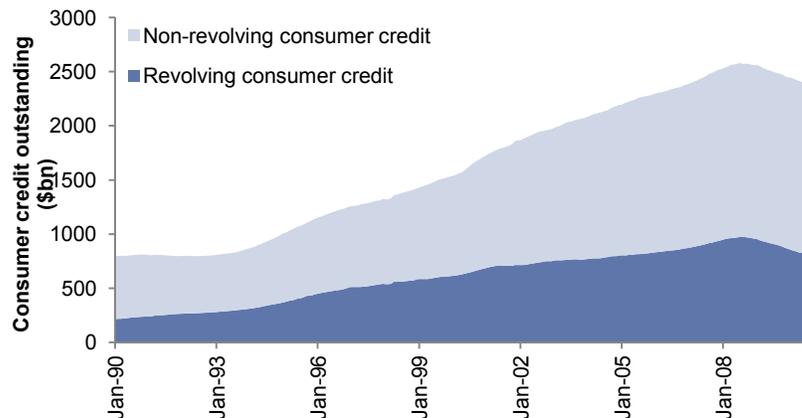
Source: Federal Reserve, Goldman Sachs Research.

Exhibit 2: Consumer credit has fallen at an unprecedented rate recently
yoy change in consumer credit outstanding



Source: Haver Analytics, Goldman Sachs Research.

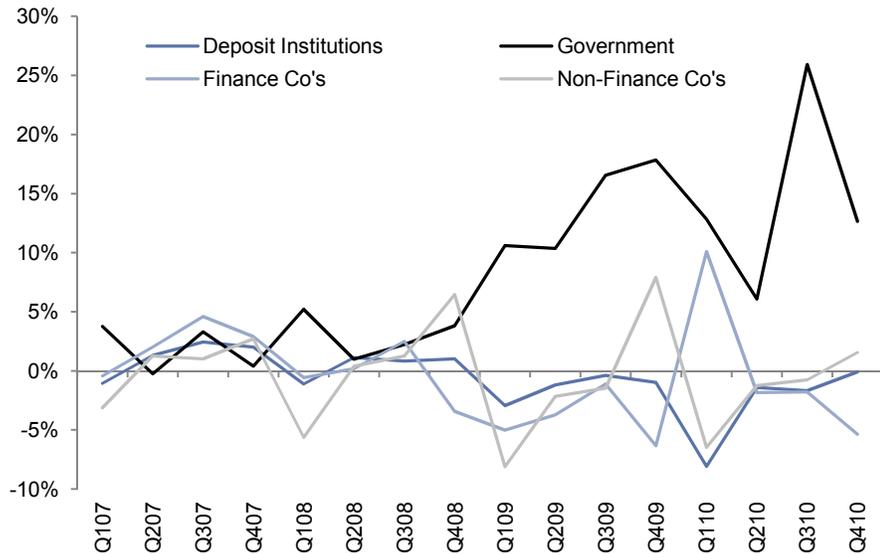
Exhibit 3: The largest decline in credit has been in revolving credit



Source: Federal Reserve, Goldman Sachs Research.

