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THE CREDIT CARDHOLDERS' BILL OF RIGHTS: PROVIDING NEW PROTECTIONS FOR CONSUMERS

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

MARCH 13, 2008

Printed for the use of the Committee on Financial Services

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U.S. GOVERNMENT PRINTING OFFICE

41–731 PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
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THE CREDIT CARDHOLDERS' BILL OF RIGHTS: PROVIDING NEW PROTECTIONS FOR CONSUMERS

Thursday, March 13, 2008

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Carolyn B. Maloney [chairwoman of the subcommittee] presiding.

Members present: Representatives Maloney, Watt, Ackerman, Sherman, Moore of Kansas, Waters, Green, Clay, Scott, Cleaver, Bean, Davis of Tennessee, Hodes, Ellison, Klein, Perlmutter; Biggert, Price, Castle, Capito, Feeney, Hensarling, Garrett, Neugebauer, Campbell, McCarthy of California, and Heller.

Ex officio: Representatives Frank and Bachus.

Also present: Representative Udall.

Chairwoman MALONEY. I call this hearing to order, and I thank everyone for being here, particularly my ranking member, Judy Biggert.

I would first like to ask unanimous consent that Mark Udall, who is not a member of this committee, be allowed to sit on the panel and be allowed to ask some questions. Is there any objection?

Hearing none, it is so ordered.

My colleague, Ms. Biggert, has requested 15 minutes per side, and that is fine with our side. And I am pleased that our chairman, Barney Frank, is with us.

Before we start, I want to inform the committee that there have been fairness concerns raised about having consumers testify this morning without a waiver that allowed their credit card issuers to respond publicly. In the interest of having the fairest hearing possible, I have decided to postpone the first panel to a future date.

We do have our witnesses here, and they are ready to testify. They are seated here. They have traveled from across the country to be here. However, in order to have a discussion that entirely focuses on the substance and not on process, we are doing everything we can to accommodate any concerns that have been raised. It is my hope that between now and a future date, we can get consumer witnesses here so that the committee can hear real world examples of how this credit card bill would help consumers.

First of all, I would like—

The CHAIRMAN. Would the gentlewoman yield?

Chairwoman MALONEY. Yes, I would.

The CHAIRMAN. I appreciate the chairwoman of the subcommittee making that accommodation. I just want to say, as Chair of the committee, it has been and will be our policy that no testimony will be given in any context in which there cannot be a full and free response. So I appreciate the chairwoman accommodating us on that, and as we go forward, that will be the context in which it happens.

Some aspects of this process are new to us, new to a lot of us. We don't always get everything—you don't always see all the implications the first time. There has been no bad faith involved, in my judgment, on anybody's part. And this will give us time to comply with what I would assume was a universally accepted principle that all debate should be conducted in fully fair terms.

I thank the gentlewoman.

Chairwoman MALONEY. First of all, I am delighted to welcome our witnesses to the first of two legislative hearings on H.R. 5244, the Credit Cardholders' Bill of Rights, which I introduced with Chairman Frank last month and which we are glad to say has over 82 cosponsors to date, including many members of this committee.

Credit cards may represent the single most successful financial product introduced in our country in the last 50 years. They have given consumers unprecedented convenience and flexibility in both making purchases and in managing their personal finances.

Over 75 percent of the adult population in America have credit cards. Credit cards have become a necessity of daily life without which it is almost impossible to travel, make non-cash purchases, or do daily business.

But with that great success, with that huge growth, with that necessity, comes shared responsibility. The credit card industry has been clear about the responsibility imposed upon consumers: Make your minimum payments on time and stay under your limit. But what about the reciprocal responsibility of card companies? What about the responsibility to stick to the terms of the deal that the customer agreed to?

Cardholders who pay at least the minimum payment on time every month and don't go over their limit expect that, in return, they can count on the card companies not imposing rate hikes or penalty fees. They don't expect the rate on money they already borrowed to go up dramatically, with no notice. They don't expect their monthly payments to double and triple, sending them further and further into debt.

But almost every card agreement allows the card company to do just that. And a cardholder who makes one late payment, even if the reason has been that they were at the hospital, will soon find that their previous history of on-time payment for years and years doesn't make any difference, that one late payment can increase their rates, in some cases substantially.

Even cardholders who are financially responsible and do their very best to meet their obligations fall victim to rate hikes that are unexplained, totally out of proportion, irreversible, inescapable, and which drive them deeper and deeper into debt.

Recently Chairman Bernanke testified to this committee that the Fed was going to use its unfair and deceptive practices authority to regulate the very same abuses my bill goes after because, he said, their authority to regulate disclosure was not enough.

Ranking Member Biggert asked him, and I quote, "What would consumers need to know to make informed decisions?" And he responded, and I quote, "They need to know the interest rate and how it varies over time and what that means to them in terms of payments." Well, how can a responsible consumer know their interest rate and what their payments will be if the interest rate changes for any time, any reason, and is applied to their existing balances?

This bill aims to bring back some balance to the playing field. It attempts to put some of the responsibility for fair dealing back on the card companies and give cardholders the tools they need to control their finances and make sure they can pay back their debts responsibly.

It puts an end to any time/any reason repricing, stops issuers from raising rates on existing balances of cardholders who make their payments on time, and gives all cardholders faced with any rate increase the ability to stop borrowing more and pay off their loan on the terms that they agreed to.

