United States General Accounting Office

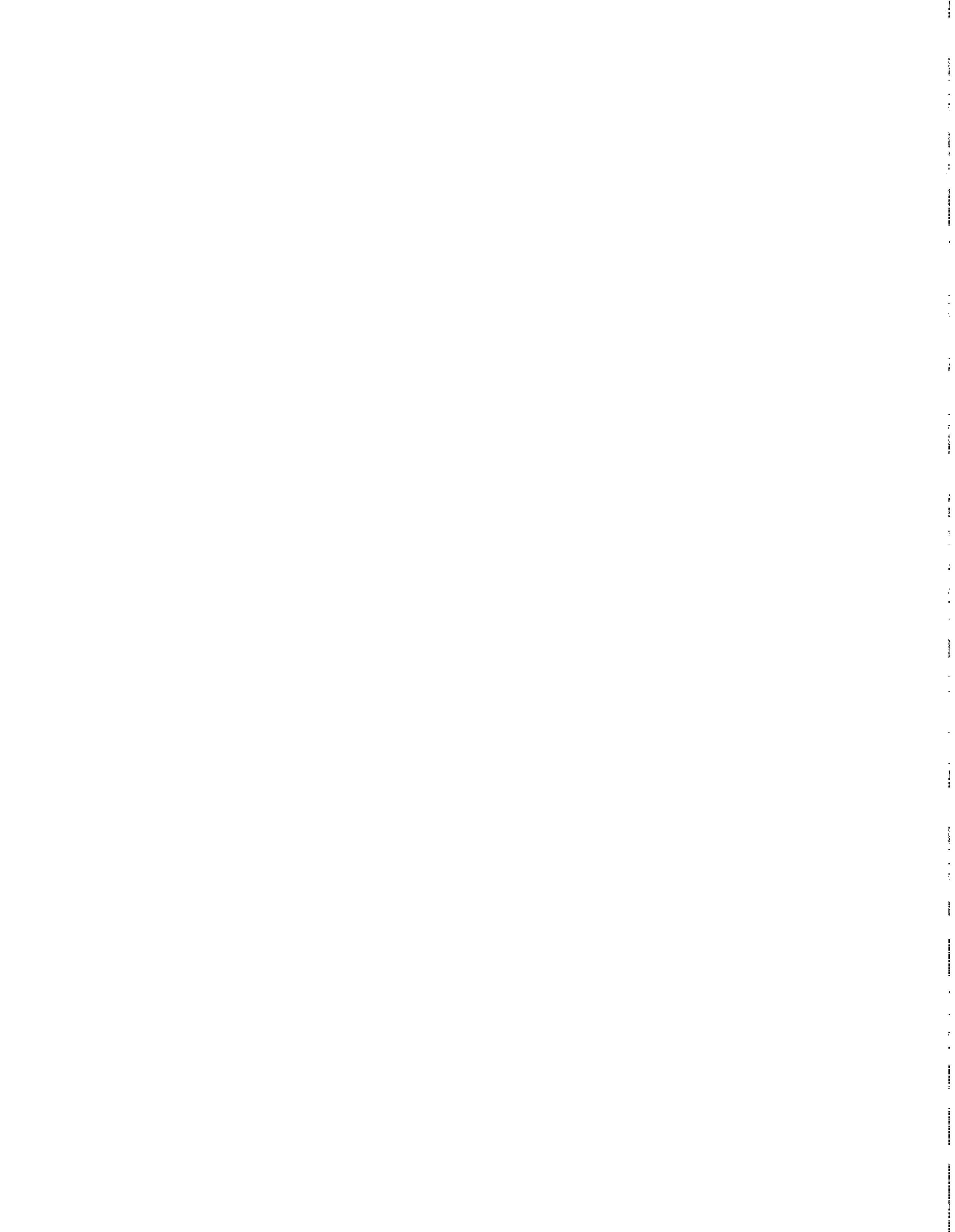
GAO

Report to Congressional Requesters

April 1994

U.S. CREDIT CARD INDUSTRY

Competitive Developments Need to Be Closely Monitored



United States
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General Government Division

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April 28, 1994

The Honorable Joseph P. Kennedy, II
Chairman
The Honorable Alfred A. McCandless
Ranking Minority Member
Subcommittee on Consumer Credit and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives

The Honorable Jim Leach
Ranking Minority Member
Committee on Banking, Finance and Urban Affairs
House of Representatives

The Honorable Esteban E. Torres
The Honorable Charles E. Schumer
House of Representatives

This report responds to your requests that we assess the competitiveness of the U.S. credit card industry. It discusses the structural characteristics of the industry, explanations for the stability of credit card interest rates, and the advantages and disadvantages of various policy options such as an interest rate cap. We also provide recommendations to the Chairman of the Federal Reserve on improving available data about credit card interest rates.

We are sending copies of this report to the Chairman of the Federal Reserve, the Attorney General, appropriate congressional committees and subcommittees, and other interested parties. We will also make copies available to others on request.

This report was prepared under the direction of Mark J. Gillen, Assistant Director, Financial Institutions and Markets Issues. Other major contributors to this report are listed in appendix III. If you have any questions, please contact me on (202) 512-8678.

James L. Bothwell
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Executive Summary

Purpose

Until 1992, credit card interest rates in the United States had remained stable at about 18 percent for many years despite wide fluctuations in the amount lenders paid for funds that they loaned to their customers ("cost of funds"). The wide difference between the cost of funds and average credit card interest rates since the late 1980s has reignited congressional concern about the adequacy of price competition among credit card issuers. In November 1991, the Senate passed a measure that would have set a nationwide cap on credit card interest rates, but the House of Representatives did not vote on such a cap before the session ended.

The former Chairman and Ranking Minority Member of the House Subcommittee on Consumer Affairs and Coinage, the Former Ranking Minority Member of the Committee on Banking and Urban Development; and Congressman Charles E. Schumer asked GAO to review the explanations that have been offered for the stable credit card interest rates and evaluate the merits of an interest rate cap and other related policy options.

GAO reviewed the (1) assessments of whether the industry's structure supports competition, (2) explanations that have been offered for the credit card industry's relatively stable interest rates and high earnings, and (3) proposed interest rate cap and various other policy options.

Background

The U.S. credit card industry consists of about 6,000 card issuers, mainly banks, thrifts, and credit unions. Increasingly, nonbank corporations—such as AT&T and General Motors—are also entering the credit card industry by establishing contractual relationships with existing card issuers. Most of these credit card issuers belong to the two card associations—VISA and MasterCard. Although VISA and MasterCard each provide a nationwide transaction processing system for cards carrying their logos, issuers of those cards own cardholders' accounts, set interest rates, and decide on other pricing aspects of the cards.

Use of credit cards in the United States has grown substantially since the mid-1980s. Between yearend 1983 and yearend 1993, total credit card balances outstanding (the dollar amount of borrowings owed by cardholders) quadrupled, rising from about $39 billion to about $156 billion in constant 1982 dollars. One reason credit card lending increased significantly in the 1980s is that many states relaxed or repealed long-standing laws that placed limits on the interest rates that card issuers could charge to consumers. This effective deregulation of credit card

interest rates encouraged card issuers to offer cards to riskier customers who previously did not qualify for them. However, after growing at an average annual rate of 15.5 percent between 1986 and 1990, outstanding card balances increased by 5.1 percent in 1991 and remained flat in 1992 during a period of slow economic growth. Credit card balances increased by 12.4 percent in 1993 as the economic recovery strengthened.

While credit card issuers' expenditures on funding costs as a percentage of their average outstanding balances have fluctuated over the past 18 years, from a high of 13.38 percent in 1981 to a low of 5.33 percent in 1993, credit card interest rates were generally stable at about 18 percent until 1992. Since that time, many companies, including new nonbank industry participants like General Motors, Ford, and General Electric, have offered variable-rate credit cards with lower interest rates to many consumers, particularly those who have good credit histories. The number of cardholders with lower interest rate cards increased substantially in 1992. Average credit card interest rates fell to 16.83 percent in 1993 as a result of the increasing price competition among card issuers.

To meet its objectives for this report, GAO analyzed available data related to the performance of the industry and reviewed a variety of studies that have been written in recent years on its competitiveness. GAO also discussed the industry's competitiveness with Federal Reserve and Department of Justice officials, private economists, industry officials, and consumer groups.

Results in Brief

Many economists have analyzed the credit card industry's structure to determine the extent to which it might have facilitated anticompetitive practices. These analyses have generally concluded that the industry's structure provides for adequate competition among credit card issuers. However, an alternative viewpoint suggests that the industry's structure may have certain characteristics that limit competition. Currently, there is no compelling evidence to either confirm or reject this viewpoint.

Differences between credit card lending and other consumer lending help explain differences in their respective levels of interest rates and earnings. Unsecured credit card lending is riskier than secured lending activities, and funding costs represent a relatively low percentage of total credit card costs. As a result, credit card interest rates are less responsive to fluctuations in the cost of funds than are interest rates for other forms of credit. The long-term stability of rates may also be explained in part by the

high demand for credit cards and the expanding economy of the 1980s and consumers' lack of response to credit cards that offer lower interest rates. GAO believes that competitive developments in the industry should be closely monitored and that the Federal Reserve can assist Congress in its oversight role by (1) collecting and publishing additional information and (2) commenting on recent competitive developments in its annual report to Congress on the profitability of the credit card industry. The Federal Reserve is considering plans to collect additional information on credit card interest rates and plans to comment further on recent competitive developments after this information is collected.

A nationwide interest rate cap could lower the cost of credit card borrowing for some cardholders, but it might also result in the cancellation of cards and restricted credit for cardholders who present higher default risks. Various other policy options include maintaining a nonintervention policy or strengthening disclosure requirements.

GAO's Analysis

Widely Held View of Industry's Structure Faces Some Challenges

Many analysts have concluded that the structure of the credit card industry provides for adequate competition among card issuers. The industry has a large number of issuers, about 6,000, who set their own interest rates and other pricing terms. The industry's concentration level, which is one measure of the degree of competition in an industry, is modest, suggesting that the industry's behavior should be quite competitive. Moreover, most depository institutions that wish to issue credit cards and compete with existing issuers can do so by simply joining VISA or MasterCard. To date, the Department of Justice has not instituted proceedings against any firm charging an antitrust violation in its credit card operations.

On the other hand, an alternative viewpoint suggests that, in some ways, the industry's structure has contributed to the performance of credit card interest rates and earnings. One argument is that the largest card issuers dominate the credit card industry and conform to one another's interest rate and pricing decisions. This may explain why several issuers charged the same annual interest rate of 19.8 percent for several years despite decreasing funding costs. However, other analysts disagree that the largest

issuers control a sufficient percentage of outstanding credit card balances to dominate the industry in this manner.

VISA and MasterCard have also been subject to antitrust complaints that, for the most part, they have successfully fought in the courts. In a private antitrust suit filed in 1991, Sears—which issued the Discover Card—claimed that VISA members used association bylaws to prevent efficient low-cost competitors from becoming members and competing against current VISA members. In response, VISA argued that its members had a right to protect their investments in the VISA logo and computer systems from competitors. Sears won by jury verdict in November 1992, but VISA has appealed the decision.

Credit Card Lending Differs From Other Consumer Lending

Many industry analysts argue that differences between credit card and other types of lending explain why credit card interest rates were stable and industry earnings were high during the 1980s. Most significantly, credit card lending is riskier than most other lending activities because it is unsecured, and cardholders use their cards more when they are in financial distress. To remain profitable, card issuers must charge interest rates and generate earnings that compensate for the risks associated with credit card lending. Moreover, operating costs as a percentage of total lending costs are relatively high for credit card lending, while funding costs are relatively low. Because funding costs are relatively low, changes in funding costs were less influential in shaping credit card interest rates. During the 1980s, issuers may have built into credit card interest rates high "risk-premiums" as they extended credit to riskier customers.

Other explanations by economists suggest that the credit card industry was not under competitive pressures during the 1980s as a result of cardholder behavior. Several economists agree that cardholders have not traditionally shopped around for credit cards that offer lower interest rates. This has given credit card issuers incentives to maintain interest rates and earnings above levels that would prevail in a more competitive market. These economists argue that consumers do not respond to offers for cards with lower interest rates due to the costs associated with finding a new card and switching issuers. Cardholders with high credit card balances and low incomes may have found it particularly difficult to switch issuers.

Recent developments suggest competition is increasing among credit card issuers. According to many industry analysts, the slowing of growth of

credit card lending and increased responsiveness by consumers to interest rates have caused issuers to work harder to maintain their market shares. In 1991 and 1992, several major issuers—such as Citibank—offered credit cards with interest rates below 16 percent to cardholders with good credit histories. Moreover, large nonbank corporations—such as Ford, General Motors, and General Electric—entered the industry, offered competitively priced cards, and attracted millions of customers. As a result, the number of cardholders with lower interest rate cards increased substantially. For example, the percentage of total credit card accounts subject to annual interest rates of 16.5 percent or less increased from 9 percent in 1990 to 39 percent in 1992.

GAO believes that these developments within the credit card industry should be closely monitored to determine whether the apparent increase in competitive performance is sustained. While many cardholders are clearly benefiting from lower interest rates, industry earnings remained relatively high throughout 1992 and 1993, due in part to record low funding costs. Also, cardholders who represent higher default risks may not be offered the advantage of programs designed to lower their borrowing costs. Therefore, they may continue to pay interest rates exceeding 18 percent. Close monitoring is also warranted because the recent competition among issuers could lessen if congressional, media, and public scrutiny of the industry's pricing practices subsides.

Currently, the Federal Reserve collects and publishes information about credit card interest rates and other industry issues. However, GAO believes the Federal Reserve can provide additional information about available credit card interest rates. With such information, Congress and industry analysts can better monitor the recent price competition among issuers and assess whether it is sustained in the short and long term. Moreover, the Federal Reserve can comment on recent competitive developments in the industry in its annual report to Congress on credit card profitability.

Analysis of Policy Options

A nationwide cap on interest rates has been proposed by some credit card industry critics to remedy a perceived lack of competition in the industry, protect consumers, and stimulate the economy. Economists who oppose a nationwide cap on credit card interest rates have argued that it would harm rather than stimulate the economy and compel issuers to cancel the cards of many riskier cardholders. Rather than impose a rate cap, they believe that Congress should maintain a nonintervention policy and permit the credit card market to determine interest rate levels.

Another policy option that has been proposed by industry analysts is strengthening credit card disclosure laws. Although Congress did strengthen these requirements when it passed the Fair Credit and Charge Card Disclosure Act of 1988, additional requirements have been suggested, such as a requirement that issuers disclose interest rates and annual fees on the envelopes of cardholder solicitations. Such disclosures may benefit some customers, although they may not benefit those who do not qualify for lower rates and will impose some additional costs on credit card issuers.

Recommendations

GAO recommends that the Federal Reserve (1) collect additional information on credit card interest rates and (2) comment on recent competitive developments in the industry in its annual report to Congress on credit card profitability. GAO is not recommending that Congress adopt any particular public policy option.

Agency Comments

GAO provided copies of a draft of this report to the Attorney General and the Chairman of the Federal Reserve for their review and comment. Although the Attorney General chose not to provide written comments, the Assistant Chief, Communication and Finance Section of the Department of Justice Antitrust Division, generally agreed with the report's analysis and conclusions. The Assistant Chief and division officials also suggested some clarifying language on the Department's activities relative to industry participants, which has been incorporated in chapter 2.