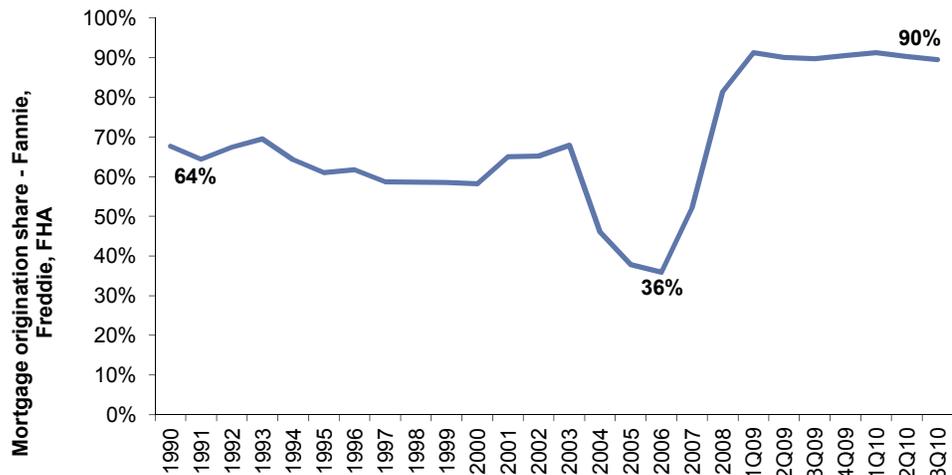
The decline in bank lending has been accompanied by an expansion of public-sector lending to consumers. Of the \$2.4 trillion in US consumer credit currently outstanding, banks account for around 65% of the total,⁴ while the US government and other institutions account for the remainder. Before the crisis, the banks' share had been closer to 75%. Thus we have seen a substitution effect as banks' ability to lend to consumers has been constrained. In fact, the only type of lender that has expanded credit to consumers has been the US government, as we show in Exhibit 4. A similar but even more dramatic substitution effect has occurred in the mortgage market, where the Government Sponsored Enterprises (GSEs) now account for roughly 90% of new mortgage originations, up from a longer-term historical average of around 60% (see Exhibit 5).

Exhibit 4: The government has been the only entity growing consumer credit



Source: Haver Analytics, Goldman Sachs Research.

Exhibit 5: GSEs now account for 90% of new originations



Source: Inside Mortgage Finance.

⁴ Consumer credit in this context includes revolving (mainly credit card) and non-revolving (mainly student and auto) consumer credit as defined by the Federal Reserve.

Bank credit will continue to contract if capital requirements rise further. We estimate that every 100 basis point (bp) increase in tier one common capital above current levels will require US bank balance sheets to contract by an aggregate of roughly \$1.5 trillion. This translates into a reduction in the amount of credit banks would otherwise be able to lend of about \$840 billion.⁵

Higher capital requirements and new regulations translate into higher costs for many bank customers

Stiffer capital requirements are not the only issue behind higher lending costs. Other new regulations are providing further upward pressure. One important additional factor is the 2009 Credit Card Accountability, Responsibility and Disclosure Act (CARD Act). Although the CARD Act does much to protect credit card users, it also makes it difficult for banks to dynamically re-price credit cards in response to changes in customer risk profiles. This forces banks to charge more to all customers based on the likelihood that they become riskier in the future.

Additionally, Regulation E, which requires consumers to opt-in for overdraft fees, has had similar effects. Namely, it has caused banks to offset the Regulation E-driven reduction in deposit margins by raising prices on other products. So too has the Durbin Amendment to the Dodd-Frank Act, which requires credit card providers to reduce by more than 75% the fees charged to merchants whose customers use debit cards. In response, most banks are considering raising fees (e.g., requiring account minimums) and reducing product features (e.g., eliminating rewards programs).

Banks pass on the higher costs they face to their customers in order to maintain their returns on equity (ROE). In the pre-crisis world, US banks averaged a full-cycle ROE of about 14%.⁶ While global capital providers may be willing to accept slightly lower returns from banks in the post-crisis world, there is a limit to how low these returns can be, as capital providers can and will allocate capital to sectors with higher returns.

