The Value of Credit Cards

A White Paper on Credit Cards and Their Associated Advantages

Michael A. Turner, Ph.D.

PERC
RESULTS AND SOLUTIONS

August 2012

The Value of Credit Cards

A White Paper on Credit Cards and Their Associated Advantages

Michael A. Turner, Ph.D.

August 2012

Acknowledgments

We wish to thank the American Bankers Association (ABA) for their grant that enabled us to undertake this research. In addition, we wish to thank Joseph Duncan, Walter Kitchenman, and Whytney Pickens for their insights, input, and edits to this series of white papers.

Table of Contents

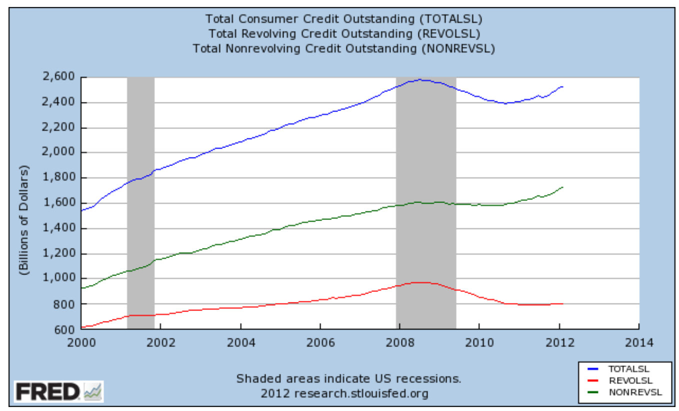
Introduction

Both the Great Recession and the consumer credit crisis at its core have focused attention on different forms of consumer credit. This is an understandable response, as lawmakers seek to understand the causes of the financial crisis to inform policy decisions. Despite years of delving into the events and the numbers leading up to and following the crisis, we have yet to reach a consensus about what led to the financial meltdown or even about the sources of consumer distress. We know that consumer debt increased substantially from the early 1990s to the eve of the crisis in 2008, and we are now witnessing some degree of rebalance by households. But in the absence of a deeper understanding of what specific credit instruments do and how they have been behaving in the period after the crisis, we run the risk of regulation that stifles growth and makes the lives of consumers more difficult.

Revolving credit and credit cards are among the more poorly understood credit instruments. Many of the popular assumptions about credit cards—that they enable profligate spending and generate their own dynamic of escalating debt service burdens—are often misleading. They obscure some of the more important aspects of how consumers see credit cards and the role credit cards play in the economy.

Figures 1 and 2, which show trends in use and delinquencies, reveal a story slightly different than one suggested by popular assumptions.

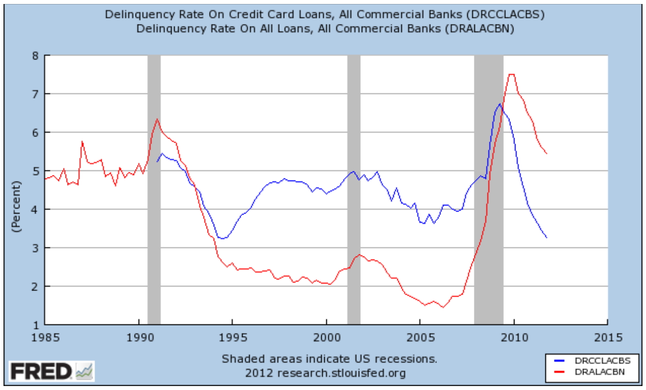
Figure 1: Trends in Credit Use, 2000-2012



Source: Federal Reserve Bank of St. Louis

Figure 1 charts total consumer credit outstanding (blue line), total nonrevolving (or other forms of credit than a credit card) credit outstanding (green line), and total revolving credit (or credit card) outstanding (red line) since 2000. Total revolving credit outstanding has declined since the recession and, unlike non-revolving credit, it has not bounced back.

Figure 2: Delinquency Rates by Lender



Source: Federal Reserve Bank of St. Louis

Figure 2 shows delinquency rates on all commercial bank loans (red line) and on all commercial bank-issued credit cards (blue line). For roughly 10 years, delinquency rates on credit cards were significantly higher than the delinquency rate for all loans. This relationship changes in 2010 at the end of the recent recession. In fact, it almost reverses, with delinquency rates for all loans almost 2 percentage points higher than the delinquency rate for credit cards.