The Chairman of the Federal Reserve provided written comments on the report that are discussed on pages 47-48 and reprinted in appendix II. In his written comments, the Chairman said the report is a comprehensive and well-documented analysis of competitive developments in the credit card industry. The Chairman generally agreed with GAO's recommendations and described additional information that the Federal Reserve plans to collect on credit card interest rates that it will report to Congress. In addition, the Chairman said the Federal Reserve believes that the credit card industry is competitive and that, in recent years, issuers have adopted variable rate pricing strategies that more explicitly track changes in market interest rates.

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Abbreviations

BCHA	Bankcard Holders of America
HHI	Herfindahl-Hirschman Index
ROE	return on equity

Introduction

Until 1992, credit card interest rates in the United States had remained stable at about 18 percent for nearly 20 years despite wide fluctuations in the amount lenders paid for funds that they loaned to their customers ("cost of funds"). In addition, since 1983, earnings in the U.S. credit card industry have been high compared to earnings produced by other types of lending. In 1991, the wide difference between the cost of funds and average credit card interest rates reignited congressional concern and a longstanding public debate about the adequacy of price competition among credit card issuers. This report summarizes and assesses various explanations for the industry's competitive performance; it also discusses the advantages and disadvantages of various policy options proposed to improve this performance.

Background

The U.S. credit card industry began around 1914, when Western Union, department stores, hotels, and oil companies issued charge cards. Typically, customers could use these cards to purchase only the issuer's product or service, and they were required to pay the amount charged in full each month. In 1950, Diners' Club introduced a "general purpose" charge card, that is, one that was accepted at a variety of merchant establishments nationwide. American Express introduced a similar card in 1958.

As banks entered the industry as credit card issuers, payment schedules evolved and nationwide services expanded. When banks first entered the credit card business in the 1950s, they issued general purpose cards that permitted cardholders to make minimum monthly payments, carrying over balances on which interest was charged. However, for more than a decade, the growth of the credit card industry was slow because most merchants accepted only cards issued by local banks and no national system existed to process credit card transactions. In 1966, the Bank of America began licensing its BankAmericard credit card logo to other banks, and these participating banks later formed the entity known today as the VISA association. Similarly, another group of banks formed an entity now known as the MasterCard association in 1966.[1] These associations each developed efficient, nationwide systems to process credit card transactions and convinced millions of merchants to accept their cards. (Appendix I explains how a typical credit card transaction is processed.) VISA and MasterCard also established fees for association membership and transaction processing; however, both allowed members

[1]VISA was called BankAmericard until 1970 when its name was changed to National BankAmericard, Inc. In 1977, the association adopted the VISA logo. MasterCard was called the Interbank Card Association until 1969 and MasterCharge until 1980.

to set interest rates, annual fees, and any other terms and conditions for the VISA or MasterCard cards the members issued.

At first, participating banks could join only one or the other association, but not both; this changed as a result of antitrust concerns. In 1971, a VISA member bank initiated a private antitrust suit that challenged a VISA bylaw preventing members from joining MasterCard. The bank won the case at the district court level, but an appellate court partially reversed the decision and ordered a new trial. Instead of pursuing a new trial, VISA dropped the restriction in 1975, after learning that the Department of Justice objected on antitrust grounds to some VISA restrictions against dual membership.[2] Most of the 6,000 card issuers today issue both VISA and MasterCard credit cards, a practice referred to as "duality." In the 1970s, VISA and MasterCard also offered membership to federally insured thrifts and credit unions.

In the mid-1980s, the Sears and American Express corporations established general purpose credit cards, the Discover Card and the Optima Card, respectively. The Optima Card (unlike the American Express charge card) permits customers to carry over balances on which interest is charged. Sears and American Express each established nationwide computer systems to process Discover Card and Optima Card transactions. In 1993, Sears divested its Dean Witter, Discover & Co. subsidiary, and that corporation now issues the Discover Card.

The Credit Card Industry Has Grown Substantially Since the Mid-1980s

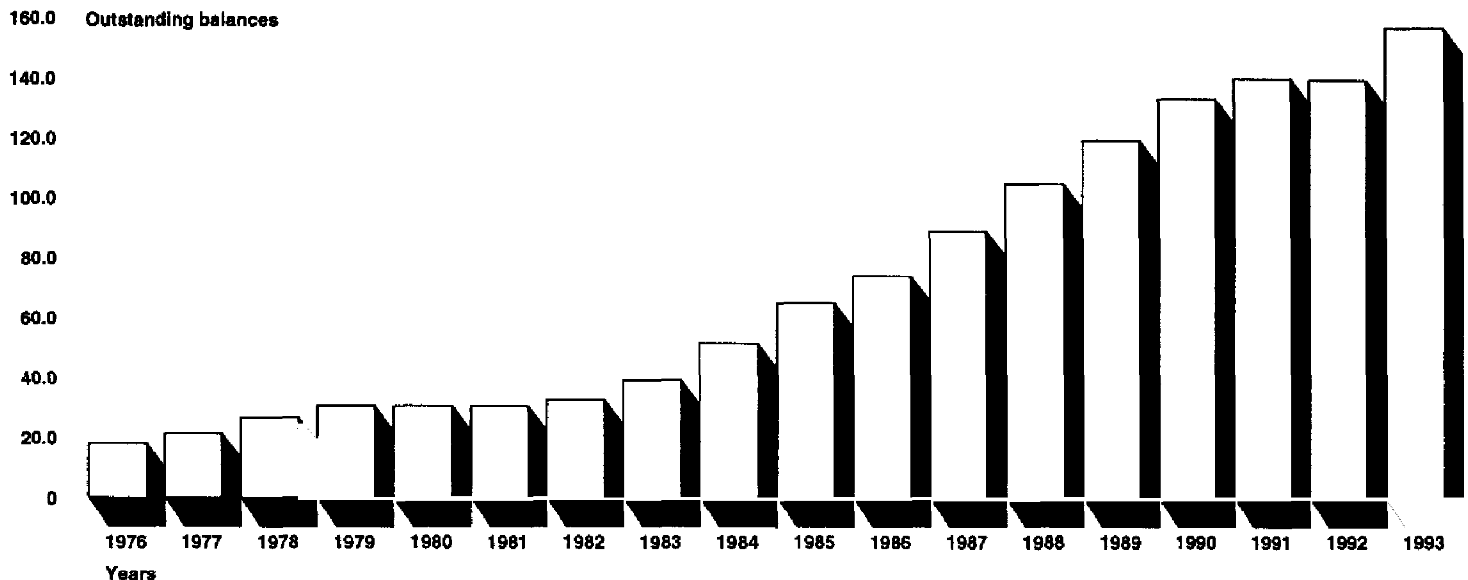
Use of general purpose credit cards has grown substantially in the United States since the mid-1980s. VISA and MasterCard members' total annual charge volume grew by 60 percent in constant 1982 dollars, from about $131 billion in 1986 to about $216 billion in 1992. Moreover, between yearend 1983 and yearend 1993, total credit card balances outstanding[3] quadrupled, rising from about $39 billion to about $156 billion in constant 1982 dollars. Figure 1.1 shows the increase in credit card balances outstanding between 1976 and 1993. The most rapid growth occurred during the period 1983 through 1990. After growing at an average annual rate of 15.5 percent between 1986 and 1990, outstanding balances increased by 5.1 percent in 1991 and remained flat in 1992 during a period of slow economic growth. However, outstanding credit card balances increased by 12.4 percent in 1993 as the economic recovery strengthened.

[2]Worthen Bank & Trust Co. v. National BankAmericard Inc., 345 F. Supp 1309 (E.D. Ark. 1972), rev'd, 485 F.2d 119 (8th Cir. 1973), cert. denied, 415 U.S. 918 (1974).

[3]The dollar amount of borrowings owed by cardholders.

According to Federal Reserve economists, not all of the increased credit card balances during the 1980s represented long-term borrowing by cardholders. Instead, many consumers, who prefer to use credit cards as a convenient payment mechanism, generally paid off their outstanding balances at the end of each month.[4]

Figure 1.1: Total Credit Card Balances Outstanding, 1976-1993, Adjusted for Inflation



Constant 1982 dollars in billions

Note: Based on consumer price index, 1982 to 1984 = 100.

Source: The Nilson Company, SMR Research Corporation, and RAM Research Corporation. There is no single source of publicly available historical data about the credit card industry's assets, revenues, and expenses. Consequently, we used several different sources to provide background data for this report. We used the best available data to present various aspects of industry performance but did not attempt to verify these data.

According to industry analysts, before the early 1980s, most states' usury laws placed ceilings on interest rates for credit cards held by consumers. These laws suppressed the growth of the credit card industry insofar as

[4]Glenn B. Canner and Charles A. Luckett, "Developments in the Pricing of Credit Card Services," Federal Reserve Bulletin, (Sept. 1992), pp. 652-666.

issuers in states with low ceilings issued cards only to the most creditworthy individuals.[5] However, a 1978 Supreme Court decision, the Marquette case, permitted a card issuer to charge the interest rate permitted in the institution's home state to its customers nationwide.[6] Subsequently, many states relaxed their usury laws and several states—South Dakota, for example—repealed their usury laws, thus becoming attractive home states for card issuers.

Higher credit card interest rates enabled issuers to offer cards to riskier customers who previously may not have qualified. Charging higher interest rates compensated the issuers for the risks associated with offering credit cards to less creditworthy individuals who were more likely to default on payment of their credit card debts. Providing cards to customers who previously did not qualify also contributed to the surge in demand for credit card loans during the 1980s. The long economic expansion of the 1980s further increased the demand for credit card loans because cardholders were in a better financial position to make purchases with their credit cards. The percentage of American households with at least one credit card account grew rapidly during the 1980s, from about 38 percent in 1977 to 54 percent in 1989 (see table 1.1). Data also indicate that the percentage of households with at least one credit card account increased in all income groups.

Table 1.1: Percentage of American Households With at Least One Credit Card Account by Household Income, 1977-1989

	Percent of households with credit card accounts		
Household income	**1977**	**1983**	**1989**
Less than $10,000	11%	10%	16%
$10,000 to 19,999	18	27	37
$20,000 to 29,999	33	42	63
$30,000 to 49,999	49	60	74
$50,000 or more	67	80	87
All households	38	43	54

Source: Federal Reserve Surveys of Consumer Finances, 1977, 1983, and 1989, conducted in cooperation with other agencies.

Despite the rapid growth of credit card lending, general purpose credit card purchases of goods and services in 1990 still accounted for only about 10.5 percent of the total U.S. payments system of $3.5 trillion, according to VISA data. Cash and checks accounted for the largest

[5]See Canner and Luckett, pp. 652-666 and Christopher C. DeMuth, "The Case Against Credit Card Interest Rate Regulation," Yale Journal of Regulation, Vol. 3: 201 (Winter 1986), pp. 201-242.

[6]Marquette National Bank v. First Omaha Service Corporation, 439 U.S. 299 (1978).

portion, nearly 84 percent, and retailer-issued charge cards and other payment mechanisms, accounted for the remaining 5.5 percent.

Sources of Credit Card Revenues and Expenses

Credit card issuers generate revenues from interest rate charges and various other fees. Data collected by the Nilson Company—an independent firm that follows the industry—indicate that VISA and MasterCard members generated about $34 billion in revenues in 1991, including $26 billion (76 percent) from interest charges and $8 billion (24 percent) from cardholders' annual membership fees, fees charged to merchants for processing credit card transactions, and other miscellaneous income.

With regard to expenses, the Nilson data show that total credit card expenses in 1991 were about $28 billion, including funding costs of $13 billion (46 percent), charge-offs for bad loans of $8 billion (29 percent), and operating expenses of $7 billion (25 percent). Funding costs, also called interest expenses, were incurred as issuers obtained funds from interest-bearing accounts and the open market. Charge-offs reflected balances delinquent for more than 180 days, as defined and accounted for under federal banking regulations. Operating expenses included labor and computer costs incurred to solicit and maintain cardholders' accounts. The industry's pretax income, revenues less expenses, was about $6 billion in 1991.

Stable Credit Card Interest Rates and Relatively High Industry Earnings Have Generated Debate

Although in 1992, many credit card issuers began to offer lower interest rates to creditworthy customers, credit card interest rates were stable at about 18 percent for nearly 20 years despite wide fluctuations in the cost of funds. The stability of these rates, combined with industry earnings that were high compared to other consumer lending activities, generated debate about the adequacy of competition in the U.S. credit card industry. While some economists and industry analysts argued that the industry's relatively high earnings and stable interest rates indicated a lack of competition, others disagreed, arguing that other factors, such as risk and consumer behavior, accounted for the industry's pricing practices and earnings.

Data Available on Credit Card Interest Rates Are Limited

The data available on credit card interest rates over the past 2 decades have certain limitations. The Federal Reserve publishes quarterly information about the average "most common" annual interest rates, based

on the findings of a survey of a sample of about 160 large banks. The survey requests banks to provide the interest rate that applies to the highest dollar amount of outstanding credit card balances. The average most common interest rate is the simple mean of the rates reported; it does not reflect the weighted market share of each reporting bank. Also, it does not capture the diversity of interest rates that a typical issuer may offer its entire customer base. For example, some issuers may offer cards with interest rates lower than their most common interest rate to selected customers who have good credit histories and who charge a certain dollar volume each year. Despite these limitations, we used the average most common interest rate data when making historical comparisons because it was the only indicator we had that was based on data collected consistently over the last 20 years.

