

CFI in Focus: Secured Credit Cards

By Ian McGroarty, Federal Reserve Bank of Philadelphia*

September 2019

*The views reflected in this report represent those of the author and not necessarily those of the Federal Reserve Bank of Philadelphia or the Federal Reserve System. No statements herein should be interpreted as an endorsement of any firm or product.

Often the first account to be opened on an individual's credit journey, a credit card offers consumers a way to borrow money to make purchases, earn rewards, and build a record of credit use and repayment with the national credit reporting agencies. This third aspect is important because a long and stable credit history allows potential borrowers to access more types of credit, often at cheaper rates.

Traditionally, credit cards provide access to credit on an unsecured basis, without the need to be backed by a deposit. However, for some people, traditional credit cards can be difficult to obtain because of a poor, brief, or nonexistent credit history. For such individuals, secured credit cards — credit cards whose limits are backed by a security deposit — serve as a potential alternative. Similar to its unsecured counterpart, secured cards allow consumers to establish and build a record of credit use and, as a result, offer an opportunity to eventually access more traditional lending products, including unsecured credit cards and auto and other installment loans.

As introduced above, secured cards differ from unsecured credit cards in that they require borrowers to make a deposit with the lender that serves as collateral for the account. Similar to a security deposit for an apartment, the borrower cannot access the money until the account is closed or converted to an unsecured credit card. The deposit guarantee allows lenders to serve consumers who might not otherwise qualify for unsecured products without taking on additional risk, since the credit line is backed (often in full) by the deposit. Lenders may choose to “graduate” secured card accounts to unsecured accounts by refunding the deposit once the

borrower has demonstrated a history of on-time payments.¹ Graduation represents a significant milestone on a borrower’s credit journey because it signals that the individual is eligible for mainstream credit products.

Given the unique features of secured cards, it is important to understand who uses secured cards as well as why some users graduate while others do not. To inform this understanding, two papers, Santucci (2016) and Santucci (2019), examine secured card acquisition and differences in borrowing behavior between secured cardholders who do graduate and those who don’t. Both of these papers use recent data from the Board of Governors of the Federal Reserve System’s Capital Assessments and Stress Testing report (FR Y-14M) data. The Y-14M collects data on the loan portfolios of bank holding companies (BHCs) and intermediate holding companies (IHCs) with \$50 billion or more in total consolidated assets.²

Who Uses Secured Cards?

Originally developed as a tool for individuals who are unable to access mainstream lending products, secured cards can be an attractive option for a variety of populations, including immigrants and young adults who may not have established a credit history and do not have a credit score, borrowers with a prolonged period of credit account inactivity, and anyone who finds their credit score too low to be approved for new or traditional credit products. An estimated 26 million Americans are “credit invisible,” meaning that they do not have any credit record with the national credit reporting agencies. Meanwhile, an additional 19 million Americans are considered unscorable because of insufficient or stale information (Brevoort, Grimm, and Kambara, 2015).

Table 1 illustrates some of the differences in secured and unsecured cardholder populations, showing that secured card borrowers tend to have lower stated incomes, fewer banking relationships, and lower credit limits than their unsecured counterparts.

¹ Some lenders chose to close the secured account, refund the deposit, and offer the consumer a new unsecured product.

² For more information about FR Y-14M data, refer to <https://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYI+5BzDYnbIw+U9pka3sMtCMopzoV>.

