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Consumers Union

TESTIMONY OF

TRAVIS B. PLUNKETT,
LEGISLATIVE DIRECTOR

ON BEHALF OF
THE CONSUMER FEDERATION OF AMERICA AND
CONSUMER ACTION

BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

THE EFFECT OF CURRENT CREDIT CARD INDUSTRY PRACTICES ON CONSUMERS

JANUARY 25, 2007

Mr. Chairman, Senator Shelby, and Members of the Committee, my name is Travis Plunkett and I am the legislative director of the Consumer Federation of America (CFA.)[1] I am testifying today on behalf of CFA, the national consumer protection organization, Consumer Action,[2] and Consumers Union, the publisher of Consumer Reports.[3] I appreciate the opportunity to offer our comments on the effect of current credit card industry practices on consumers.

Given the dramatic changes that have occurred in the credit card industry in recent years – and the negative impact that some of these changes have had on consumers – no industry in America is more deserving of oversight by Congress. For example, agencies that receive consumer complaints regularly report that credit card problems are a major concern. The U.S. Better Business Bureau reported more than 17,000 complaints about credit cards in 2004, the third highest source of consumer complaints after cellular phone services and new car dealers.[4] There is clearly a need to examine many questionable practices in the industry including marketing, credit extension, the terms and conditions of credit card contracts and rising fees and interest rates. We applaud you for calling this important oversight hearing and look forward to working with you and the committee to enact legislation that will make this industry more consumer-friendly. In particular, Mr. Chairman, we urge this Committee to consider and to move your legislation, S. 499 of 2005, which will address many of the abuses I will speak about today.

I will begin my remarks with an examination of recent credit card lending practices. We find that credit card issuers are expanding efforts to market and extend credit much faster than Americans are taking on new credit card debt. This credit expansion has had a disproportionately negative effect on the least sophisticated, highest risk and lowest income households. It has also resulted in both relatively high losses for the industry <u>and</u> record profits. That is because the industry has been very aggressive in implementing a number of new – and extremely costly – fees and interest rates.

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[1] The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

[2] **Consumer Action** (www.consumer-action.org), founded in 1971, is a San Francisco based nonprofit education and advocacy organization with offices in Los Angeles and Washington, DC. For more than two decades, Consumer Action has conducted a survey of credit card rates and charges to track trends in the industry and assist consumers in comparing cards.

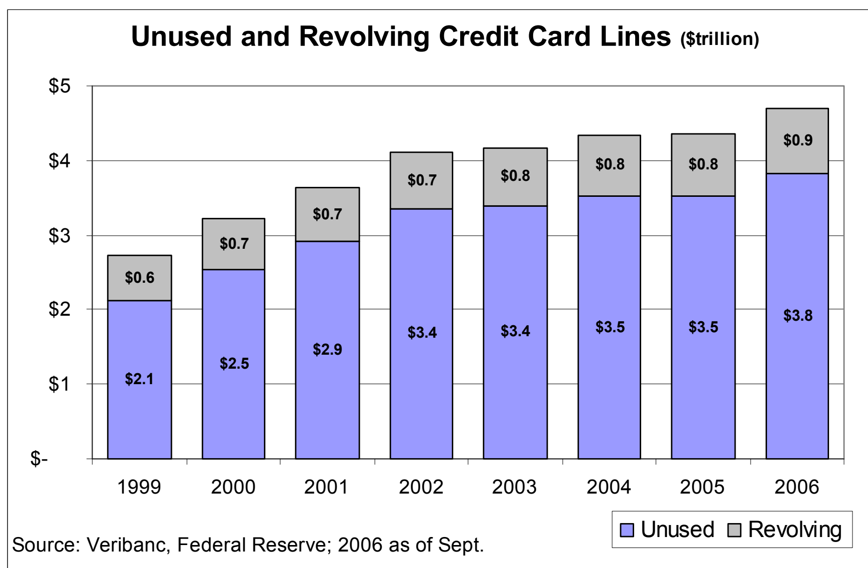
[3] **Consumers Union** is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[4] The U.S. Better Business Bureau received fewer credit card complaints in 2005, but the number – over 10,000 – still ranked credit card problems in the "top ten." U.S. Better Business Bureaus, Complaint & Inquiry Statistics, 2005, Complaint Rank 2005, March 01, 2006.

I conclude that these new pricing policies cannot be justified by stating that creditors are simply leveling higher charges for consumers who represent higher financial risks. In fact, some of these fees and interest rates appear to be predatory; charging what the market will bear while ignoring the harmful impact this pricing has on many Americans. I will close by making a number of legislative and regulatory recommendations that should eliminate abusive pricing in the industry and empower consumers to make better credit decisions.

A. AS CONSUMERS EXERCISE MORE CAUTION IN TAKING ON NEW DEBT, ISSUERS ARE ESCALATING THEIR MARKETING AND INCREASING THE AVAILABLITY OF CREDIT

It is conventional wisdom that consumer demand has fueled the growth of revolving debt to just under $873 billion.[5] However, a careful analysis of lending patterns by credit card companies shows that aggressive and even reckless lending by issuers has played a huge role in pushing credit card debt to record levels. Since 1999, creditor marketing and credit extension has increased about twice as fast as credit card debt taken on by consumers.[6] Moreover, when consumers become more cautious in taking on new revolving debt, as they have in recent years, issuers often sharply increase their marketing and credit in an attempt to entice reluctant consumers to exercise riskier behavior. That is why there is a growing credit "gap" between creditor supply and consumer demand.



[5] As of November, 2006, the amount of revolving debt held by Americans was $872.6 billion. Federal Reserve, Statistical Release, Consumer Credit Outstanding, Table G.19, January 8, 2007. Although this figure is often used as a proxy for credit card debt, most experts believe that outstanding credit card debt is slightly lower. First, approximately 5 percent of consumer revolving credit is not on credit cards. Second, between 4 to 9 percent of the debt does not truly revolve. It is repaid to the credit card issuer before the next billing cycle starts. Taking these two factors into account, outstanding credit card debt is likely to be between $750.8 billion and $794.4 billion.

[6] Veribanc, Inc. and Federal Reserve Consumer Credit Outstanding. According to Federal Reserve figures, consumer revolving debt grew by 41.6 percent from $609 billion in December 1999 to $861 billion at the end of the third quarter of 2006. According to Veribanc, unused lines of credit grew at more than double the rate consumers increased their use of credit card lines, increasing from $2.1 trillion in 1999 to $3.8 trillion at the end of the third quarter of 2006.

The total amount of credit made available by issuers now exceeds an astonishing $4.6 trillion.[7] The average amount of credit available per household is $41,441.[8] Of that amount, only 18 percent has been taken on as debt by consumers. According to figures from Veribanc Inc., there were more than $3.8 billion in unused credit lines in the fiscal quarter ending in September 2006. Between December 1999 and September 2006, revolving debt grew by 41.6 percent, but unused credit card lines made available by creditors grew by 81.4 percent, about twice as fast.[9] As a result, revolving consumer credit has *declined* as a share of total outstanding credit lines from 22.3 percent to 18.6 percent of total credit lines – a 17.0 percent decline.[10]

A similar trend is evident when examining the consumer response to massive increases in marketing by creditors. The most significant form of marketing for creditors remains solicitation by mail. Over half of credit cards held by consumers are the result of mail solicitation.[11]

	Solicitations (billions)	Response Rate
1990	1.1	2.1%
1991	0.99	2.4%
1992	0.92	2.8%
1993	1.5	2.2%
1994	2.5	1.6%
1995	2.7	1.4%
1996	2.38	1.4%
1997	3.01	1.3%
1998	3.44	1.2%
1999	2.54	1.0%
2000	3.54	0.6%
2001	5.01	0.6%
2002	4.89	0.5%
2003	4.29	0.6%
2004	5.23	0.4%
2005	6.06	0.3%

Issuers have increased the number of mailed credit card offerings by six-fold since 1990, from just over 1.1 billion to a record 6.06 billion in 2005.[12] The number of solicitations mailed by issuers in 2006 likely exceeded this amount.[13] CardTrak estimates that each household receives nearly 50 credit card solicitations in the mail each year. Wealthier families receive the highest number of credit card mailings, but low-income families are more likely to open the solicitations they receive.[14] The table at right indicates that issuer interest in marketing credit cards has grown much faster than consumer interest in accepting new cards. The consumer response rate to mail solicitations has declined seven-fold from 2.1 percent in 1990 to .3 percent in 2004. This means that for every 250 solicitations consumers receive, they reject more than 249. The tiny response rate demonstrates that the vast majority of consumers are being responsible when offered unsolicited credit.

