ARTICLE IN PRESS

Journal of Financial Intermediation xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Journal of Financial Intermediation

journal homepage: www.elsevier.com/locate/jfi

The Credit Card Act and consumer finance company lending☆

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ARTICLE INFO

Keywords:
Credit supply
Credit cards
CARD Act
Subprime credit
Consumer credit
Personal loans
Household finance

JEL classification:
G21
G23
G28

ABSTRACT

The Credit Card Accountability and Disclosure Act (CARD Act) of 2009 restricted several risk management practices of credit card issuers. Using a quasi-experimental design with credit bureau data on consumer lending, we find evidence consistent with the hypothesis that the act's restrictions on risk management practices contributed to a large decline in bank card holding by higher risk, nonprime consumers but had little effect on prime consumers. Looking at consumer finance loans, historically a source of credit for higher risk consumers, we find greater reliance on such loans by nonprime consumers in states with high consumer finance rate ceilings following the CARD Act than by nonprime consumers in states with low rate ceilings or by prime consumers. That nonprime consumers in states with high consumer finance rate ceilings relied more heavily on consumer finance loans suggests that consumer finance loans were a substitute for subprime credit cards for risky consumers when rate ceilings permit such loans to be profitable. Consumer finance loans would not be available to many higher risk, nonprime consumers in low rate states because such loans would be unprofitable, and prime consumers would not need consumer finance loans because other less expensive types of credit would generally be available to them.

1. Introduction

In the years following their introduction, bank credit cards expanded from a niche product held mostly by higher income individuals to the most widely used credit product in the United States. By the beginning of the 21st century, bank credit cards were available to even many of the riskiest of individuals.[1] About seven in ten individuals in the bottom quartile of credit bureau scores held bank credit cards in 2001 (Canner and Elliehausen 2013). Contributing to this development was credit card companies' adoption of risk-based pricing, which enabled companies to discourage risky behavior and raise additional revenue or limit losses when customers engaged in risky behavior (Furletti 2003).[2]

In this environment, new Federal Reserve regulations and the Credit Card Accountability, Responsibility and Disclosure Act (the CARD Act) of 2009 mandated significant disclosure and substantive requirements for credit cards. Among the substantive requirements were restrictions on practices that credit card companies used to manage risk. These restrictions prompted credit card companies to raise prices, reduce credit limits, and limit availability of credit card loans to riskier individuals (Canner and Elliehausen 2013). Reductions in the availability of credit card loans may have stimulated demand for finance company loans, historically an important source for small amounts of unsecured credit for riskier consumers (National Commission on Consumer Finance 1972).[3] This paper examines some material consequences of the regulatory and legislative actions on the quantity and sources of credit used by different types of households. Specifically, we focus on identifying changes in availability of credit card credit and possible substitution of consumer finance company loans for bank credit card debt by risky borrowers following implementation of the CARD Act.

The CARD Act's restrictions on risk-based penalty pricing, late payment fees, over-the-limit fees, and initial and periodic fees weakened tools that helped credit card companies extend credit to riskier consumers. As a result of these changes, the act appears to have reduced availability of bank card credit to risky consumers. By 2010, after the

☆ We thank Neil Bhutta and Henry Korytkowski for generous help for using the Equifax data, Jessica Hayes and Kara Ramsey for excellent research assistance, and, alphabetically, to Thomas A. Durkin, Harry P. Huizinga, Benjamin S. Kay, R. Burak Uras, and Cindy M. Vojtech for helpful comments and suggestions.

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[1] Overall, bank card holding increased from 16% of households in 1970 to 70% of households in 2007. A large share of lower income households also became bank card holders. Among households in the lowest income quintile, bank card holding increased from 2% in 1970 to 38% in 2007. Source: Survey of Consumer Finances, authors' calculations.

[2] Also, Brito and Hartley (1995) observed that relatively high fixed costs of origination and servicing loan provided lenders an incentive to use open-end credit rather than closed-end credit for making small loans. This incentive led over time to an increase in credit card lending and a decline in small closed-end finance company loans (Durkin et al. 2014, chapters 5 and 7).

[3] Consumer finance loans are small, closed-end loans offered by consumer finance companies. The characteristics of consumer finance loans today are much the same as those of consumer finance loans studied by the National Commission on Consumer Finance. See Durkin et al. (2016).

https://doi.org/10.1016/j.jfi.2018.01.007

CARD Act had become effective, bank credit card holding by risky consumers had fallen from seven in ten to a little more than one-half of consumers in the bottom quartile of the credit bureau scores (Canner and Elliehausen 2013).[4]

Using credit bureau data, we examine consumers' holding of bank card accounts and non-auto, non-student closed-end finance company loans (hereafter referred to simply as "consumer finance loans") of prime and nonprime consumers for states with low and high rate ceilings for the consumer finance company loans. We compare use of these types of credit for each of the credit risk/rate ceiling groups before passage of the act, during the implementation period (which included the 2007–2009 recession), and after the regulation implementing the act became effective. Consideration of credit risk and state rate ceilings for consumer finance loans helps distinguish between changes in bank card accounts due to the CARD Act and those due to other factors. We expect that the act's effect on nonprime consumers is greater than that on prime consumers and that consumer finance loans are more readily available to higher risk nonprime consumers in states with high rate ceilings than states with low rate ceilings.