Table 1: Characteristics of Secured Cardholders and Unsecured Cardholders

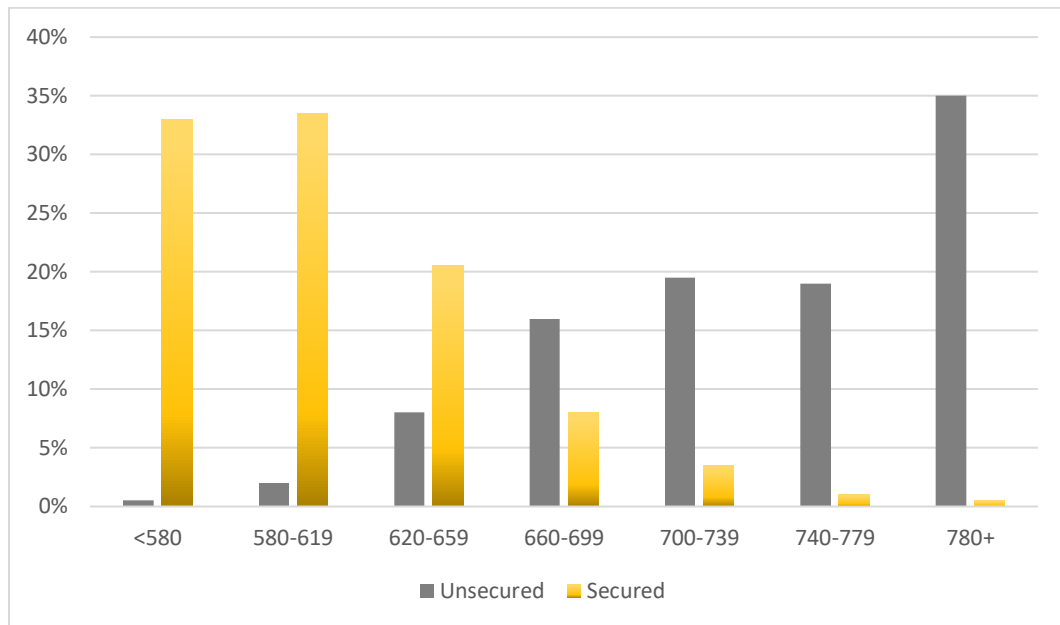
	Secured	Unsecured
Income Type — Individual		
10th percentile	\$16,000	\$15,000
25th percentile	24,000	30,000
50th percentile	35,000	50,000
75th percentile	50,000	80,000
90th percentile	100,000	165,000
Income Type — Household		
10th percentile	9,000	16,800
25th percentile	22,000	38,600
50th percentile	37,000	70,000
75th percentile	60,000	111,000
90th percentile	94,000	170,000
Average Number of Other Open Cards	0.43	2.58
Average Credit Limit on Existing Accounts	\$1,379	\$24,032
Average Utilization of Existing Credit	14.5%	31.4%

Source: Author's calculations in Santucci (2016) using data contained in the FR Y-14M data.

In addition, Figure 1 shows that, conditional on having a credit score, secured card borrowers tend to be in the lower credit score (higher-risk) groups, and unsecured borrowers tend to be in the higher credit score (lower-risk) groups. Furthermore, about half of new secured card borrowers lack a credit score at the time of origination.³

³ This group tends to exhibit different borrowing behaviors and graduation patterns than those of secured card borrowers with a credit score.