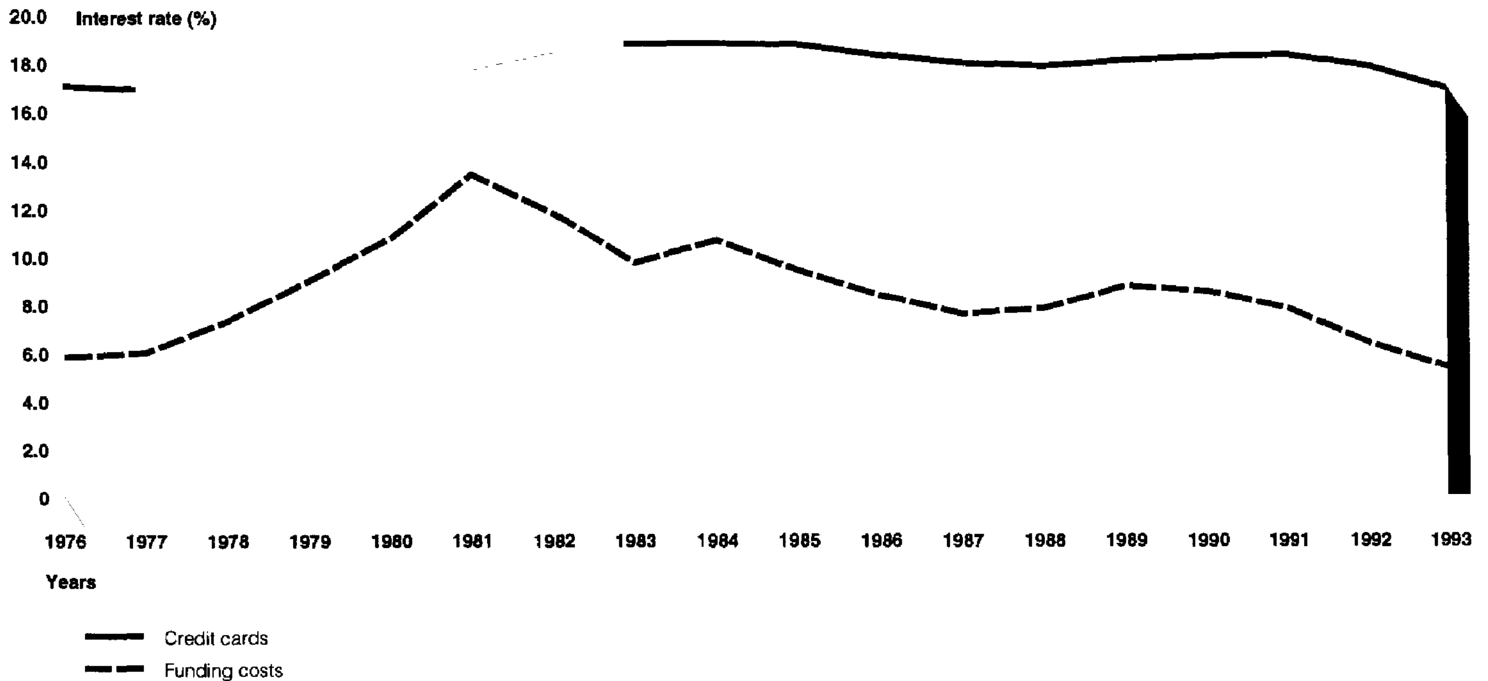
It is important to note that cardholders do not always pay the interest rate an issuer charges. The actual interest rate that a cardholder pays depends upon the extent to which he or she takes advantage of grace periods—the time period issuers allow cardholders to carry their charges without interest charges. Cardholders who always repay their charges in full within the typical grace period of 25 to 30 days pay actual interest rates of zero. On the other hand, cardholders who regularly carry balances pay effective rates closer to the interest rate stated by the issuer. Consumer surveys estimate that about one-third of all cardholders consistently take advantage of grace periods, while the remaining two-thirds occasionally or always pay interest.[7]

Average Interest Rates Were Stable for Many Years

Figure 1.2 shows that the average most common interest rate has remained stable at about 18 percent for many years, ranging from 16.89 percent in 1977 to 18.78 percent in 1983. However, in recent years, the average rate has declined from 18.23 percent in 1991 to 17.76 percent in 1992, and it further declined to 16.83 percent in 1993. During the period that the average most common interest rate was generally stable, the cost of funds fluctuated significantly.

[7]Although about 50 percent of consumers report that they pay their balances in full each month, surveys of actual repayment patterns indicate that only about one-third do so.

Figure 1.2: The Average Most Common Interest Rates and Funding Costs for Credit Card Issuers, 1976-1993



Note: Credit card funding costs are a percentage of average outstanding balances.

Source: Federal Reserve data and VISA.

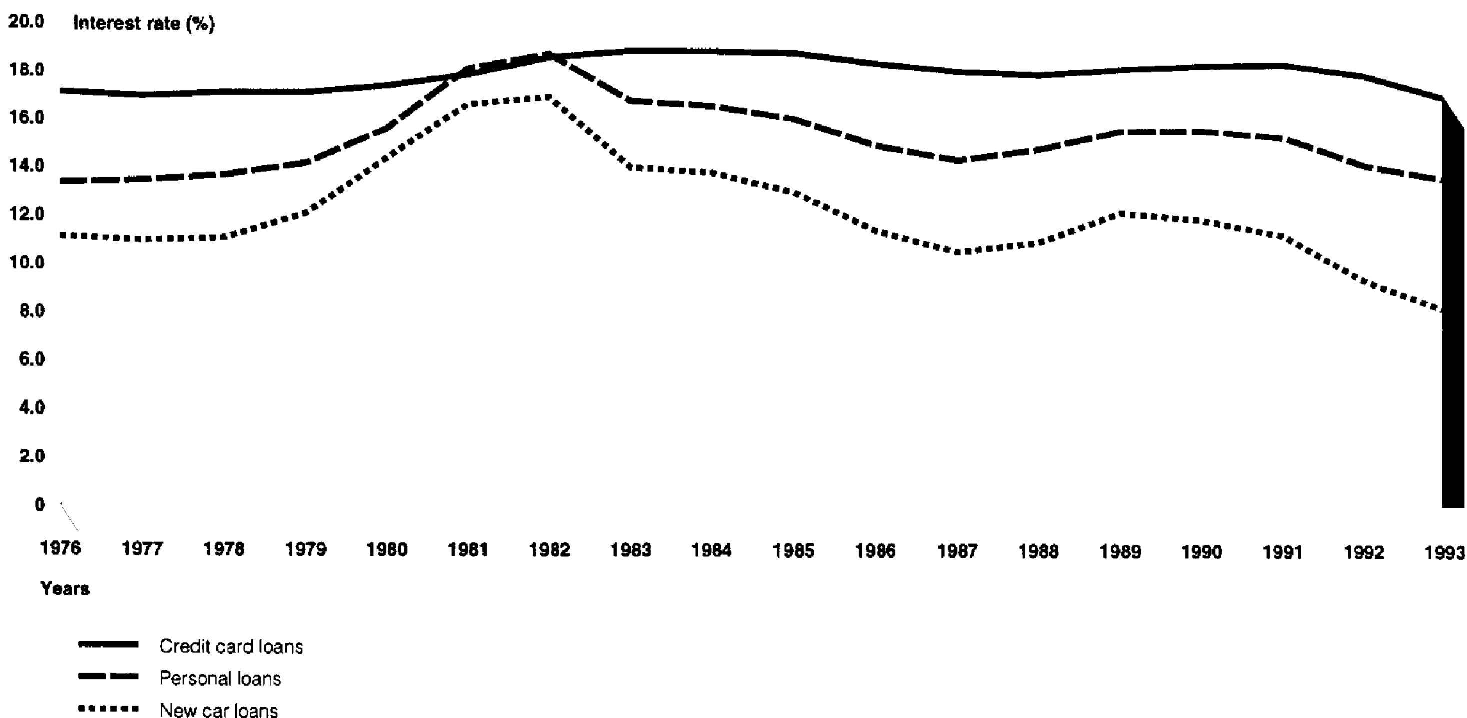
As shown in figure 1.2, credit card funding costs as a percentage of average outstanding balances jumped from 5.83 percent in 1976 to 13.38 percent in 1981.[8] The funding costs fell substantially in 1992 to 6.34 percent and then dropped further to 5.33 percent in the first 9 months of 1993. The difference between the credit card interest rate and the cost of funds reached 11.50 percentage points in 1993, the highest level since 1976.[9]

[8]The data represent credit card issuers' expenditures on funding costs as a percentage of their average annual outstanding balances. These data, which were provided by VISA, represent the funding costs for VISA and MasterCard issuers.

[9]Average credit card interest rate data are for all of 1993, while the funding cost data are for the first 9 months of the year.

The average most common credit card interest rate has also remained stable over the past decade compared to interest rates on other types of consumer loans, as shown in figure 1.3. For example, while the average interest rate on personal loans fell from 18.65 percent in 1982 to 13.47 percent in 1993, the average most common credit card interest rate remained generally stable at between 17 and 18 percent. While average personal loan rates have fluctuated more widely than average credit card interest rates over time, credit card interest rates did decline more rapidly between 1992 and 1993. Specifically, credit card interest rates fell from 17.76 percent in 1992 to 16.83 percent in 1993 (a decline of .93 points or 5.2 percent), while personal loan rates fell from 14.04 percent to 13.47 percent (a decline of .57 points or 4.1 percent). The most common credit card interest rate began to decline more rapidly than some other types of interest rates in 1992 and 1993 as a result of increasing price competition among card issuers.

Figure 1.3: Average Credit Card, Personal, and New Car Loan Interest Rates, 1976-1993



Source: Federal Reserve data.

Many Cardholders Were Offered Lower Interest Rates in 1992

In late 1991 and throughout 1992, several large card issuers began to offer lower interest rate cards to cardholders with good credit histories and annual total credit card charges of at least $1,000. Many issuers also began offering variable-rate cards indexed to the prime lending rate. (This means that if the cost of funds rises or falls, the credit card interest rate rises or falls proportionately.) In addition, during 1992 and 1993, several nonbanks, such as General Motors, Ford, and General Electric, entered the credit card business and began to offer relatively low variable rate interest rates and other incentives to attract potential customers. The nonbanks have established several different approaches to gain entry into VISA and MasterCard and to issue their credit cards. For example, some nonbanks, such as General Electric, have acquired federally insured depository institutions and thereby gained association membership.[10] Other nonbanks, such as AT&T—which introduced its Universal Card in 1990—and General Motors, have established contractual relationships with existing VISA and MasterCard members to issue credit cards in the nonbanks' names and to process associated credit card transactions.[11]

Because of these new offerings, the number of cardholders who qualified for lower interest rates increased substantially in 1992. The RAM Research Corporation, an independent firm that tracks credit card rates, found that the percentage of total credit card accounts subject to annual interest rates of 16.5 percent or less, increased from 9 percent in 1990 to 39 percent in 1992. Meanwhile, the percentage of total credit card accounts subject to annual interest rates of 18 percent or more, fell from 69 percent in 1990 to 43 percent in 1992. In chapter 3, we discuss possible reasons for these new offerings and some of their implications.

Credit card interest rates are important because they account for most credit card revenues; however, card issuers may compete on other terms and features of credit card accounts. As examples, issuers have competed on credit card enhancements, such as frequent flyer miles, rebates, annual fees, and credit limits. When Sears introduced its Discover Card in 1986, it offered cardholders rebates of up to 1 percent of their total annual credit card purchases. Also, new industry nonbank entrants offered rebates on amounts charged and credits for future purchases. Such enhancements are designed to make these and other nonbank companies more competitive in the credit card industry, as well as in their primary lines of business. After AT&T entered the credit card business in 1990 and offered a "no

[10]General Electric offers MasterCard credit cards through its Monogram Bank subsidiary.

[11]AT&T has established a contractual relationship with Synovous Bank of Georgia while General Motors has established a contractual relationship with Household International, Inc.

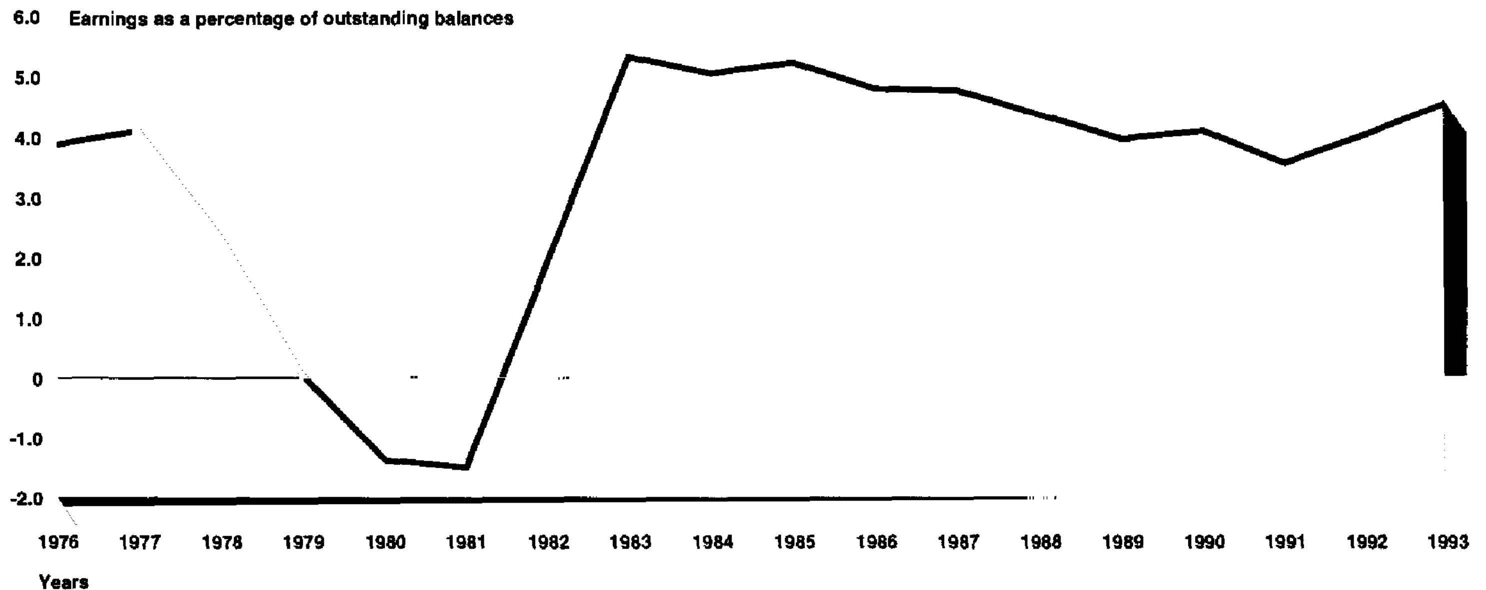
annual fee for life" incentive on its Universal credit card, several other issuers, including the major issuers, waived annual fees or offered cards without annual fees. In addition, issuers have competed on cardholder credit limits, with higher credit limits being extended to lower-risk cardholders.

Credit Card Earnings Have Been Relatively High in Recent Years

Figure 1.4 shows the average pretax earnings as a percentage of average outstanding balances (the usual measure of earnings for credit card issuers) for VISA and MasterCard issuers between 1976 and 1993. A percentage of earnings to outstanding balances measure is comparable to a return on assets, a standard measure of profitability for other businesses. In the late 1970s and early 1980s, card issuers experienced low earnings or even losses because of the many state usury laws' caps on credit card interest rates. These interest rate caps prevented issuers from recovering their total costs of operations, which had increased because of a sharp rise in the cost of funds.

Figure 1.4 also indicates that the pretax earnings of credit card issuers began to recover in 1982, increased substantially in 1983, began to decline gradually afterwards, and started to recover in 1992 and 1993. Between 1983 and 1990, VISA and MasterCard issuers' earnings averaged 4.68 percent of outstanding balances, while the overall earnings of banks in general averaged .57 percent of assets (bank assets consist primarily of loans including credit card loans). In 1991, VISA and MasterCard issuers' average earnings fell to 3.55 percent, partly as a result of higher charge-off costs following the recession. However, average earnings reached 4.02 percent in 1992 and 4.53 percent in the first 9 months of 1993, partly because of a substantial decrease in funding costs.

