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The Market for Information and Credit Card Regulation

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In December 2008 the Federal Reserve announced several new regulations for credit card practices and billing. The rules, which will become effective on July 1, 2010, impose new regulations governing the minimum period that cardholders have to make payments, the manner in which payments will be allocated among balances with different APRs, regulations on increasing interest rates on preexisting balances, and various regulations to the Truth-in-Lending Act. It is also possible that Congress may impose still further regulations on credit card marketing and operations, such as the Credit Card Holders Bill of Rights. These new regulations and those being considered by Congress follow the pattern for many regulations of financial products in the past—additional disclosures of certain practices and new substantive restrictions on certain credit card practices, such as raising rates on existing balances, prohibition of cross-default clauses, and new rules for allocating payments among higher- and lower-interest rate balances.

These regulations, as with those that have come in the past, suffer from a fundamental flaw that continues to undermine efforts to coherently regulate credit cards (and consumer credit generally): Regulation is enacted without always clearly specifying the market failure to be addressed. Most credit card regulation today is disclosure-based rather than substantive. A substantive regulation is something like a usury regulation that places a legal cap on the interest rate that can be charged. There is a general consensus today that substantive regulation (such as usury regulation) is generally counterproductive in consumer lending markets, as the negative unintended consequences tend to exceed the benefits of the regulation. There are several unintended consequences. First, they include term re-pricing, such as offsetting caps on interest rates by the imposition of an annual fee or other costs. Second is product substitution. For instance, if higher-risk borrowers are unable to obtain credit cards then they will turn to other forms of borrowing, such as pawn shops or payday lenders. Third is credit rationing. If despite these efforts at term re-pricing and product substitutions it is still too difficult to lend to certain borrowers, then those borrowers will be unable to get credit at all or will have to turn to illegal sources of credit. Thus, although the regulation may accomplish its narrow direct regulation (limiting the interest rate charged) it may do so only at a substantial social cost that leaves consumers worse off in the end.

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Disclosure-Based Regulation

As a result of these unintended consequences of substantive regulation, in recent decades there has been a general movement toward disclosure-based regulation, such as the Truth-in-Lending Act. Under disclosure-based regulation, rather than prohibiting certain terms, regulators try to improve the operation of the marketplace and strengthen consumer choice and information. The logic behind disclosure-based regulation is that, by creating standardized disclosure of terms thought important, then it eases consumer shopping.

That is true as far as it goes, but the disclosure and standardization rationale doesn't work well when consumers have heterogeneous preferences and shop on many margins. So, for instance, credit card solicitations include the Schumer Box, which requires certain important terms to be disclosed prominently in a tabular format. Those terms include things that are obviously important to many borrowers, such as the APR and annual fee. But the Schumer Box also includes several terms that may have been important 20 years ago but which are far less important today. For instance, perhaps there was a time when the mandatory disclosure of the minimum finance charge made some sense. Today, however, the minimum finance charge is a trivial term and varies little among cards; it is 50 cents for almost every card.

Moreover, some card issuers now disclose in the Schumer Box things that are relevant to a very small number of borrowers, including (increasingly) the foreign transaction and currency conversion fees. This is a term that is surely important to some small number of consumers who travel abroad frequently. But it is largely irrelevant to the bulk of cardholders who rarely leave the country and the even smaller number of consumers who choose their credit card based on this term. Nonetheless, this esoteric term is now routinely disclosed in the Schumer Box along with bread-and-butter issues of interest to many consumers.

Even this gives too much credit to the logic of standardized disclosures. The disclosures required by the Schumer Box are premised on the idea that consumers shop for credit cards based on the price of revolving credit on the card. Yet about half of consumers are transactional users who usually pay their balances in full each month and rarely or never revolve a balance. For those consumers, even the seemingly most useful disclosures (such as the interest rate) are largely irrelevant to their card decision. Those who do not revolve will tend to shop for cards based on features such as the benefits it offers (such as rental car insurance) or co-branding or other benefits, such as cash back or frequent flyer miles. I confess that I have no idea what the interest rate is on any of the credit cards that I own, much less the foreign currency conversion fee. I am well aware, however, of which cards give me cash back and the rate at which I accrue bonus certificates at L.L. Bean.