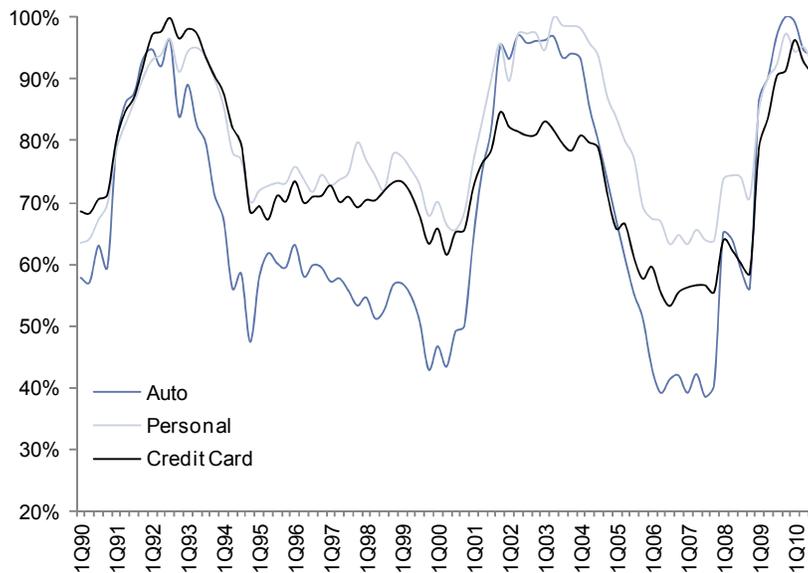
These trends can be seen in Exhibit 6, which shows that spreads across consumer products have increased rapidly since the beginning of 2008, and they remain at peak levels today. Credit card rates are at an elevated spread of 13% versus the historical average of 10.5%. So too are automobile and personal loan spreads of 6% and 10%, versus historical average spreads of 4% and 9%, respectively. In fact, our work shows that the same quality borrower would pay 500 bp more for a credit card loan today than before the crisis.⁷

⁵ Our analysis assumes that bank credit is risk-weighted at 56% of assets.

⁶ We use the FDIC's US average bank ROE from 1992 through 2006 of 14%.

⁷ We estimate credit card pricing controlling for quality of borrower by taking industry credit card spreads and then assuming that prime borrowers are generally 300 bp below this level, near-prime borrowers are at this level and subprime borrowers are therefore the plug. Based on these assumptions, spreads are 500 bp higher today for all borrowers than in years prior to this cycle.

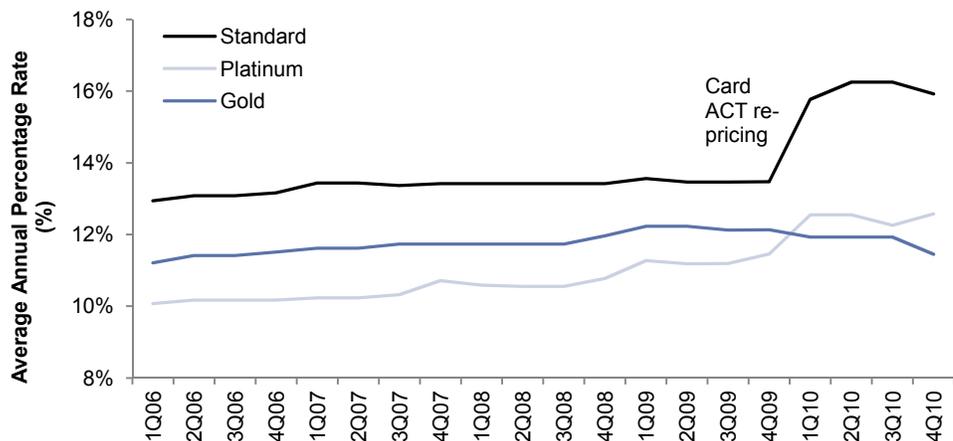
Exhibit 6: Consumer lending spreads are at historical highs across the board
 lending spread over 3 month LIBOR indexed to peak levels



Source: Federal Reserve, Haver Analytics, Goldman Sachs Research.

Low-income borrowers appear to be feeling the impact of higher borrowing costs disproportionately. As we show in Exhibit 7, the average Annual Percentage Rate (APR) charged to “standard” credit card borrowers has soared in the past few quarters, growing nearly twice as fast as rates paid by less-risky platinum and gold borrowers. The APR for a standard borrower now stands at nearly 16%, roughly 400 to 500 bp higher than the rate paid by higher income or less risky borrowers, versus the historical spread of 270 to 320 bp.

Exhibit 7: Low-income borrowers face substantially higher credit card rates



Source: Bloomberg, Bankrate, Goldman Sachs Research estimates.

Low-income borrowers face restricted access to credit

Low-income borrowers are hurt not only by the higher cost of borrowing but also by more limited access to credit. Their difficulty in gaining access to consumer credit is visible in Exhibit 8, which shows that credit card loans to sub-prime borrowers have shrunk twice as much as loans to other borrowers since 2008. This trend can also be seen in Exhibit 9,

which shows that prime credit card loans have grown from 44% of bank credit card portfolios in 2005 to 48% today, despite the fact that the share of the US population considered to be sub-prime borrowers has risen by 150 bp over the same timeframe.