Figure 1: Credit Score at Origination

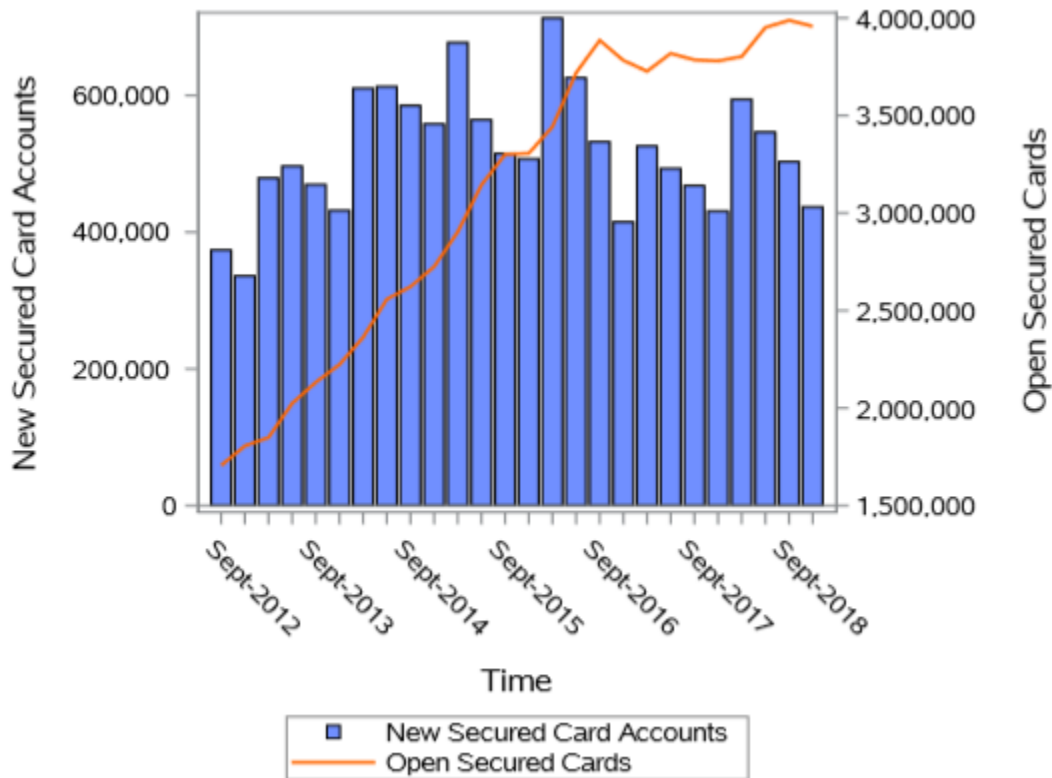


Source: Author's calculations in Santucci (2016) using data contained in the FR Y-14M data.

There are also important distinctions in cardholder terms for secured and unsecured card accounts. Santucci (2016) presents evidence that secured cardholders are subject to higher interest rates and higher fees than unsecured cardholders. The author shows that 55.8 percent of unsecured card borrowers have an interest rate below 20 percent, compared with 35.4 percent of secured borrowers (p. 22). In addition, only 12 percent of secured card accounts had any kind of rewards program, compared with 47 percent of unsecured cards. This is not to say that secured cards are a worse option for certain borrowers, particularly for those who are unable to qualify for unsecured credit cards.

Figure 2 provides a sense of the broader market for secured cards: It shows that the number of open secured cards grew rapidly through 2016 but has leveled off in recent years. Trends in the number of new secured cards being originated are a bit more subtle. It appears that the number of new cards was increasing from 2012 to a peak in September 2016, then fell and leveled off in 2017 and 2018.

