Is There A Credit Card Puzzle? – An Exploratory Study

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Abstract

Credit cards are a prevalent tool for borrowing. According to the 2001 Survey of Consumer Finances, over three quarters of all US households have at least one credit card, and among households with credit cards 56% actually carry a credit card balance. In aggregate, U.S. consumers currently hold approximately $700 billion in credit card debt, and pay interest rates on credit card balances of 13% on average (Federal Reserve Report, 2004). Dividing this debt by 109 million U.S. households, the average credit card debt is over $6,000 per household. If we focus on all credit card holders, the average debt increases to over $8,000. This large magnitude of credit card debt comes with substantial costs. The average annual interest paid on credit card debt exceeds $1,000 per household among all households with credit cards. Most households who carry credit card debt also hold financial assets, and almost 40% of these households hold positive liquid assets in excess of one month's income. Though credit card issues attract attention of many researchers, little research has considered the behavior of consumers who simultaneously borrow on credit cards, with an average interest rate above 10%, and accumulate liquid assets, earning less than 2% on average.

The purpose of this study is to examine the factors associated with the likelihood of simultaneously borrowing on credit cards and accumulating liquid assets. This study explores the possible explanations for the behavior based on models of saving with uncertainty and liquidity constraints, and the model of mental accounting. Data from the 2001 Survey of Consumer Finances (SCF) are used for the empirical analysis. The sample for testing the hypotheses is limited to active users of major credit cards (MasterCard, Visa, Discover, and Optima card) who also have liquid assets in excess of one month's income. Since anyone with a zero interest rate on her credit card would be rational to revolve, households with zero interest rates are excluded from the analyses. As a result, 1579 financially sufficient credit card users, including 928 convenience users and 651 revolvers, are included for analysis.

Results from logistic regression suggest that having precautionary saving motives, having other debt repayment obligations, having multiple liquid accounts, using financial planners for saving or investment advice, having a positive attitude towards credit, and being non-Hispanic Black or Hispanic are important factors positively associated with the probability of being financially sufficient revolvers.

This is the first study to explore the phenomenon of simultaneously borrowing on credit cards and saving in liquid form. This study will help us better understand consumers' behavior related to managing credit card debt and financial assets. Non-Hispanic Blacks and Hispanics may benefit from specially targeted financial education programs. Households using financial planners for saving/investment advice are more likely to engage in the less economically efficient practice of borrowing at a high price and lending at a low rate of return. If these households are influenced by the advice for emergency funds, it might suggest considering lines of credit when making recommendations for emergency funds. Given the prevalence and ease of using credit nowadays, especially through credit cards, lines of credit could be an efficient buffer stock. However, not many households really consider this as a component of their emergency funds (Bi & Montalto, 2004). In terms of a comprehensive family financial plan, the counselors or educators may evaluate whether the households should pay off their credit card debt first or should consider emergency funds first. For financially sufficient revolvers, they could be better off by retiring their credit card debt using their available liquid assets or other assets, and using that credit line again in case of emergencies.

References

Bi, L. & Montalto, C. P. (2004). Emergency funds and alternative forms of saving. Financial Services Review, 13 (2), 93-109.

Federal Reserve Board, 2004. Table G19, Consumer Credit.

Endnotes

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