

Patterns of Credit Card Use Among Low- and Moderate-Income Households

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Ensuring that the poorer segments of the population have access to financial products and services has taken on increased significance as policymakers have come to understand the broad social ramifications of inclusive financial regimes. Access not only promotes savings but also enables the poor to manage cash flows and to meet basic needs such as health care, food, and housing. In the United States, the last few decades have seen remarkable progress on that front as low- and moderate-income (LMI) households increasingly use both mainstream products like deposit accounts and “fringe” products like payday lending, check-cashing services, and pawnshops (Barr, this volume; Caskey 1996; Hogarth, Anguelov, and Lee 2004; Mann and Hawkins 2007). At the same time, because many of those products exploit cognitive and financial constraints, policymakers are now increasingly moving beyond concerns about access to emphasize the need for safety in the design and marketing of financial products (Warren 2007).

Credit cards cut across those concerns. With respect to access, the credit card is a profoundly democratizing instrument. It is only a slight exaggeration to say that any person with a Visa or MasterCard product can walk into the same stores and restaurants as the most elite trendsetters in our society and purchase the same goods and services, at the same prices. As status in a consumer society shifts to depend more heavily on consumption (rather than family wealth or occupational status), the credit card acts as a leveler of status (Cross 2000, 169–84; Frank 1999, ch. 4). The credit card also provides a remarkably flexible safety net that can be deployed in response to unexpected financial crises (Mann 2006). That protection is particularly important in the United States, where the public safety net is more porous than it is in many peer nations (Hacker 2002; Howard 2007).

At the same time, the credit card is singled out as one of the most perilous consumer financial products. The prevalence of credit card use raises concerns that consumer spending is leading to overindebtedness (Schor 1999). In previous work, I present aggregate data that suggest a significant relation between increased credit card use and consumer bankruptcy filings at a national level (Mann 2006). The

flexibility that makes the credit card so useful for households faced with unexpected difficulties is central to the danger that the product can bring to those who use it in excess (Littwin 2008a; Mann 2007; Mann and Hawkins 2007). Safety concerns are particularly important in connection with financial products for the poor (McCloud 2007).

This chapter uses data from the Federal Reserve Board's Survey of Consumer Finances (SCF) for 2004 to examine the penetration of credit cards into LMI markets. The chapter has two purposes. First, I discuss the rise of the modern credit market, emphasizing the segmentation of product lines based on behavioral and financial characteristics of customer groups (for more detail, see Mann 2007). Among other things, that trend involves the use of products aimed at LMI households that differ significantly from those aimed at middle-class households.

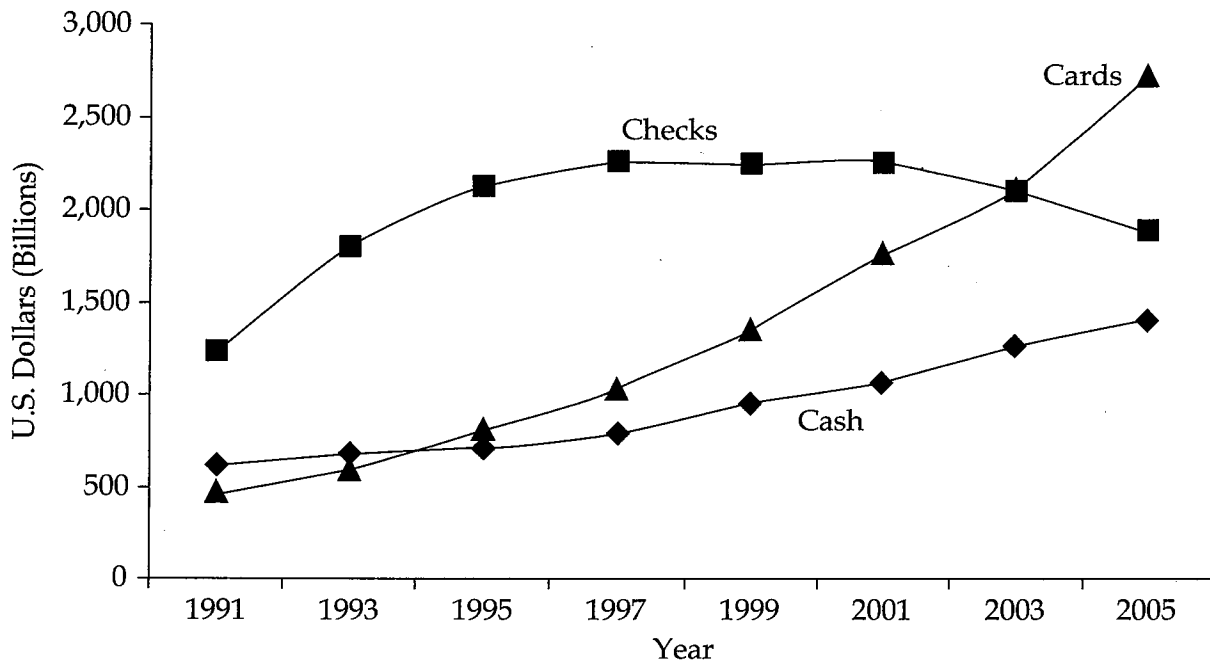
Second, I describe the use of credit cards by LMI households: the amounts of debt they carry; the types of LMI households that carry debt; and how these households differ from higher-income households that carry debt. Despite their lower incomes, LMI households use credit cards almost as often as other households do. Indeed, measured as a share of income, the credit card balances that LMI cardholders carry are substantially higher than those of higher-income households. To refine the analysis, the chapter closes with the results of a multivariate regression analysis of the characteristics of LMI households with credit card debt. Generally, those results suggest that the demographic characteristics of LMI households that have credit card debt are different in material ways from the characteristics of those households in the overall population with credit card debt. The models I summarize here suggest that age, race, and education correlate with credit card use in the population at large. At least in these models, however, age and race become less important predictors, and education has only a marginal relation to credit card use in LMI households. In LMI households, by contrast, credit card use is most closely related to the use of other financial products: checking accounts, mortgage loans, and car loans.