Figure 1.4: Average Pretax Earnings of VISA and MasterCard Issuers, 1976-1993



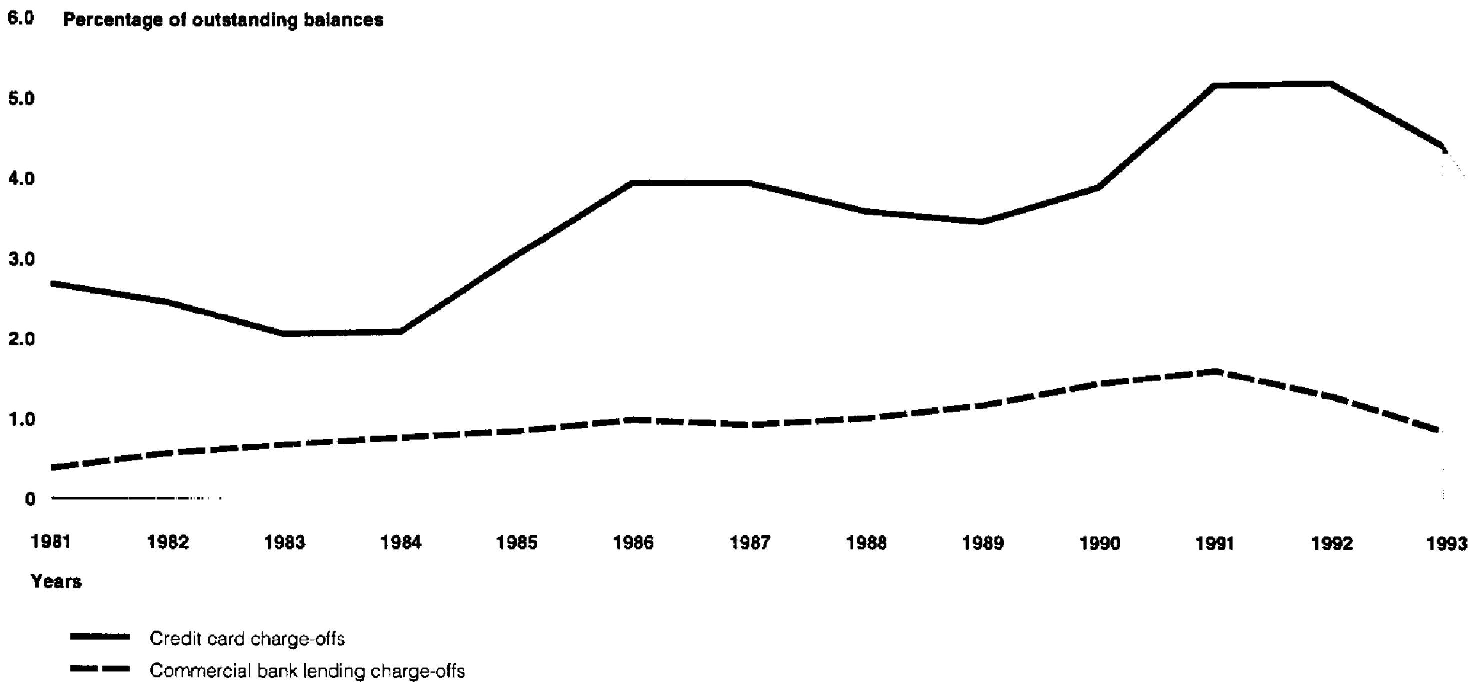
Note: These earnings data, which were provided by VISA, represent the overall profitability for credit card lending at depository institutions. The data do not distinguish between the earnings generated on VISA and MasterCard balances because most issuers offer both types of cards. The combined market share of VISA and MasterCard members is about 90 percent of outstanding balances. Data for 1993 are for the first 9 months of the year.

Source: VISA.

VISA and MasterCard members had relatively high earnings in recent years despite relatively high charge-off costs for bad loans. Figure 1.5 shows that the average charge-off rate for VISA and MasterCard members' credit card lending has consistently exceeded the charge-off rate for commercial bank lending as a whole. Between 1990 and 1992, the charge-off rate, as a percent of outstanding credit card balances, increased from 3.88 percent to 5.17 percent. Although the credit card charge-off rate fell to 4.37 percent

in the first 9 months of 1993, it was still more than five times the charge-off rate for commercial bank lending.[12]

Figure 1.5: Charge-Off Rates for Credit Card Lending and Commercial Bank Lending Activities, 1981-1993



Note: The credit card charge-off data, which were provided by VISA, represent the overall charge-off rate for credit card lending at depository institutions. The data do not distinguish between the charge-off rates incurred on VISA and MasterCard balances since most issuers offer both types of cards. Data for 1993 are for the first 9 months of the year.

Source: VISA and FDIC.

Credit Card Interest and Earning Rates Have Attracted Congressional Attention

In 1985 and 1986, the former House Subcommittee on Consumer Affairs and Coinage, Committee on Banking, Finance and Urban Affairs and the former Senate Subcommittee on Financial Institutions and Consumer Affairs, Committee on Banking, Housing, and Urban Affairs held hearings

[12]For more information about the differences in profitability between credit card and other types of lending, see Lawrence M. Ausubel, "The Failure of Competition in the Credit Card Market," American Economic Review, Vol. 81, No. 1 (Mar. 1991), pp. 50-81; Paul S. Calem, "The Strange Behavior of the Credit Card Market," Business Review, Federal Reserve Bank of Philadelphia, (Jan./Feb. 1992), pp. 3-13; S. Park, The Credit Card Industry: Profitability and Efficiency, Federal Reserve Bank of New York (July 1992); and Paul R. Watro, "The Bank Credit-Card Boom: Some Explanations and Consequences," Economic Commentary, Federal Reserve Bank of Cleveland (Mar. 1, 1988).

on the reasons average credit card interest rates did not fall despite substantial decreases in funding costs since the early 1980s. At the hearings, some industry critics, arguing that the stability of average interest rates indicated inadequate price competition among credit card issuers, suggested that the government impose interest rate caps on credit cards. Other witnesses, including Federal Reserve officials, contended that the U.S. credit card industry was structurally competitive and that risks associated with credit card lending explained why high interest rates did not fall. These officials argued that imposing interest rate caps would disrupt the market and force issuers to cancel the cards of many riskier customers.

Congressional attention again focused on competition within the U.S. credit card industry during the fall of 1991. In November, President Bush publicly remarked that credit card rates were too high and that lower rates could help the economy recover from its prolonged recession. Senator Alfonse D'Amato then introduced a measure that would have limited credit card rates to 14 percent. Although the Senate passed this measure overwhelmingly by a vote of 74 to 19, the legislative session ended before the House acted on such a rate cap. The proposal raised considerable controversy, with industry representatives arguing that the proposed limits would result in widespread card cancellations and credit line curtailments for many customers. Some industry analysts also believe the legislation disrupted trading in the markets for securities backed by outstanding credit card balances.

Objectives, Scope, and Methodology

We received two separate requests to assess the competitive performance of the U.S. credit card industry. The first request came jointly from former Chairman Esteban E. Torres, House Subcommittee on Consumer Affairs and Coinage, House Committee on Banking, Finance and Urban Affairs, and Congressman Charles E. Schumer. The second request came from the Subcommittee's Ranking Minority Member, Al McCandless, and the former House Banking Committee Ranking Minority Member, Chalmers P. Wylie. On the basis of discussions with the requesters, our objectives were to review the (1) assessments of whether the credit card industry's structure supports competition, (2) explanations that have been offered for the credit card industry's relatively stable interest rates and high earnings, and (3) proposed credit card interest rate cap and various other policy options.

To meet these objectives, we analyzed available credit card industry data to identify trends and patterns in costing, pricing, and earnings. Because

there is no single data source for credit card performance over time, we used the best available data relevant to the issues raised by various industry analysts and critics. We also reviewed the related economic literature and several industry studies. Except where noted, we did not try to independently verify or replicate the methodologies of these studies.[13] We also obtained and reviewed court documents of recent antitrust litigation between Sears and VISA involving, among other issues, alleged barriers to entry into the U.S. credit card industry. We reviewed these documents, to better understand the issues raised in the litigation, as well as the structural characteristics of the credit card industry that allegedly limit competition.

We also interviewed economists, financial analysts, industry executives, and consumer advocates to obtain their views on competition in the credit card industry and to identify the advantages and disadvantages of various policy options. We met with officials from VISA and MasterCard, Sears, American Express, RAM Research Corporation, the Nilson Company, and Bankcard Holders of America, among others. We contacted representatives from each of the federal bank and thrift regulatory agencies: the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. Additionally, we contacted officials at the Department of Justice who are responsible for investigating allegations of anticompetitive industry practices and officials from the Federal Trade Commission.

We provided copies of a draft of this report to the Attorney General and the Chairman of the Federal Reserve for their review and comment. Although the Attorney General chose not to provide written comments, the Assistant Chief, Communications and Finance Section of the Department of Justice Antitrust Division, commented on the report's findings and analysis. He and division officials also provided technical comments that have been incorporated in chapter 2. The Chairman of the Federal Reserve provided written comments on the draft report's analysis and recommendations that are provided in appendix II.

We did our work between May 1992 and October 1993 in New York City, San Francisco, and Washington, D.C., in accordance with generally accepted government auditing standards.

[13]A list of these studies is provided at the end of the report.

Widely Held View That the Credit Card Industry's Structure Is Competitive Faces Some Challenges

The stability of average credit card interest rates and the industry's relatively high earnings have perplexed many analysts and generated much controversy. Because stable prices and high earnings are often viewed as indicators of anticompetitive conditions, government and private sector economists have analyzed the credit card industry's structure to determine the extent to which it might have facilitated anticompetitive practices. These analyses have generally concluded that the industry's structure provides for adequate competition among credit card issuers.

On the other hand, an alternative viewpoint suggests that certain characteristics of the credit card industry's structure may have limited competition. One argument is that the largest card issuers, who collectively hold a significant portion of the industry's outstanding balances, have conformed to one another's pricing decisions over the years. Another argument is made by Sears, that alleged in an ongoing private antitrust suit that large bank issuers use VISA's membership rules to limit the competition from firms that have established independent credit cards, such as the Discover credit card. This antitrust controversy has not yet been resolved in the courts.

The Structural Characteristics of the Credit Card Industry at the Card Issuer Level

At the card issuer level, the credit card industry displays many of the structural characteristics of a competitive industry. It has a large number of participants, modest concentration levels, and relatively low barriers to entry for new card issuers. In addition, the Department of Justice, which has monitored the credit card industry over the years, has not instituted proceedings against any firm charging an antitrust violation in its credit card operations. It is true, however, that certain large issuers had the same most common annual interest rate of 19.8 percent for several years. This may have occurred because these issuers hold about half of all outstanding credit card balances and followed one another's pricing decisions. However, other analysts do not believe that there is sufficient evidence to conclude that issuers have engaged in this practice.

Standard Measures Suggest That the Industry Is Competitive at the Card Issuer Level

Although the credit card industry is composed of both card issuers and card associations—VISA and MasterCard—most analysts generally view card issuers as the relevant level of business for assessing the industry's competitiveness. This view is based on the fact that individual issuers own cardholders' accounts, set credit card interest rates and other terms, and make other business decisions. Many analysts have found that the structure of the credit card industry at the issuer level has those

characteristics that favor competition. These characteristics are discussed next.

- a large number of competitors

Nearly 6,000 depository institutions issue credit cards—a much larger number of competitors than exist in many other industries.

- a lack of concentration

The Department of Justice and the Federal Trade Commission use the Herfindahl-Hirschman Index (HHI) to measure market concentration.[1] Industries with HHI values below 1,000 are considered unconcentrated, and those with HHI values above 1,800, highly concentrated. Although estimates vary, most analysts place the HHI value for the credit card industry at less than 564.[2]

- few barriers to entry for depository institutions that wish to issue credit cards

VISA and MasterCard permit virtually any federally insured depository institution (bank, thrift, or credit union) to join and issue their credit cards. Approximately 4,500 of the 6,000 depository institutions that issue credit cards joined VISA and/or MasterCard between 1980 and 1991. Approximately 14,000 "participating" institutions offer credit cards under their names, but conform to pricing decisions made by issuing institutions with whom they have established contractual relationships.[3] For example, the participating institutions charge credit card interest rates specified by the card issuers.

[1]The HHI value represents the sum of the squared percentage shares of every firm in the market chosen to do the analysis (i.e., the relevant market). Thus, a relevant market with ten firms each with 10 percent market share, has an HHI value of 1,000.

[2]The HHI value estimates vary depending upon the definition of the relevant market and the year chosen to do the analysis. Robert Litan, in his 1992 study, Consumers, Competition, and Choice: The Impact of Price Controls on the Credit Card Industry, estimated that the HHI value for the credit card industry was 375 in 1990. Mr. Litan's definition of the relevant market included traditional VISA and MasterCard issuers, as well as store and oil company charge cards. Using a sample of 124 VISA issuers, Richard Schmalansee, an expert witness for VISA, estimated the industry's HHI value at 453 in 1990. On the basis of data provided by the RAM Research Corporation for yearend 1992, we estimated the HHI value for the industry was about 564. The data consisted of the 212 largest general purpose credit card issuers who accounted for about 95 percent of industry balances. This estimate of the industry's HHI value would have been lower if all 6,000 issuers had been included in the calculation.

[3]Although regulatory barriers to entry in the credit card industry are generally considered low, in 1991, Sears initiated an antitrust suit against VISA alleging it has been prevented from joining the association. This issue is discussed later in this chapter.

The number of competitors and the relatively modest concentration levels in the industry are regarded by many analysts as compelling evidence that the industry structure does not favor anticompetitive practices by credit card issuers. To date, the Department of Justice has not instituted any antitrust proceedings against any firm charging an antitrust violation in its credit card operations. However, Department of Justice officials told us that they continue to monitor the industry, as they routinely monitor other significant industries, to detect potential antitrust violations.

There Is a Potential for "Tacit Coordination" Among Large Credit Card Issuers, but the Evidence Is Inconclusive

We were asked to assess the extent of competition among the 10 largest credit card issuers and to assess why several of these issuers had charged the same most common interest rate of 19.8 percent for several years, despite substantial declines in the cost of funds. Although standard measures of the industry's structure suggest that it should be competitive, some analysts and congressional critics have suggested that large issuers may dominate the industry and thereby limit interest rate competition. An industry dominated by several large firms is called an oligopoly.

Although there is no single explanation for how prices charged to consumers are determined in an oligopoly, it is clear that the pricing decisions by any one firm are significantly influenced by the pricing decisions of its rivals. Economists have shown that if the firms in an oligopoly form a cartel, they can maximize their earnings by formally negotiating price and output decisions at least over the short term. However, such price fixing among firms is illegal under U.S. antitrust laws. In certain circumstances, however, firms could achieve the same ends through "tacit coordination," i.e., establishing, without an explicit agreement, a market price that resembles a formally negotiated price.

One form of tacit coordination is a situation in which a clearly dominant firm acts as a price leader. That is, the price leader sets a price and the other firms in the industry follow by setting the same price. Another form of tacit coordination exists when a firm matches a price cut by its rivals because to do otherwise would result in a loss of its customers. However, the firm would not necessarily match price increases because it could attract customers from its rivals who had raised their prices. Economists believe that this form of tacit coordination results in stable prices that are unlikely to change in response to small- or medium-sized changes in firms' cost of producing the good or service.[4] Either form of tacit coordination is

[4]Edwin G. Dolan and David E. Lindsey, Economics, (The Dryden Press, 1991), p. 683. This latter form of tacit coordination is referred to as the "kinked demand curve" theory of oligopoly.

easiest to achieve when (1) the market is limited to a few firms; (2) the market is characterized by a stable demand for the good or service, rather than by wide fluctuations in demand; and (3) the good or service being offered by each firm is generally the same.

It could be argued that the structural characteristics of the credit card industry are favorable toward tacit coordination among card issuers. First, although there are about 6,000 card issuers and the industry has modest concentration levels, as measured by the HHI value, the 10 largest credit card issuers hold about 57 percent of outstanding balances (see table 2.1). In a 1992 paper, an economist suggested that, because of their collective market share of about 50 percent, the largest card issuers may have engaged in price leadership.[5] Second, despite the surge in credit card borrowing during the 1980s, the market has not been characterized by wide fluctuations in demand (i.e., periods of high demand followed by sharp reductions in demand). Third, each issuer generally offers a similar product to its customers, a convenient means of payment and borrowing.