The effect of the modern disclosure-based regime of consumer credit regulation, therefore, is to require prominent disclosure of many terms that many people do care about but also require prominent disclosure of terms that people *don't* care about. Moreover, government being what it is, once certain disclosures are set by law or regulation, they are frozen in amber and become very difficult to change. Thus, credit card issuers still are required to prominently disclose terms that seemed significant 20 years ago, yet are trivial today.

Why is this a problem? Is there any downside to simply requiring more disclosure so that consumers have more information? The problem with this is that, by requiring certain terms to be prominently disclosed, it becomes more difficult for consumers to locate the terms that they do care about. Consumers have limited time, energy, and attention to locate and understand all of the terms of a credit card contract. Consumers can be quickly overloaded with information, and the more information that they are forced to process, the more difficult it is for them. So forcing consumers to wade through many irrelevant disclosures to locate those that they consider more relevant makes it more difficult for them to make knowledgeable decisions on the terms that are actually of interest to them. Compelling more disclosures also can gives rise to the problem of fine print and densely worded disclosures, as requiring the disclosure of certain terms in a more prominent fashion leaves less room and attention for disclosing other terms.

The Market for Information

The current model of credit card regulation largely misunderstands the logic of the market for information. If a term is important to consumers (such as the interest rate or annual fee), it seems likely that credit card issuers would disclose it or consumers would demand that information before acquiring the card. I am not aware of any other market where consumers would routinely buy or use products when they don't know the price, and it is not clear why they would not insist on knowing the price of a credit card before using it.

With respect to information that most consumers do not care about, such as the minimum finance charge or the foreign transaction fee, most consumers are unlikely to shop on that margin. Thus, it is unlikely to be relevant for most consumers. As a result, in a smoothly functioning competitive market this information would not be expected to be routinely and prominently disclosed to all consumers. Instead, this sort of information would be expected to be disclosed on a need-to-know basis, in the sense that idiosyncratic consumers would get that information when and if they needed it.

To the extent that regulation is appropriate, therefore, the first question should be to ask whether there is a market failure in the market for information and what kind of regulation will best address it. It may be that there are market failures in the information market that require intervention. But current regulation doesn't even really seem to be asking the question this way. Rather than asking what exactly the market failure is that needs to be addressed, regulators seem to take the same basic model and replicate it in applying it to new situations as they arise.

Normative Disclosure

This regulatory approach exacerbates the problem of what I call "back-door substantive regulation" or "normative regulation." This is the problem that arises when regulators use disclosure regulation not to improve consumer choice and to help consumers shop for and get what they actually want but rather to try to influence their choices and try to get them to focus on what the regulator wants them to focus on or to try to shape consumer choices.

So, for instance, a regulator might say, "I'm worried that consumers are borrowing too much on credit cards. One option to try to restrict credit card borrowing would be to impose usury regulations. But I now know that the unintended consequences of usury regulation often exceed the benefits. So, instead, I will hit consumers over the head with information about how much credit costs them, which might frighten them into borrowing less." Thus, certain terms end up getting disclosed more prominently then they would be disclosed if the primary goal was simply to make it easier for consumer to compare terms on the margins that they care most about. These terms are disclosed because of their interest to the regulator, rather than because of their interest to the consumers.

With back-door substantive regulation, the regulator is trying to achieve substantive regulatory outcomes through the indirect method of disclosure regulation. But if substantive regulation or affecting the substance of consumer choices is the regulator's goal, fiddling with disclosure-based regulation seems like a poor way to do this.