Our findings suggest that the CARD Act reduced credit availability for higher risk consumers and that some higher risk consumers used consumer finance loans as a substitute for credit card debt. First, we observe that the number of credit card accounts declined substantially in the implementation period for both nonprime and prime consumers. The number of credit card accounts declined further for nonprime but not prime consumers after the CARD Act became effective. While some part of the decline may be attributed to deleveraging due to the recession, the larger further decline for nonprime customers in the post-law period suggests that the CARD Act's restrictions on risk management practices adversely affected availability of credit card debt for higher risk consumers more than others.

Second, consumer finance loans were a viable substitute for consumers that lost access to credit cards, but only in states where interest rate ceilings were high enough to make such loans profitable. We find evidence that, in response to the CARD Act, the substitution into consumer finance loans occurred only in the subprime segment of the population in high ceiling states, exactly the subpopulation with the interest and opportunity to use such loans. Prime consumers had fewer consumer finance loans than nonprime consumers because prime consumers' low risk made prime consumers more likely to have lower rate alternatives to consumer finance loans, including bank credit cards. Nonprime consumers in low-rate states had fewer consumer finance loans because low rate ceilings made such loans unavailable for riskier nonprime consumer finance loans.

The remainder of this paper is organized as follows: Section 2 discusses risk management practices of card issuers, provisions of the CARD Act affecting these practices, and evidence on effects of the act. Section 3 presents the research design and our hypotheses. Section 4 presents results of the empirical analysis. Section 5 summarizes our findings.

2. Risk management practices and the CARD Act

Retail credit cards offering financing for a short-period of time (commonly, a month) have existed since the early 20th century, and the travel and entertainment card that could be used at more than one place first appeared in 1950 (Mandell 1972). However, it was the bank card, introduced in 1958, that became the most successful type of credit card.[5] The bank card's innovation was a revolving credit feature, which allowed consumers to pay balances over time and charged interest on unpaid balances. Credit standards for bank cards were stringent throughout the 1960s, and high inflation and high interest rates in the 1970s caused state interest rate ceilings for credit cards to be restrictive. Restricted in most states by interest rate ceilings, bank credit cards were limited to a small percentage of mostly low-risk, high-income consumers (Ellis 1998; Durkin et al., 2014, chapter 11).

The Supreme Court's *Marquette* decision in 1978, which allowed national banks to charge any price in compliance with the laws of the state in which the bank is located regardless of where the customer is located, enabled credit card companies to expand their offerings to higher risk consumers (Ellis 1998; Durkin et al., 2014, chapter 11). Credit card companies moved to states with high or no credit card rate ceilings. Not only were credit card companies able to assess consumers' credit risk and initially charge them a premium for that risk on initial offerings, companies were also able after card issuance to increase premiums or charge fees when consumers' risk increased. This development facilitated an expansion of credit card debt to higher risk consumers (Furletti 2003).[6]

2.1. Risk management practices

The CARD Act restricted several practices that credit card companies used to manage risk, including risk-based penalty pricing, charging substantial late and over-the-limit fees, and high initial and recurring fees on deep subprime accounts.[7]

2.1.1. Risk-based penalty pricing

Risk-based penalty pricing is a practice that raises the interest rate on an account when the consumer's behavior on the account suggests that credit risk has increased. Triggers for raising the interest rate included late payments, exceeding the credit limit, returned checks on payments, or a combination of such actions. For example, risk-based penalty pricing might be triggered by either two payments 5 days late within a period of time (such as a year) or a returned check on a payment.

Triggers invoked risk-based penalty pricing far sooner than 30 days past due. According to industry sources, such triggers generated greater interest income but also resulted in lower default losses. The higher interest rate apparently provided a stimulus to the consumer to take actions to avoid default, specifically by reducing new charges and pay down balances more quickly, thereby reducing default risk. That the higher interest rate stimulated faster repayment is consistent with research on credit card customers' sensitivity to interest rates. Analyzing a large panel of monthly activity of individual credit card accounts of several large companies, Gross and Souleles (2002) found that account holders responded to interest rate increases by reducing new charges and paying down balances on the account. Their database also contained information from credit bureau files showing that customers reduced balances on all accounts, not just the one receiving a rate increase. Credit card companies' experiences with the effects of risk-based penalty are consistent with Gross and Souleles's findings.

[4] Financial difficulties caused by the severe 2007–2009 recession undoubtedly contributed to the decline in card holding. However, the decline in the percentage of card holders in lowest credit bureau score quartile continued after the recession ended and in spite of sharply falling post-recession bank card delinquency rates (Canner and Elliehausen 2013). The decline after the recession and the effective date of the CARD Act suggests the possibility that the act's restrictions or risk management practices may have inhibited bank card lending to risky consumers.

[5] For a historical account of the introduction of bank credit cards, see Nocera (1994).

[6] A widespread adoption of risk-based pricing is reflected in the growth in late fees in the late 1990s. Average late fees doubled (from $13 to $27) between 1996 and 2001, but annual late fee revenue quadrupled (from $1.7 to $7.3 billion) during this period (Furletti 2003). The much greater than proportionate increase in late fee revenue suggests a substantial increase in late fee incidence. As the economy was in an expansion for all but the last year of this period, much of the growth in late fee revenue can be attributed to an increase in availability of credit cards to higher risk consumers.

[7] The CARD Act included additional requirements not related to risk management including rules for standardizing the calculation of interest charges, notification of changes in account terms, issuance of accounts to persons under 21 years of age, disclosures on certain effects of making only minimum payments, and time to make payments. See Koppel et al. (2009) for a summary of the act's requirements.