THE MODERN CREDIT CARD MARKET

The rise of the credit card to dominance in American payment and lending transactions is well known. The total value of credit card transactions increased from about \$800 billion in 1990 to more than \$1.7 trillion in 2006. Similarly, credit card balances increased from about \$450 billion in 1990 to more than \$750 billion in 2006 (Nilson Report; for a more detailed discussion, see Mann 2006). As figure 9.1 illustrates, the rise in spending on cards reflects a substantial shift toward cards and away from other payment devices.

What is less widely understood is the mechanism by which this has occurred. Credit card lending is by nature risky. Unlike the home mortgage lender or the car lender, the credit card lender has no collateral to which it can look for repayment. Moreover, several factors combine to leave the credit card lender with no practical device for collecting payment. First, in most American jurisdictions,

FIGURE 9.1 / Spending on Retail Payment Systems in the United States, 1991 to 2005



Source: Author's calculations based on the Nilson Report.

unsecured lenders have no practical remedy other than litigation, either because garnishment is illegal (the rule in some states) or because it is ineffective, especially against debtors who do not have regular incomes or bank accounts. Most jurisdictions also have schedules of exempt assets that are not subject to seizures by unsecured creditors, even when they hold unpaid judgments. Thus, exemptions in many cases cover all assets in the household. Finally, the availability of a discharge in bankruptcy means that debtors who are pushed too far normally can discharge their obligations to the credit card lender.

In practice, the most effective lever the credit card lender has is the threat of damaging the credit report of the borrower. A credit card debtor who does not pay will suffer a substantially lower credit rating. Although the lower credit card rating will have only a limited impact on the debtor's access to credit card debt, it will substantially increase the cost of subsequent borrowing. This is particularly true for mortgage lenders, which continue to use crude underwriting systems that rely directly on the credit rating system. For the sophisticated credit card lender, in contrast, the credit rating is at most one of many inputs into the underwriting process. In any event, the threat of an adverse credit report is ineffective against debtors who are in serious financial distress and whose credit rating already has been compromised because of missed payments to other creditors.

Because of the riskiness of the credit card business model, the industry, in its infancy, used a unitary business model. The product offerings of the different issuers were similar, so competition occurred mainly through marketing and customer

