Introduction

I start in 2003 at a parliamentary hearing in London. The witnesses are an impressive group, the CEOs of most of the large issuers of credit cards in the United Kingdom. The topic is the concern of a select Treasury Committee about the high cost and excessive use of credit cards. From the perspective of the media, the high point of the hearing was a sound bite from an exchange with Matthew Barrett, Chief Executive Officer of Barclays Bank. In the course of questioning Mr. Barrett about the high interest charges on the cards that Barclays issues, one member of the committee jests that "you probably have a Cahoot card in your wallet," referring to a low-cost card issued by a British Internet bank. In Washington, you could predict with great certainty that the CEO of Citibank would respond tartly that he of course carries a CitiCard and uses it everywhere he goes. In the more casual British atmosphere, however, Barrett offers us a lapse of apparent sincerity:

> I do not borrow on credit cards; it is too expensive.
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> I have four young adults in my family, and I give them advice on "don't get too much debt on credit cards" and they are very literate and fluent and extremely well informed because of who their dad is, but it does not matter a w[h]it; they still run their credit cards.[1]

The British press, as might be expected, filled stories for weeks with amused commentary on Barclays' admission that credit cards are too expensive. But the second statement is what intrigues me. What are we to think about this financial product, marketed around the globe by the world's leading financial institutions? In his capacity as a parent, Mr. Barrett (like many of us) is filled with trepidation at the thought that *his* children would use the product frequently. And if that is not enough, he tells the committee that despite the expressed fears of a sophisticated, informed, and apparently concerned parent, his children nevertheless use the product excessively. How can such a product be so successful? Why do we tolerate it? Why have so many of the world's largest economies allowed it to flourish?

The pages that follow provide a broad overview of my answers to those questions. In brief, the product is successful because it is one of the most effective mechanisms ever devised for retail purchasing and borrowing. Thus, we tolerate the product because efforts to ban it would do much more harm than good. At the same time, the problematic aspects of the product that motivate Mr. Barrett's trepidation cannot be ignored. Rather, they demand policy responses that allow the card to do what it does well, but limit the harms from excessive spending and debt that afflict many of those that use the card.

The problems have not escaped the attention of governmental policymakers. Australia and the United Kingdom have been investigating card markets for a decade. More recently, initiatives have appeared in the European Union, Spain, Mexico, and Argentina. Even the United States – where the credit card was invented and has been most warmly welcomed – has begun to consider major market interventions. At the same time, the legislative desire to protect the credit card's place in the American economy was one of the most important motivations for the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Academic contributions, by contrast, have largely missed the hard problem – the mix of values and costs that card use offers an economy. That is not to say that academics have ignored the card entirely. On the contrary, prominent critics like Robert Manning, George Ritzer, and Juliet Schor all have decried the contribution of the credit card to the increasingly consumerist society in the United States. From a wholly different perspective, David Evans and Richard Schmalensee have focused on the structure of the networks that dominate modern credit card markets, arguing that antitrust concerns about those networks have been seriously overstated. Finally, populist supporters of recent U.S. bankruptcy legislation have argued that the laxity of the consumer bankruptcy system in the United States paved the way for widespread abuse of the freedom that the credit card offers.

To make sense of the phenomenon from a global perspective, it is important to situate the rise of the credit card in the general shift from paper-based to electronic payments. Part I of this book explains the importance of that shift. Among other things, it shows how the United States, despite its affection for the plastic card, is far behind other developed countries in moving away from the wasteful use of traditional paper checks as a device for retail payments. Given the resources the United States wastes – about one-half of one percent of its gross domestic product – on processing paper checks, the United States is the *last* place in which it would make sense to stifle card-based payments as a retail payment system.

Part II of this book provides an empirical understanding of the costs and benefits of the card. The plastic card brings substantial benefits as an effective device for payment and for borrowing. To the extent consumer spending, consumer borrowing, and entrepreneurial activity are important drivers of economic growth, the card is an important component of a modern healthy economy. At the same time, the convenience of the card – in particular, the credit card – is uniquely associated with an increase in financial distress. The social costs of financial distress offset the benefits of convenience if they do not in fact outweigh them.

To some degree, this should come as no surprise. Academics for more than a decade have noted simple and apparent correlations between increased debt and consumer bankruptcy filings. And there can be no doubt that the rise of the credit card has been associated with a general rise in consumer borrowing. My work here extends the existing work in three important ways. First, the credit card is a global phenomenon, and I analyze data not only from the United States but also from other developed countries in which the card plays an important role in the economy. Second, I quantify the specific effects of credit card debt, as opposed to consumer debt in general. That analysis supports two premises: increased card spending leads to an increase in overall consumer borrowing; and increased credit card debt leads to an increase in consumer bankruptcy (even when I control for overall borrowing levels). Third, I emphasize the social costs of consumer financial distress, something of which previous writers have lost sight. Nearly everyone loses when consumers are mired in debt. Taken together, those points suggest a classic base for regulatory intervention: credit card borrowing as it exists in the globalized West imposes substantial external costs on the economy, not internalized by the networks, issuers, or cardholders.

