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Credit lender–borrower relationship in the credit card market – Implications for credit risk management strategy and relationship marketing

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A B S T R A C T

Lehman Brothers filed for bankruptcy in 2008, precipitating the international financial crisis. Many questioned the banks' risk-taking credit system. Understanding credit risk and how the credit system functions may provide knowledge on managing credit, to avoid another such international crisis. We study the credit card field and present a pricing decision model for managing credit risk. Recent credit lenders' portfolio re-pricing practices call for immediate attention to the credit lender–borrower relationship and relationship marketing. A literature review and recent phenomena in the credit card industry reveal that the lenders' re-pricing strategy negatively affects the credit lender–borrower relationship and relationship marketing. Thus, we introduce a pricing decision model incorporating the lenders' re-pricing strategy and the credit lender–borrower relationship. Further, we discuss the implications of, and the role of marketing in, credit risk management and the implications of relationship marketing for credit lenders in foreign markets, including the US market.

1. Introduction

Consumer credit constitutes a significant part of banking. Although all consumer credit is quite limited in comparison to corporate credit, the amount of consumer credit makes it at least as important to monitor as corporate credit. A particularly significant part of consumer credit is credit cards, which have developed into a dominant and rapidly expanding method of payment. For instance, according to the credit card research firm CardHub.com (2011), Americans added $18.5 billion to their debt load in the second quarter of 2011, representing a 66 percent increase from the debt they had accumulated in the same quarter of 2010, and a 368 percent increase as compared to 2009. Furthermore, the debt in the third quarter showed a staggering increase of around $16.8 billion, which is 154 percent higher than the increase observed in the same quarter in 2010 and 58 percent higher than the increase in the same quarter of 2009.

However, credit card lending is not only a US phenomenon. It is a global one operated by transnational companies in collaboration with national banks. In this way, the card industry plays a significant role in the international financial system, which must be kept in mind in times of financial crisis. We can thus note that in recent years, after a couple of years of diminishing credit card loan losses, consumers are becoming slightly less responsible with their credit cards (Ellis, 2011). A recent report from the United States showed that late payments among customers of some of the country's major credit card issuers have been rising since June 2011 (Money.cnn.com, 2011). According to the report, with the exception of Capital One, the delinquency rates of American Express, Discover, Chase, and Bank of America in September 2011 had increased from those in August 2011. Instead of worrisome debates on the tools and remedies for unrealized damages, these companies might reap the resulting increase in late payment fees. However, the credit lenders are well aware that this can easily turn against them, and soon. Therefore, this calls for immediate attention to the recent credit lenders' portfolio re-pricing practices that have raised their interest rates to cover their losses.

Against this background, this paper focuses on re-pricing in the credit card industry. In so doing, it uses the relevant literature and particularly provides empirical evidence from the US market – a vital part of the world's international financial service industry. The paper shows that this strategy affects the credit lender–borrower relationship negatively. To support the finding, we introduce a pricing decision model to incorporate the re-pricing strategy of credit lenders and the credit lender–borrower relationship. The implications for credit risk management and the role of marketing in credit risk management are discussed.

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Moreover, the implications of relationship marketing are discussed for the credit lenders in foreign markets.

2. Delinquency issues

2.1. Delinquency and interest rates

Delinquency has been the subject of various studies on consumer credit, and it has been highlighted as one of the determinant factors of consumer interest rates (Avery, Calem, & Canner, 2004; Coffman & Chandler, 1983; Edelberg, 2006) and a reflection of the credit quality of a loan portfolio (Sullivan, 1987). In addition, delinquency has been studied in the presence of credit rationing and adverse selection (Stavins, 2000; Stiglitz & Weiss, 1981). Musto and Souleles (2005) discussed it in relation to their portfolio view of consumer credit, where delinquency is a subset of covariance risk, on which the aggregated volatility of a portfolio of loans depends. Delinquency has also been a popular topic from the perspective of household bankruptcy (Ausubel, 1997; Canner & Luckett, 1990; DeVaney & Lytton, 1995; Gross & Souleles, 2002; Sanchez, 2008; Stavins, 2000). However, few studies have discussed delinquency in terms of its effect on credit lenders' loan portfolio re-pricing strategies and the resulting impact on existing credit borrowers' repayment burdens.