Exhibit 8: Sub-prime loan shrinkage is even more pronounced
after adjusting for the shift in US population towards subprime credit scores

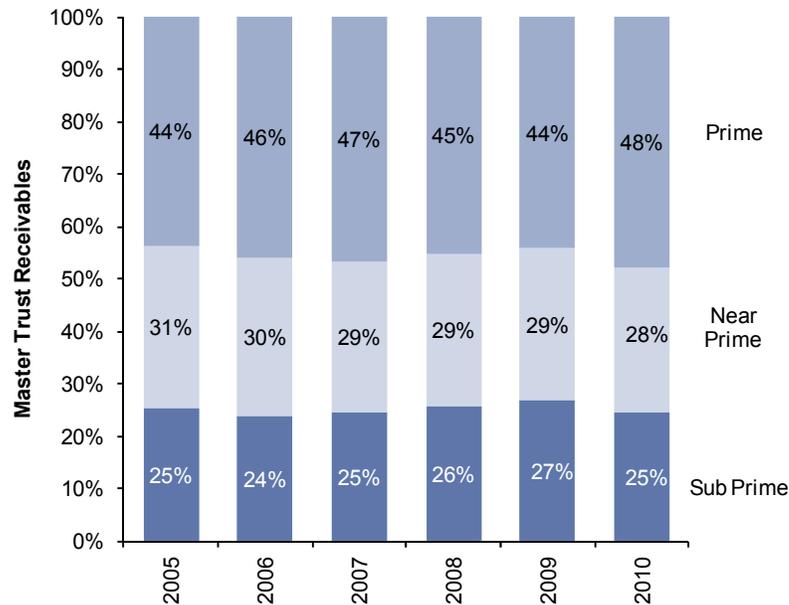
Subprime as % of US Population	
2008	24%
2010	26%
FICO "drift" to subprime	150 bp

Subprime Card Core Growth	
2008 % of cards	26%
2008 cards outstanding	958
2008 subprime cards	245
2010 % of cards	25%
Adjust for FICO drift	150 bp
2010 % adjusted for FICO	23%
2010 cards outstanding	832
2010 adjusted subprime card	193
Growth as % of starting	-21%

This is 2X the shrinkage of the rest of the credit card market

Source: FICO, company data, Goldman Sachs Research estimates.

Exhibit 9: Credit card books shifting composition towards prime borrowers
and away from sub-prime and near-prime borrowers



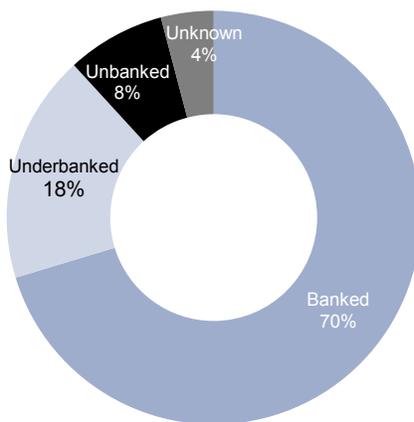
Source: Company data, Goldman Sachs Research estimates.

The impact of higher cost and restricted access to consumer credit on US companies

Alternative sources of financing and payment methods are growing

As a result of contracting credit availability for low-income borrowers, a significant number of US households are now considered either “under-banked” (defined by the FDIC as households with a bank account who rely on alternative financial services for funding) or “unbanked”⁸ (see Exhibit 10). These households tend to use money orders, non-bank check cashing services, payday loans, rent-to-own agreements, pawn shops and refund anticipation loans as alternative sources to traditional bank financing. Payday lenders, for example, have benefitted substantially from this trend. As we show in Exhibit 11, the three public US payday lenders have grown their loan balances by nearly 150% since early 2006, even as overall credit has contracted. The price of this type of financing is typically nearly 20X more than the price of traditional bank loans.

