Credit Card Users With Highest Balances Pay Lowest Rates

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People who hold credit cards with the lowest interest rates are not the ones you might expect – they're the borrowers who carry the highest credit card debt, according to new research.
The assumption has been that credit card users with high balances posed a bigger risk of defaulting on their payments, so banks would charge them a higher interest rate.
But a study of Ohio consumers suggests that savvy card users are shopping around, finding the cards with the lowest interest rates to minimize their payments, said Lucia Dunn, co-author of the study and professor of economics at Ohio State University .

“People with large balances are playing the game,” Dunn said. “They have the most incentive to find cards with the lowest rates, and that's exactly what they are doing.”

Results showed that credit card holders who carry a balance but who have not missed payments have an average annual percentage interest rate (APR) of 13.9 percent – 1.2 percentage points lower than that of convenience users, who pay off their balances each month The highest APR (15.9 percent) went to those who carry balances and have missed payments.

Moreover, among those consumers who carry balances and have not missed payments, an increase of $10,000 in the balance they owed was linked to a 1 percent decrease in APR.

Dunn conducted the study with Taehyung Kim, a graduate student at Ohio State when the study was done, and Gene Mumy, an associate professor of economics at Ohio State . Their results were published in the most recent issue of the journal Economic Inquiry.

The researchers used data collected from the Ohio Economic Survey, a monthly telephone study of Ohio adults conducted by Ohio State 's Center for Survey Research. The survey, which was started in 1996 and included at least 500 randomly chosen people each month, included several questions about credit card use. Data for this research was collected between December 1998 and April 1999.

This monthly survey provides an important snapshot of credit card use in the United States , Dunn said.

“Until this survey, there has been almost no data available to researchers on credit card use, which is surprising given the importance of the issue,” she said.

The other main data set has been the Survey of Consumer Finances, sponsored by the Federal Reserve Board, but this survey is only done once every three years.

With the dearth of real research, there has been a common belief that banks would view high credit card balances as a default risk, and would give these consumers higher interest rates, Dunn said. While this seems logical, this study suggests something altogether different is going on.

For one, Dunn said she believes banks have become more sophisticated in evaluating credit risk, and no longer penalize people simply for having large balances.

“If anything, banks want a low-risk, high-balance customer,” she said.

"That's how they make the most money. They want consumers to carry a balance, as long as they are going to continue paying it off."

At the same time, banks have become more competitive and are aggressively seeking new credit card customers by offering low introductory rates – sometimes even 0 percent APR for a period of time.

One study showed that from 1991 to 2001, the number of mailed credit card solicitations increased fivefold to 5 billion per year. The number had reached 6 billion by 2003.

"All people have to do to find a better interest rate is go through their mail," Dunn said. "That's what people with balances seem to be doing, switching to whichever card will offer the best deal."

Convenience users tend to have credit cards with higher APRs because they have no incentive to search for lower rates. Because they pay off their balances each month, they never pay interest anyway.

Those who have missed payments are the ones who are seen by banks as truly risky. That's why they pay the highest APR on their cards, Dunn said.

While some consumer advocates have argued that the government should impose credit card interest rate ceilings, the results of this study suggest that may not be necessary, she said.

"Our results show people are taking care of themselves. They are not being taken advantage of and know how to find the lowest rates. There seems to be enough competition in the market," Dunn said.

"Of course, some people think that overall the rates are just too high, but if people are willing to pay these rates, there's nothing the government should do. Competition in the market should bring those rates down."

Kim, who was a graduate student at Ohio State when this study was done, now works for Wachovia Corporation, a North Carolina-based bank. Neither Dunn nor Mumy have any paid associations with the credit card industry.

Source: Ohio State University