

# COMPETITION IN THE NEW ZEALAND CREDIT CARD MARKET FROM THE CONSUMER PERSPECTIVE<sup>1</sup>

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## **Abstract:**

It is common to argue that markets are competitive when there is a significant range of options, including with respect to price, for consumers to choose between. As such the New Zealand credit card market might be regarded as competitive, but what we see in practice is a high degree of similarity in different banks' offerings.

Previous studies in the United States market have suggested that consumers fail to distinguish between different banks' credit card offerings, and that this contributes to the high profitability of their credit card businesses.

This study looks at consumer awareness of the pricing of credit card services in New Zealand, and finds that it is very low. This suggests that the extent of actual effective competition in the New Zealand market may be overstated.

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## 1. Introduction

Since credit cards were first launched onto the New Zealand market in the late 1970s, their use has grown substantially, not only as a vehicle for payment transactions, but also as a means of borrowing. Much of the growth in credit card usage since 1998 has coincided with the introduction of loyalty programmes, which are designed to promote card usage, and thus generate increased returns to banks through merchant fees and interchange fees. To get the greatest benefit from a credit card loyalty programme, the cardholder should be using the card for as much as possible of their spending. However, if cardholders do not understand the way in which interest is charged on credit card accounts, credit card spending can be rather more expensive than anticipated, because of the costs of borrowing on which interest is being charged. This is because, under most New Zealand card plans that provide a free credit period, that free credit period can only be availed of if the previous outstanding balance has been repaid in full.

By 30 April 2003, total credit card outstandings in New Zealand had reached \$3509 million, of which \$2569 million, or 73.2%, were interest-bearing. This represents 4.4% of the total household debt in M3, or 53.8% of household indebtedness to the banking sector, other than for housing.<sup>2</sup> The increase in borrowings over the last six years is shown in Figure 1.

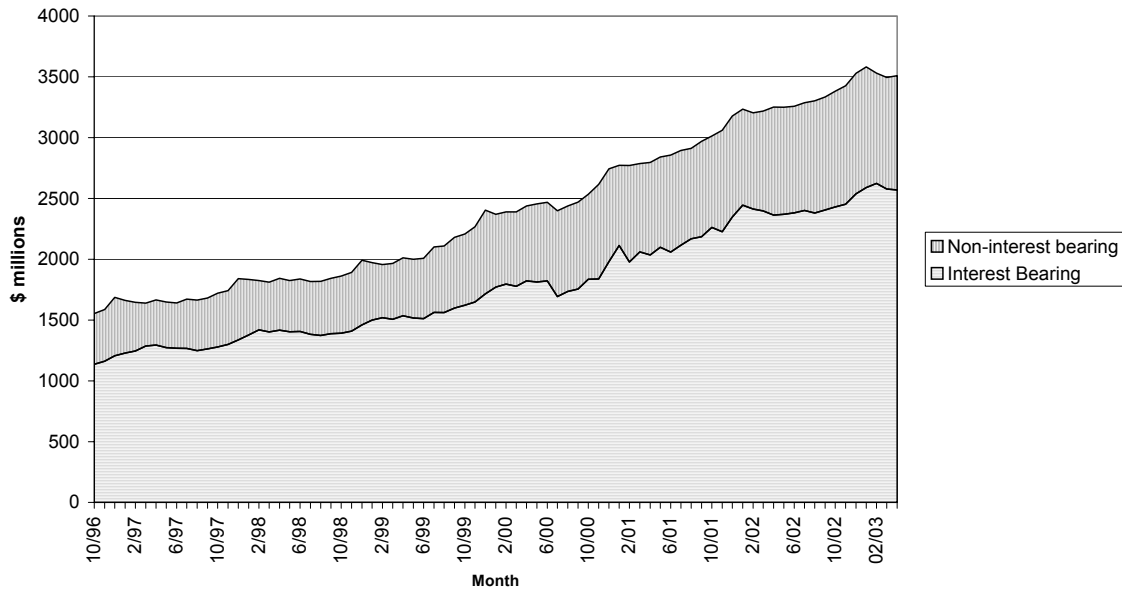
The growth in credit card outstandings has occurred despite the relatively high interest rates applying to credit card borrowing. As at 30 April 2003, the average effective interest rate on interest-bearing balances was 19.0% (equivalent to 13.9% on all outstanding balances).<sup>3</sup> An obvious question that arises from this is that, if interest rates on credit card borrowings are so high, why should consumers be borrowing using credit cards to the extent that they do, rather than refinancing through other cheaper channels such as housing finance? This is despite banks' apparent willingness to refinance credit card debt as part of long-term housing finance. This is also despite a worthwhile range of bank credit card products which provide for much lower interest rates, but which offer no free credit period.

