What’s Draining Your Wallet?
The Real Cost of Credit Card Cash Advances

Joshua M. Frank
Center for Responsible Lending

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About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation’s largest community development financial institutions.

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EXECUTIVE SUMMARY

Americans have come to rely on their credit cards as both a form of payment for purchases and a flexible way to borrow cash. The total amount of credit card debt is approaching a trillion dollars. Credit cards are a key source of revenue for financial institutions and usually among the most profitable loan products available today.

Credit card pricing has become highly complex and increasingly difficult for borrowers to follow. Credit card issuers at one time charged a single fixed interest rate to all customers and now charge individual customers several different varying interest rates at once, some of which expire after a short time period, and some rates suddenly changing to “penalty rates” under certain conditions. The number and importance of fees charged to consumers has also grown dramatically.

While there has been significant public discussion of certain hidden fees that are common on credit cards, manipulating how consumers’ payments are allocated towards a borrower’s balance is another hidden charge that can impose significant costs on the borrower without their knowledge. Borrowers can have balances on the same card at several different rates at once such as a purchase balance, a temporary promotional – or “teaser” – balance and a high-rate cash advance balance. By putting all of the payment toward the lowest rate balance (typically the purchase balance or teaser balance), issuers can in effect substantially raise the interest rates paid by borrowers.

This report demonstrates that this ordering of payments or “payment allocation” policy can be both expensive and confusing for credit card customers who, as a group, have little knowledge of the mechanics or cost. The data analyzed in this report shows that allocating payments to the lowest rate first is harmful to borrowers, highly deceptive, and inconsistent with risk-based pricing. More specifically the study finds the system is stacked against borrowers in the following ways:

- **Payment allocation forces borrowers to pay the highest prices, as much as 7 percentage points higher.** By paying the lower-cost purchase balance first, payment allocation increases the borrower’s other balances and effectively raises the total interest paid by the borrower. As a result of payment allocation abuses, some borrowers with credit card debt pay as much as $700 extra each year.

- **Customers are unaware of the significance and impact of these hidden charges.** Only 3% of borrowers surveyed have the knowledge and capacity to evaluate credit card companies’ payment allocation policies.

- **Payment allocation distorts risk-based pricing.** When all measures of risk are taken into account, our analysis reveals the opposite of risk-based pricing. Lower risk customers pay significantly higher interest rates compared to high-risk borrowers.
The Surprising Impact of Where the Payments Go

For a consumer who uses both cash advances and purchases, a credit card company that allocates a customer’s payment to the lowest rate first (LRF) converts almost the entire balance to the cash advance rate.

For example, take a consumer who starts with a $1,000 purchase balance and makes cash advances and purchases at an equal rate. More specifically, assume they make a $200 payment each month and take $100 in purchases and $100 in cash advances each month. In month 1, all of their balance is at the purchase rate.

By month 2, the $200 payment applied to their lowest interest rate balance is partially offset by the $100 in purchases, bringing the purchase balance down to $900 (excluding the impact of finance charges). The cash advance balance increases to $100 from new cash advances, which is not offset by any payments applied to this balance.

In month 3, the purchase balance gain declines by $100 to $800 while the cash advance balance increases to $200. By month 10, the purchase balance is down to $100 (where it stays due to new charges each month), and the cash advance balance has increased to $900. Even though the cardholder started with just a purchase balance and makes equal amounts of purchases and cash advances, payment allocation has converted almost the entire balance to a cash advance balance.

The figure below shows the impact using this same scenario after including finance charges using a cash advance APR of 19% and a purchase APR of 12%. This seemingly minor rule regarding where payments go caused the average interest rate to rise from the 12% to 18.35% in under a year. Also, over 90% of the balance goes to the cash advance.
rate even though half of the consumer’s activity is from purchases. For a consumer with a teaser rate, the impact is even larger.

Customers are unaware of the consequences of payment allocation. Payment allocation practices capitalize on the knowledge that borrowers lack the information they need to make the decisions about payments that limit their costs. In order for a borrower to make decisions about maintaining balances at different rates and paying down credit card debt, they must understand the following:

1) Different rates are charged for different types of account activity (for example, a separate cash advance rate);
2) The issuer’s payment allocation policy;
3) If they are aware of 1 and 2, they still need to be aware of how large an impact this seemingly minor rule can have on a customer’s effective interest rate.

