



The cost of being late? The case of credit card penalty fees

Nadia Massoud^{a,*}, Anthony Saunders^b, Barry Scholnick^c

^a Schulich School of Business, York University, Toronto, Canada

^b Stern School of Business, New York University, New York, NY, United States

^c School of Business, University of Alberta, Edmonton, Alberta, Canada

ARTICLE INFO

Article history:

Received 26 August 2009

Received in revised form 2 December 2009

Accepted 10 December 2009

Available online 14 January 2010

Keywords:

Credit cards

Penalty fees

Late payment fees

Interest rate

ABSTRACT

This paper is the first in the literature to examine the determinants of US credit card penalty fees. Many critics of credit card fees – including a number of US Senators – have argued that credit card penalty fees reflect banks' market share. Using a unique data set we find that fees are increasing in customer risk which supports the position of defenders of penalty fees, such as banks. However, our finding that fees are increasing in a bank's market share is consistent with the concerns expressed by politicians and regulators. We also find card penalty fees are direct substitutes for card interest rates.

© 2010 Elsevier B.V. All rights reserved.

1. Introduction

The current financial crisis has had a significant negative effect on consumers' welfare globally. With banks limiting home equity lines, gas and food bills on the rise and homeowners struggling to make their mortgage payments, consumers are turning to credit cards to make ends meet. At the end of 2008, Americans' credit card debt reached \$972.73 billion, up 1.12% from 2007 (Nilson Report, April 2009).¹ Many, however, are finding their cards more expensive to use as credit card companies increasingly raise interest rates, raise card fees, lower credit limits and cancel inactive accounts. The interest rate on the card with the largest balance (or on the newest card, if no outstanding balances existed) rose 1%, to 12.5% (Federal Reserve Survey of Consumer Finances, February 2009) and late fees reached up to \$39 per incident (Consumer Action credit card survey, July 2008). In the last 12 months, 15 percent of American adults have been late making a credit card payment (National Foundation for Credit Counseling, 2009 Financial Literacy Survey, April 2009).

Moreover, this trend is also occurring internationally with 20% of British adults incurring a penalty fee in 2008, and some 5.7 mil-

lion charged a penalty fees more than three times in that year (2008 UK Financial News). Interestingly, during this economic downturn, British credit card supplies collected £213 million in penalty charges in 2008, while according to R.K. Hammer, a consultant to the credit card industry, the penalty fees from credit cards in the US will add up to about \$20.5 billion in 2009 (New York Times, September 2009). However, such fees are of less concern in countries of Scandinavia, France and Italy where debit cards are more prevalent than credit cards.

Yet despite of the importance of the issue the literature has been quiet on important aspects of the pricing structure of credit card debt, especially as to the determinants of credit card penalty fees that are generating such considerable revenue for card suppliers. Two such fees that have caught the attention of both regulators and politicians are late fees and overlimit fees. The rising level of these penalty fees and their impact on consumers has been prominent in recent public policy debates in the US. For example, as part of his 2004 Presidential campaign, John Kerry called for credit card penalty fees to be regulated. In January 2007 the Chairman of the Senate Banking Committee, Senator Chris Dodd, at a hearing over rising credit card fees said he was "putting the industry on notice that if it doesn't improve practices on its own, legislation may be warranted" (Associated Press, 7 March 2007). In March 2007, Senator Carl Levin said he is "threatening possible legislation to outlaw them (card fees) as a spur to the banking industry for voluntary changes" (Associated Press, 7 March 2007). In July 2008 the New York Times reported that new credit card regulation (includ-

* Corresponding author at: Schulich School of Business, Finance, York University, 4700 Keele Street, Toronto, ON, Canada M3J 1P3.

E-mail addresses: nmassoud@schulich.yorku.ca (N. Massoud),

asaunders@stern.nyu.edu (A. Saunders), Barry.Scholnick@ualberta.ca (B. Scholnick).

¹ In comparison, to the net issues of US debt securities during 2007 it was 1.154 trillion (IMF report on Global Financial Stability, October 2008).

ing the regulation of card fees) was becoming much more likely because Congress believed that lack of regulation in the mortgage market had resulted in the mortgage crisis (5 July 2008).² Indeed, in response to the 2007–2009 financial crisis, the US Senate has proposed the establishment of a Consumer Protection Agency to oversee issues such as the level of credit card penalty fees.

Despite the significant public policy interest in card penalty fees as well as the large dollar magnitudes involved, this is the first paper in the literature to focus specifically on their determinants. Indeed, until now, the credit card literature has focused almost exclusively on credit card *interest rates* and not on *penalty fees* (e.g. Ausubel, 1991; Brito and Hartley, 1995; Calem and Mester, 1995; Stango, 2000; Stango, 2002; Knittel and Stango, 2003; Berlin and Mester, 2004; Calem et al., 2006)³ (see Scholnick et al., 2008 for a survey).