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<sup>2</sup> As Thorp (2003) has noted, however, there is significant other debt to the finance company sector, which will be outside the M3 statistics.

<sup>3</sup> Data are from the Reserve Bank of New Zealand's web-site, at [www.rbnz.govt.nz](http://www.rbnz.govt.nz).

**Figure 1: Total credit card borrowing, personal sector**

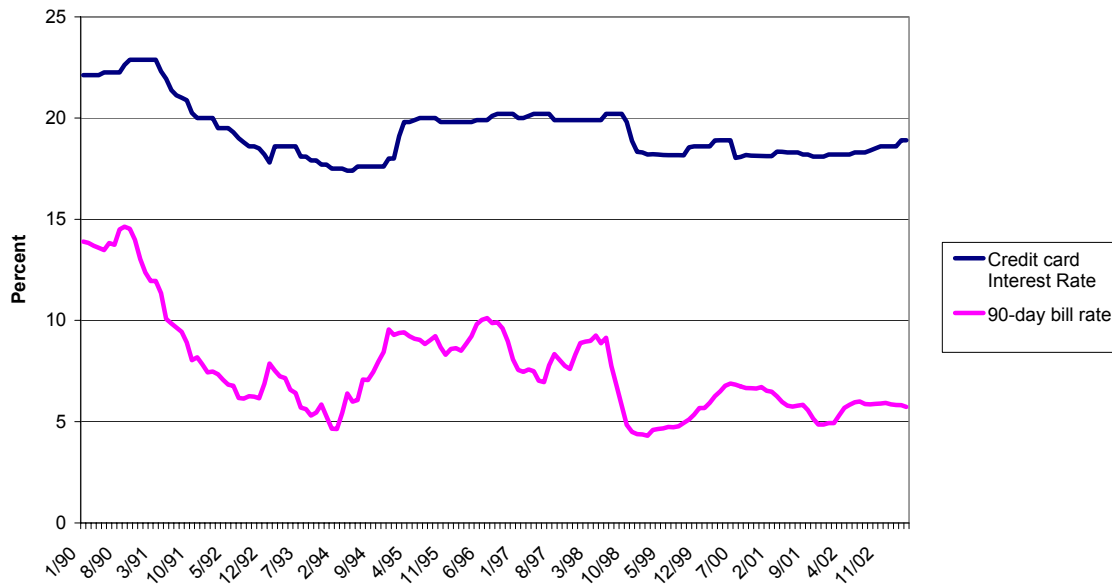


There are some further questions which arise in the context of credit card interest rates and credit card debt. Despite the range of credit card offerings in the New Zealand market, there is a remarkable degree of similarity between the rates charged by the different major providers. We have also seen a steady increase in the margin between banks' standard credit card interest rates and the 90-day bank bill rate, which is the standard accepted benchmark interest rate in New Zealand. The trends are shown in Figure 2 below<sup>4</sup>. How is it that margins have increased, for all major banks, in what is supposed to be a competitive market? How can the banks get away with rates that are similar to each other? How competitive really is the New Zealand credit card business? Why might consumers not respond more strongly to introductory special offers made by different banks and credit card operators from time to time?