The huge increase in mail marketing despite a plummeting response rate is yet more evidence that credit cards are highly profitable. In a normal business, declining consumer demand would result in reduced product marketing.

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[7] Veribanc, Inc. and Federal Reserve Consumer Credit Outstanding, Table G.19.
[8] There are 111 million households in the U.S., U.S. Census Bureau, "American's Families and Living Arrangements: 2003," November 2004, at 2.
[9] Veribanc, Inc. and Federal Reserve Consumer Credit Outstanding, Table G.19.
[10] CFA calculation based on Veribanc, Inc. and Federal Reserve figures.
[11] Vertis Inc. press release, "Financial Direct Mail Readers Interested in Credit Card Offers," January 25, 2005; "Card Marketing 101," *CardTrack*, September 2002.
[12] Synovate, press release, "Mail Monitor Reports Record Six Billion Credit Card Offers Mailed in U.S. during 2005," April 27, 2006.
[13] Consumers received 4.2 million direct mail pieces during the first half of 2006 compared to 3.9 million during the same period in 2005. This calculation includes acquisition, cross-selling and follow up mailings. "Mintel Comperemedia Reports Higher Credit Card Mail Volumes for First Half of 2006," September 7, 2006.
[14] Kidane, Amdetsion and Sandip Mukerji, Howard University School of Business, "Characteristics of Consumers Targeted and Neglected by Credit Card Companies," *Financial Services Review*, Vol. 13, No. 3, 2004 at 186.

Issuers also spend extremely large sums on many other forms of marketing and advertising, through television, telemarketing, the internet, radio, print and even outdoor billboards. *Nielsen Monitor* reported that credit card companies were among the top advertisers nationally and the fastest growing segment of purchased advertising in 2004, with credit card television advertising growing to $1.7 billion in 2004, a $438 million and 32.4 percent increase over 2003.[15] These figures are before the fourth largest credit card issuer, MBNA, started its first national advertising campaign during the 2005 Super Bowl.[16]

Credit cards also promote and advertise their cards by establishing significant networks of co-branded affinity relationships, which offer credit cards with the logo and affiliation of a sports team, university, association or non-profit. Credit card companies gain access to mailing lists, market the credit card branded with the group's logo directly to the group's membership. Organizations are paid a bounty for each account that is opened as well as revenue from any open balances on the affinity cards. Once a consumer relationship is established with the affinity card, the credit card issuers can market other lending products including student loans, home equity loans or auto loans to their affinity card customers.[17]

B. ISSUERS TARGET THE LEAST SOPHISTICATED AND RISKIEST HOUSEHOLDS AND ENCOURAGE THEM TO RUN UP UNSUSTAINABLE LEVELS OF DEBT

The growth of revolving debt in this country to $873 billion has obviously not affected all Americans equally. The extraordinary expansion of the credit card industry in the 1990s was fueled by the marketing of credit cards to populations that had not had widespread access to mainstream credit, including lower- and moderate-income households, consumers with seriously blemished credit histories, college students, older Americans and minorities.

In a practice widely known as risk-based pricing, creditors charged riskier consumers more to cover potential losses, usually in the form of higher interest rates. To make the assumption of debt more attractive to these households – and to entice them into carrying debt for longer periods – creditors lowered minimum payment balances from around five percent of principal to just over two percent. As a result, an estimated eighty percent of all households now have at least one card.[18] Moreover, vulnerable households shoulder a disproportionate share of the debt burden relative to their incomes. In other words, "democratization of credit" has had serious negative consequences for many Americans, putting them one unexpected financial emergency away from bankruptcy.

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[15] Nielsen Monitor, "U.S. Advertising Spending Rose 6.3% in 2004, Nielseon Monitor-Plus Reports," March 1, 2005.
[16] Sidel, Robin, "Card Issuer MBNA lets the Public Take a Peek at Its Hand," *Wall Street Journal*, January 20, 2005 at C1.
[17] *Ibid.*
[18] Cardweb.com

Lower-Income and Minority Households

While the share of higher income families carrying credit card debt declined between 1998 and 2001, more lower- and moderate-income families were taking on debt.[19] The share of homeowners with credit card debt declined (probably due to a large increase in "cash out" refinancings that were used to pay down credit card debt), but the number of renters with debt increased. While fewer white families accumulated credit card debt, more minority households did.[20] Moreover, although minority households are less likely to have credit cards than white families, they are more likely to have credit card debt.[21] The amount of credit card debt held by minority households has also increased compared to white households.[22]

Credit card debt also represents a significant portion of lower-income families' income. A 2004 Gallup poll found that families with credit card debt earning under $20,000 a year owed 14.3 percent of their income in credit card debts, those earning between $20,000 and $29,999 owed 13.3 percent and those earning between $30,000 and $39,999 owed 11.0 percent. Compare this to the 2.3% of their income owed by families earning over $100,000.[23] The increase in credit card debt has contributed to alarmingly high overall levels of debt for many of these lower and moderate-income families. More than one-quarter of the lowest income families spent over 40 percent of their income on debt repayment in 2001.[24] The proportion of lower income families falling behind on their debts is also increasing.[25]

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[19] Aizcorbe, Ana M., Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, January 2003 at 22-23 Table 11. The percentage of families earning the lowest 60% of income grew by 10.5% from 38.5% of these families in 1998 to 42.5% of the lowest earning families in 2001. The share of families with credit card balances earning the top 20% of incomes fell by 12.6% from 47.7% of top earning families in 1998 to 41.7% of these families in 2001.

[20] Aizcorbe, Kennickell and Moore, 2003 at 24.

[21] Draut, Tamara, Director of the Economic Opportunity Program Demos, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 6. Although African American and Latino families are less likely to have credit cards than white families (59%, 53% and 82% of these families have credit cards respectively), they are more likely to be carrying debt than white families. Just over half (51%) of white families reported having debt in 2001, compared to 84% of African American families and 75% of Latino families.

[22] Aizcorbe, Kennickell and Moore, 2003 at 22, Table 11.

[23] Gallup Poll News Service, "Average American Owes $2,900 in Credit Card Debt," April 16, 2004.

[24] Aizcorbe, Kennickell and Moore 2003 at 29, Table 14. In 2001, more than one in four (27.0%) families in the lowest income quintile spent more than 40% of their income on debt payments, compared to less than one in six (16.0%) of families in the second lowest income quintile and one in nine (11.0%) of all families who spend 40% or more of their income on debt payments.

[25] Aizcorbe, Kennickell and Moore 2003 at 29, Table 14. a larger share of lower-income families is behind on their debt in 2001 than a decade earlier. In 2001, about one in fifteen of all households (7.0%) were at least 60-days behind on at least one debt payment according to the Federal Reserve. In comparison, more than one in eight (13.4%) of households in the lowest income quintile and one in nine households (11.7%) in the second lowest income quintile were 60-days or more behind on a debt payment.