Table 2.1: Outstanding Balances of the 10 Largest Credit Card Issuers, December 31, 1992

Card issuer	Total outstanding balances (dollars in billions)	Market share percent
Citicorp	$35.5	18.3%
Sears' Discover	16.4	8.4
Chase Manhattan	9.8	5.0
MBNA America	9.2	4.8
First Chicago	8.5	4.4
Bank of America	8.1	4.2
AT&T Universal	6.6	3.4
Chemical Bank	5.8	3.0
Household Bank	5.7	2.9
Bank of New York	4.9	2.5
Totals	**$110.5**	**56.9%**

Source: RAM Research Corporation.

Based on our discussions with industry analysts and review of studies on the credit card industry's competitive performance, the available evidence does not appear to suggest that any one credit card issuer has acted as a

[5]Carl Shapiro, Controlling Credit Card Costs, Haas School of Business, University of California, Berkeley, (Dec. 1992). This study was sponsored by American Express.

dominant price leader.[6] However, several of these large card issuers charged the same most common interest rate of 19.8 percent over a period of several years. This suggests that these large card issuers may have engaged in the second form of tacit coordination, whereby firms will not necessarily match a price increase made by their rivals but will match a price decrease, that generally results in stable pricing.

Although several large card issuers charged the same most common interest rate of 19.8 percent over a period of several years, there is some evidence that these issuers have not behaved according to the tacit coordination model discussed above. Specifically, some large card issuers have lowered their interest rates in the past, but their rivals have not matched these interest rate decreases. For example, in 1986, the former Manufacturer's Hanover Bank reduced its credit card interest rates from 19.8 to 17.8 percent and, in 1988, Chase Manhattan Bank reduced its credit card interest rates from 19.8 to 17.5 percent. Other large issuers, such as Citibank, did not match these interest rate decreases, and, by 1990, Manufacturer's Hanover and Chase Manhattan had resumed charging the most common annual interest rate of 19.8 percent on their credit cards.[7]

Moreover, some analysts are not convinced that the largest card issuers control a sufficient percentage of outstanding credit card balances for tacit coordination to exist.[8] A Federal Reserve economist we contacted also said that the fact that several large issuers have charged the same most common annual interest rate is consistent with theories about open competition. If these large issuers offer their cards to similar customer groups and have similar expenses, economists would expect these issuers to charge similar interest rates in a competitive market.[9] We have noted that several of these large issuers also charge the same prime lending rate to their large corporate customers.

[6]For example, according to one economist, the largest firm must control 50 to 95 percent of the relevant market to be a dominant price leader. Douglas F. Greer, Industrial Organization and Public Policy, 3rd Ed. (New York: Macmillan Publishing Company, 1992), p. 372.

[7]The fact that large card issuers did not match the interest rate cuts by Manufacturer's Hanover and Chase Manhattan, and the fact that these banks raised their rates to 19.8 percent later in the decade suggests that consumers may have been indifferent to credit card interest rates during the 1980s. This issue is discussed further in chapter 3.

[8]Lexecon, Inc., Economic Analysis of VISA's Exclusion of Sears, (Chicago, June 5, 1992), p. 20. This study was sponsored by Sears. The authors do note that tacit coordination may be possible if the largest issuers have significant cost advantages over the smaller issuers. However, they have not studied whether the larger issuers have such cost advantages.

[9]Large issuers tend to offer their cards to riskier customers, including younger customers with shorter credit histories, and charge higher rates to compensate for these risks than do smaller issuers.

The limitations of available data and the unique aspects of the credit card business discussed in chapter 1 also complicate any analysis of pricing trends in the credit card industry. The focus on the most common interest rates overlooks the interest rates charged to groups other than those with the highest credit balances. Moreover, as discussed in chapter 1, large issuers compete on terms other than the credit card interest rate, such as annual fee levels, rebates, and various enhancements.

VISA and MasterCard Have Been the Subjects of Antitrust Lawsuits

The VISA and MasterCard associations are organized as joint ventures among credit card issuers who otherwise compete against one another for cardholder business. The associations have various responsibilities, including (1) developing and maintaining automated transaction processing systems, also known as authorization and settlement systems; (2) setting fees for use of the automated systems; (3) establishing rules and membership bylaws; and (4) initiating advertising campaigns to increase credit card usage. Under VISA and MasterCard rules, a member card issuer that belongs to both associations may have a representative on the board of directors of one association and may have representatives on the policymaking committees of the other association. However, the member institution may not have representatives on the boards of directors of both associations.

Because of their structure and dual membership, VISA and MasterCard have been the subjects of various antitrust lawsuits, which, for the most part, they have fought successfully. For example, in 1986, VISA successfully defended its members' right to collectively set fixed fees that banks pay one another during credit card transactions.[10] The plaintiff in the case, Nabanco, was an independent company that wanted to process credit card transactions for card issuers and merchants. Nabanco argued that the fixed fees established collectively by VISA members were designed to prevent independent companies from entering the credit card processing business. VISA won the case at both the federal district and appellate court levels. In its decision, the appeals court concluded that VISA members should be granted latitude to set fixed fees to ensure the efficient operations of the VISA system.

Pending Litigation Involves Visa Membership Rules

In an ongoing lawsuit filed in 1991, Sears, which issued the Discover Card, challenged a VISA membership bylaw that expressly named Sears and American Express as ineligible for membership. Sears had unsuccessfully

[10]See National Bancard Corporation v. VISA, 779 F.2d 592 (11th Cir.), cert. denied, 479 U.S. 923 (1986).

tried to join VISA by purchasing from the Resolution Trust Corporation a failed savings and loan in Utah, MountainWest Savings and Loan, that was already a VISA member. MasterCard had also denied a similar application for membership from Sears and was involved in separate litigation with Sears in a New York federal district court. This litigation was settled in November 1993 and is discussed later in this section. Although acknowledging that VISA members compete against one another, Sears argued that card issuers acted anticompetitively by using the association's membership bylaws to prevent low-cost competitors from joining VISA. Sears also argued that VISA members acted as a group, rather than as individual competitors, to protect their high earnings from unwanted competition. Furthermore, Sears called the association's rulemaking authority a potential anticompetitive force because VISA's and MasterCard's members have a 72-percent collective market share of annual credit card charge volume.

During the trial, further evidence was presented that VISA and its members took steps to limit competition from the Discover Card. For example, during the mid-1980s, VISA tried to prevent merchants who accepted VISA credit cards from processing Discover Card transactions on the merchants' computer terminals. Sears also alleged that some VISA members tried to block AT&T's entry into the credit card industry by attempting to initiate regulatory action against AT&T in its efforts to introduce the Universal credit card in 1990. As pointed out in chapter 1, AT&T was able to issue a VISA credit card by establishing a card-processing relationship with another VISA member, Synovous Bank of Georgia.

At the trial, VISA denied that its membership restriction policy against Sears and American Express was anticompetitive, arguing that the restriction was justified on several grounds. For example, VISA claimed that the policy's intention was to protect its members' investments and property rights from "direct competitors"—Discover and Optima—who had established their own credit cards. VISA defended that intention by saying that economists and courts traditionally recognized the right of firms to protect their investments and property—such as VISA members' investments in the association's logo and computerized transaction settlement systems—because that right created incentives to develop superior products that benefited consumers.

VISA also asserted that permitting Sears to join it would further diminish "intersystem" competition in the credit card industry. Intersystem

competition is typically defined as the competition among VISA, MasterCard, Sears, and American Express. As examples, these entities compete to promote consumer use of their cards and to develop lower-cost card processing technologies. Intersystem competition had already been diminished, VISA argued, by VISA and MasterCard's sharing of a common pool of members. According to VISA officials, granting Sears VISA membership would further weaken intersystem competition in that Sears could cancel its Discover Card once it was admitted as a member.

In November 1992, Sears won the initial round of this antitrust dispute when the jury at the Federal District Court in Salt Lake City ruled in Sears' favor. On April 2, 1993, the trial judge issued an opinion that upheld the jury decision. However, in his decision, the judge prevented Sears from issuing a VISA card until VISA had an opportunity to appeal the decision to a higher court. After acknowledging that Sears had presented sufficient evidence for the jury to conclude that VISA's membership policy was anticompetitive, the judge stated his belief that requiring VISA to grant membership to Sears would not necessarily provide long-term material benefits to consumers. He noted that Sears charged (at the time of the trial) an interest rate of 19.8 percent on its Discover Card and an interest rate exceeding 20 percent on its store charge cards.[11] However, he agreed with VISA that permitting Sears to join VISA would further diminish intersystem competition in the credit card industry. VISA filed for an appeal to the court's decision on May 6, 1993.

Since the court's decision, Sears completed a previously announced divestiture of its Dean Witter, Discover & Company financial services subsidiary. Dean Witter now issues the Discover Card and, as the owner of MountainWest Savings and Loan in Utah, is involved in the litigation against VISA. VISA officials said they will continue to pursue their appeal even though MasterCard has since settled its litigation with Dean Witter.

In November 1993, MasterCard settled its ongoing litigation with Dean Witter that had involved Sears prior to the divestiture. In the settlement, MasterCard authorized Dean Witter to issue a MasterCard credit card by establishing a contractual relationship with an existing association member, NationsBank of Charlotte, N.C. NationsBank will issue the credit card, called Prime Option MasterCard, but will share revenue and expenses with Dean Witter.

[11]Sears subsequently introduced a program that offers lower interest rates to Discover cardholders who charge at least $500 annually and are not late on consecutive payments.

Conclusions

The structure of the credit card industry meets the standard criteria for competitiveness in terms of its number of card issuers and lack of concentration. Although it is possible that large issuers have influenced interest rate levels through tacit coordination, no compelling evidence exists to either confirm or reject this explanation for the stability of average most common interest rates and the industry's relatively high earnings compared to earnings on other bank assets. The ongoing VISA-Dean Witter litigation is likely to be important regarding the impact of certain membership restrictions on the competitiveness of the U.S. credit card industry.

Credit Card Lending Differs From Other Types of Consumer Lending

Many analysts argue that differences between credit card and other types of consumer lending help explain why credit card interest rates were stable and industry earnings were relatively high during the 1980s. Some of these analysts agree that the higher risk of credit card lending accounts, at least in part, for the performance of credit card interest rates and earnings. Other factors cited include the unique cost structure of credit card lending, the effects of the expanding economy on competition within a relatively young industry and consumer behavior, such as consumers' indifference to credit cards with lower annual interest rates. For various reasons, competition in pricing among issuers is increasing and many cardholders, especially those who are better credit risks, are being charged lower interest rates. However, we believe that these developments need to be closely monitored to assess their long-term effects on industry competition.

Risks and Costs of Credit Card Lending and the Long Economic Expansion of the 1980s

To explain the historical performance of credit card interest rates and earnings, industry analysts have cited its high risks and unique costs, such as high charge-off and operating costs. Analysts have also pointed out that during the economic expansion of the 1980s, card issuers (1) charged relatively high interest rates to compensate for customers who represented higher default risks and had obtained credit cards for the first time and (2) had few incentives to lower their interest rates because the growth in credit card lending ensured sufficient business for all competitors. Furthermore, these analysts say that as growth slows and the credit card industry matures in the 1990s, card issuers should have greater incentives to compete on interest rates and other pricing terms.

Lending Risks Help Explain Credit Card Interest Rates and Earnings

Some industry analysts believe that the stable interest rates and the relatively high earnings of the credit card industry in the 1980s can be explained primarily by the high credit risk of credit card lending. As mentioned in chapter 1, the average annual charge-off rates for VISA and MasterCard members from 1981-1993 consistently exceeded the average charge-off rates for commercial bank lending in the same period. In 1993, the charge-off rate for credit card lending was more than five times the charge-off rate for all bank lending. Most other types of consumer lending—such as loans for new cars—are collateralized and involve the extension of a fixed amount of credit under fixed terms of repayment (i.e., the borrower must repay an established amount of principal plus interest each month). Credit card loans present greater risks in that they are unsecured, available to large and heterogenous populations, and can be

repaid on flexible terms at the cardholders' convenience. Moreover, cardholders tend to borrow more on their credit cards when they are financially stressed, and credit cards are highly subject to fraudulent use.

An argument has also been made that some cardholders, who are attracted by low interest rate credit cards, pose higher default risks to issuers. If so, issuers who lower their credit card interest rates may disproportionately attract these types of potential customers. Therefore, issuers have incentives to maintain interest rates at relatively high levels.[1]

This phenomenon may partly explain the recent losses that American Express incurred on its Optima credit card. American Express first offered the card in 1987 to its established charge card customers. The Optima Card's 13.5 percent interest rate was relatively low compared to the 18-percent rate that was then the industry's average most common interest rate. In industry reports, analysts said that most American Express charge card customers already had three or four credit cards and did not respond to offers for the new Optima credit card. However, those customers who responded to the offers for the Optima Card—and its annual interest rate of 13.5 percent—reportedly presented higher-than-expected default rates. Many of these cardholders defaulted on their Optima debts, and by 1992, American Express had lost more than $1 billion on the card. In 1992, Optima's charge-off rate of approximately 10 percent of outstanding balances was about twice the industry average.

However, some economists have questioned whether the risks that exist fully explain the sustained high credit card interest rates and earnings of the 1980s. Credit card earnings have been substantial despite high charge-offs of unpaid balances. As discussed in chapter 1, issuers' earnings on credit card balances have generally averaged more than 4 percent of the average outstanding balances since 1983, despite charge-off rates as high as 5 percent. By contrast, the average earnings of banks as a percentage of assets has been about 0.6 percent, with a charge-off rate of about 1 percent.

To provide a further assessment of the differences between the profitability of credit card lending and commercial lending in the period 1986 through 1993, we estimated another profit measure commonly used for that purpose—return on equity (ROE). Assuming that credit card lending was at least 50-percent riskier than other lending activities, as

[1]Robert E. Litan, "Consumers, Competition, and Choice: The Impact of Price Controls on the Credit Card Industry," (Feb. 1992). This study was sponsored by MasterCard.

assumed in one study, we estimated that VISA and MasterCard issuers earned an average ROE of 42.5 percent.[2] This is about 4.5 times higher than the average ROE of 9.7 percent for commercial banks in the same period.

Unique Credit Card Lending Costs May Have Contributed to Stable Interest Rates

Some economists who explain stable interest rates partly in terms of risk also believe that the industry's unique cost structure is a factor in making credit card rates less responsive to changes in the cost of funds, and therefore more stable, compared to interest rates for other lending activities. For example, they point out that funding costs for credit card lending, as a percentage of total lending costs, are low compared to other types of lending. They estimate that credit card funding costs are 25 to 50 percent of total costs, while funding costs for other lending are 60 to 80 percent of total costs. Therefore, changes in funding costs provide issuers less of a basis to change their credit card interest rates than lenders who offer other types of loans.

