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Let's reinvent credit cards

THE LAST WORD

Dr Larry Haverkamp
lhaverkamp@smu.edu.sg

EVEN if you pay your credit card bills on time, banks still make money. How? They charge merchants who pay up to 3 per cent per transaction. It's less for debit cards where banks charge about 1 per cent as the banks receive the money immediately, eliminating default risk.

How about the default risk on credit cards? Is it high like the banks claim to justify the interest they charge? It seems logical since a cardholder who is willing to pay such high rates must be desperate for money and therefore at higher risk of default.

But according to a Sept 16, 2013 reply to a parliamentary question on credit card debt, credit card default rates are very low, at only 0.2 per cent.

So, where's the risk? And if there's not much risk, how to justify the high interest rates?

First, are credit card interest rates high? Yes, they are. If you don't pay your credit card bill in full by the due date (usually 52 days after purchase), banks typically charge a monthly interest of 2 per cent, which works out to be 24 per cent per year and 26.8 per cent with compounding.

It's an expensive way to borrow and in the last year, some banks have increased credit card interest rates by another 1 to 2 per cent, bringing it to around 28 per cent.

A brilliant idea

This brings me to my great idea for the banks. Why not lower interest rates instead of raising them?

Here's the scheme: Banks will classify cardholders according to their credit worthiness and then charge accordingly. For example, banks can classify credit card holders as "prompt payers" if they pay in full by the due date. (Better still, we'll give them a break and call it "prompt" if they simply pay the monthly minimum.)

If they do it for 12 months in a row, the interest rate will be capped at 15 per cent. That's high but manageable and a lot better than 28 per cent. Those who pay promptly for 10 of the past 12 months will pay 17 per cent. All others will be classified as "not prompt" and pay the highest rate of 18 per cent.

> *Quick***Quote**
>
> **"When you come to the fork in the road, take it."**
>
> Yogi Berra, 89, baseball great and world-renowned guru

As a bonus, I envision banks competing for the most credit-worthy cardholders by lowering the base rate from 15.0 to 8.88 per cent interest.

That is my brilliant scheme. Now, get ready for a shock. This is not an impossible dream and not even my idea. It is happening right now in our own backyard, in Malaysia. Malaysian banks use the three-tiered interest rates structure I just described, based on the borrower's credit history. That history determines the customer risk and how much interest banks can charge.

Even the part about competing for the most credit worthy customers is happening now. Maybank, Alliance bank and Citibank have all dropped their best rates from 15.0 to 8.88 per cent in Malaysia.

It gets better: Competition for customers has escalated to include cash-back deals. These return 2 to 8 per cent of your purchase in cash. By the way, in Malaysia, there is an 8 per cent cash-back for the Shell-Citi Gold Credit Card on Shell fuel purchases if you meet the required amount of spending. (I'll take that one.)

This brings us to the question of the day, the week and the decade: If Malaysia can do it, why can't we?

Balance transfer

There is a way to reduce credit card interest here in Singapore, called "balance transfer". It's not permanent like Malaysia's credit card scheme, but it permits each bank to offer its own customised balance transfer programme which applies to the bank's other personal loans too. Some, like lines of credit, can charge 20 per cent or more.

The deal is that you transfer your loan balance to the new bank and pay a 3 to 5 per cent one-time fee plus 0 to 8 per cent interest for a period of 6 to 12 months. It's worth it for the new bank which sees you as a good customer who is likely to bring them income, so the bank doesn't mind offering a low introductory rate.

After the trial period ends, credit card debt is subject to the bank's standard rate of around 28 per cent – and it's time to go shopping for another balance transfer deal.

An adjunct professor at SMU, Dr Haverkamp contributes this column weekly to help our readers understand money matters better.

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