Younger and Older Americans

Starting in the early 1990's, credit card issuers targeted massive marketing efforts at college campuses throughout the country, resulting in a sharp growth of credit card debt among college-age and younger Americans. CFA and Dr. Robert Manning were among the first to document the serious consequences of this trend.[26] Since Dr. Manning's report for CFA in 1999, this issue has been the subject of much public and media scrutiny. One of the few Congressional oversight hearings of the credit card industry in recent years was conducted by this committee and focused on financial literacy among college students and the extension of credit cards on campus.[27]

And yet, Americans under 35 years-of-age continue to show more signs of trouble managing credit card debt than any other age group. The amount of credit card debt held by students graduating from college more than doubled to $3,262 between the mid-1990s and 2004.[28] Americans under 35 are less likely to pay off their credit card balances every month than average Americans,[29] are paying more for debt obligations than in the past and are increasingly likely to pay more than 40 percent of their incomes on credit card debt.[30] Not surprisingly, more young Americans are declaring bankruptcy than in the past.[31] Moreover, there is increasing evidence that issuers are now targeting high school students with credit card offers.[32] They are also marketing branded debit cards to adolescents, in part to encourage these young consumers to use similarly branded credit cards when they are older.[33]

The growth of credit card debt among older households is also troubling. Although these households were long thought to be the most frugal and resistant to consumer debt, changing economic conditions – especially declining pension and investment income coupled with rising health care and prescription costs – have made credit card debt a more serious financial issue for older Americans. Between 1992 and 2001, Americans over age 65 saw their credit card debt nearly double from $2,143 to more than $4,000.[34] The number of seniors filing for bankruptcy

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[26] Manning, Robert, "Credit Cards on Campus: Costs and Consequences of Student Debt," June 8, 1999. CFA Press Release available at: http://www.consumerfed.org/ccstudent.pdf

[27] Hearing of the Senate Committee on Banking, Housing and Urban Affairs on "The Importance of Financial Literacy Among College Students," September 5, 2002. Witness testimony and other hearing documents available at: http://banking.senate.gov/02_09hrg/090502/index.htm

[28] Trigaux, Robert, "Generation Broke: New Grads Bear Heavy Load," *St. Petersburg Times*, November 22, 2004.

[29] Draut, Tamara, Director of Demos Economic Opportunity Program, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 8. More than half (55%) of Americans carry revolving balances compared to 71% of borrowers aged 25-34.

[30] *Ibid*. at 4-5. In 1992, about one in thirteen (7.9%) Americans aged 25-34 had debt greater than 40% of their income; by 2001, about one in eight (13.3%) had these high debt burdens.

[31] Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001.

[32] Mayer, Caroline E., "Girls Go From Hello Kitty To Hello Debit Card; Brand's Power Tapped to Reach Youth," *The Washington Post*, October 3, 2004.

[33] *See* Ludden, Jennifer, "Credit Card Companies Target Kids," *All Things Considered*, National Public Radio, February 6, 2005.

[34] Demos, "Retiring in the Red," January 19, 2004 at 3.

more than tripled from 1991 to 2001.[35] Other warning signs are also evident. The proportion of income spent to pay off debts by households headed by individuals 65 to 74 years of age has risen steadily over the past decade[36] while about one in seven senior households paid more than 40 of their income towards their debts in 2001.[37]

Seniors have fewer credit cards than other age groups and are more likely to pay their credit cards in full every month, but a greater proportion also have lower incomes.[38] This means that credit card debt has a more severe impact on this age group. For example, credit card debt can threaten older homeowners, who stand to lose their home – and their most significant hedge against poverty – if they use home equity to pay off credit card debt.

The Downsizing of Minimum Payments

As credit card issuers dramatically expanded their marketing and extension of credit in the 1990s, they lowered monthly minimum payment amounts. By reducing the minimum payment, issuers could offer more credit, encourage consumers to take on more debt, and ensure that consumers would take far longer to pay off their debts, thus making them more profitable for the industry.[39] Monthly minimum payment rates were reduced from around 5 percent of principal owed in the 1970s to just over 2 percent by the turn of the century.[40] In 2005, 19 million credit card borrowers make only the minimum payments.[41]

The number of consumers paying just above the minimum rate is even larger. In a representative survey conducted for the Consumer Federation of America by Opinion Research Corporation in November of 2005, 34 percent of those questioned said that they usually pay the minimum rate or somewhat more. More than 40 percent of respondents earning less than $50,000 a year said they paid the minimum rate or somewhat more, while 45 percent of African Americans and 51 percent of Hispanics did so.[42] An examination by the Credit Research Center of 310,000 active credit card accounts over 12 consecutive months in 2000 and 2001 found similar results. Just under one-third of the accounts paid 5 percent or less per month of the total amount due.[43] Moreover, payment habits for many cardholders are not static over time.

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[35] Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001, at 5. The number of older Americans declaring bankruptcy during this period rose from 23,890 to 82,207.
[36] Aizcorbe, Kennickell and Moore 2003 at 28, Table 14. According to the Federal Reserve Survey of Consumer Finances, the median debt services ratio of households aged 65-74 grew by 54% from 9.8% in 1992 to 15.1% in 2001 and the debt services ratio for households 75 and older grew 169% from 2.6% to 7.0% in 2001.
[37] *Ibid*. 13.9% of households aged 65-74 and 14.3% of households aged 75 and over spent more than 40 percent of their income on debt service.
[38] Hanway, Steve, Gallup News Organization, "Do Credit Card Habits Improve with Age?" May 18, 2004. Nearly half (48%) of households over 65 years old have incomes below $30,000, compared to 16% of those aged 30-49 and 18% or those aged 50-64.
[39] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.
[40] Kim, Jane J., "Minimums Due on Credit Cards are on the Increase," *Wall Street Journal*, March 24, 2005.
[41] Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.
[42] Opinion Research Corporation, "Consumer Financial Services Survey," November 3-7, 2005.
[43] Credit Research Center, McDonough School of Business, Georgetown University.

Depending on the economic circumstances of the cardholder involved, he or she could shift from fully paying outstanding balances every month to paying at or near the minimum rate.

However, paying only the minimum on credit cards can increase the length of time the debt is carried and significantly add to the interest cost of the credit card loan. Julie Williams, the First Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency has noted that reduced minimum payments "dig borrowers into an ever deeper hole, requiring increasingly more difficult measures" for consumers to get out of debt.[44] CFA has concluded that reduced minimum payments were a significant cause of increasing bankruptcies in the last decade.[45]

One way to alert consumers to the consequences of paying off credit card balances at the minimum rate is to offer each consumer a personalized notice on the billing statement about how long it would take to pay off the balance at the minimum rate, and what would be the total costs in interest and principal. That is what Senators Akaka, Durbin, Schumer and Sarbanes proposed in the 109th Congress with S. 393. Such a personalized disclosure is, unfortunately, not included in recently enacted bankruptcy legislation, which requires consumers to call a toll-free number to get information about how long it would take to pay off their balances.[46] No specific information would be offered on the total cost of paying at the minimum rate. This bankruptcy law requirement will likely have no impact on the millions of consumers paying at or near the minimum rate who will not call a toll-free phone number.