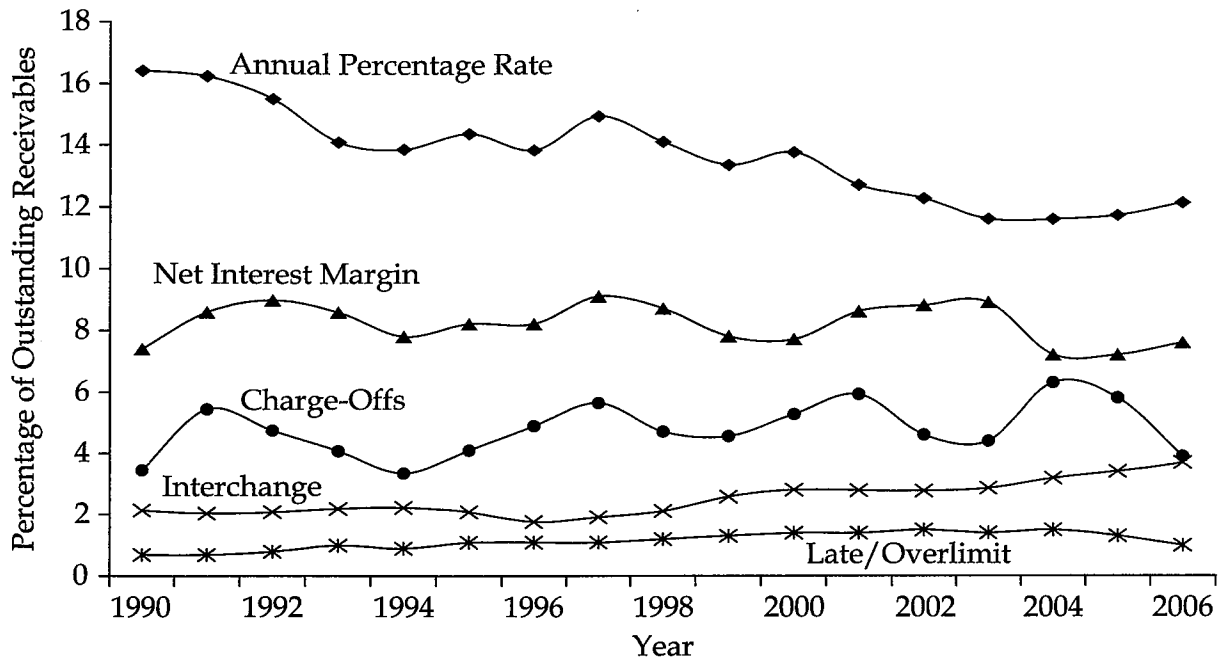
service. Interest rates were standard and relatively high, typically in the range of 18 percent. At the same time, despite those relatively high rates, the customers to whom credit card lenders could make profitable loans were a relatively small part of the middle class. The wealthy had little interest in borrowing at 18 percent, and those who had no reliable income stream were too risky. In general, most issuers had a large group of profitable customers who borrowed and paid substantial amounts of interest, a second group of generally unprofitable customers who did not borrow but instead paid their bills each month, and a third group of highly unprofitable customers who borrowed and did not repay their debts. Profitability came from maximizing the number of customers in the first group and minimizing the number in the second and third groups.

The advent of technological underwriting tools in the 1990s changed everything. The most capable lenders developed increasingly complex statistical models that predicted more accurately the spending and repayment behavior of smaller slices of the potential cardholding population (Johnson 2005). The result has been a steady segmentation and specialization of the market. The first stage involved differential pricing, in which low-risk customers received lower interest rates (to encourage borrowing) and high-risk customers received higher interest rates (to provide a margin for delinquencies).

Differential pricing has not led to a decline in net interest margins. Although the effective annual interest rate has fallen in the last fifteen years, from about 16.4 percent in 1990 to 12.2 percent in 2006, a parallel decrease in the cost of funds means that the net interest margin has not changed substantially during that period (rising from 7.4 percent in 1990 to 7.6 percent in 2006).¹ At the same time, however, the portfolios underwritten at that margin have become considerably riskier. For example, the rate at which issuers write off unpaid balances (charge-offs) steadily increased during this period, from 3.5 percent in 1990 to about 6 percent during 2004 to 2005.² Essentially, improved underwriting technologies allowed the successful credit card lenders to develop reliable predictions about the repayment behavior of increasingly unreliable customers. This capability has allowed those lenders to acquire profitable portfolios filled with cardholders who would have been unacceptably risky a few decades ago.³

The maintenance of a relatively constant net interest margin suggests a balance of increased borrowing at lower rates by relatively creditworthy customers against new borrowing by relatively risky customers at higher rates. The ability to profit with flat interest margins despite the increase in charge-offs suggests that the card issuers have developed new revenue sources. The first is an increased reliance on fees, particularly in the subprime product lines discussed later in this chapter. Late and overlimit fees on an annual basis were only 0.7 percent of the average outstanding balances in 1990, but doubled during the 1990s to 1.4 percent or 1.5 percent of the average outstanding balances, a plateau at which they remained until they began to decline in 2005 and 2006. The second increased revenue source is fees paid by merchants that accept cards (interchange), which has risen about 70 percent faster than receivables, from 2.15 percent to 3.69 percent of average outstanding balances. In part, this reflects the ability of issuers, especially in recent years, to shift