Figure 2: Secured Card Trends*

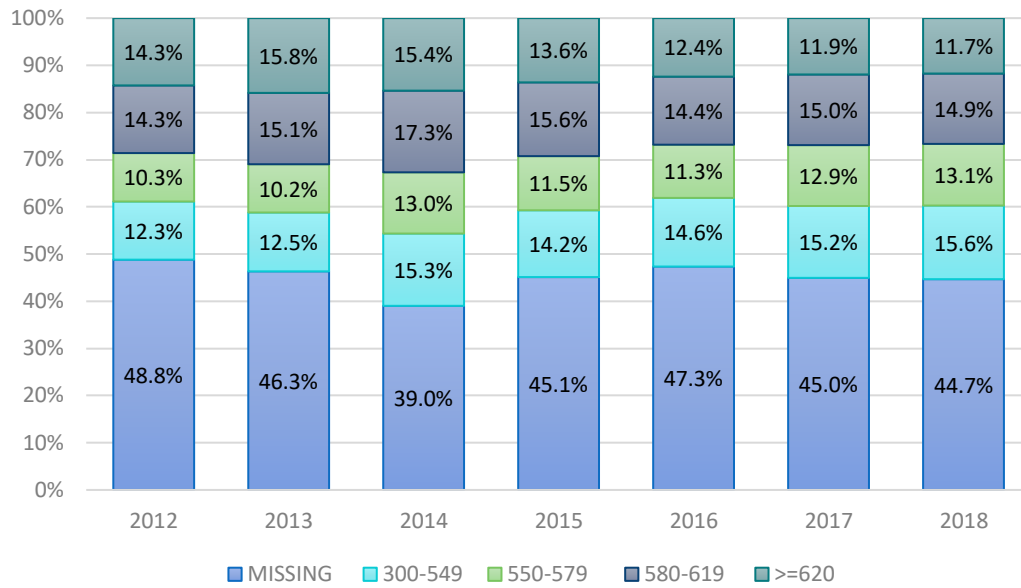


Source: Author’s calculation using data contained in the FR Y-14M data.

* These values plotted are the number of new or open secured cards among the financial institutions represented in the Y14 data. This should account for the vast majority, but not all, secured cards issued in the U.S.

There have also been recent changes in the characteristics of secured card borrowers. Figure 3 shows that the percent of secured card borrowers in the lowest two credit score groups (300–580) has been increasing. This means that the composition of secured card borrowers is becoming riskier. Santucci (2019) suggests one possible reason for this trend: Increasing competition in the secured credit card market may be leading lenders to lower credit standards. Another explanation, he suggests, is that an increase in the number of alternatives available to some borrowers (e.g., offers of unsecured cards with small credit lines became more common), making the secured card less attractive to consumers with higher scores.

Figure 3: Distribution of Credit Score at Origination



Source: Author’s calculations in Santucci (2019) using data contained in the FR Y-14M data.

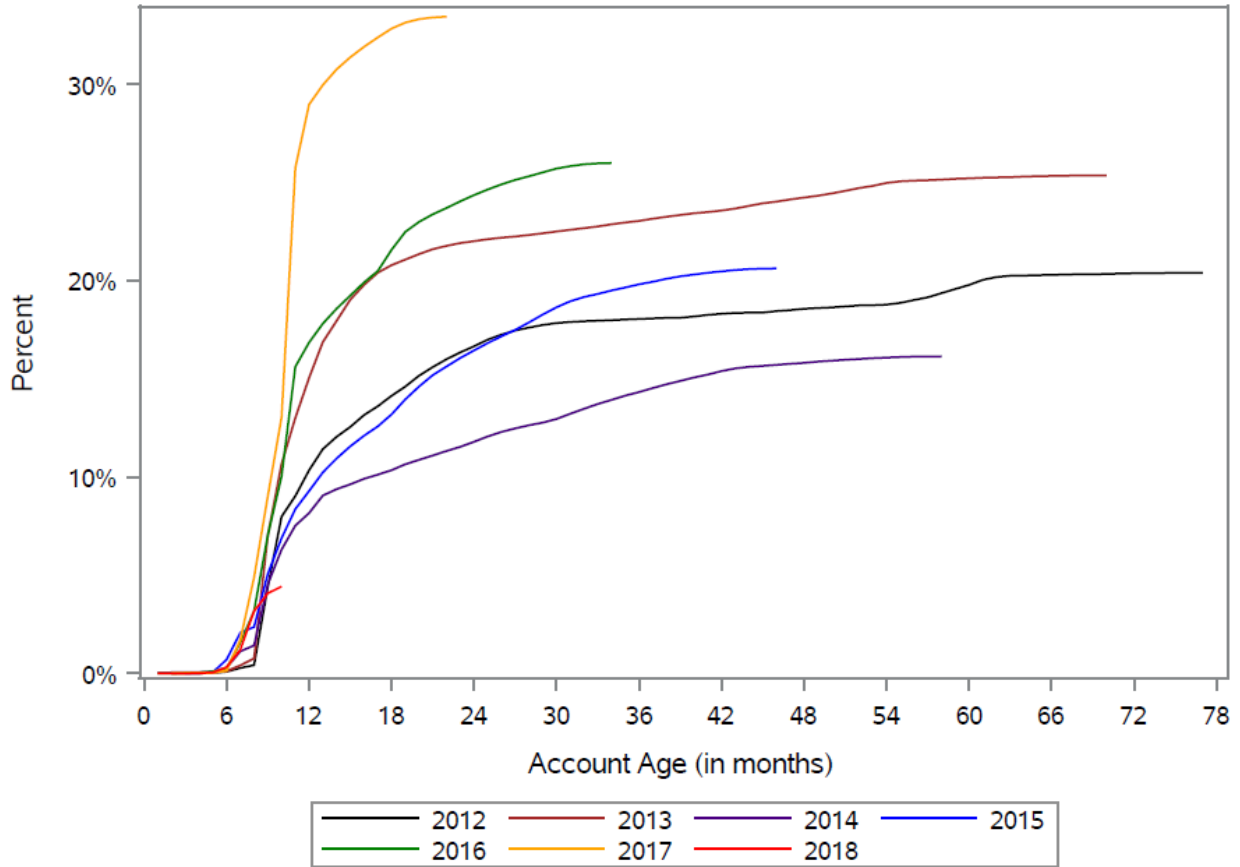
Transitioning to Traditional Credit Cards