One positive development regarding credit card minimum payments is that regulatory guidance issued by federal banking regulators in January 2003 directed credit card lenders to set minimum payments that "amortize the current balance over a reasonable period of time" and noted that prolonged negative amortization would be subject to bank examiner criticism.[47] Many major credit cards began increasing their minimum payments requirements in 2005, including Bank of America, Citibank, Discover and JPMorganChase,[48] in some cases to as high as 4 percent.[49] All issuers were required to fully phase in the changes by the end of 2006.[50]

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[44] OCC, Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel before the Risk Management Association's Retail Risk Management Conference on Regulatory Concerns about Certain Retail banking Practices, Chicago, June 3, 2003, in "Speeches and Congressional Testimony," *OCC Quarterly Journal*, Vol. 22, No. 3, September 2003 at 107.
[45] Consumer Federation of America, "Consumer Restraint Pressures Lenders to Reduce Credit Card Marketing and Credit Extension," January 18, 2000.
[46] Section 1301, S. 256, Public Law 109-8.
[47] Joint Press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," January 8, 2003, see attached "account Management and Loss Allowance Guidance" at 3.
[48] American Financial Services Association, "Credit Card Minimu Payments Going Up," *Spotlight on Financial Services*, April 2005.
[49] Warnick, Melody, "Credit Card Minimum Payments Doubling," *Bankrate.com*, May 3, 2005. Citibank and Bank of America have announced they are doubling their minimum payment requirements from 2% to 4% of the balance.
[50] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

The Office of the Comptroller of the Currency (OCC) has warned banks that increasing minimum payments may need to be accompanied by a reduction in Annual Percentage Rates (APRs) or eliminating fees to ensure that cardholders can actually reduce their balances and not just tread water with higher minimum bills.[51] Rising APRs and other increasing prices – such as energy costs – are leaving many consumers with less flexibility in their budgets. Even before the industry began to raise its minimum payments, consumers were increasingly worried about making their minimum credit card payments.[52] Since the increases took effect, consumers with interest rates above 20 percent have had to cope with payments that have roughly doubled.[53] Higher minimum payments are likely to be one reason why consumers are reporting increased concern about their ability to make credit card payments. In a survey conducted by CFA and the Credit Union National Association, the number of Americans who said they were concerned about paying off their holiday spending credit card balances increased to 33 percent in 2006, compared to 25 percent the year before. Over half of all young people (52 percent) said they were concerned.[54]

Targeting Consumers in Financial Distress

Nothing illustrates the perverse incentives of the credit card market better than the marketing of cards to consumers on the brink of bankruptcy, or to those just discharged from it. Several major issuers market high-cost, "sub-prime" cards to those with blemished credit histories. This population of cardholders can be profitable for the industry. Credit card industry consultant Andrew Kahr estimates that average subprime consumers will make two or three late payments a year, that the industry can generate fees from each of those tardy payments, and that these fees that can greatly exceed the interest payments on the small lines of credit themselves.[55]

Sub-prime consumers haven't just encountered high-cost offers of credit, but deceptive marketing practices. In 2000, Providian was required to pay more than $300 million in restitution to its sub-prime cardholders for unfair and deceptive practices.[56] More recently, Cross Country Bank, the sub-prime and secured credit card issuer that has been investigated by state and federal regulators for misleading consumers about the terms of its sub-prime credit card accounts and engaging in abusive collection practices, advertised on late night and daytime television when more unemployed potential sub-prime customers are most likely to be watching television.[57]

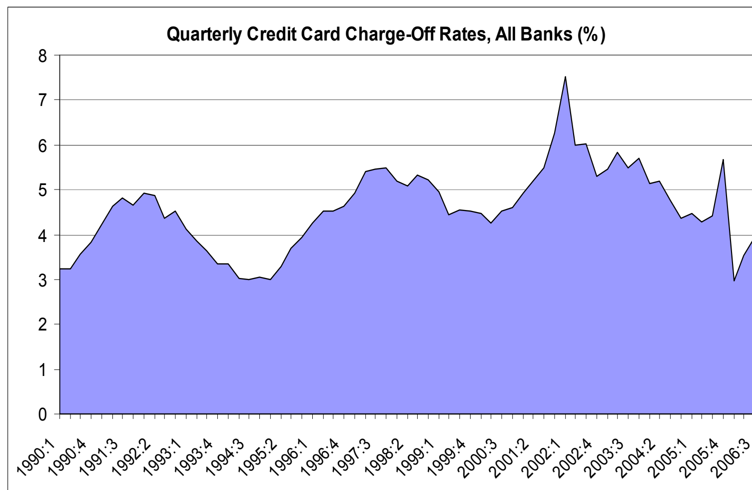
Consumers exiting bankruptcy are often swamped with offers at prime terms – low interest rates and without annual fees.[58] Many bankruptcy attorneys believe these offers are being made because consumers leaving bankruptcy court cannot erase their debts for another six

[51] Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.
[52] Gallup Poll News Service, "Average American Owes $2,900 in Credit Card Debt," April 16, 2004.
[53] "Minimum Payments," *CardTrack*, September 6, 2006.
[54] "Holiday Spending Likely to Rise Moderately in 2006, But Consumers Concerned about High Energy Costs, Debt Concerns," Consumer Federation of America, Credit Union National Association (CUNA), November 21, 2006.
[55] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.
[56] OCC, Statement of Comptroller of the Currency John D. Hawke J., June 28, 2000.
[57] Pacelle, Mitchell, "Pushing Plastic," *Wall Street Journal*, November 5, 2004.
[58] Mayer, Caroline E., "Bankrupt and Swamped with Credit Offers," *Washington Post*, April 15, 2005.

years. Under the new bankruptcy legislation consumers will not be able to wipe away any credit card debts for eight years. Some categories of credit card debt will not be "dischargeable" at all, no matter how long the consumer waits.[59]

C. AS ISSUERS HAVE DRAMATICALLY EXPANDED THEIR MARKETING AND CREDIT EXTENSION, THEY HAVE EXPERIENCED HISTORICALLY HIGH LOSSES AND BROUGHT IN RECORD PROFITS

Although credit card obligations, late payments and delinquencies have declined in the past two or three years, they are still higher than they were before the marketing expansion accelerated. Credit card charge-offs, the percentage of the value of credit card loans removed from the books (net of recoveries), or "written off," have been persistently high for the past decade. During the decade between the end of 1995 and the start of 2006, credit card charge-offs were not below 4 percent in a single quarter.[60] From the peak in 2002, charge-offs have been trending down overall and in 2006 charge-offs were below 4 percent for three consecutive quarters. However, most experts attribute lower charge-offs in 2006 to the surge of bankruptcy filings (and corresponding increase in charge-offs) that occurred in the third and fourth quarters of 2005. In fact, both charge-offs and the number of delinquent credit card payments – an early sign of payment difficulty – have been increasing recently. Since the beginning of 2006, credit card delinquencies have increased substantially.[61]



Despite these losses, the credit card industry is typically the most profitable in the banking sector, earning a return on assets since 1995 that is more than three times greater than that for commercial banks overall.[62] The return on assets for credit card companies has grew every year between 1988 and 2004, by a total

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[59] *Ibid*.

[60] Federal Reserve Board, Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks, available at www.federalreserve.gov/release/chargeoff, accessed January 19, 2007.

[61] Since the beginning of 2006, credit card delinquencies have increased from 4.27 percent of accounts to 4.57 percent. American Bankers Association, "Late Payments in Most Consumer Loan Categories Improve While Credit Card Delinquencies Rise," June 27, 2006; "Late Payments in Most Consumer Loan Categories Rise in the Third Quarter of 2006," January 8, 2007.

[62] "Card Profits 04," *CardTrak*, January 24, 2005; "Banner Year," *CardTrak*, February 2004; FDIC, *FDIC Quarterly Banking Profile*, Third Quarter 2006 at 5, Table I-A; FDIC, *FDIC Quarterly Banking Profile*, Fourth Quarter 2000 at 4, Table I-A. Commercial banks average return on assets between 1995 and 2004 was 1.23 percent, less than one third the size of the credit card industry average return on assets of 3.73 percent over the same period, according to R.K. Hammer and Associates.

of 80 percent.[63] In 2004, the credit card industry had its most profitable year since 1988.[64] The industry exceeded these extraordinary profits in 2006, after profits and return on assets dipped in 2005 due to a large number of personal bankruptcies filed in advance of the new bankruptcy law. The industry earned $36.8 billion in profits in 2006, up nearly 80 percent from $20.5 billion in 2000.[65]

According to credit card industry consultant Andrew Kahr, the basic profitability of the credit card industry is tied to those who carry revolving debt. Borrowers who pay off their balances in full and on time each month do not earn profits for the industry.[66] With revolving debt nearly quadrupling since 1990, credit card companies' profitability should remain strong. About 90 million Americans do not pay off their cards each month,[67] and of those about 19 million usually make only the minimum payment.[68] Currently, about one-fifth of credit card debt is repaid every month. The repayment ratio has been increasing slightly in recent years, due to higher required minimum payments, the use of loans secured by homes to pay off credit card debt and smarter bill paying strategies by consumers.[69]

Second, credit card issuers earn a significant piece of their revenues from penalty fees alone. In 2004, issuers collected $14.8 billion in penalty fees, or 10.9 percent of revenue, up from $10.7 billion and 9 percent of revenue in 2002.[70] Credit card analysts have consistently predicted that the trend toward "repricing" of products and new and higher fees will continue, especially the use of higher late and over-limit fees, and universal default provisions that trigger higher penalty interest rates.[71]

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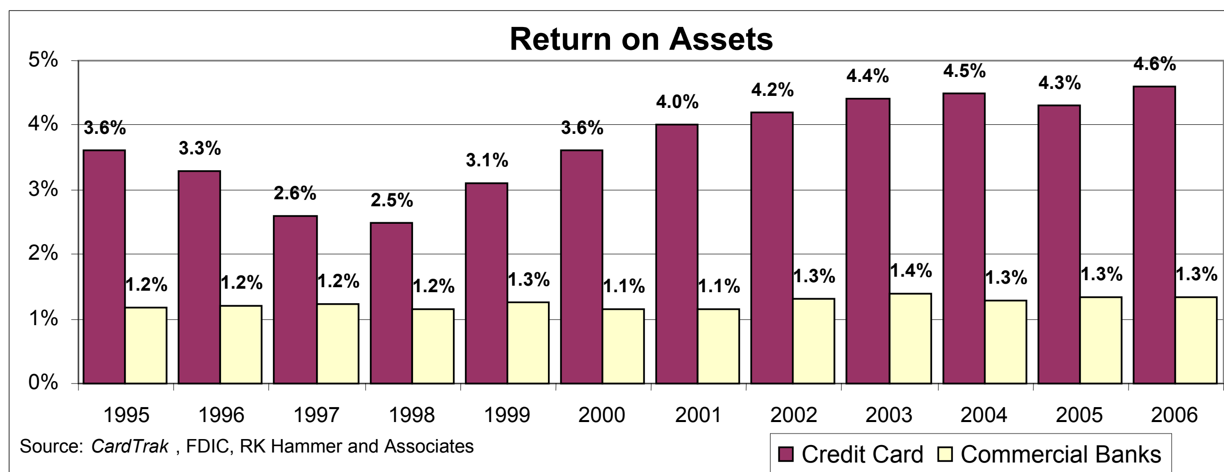
[63] "Card Profits 04," *CardTrak*, January 24, 2005. The industry's return on assets grew from 2.5% in 1998 to 4.5% in 2004.
[64] "Card Profits 04," *CardTrak*, January 24, 2005.
[65] "Banner Year," *CardTrak*, February 2004; Ellen Cannon, "Credit Card Issuers' Profits Grew," *Bankrate.com*, January 9, 2007.
[66] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.
[67] Gallup 2004; McGeehan, Patrick, "The Plastic Trap," *New York* Times, November 21, 2004. CFA calculation based on Gallup 2004 poll results and number of cardholding Americans.
[68] Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.
[69] "Loss of Balance: Credit-Card Issuers' Problem: People are Paying their Bills; As Users Juggle their Debts, Revenues to Banks Fall; The Home-Equity Effect; Ms. Bode Seeks a Fresh Start," *Wall Street Journal*, May 25, 2006.
[70] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.
[71] "Card Profits 04," *CardTrak*, January 24, 2005.



Bankruptcy legislation enacted by Congress in 2005 could further improve the bottom line for credit card companies. By preventing some consumers from eliminating their credit card debts, various estimates show that credit card companies could recover an additional $3 billion to $40 billion annually from households in bankruptcy.[72]

D. ISSUERS HAVE PURSUED ABUSIVE INTEREST RATE AND FEE POLICIES THAT HAVE A HARMFUL IMPACT ON MANY HOUSEHOLDS

In recent years, credit card companies have become far more aggressive in implementing questionable fees and interest rate practices. The upshot of these practices is that penalty interest rates, high and accumulating fees and interest on fees can push consumers with high debts over the financial brink into bankruptcy.[73] In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges, as in principal. Consumers also have to worry that an older industry practice – "sticky" interest rates that shoot up fast but decline much more slowly – will threaten their financial stability as interest rates increase.

High fees and interest rates can push consumers into negative amortization, where the principal on their credit card debt continues to rise despite making payments. Negative amortization in effect traps credit card borrowers on a debt treadmill that keeps moving faster. Although they are making regular payments, their debts continue to mount. In 2004, a Cleveland judge ruled against Discover Card's efforts to collect debts from a cardholder whose balance nearly tripled from $1,900 to $5,564 without making additional purchases because of fees and penalties, including $1,158 in over-limit fees alone. [74]

In another case, a bankruptcy court in North Carolina ordered a credit card company to itemize the claims it files in chapter 13 bankruptcy cases.[75] In its findings in support of the Order, the bankruptcy judge listed claims filed in eighteen separate cases broken down as

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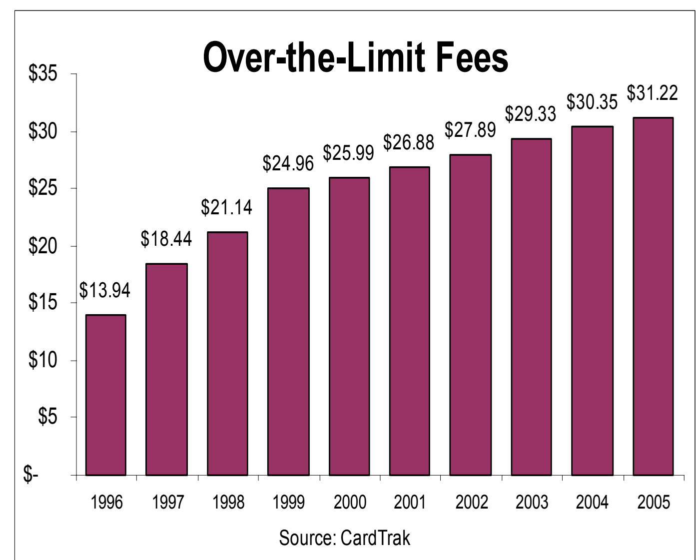
[72] Heller, Michelle, "Gauging the Bottom-Line Effects of Bankruptcy Bill," *American Banker*, April 15, 2005.
[73] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.
[74] National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.
[75] *In re* Blair, No. 02-1140 (Bankrate. W.D.N.C. filed Feb. 10, 2004)

between principal and interest and fees. On average, interest and fees consisted of more than half (57 percent) of the total amounts listed in the claims. In one case, the card company filed a claim in the amount of $943.58, of which $199.63 was listed as principal and $743.95 was listed as interest and fees. In another case, a claim of $1,011.97 consisted of $273.33 in principal and $738.64 in interest and fees. It is almost certain that pre-bankruptcy payments in these cases had more than paid off the real charges made by the consumers.[76]

Penalty Fees

Traditionally, penalty fees were designed to deter irresponsible cardholder behavior, but in recent years these fees have become primarily a revenue enhancer for credit card issuers. An analysis by the United States Governmental Accountability Office (GAO) found that, "…typical cards today now include higher and more complex fees than they did in the past for making late payments, exceeding credit limits, and processing returned payments."[77] The GAO also identified several new fees that issuers have begun using in recent years, some of which they are not required to disclose to consumers in advance. One example of such a fee is for the payment of bills by telephone, which can range from 5 to 15 dollars.[78]

A substantial number of Americans are paying these fees. Thirty-five percent of the credit card accounts from the six largest issuers that the GAO examined had at least one late fee in 2005,[79] representing about 242 million credit cards.[80] Thirteen percent of all accounts – or about 90 million cards – were assessed over-limit fees in 2005.