Credit card penalty fees, however, serve a very different function than interest rates. Penalty fees are essentially a way that banks use to extract rents from (or to “punish”) only those borrowers who exceed their contractual obligations (by being late or over-limit), while interest rates are charged to all borrowers who use their credit cards and do not repay the full amount on receipt of their credit card bill. Furthermore, penalty fees are imposed only when a consumer is late or overlimit independent of dollar value.⁴ By comparison, card interest charges are increasing functions of both time and amount borrowed. Two different types of penalty fee are commonly charged by banks; late fees which are charged when borrowers repay after their due date and overlimit fees which are imposed when borrowers charge amounts that are larger than their pre-approved limits. For example, Chase Manhattan in 1998 charged a \$20 overlimit fee and a \$20 late fee while in 2002 it charged a \$28 overlimit fee and a \$28 late fee. A credit card borrower can be either late with a payment (i.e. a time dimension to the loan) or have charged an amount over their preauthorized limit (i.e. a dollar dimension to the loan) or both (in which case both the late and overlimit fees would be applied). Importantly, in this paper we focus only on credit card *penalty fees* charged to consumers as a punishment for being late or overlimit and not other fees such as the fixed annual fees paid up-front by all holders of specific cards (i.e. annual membership fees), or for certain services associated with a credit card (e.g. travel rewards, etc.).

The main contribution of this paper is to investigate the determinants of credit card penalty fees. The standard argument is that the price of credit card debt should be positively related to a consumers’ default risk. Such an argument has been proposed by those who defend penalty fees, in particular the American Bankers Association (2005) (henceforth the ABA) who have argued that penalty fees compensate banks’ for increased credit card default risks. Furthermore, in describing the fee structure of credit cards, Furletti and Ody (2006b, p. 18) argue that card fees consumers pay are “based on their risk”. Until now, however, no formal empirical study has been undertaken to examine whether consumer default risk is a determinant of credit card penalty fees. Evaluating whether penalty fees are based on risk is especially important, given recent public policy

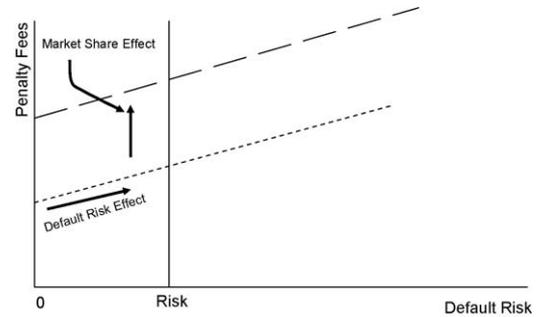


Fig. 1. The relationship between penalty fees, default risk and market share.

debates on the determinants and size of these fees.

In order to account for potential rent extraction behavior by banks, we examine whether penalty fees are also related to a bank’s credit card market share. The issue of larger banks being able to exploit their size and market share has played an important role in the banking literature in general. However, research on whether market share is related specifically to bank fees is much more limited, see for example Hannan (2006). Stripped to the basics we examine whether: (1) penalty fees are positively related to consumer default risk and (2) whether for any *given* level of default risk an increase in bank credit card market share also increases fees (see Fig. 1).

In addition to the determination of credit card penalty fees we also examine the relationship between such fees and card interest rates. A finding that card penalty fees and interest rates are substitutes, i.e. penalty fees increase when card interest rates go down, implies that banks may simply be changing the composition of their card pricing structure by charging higher fees while lowering card interest rates. A finding that card fees and interest rates are substitutes could imply that if regulators impose a ceiling on card fees, then banks might respond by raising card interest rates.

The outline of the remainder of the paper is as follows. In Section 2 of the paper, we provide further evidence of the importance of credit card penalty fees to banks by analyzing the impact of various proposed changes in card penalty fee regulations on US banks stock returns and market values.

In Section 3 of the paper, we provide empirical tests of three hypotheses. The first is that penalty fees are positively related to consumer default risk, the second is that card penalty fees are direct substitutes for card interest rates, while the third relates to the positive impact of bank credit card market share on the level of penalty fees. In Section 4 of the paper, we test these hypotheses using a unique data base developed from a number of primary sources. The core of our data base is the TCCP (Term of Credit Cards Plans) data base collected by the Federal Reserve. In addition we utilize a number of other data bases, including Bank Call Reports and the American Bankruptcy Institute consumer bankruptcy database, to derive measures of consumer risk, credit card market share and consumer income. Using three different econometric methodologies (2SLS, 3SLS and GMM) in order to control for endogeneity, we find strong support for our theoretical hypotheses concerning the effects of risk, market share and card interest rates on penalty fees.

2. Credit card penalty fees and banks’ equity market values

In order to motivate the importance of credit card penalty fees for banks, in this section we analyze the impact of the US Supreme Court’s *Smiley v. Citibank* case in 1996 on US bank equity market values. The *Smiley* ruling was a landmark decision regarding credit card penalty fee regulation. In addition, we analyze the mar-

² Moreover, the issue of credit card fees has gained prominence in the national press, with headlines claiming: “Credit Card Fees Can Suck You In”, USA Today (2006), “Credit Card Penalties, Fees Bury Debtors”, Washington Post (2005), “Credit Card Fees become Cash Cow”, USA Today (2004) and “Credit Card Firms Collect Record Level of Late Fees” Wall Street Journal (2002).

³ Other papers have used Credit Card data to examine topics such as personal bankruptcy (Gross and Souleles, 2002a; Domowitz and Sartain, 1999), liquidity constraints (Gross and Souleles, 2002b) and factors affecting the growth of bank credit cards (Peterson, 1977).

⁴ Furletti and Ody (2006b) report that until 2002 banks charged a single “flat” fee irrespective of how late or overlimit the card account was. After 2002 banks began to charge “tiered” fees. We discuss this issue below in our data section.

متن کامل مقاله

دریافت فوری ←

ISIArticles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات