OP-ED CONTRIBUTOR

A Fairer Credit Card? Priceless

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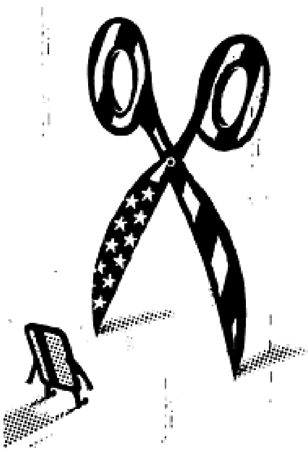

Gary Taxali

INDUSTRY representatives would have you believe that the Credit Card Accountability, Responsibility and Disclosure Act enacted last month spells the end of the credit card as we know it. President Obama's proposal last week to create a Consumer Financial Protection Agency to enforce the law has increased the industry's concerns.

But the example of cards issued by credit unions puts the lie to these claims. Credit unions largely conform to the new rules already, while profitably maintaining the basic features that users know and love.

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The credit card act is under fire for limiting a number of fees commonly used in credit card contracts, like the charge for going over the credit limit and the increased interest rate that applies once a borrower has missed a payment. These changes might look like a boon for the average card user, but industry advocates claim that fees on delinquent borrowers subsidize the perks for those who pay on time. Take away the lucrative fees, the argument goes, and credit card issuers will be forced to ax free plane rides, slash generous credit limits and impose hefty annual dues for all.

Some in the industry even say that profitability would require issuers to charge interest from the moment of purchase, thus eliminating the grace period of interest-free lending that borrowers have long enjoyed.

These fears are largely unfounded. We have performed a study that compared credit cards issued by investor-owned banks to those issued by customer-owned credit unions. We found that credit unions are less likely to charge the fees and penalties that the new act hopes to eliminate — and when they do, they charge less than other issuers.

While virtually all banks and other for-profit issuers increase the interest rate if the borrower fails to make a minimum payment on time, most credit unions do not.

Next Article in Opinion (4 of 28) »

Similarly, credit union fees for exceeding the credit limit are on average just half those of other issuers. But contrary to industry assertions, more responsible card users don't pay the price. Credit union cards actually offer lower annual fees and longer grace periods than regular cards.

Is the lending model used by credit unions feasible for banks and other issuers? Absolutely. Banks and credit unions compete for customers in the same market. The primary distinguishing characteristic of credit unions is that they answer to a different group of owners: profits that are not reinvested are paid to the union's shareholder-customers as a dividend, much as investor-owned banks reinvest or pay dividends to their shareholder-investors.

True, unlike typical banks, credit unions have the advantage of being exempt from corporate income taxes, thus some might argue that this gives them an edge. But this is a proportional tax on profits. In other words, if credit unions were not exempt from the tax, their model would still make profits, they would just retain less of them.

Credit union cards are a great test case for how regular cards will perform under the new law. The evidence so far suggests that the credit card act is likely to bring about moderate, and even positive, changes. Card issuers, after all, need to retain customers. Any bank that attempts to pad its bottom line by, say, levying large annual fees will likely see its customers flee to credit unions or to banks that emulate the credit union model.

To be sure, the new law will require some sacrifices. Our data indicate that rewards programs, for example, may become less generous or less common. But is this necessarily a bad thing? While you may be reluctant to sacrifice your airline miles, rewards programs are anything but free for the nation as a whole. Debt-laden and often low-income borrowers tend to pay high fees to subsidize the vacations of those who manage to pay on time.

Credit union cards demonstrate that punishing fees are not an essential ingredient of profitable lending. This should help assuage fears that the credit card act will bring disaster for credit cards. Rather, it should nudge them toward the gentler credit union model that many Americans already enjoy.

Ryan Bubb and Alex Kaufman are doctoral candidates in economics at Harvard.

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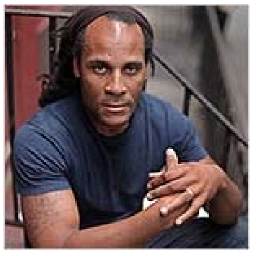

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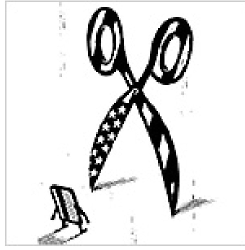

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