Taken together, the story these two figures tell is not obvious. Credit card accounts were quite possibly closed during the recession and its aftermath, and these consumers are likely opening very few new ones. Yet outstanding revolving credit has not increased since 2008 and there has been a sharp decline in credit card delinquencies. Perhaps more important, credit card delinquencies have declined to a 20-year low and may reach a historic low at a time when the delinquency rate on all loans remains near historic highs. Why have delinquency rates on credit card payment fallen so steeply in absolute and in relative terms? Some argue that given the higher interest rates on credit cards relative to other personal loans, consumers are keen to reduce their outstanding balances and debt service burden. But if so, they are doing it at the expense of nonrevolving, largely secured lines of credit, which brings with it the loss of assets. Another argument is that since 2010 consumers are prioritizing paying credit card balances, and that this shift is the result of a strong liquidity preference in uncertain economic times. The growing number of credit cards in circulation, from 1.50 cards per person in 2010 to 1.56 cards in 2011, suggests the latter is more likely.[1]

Consumer debt is a key driver of economic growth. Credit card debt reached a peak of $976 billion in October 2008, an average of $8,299 per household.[2] More recent data show that in May 2012, U.S. consumers experienced the biggest increase in revolving debt in the past four and a half years. Revolving debt and credit card debt are included in that rise by $8 billion. This is the highest jump since November 2007, before the financial crisis and recession.[3] It is an indication of overall economic recovery in the post-recession period.

These measures of historic and recent consumer credit card use suggest one clear message: *consumers value credit cards, perhaps even more than in the past*. In part, these shifts reflect a preference for liquidity in uncertain times, showing that consumers value these credit facilities even if they use them less. But to a significant extent, these shifts reflect not simply current circumstances but some of the inherent value of revolving credit, which the economic climate has brought into sharper relief.

[1] Woolsey, B. and Schulz, M. "Credit card statistics, industry facts, debt statistics"

[2] Kimberley Amadeo, "Consumer Debt Statistics: Consumer Debt's Role in the US Economy," *About.com*, July 19, 2012. Available at: useconomy.about.com/od/demand/a/Average-Consumer-Debt-Statistics.htm

[3] Shannon Bond, "US Consumer Growth Beats Forecasts," *Financial Times*, July 9, 2012, available at http://www.ft.com/intl/cms/s/0/b08c8e64-c9ff-11e1-844e-00144feabdc0.html#axzz20KGObyxQ

What Do Credit Cards Offer?

Credit cards, specifically their functions and their features, have changed over the years. Credit cards today offer more than a line of credit and a one-month interest-free loan. To understand what cards offer and why consumers have been prioritizing credit cards, it is useful to contrast credit cards with debit cards. While offering many conveniences, debit cards lack some very important benefits that come with a line of credit. In Table 1, we list the main differences between credit cards and debit cards.

Perhaps the more immediate feature that distinguishes credit cards from debit cards is that they offer consumers much greater protection, as lenders have often built in insurance-like features into the former.

Table 1: Differences between Credit and Debit Cards

Features	Credit Card	Debit Card
Unauthorized charges	• Maximum Liability of $50 by federal regulation • Increased protection on online transactions	• Liability up to $50 only when notified within 48 hours, else can be up to $500[1]
Mistaken transactions	• Stops payment immediately and continues using cards while contesting charges	• Lenders have 10 business days to investigate and may withhold the contested amount. • No right to withhold payment on damaged goods
Fees	• Only 14% credit cardholders pay a fee[2] • Incidence of late fees steadily declining • Over-limit fees steadily declining and virtually eliminated[3]	• Debit Cards involve checking account fees • Overdraft fees can be substantial
Price of borrowing	• Provide unsecured loans • Interest rate on cards is often regulated, depending on the state where it is issued. • Interest rates on credit cards must be clearly disclosed • Regulations limit ability of lenders to increase rate without borrower notification	• New regulations prohibit charging overdraft fees on debit card transactions and ATM withdrawls.[4] • Outstanding overdraft fees are usually fixed and very high
Smoothing consumption	• "Buy now, pay later" helps smooth consumption	• Money is immediately withdrawn from the checking account
Big ticket consumption	• Opportunity to pay for additional expenditures or big-ticket purchases at a later date.	• Funds must be in one's account to make big-ticket purchases
Deposits for hotels, car rentals, etc.	• The amount is blocked and funds are not immediately withdrawn	• The amount is blocked in the checking account, which could result in a bounced check.
Potential warranties, general purchase protection	• Purchase protection • Damage protection • Return protection: possible to recoup the funds from a credit card if dissatisfied with purchase and the retailer refuses the return. • Extended warranty • Collision damage protection on rental cars[5]	• None
Rewards	• Approx. 57% of credit cardholders claim they use credit cards because of the associated rewards. • Credit card rewards are more valued and older than debit card rewards.[6]	• Less popular • Consumers less satisfied • Issuers are eliminating reward programs for debit cardholders

[1] Payment card networks have established zero-liability policies for fraudulent protections that go above and beyond the limits set under law for debit and credit card transactions. See also, "Credit Card, ATM and Debit Cards: What To Do If They Are Stolen" (Washington, Federal Trade Commission, 2012), www.ftc.gov/bcp/edu/pubs/consumer/credit/cre04.shtm

[2] PERC/ORC cardholder survey 2012.