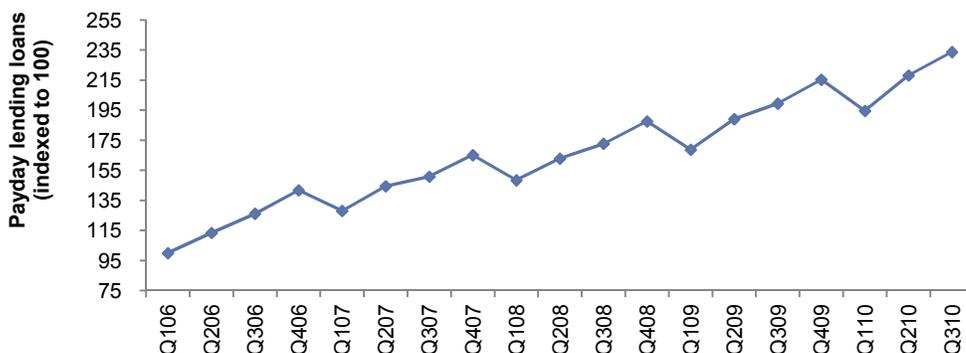
Exhibit 10: A significant number of US households are either under-banked or un-banked



Source: FDIC National Survey of Unbanked and Underbanked Households, Goldman Sachs Research.

Exhibit 11: Pay-day lenders have been the beneficiary of declining sub-prime credit availability

aggregate gross loans for World Acceptance Corporation, Cash America Intl and EZ Corp, Inc.



Source: SNL Financial, Goldman Sachs Research estimates.

⁸ The under-banked survey was only a recent FDIC initiative, done as part of Census legislation, so we have no historical basis for comparison.

Prepaid benefitting from limited access to traditional debit services

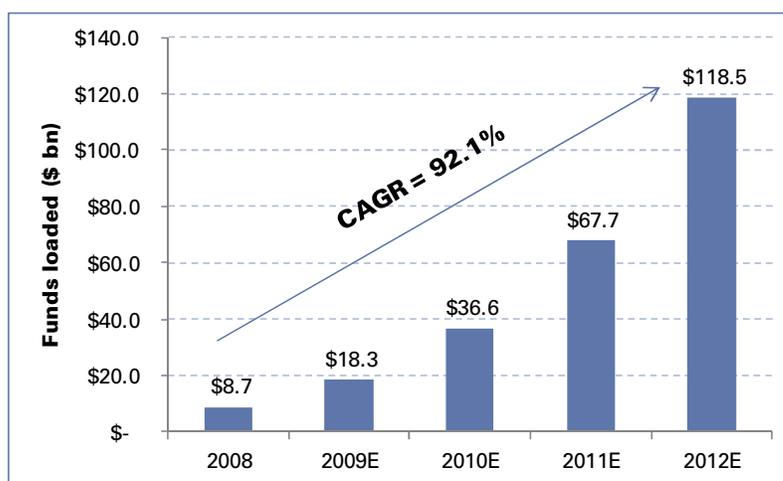
Prepaid card companies, including NetSpend (NTSP, Buy) and Green Dot (GDOT, Neutral) are also benefitting from these trends. These companies serve as prepaid “program managers” that administer General Purpose Reloadable (GPR) card programs that allow customers to deposit cash into FDIC-insured accounts and then access this cash using Visa or MasterCard-branded debit cards that function like traditional debit cards. Because low-income consumers lack access to traditional banking services – like checking accounts and credit cards – they tend to be significant users of these prepaid cards: between 15% and 30% of pre-paid card customers are categorized as “unbanked” or “under-banked” by the FDIC.

PayPal, for example, uses a prepaid service for customers who cannot access traditional checking account or credit card services. Customers can use cash to purchase MoneyPak, a prepaid product offered by Green Dot for a fee of about \$5⁹ at traditional retailers that are part of Green Dot’s network, such as Wal-Mart and CVS. Customers can then load these funds directly onto their PayPal account to make online purchases.