Santucci (2019) finds that the two-year graduation rate for nearly every credit score group has been increasing. Figure 4 shows the cumulative graduation rate by account age for each cohort year. It is clear that graduation is not only becoming more common but is also happening earlier in the life of the account with each successive cohort. Santucci (2019) suggests that an increase in the risk of “poaching” may be contributing to this trend of earlier graduations, as lenders attempt to retain their more promising secured card customers before they migrate to other lenders.⁴ This may simply reflect the gradual loosening over time of what were very tight credit standards during the financial crisis.⁵

⁴ Improvements in the credit profile of secured card borrowers might make them eligible customers to competing banks that will in turn offer them an unsecured line of credit. While this is good news for borrowers, lenders run the risk of losing the “fruits of issuing the secured card” (Levy et. al. 2016).

⁵ It is possible that this is in part because of the accelerated account graduation timeline. For example, in January 2018, there were approximately 600,000 new secured credit cards issued. Meanwhile, the total number of open secured cards remained constant at around 3,750,000. This implies that there were around 600,000 account closures or graduations.

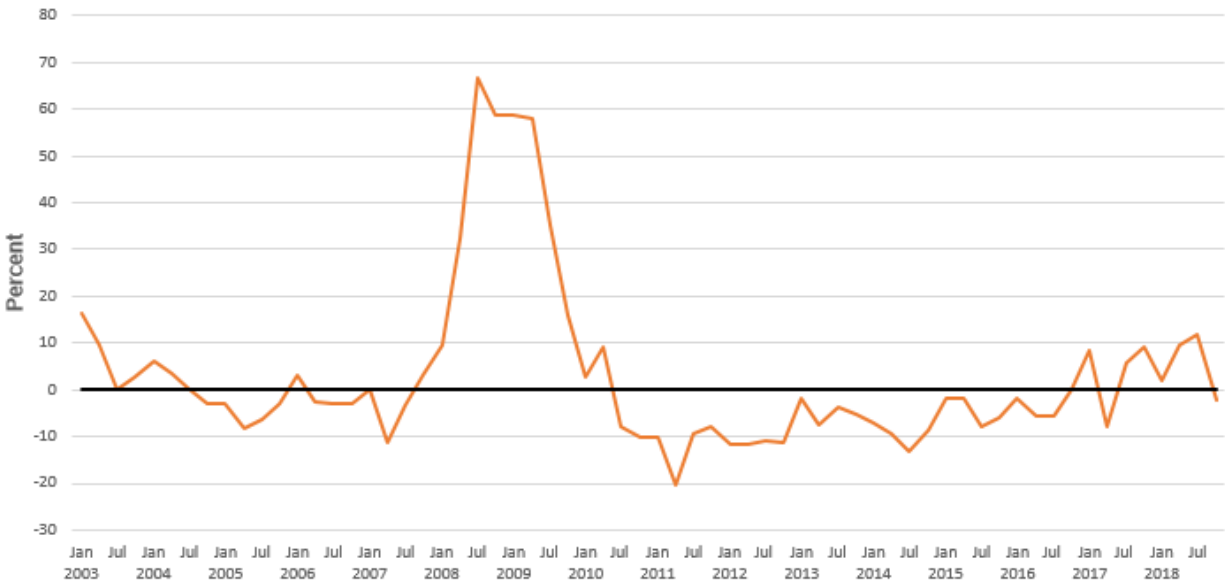
Figure 4: Cumulative Graduation Rates by Cohort Year