Late fees have been steadily rising over the past decade and can easily exceed monthly payments for consumers paying low minimum balances.[81] In 1996, a Supreme Court decision prohibited states from setting limits on the fees credit card companies could charge their cardholders. Prior to this court ruling, credit card late fees were commonly around five to ten dollars, but have risen sharply since the decision.[82] The GAO analysis found that late fees jumped sharply after the court ruling. The GAO examined fee data collected by CardWeb.com and found that late fees jumped by 160 percent from $12.83 in 1995 to $33.64 in 2005. The GAO also found a sharp fee increase from data collected by Consumer Action, which showed a 119 percent

[76] National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.
[77] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 18.
[78] *Ibid*, p. 23.
[79] *Ibid*, p. 1.
[80] CFA calculation based on 691 million credit cards, as reported in, *Ibid*, p. 9.
[81] "The Ugly Issuer," *Credit Card Management*, September 2004.
[82] Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.

increase from $12.53 in 1995 to $27.46 in 2005.[83] Even more striking, the GAO found that late fees paid by borrowers with typical balances were an average of $37 in 2005.[84] This is important to note as credit card issuers are increasingly assessing "tiered" fees based on the borrower's balance.

Credit card issuers use to reject transactions that exceeded a cardholder's credit limit, but it has become common for issuers to accept the transaction and then apply an over-limit fee on cardholders who exceed their credit limits.[85] These fees are often applied by issuers in addition to a higher "penalty" interest rate charge for exceeding the credit limit or carrying a high balance.[86] These monthly fees are charged every month a consumer carries a credit balance higher than their credit limit. According to the GAO report, data collected by Consumer Action shows a 114 percent increase in over-limit fees between 1995 and 2005.[87] Critics of this practice argue that issuers should not assess a penalty fee when they can simply enforce the credit limit if they wish to prevent consumers from exceeding it.

Penalty Interest Rates

The majority of credit card issuers also increase interest rates for credit card account holders who pay their bills late, even by a few hours. In 2005, Consumer Action found that 78.7 percent of issuers charged penalty rates for late payments on their cards.[88] For example, representatives for one large issuer told the GAO that they automatically increase a customer's interest rate if this person pays late or exceeds the credit limit. The GAO found that all but one of the 28 cards from the six largest issuers they reviewed charged default rates in 2005. The average default rate was 27.3 percent, up from 23.8 percent in 2003.[89] Some consumers with low-rate cards could have their interest rates double overnight for being late on one payment to their credit card.[90] Some issuers also say that they will charge default interest rates for exceeding the credit limit on the card or for returned payments, or that they will increase interest rates for cash advances and balance transfers for violations of card terms.[91]

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[83] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 18.
[84] *Ibid*, p. 20.
[85] "The Ugly Issuer," *Credit Card Management*, September 2004.
[86] Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.
[87] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 20.
[88] Consumer Action, 2005 Credit Card Survey, "Card Companies Use Common 'Risk Factors' to Impose Unfair Rate Hikes, Finds CA," *Consumer Action News*, Summer 2005.
[89] The GAO did find that some issuers do not assess default rates unless there are multiple violations of card terms. "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, pgs. 24, 25.
[90] Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.
[91] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 25.

Retroactive Application of Penalty Rates

Most issuers also apply penalty interest rates retroactively to prior purchases. This has the effect of increasing the price on purchases already made but not paid off.[92] Some cards even apply penalty rates to debts that were already paid at a lower rate.[93] There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance. There is no other industry in the country that is allowed to increase the price of a product once it is purchased. Issuers have already assessed a consumer's risk of not repaying the loan and presumably offered an interest rate based on that risk. Issuers should be required to allow a consumer to pay off his or her existing balance at that interest rate.

Universal Default

Universal default clauses in credit card contracts allow credit card companies to raise interest rates on debtors who have problems with other creditors or whose credit scores decline. The increases are triggered not just by a late mortgage or credit card payment to other lenders but also to payment disputes with other types of creditors, like utilities or book clubs.[94] In 2005, 44.7 percent of credit card issuers surveyed by Consumer Action reported having universal default policies in place.[95] The GAO reported that four of the six largest issuers reserve the right to impose rate increases because of behaviors related to other creditors as a change in terms,[96] which typically requires only 15 days notice under Regulation Z of the Truth in Lending Act.[97] A review of credit card disclosures issued in October 2006 by Consumer Action found six major issuers assessing universal default interest rates: Citigroup, JP Morgan Chase, HSBC, Washington Mutual and Wells Fargo. Only one – Citigroup – offered consumers advance notice of the change and the opportunity to choose not to accept the interest rate.

In 2004, the OCC sent an advisory letter to the institutions it oversees covering credit card marketing practices the OCC "regards as unacceptable," including failing to disclose the conditions for imposing unilateral cost increases for cardholders. However, disclosure will not help consumers avoid a practice that many consumers find inequitable when most major issuers pursue this practice. It is fundamentally unfair to impose a penalty interest rate on a consumer who has not made a late payment or defaulted on an obligation, especially when this rate

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[92] Draut, Tamara, Director of the Economic Opportunity Program Demos, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 16-17.
[93] McGeehan, Patrick, "The Plastic Trap," *New York Times*, November 21, 2004. Discover disclosed to its customers that it had changed the terms of its interest rates from a low of zero to 19.99% for a single late payment, but it applied that rate increase for late payments from 11 months prior to the disclosure of the changing interest rate terms.
[94] Burt, Bill, "Pay One Bill Late, Get Punished by Many," *Bankrate.com*, January 20, 2004.
[95] Consumer Action, 2005 Credit Card Survey, "Card Companies Use Common 'Risk Factors' to Impose Unfair Rate Hikes, Finds CA," *Consumer Action News*, Summer 2005.
[96] Only a few of the cards assessed by the GAO assess universal default rates automatically with no notice. The GAO also noted that some states where large issuers are based require that cardholders must be offered an opportunity to refuse or opt out of a universal default rate change. This may not be practical for many cardholders, however, if it entails a requirement to pay off the existing balance immediately in full. "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 26.
[97] 12 C.F.R. Section 226.9(c)

increase is applied retroactively. Another concern with using credit reports to trigger a penalty rate is the problems with inaccuracies in credit scoring and credit reporting that CFA and other organizations have documented.[98]

Although credit card issuers contend that interest rate penalties that increase because of universal default are related to the credit risk of the borrower, the application by some issuers of these punitive rate hikes seems to believe that contention. One late payment can result in significant increases in interest rates in some cases, even though there is little evidence that a single late payment to one creditor increases the likelihood of default to all creditors. Moreover, increased fee and interest rate payments may have a similar or greater impacts on the borrower's ability to repay than modest problems with another creditor.