FIGURE 9.2 / Cards Profitability Data



Source: Author's calculation from Cards Profitability Survey, published by *Cards and Payments*.

increasing numbers of cardholders to high-interchange premium and “platinum” products.⁴

The second stage of market segmentation involves the development of increasingly complex product attributes that tailor products to specific classes of potential cardholders.⁵ Thus, different issuers are particularly expert in superprime offerings (Chase Bank and Bank of America), affinity offerings (Bank of America’s MBNA division), cobranded offerings (Chase Bank), relational offerings (Wells Fargo), subprime offerings (Capitol One), and foreign offerings (CitiBank). Each issuer tailors its products carefully to make them both profitable and attractive, with a different mix of anticipated revenue streams based on the type of customer. Superprime offerings, for example, attract a portfolio of customers who spend very heavily and borrow occasionally, primarily for convenience. Issuers rely heavily on interchange and episodic interest payments, balanced against the large losses that come when a customer with a five-figure credit line becomes insolvent. Affinity products (bearing logos of universities, sports teams, or the like) are more likely to balance interchange against limited payments to sponsors, while cobranded offerings (bearing logos of airlines or leading retailers) are likely to balance annual fees and interchange against relatively high payments to sponsors. Relational offerings are part of a strategy in which a bank strives to provide many products to each customer, with a view to lowering the customer’s price sensitivity on particular products.

Insufficient Funds

For a study of LMI households, subprime issuers are the most interesting, because the unstable incomes and poor or spotty repayment histories of many LMI families make them likely users of those products.⁶ Not surprisingly, subprime products rely heavily on interest income and fees. Indeed, a dominant share of the increase in fee revenue discussed in this chapter has come from the subprime market. In part, this reflects the reality that the stated interest rates on those products (often in the range of 18 to 24 percent per annum) are inadequate to provide a return on a portfolio with a charge-off rate in the vicinity of 15 to 20 percent. Fee revenue provides a simple way to substantially increase the effective interest rate. Take, for example, a typical subprime \$500 credit card line that has been fully extended. If the cardholder incurs three late or overlimit fees per year (not an unreasonable estimate), the issuer is likely to receive approximately \$100 in extra revenue.⁷ Those fees add an additional 20 percent return per year on the credit line, for a total effective rate (assuming no other fees or charges) of about 35 to 40 percent.

More aggressive card issuers, targeting higher-risk customers, design products with even higher effective rates. For example, one popular subprime card has a \$300 limit and a 20 percent interest rate, with \$247 in up-front fees (\$49 annual fee, \$99 account processing fee, \$89 program participation fee, and \$10 monthly maintenance fee).⁸ The fees are charged against the card when the cardholder receives it, leaving an available credit line of \$53. If a cardholder makes a \$53 purchase on the date the card arrives (thus expending the entire remaining available balance) and repays the balance in one month, the effective interest rate would be about 5,500 percent. From a marketing perspective, this card might look attractive because it offers a grace period to cardholders who pay their entire balance. Nor is this card unique. Another successful product offers a \$250 limit and an interest rate of only 10 percent, with \$178 in up-front fees (\$29 account setup fee, \$95 program fee, \$48 annual fee, \$6 participating fee). If that cardholder spends the entire available credit (\$72) on the first day and repays the balance at the end of the first month, the effective interest rate would be about 3,000 percent. To be sure, the interest rates would fall if the cardholders took longer to repay their balances, but the large share of fees compared to the maximum amount of available credit ensures that the effective interest rate will remain substantially higher than the stated interest rate.

Collectively, these market segmentation strategies are highly effective, at least for lenders that are able to employ cutting-edge technology. Large issuers say privately that only about 25 percent of their customers are unprofitable, a substantial improvement from the early 1990s, when about half of the customers in a typical portfolio would be profitable to the issuer. One final corollary of the increasing importance of sophisticated underwriting technology is the rapid concentration of the lending market. Issuers that do not invest heavily in technology quickly fall behind, losing the ability to compete against those that do. As of 2006, the top five issuers held more than 70 percent of the outstanding credit card balances, up from only 39 percent in 1994 (Nilson Report).

The changes in the credit card market raise important questions about the role of credit cards in the finances of LMI households. It is clear, of course, that a con-