There are several reasons why funding costs represent a relatively low percentage of total credit card costs. As discussed earlier, charge-off costs for credit card lending are comparatively high. Moreover, operating costs for credit card lending are also relatively high. For example, it has been estimated that the operating costs for small banks that issued credit cards in 1991 were about 55 percent of their total credit card lending costs. By contrast, these banks' operating costs for other types of lending, such as home mortgage and commercial lending, represented only about 20 percent of the total costs for each of these lending activities.[3] One reason that operating costs are higher for credit card lending is that issuers must engage in a variety of ongoing activities to run successful programs, such as soliciting new customers, servicing accounts, and processing merchant credit card receipts. Operating costs are also relatively high because

[2]See the Robert E. Litan study referred to earlier. Assuming that credit card lending is 50-percent riskier than other lending activities, the Litan study estimated that credit card issuers needed to maintain capital ratios at least 50-percent higher than for other commercial bank lending activities. Since commercial bank capital ratios had averaged 6.6 percent—which was higher than the 6-percent capital to asset ratio required by federal banking regulations for banks to be considered adequately capitalized—Litan estimated that credit card issuers need capital ratios of 10 percent. Using Mr. Litan's assumption that credit card lending is at least 50-percent riskier than other lending activities, we calculated the ROE estimate of 42.5 percent by dividing the earnings as a percentage of average outstanding balances for VISA and MasterCard issuers (4.25 percent) between 1986 and 1993 by the 10-percent capital ratio (4.25/.1 = 42.5 percent).

[3]These cost estimates are based on the Federal Reserve Board's Functional Costs Analysis (FCA) program. Under the FCA program, banks throughout the country—who generally have less than $1 billion in assets—voluntarily supply financial data for various lending functions to the Federal Reserve. The Federal Reserve uses a standardized methodology to calculate revenue, expense, and profitability ratios and publishes this data annually in aggregate form.

issuers must service a large number of relatively small accounts—the average credit card balance is only about $1,250.

Another factor that has been mentioned as a potential cause of interest rate stability is the tendency of funding costs and charge-off costs to move in opposite directions during recessionary periods. Thus, to the extent that issuers may use lower funding costs to offset higher charge-off costs, those savings would not be available to pass on to the consumer in the form of reduced interest rates. For example, between 1989 and 1992—a period of economic weakness in the United States—the average funding costs for VISA and MasterCard issuers fell from about 8.73 percent of their average outstanding balances to about 6.34 percent (a decrease of 2.39 percentage points). During the same period, however, charge-offs as a percentage of outstanding balances increased from 3.45 to 5.17 percent (an increase of 1.72 percentage points).

The Long Economic Expansion of the 1980s May Also Have Contributed to Stable Interest Rates and High Earnings

Federal Reserve economists have argued that the relatively high credit card interest rates and earnings of the 1980s may have also resulted in part from the unusually long economic expansion of that period. As card issuers widened their markets following the Supreme Court decision in the Marquette case, these issuers may have expected higher loan losses than normal, since they were extending cards to riskier consumers. For this reason, they may have incorporated a high "risk premium" into the pricing of credit cards as reflected in average interest rates around 18 percent. However, the economic expansion of the 1980s may have resulted in lower losses than expected. If issuers did overestimate potential losses in the 1980s, average interest rates may decline in the future, according to the Federal Reserve economists.[4]

Economic theory regarding growing or maturing industries has also been used to explain the strong earnings of credit card lending during the 1980s. Theoretically, when an industry is growing rapidly, firms in that industry do not have to compete as much on price to maintain their market shares because the expanding market ensures business for all competitors. Instead, they can maintain prices at current levels and offer their products and services to a larger customer base. The growing demand for credit card loans during the 1980s may have reduced issuers' incentives to offer lower interest rates and contributed in this way to the industry's strong earnings. According to the maturing industry theory, as the growth in

[4]Canner and Luckett, pp. 652-666.

credit card debt slows, competition should intensify, causing issuers to lower their credit card interest rates to maintain their market shares.

Other Explanations Focus on Cardholder Behavior

Analysts have also cited consumer and cardholder behavior as a contributing cause of stability in credit card interest rates. According to these analysts, consumers' lack of responsiveness to lower interest rates during the 1980s provided issuers with few incentives to compete on this basis. These analysts pointed out that, for many cardholders, the costs associated with searching for and switching to new credit cards outweighed the expected savings of lower interest rates. These costs may have been particularly high for cardholders with low incomes and poor credit histories. In addition, consumers with good credit histories who intended to avoid paying interest charges on their credit cards may have overextended themselves and ended up paying interest charges. These circumstances could have allowed issuers to continue charging relatively high interest rates and generating substantial earnings.

The Search Cost Theory

One common explanation economists have offered for cardholder unresponsiveness to lower interest rates is based on the search cost theory. According to this theory, the costs of searching for information about a product or service places limits on the amount of information a consumer will obtain. Because consumers may lack information as a result of search costs, firms have less cause to be concerned about whether their prices exceed the prices charged by their competitors. Consequently, firms have fewer incentives to match those lower prices. In the past, there have been several potential sources of search costs in the credit card industry. For example, to obtain a credit card with a lower interest rate, a cardholder had to contact a variety of issuers, collect information, and compare the costs and benefits of each available card. Recently, more information has become available about credit card interest rates and other pricing terms. This development is discussed later in this chapter.

The willingness of consumers to search for information depends in part on the benefits they anticipate and in part on the cost of the search. Consumers are more likely to search when purchasing a big-ticket item, because search efforts could produce large savings; they are also more likely to search when the cost of searching is low. Some analysts contend that for many cardholders, the benefits of finding a lower rate card may not be worth the likely search costs. The average cardholder with an average balance of $1,250 would save about $40 a year by switching to a

card with an interest rate 3 percentage points lower than his or her current card. Such expected savings may not be sufficient to motivate cardholders—who already value the service and convenience of their current issuers—to seek cards that offer lower interest rates.

The Switching Costs Theory

A related explanation economists offer for cardholders' perceived unresponsiveness to lower interest rates is based on the switching costs theory that maintains that some cardholders are "tied" to their current card issuer by the high costs of switching, or changing, credit cards. According to this theory, a change in credit cards imposes prohibitive costs on many cardholders, particularly those who carry over high balances relative to their incomes. First, cardholders who have established a good payment record (and thus have high credit limits) may be reluctant to switch to a new card issuer that may not initially give a comparable credit limit. Also, cardholders with large outstanding balances may find it difficult to qualify for new cards, because the issuers may perceive them as high-risk applicants. They could be required to pay off and close their existing accounts to qualify for the new card. This could cost them substantial time, effort, and money.[5]

Research findings of Federal Reserve Bank of Philadelphia economists are consistent with the view that higher switching costs of high-balance cardholders contribute to the incentives issuers have to maintain high interest rates and earnings.[6] In 1992, the economists initiated an examination of the empirical significance of switching costs for cardholders. According to their preliminary study findings, when cardholders with large balances applied for a card from a new issuer, they were more likely than those with lower balances to be turned down or be given a credit limit lower than the one they requested. The analysis, which held constant factors such as income, sex, and age, was based on data from the 1989 Survey of Consumer Finances.

According to the economists, the only way for a card issuer to attract cardholders from rival cards is to underprice those cards by an amount substantial enough to at least compensate cardholders for their switching costs. In planning their marketing strategies, issuers have to balance the cost of underpricing other cards against the possible gain. Even if the card

[5]Paul S. Calem, "The Strange Behavior of the Credit Card Market," Business Review, Federal Reserve Bank of Philadelphia, (Jan./Feb. 1992), pp. 3-13.

[6]Paul S. Calem and L. J. Mester, "Search, Switch Costs, and the Stickiness of Credit Card Interest Rates," Working Paper No. 92-24, (Dec., 1992).

issuer can increase its market share by offering a sufficiently low rate, the potential gain from this may not be sufficient to offset direct costs, such as marketing expenses and reduced interest payments, from existing cardholders (assuming that the lower rate also applied to them). Thus, card issuers with a large number of "tied" or "loyal" cardholders may not be willing to compete on interest rates. However, they may be willing to offer various incentives such as frequent flyer miles to attract creditworthy customers.

Some Cardholders May Overestimate Their Ability to Avoid Finance Charges

Yet another explanation for consumers' apparent unresponsiveness to lower interest rates is offered primarily by another economist who claims that some cardholders may overestimate their ability to avoid finance charges on their credit cards.[7] These cardholders intend to take advantage of grace periods and avoid interest payments altogether; however, despite these intentions, they overextend themselves and end up paying interest on outstanding balances. Card issuers find these customers desirable because they borrow at high interest rates, while posing little default risk.

Federal Reserve economists, however, have questioned whether a class of cardholders can be persistently wrong in anticipating the amount of interest they pay over an extended period and be indifferent to interest rates. They argue that cardholders may overestimate their ability to take advantage of grace periods and avoid interest payments in the short run. But, over time, their expectations are likely to become more accurate as they realize the actual cost of their behavior and become more responsive to interest rates.[8]

Recent Developments in the Credit Card Industry

Several conditions that may have contributed to the stable interest rates and high earnings of credit cards have changed during the 1990s. In particular, the growth in credit card lending has slowed in recent years, new card issuers have entered the industry, consumers may have become more responsive to lower interest rates, and the availability of information about credit card pricing terms has increased. A variety of issuers have offered many lower-risk cardholders interest rates lower than 16.5 percent and have offered higher-risk cardholders opportunities to borrow at lower rates under specific conditions; however, some cardholders have continued to pay rates higher than 18 percent.

[7]Lawrence M. Ausubel, "The Failure of Competition in the Credit Card Market," American Economic Review, Vol. 81, No. 1 (Mar. 1991), p. 70.

[8]Canner and Luckett, pp. 652-666.

Growth Has Slowed in Recent Years and New Card Issuers Have Entered the Industry

The annual rate of growth of total outstanding credit card balances, adjusted for inflation, fell from an average of 15.5 percent in the period 1986-1990 to 5.1 percent in 1991 and remained flat in 1992. Several analysts we contacted said that the market was maturing and the American public was "saturated" with credit cards. As pointed out in chapter 1, more than half of all households had at least one credit card account in 1989, and nearly 90 percent of upper income households (with incomes of $50,000 or more), presumably the most desirable customer group, had at least one account. These analysts believed that existing issuers must compete more vigorously on interest rates to maintain their market shares. However, outstanding credit card balances grew by 12.4 percent in 1993 as the economic recovery strengthened. Currently, it is unclear whether the growth in outstanding balances will continue at double-digit rates.[9]

Moreover, several major nonbank corporations have entered the credit card industry. According to the SMR Research Corporation—a firm that tracks developments in the industry—these nonbank entrants may be more comfortable than depository institutions with lower interest rates and earnings because their primary reason for issuing credit cards was to increase volume in their traditional lines of businesses. For example, in its 1992 offering of its new credit card, General Motors offered rebates on the purchase of its vehicles, an interest rate of 16.4 percent, and no annual fee. These incentives encouraged 7 million consumers to accept the General Motors credit card in its first year on the market.

The industry expanded into new markets as the growth in traditional lending slowed and new entrants have begun to issue cards. For example, VISA and MasterCard have tried to expand the use of credit cards as the normal means of payment for activities such as purchases in grocery stores and services from health care providers. The two associations have also developed systems to process "debit-card" transactions. Unlike credit cards, for a fee debit cards automatically deduct the purchase price from a cardholder's checking or savings account at the point of sale. VISA and MasterCard believe that debit cards will benefit their members in the future because of their increasing popularity among consumers and merchants as a payment device.

[9]According to the RAM Research Corporation, most of the growth in credit card balances in 1993 occurred during the latter half of the year. During the first 6 months of 1993, the growth in outstanding balances was essentially flat on an inflation-adjusted basis.

Consumers May Have Become More Responsive to Interest Rates and Improved Information Is Available

A variety of industry reports in the early 1990s indicated that consumers were increasingly concerned about credit card debt and interest rates. The reports attributed the increase in concern to the (1) excessive borrowing of cardholders who obtained credit cards for the first time in the 1980s, (2) many credit card defaults and delinquencies caused by the economic downturn of the early 1990s, and (3) 1986 phase out of tax deductions for credit card interest payments. According to these reports, cardholders are more interested in retiring their existing debt than incurring new debt, and motivated to find credit cards that offer relatively low interest rates. The tax law changes have prompted many consumers to make use of home equity lines of credit, because interest payments on these loans remain tax deductible.

Congressional attention to credit card competition has also focused consumers on interest rates. For example, in November 1991 when the Senate passed an interest rate cap, the media gave widespread coverage to the event. As a result, many consumers became more aware of the interest rates they were paying and were more willing to seek competitively priced credit cards, according to credit card industry reports.

In the early 1990s, improved information about interest rates and other credit card pricing terms was available to consumers willing to shop for credit cards. The increase in available information is partly because of the passage of the Fair Credit and Charge Card Disclosure Act of 1988. Among other provisions, this act requires card issuers to provide readily understandable information in all card solicitations about their interest rates, annual fees, and grace periods. This information is typically presented in a table in credit card solicitations. The act also required the Federal Reserve to collect data on credit card price and availability from a broad sample of financial institutions offering credit card services. The data must be publicly available and must be reported to Congress semiannually. The Federal Reserve has complied with these requirements by semiannually reporting data on the most common interest rates, annual fees, and other pricing terms offered by a sample of card issuers. (Before these amendments, cardholders sometimes did not obtain full disclosure of these credit card terms until their applications were approved.) Finally, the act requires the Federal Reserve to report to Congress annually on its assessment of the profitability of credit card lending.

In addition to the Federal Reserve, the Nilson Company, the RAM Research Corporation, Bankcard Holders of America, and other organizations published periodic information about the pricing terms

offered by a variety of credit card issuers. Stories that discuss credit card interest rates have appeared in both national and local newspapers, magazines, and television and radio broadcasts.

Card Issuers Have Responded to Changes by Offering Lower Interest Rates

Many credit card issuers have responded to these competitive developments by offering lower interest rates to creditworthy customers who represent lower default risks. For example, Citibank, the largest issuer as measured by outstanding balances, offers some of its customers who have good credit histories a card with a promotional rate of 6.9 percent and no annual fee. Several regional issuers have also offered credit card terms designed to be competitive. For example, in 1992, Wachovia Bank in North Carolina offered a credit card with an interest rate of 8.9 percent and a $39 annual fee to selected customers. Wachovia officials estimated that the offering increased the bank's outstanding credit card balances by about 7.6 percent (approximately $2.2 billion at yearend 1992). Many issuers have also started to offer "balance transfer" programs to encourage credit card switching by qualified, low-risk prospective cardholders. These issuers include blank checks with their solicitations to enable recipients to close out their existing credit card accounts and move their outstanding balances to the new card.

These recent lower interest rate credit card offerings have clearly benefited many cardholders. By December 31, 1992, the percentage of total credit card balances subject to annual interest rates of less than 16.5 percent was 41 percent—nearly seven times the total balances with such rates in 1990 (see table 3.1). However, the reduction in rates has not been universal because, at yearend 1992, 40.1 percent of outstanding balances were subject to annual interest rates exceeding 18 percent. The cardholders paying the highest rates may well be those who overestimate their ability to avoid finance charges for short periods, those who continue to be unresponsive to rates because of search and switch costs, and those who have credit history problems. The data may also include credit cardholders who pay their balances in full each month, and therefore are indifferent to interest rate levels.[10] There are no data presently available that would allow us to make determinations as to what percentage of cardholders fall into each category.

[10]These cardholders tend to be more responsive to annual fees, credit limits, and enhancements such as frequent flyer miles, rather than to changes in the annual interest rates.