Part III of the book takes that concern as the basis for a critical examination of global card usage and the circumstances that have led to its oddly varied pattern. I write from the perspective that regulators dealing with a global phenomenon like the credit card cannot sensibly design policy responses without some understanding of the reasons for the wide variations in usage patterns around the world. As I explain, fortuitous features of the post-war institutional setting in the United States – a fractionated banking system, the interstate highway system, the lack of serious data protection – made the United States uniquely suited to a rapid uptake and adoption of the card. Those circumstances have left the United States dependent on a credit-centered cards market to an extent unmatched in any other economy.

In countries less dependent on the credit card, the forces of globalization are pushing toward markets in which lending and payment functions are more segmented. That norm – epitomized by the United Kingdom and Commonwealth members like Canada and Australia – is characterized by common use of the debit card as a payment device, coupled with rapid increases in credit card borrowing and consumer bankruptcy (albeit at much lower levels than in the United States). Resisting that global norm is a third pattern, epitomized by the continental European Union. There, the coincidence of strong norms of data protection and resistance to consumer debt has hindered the development of the plastic card, forfeiting the benefits of the card but avoiding its costs.

The natural question, then, is what policies will be useful to confine the problems related to credit cards without creating undue inefficiencies in retail payment systems. Parts IV and V consider that question. The most obvious solution would be to push the United States toward debit cards for paying and credit cards for borrowing. But what policies encourage debit card use? Should the government police the price the card industry charges merchants ("interchange fees") or the prices merchants charge customers (credit card "surcharges" or cash discounts)? Should the government conduct a press campaign enlisting Oprah or Dr. Phil?

Unfortunately, those initiatives range from counterproductive to ineffectual. Any serious effort must focus on the heart of the problem: the relation between the issuer of the card and the cardholder. That relation, in turn, can be understood only in the context of the unusual contracting practices that dominate the modern cards industry. My analysis builds on the premise that firms use contracting and marketing techniques that focus the attention of myopic consumers on the more favorable parts of a relationship. Where those techniques are effective, consumers will give inadequate attention to the less favorable aspects of a relationship. In this context, sophisticated card issuers have learned to exploit the boilerplate terms of their agreements to produce a set of obligations that even the most sophisticated cardholder could not master. What does a government do about this? Should regulators then invalidate agreements that disadvantage cardholders? I conclude that regulatory standardization of cardholder agreement makes a great deal of sense. At a minimum, a strong case can be made for regulatory stabilization of terms, to bar the frequent post-hoc amendments that make it difficult for cardholders to understand their obligations.

The complexity of the relationship combined with the tendency of issuers to exploit consumer shortsightedness suggests that the existing system of agreement-based disclosures is at best ineffectual. I recommend a ban of all marketing aimed at minors and college students. I also suggest a revamped disclosure strategy – one that focuses on the critical times, the points at which purchasing and borrowing decisions are made. If one of the major causes of limited borrowing in Japan is the need for consumers to make their borrowing decisions at the point of sale, there is some reason to think that disclosures at that point might lead to more careful cardholder behavior. Finally, the most direct response would prohibit the rewards programs that issuers currently use to give cardholders such a strong incentive to use their cards as their regular spending device and the teaser rates that encourage them to borrow.

As the data presented in Part II suggest, consumer financial distress is rising rapidly even in the countries that use the credit card much less pervasively than the United States. Thus, even if the reforms discussed earlier could shift the United States toward the less credit-dominated global norm, they would not solve the problem entirely. Accordingly, Part V closes with a discussion of broader reforms directed to consumer credit markets in general. Starting again from the premise that the issuer/cardholder relationship imposes social costs, I show how modern technology gives the issuer a ready capacity to limit financial distress through actions designed to limit borrowing by distressed cardholders. The natural implication is that a sophisticated regulatory policy would harness that capacity by giving credit card issuers a monetary incentive to limit borrowing by the financially distressed. If that lending is privately profitable only because of the lender's ability to externalize the consequent costs of distress, the natural response is to inhibit lending. Among other things, that rationale supports mandatory minimum payment requirements, a tax on distressed credit card debt, and the subordination of payments to credit card lenders in bankruptcy.

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I have a great belief in the ability of the market to drive behavior, and an abiding skepticism in the ability of the government to improve on the results produced even by flawed markets. Thus, it has been most unsettling as the evidence that I have collected and the theoretical frameworks built on it have steadily driven me to the interventionist conclusions presented in the closing parts of the book. As you read forward, I hope you can sense the atmosphere of inquiry and the quest for understanding that has motivated my long work on this project.

