

High Credit-Card Interest Rates: What Gives?

Chairman Greenspan and his colleagues on the Federal Open Market Committee have engineered some of the lowest interest rates that many of us can remember, even though long-term interest rates have inched higher in recent weeks. Credit-card interest rates prove the exception to the rule. What gives?

Before addressing this question, some background information about credit cards provides important context. A credit card allows financial institutions to establish credit lines for cardholders (borrowers). Approving a credit line, a one-time cost, saves immeasurably on the underwriting costs associated with the numerous loans that will ultimately occur from the use of that credit line.

To exercise that credit line, the cardholder merely uses the card to make a purchase. At that instant, the credit-card user receives a short-term loan from the financial institution that issued the card.

Credit cards come in two types – variable- and fixed-rate versions. The variable-rate cards, which constitute just over half the market, tie their interest rate to the prime rate. So the credit-card rate moves up and down with the prime rate. The fixed-rate cards do adjust their interest rates, but only in response to management decisions.

The credit-card issuer also receives a payment from the merchants who accept the credit card in payment for goods and services. That is, both sides of the market – buyers and sellers pay for the convenience of credit-card use.

The credit-card loan contract, however, typically possesses a unique feature. To wit, if the borrower pays the entire balance (loan) within the grace period, then the financial institution waves interest payments.

The average credit-card balance per household has climbed to nearly \$9,000. If you owe credit-card debt, what can you do to lower your costs? Several options exist. First, and best, pay your debt each month within the grace period and don't get caught with interest charges.

Second, if you are a good customer, then call the card issuer and ask for a lower interest rate. A survey conducted by the Public Interest Research Group (PIRG) found that over 50 percent of those surveyed got their credit-card rates lowered just by asking.

Third, switch your credit-card debt to another company. In the current low interest rate environment, some companies will offer low “teaser” rates to get your business. But, read the fine print. Some companies only apply the low, or even zero, rate to new purchases. If the low rate does apply to the entire balance, make sure that the rate doesn’t go through the ceiling after the “teaser” period ends. This last option only makes sense, if you can arrange to pay off your indebtedness before the teaser period ends, unless the final contract rate falls below your current rate.

Returning to the opening query, what gives? Why are credit-card interest rates so high? Two complementary explanations exist – the conventional explanation and a signaling explanation. The conventional explanation relies on higher costs, while the signaling explanation exploits incomplete information.

Conventional Explanation: Higher Costs

Since credit cards establish a credit line for the cardholder, you and I each manage that portion of our indebtedness. Without good discipline, we can easily slip into an untenable debt position, whereby our income cannot provide the wherewithal to service the credit-card debt. We may create problems for the lender and ourselves by exceeding our credit limit, making payments after the due date, or even declaring personal bankruptcy. Financial institutions face higher costs to administer such problem loans. Moreover, problem loans account for a larger share of credit-card loans than for other types of loans, causing the required interest rate on credit-card loans to exceed that on other forms of borrowing.

Unconventional Explanation: Market Signaling

Signaling occurs in markets with incomplete information. In this case, when the financial institution issues credit cards, it receives a mix of borrowers from good to bad credit risks. Credit-card issuers want to attract good, and not bad, credit risks. Can credit-card issuers design a contract to elicit an accurate signal from applicants that they are good credit risks? That is, can that contract screen out bad credit risks?

Who is a good credit risk? The safest credit-card borrowers repay their balance each month. But, in that case, the credit-card issuers earn no interest on those loans. Such lending is not profitable.

The credit-card issuer, however, may want to attract credit-card borrowers who intend to pay off their entire balance each month. Surveys suggest that a large fraction of credit-card users, up to $2/3^{\text{rds}}$, intend to repay the credit-card balance each month, but only about half who say they will, actually do.

So good credit risk customers may pay less attention to the interest rate charged by the credit-card issuer. Moreover, to attract those customers, credit-card issuers usually offer additional perks or inducements, such as frequent flier miles. Low interest rate credit cards generally strip away such perks.

In sum, credit-card customers who are good credit risks, signal their status by taking a credit card with a high interest rate and additional inducements. Thus, credit cards with high interest rates and additional perks sort good from bad credit risks. And the credit-card issuer profits because nearly half of those folk pay interest that they did not intend.

Stephen M. Miller is Professor and Chair of the Department of Economics, College of Business at the University of Nevada, Las Vegas.
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