Table 3.1: Credit Card Outstanding Balances by Interest Rates, 1990-1992

	1990		1991		1992	
Interest rate group	Balance amount	Percent of total balance	Balance amount	Percent of total balance	Balance amount	Percent of total balance
Under 16.5%	$10.3	6.1%	$13.2	7.4%	$76.5	41.4%
16.5% - 18.0%	34.4	20.5	40.4	22.6	34.3	18.5
Above 18.0%	123.2	73.4	125.2	70.0	74.2	40.1
Total	**$167.9**	**100.0%**	**$178.8**	**100.0%**	**$185.0**	**100.0%**

Source: RAM Research Corporation. The data are based on a survey of about 250 depository institution card issuers. The surveyed issuers account for about 90 percent of outstanding card balances.

Opportunities to Qualify for Lower Interest Rates

Some card issuers have offered special programs for cardholders who have not qualified for lower rates on the basis of good credit histories. Under these programs, such cardholders may qualify in time for lower rates through charge and payment performance. Through the Discover Card, for example, Sears (now Dean Witter) provided opportunities for cardholders with interest rates of 19.8 percent to qualify for a 14.9 percent rate if they charge at least $1,000 within a year and were not late on two consecutive payments. American Express offers similar incentives to its Optima cardholders to expand its market share and the quality of its cardholder accounts. In addition, some individuals who represent higher default risks and may not otherwise be able to obtain credit cards can qualify for "secured" credit cards. To qualify for a secured card, a customer pledges cash deposited in a savings account as collateral for credit extended by the issuer.

Competitive Developments in the Industry Need to Be Closely Monitored

Although many cardholders, particularly those who represent lower default risks, are clearly benefiting from cards that offer lower interest rates, we believe recent developments in the industry must be closely monitored to determine whether the apparent increase in competitiveness is sustained. There are certain issues and potential limitations to the recent developments that are important to understanding the future competitiveness of the industry. However, the ability of Congress and industry analysts to monitor these recent developments is limited because the Federal Reserve does not collect and publish sufficient information about available credit card interest rates. The Federal Reserve is considering taking steps to address this issue by collecting additional information on credit card interest rates.

Potential Limitations to Recent Developments

Since many of the recent offerings are credit cards with variable interest rates tied to the prime rate, credit card interest rates can be expected to rise if the prime rate increases. Moreover, the recent price competition among issuers will not necessarily result in reduced earnings over the short term because of the sharp decline in funding costs in recent years. The industry's pretax earnings as a percent of outstanding balances reached 4 percent in 1992 and 4.53 percent in the first 9 months of 1993, partly because of record low funding costs, after falling to 3.55 percent in 1991. The difference between credit card interest rates and funding costs remained at relatively high levels in 1993 despite the recent competition among issuers.[11] While in the long term economists would expect earnings to fall because of increased price competition among existing issuers and nonbank entrants, earnings may remain at relatively high levels if funding costs remain low. Issuers who offer relatively low interest rates could also compensate for the lost revenue by actions such as limiting the period of time that introductory interest rates apply, raising annual fees, imposing other charges or fees for late payments and cash advances, and shortening grace periods.

The potential also exists that certain cardholders, particularly those who represent higher default risks, will not be afforded the opportunity to take advantage of programs designed to lower their credit card borrowing costs. Although it is logical for issuers to charge higher interest rates to these types of cardholders, they may continue to pay historically high rates (exceeding 18 percent) because they are "tied" to their current issuers. Moreover, because they are "tied" to their current issuers, these issuers will have incentives to continue charging them relatively high interest rates even though funding costs have declined.

Finally, lower interest rates may not be a trend that will continue. During the mid-1980s, some issuers—including Manufacturer's Hanover and Chase Manhattan—announced offerings of relatively low interest rates during an earlier period of widespread congressional, media, and public scrutiny of the industry's pricing practices. However, average interest rates remained stable at 18 percent, and by 1990, after scrutiny of the industry's pricing practices had subsided, Chase Manhattan and Manufacturer's Hanover had resumed charging the 19.8 percent most common rate charged by other large issuers.

[11]As discussed in chapter 1, in 1993, the difference between the average most common interest rate of 16.83 percent and credit card funding costs reached 11.50 percentage points in 1993, the highest level since 1976.

The Federal Reserve Can Expand Its Reporting on Competitive Developments in the Credit Card Industry

We believe the Federal Reserve can assist Congress and industry analysts in monitoring competitive developments in the credit card industry by collecting a wider variety of information about credit card pricing activity. As discussed in chapter 1, the Federal Reserve currently collects and publishes information about the "most common" credit card interest rates charged by a sample of banks. This information does not capture the diversity of card terms that individual issuers offer to their customers, particularly interest rates offered to the most creditworthy cardholders. Therefore, the information does not permit analysts to assess the extent to which different types of customers—on the basis of their perceived credit risk—are benefiting from lower rate card offerings. Although private organizations like RAM Research collect some information on the range of available interest rates (see table 3.1), this information is generally provided only to those who pay for subscriptions, although the media has drawn upon it for periodic articles and broadcasts about the industry. During our review, a Federal Reserve official said that the organization recognizes the need for additional information on the extent to which the recent price competition among card issuers is affecting cardholders, and that it would try to collect and publish more interest rate information on a voluntary basis to minimize industry reporting costs.

The Federal Reserve could also provide this additional information in its annual report to Congress on credit card profitability, which is required by the Fair Credit and Charge Card Disclosure Act of 1988. As required by the act, the Federal Reserve has issued the profitability report since 1990. Among other issues, these reports have commented on the profitability of large and small credit card issuers, the competitive structure of the industry, and the impact of new disclosure requirements on the industry. In our view, these reports could also serve as a forum for the Federal Reserve to comment on the extent to which the recent offerings of lower interest rate cards are (1) benefiting cardholders who represent varying degrees of credit risk and (2) affecting the industry's earnings. In the profitability reports, the Federal Reserve could also comment on other issues that affect industry competition such as the potential for tacit coordination, barriers to entry issues raised in the ongoing Dean Witter-VISA litigation, and the state of intersystem competition. This information could help Congress and industry analysts better monitor and assess the competitive performance of the U.S. credit card industry over the short and long term.

Conclusions

The contrast between stable credit card rates and fluctuating interest rates for other types of lending has prompted widespread concern about the pricing practices of the credit card industry. We believe that some, but perhaps not all, of the concerns that have been raised may be alleviated by a better understanding of the credit card industry. Expecting credit card interest rates and interest rates charged on other consumer loans to rise and fall in a parallel manner with the cost of funds is to assume that the two types of lending are more alike than they actually are.

We agree with many analysts that the risks of unsecured credit card lending are greater than those of most other types of consumer loans and can help explain the stable credit card interest rates of the 1980s. However, we do not believe that the differences in risk alone provide a complete explanation. The unique cost structure of the credit card industry also helps explain the stability of credit card interest rates. Because credit card funding costs are relatively low, credit card interest rates are likely to be somewhat less sensitive to changes in the cost of funds compared to rates for other types of consumer lending. During the 1980s, card issuers may also have built "risk premiums" into their pricing as they offered credit cards to riskier customers, and the expanding demand for credit card loans may have reduced issuers' incentives to offer lower interest rates. Analysts have also commented that, in the past, consumers' failure to shop for cards that offered lower interest rates—because of search and switch costs—permitted issuers to maintain interest rates and earnings at relatively high levels.

Several of the conditions that may have contributed to stable and high earnings changed in the 1990s. The reduced growth in outstanding credit card balances in 1991 and 1992, along with new industry entrants, most likely increased competitive pressures within the credit card industry. In addition, improved information about credit card terms and conditions, and heightened public awareness of industry pricing practices may promote greater consumer responsiveness to interest rates, especially among creditworthy consumers who are eligible for the lower rate cards. This, in turn, may encourage more issuers to offer lower rate cards.

Despite the lower interest rates on some cards offered in 1992 and 1993, we believe that the U.S. credit card industry's performance should still be closely monitored to determine whether the apparent increase in competition is sustained over the short and long term. Industry earnings remained high throughout 1992 and 1993 partly because of record low funding costs. Also, for various reasons, some cardholders may not be able

to take full advantage of lower cost cards and may continue to pay interest rates exceeding 18 percent. Close monitoring is also warranted because the recent competition among issuers could lessen if congressional, media, and public scrutiny of the industry's pricing practices subsides. The Federal Reserve is already planning to increase the information it gathers about issuers' credit card offerings, and it could use the information, along with other information, to expand its annual reporting to assist Congress in monitoring competitive developments in the credit card industry.

Recommendations

We recommend that the Chairman of the Federal Reserve (1) collect additional information on credit card interest rates that permits an assessment of the extent to which cardholders are benefiting from lower credit card interest rates and an assessment of how these rates affect industry earnings and (2) assess the short-and long-term impacts of competitive developments within the industry. We also recommend that the Chairman of the Federal Reserve incorporate this information and analysis in the annual report to Congress on industry profitability to assist Congress in making informed public policy decisions.

Agency Comments and Our Evaluation

We provided copies of a draft of this report to the Attorney General and the Chairman of the Federal Reserve for their review and comment. Although the Attorney General chose not to provide written comments, Department of Justice Antitrust Division officials told us in March 1994 that they generally agreed with its analysis and conclusions.

The Chairman of the Federal Reserve said the report is a comprehensive and well-documented analysis of competitive developments in the credit card industry (see app. II). The Chairman agreed with our recommendations and described the additional information that the Federal Reserve plans to collect on credit card interest rates and the expanded analysis it plans to include in its annual report to Congress. We believe these actions will provide improved information about the extent to which cardholders are benefiting from offers of lower interest rates. In addition, the Chairman said the Federal Reserve believes that the credit card industry is competitive and that, in recent years, issuers have adopted variable rate pricing strategies that more explicitly track changes in market interest rates. The Chairman also provided some technical comments that have been incorporated in the report.

However, the Chairman did take issue with our statement in the draft that the adequacy of available information published by the Federal Reserve limits the ability of Congress and analysts to assess recent competitive developments in the industry. He said such information is available from a variety of private-sector sources. The report has been clarified on page 43 to state that our concern relates only to the adequacy of information on the range of interest rates that issuers offer to their cardholders. We believe this concern will be addressed by the Federal Reserve's plans to collect additional information about credit card interest rates.

Analysis of Policy Options

Since the mid-1980s, Congress has considered several public policy options in response to the stability of average credit card interest rates and the relatively high earnings of the industry. One proposed policy option was to impose a nationwide cap on credit card interest rates. The basic argument for such a cap was that interest rates were too high because of inadequate competition and that government intervention was necessary to lower rates, protect consumers, and stimulate the economy. Opponents of the proposal argued that the government should maintain a nonintervention policy because the industry is becoming increasingly competitive, and an interest rate cap would harm the economy by compelling issuers to cancel the cards of many individuals who represent higher credit risks. A third policy option was for the government to encourage more consumer responsiveness to credit card interest rates through additional disclosure requirements. Although we are not recommending any of these policy options, this chapter discusses some of their advantages and disadvantages.

Policy Option 1: Establish a Nationwide Cap on Credit Card Interest Rates

On several occasions since 1985, Congress has considered enacting a national cap on credit card interest rates to address alleged deficiencies in competition within the industry. As discussed earlier in this report, in November 1991, the Senate passed a measure that would have imposed a variable interest rate cap of 14 percent, but the legislative session ended before an interest rate cap was considered by the House of Representatives. The bill set the maximum allowable interest rate at 4 percentage points above the Internal Revenue Service penalty rate, which was 10 percent in 1991.[1] This bill generated considerable controversy in Congress and among industry participants, consumer groups, and the public.

Interest rate caps, such as the one debated in 1991, have generally been proposed to protect consumers from credit card interest rates that were viewed as unnecessarily high and as a means to stimulate the economy. Proponents of the 1991 bill argued that the failure of credit card interest rates to fall despite significant declines in both funding costs and the interest rates of other lending activities showed that the industry was not performing competitively. Earnings higher than those that would prevail in a more competitive market in effect redistribute income away from lower-income to higher-income individuals. Proponents also argued that if credit card interest rates were lower, more people would borrow to

[1] The penalty rate, the rate the IRS charges to citizens who are delinquent on their taxes, is set at 3 percentage points above the average yield on Treasury securities with maturities of 3 years or less.

purchase goods and services, and this would have the effect of stimulating the economy.

Some analysts also pointed out that, despite the risks associated with credit card lending and high charge-offs, issuers still generate relatively high earnings. Consequently, it could be argued that issuers could still generate reasonable earnings even if Congress passed an interest rate cap. For example, one well-known financial commentator has argued that if Congress established an interest rate cap that exceeded the federal funds rate[2] by 10 percentage points, efficient credit card issuers would still generate reasonable earnings.[3]

Evidence Suggests That a Cap Could Lead to Restrictions on Credit Card Lending

Opponents of government intervention in the credit card industry argue that an interest rate cap would be counterproductive and could have unintended consequences. In particular, they argue that if issuers determine that an interest rate cap did not permit them to recover their full cost of operations, they would respond by canceling the cards of customers who represented their greatest default risks. These cardholders are typically younger individuals with high debt levels and relatively low income levels.

Several studies indicate that an interest rate cap, depending upon the level it is set, would lead issuers to tighten their lending criteria. A 1981 study published by the Credit Research Center at Purdue University examined the lending criteria of credit card issuers in Arkansas, which at the time had a usury ceiling of 10 percent. The Credit Research Center found that issuers located in Arkansas were more likely than issuers in most other states to restrict their cardholder base to upper-income individuals.[4] The RAM Research Corporation has found that credit card issuers with headquarters in Arkansas reject 80 to 90 percent of all applications, restrict new customers to relatively low credit limits of $800 to $1,000, and charge annual fees as high as $35. In addition, a recent industry-sponsored study estimated that issuers would cancel the credit cards of as many as

[2]The federal funds rate is the rate charged in the interbank market for excess reserve balances and was about 3 percent for much of 1992 and 1993. Therefore, a credit card interest rate cap set 10 percentage points above such a federal funds rate would be 13 percent.

[3]Martin Mayer, "Counterpoint," The Wall Street Journal, (Nov. 21, 1991).

[4]William C. Dunkelberg, et al., CRC 1979 Consumer Financial Survey, Monograph No. 22 (1981), Credit Research Center, Krannet Graduate School of Management, Purdue University.

32 million cardholders if Congress passed a rate cap of 14 percent as proposed in the recent Senate bill.[5]

Historical experience also suggests that an interest rate cap could result in a tightening of credit standards. Many states had usury laws in place until they were repealed or relaxed in the early 1980s. Several economists argue that the deregulation of credit card interest rates encouraged issuers to offer cards to riskier potential customers who previously did not qualify. Such customers are generally believed to be the most vulnerable to cancellation of their cards in the event of any new, federally imposed interest rate cap.

Moreover, issuers could respond in several other ways to maintain their earnings if Congress establishes an interest rate cap. In particular, they could raise cardholders' annual fees, increase the fees to merchants for accepting credit cards, tighten credit limits, shorten or eliminate grace periods, and eliminate enhancements. Many issuers instituted annual fees for the first time in the early 1980s as a result of sharp rises in funding costs during the late 1970s and early 1980s that, with state usury laws, prevented issuers from being able to recover the full cost of their credit card operations through interest charges.