This research does not hope to find full and final answers to all of these questions, but it does outline what is at least an introductory explanation of some of the relevant issues. It reports on a pilot survey of consumers in Palmerston North in 2001, which was primarily directed at discovering some preferences and views on credit card usage, in relation to actual card usage.

<sup>4</sup> Figure 2 also shows that credit card interest rates are less variable than 90-day bill rates. In terms of previous research, this would also raise questions about the extent of competition in credit card lending. See, for example, Neumark and Sharp (1992).

**Figure 2: Interest rate trends**



The rest of the paper is structured as follows. The next section reviews relevant prior research, while section 3 reviews the data and methodology, in terms of the survey method used. Section 4 reports the research findings, which are discussed in section 5. Section 6 concludes and discusses issues for further research.

## 2. Prior research

Despite the first bank credit cards having been issued approximately 50 years ago, research into their usage has been relatively limited. Such research as has been undertaken has been done in the USA, relative to that market, and there has been no research published specific to interest rates or competitive conditions in respect of the credit card market in New Zealand.

The seminal contribution on the deficiencies of competition in the credit card market was made by Ausubel (1991), with further major contributions by Calem (1992) and Calem & Mester (1995). Ausubel highlighted the large number of credit card issuers in the USA, and noted that this ought to have led to effective competition. Credit card interest rates were found, however, to have been very sticky during the period 1982 to 1989, despite considerable variation in the underlying cost of funds. This seemed to be reflected in very high rates of profit for credit card operations<sup>5</sup>.

<sup>5</sup> See also Meyercord (1994).

Ausubel suggested three reasons why competition might be relatively ineffective in the credit card market. The first related to search and switching costs, although he suggested that these could not provide a complete explanation. The second possible reason was a type of adverse-selection theory: if credit card issuers charged lower rates, they would be flooded with cardholders who intended to use their card accounts to borrow, and who would thus have a less attractive credit risk profile than the average, who would include cardholders who would more often repay outstanding balances in full. Ausubel's third suggestion was that consumers might sometimes be irrational: they might understate the frequency with which they borrowed on their card accounts, while cardholders would be much more sensitive to annual fees on cards than on the interest rates applying to borrowing.

Calem & Mester (1995) tested some of these theoretical propositions against data from the 1989 Survey of Consumer Finances. They found that consumers who searched for the best rates on deposit and loan products tended to incur less credit card debt (p 1333), while households with more credit card debt were more likely to be credit constrained, and would thus find it more difficult to obtain credit approval for refinance applications. Thus cardholders for whom switching to a lower cost card would provide the greatest benefit were likely to face the greatest barriers to doing so.

The research calls into question the effectiveness of competition in credit card issuance as a way of driving down interest rates and the profits earned from high interest rates. The next section of the paper outlines how the pilot research was undertaken.

### **3. Methodology and data**

The research consisted of a survey questionnaire, of which 200 were distributed. The method of distribution was via a network of the researcher's contacts, who distributed the questionnaires to their own contacts. It is acknowledged that the distribution method raises issues of randomness and representation, but is acceptable in the context of a pilot study. A response rate of 91.5% was achieved, with 183 completed questionnaires returned. The questionnaire sought responses with regard to frequency of card use, factors influencing card use and card costs.

In addition to the distribution method, it must be acknowledged that the results reported here have other possible limitations, including:

- The relatively small sample size which reduces the statistical significance
- The age distribution, which is markedly younger than the wider population
- Possible response bias, as certain responses may be considered more socially desirable leading to respondents to report their behaviour inaccurately.

#### **4. Research findings**

In order to get some perspective on the consumer view of credit cards, respondents were asked about their existing credit cards and the use made of them. Most (62%) reported having just one card, with 36% reporting having two or more, and less than 3% having no card<sup>6</sup>. A minority of cardholding respondents (29%) reported having a Gold card among their credit cards. Limits tended to be relatively small, with 41% having a highest limit of less than \$4000 and only 37% having a highest limit of more than \$7000. Obtaining a credit card was not considered difficult with 69% rating it as easy (1 on a scale of 1 to 5), and fewer than 9% rating it higher than 2.