As we show in Exhibit 12, growth in prepaid cards has been robust and appears likely to remain so. This growth, coupled with the potential for fee generation, has attracted the attention of traditional banks. As such, some banks may roll out new prepaid card products or convert some of their existing debit card holders over to prepaid cards in an effort to make up for fees lost elsewhere due to regulation. Alternatively, they might elect to partner with established prepaid program managers in an effort to ensure a faster and smoother rollout. Still, early movers like NetSpend and Green Dot should remain well-positioned given their exclusive distribution partnerships, the near-ubiquity of their load and reload networks, and their now-familiar brands.

There are some near-term concerns surrounding the prepaid card market to consider, including proposed legislation that would increase disclosures and limit fees charged by prepaid card providers as well as uncertainty around oversight by the CFPB. However, given the political environment, such legislation appears unlikely to pass in its existing form, if it passes at all.

Exhibit 12: Total funds loaded on US GPR products, 2008-2012E (92.1% CAGR)



Source: Mercator Advisory Group.

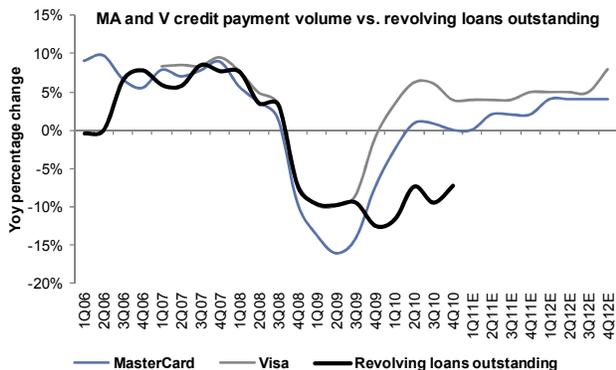
⁹ Paypal requires that no more than \$500 to \$1100 and no less than \$20 be added to the Green Dot product.

More affluent “transactors” drive credit card volumes for Visa and MasterCard

US credit card client activity has snapped back modestly for Visa (V; Buy) and Mastercard (MA; Buy) well ahead of a recovery in overall revolving loans (see Exhibits 13 and 14). This quick recovery is being driven not only by secular growth in electronic payment methods, but also by high transaction volumes from more affluent customers.

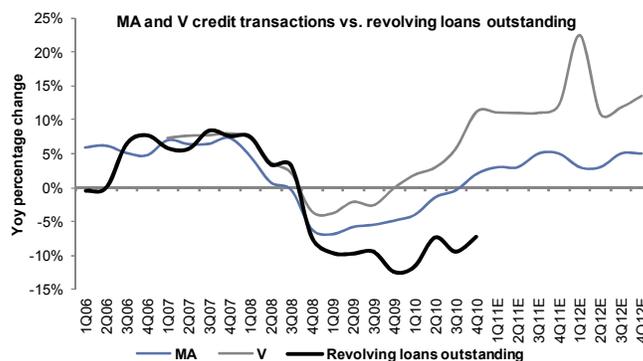
These affluent customers – known as “transactors” – typically pay off their balances monthly but use their credit cards frequently to benefit from points, rewards and the other features usually available on premium cards. For Visa, for example, “transactors” account for roughly 50% of transaction volumes. Visa and Mastercard generate fees largely from transaction dollar volumes and actual card swipes at the point-of-sale. As such, they are not affected if their customers choose to revolve their credit card balances (rather than transact and pay off each month) but they do benefit from high affluent-customer transaction volumes. They are therefore likely to continue to grow even if the supply of revolving credit remains stagnant.

Exhibit 13: MA/V US credit payment volume vs. revolving loans outstanding



Source: Company data, Haver Analytics.

Exhibit 14: MA/V US credit transaction volume vs. revolving loans outstanding



Source: Company data, Haver Analytics.

Mid-tier broadline retailers appear to be losing ground

The higher cost and limited availability of credit, in addition to the high unemployment rate, appear to have caused lower- and middle-income consumers to “trade down.” As a result, mass market discount retailers have been losing ground and some big-ticket hardline retailers such as Sears also continue to see weakness. Autos have been an exception, with OEMs such as Ford benefiting.