2.2. Delinquency vs. revenue

In consumer lending businesses, such as credit card or personal lending businesses, revenue is a current indicator of business performance. Meanwhile, delinquency is a lagging indicator of loss to business performance. The delinquency rates on the current loan portfolio (a collection of credit lenders' loans) do not affect today's profit, but will eventually have a negative effect on future earnings by being rolled over to the charge-offs (i.e., credit losses). Credit lenders have options for dealing with delinquency. These include strengthening collection activities (phone calls and letters) and providing incentives for repayment (partial and delayed repayment and additional loans). However, such efforts require a continuous high level of management of the collection activities, and they fail to recover one fourth of the previous month's delinquencies (Coffman & Chandler, 1983). Therefore, until the delinquent account is charged-off at 180 days-past-due (DPD), credit lenders must bear the delinquency costs. Fig. 1 illustrates how a delinquency generates the lagging effect on business performance. If a credit card owner spends X dollars now, he or she will owe an amount of X dollars with a monthly interest rate of r (i.e., $X + (X \times r)$). If he or she fails to pay the amount due in the next month and keeps failing to repay the loan until 180 DPD, the credit card firm eventually received the unearned revenue of $[X + (X \times r)(1 + d)^5]$ due to the delinquency after 180 days from the first due date.

2.3. Mitigating unrealized losses

The upward trend of the delinquencies of credit card companies has two major causes: the national or regional economic environment and the expansion of credit offerings by the lenders. According to Sullivan (1987), delinquencies in consumer credit portfolios dynamically change, not simply with shifts in credit management policies but also with macroeconomic conditions affecting the ability of consumers to repay debt. In addition, according to Avery et al. (2004), adverse temporary economic or personal shocks, such as income disruptions, are important factors influencing payment performance even after accounting for an individual's *ex-ante* credit. Dell'Ariccia and Marquez (2006) observed the recent trend in consumer loan markets and showed that as banks obtain private information about borrowers and as information asymmetries across banks decrease, the banks may loosen their lending standards, leading to equilibrium with

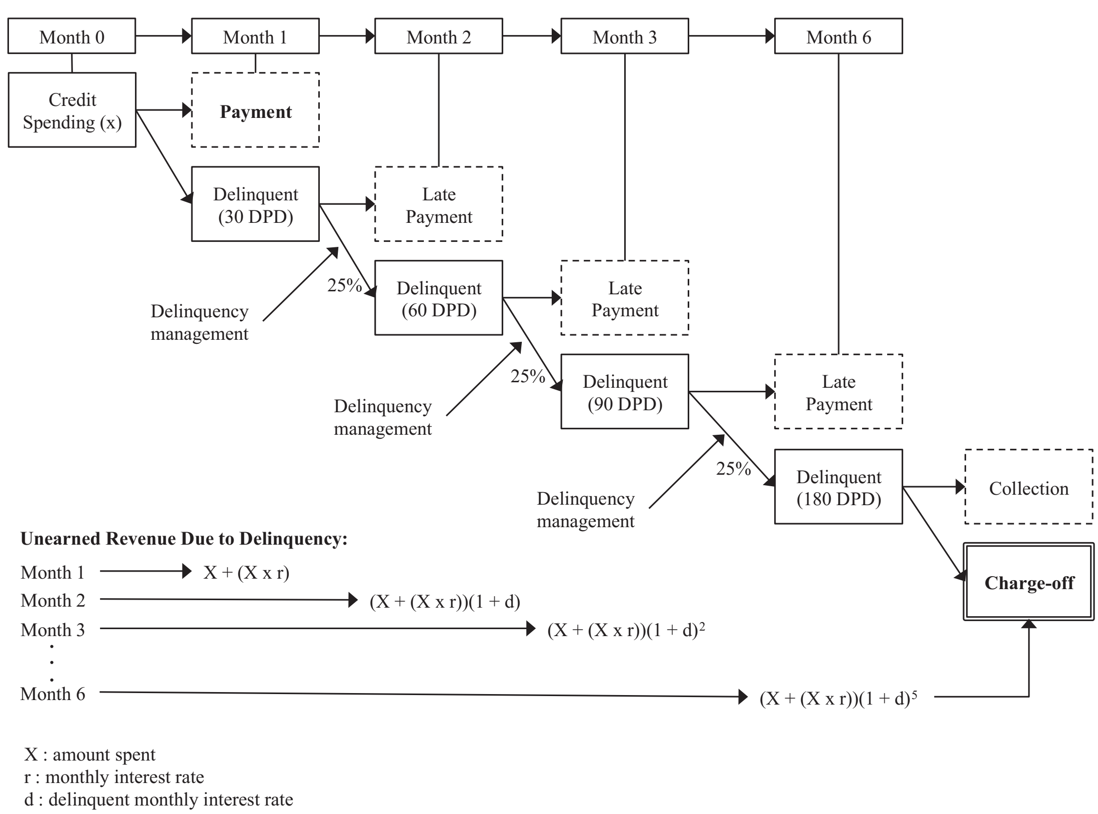

Fig. 1. Credit spending, delinquency, charge-off, and unearned revenue.