When it came to making use of their credit cards, frequency of use was well spread, with 27% using their card more than three times per week, 22% once per week, 22% less than weekly but more than twice a month, and 26% using their card less than twice a month<sup>7</sup>. The two factors that most influenced credit card use were loyalty points (27%) and convenience of payment (27%), with the credit free period (19%) and the credit facility (18%) less important.

When it came to knowledge of their credit card costs, 65% reported that they did not know what their current credit card interest rate was and 59% did not know the total annual fees payable. Those who claimed to know provided a range of figures for both the interest rate and fees, but these appeared to be guesses as they bore little resemblance to any of the card issuers' actual interest rates and fees which applied at the time of the study, suggesting that the true level of knowledge is lower than reported.

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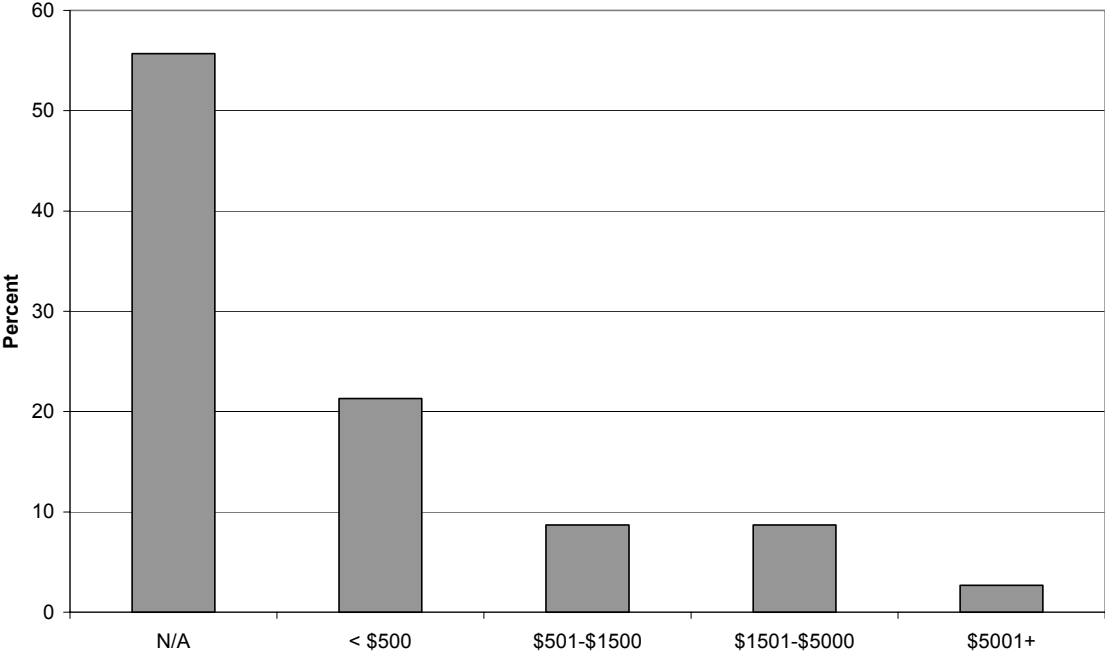
<sup>6</sup> Interestingly, all those who reported not having a card had been cardholders previously but a bad experience with the resultant debt had led to them cancelling their credit card accounts.

<sup>7</sup> By comparison, in 2001 on average there was one transaction per credit card every 3.6 days which is approximately twice a week.

Respondents were also asked about the interest costs incurred when they did not repay their full balance by the due date. While there was an option to specify an amount, 48% claimed it was not applicable and 42% reported they had ‘no idea’. The remaining 10% of respondents provided a figure, but these did not necessarily appear to be consistent with other answers given by the respondents, and there is therefore some question as to the reliability of the answers provided.