This trend is reflected in surging “dollar store” same-store sales, running at roughly 7% over the past two quarters (see Exhibit 15). Even as “dollar stores” are doing well, mid-range discount retailers, such as Target (TGT; Buy) and Wal-Mart, have experienced only a tepid rebound with barely positive aggregate growth in 2009 and 2010, though we expect Target to break out of this trend given powerful internal initiatives. Consumers who may have previously relied on credit to shop in these mid-range stores are now likely using cash instead to shop at lower-end stores.

Sales for auto parts retailers, which tend to benefit in the aftermath of slower new car purchases as average car ages rise, are also surging: our weighted average same-store sales index for the three largest auto parts retailers increased 5% in 2009 and an estimated 7% in 2010 after six years of 0% to 3% growth.

While mid-tier retailers are losing ground to the low-end, high-end retailers remain resilient. This is because high-income consumers not only continue to be able to access credit, but they are also benefiting from a rebound in financial assets, allowing them to generate strong spending growth. As such, sales at high-end department stores have rebounded nicely, with same-store sales growth running at roughly 6% over the past two quarters. Growth in this segment is outpacing same-store sales growth overall.

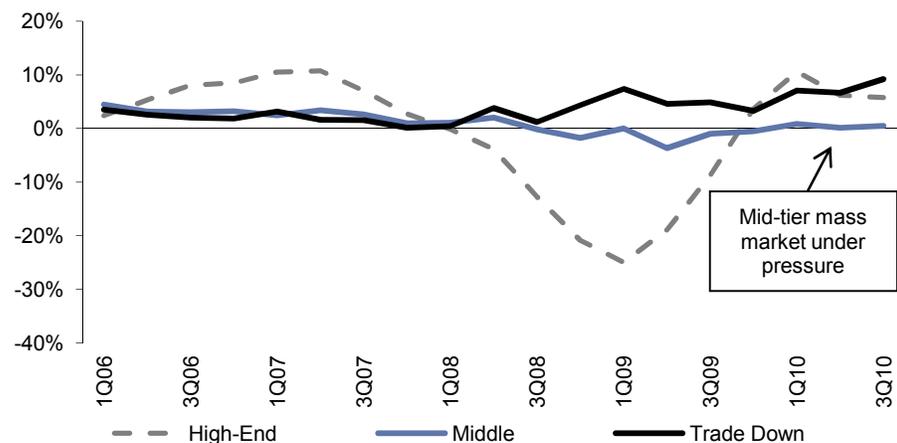
Many big-ticket hardline retailers are also being negatively affected

Mainstream retailers of big-ticket durable goods have also been impacted by higher cost and less available consumer credit. After a few years of substantial top-line pressure, retailers such as Best Buy (BBY; Neutral), Home Depot (HD; Neutral), Lowe’s (LOW; Buy), and Sears Holdings (SHLD; Sell), for example, continue to experience subdued sales trends despite signs of an improvement in the broader economy (see Exhibit 16). Customers who once charged big-ticket items like flat screen TVs and home goods are now restricted by costlier and less-available credit. Continued weakness in the housing market is another significant contributor to lackluster demand for big-ticket items, and the home price outlook remains subdued, with the Goldman Sachs US Economics team expecting prices to fall by another 5% through the end of 2011.

Auto sales appear to be an exception to the trend of weak big-ticket sales. Reasonable auction values have led to higher recovery rates, and modest charge-offs throughout the cycle have emboldened auto lenders to re-enter the market. Auto sales growth has thus been outperforming other big-ticket areas more recently (other than the tough comparison associated with “cash for clunkers” in the late summer of 2010; see Exhibit 16). We expect continued double-digit growth in auto same store sales over the next several quarters as this trend continues. We would further note that anecdotal evidence from automakers and dealers suggest that the prime market remains healthy, while constraints still exist in the subprime and leasing segments of the market.