Source: Author's calculations in Santucci (2019) using data contained in the FR Y-14M data.

A trend toward loosening credit standards is also reflected in data from the Board of Governors of the Federal Reserve System's Senior Loan Officer Opinion Survey and Bank Lending Practices. Figure 5 plots the net percentage of banks tightening standards on Consumer Loans and Credit Cards. The negative trend persisting from 2011 through 2016 confirms that credit standards have been loosening during this period.

Figure 5: Net Percentage of Domestic Banks Tightening Standards on Consumer Loans and Credit Cards



Source: Federal Reserve System’s Senior Loan Officer Opinion Survey and Bank Lending Practices.

Given this and other business strategies, what factors do lenders consider when graduating a secured account? Santucci (2019) identifies the determinants of graduation for secured card borrowers. Unsurprisingly, a borrower’s most recent credit score is a significant determinate of graduation. Comparing credit score bands, Santucci finds that borrowers whose most recent credit scores were in the highest- and second-highest score bands (620–659, 660+), respectively, were more likely to graduate than borrowers in the lowest score band (570–619). When comparing graduation rates within credit score bands at the time of the account opening, Santucci finds that the unscorable population was most likely to graduate. Santucci notes that, upon receiving a score, the unscorable population of secured card borrowers has a median score of 687.

Borrowing behavior that is generally associated with riskier populations also decreases the likelihood of graduation. Notably, higher utilization rates and instances of account delinquency are associated with lower graduation rates. Similarly, transactors (those who pay the balance in full at the end of each month) tend to have higher graduation rates than borrowers who revolve their balances month to month.

Conclusion

The papers discussed here are some of the first accessible sources that provide quantitative measures to describe who obtains secured cards, how these cards perform, and the pattern of migration to more standard credit cards. Many important questions remain to be explored. For example, after graduating from a secured card, what kind of credit behavior do these consumers exhibit? The critical role this product plays in developing a person's credit, along with its potential for managing risk from a lending perspective, illustrates the importance of expanding our understanding of secured credit cards.

References

- Brevoort, K., P. Grimm, and M. Kambara. (2015). “Credit Invisibles,” Consumer Financial Protection Bureau Data Point, <https://doi.org/10.13140/rg.2.1.2163.8566>.
- Board of Governors of the Federal Reserve System (U.S.), Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Large and Middle-Market Firms [DRTSCILM], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DRTSCILM>, last accessed July 2, 2019.
- Levy, R., L. Cummings, J. Hogarth, K. Asrow, and T. Ladha. (2016). “[Secured Credit Cards: Innovating at the Intersection of Savings and Credit](#),” Center for Financial Services Innovation White Paper.
- Santucci, L. (2016). “The Secured Credit Card Market,” Federal Reserve Bank of Philadelphia, Payment Cards Center Discussion Paper 16-03, <https://doi.org/10.21799/frbp.dp.2016.nov>.
- Santucci, L. (2019). “Moving into the Mainstream: Who Graduates from Secured Credit Card Programs?” Federal Reserve Bank of Philadelphia Discussion Paper 19-02, <https://doi.org/10.21799/frbp.dp.2019.02>.