Potential Effects on the Market for Securities Backed by Outstanding Credit Card Balances

An interest rate cap that does not permit issuers to fully recover their costs could also have negative implications for the securitization programs of many issuers—through which a number of large issuers convert credit card balances to securities and sell them. Since 1987, several large issuers have placed a portion of their outstanding credit card balances into trusts. In turn, the trusts issue securities that are sold to investors. Typically, the issuer retains a portion of the interest and fee income generated from the "securitized" balances to service the accounts and build a reserve fund to protect investors against losses. The investors who purchase the securities receive interest income that usually exceeds the yields on short-term Treasury notes.[6] These securities are traded on secondary markets and are primarily held by large institutions such as banks, insurance companies, and pension funds. At yearend 1992, the level of securities backed by

[5]Robert E. Litan, Consumers, Competition, and Choice: The Impact of Price Controls on the Credit Card Industry, (Washington, D.C.: Feb. 1992).

[6]An official at Moody's Investors Services said that a "generic" securitized transaction might be structured in the following way. Assuming that the balances yield 18 percent, 6 percent would be paid to the investors, 7 percent would be set aside to cover losses, and 2 percent would be used to service the accounts (i.e., bill customers), which totals 15 percent. The issuing institution would retain the remaining 3 percent, which is sometimes referred to as "excess" servicing costs.

credit card outstanding balances issued by large commercial banks had reached $64 billion, according to a Federal Reserve official.

Issuers have securitized their credit card balances for a variety of reasons. In particular, securitization permits depository institutions that issue credit cards to more easily meet federally imposed capital standards because they generally do not have to hold capital against credit card balances that have been securitized. In addition, issuers can use the proceeds from the sale of these securities to build capital, pay dividends, and to fund additional lending.

A federally imposed interest rate cap could also increase investors' risks. According to an official at Moody's Investors Services, many securitized transactions have built-in investor protections that, under certain conditions, require issuers to pay back investors' principal before the securities mature. For example, if charge-offs exceed predetermined levels—say 7 percent of the securitized balances—the issuer must automatically repay the principal on outstanding balances. An interest rate cap could also trigger automatic repayment because it could reduce issuers' revenues from interest charges and thereby limit their ability to pay operational and charge-off costs.[7] While such prepayments permit investors to recover their principal, they may have to reinvest the principal in investments that have lower interest rates. Thus, an interest rate cap may diminish the value associated with holding securities backed by credit card balances. According to industry reports, when the Senate passed legislation imposing a credit card interest rate cap of 14 percent in 1991, trading in securities backed by outstanding credit card balances halted.

Policy Option 2: Allow the Credit Card Market to Determine Interest Rate Levels

Another policy option is for Congress to avoid intervention in the credit card market, permitting market forces to determine interest rates. Proponents argue that the industry is, in fact, performing competitively and that competition is increasing. They also argue that a nonintervention policy would avoid risks associated with an interest rate cap, particularly the cancellation of many credit cards.

Evidence that the market is performing competitively includes the number of issuers in the market, the acceptable levels of concentration, and lower interest rates offered by major issuers in 1992 and 1993. Proponents of nonintervention also point to the entry of large nonbanks as evidence of

[7]Using the "generic" security transaction described in footnote 6, an interest rate cap of 14 percent would limit the issuers' ability to cover losses or pay operating expenses, which in this example totaled 15 percent, and would trigger automatic repayment provisions.

increasing industry competition. Another factor pointing to increasing competition is that consumers who may have found search costs prohibitive in the 1980s were receiving improved information about interest rates, annual fees, and grace periods in the early 1990s. This information has been made available through requirements of the Fair Credit and Charge Card Disclosure Act of 1988 and through various other media and organizations that follow the industry.

On the other hand, several limitations to the recent competitive developments could be used to justify an interest rate cap. For example, two large issuers lowered their interest rates in the mid-1980s during a period of congressional scrutiny of the industry's pricing practices, but raised their interest rates later in the decade. Intervention may also be justified to provide relief to riskier cardholders who, because they are "tied" to issuers charging high rates, may not benefit from the lower rates offered in 1992 and 1993. Further, since most issuers have pegged their new low-rate cards to the prime rate, credit card interest rates will increase when the prime rate increases.

Policy Option 3: Further Strengthen Disclosure Requirements

In recent years, several proposals have been made to strengthen the provisions of the Fair Credit and Charge Card Disclosure Act of 1988 to provide more information to consumers. One legislative proposal designed to strengthen the act would require issuers to print tables that show their credit card pricing terms on the envelopes used in mail solicitations. Moreover, Bankcard Holders of America (BCHA), a cardholder advocacy group, has argued that consumers need more information about issuer pricing practices. For example, a study by BCHA found that some issuers charge much higher rates for cash advances than for purchases and do not disclose this information in their solicitations.[8] BCHA believes that issuers should disclose the interest rate for cash advances. In addition, BCHA has argued that some issuers use deceptive billing calculation methods that can result in excessively high interest charges to consumers. BCHA has advocated these billing practices should be banned.

By reducing search costs, further disclosure requirements may benefit consumers who are willing to shop around for new cards and can qualify for lower rates. Several analysts have commented that the Fair Credit and Charge Card Disclosure Act of 1988 and increased mass mailings and publicity about the industry have probably lowered consumer search costs in recent years. The proposals cited above, and others, may reduce search

[8]Bankcard Holders of America, "Credit Cards: What You Don't Know Can Cost You." (June 18, 1992).

costs even more. However, new disclosure requirements would not necessarily benefit cardholders whose credit histories prevent them from taking advantage of more attractive credit card offerings.

New disclosure laws would also impose some additional regulatory costs on credit card issuers. For example, any changes to current disclosure requirements will require issuers to redesign their solicitations, notices, billings, and possibly their envelopes. Critics of such disclosure requirements could argue that they raise costs on the credit card industry without necessarily benefiting consumers. However, the Federal Reserve, when commenting on similar disclosure requirements for the Fair Credit and Charge Card Disclosure Act of 1988, pointed out that such redesign costs are not necessarily substantial. These costs are typically one-time expenses associated with changing solicitation notices to reflect new disclosure requirements.[9] Therefore, any effort to strengthen disclosure laws would require careful consideration of whether customers would benefit and the costs credit card issuers would incur.

[9]Board of Governors of the Federal Reserve System, "Annual Report on the Profitability of Credit Card Operations of Depository Institutions," (1990).

How a Typical Credit Card Transaction Works

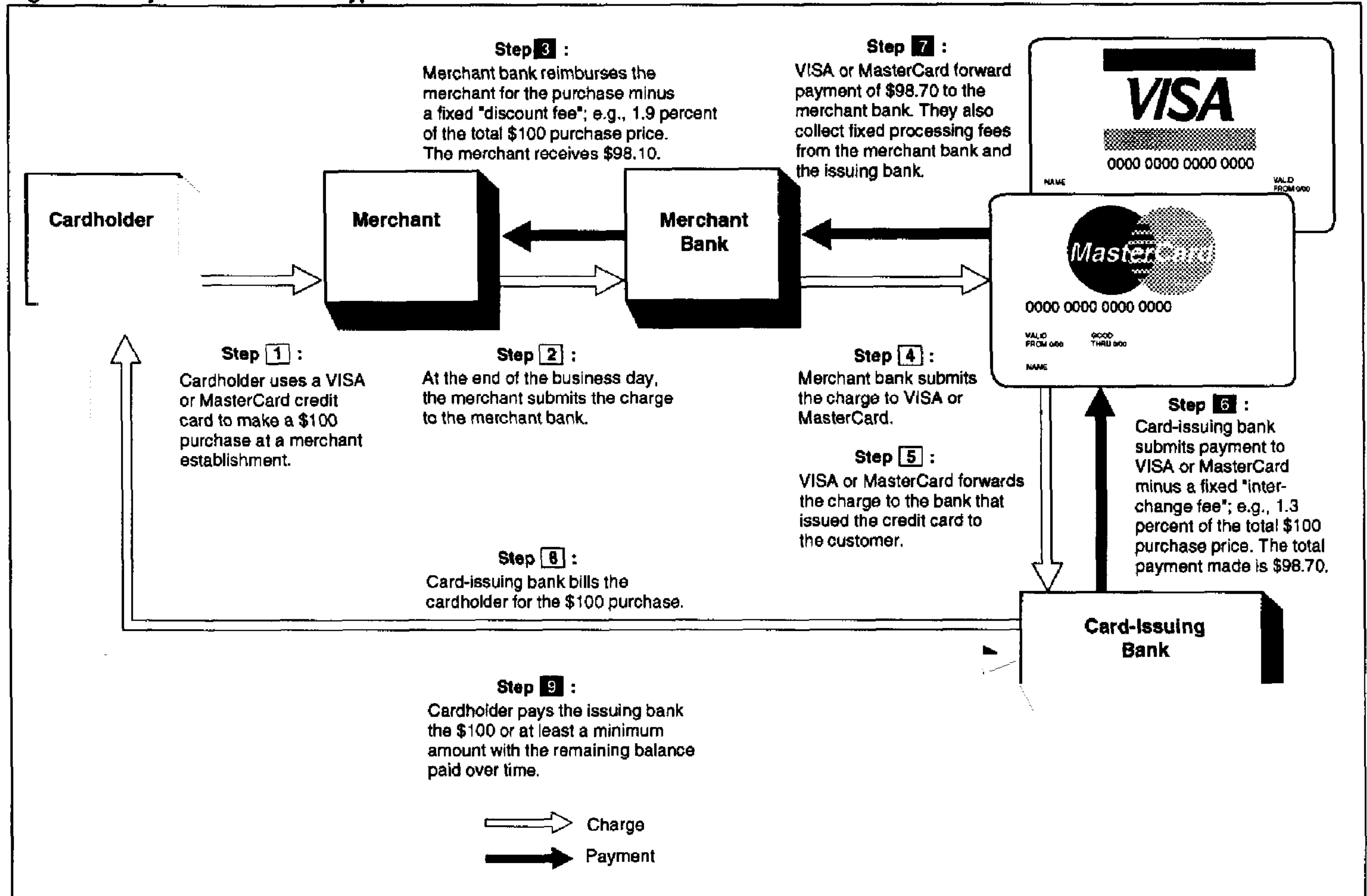
A typical credit card transaction involves the cardholder, the merchant, the merchant's bank, VISA or MasterCard, and the depository institution that issued the credit card (see figure I.1).[1] In most cases, the merchant will seek authorization for the purchase from the cardholder's bank via a computer hook-up provided by VISA or MasterCard or an independent company such as Nabanco. The issuing bank maintains information on the cardholder's credit limit and can authorize a transaction in as little as 2 seconds, according to a VISA official.

During the processing of credit card transactions, fixed fees are charged to the merchant, the merchant's bank, and the card issuer. The merchant's bank subtracts a "discount" fee of 1.9 percent of the total purchase price as compensation for providing credit card processing services to the merchant.[2] An "interchange" fee of 1.3 percent of the total purchase price is paid to the depository institution that issued the credit card. Finally, VISA and MasterCard charge fixed processing fees to the merchant bank and the card issuers for using their computerized transaction settlement systems.

[1]VISA and MasterCard have authorized certain of their members—often called merchant banks—to sign-up merchants to accept their credit cards and to service their accounts. Certain independent companies, such as Nabanco, compete with VISA and MasterCard members in providing credit card processing services to merchants.

[2]Based on MasterCard's fee schedule. VISA has established similar fees.

Figure I.1: Payment Flows in a Typical Credit Card Transaction



Note: Sears and American Express developed their own systems to process Discover and Optima credit card transactions.

Source: VISA, MasterCard, and the New York Times.

Comments From the Chairman of the Federal Reserve

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

February 23, 1994

Mr. James L. Bothwell
Director
Financial Institutions and
Market Issues
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

The Federal Reserve is pleased to respond to your request for comments on the draft of the GAO report on the "U.S. Credit Card Industry." The draft report includes two recommendations for the Federal Reserve pertaining to the collection of additional information on credit card interest rates and to the expansion of the analysis in our annual report to the Congress on the profitability of the credit card operations of depository institutions.

Our review of the GAO report found that it provides a comprehensive and well-documented analysis of developments in the credit card industry. The report describes in a straightforward manner the competing explanations for the relative stickiness of credit card interest rates, a phenomenon that has drawn considerable public attention. While we have no substantive comments on the analysis provided in the study, we have provided the GAO with some technical comments, and have suggested a few clarifications that we understand will be incorporated into the final report.

Now on pp. 43, 45, 48

We do not agree, however, with the statement in the report that the ability to monitor recent developments in the credit card industry is limited because the Federal Reserve does not publish sufficient information about the competitiveness of the industry. As the GAO report documents, a number of private sector sources offer information on credit card industry activities, providing ample opportunity for those interested to monitor industry developments. In addition, the Federal Reserve System collects and disseminates considerable information on credit card rates and terms in the E.5 Statistical Release ("Terms of Credit Card Plans") and in the G.19 Statistical Release ("Consumer Installment Credit"). As noted in the GAO report, we already have taken steps to improve existing measures of credit card rates. To implement more detailed reporting, however, would impose costly burdens that do not appear to be warranted by any potential benefits to consumers.

Mr. James L. Bothwell
February 23, 1994
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With respect to the two recommendations in the report regarding the Federal Reserve we have the following comments:

Now on p. 47

Recommendation 1: The Federal Reserve System should collect additional data on credit card interest rates.

The Federal Reserve agrees with the recommendation and has already initiated the process of collecting additional data on credit card interest rates. The Federal Reserve Board, on December 30, 1993, proposed for public comment a new data collection report form for credit card interest rates (the FR 2835a). We are currently preparing to implement a pre-test of the form. Results of the pre-test will be used to help evaluate the data collection burden associated with the proposal and to identify any difficulties respondents may have in reporting the new data items.

The new information on credit card interests rates, to be collected quarterly from a nationally representative sample of credit card issuers, would replace the information currently collected and reported in the G.19 statistical series. It will be used to measure (1) the "average nominal interest rate," which is the simple average interest rate across all accounts, and (2) the "average computed interest rate," which will be the average interest rate paid by only those cardholders who revolve balances and thus incur finance changes.

We believe the new data on credit card interest rates will provide better information on current developments in credit card pricing and more accurately describe the actual interest rates paid by those that revolve balances.

Now on p. 47

Recommendation 2: The Federal Reserve should assess the short and long-term impacts of competitive developments within the industry.

The Federal Reserve is required by the Fair Credit and Charge Card Disclosure Act of 1988 to prepare an annual report to the Congress on the profitability of the credit card operations of depository institutions. To date, the Federal Reserve has submitted four such reports. In these reports, we take note of major developments in the industry that bear on competition and profitability, such as the entry of major new issuers or changes in costs. We plan to expand our analysis in future reports to include a more detailed discussion of changes in credit card interest rates once the new information on rates from the FR 2835a becomes available.

Let me conclude by noting that the Federal Reserve has stated on a number of occasions our view that the credit card market is competitive. Indeed, we believe that competition has grown more intense in recent years as new firms have entered the market. The nature of competition, however, has changed some over time. Credit card issuers during most of the 1980s focused on efforts to broaden customer bases by increasing the availability of cards to higher risk groups and by offering additional product enhancements. Today, the focus has shifted to efforts to retain and broaden customer bases by offering more favorable interest rates and by explicit risk-based

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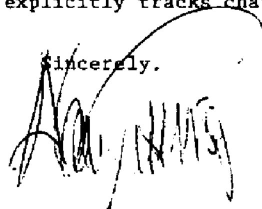
pricing of different segments of the market. The sharp and sustained reduction in the costs of funds has prompted many issuers to reduce interest rates and to switch their products to variable rate pricing. a pricing policy that more explicitly tracks changes in market interest rates.

Sincerely.



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