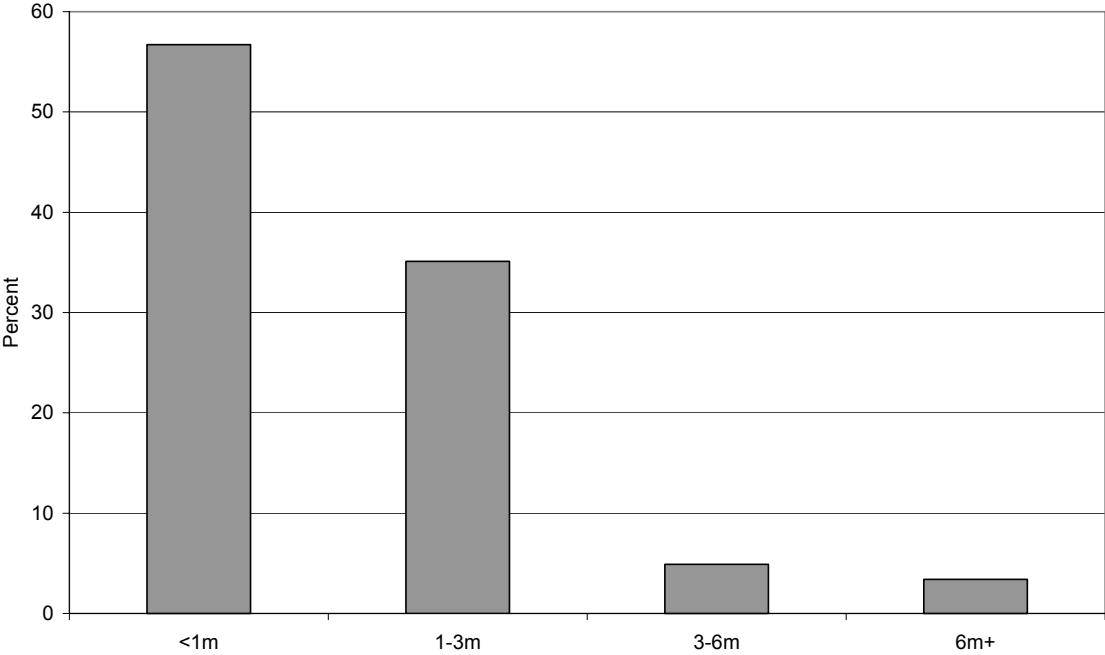
Respondents were then asked about their repayment behaviour, in an attempt to see if their behaviour reflected their level of knowledge of their credit card costs. Most (58%) respondents claimed to repay the full amount owing on their credit card each month. Fourteen percent reported paying only the minimum payment, while 25% reported paying what they could afford. A small number (0.5%) reported making no payment, and allowing the balance to rollover. Those who did not repay the outstanding balance in full were asked what dollar value was left unpaid. Interestingly, a slightly smaller proportion (56%) answered ‘not applicable’ than had claimed to repay the balance in full each month. The proportion that left a balance owing, on which interest would be charged, by outstanding balance, is shown in Figure 3.