In a random national survey of a thousand people, most consumers did not know each of these three key points. In fact, only 3% of cardholders surveyed for this study could “pass” a payment allocation test by answering three questions about payment allocation correctly (one addressing each point above). More cardholders could have passed by randomly guessing. The fact that respondents did significantly worse than random suggests that credit card users’ expectations are systematically violated, making the policy inherently deceptive.
Payment Allocation Distorts Risk-Based Pricing.

This report used computer-simulated accounts to analyze the relationship between risk and APR under different payment allocation policies. Three different measures of risk were studied including payment size, change in balance, and recent cash advance activity. The lowest rate first policy distorts recent cash advance activity as a risk indicator, for example, by treating a cash advance in an “unforgiving” manner: as long as a customer does not pay their entire balance in full, a cash advance balance will still affect their APR, even if the only cash advance took place ten years ago.

For every measure of risk tested, the prevailing policy used by issuers causes less efficient risk-based pricing than any other policy alternative. The policy alternatives examined include distributing payments proportionally to the balance, distributing payments equally across balance types, and paying the highest rate first. When these three risk measures are combined into a single scale giving each factor equal weight (designed to statistically mimic a credit score), the prevailing issuer policy shows inverse risk-based pricing while all the other policy alternatives show correct risk-based pricing. This is illustrated in the table below through statistical regression analysis. A negative coefficient for the regressions on the table below indicate risk-based pricing. As indicated, all policy alternatives show proper risk-based pricing, while the alternative used by issuers (LRF) shows inverse risk-based pricing where lower risk consumers receive a higher APR.
How APR Changes with Risk under different Payment Scenarios

<table>
<thead>
<tr>
<th>Change (percentage points) in APR for a 100 point increase in credit score</th>
<th>Lowest Rate First (LRF)</th>
<th>Proportional Payment (PP)</th>
<th>Equal Payment (EP)</th>
<th>Highest Rate First (HRF)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.32</td>
<td>-0.84</td>
<td>-1.07</td>
<td>-1.27</td>
</tr>
</tbody>
</table>

What advantage do issuers get from paying the Lowest Rate First (LRF)?

While paying the lowest rate first is an inefficient and imprecise way to raise rates that also price badly for risk, issuers may have other reasons to favor as the practice because it:

- raises effective rates while the stated rates the consumers see remain unchanged;
- takes advantage of known tendencies for people to overvalue the present and over-discount the future by raising rates over time;
- allows issuers to phase out even “lifetime” teaser rates in short order; and
- capitalizes the well-known behavioral bias of “excessive optimism” in consumers since the impact of payment allocation policy depends on whether a consumer carries a balance and whether they take a cash advance.

Policy Recommendations

It is understandable that credit card issuers may sometimes need to raise prices to manage risk. However, when they do, their approach should be transparent and should allow markets to remain efficient. Manipulating where payments are allocated amounts to hidden and deceptive pricing that penalizes lower-risk borrowers and only exists because it is not understood by borrowers.

Due to a borrower’s general lack of knowledge and the complexity of payment allocation policy’s impact, disclosure is an inadequate solution. Proposed regulations under consideration by federal financial regulators would prohibit the use of the lowest rate first method, which is the most costly to consumers. By requiring issuers to choose among three other allocation options, the proposal represents a potential improvement that would take less advantage of consumers and improve risk-based pricing. However, the concept of consumer choice is meaningless because the evidence strongly indicates that people do not have the information or understanding necessary to choose among issuers with different policies, if major issuers do in fact vary in payment policy in the future. Therefore the optimal public policy would select a single policy and make it uniform throughout the industry. Specifically paying the highest rate first is the optimal policy.
since it saves consumers the most money and is the most consistent with risk-based pricing.

**Borrower Recommendations**

*Scrutinize all credit card offers and terms, especially the “fine print”*
Don’t be fooled by teaser rates and cash advances. Under current policy, teaser rates can last a much shorter term than you might anticipate. A cash advance will raise interest rates for longer than expected—a single cash advance can still raise the interest paid decades later if an account is never paid in full.

*Segregate your card use if possible*
Customers with enough available credit should use separate cards for borrowing at a promotional rate, making purchases, and taking cash advances. If each credit card has only one type of balance, borrowers can control the allocation of payments by paying the most to the card with the highest rate.

*Pay the highest APR balance first*
If you are able to segregate your card use, pay anything above the minimum to the card with the highest APR balance first.