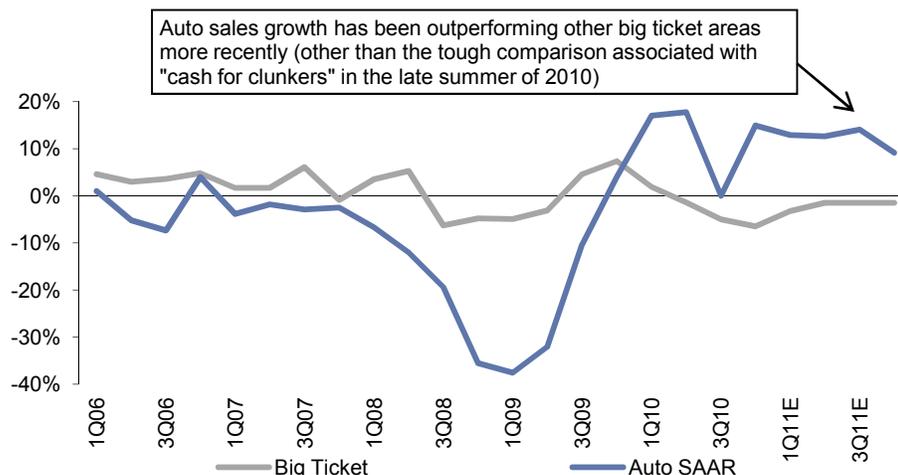
Exhibit 15: Mid-tier retailers appear to be losing ground; while low-end retailers remain resilient

High-end includes JWN, SKS, NMG and TIF. Middle includes WMT and TGT. Trade down includes DLTR, FDO, AAP, AZO and ORLY



Source: Company data.

Exhibit 16: Auto sales appear to be an exception to the trend of weak big-ticket sales
 Big ticket includes HD, LOW, SHLD and BBY



Source: Company data.

Companies with captive financing arms could differentiate themselves

Companies that have captive financing arms could gain a competitive edge by providing credit to customers who are unable to afford or access traditional bank credit, and who would otherwise be unable to purchase any goods or services. Competitors who cannot offer reasonably priced financing may find themselves losing share as a result. Examples of companies that cater to the consumer market and derive a significant percentage of their earnings from their financial segments include, among others, Harley-Davidson (HOG; Sell), CarMax (KMX; Neutral), Ford (F; Buy), Target (TGT; Buy), Wyndham (WYN; Neutral), Nordstrom (JWN; Neutral) and Marriott (MAR; Buy; see Exhibit 17).

Exhibit 17: Examples of companies that derive a significant % of their earnings from their financial segments

Financial Segment Earnings as a % of Total		
Company	Ticker	%
Harley-Davidson, Inc.	HOG	36%
CarMax Inc.	KMX	35%
Ford Motor Company	F	33%
Target Corporation	TGT	13%
Wyndham Worldwide Corp.	WYN	11%*
Nordstrom, Inc.	JWN	9%
Marriott International	MAR	6%*

* Denotes percentage of revenue where earnings are not available.

Source: Company data, Goldman Sachs Research estimates.

Pricing information for rated stocks mentioned in this document:

Best Buy Company, Inc. (BBY; Neutral; \$35.14); Ford Motor Company (F; CL Buy; \$17.89); Green Dot Corp. (GDOT; Neutral; \$63.20); The Home Depot, Inc. (HD; Neutral; \$37.16); Harley-Davidson, Inc. (HOG; Sell; \$39.43); Nordstrom, Inc. (JWN; Neutral; \$41.56); CarMax Inc. (KMX; Neutral; \$32.06); Lowe’s Companies, Inc. (LOW; Buy; \$25.56); Mastercard Inc.

(MA; Buy; \$241.54); Marriott International (MAR; Buy; \$39.87); NetSpend Holdings, Inc. (NTSP; Buy; \$13.98); Sears Holdings Corp. (SHLD; Sell; \$77.57); Target Corporation (TGT; Buy; \$55.95); Visa Inc. (V; Buy; \$71.58); Wal-Mart Stores, Inc. (WMT; Neutral; \$57.26); Wyndham Worldwide Corp. (WYN; Neutral; \$29.15).

Pricing is as of the market close of January 25, 2011.

Reg AC

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