**Figure 3: Amount left owing each month**



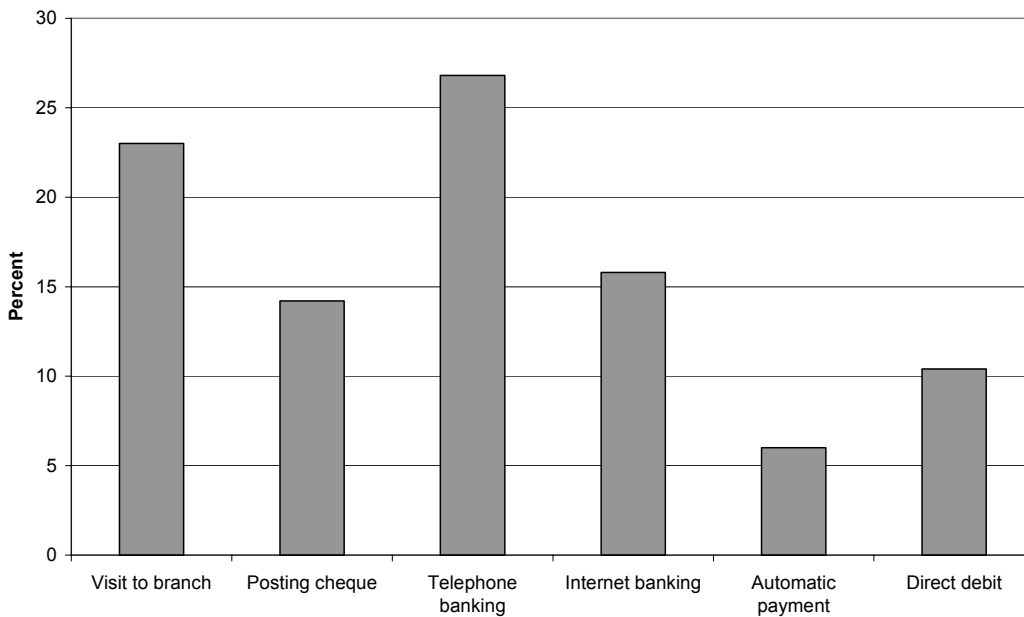
The survey also asked the time frame over which a cash advance would be repaid given that cash advances are interest bearing from the time of drawing the funds. While 65% indicated that they don't obtain cash advances, choosing 'not applicable', most of the others reported repaying it within three months as shown in Figure 4.

**Figure 4: Cash Advance Repayment Period**



Cardholders need and/or desire to have control over repayments can be seen in the preferred method of payment for credit cards, as shown in Figure 5. Despite attempts by some banks to promote direct debits for payment to credit card accounts it appears that cardholders do not like the loss of control perceived as being associated with direct debits, particularly if they do not wish to repay the full outstanding balance every month.

**Figure 5: Payment Method**



## 5. Discussion

Credit cards offer a range of features and benefits to consumers and these vary between issuers, and between different cards from the same issuer. One area in which there is significant variance between the cards that are available is in respect of the interest rates charged on outstanding balances. As the table in Appendix 1 shows, as at August 14<sup>th</sup> 2003 the rates available ranged from 11.5% to 19.95%, although concentrated at the higher end. Special ‘honeymoon’ rates are also often available for customers who move a card balance from one issuer to another, and these can be less than 10% for up to six months, with American Express offering \$9.99 for the first six months as at this date. Given the consistently high level of interest bearing credit card debt it would be reasonable to expect consumers to have a good knowledge of the interest rate they are paying on their credit card debt and for lower rates to be attractive. However, as reported in the previous section the pilot study indicates that this is not correct and customers have a poor knowledge of the charges on their credit cards.

The number of cards on issue has grown steadily, as has the outstanding debt, but the limits available have grown more rapidly. Between 1995 and 2002, the average card limit has

increased from \$3351 to \$5274, an increase of 57.4%, while the average balance has only increased 46.5%, from \$969 to \$1420<sup>8</sup>.

Looking at the average balance of the respondents suggests it would be around \$1000 (see Appendix 2 for the calculation), and this starts to explain why customers may be less interested in at least the interest cost of their credit cards than expected. This average can be compared to the average balance of \$1295 and the average interest bearing balance of \$922 at the end of 2001. The average balance as calculated for the respondents is in line with these, particularly the latter, which suggests that the distribution of outstanding balances in the market may be as skewed as seen in Figure 3. On that basis 50-60% of all cardholders operate their card efficiently by paying off the full balance, 25% have an outstanding balance of \$500 or less and fewer than 5% of all cardholders have an outstanding balance of more than \$5000. This suggests that for the majority of cardholders the interest cost is either non-existent or minimal – even at 20% pa the monthly charge on a balance of \$500 would be only \$8.33 – and therefore of limited interest.