Pricing Tricks: Double Cycle Billing and Manipulation of Payment Order

The GAO found that two of six major creditors are using a practice called double-cycle billing, which results in illegitimate interest charges on balances that have already been paid on time.[99] With this practice, issuers consider two billing cycles in assessing interest. A consumer who begins with no balance and pays off most but not all of the purchases he or she makes in the first month would still be charged interest for the entire amount of the balance in the second month. A fair billing process would only result in an interest charge on the amount of the unpaid balance.

The GAO also determined that for 23 of the 28 large issuer cards they reviewed, cardholder payments were first allocated to the balance assessed at a lower rate of interest.[100] This practice is problematic for the many cardholders who now carry balances at different rates of interest, such as introductory "teaser" rates, cash advance rates, and balance transfer rates. The lower interest rate balances must first be paid off before the issuer will allocate payments to higher rate balances. Allocating payments to lower interest rate balances first unfairly extends the length of time it takes consumers to pay down their balances while increasing the finance charges that issuers earn.

As Variable Rate Cards Proliferate, Consumers are Vulnerable to Higher Interest Rates

For many years, analysts and observers of the credit card industry have noted a phenomenon called "sticky" interest rates. This typically refers to the fact that creditors are often slow to pass on savings when the cost of funds decline, but quicker to increase rates when cost rise. As a result, the "spread" between the credit card issuers' cost of funds and the interest rates charged to cardholders have tended to benefit the credit card companies, regardless of the direction of the interest rate changes. For example, although interest rates were at historical lows

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[98] Consumer Federation of America and National Credit Reporting Association, "Credit Score Accuracy and Implications for Consumers," December 17, 2002. CFA and NCRA reviewed over 500,000 credit files and found that 29 percent of consumers have credit scores that differ by at least 50 points between the credit bureaus.
[99] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 27.
[100] *Ibid*.

at the turn of the century, issuers did not pass the cost savings completely through to their customers.[101]

The higher interest rate environment Americans are now experiencing will primarily impact credit card debt carried on variable rate credit cards. Variable rate cards first appeared on the market in 1991.[102] Over the past six years, it appears that the distribution of credit cards between variable and fixed rates is somewhat related to the interest rate picture. As interest rates increase, issuers tend to switch consumers over to variable rate cards. *CardTrak* reported in November 2004 that more than half (55 percent) of credit card debt was carried on variable interest rate cards, a major change from three years earlier when rates were declining and card issuers were shifting to fixed rate products.[103] This month, *CardTrak* reported that 86 percent of credit card balances were carried on cards with variable rates.[104] This trend means that more consumers will be extremely vulnerable to rising interest rates. Variable rate cards now carry an average interest rate of 16.55 percent, while fixed rate cards average only 14.67 percent.[105]

Increases in Credit Card Fees and Interest Rates Significantly Affect Consumer Debt

Penalty fees and interest made up more than three-quarters of credit card issuers revenues throughout 2002 and 2003. Credit card issuers earned $65.4 billion in interest and $7.7 billion in penalty fees in 2003 or 75.7 percent of the total $96.5 billion in revenue.[106] In 2002, penalty fees and interest made up 76.8 percent of the industry's $97.1 billion in revenues. For the approximately 88 million credit cardholding households, penalty fees and interest on their credit card debt cost an average of $830 in 2003.[107]

E. ISSUER "RISK-BASED" PRICING OFTEN LOOKS PREDATORY

Credit card issuers often claim that their interest rate and fee policies are justifiable because they are necessary to compensate for the increased financial risk of lending to borrowers with blemished or limited credit histories. It is clearly true that borrowers who pay their balance every month are receiving a valuable service at no cost in many cases. It is quite possible, in fact, that riskier borrowers who revolve their debt and pay higher interest rates and fees are subsidizing in-part the cost of services that these non-revolvers receive. It is important to note, though, that issuers still receive substantial fee income from merchant "interchange" fees and, in some cases, from annual fees.

The key question is whether interest rates and fees charged to riskier consumers are fair and can be legitimately related to the actual financial risk incurred by creditors. There is increasing evidence that the answer to this question is "no." It is becoming ever more apparent

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[101] "The Ugly Issuer," *Credit Card Management*, September 2004.
[102] "Card Rates," *CardTrak*, September 17, 2001.
[103] "5% Prime," *CardTrak*, November 10, 2004.
[104] "Rate Gap," *CardTrak*, January 18, 2007.
[105] *Ibid*.
[106] Daly, James J., "Smooth Sailing," *Credit Card Management*, May 2004 at 31.
[107] CFA calculation from Daly, James J. 2004 and Census Bureau figures.

that many of the most abusive fees and interest rates are assessed simply because it is what the market will bear.

The amount of fees and penalty interest rates do not appear to be proportional to the risk or cost incurred by issuers. For many years, issuers have justified "sticky" interest rates that rise faster than they decline by stating that these higher interest rates were necessary to compensate for increased risk. As issuers have increased the number and amount of fees and penalty interest rates they charge, it seems that higher baseline interest rates alone are not sufficient anymore to compensate for risk. There is very little evidence that relatively modest problems, like one or two late payments – significantly increase a consumer's chances of default. It would appear to be impossible to justify charging a consumer with a reasonably good credit history with a late payment fee of $35 and a default interest rate of 29 percent on prior purchases, <u>in addition to</u> the finance charge the consumer would already pay on a fairly high interest rate, such as 17 percent. One sign that default rates may not be truly reflective of costs or risk incurred by issuers is that the "fixed amount" that issuers add to the index rate in setting default rates is increasing. The GAO found that this fixed amount increased from about 19 percent in 2003 to 22 percent in 2005 on the 28 large issuer cards they evaluated.[108]

A rational market would lead lenders to limit their risk by limiting credit available to consumers with riskier credit records or histories, instead of increasing this risk by leveling higher charges on consumers who may be in significant financial trouble. Allowing higher-risk consumers to continue borrowing at a more expensive, higher rate does not limit consumers' risk of default, it increases it. If the cardholders are indeed higher-risk, lenders would limit their exposure by cutting off new purchases more frequently, preventing balances from increasing and helping to keep the cardholder out of default. However, in many cases, credit card issuers are not cutting off the credit, freezing the credit limit or closing the accounts of cardholders that the issuers deem increased risk. Instead they are allowing the borrowers to rack up more credit under more expensive terms,[109] making it more likely that the consumer might suffer serious financial circumstances. This demonstrates that issuers are not particularly concerned about the financial consequences to the consumer of these higher costs since distressed customers are so lucrative and the profits earned from these consumers more than compensates for the financial risk involved.

If risk-based pricing truly reflects risk, it should decline or at least moderate as risk decreases. For example, as noted above, the amount of credit written off by issuers declined for the first three quarters of 2006, dipping below 4 percent for the first time since the end of 1995. Given that issuers have stated so frequently that they are adhering to the doctrine of risk-based pricing, it is perfectly appropriate for consumers to ask why they do not see interest rates or fees that decline or moderate in response to a more positive credit environment.

The assessment of retroactive interest rates is another sign of abusive rather than risk-based pricing. As stated above, interest rate increases that apply to past purchases cannot

[108] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 24.
[109] Pacelle, Mitchell, "Growing Profit Source for Banks: Fees From Riskiest Card Holders," *Wall Street Journal*, July 6, 2004.

be justified under a true risk-based pricing model. Issuers assess risk based on the best information available on a consumer's credit history. If the risk profile of the consumer declines, the only way issuers could possibly justify a rate increase would be if it were legitimately related to the customer's increased risk, if it did not violate the creditor's agreement to offer credit under certain terms for a specific length of time, and if it were applied prospectively.

