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Switching costs and adverse selection in the market for credit cards: New evidence

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Abstract

To explain persistence of credit card interest rates at relatively high levels, Calem and Mester (AER, 1995) argued that informational barriers create switching costs for high-balance customers. As evidence, using data from the 1989 Survey of Consumer Finances, they showed that these households were more likely to be rejected when applying for new credit. In this paper, we revisit the question using the 1998 and 2001 SCF. Further, we use new information on card interest rates to test for pricing effects consistent with information-based switching costs. We find that informational barriers to competition persist, although their role may have declined.

JEL classification: D82; G2

Keywords: Credit cards; Consumer switching costs; Search; Adverse selection

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1. Introduction

Persistence of credit card interest rates at relatively high levels has been the subject of lively debate. Simple explanations based on consumer search have not generally been supported by the data. Berlin and Mester (2004) find that consumer search costs were likely not adequate to explain imperfect competition in the credit card market. They found that the distributions of credit card rates in the 1980s, a time when search costs were thought to be significant, were inconsistent with those derived from many models of search. Ausubel (1991) documented rate stickness and the persistence of high issuer profits during the 1980s. He proposed an adverse selection model in which low-risk consumers underestimate their likelihood of borrowing, and thus are less sensitive to interest rates than high-risk consumers. In this case, card issuers would be discouraged from competing on interest rate, because a rate cut would disproportionately attract high-risk borrowers.

Calem and Mester (1995) proposed an alternative explanation of persistence in credit card rates. They argued that such persistence is consistent with imperfect competition for high-balance customers that is tied to information-based barriers to switching between issuers. In particular, switching costs may arise because card issuers cannot readily distinguish between applicants intending to switch and those intending to accumulate more debt, implying that high-balance customers may have difficulty qualifying for new credit. Adverse selection effects may compound these switching costs because those seeking to accumulate more debt are likely to have the stronger incentive to respond to a solicitation. For example, they may have been denied higher credit limits by their current issuer on the basis of private information.

Calem and Mester (1995) found general support for these theories using data from the 1989 Survey of Consumer Finances (SCF). They found that households with larger balances were more likely to be rejected or to be granted a lower-than-desired credit limit when applying for new credit, and thus might have found it difficult to switch from one card issuer to another. In addition, they found that credit card borrowing was inversely correlated with a household's willingness to comparison shop for loans and deposits.

Much has changed in the credit card industry since 1989. In particular, advances in credit scoring technology and data quality have led to widespread use of automated systems for the prescreening and solicitation of card applicants. Proponents claim that these advances improve issuers' ability to judge creditworthiness and lower evaluation costs. Moreover, marketing innovations, such as the development of affinity card programs, may have improved issuers' ability to target solicitation activity to higher credit-quality borrowers. If so, then the economic significance of information-based barriers to switching should be reduced, enabling the market to become more competitive.

Existing evidence on whether the market has evolved in this direction is mixed and somewhat difficult to interpret. On the one hand, anecdotal evidence concerning the introduction of balance transfer checks coupled with offers of teaser rates suggests that the cost of switching among cards may be lower now. Crook (2002) and Kerr and Dunn (2002) used data from the 1998 SCF to revisit Calem and Mester's (1995) analysis. Using the later data, they find no relation between search behavior and credit card balance, consistent with reduced barriers to searching and switching and, hence, a more competitive market structure. On the other hand, the rapid expansion of solicitation activity and new card issuance in the mid-1990s was accompanied by unexpectedly large increases in delinquency rates (Ausubel, 1999; Gross and Souleles, 2002), consistent with information-based switch-