The level of knowledge reported in this study can be compared to that regarding housing loan interest rates. Anecdotally, most people would have a good idea of their current housing loan interest and there is certainly more emphasis on noting the changes in the rates which occur. There is a reasonable level of complaints from borrowers regarding the speed with which changes occur (being increased too quickly and reduced too slowly). This may reflect the greater average loan size<sup>9</sup>, compared to the average credit card balance, and the importance placed on one's home and the associated loan.

It is interesting to note that there is some inconsistency within the study with regard to the proportion of respondents who report repaying their balance in full, as shown in the following table.

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<sup>8</sup> Over this time the number of cards on issue has increased from 1.5 million to 2.6 million, according to figures provided by the New Zealand Bankers' Association on their website at [www.nzba.org.nz](http://www.nzba.org.nz). Note, however, that these figures are for numbers of cards: numbers of credit cards accounts are likely to be lower than this, and average balances correspondingly higher. We have no data to allow us to measure this effect, although we assume it would be small.

<sup>9</sup> Average loan size as at December 2002 was \$78,500, although there would appear to be around 1.7 loans per mortgage borrower, giving an average mortgage debt of approximately \$135,500, which is almost 100 times the average credit card debt.

58%	Reported repaying the balance in full each month
56%	Answered 'not applicable' as to what amount they leave owing each month
48%	Answered 'not applicable' to the amount of interest incurred
24%	Answered 'not applicable' to the incurring of interest or late payment penalties

This may reflect the question that was asked in each case, as only the first asked directly. It may also reflect the social desirability of giving the perceived correct answer. There are frequent stories in various media outlining the dangers of credit cards, and the importance of repaying the balance each month. Therefore there may be a reluctance to admit to not doing so when asked directly, even in an anonymous survey.

The situation with the card fees is different, as these are payable irrespective of account balance, being based on the type of card and the associated benefits. Fees range from \$15 pa to \$450pa, with most being \$20 for a standard/classic card and around \$70 for a gold card – the fee of \$450pa applies to the BNZ Platinum Visa. With the majority of cardholders having standard cards, the annual fee of \$20 that would apply is going to be relatively insignificant and therefore of limited interest. Furthermore the fee is charged infrequently, either 6-monthly or annually, which will affect respondents' recall of it. It is also worth noting that some customers do not pay the annual fee, usually due to the total value of their banking relationship. These factors combine to explain the 59% of respondents who did not know what their fee was, the 6% who reported paying no fee, and the apparently inaccurate amounts claimed by some of those who specified the fee payable.

From the issuers' perspective, there appears little incentive to reduce the interest rates on credit cards. Reasons may include the low proportion of customers actually affected, and the need to cover the costs of providing the products. Looking first at the proportion of customers affected, we have seen that for up to 80% of all cardholders this is a trivial issue and only for the estimated 5% of cardholders with a balance of more than \$5000 is it a significant issue. From the issuer's perspective this means that most customers are not complaining.

Another possible reason for the high interest rates from the issuers' perspective is that the level of outstandings as a proportion of limits is low, being 25.47% of limits at as January

2003 and having fallen from 27.02% since January 1994. The issuers could be providing capital against the contingent liability of the full limit, which would incur a cost that must be met. There is also a need to manage the liquidity risk that exists as a result of the contingent liability and the uncertain potential for drawings against the limit in excess of the normal level. Another cost that must be met by the issuers is the losses from credit card fraud, which is an important issue in the credit card market.

Furthermore a consistent 25-30% of the outstandings are non-interest bearing<sup>10</sup>, and as noted earlier the effective interest rate on all outstanding balances as at April 30<sup>th</sup> 2003 is a more reasonable 13.9%.

We're now in a position to return to the questions posed in the introduction. We are unable to explain the increase in margins on credit card debt, apart from noting cardholders' apparent unawareness of the rates being charged. We have been unable to find any evidence that the credit card market in New Zealand is competitive. A large number of competing products does not inherently mean a competitive market.