PART I

The Basics of Payment Cards

1 Paper or Plastic? The Functionality of Payment Systems

We live in a world of choices – sometimes seemingly endless choices. Some are important and some are meaningless. It is rational to make irrational choices some of the time, particularly in our capacity as consumers. In the grocery store, for example, after making "important" choices about what to cook in the coming week or whether to indulge the children with the new Star Wars cereal, we have to decide trivial things like how we want our groceries packaged and how we want to pay.

Merchants have some say in how we pay, and sometimes their choices limit our choices as consumers. Even so, merchants often accept payment forms that have distinctively different advantages to themselves and to their customers. What could be an advantage to a merchant could be a disadvantage to a customer and vice versa.

Plastic cards are one of the many different payment forms that are common in developed economies. To understand their importance, it is helpful to discuss some of the distinctions between different types of payments and payment transactions. For present purposes, the most important distinctions are between cash and noncash payments, paper and electronic payments, in-person and remote payments, and universal and networked payments.

Cash and Noncash Systems

Payments can be cash or noncash systems. The benefits of cash are obvious. It is widely accepted as payment. In the United States, creditors act wrongfully if they refuse to accept U.S. coins or currency when offered to

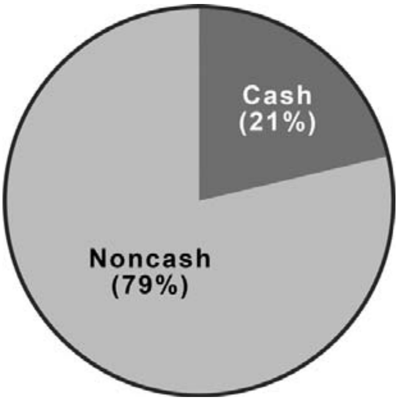

Figure 1.1. Value of cash and noncash retail transactions. Values for the United States in 2003. *Source:* Nilson Report 823.

discharge an obligation.[1] Sellers generally like cash because when a purchaser pays with cash, the seller receives immediate and final payment in a form that the seller can immediately use to make other payments without further processing or transformation.

Cash is also anonymous. It usually leaves no trail from which investigators or data marketers can track the payment. The privacy benefits of cash have led technologists to devote substantial efforts to provide similarly anonymous electronic payment solutions, but those efforts have not been successful to date. The anonymity feature raises a concern that people will use cash when they wish to avoid the notice of law enforcement for tax purposes or other reasons. Because of those concerns, some governments affirmatively discourage cash payments.

Cash is used for little more than one-fifth of the value of retail transactions in the United States (Figure 1.1). The reasons are obvious. It is difficult to transport and to use securely.[2] In addition, the finality of cash induces some purchasers to use noncash payment systems. Although it is difficult to quantify the effect, some purchasers use checks or credit cards solely to obtain the “float” that we gain when we can purchase an item today in return for a withdrawal from our deposit account that occurs some days later. Similarly, although less common, strategic purchasers should use credit cards when dealing with merchants of dubious reliability because of legal attributes of the credit card system that give purchasers a right to withhold payment that is not paralleled in other modern systems. Finally, in some cases, a merchant or individual may wish to leave a paper trail that proves the payment has been made. Few of us, for example, use cash to pay reimbursable expenses.

Noncash payment systems provide payment from a reliable third party, usually a bank or other financial institution. A check, for example, offers the hope – certainly not a promise – of payment from funds the purchaser has deposited with a bank. A credit card offers payment from the financial institution that has issued the card. The key point, however, is that all noncash payment systems depend for their success on credible arrangements to facilitate collection of claims in a timely and inexpensive manner.

Paper and Electronic Systems

Another important fault line lies between paper-based and electronic systems. In the United States, after depositing funds in a checking account a consumer can make payments through the largely paper-based checking system or through the mostly electronic automated clearinghouse (ACH) system that facilitates direct debits and direct credits to banking accounts. More commonly, the traditional, paper-based checking system is used. Even now, the procedures for using and collecting on checks center almost exclusively on the tangible object. Compared to procedures that manage information electronically, check collecting procedures are quite costly, in the range of several dollars per check (including the costs of handling the item by the payor, the payee, and the various banks that process it). Because of the large number of checks that are written in the United States, about 0.5% of the gross domestic product is spent in creating and processing paper checks.[3]

The procedures are slow, typically requiring days – not hours – for the merchant to be sure that the bank on which the check is drawn ultimately will pay it. Such delays hinder the efficiency of the system. Just as seriously, the procedures increase the potential for fraud. The delay between the time of deposit and the time at which the depositary bank discovers whether the check will be honored presents an opportunity for a variety of creative schemes to steal the money.