[3] See "CARD Act Factsheet." http://www.consumerfinance.gov/credit-cards/credit-card-act/feb2011-factsheet/ The 2009 Credit Card Accountability, Responsibility and Disclosure Act limits the ability of issuers to allow borrowers to exceed their credit limits without permission in writing and subjects those fees charged in connection with exceeding a credit limit to a level that is reasonable and proportional. Recent changes to Regulation E require financial institutions receive express opt-in from consumers before they can be enrolled in an overdraft program associated with a debit card.

[4] Press release, Board of Governors of the Federal Reserve System, Nov. 12, 2009. www.federalreserve.gov/newsevents/press/bcreg/20091112a.htm

[5] For further details on credit card benefits, see "Eight Forgotten Credit Card Perks," My Money, U.S. News, April 12, 2012. http://money.usnews.com/money/blogs/my-money/2012/04/12/eight-forgotten-credit-card-perks)

[6] Michael Turner, "Credit Card Rewards: Context, History and Value, A White Paper on Credit Card Rewards" (Durham, NC: PERC, 2012).

The debate between credit card and debit card based overdraft could be never-ending. The question of which payment means is preferable for a consumer depends on circumstances, and the question of which is preferable, late fees or overdraft fees, is a misleading one. Each payment method offers its own costs and benefits. As Table 1 shows, the view that credit cardholders necessarily incur higher costs for borrowing can be misleading, depending on overdraft fees Also, in its role as a 30-day interest-free loan for transactions, credit cards provide a function we commonly associate with debit cards. Similarly, in providing overdraft facilities, debit cards provide lending features along with overdraft fees, a function we associate with credit cards. The seemingly unfair interchange fee could in effect be funding all the added features, insurance, and protections available on credit cards.

A final benefit of credit cards is their credit-building history. Only credit cards can help individuals build a good credit history, leading to greater access and better loan terms for automobiles, houses, and small business activity.

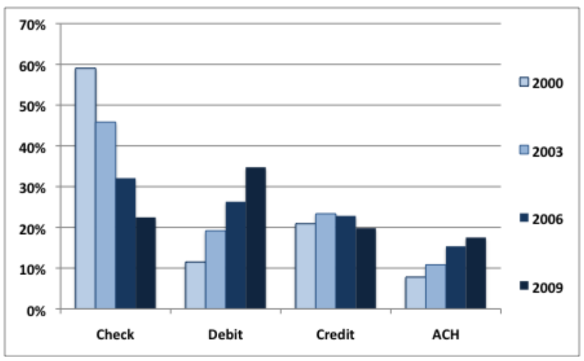
How Consumers Use Credit Cards

Many of the benefits of credit cards present themselves in consumer usage patterns for different methods of payment. The past decade has witnessed a radical transformation of how goods and services are provided and paid for. The ubiquity of debit cards, access to payment systems for all types of merchants, the rise of online payment systems such as PayPal and others, and interfaces with mobile systems have presented consumers with a wide choice of where to buy and how to pay.

Despite the significant disruptions in payment patterns, with new methods displacing old methods amid rapid technological change, what stands out in the figures is the remarkable stability of credit card use. The share of transactions accounted for by credit cards has remained nearly 20% for more than a decade--a decade in which payment options for consumers have increased dramatically.

The rising use of debit cards has come at the expense of the use of checks, as Figure 3 illustrates. The decline in the share of transactions made with checks is almost identical to the increase in the share of transactions made with debit cards and automated clearinghouse payment facilities. The share of transactions made by credit cards has remained largely stable, and the very small decline in 2009 from 2006 (of approximately 2%) is most likely a result of financial crisis and ensuing recession.

Figure 3: Share of Transactions by Method of Payment

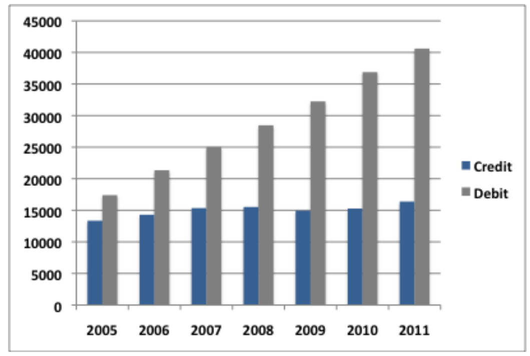


Note: ACH = automated clearinghouse transactions.

Sources: 2004 Electronic Payments Study for Retail Payments Office at the Federal Reserve Bank of Atlanta; 2007 Federal Reserve Payments Study: Noncash Payment Trends in the United States, 2003 – 2006; and 2010 Federal Reserve Payments Study Noncash Payment Trends in the United States: 2006 – 2009.