Consumers' lack of response to special introductory offers may be attributed to the large proportion of cardholders who do not admit to having any borrowing and the apparent lack of appreciation by cardholders of the interest rates they are being charged. These points link back to Ausubel's suggestion of the apparent irrationality of consumers. The effects observed could also be interpreted as consumers' failure to acknowledge the amount of their indebtedness, and the charges they are paying in consequence.

## **6. Conclusions**

We can start to see some of the reasons that the credit card market in New Zealand appears relatively insensitive to the interest rates and fees being charged, and why card issuers appear reluctant to reduce the charges applying to their credit card offerings. Clearly there is a lack of knowledge among cardholders regarding the costs of their cards. However, this appears to

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<sup>10</sup> There is also the question of the funding of the loyalty schemes provided to all cardholders.

reflect the high proportion of cardholders who do not carry a debt, and for whom the costs are therefore irrelevant.

It also raises some issues that are worthy of further investigation, including:

- The apparent increase in the margin being earned on credit card debt
- Extending the work in this pilot study to investigate the levels of debt held by cardholders, in particular to understand more about the small percentage of cardholders who carry the highest levels of debt to see if they suffer any impairment which prevents them seeking cheaper sources of finance
- The costs and benefits associated with the loyalty schemes associated with credit cards, because of their contribution to the overall economics of credit card schemes and recent regulatory action in Australia, which may in due course be mirrored in New Zealand.

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## Appendix 1: Credit card interest rates (as at August 14<sup>th</sup> 2003)

Rate	Card Issuer	Details
9.99%	American Express	Special offer – balance transfer (6 months)
11.50%	BNZ	Platinum & Private Bank Visa Gold
12.90%	ASB Bank	MasterCard Low Cost
	Kiwibank	Standard MasterCard (only card)
13.49%	The Warehouse Financial Services	Merit MasterCard *
13.75%	National Bank	Freestyle (HP card) *
14.25%	BNZ	Activator (HP card) *
	National Bank	Balances \$6500.01+
16.25%	National Bank	Balances \$4500.01 - \$6500
16.99%	American Express	Gold credit card
17.25%	TSB Bank	Classic Visa (only card)
17.99%	American Express	Standard Credit card
18.25%	National Bank	Balances \$2500.01 - \$4500
18.49%	The Warehouse Financial Services	Value MasterCard
18.75%	ASB Bank	All cards, except MasterCard Low Cost
19.20%	ANZ	Gold cards
19.25%	National Bank	Balances \$0 - \$2500
19.45%	ANZ	Standard cards
19.95%	BNZ	Classic and Gold cards
	BNZ	Rewards Plus and Global Plus **
	Westpac	All cards
	ANZ	Qantas Telstra ANZ Visa **

\* = no interest free period

\*\* = maximum interest free period of 44 days, rather than the standard 55 days

**Appendix 2: Pilot Study Average Balance Calculation**

Amount left owing	Proportion of respondents	Assumed balance	Estimated number of cardholders	Total outstanding
Not applicable	55.7%	\$0	57	\$0
<\$500	21.3%	\$500	22	\$11,000
\$501-\$1500	8.7%	\$1,500	9	\$13,500
\$1501-\$5000	8.7%	\$5,000	9	\$45,000
>\$5000	2.7%	\$10,000	3	\$30,000
			TOTAL	\$99,500

The estimated number of cardholders has been calculated to give total cardholders of 100 in the same proportions, and on that basis we find we have an average outstanding balance of \$995 per cardholder.

A relatively small increase in the assumed balance for the top tier of cardholders to \$12,000 would increase the average balance to \$1055, while reducing the assumed balance of the lower tier to \$250 would reduce the average balance to \$940 (a similar amount). This illustrates that the impact of the small number with the highest balance is far in excess of their proportion of cardholders.