A good example of back-door substantive regulation is the requirement included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which requires that consumers be told how long it will take to pay their balances if they make only the minimum payment each month on their balances. According to former Federal Reserve Economist Thomas Durkin, this provision actually affects only about 4 percent of cardholders.[1] Despite the small number of consumers who actually care about this information, Congress has mandated the disclosure of this information on card holders' monthly statements resulting in costs to card issuers and to those consumers who will have yet another irrelevant disclosure to navigate. In the end, normative disclosure ends up being a poor way of helping consumers to shop better (the purpose of disclosure-based regulation) and a poor way of doing substantive regulation. It is a schizophrenic regulatory scheme that accomplishes neither purpose effectively.

Disclosure-Based Regulation and Heterogeneous Consumers

The problems associated with disclosure-based regulation are exacerbated with heterogeneous consumers. As noted, about half of consumers use their credit cards for convenience or transactional purposes and do not revolve balances, a category that includes myself. I have no idea what my interest rates are on my credit cards. Nor do I know my minimum finance charge, my interest rate on cash advances, etc. And I don't shop for credit cards on those margins. I shop on the basis of my annual fee and benefits, such as cash back or frequent flyer miles.

Yet if I shop for a new credit card, the credit card solicitation is filled with a lot of information that I don't care about. So it becomes more difficult for me to find the information I *do* care about. Again, absent the compulsory disclosures, it seems like credit card issuers would have an incentive to provide me with the information that I need and want to shop and choose their card. Moreover, research shows that consumers who do revolve balances are very aware of their interest rates and related terms, read credit card solicitations more carefully, and choose their cards based on those terms. Disclosure may help those consumers to make more educated choices, but given their interests, it seems likely that they would insist on disclosure of the relevant terms regardless. By contrast, for transactional users of credit cards, these disclosures are largely irrelevant and come at the expense of locating more relevant disclosures.

Technology and Competition in the Market for Information

The key challenge in the credit card market today is to better match heterogeneous consumer needs with the increasing complexity and heterogeneity of credit card issuers seeking to provide products increasingly well tailored to consumer demand. Some consumers want cards that provide frequent flyer miles, some want cards with a low interest rate, and still others want cards that are available to those with impaired credit. Today, there are cards that will satisfy almost every conceivable consumer preference and consumers that have almost every consumer preference. What is necessary is to better match these heterogeneous consumers to this wide variety in cards. Traditional disclosure regulation fails to appreciate the innovations in consumer credit markets of the last decade. In so doing, it also fails to match the developments in the market for information that have arisen during this same time. Rather than reflecting the increasing complexity and variety of credit cards and credit card users, traditional disclosure regulation can stifle innovation and sacrifice efficiency.

Technology and market innovation may provide an opportunity for overcoming this traditional approach to the market for information. Consider, for instance, the new Web site *Cardhub.com*. This Web site matches credit card issuers with credit card customers by enabling consumers to sort and compare competing credit card offers by the terms that they care most about. Consumers can search for cards among one or several terms, including not just the typical terms (annual fee, interest rate) but also more obscure fees such as balance transfer fees, default APR, etc. Not only can consumers search for benefits, but for particular types of benefits, such as cash back, frequent flyer miles, etc.

In short, *Cardhub.com* allows consumers and card issuers to end run the horse-and-buggy regulatory apparatus that currently exists. The disclosure-based regulatory regime that was issued in by the Truth-in-Lending Act has functioned tolerably well for several decades. It is a vast improvement over the traditional substantive-regulation regime that historically applied to consumer credit. But technology offers the potential improved consumer choice and more robust competition.

Note

1. Thomas A. Durkin, "Requirements and Prospects for a New Time to Payoff Disclosure for Open End Credit Under Truth in Lending," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board (Washington, DC), Paper 2006-34 (July 2006). Durkin reaches this estimation by determining the percentage of cardholders who revolve a balance, express an intention to payoff the existing balance by making only the mandatory minimum payment, and would be willing to stop using the card to accrue new charges while doing so.