The stability of the share of transactions made using credit cards is mirrored in Figure 4. This shows the volume of Visa and MasterCard credit and debit transactions for the past seven years (2005–2011). American Express or Discover transactions are not included. Credit card use is considerably stable, with 2011 volumes only slightly greater than 2005 volumes. This stability is remarkable given the fact that the majority of this period spans the financial crisis and recession. Far from an image of the American consumer binging and purging revolving credit, as the news media has portrayed, we witness stability more indicative of a consumer who finds credit cards to be an integral and seemingly unsubstitutable part of a great share of transactions, the very same picture painted in Figure 3.

Figure 4: Number of Visa and MasterCard Debit and Credit Transactions (millions)



Source: PaymentSource, see http://www.paymentssource.com/statistics/. Figures compare Visa and MasterCard credit and debit card transactions.

This stability in economic activity, and the implication from Figures 3 and 4 that new payment methods have not led consumers to substitute other payment means for credit cards, points to a crucial aspect of credit cards in economic life. Economists have long argued that consumption is largely determined by a consumer's permanent rather than transitory income, or their expected income over their life cycle. Transitory shocks, in this understanding, do not alter a person's consumption. Instead, individuals respond to the shock by using savings or borrowing against future earnings to adjust. This conception of consumer activity has assumed that consumers are not liquidity constrained. Credit cards help mitigate such a constraint, and the stability of credit cards in terms of share of payment methods, volume, and continued use during economic booms and busts suggests that they stabilize consumption.

Therefore, it is no surprise that small business operators believe that credit cards and associated programs, such as rewards programs, help boost sales and increase economic activity. Figure 5 depicts the results of small business operators' responses to questions about the effect of credit cards on sales. The questions were part of a survey that PERC fielded in 2012. Results show that 75% of small business operators believe that credit cards increase sales; 50% believe that rewards programs designed to encourage the use of credit cards also increase sales. This perception is in keeping with the theory and empirical observation, and suggests that altering this dynamic can have adverse consequences on economic activity.

Figure 5: Small Business Operators' Views on the Effect of Credit Cards on Sales

Source: 2012 PERC Business Survey

Consumers Payment Activity, Attitudes, and Proposed Regulation

It is against this integral role that credit cards play in daily household economic activity that we should approach the regulation of credit card activity. Regularly, reforms are proposed to change the pattern of credit card use or increase its cost. The proposals fall roughly into two types. The first is to change the incentives to use cards by regulating the rewards programs attached to cards. The second calls on regulators to change prices for goods based on the payment methods used.

Above, we suggested that credit cards use spurs economic activity and that consumers find substantial value in them, most likely in the form of liquidity. In the survey noted above, we asked both consumer and small business operators if prices should be adjusted by payment method to reflect the costs of the interchange fee. By a majority, neither consumers nor small business operators preferred pricing by method of payment. More than 85% of consumers responded that such a pricing system would be either too complicated (42%) or that such a system that allowed sellers to charge different prices to different consumers would open the door to abuse.

Of the small business operators surveyed, 72% opposed pricing by different payment methods. Given that most small business operators (75%) believe that credit cards increase sales, this is no surprise. Moreover, a majority of small business operators (68%) believe that the merchant fee is simply a cost of doing business, and nearly one-half (46%) believe the fee to be fair.

Conclusion

The data and survey results above point to two reasons to be wary of regulations designed to alter the incentives to use credit cards. The first reason is that credit cards provide a convenience that is not provided by substitutes. The convenience of credit cards goes beyond their revolving credit line. According to the 2007 *Survey of Consumer Finances*, approximately 60% of credit card users do not pay their full balance every month. The 40% who pay off their balances also use credit cards because of the other associated advantages. In fact, the stability of the use patterns for credit card payments across different economic climates and widening payment options suggests that there are few, if any, perfect substitutes. Making credit card use more costly may curb economic activity rather than spur the use of alternative payment methods. By exactly what share cannot be estimated here. But there are strong reasons to believe that the full value will not be taken up by other payment means.

The second reason to be wary of regulations is that credit cards stimulate economic activity in a way that other payment methods do not. Small business operators experience it as increased sales, while economic theory and some observation suggest that it is the process of smoothing consumption over a consumer's life cycle. Access to revolving credit is one key mechanism in this process. Incentives to not use credit cards would limit consumers' ability to even out consumption over their lives. Those calling for regulations designed to reduce credit card use would do well to consider these effects.

PERC

RESULTS AND SOLUTIONS

PERC
302 E. Pettigrew St., Suite 130
Durham, NC 27701

p: +1 (919) 338-2798
f: +1 (919) 640-8881

www.perc.net