NORTH-HOLLAND

Review of Financial Economics 13 (2004) 179–198

RFE
Review of Financial Economics

www.elsevier.com/locate/econbase

Credit card rates and consumer search☆

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Abstract

Credit card rates have tended to be higher and stickier than other loan rates but have fallen over the past decade. Some argue this decline is due to a reduction in consumer search costs. Our evidence suggests search costs are not the best explanation for the decline. We test whether consumer search models explained credit card pricing in the 1980s when search costs were thought to be significant. We find that the distributions of rates were inconsistent with those derived from many models of search. Proposals for stricter disclosure requirements may have less effect on equilibrium credit card rates than intended.
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JEL classification: G2; G1; D83; L1
Keywords: Credit cards; Consumer search; Interest rates

1. Introduction

Credit card interest rates have tended to be higher and stickier than other types of loan rates, and the credit card business has tended to be more profitable than other parts of a bank's business. For example, Ausubel (1991) found that during the 1980s, bank credit card operations earned three to five times the rate of return earned overall in the banking industry. From 1982 to 1986, market interest rates declined rapidly and continuously, yet credit card rates remained remarkably stable. In

☆ The views expressed here are those of the authors and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or of the Federal Reserve System.

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1058-3300/$ - see front matter © 2003 Elsevier Inc. All rights reserved.
doi:10.1016/j.rfe.2003.06.001

the eyes of many consumer groups and some legislators, banks unwillingness to lower credit card rates despite declining funding costs was suspicious. Suspicion soon gave way to demands for federal legislation to supplement the seemingly weak competitive pressures on card-offering banks. The more extreme proposals required usury ceiling linked to some measure of bank funding costs, while the more moderate remedies sought to impose standardized disclosure requirements on banks to increase the information available to consumers. The argument was that issuers were able to charge high credit card rates partly because it was difficult for consumers to get information that made it easy to compare rates across cards. Thus, reducing these search costs through disclosure might result in more competitive pricing. In November 1988, proponents of disclosure won the day as the Fair Credit and Charge Card Disclosure Act, an amendment to the Truth in Lending Act, was signed into law.[1]

However, the act did not appear to resolve the issue of high credit card rates. As discussed in Calem and Mester (1995), between May 1989 and November 1991, even though the prime rate dropped from 11.5% to 7.5% and the interest rate on large-denomination CDs fell from around 9% to 5%, bank credit card rates barely moved, with the largest issuers holding their rates fixed at 18–20%.

Since the early 1990s, there have been several changes in the credit card market. Issuers have switched from charging fixed to variable rates. The average rate paid has fallen to around 14–15% in 2002; however, the spread between credit card rates and those on other loans has been relatively stable. There have been significant changes in the way credit cards are marketed, with many more solicitation mailings. These solicitations often include introductory low teaser rates and offer balance transfer checks, making it easier for customers to switch their outstanding balances to a new card. Affinity cards were also introduced, and important new issuers including the AT&T Universal card and Discover card entered the market (for further discussion, see Calem, Gordy, & Mester, 2003). In addition, technological changes have affected the market. The Internet has made it easier to search for products and to compare rates. Risk-management technologies, e.g., credit scoring models, are being used by issuers to manage risk.

Since there are numerous issuers of credit cards, one might expect pricing to be competitive. Yet the slow response of credit card rates to changes in money market rates is consistent with imperfect competition. It is still debatable whether recent changes in the pricing structure and technological changes resulted in (or are the result of) increases in competition in the credit card markets.

As discussed in Calem and Mester (1995), Ausubel (1991) argues that the industry deviates from the perfectly competitive model because cardholders do not conform to the behavioral assumptions of perfect competition. He suggested that deviations from the outcome of the perfectly competitive model could result from the following: (1) consumers facing search costs; (2) consumers facing switching costs; and/or (3) firms facing an adverse selection problem if they were to unilaterally reduce their interest rates. Calem and Mester presented empirical results that suggested that each of the three factors contributed to the performance of the credit card market. In particular, using the 1989 Survey of Consumer Finances (SCF) data, they found that credit card indebtedness was inversely related to an individual's propensity to comparison shop "for the best terms" on loans or

[1] Under the act, credit card issuers are required to disclose the annual percentage rate, fees, grace period, and method of calculating balances in all solicitations and applications. This information must also be reported to the Federal Reserve, which makes it available to the public on request.

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