Increased expenditures on marketing at a time of relative caution by consumers is also a red flag that pricing in the credit card industry is skewed. As documented above, issuers continue to increase their marketing expenditures significantly, even as consumers respond less frequently to mail solicitations and show more caution in taking on new debt. A rational market response to these dynamics would be to pull back on marketing expenditures, unless other factors existed, such as windfall profits resulting from abusive pricing.

In response to these "tell-tale" signs of price gouging, it is time for issuers to provide more information to lawmakers and the public about their true costs to demonstrate that their pricing practices are truly fair.

F. LEGISLATIVE RECOMMENDATIONS

Attached are proposed legislative reforms developed by national consumer organizations. Several of the proposals mentioned in this platform are particularly important:

1. Eliminate abusive lending by credit card companies. A good starting point would be to enact S. 499, Senator Dodd's "Credit Card Accountability Responsibility (Credit CARD) Act of 2005." This proposal would take many important steps to reign in abusive lending practices. For instance, it would mandate that issuers lend responsibly to young Americans, by either assessing an applicants ability to pay or requiring a co-signor who could pay back the amount loaned. S. 499 would also prohibit credit card lenders from attempting to collect on high-interest loans in bankruptcy that exceed the federal prime rate by more than 20 points. We also strongly support S. 2654, the "Protection of Young Consumers Act of 2006," introduced by Senator Menendez. This bill takes the important step of allowing young consumers to choose whether or not to accept pre-screened credit card solicitations. Credit card issuers are not allowed to send these marketing offers to consumers younger than 21 years-of-age unless the consumer affirmatively agrees to accept them.

2. End unjust interest rates and fees. Once again, the Credit CARD Act has a number of important provisions. S. 499 would prohibit issuers from applying interest rates retroactively to past purchases. It would also require credit card companies to take the same approach as the Internal Revenue Service (IRS) in assessing whether a customer has paid on time. Issuers would be required to accept the postmarked date as proof of on-time payment. This bill would also prohibit the abusive practice used by most issuers of assessing fees for consumer behavior allowed by the creditor, such as exceeding a credit limit. Senator Menendez's "Credit Card Reform, Debit and Check Card Consumer Protection Act of 2006 would also implement several important reforms. It would prohibit issuers from unilaterally altering the terms and conditions of a credit card agreement, ban the imposition of "universal default" interest rates based on

alleged missteps with another issuer, and require that fees be reasonably related to costs incurred by the creditor.

3. Ban deceptive and unfair practices. Issuers should not be allowed to require consumers to relinquish their legal rights and enter mandatory arbitration, in the event a dispute arises. We also encourage Congress and banking regulators to prohibit deceptive advertising and "invitation to apply" solicitations that do not require a firm offer of credit and lead consumers to believe that they are pre-approved for or have a good chance of receiving certain interest rates or terms.

4. Empower consumers with more detailed information. We strongly support S. 393, Senator Akaka's Credit Card Minimum Payment Warning Act of 2005. This legislation would provide all cardholders with personalized information on the length of time—in months and years—and the total costs of paying only the minimum payment. Congress should also take steps to prevent issuers from downplaying permanent interest rates in advertisements and solicitations, while temporary "teaser" rates are prominently disclosed. We also support requiring issuers to include an improved "Schumer Box" of key terms and conditions to all cardholder agreements. It should disclose the card's APR including fees, the credit limit, and the amount of all fees, such as late charges, cash advance fees, over-limit fees and any other applicable miscellaneous fees to the table.

5. Increase penalties to deter illegal acts by credit card companies. In particular, fines under the federal Truth in Lending Act need to be increased. We also support the inclusion of a "private right of action" to empower consumer to use the Federal Trade Commission Act to challenge unfair or deceptive practices by businesses, including banks.

ACORN * Center for Consumer Finances * Consumer Action * Consumers Union
Consumer Federation of America * Demos * National Association of Consumer Advocates * National Consumer Law Center • U.S. PIRG

Joint Recommendations of Consumer Groups on the Eve of the Jan. 25, 2007 U.S. Senate Banking Committee Oversight Hearing on Unfair Credit Card Practices

Eliminate reckless and abusive lending by credit card companies

No unsound loans: Make issuers offer credit the old fashioned way, using sound underwriting principles based on the ability of consumers to pay and that ensure the cardholder is not overextending financially by taking on more debt.

Restrict lending to youth without conditions. Young people deserve credit, but only if they qualify. Yet right now, young people are the only group that can obtain a credit card without either a positive credit report, a job, or other evidence of ability to pay, or, barring any of these, a co-signer. No other adult can get a credit card without meeting at least one of these conditions. Young people should have the same safeguards.

No abuse of consumers in bankruptcy. Credit card issuers drive consumers into bankruptcy with abusive terms and collection practices. Stop issuers from collecting on these abusive loans in bankruptcy.

End deceptive and unjust terms, interest rates and fees

Ban retroactive rate increases. Stop issuers from changing the rules in the middle of the game by raising interest rates on past purchases.

No unilateral adverse changes in terms for no reason: Credit card company contracts currently claim the right to change terms for any reason, including no reason. Any change in terms during the course of the contract should require knowing affirmative consumer consent and reasonable notice.

Ban universal default in all its forms. Prohibit punitive “universal default” interest rates based on alleged missteps with another issuer but involving no missed payments to the credit card company itself. It is unfair to impose a penalty rate on a consumer who has not made a late payment to that creditor. Stop card companies from using a change in terms clause to impose penalty rates.

Stop late fees for payments mailed on time. Require credit card companies to follow the Internal Revenue Service (IRS) and accept the postmarked date as proof of on-time payments. This will also eliminate the tawdry practice of assessing late payment fees when payment is received on the due date, because it did not arrive by a specific time (such as 11 a.m.).

Relate fees to cost. Ensure that all fees and other charges closely match the true cost borne by the card issuer.

End roll-over or repeat late and over-limit fees. Ban fees that are charged in consecutive months based on a previous late or over the limit transaction, not on a new or additional transaction offense, even if the consumer remains over the previous limit.

No fees for creditor approved transactions. Don't let the credit card company charge a fee for a transaction it has approved. Ban over-limit fees when the issuer approves the over limit transaction.

Empower consumers with more detailed information.

Ban deceptive credit card offers. Solicitations and "invitation to apply" solicitations that do not make a truly firm offer of credit are deceptive because they lead consumers to believe that they are pre-approved for or have a good chance of getting certain interest rates. Most consumers instead receive cards at much less favorable interest rates and terms.

Simplify pricing. Reduce the number and types of fees so consumers can compare cards and understand the real cost of using the card.

Real minimum payment warning. Give each consumer a personalized warning on his or her monthly statement calculating the length of time—in months and years—and the total interest costs that will accrue, if the consumer makes only the requested minimum payment.

Ban unfair teasers. Stop issuers from downplaying permanent interest rates in advertisements and solicitations and from trumpeting temporary rates as "fixed rates."

Enhance 'Schumer Box' disclosures. Include a "Schumer box" disclosure table in all cardholder agreements containing personalized information about the terms of the card granted. The box should include the APR, the credit limit, and the amount of all fees, such as late charges, cash advance fees, over limit fees and any other applicable miscellaneous fees.

Give consumers strong protections to deter illegal acts

Ban pre-dispute binding mandatory arbitration. No consumer should be forced to waive his or her right to a court trial as a condition of using a credit card. Prohibit binding mandatory arbitration for consumers' claims *and* for collection actions against consumers.

Toughen Truth In Lending Act (TILA) penalties. TILA penalties have stagnated since 1968.

Give aggrieved consumers a private right of action to enforce the Federal Trade Commission Act to challenge unfair or deceptive practices by businesses, including banks.

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