We seem to have forgotten that a credit card agreement is just that, an agreement. When the terms change—and the interest rate is the most important term for most customers—cardholders should have a chance to say no to the new deal and pay off the loan they have at the terms that they originally agreed to.

USA Today called this, and I quote, " a sensible bill and much-needed reform." Unlike other proposals before Congress, our bill does not set price controls. It does not set rate caps or limit the size of fees. I believe that our bill is a much-needed correction to a market that has gotten wildly out of balance.

I have always believed that responsible access to credit is critical to our economy, and that access to appropriate credit should be as broad as possible consistent with the safety and soundness of the financial system. I believe in free market solutions, but the free market only works when consumers have the information they need and the ability to make informed choices.

I think our bill will help cardholders and issuers exercise their shared responsibility and promote a sounder economy. And I look forward to the testimony of our witnesses.

I now recognize my good friend, Ranking Member Judy Biggert.

Mrs. BIGGERT. Thank you. Thank you, Madam Chairwoman. I made a mistake, and I would ask unanimous consent to increase the time to 20 minutes per side.

Chairwoman MALONEY. Whatever the ranking member wants.

Mrs. BIGGERT. Thank you.

Chairwoman MALONEY. And I yield as much time as she may consume.

Mrs. BIGGERT. Thank you.

The CHAIRMAN. If the chairwoman would yield, don't be setting any bad precedents here with that.

[Laughter]

Chairwoman MALONEY. No, sir. Okay, Mr. Chairman.

Mrs. BIGGERT. Thank you, Madam Chairwoman, for holding this hearing on your bill today. Despite our differences on the specifics of the bill, I have no doubt that the chairwoman herself believes that she has the best interests of the consumers at heart, and I believe that we all do. The borrowers need transparency. They need to know what the terms of their contract are simply, clearly, and reliably. And on this I agree with Chairwoman Maloney.

There are a number of us in the room today who remember when there was only one credit card, the Diners Club card in the 1950's, a rare commodity for a few lucky individuals. A couple hundred customers used the cards at restaurants that were part of the card program.

Within a short time, the card evolved into a travel and entertainment card, and was issued only to high-income, highly creditworthy individuals who could immediately pay off their entire bill balance upon receipt of the card. Let's not forget that not much more than 2 decades ago, interest rates were capped by State regulation. Card issuers charged borrowers a sizeable annual fee. And if you didn't pay off the entire balance each month, you faced a 20 percent fixed income rate.

No matter what your income or creditworthiness, it is hard for young people today to believe it, but that is what credit cards were like in the early days, prizes that were won by people who, when you think about it, didn't especially need them.

We don't want to go back to those days, so fast forward to today. Innovation, technology, competition, and reduced regulatory restrictions on interest rates have meant that Americans of all income levels, ages, and walks of life have access to credit cards and much, much cheaper credit cards. According to the Federal Reserve data, about three-quarters of American families have at least one credit card.

Would everyone in this room with a credit card please raise their hand?

[Show of hands]

Mrs. BIGGERT. It is obviously a popular financial tool. But my goal is to ensure that everyone who wants and likes their credit card is not hurt today in this weakened economy or tomorrow in an improved economy by the problems of a few customers or abuses of a few issuers. We must first do no harm.

That having been said, do I believe that each and every cardholder is completely happy with his or her credit card? Of course not, no more than every cable TV subscriber or utility company customer is completely happy with their service.

But unlike customers of those companies, credit card borrowers have thousands of cards to choose from. They have greater access to credit, access to cheaper credit, and access to financial education and counseling on financial matters.

The success story of credit cards, I think, is often overlooked. Credit card loans can be used for emergencies, holiday shopping, paying bills, taking vacations, buying books for school, and starting a business. You can even buy a cup of coffee at Starbucks with a credit card.

Unfortunately, the credit card success story does not bring us here today. What brings us here today are the problems that some

borrowers may have with their credit card companies and some practices that should be changed.

As for the facts, I am pleased that Congress tasked the experts at the Federal Reserve under the Truth in Lending Act and Federal Trade Commission Act with the job of gathering empirical evidence on all consumers and credit cards.

Two weeks ago, Federal Reserve Chairman Bernanke testified before this committee that the Fed is writing regulations to update disclosures and notices as well as rules to address unfair and deceptive practices. He anticipates a final release of both sets of rules later this year.

I am inclined to reserve judgment on the bill, H.R. 5244, until we hear the results of what we in Congress authorized the Fed to undertake, its revision of Regulation Z, which is the culmination of 4 years of intensive expert review utilizing consumer focus groups and other sound methodology as opposed to anecdotal evidence.

Do consumers need improved and more helpful disclosures? Do they need information so that they have the tools to make more informed decisions about choosing a credit card, about their card, or borrowing altogether? Finally, what is the best way to address these matters? Is it through education, legislation, regulation, self-regulation—in other words, letting the marketplace and competition work for the consumer—or is updating disclosures and cracking down on unfair and deceptive practices the answer?

I must say that after reviewing data studies and testimony, at this time it appears that regulation and education should at least be among the first steps. Should Congress step in on that basis and preempt the Fed? I'm not sure that is the answer.

But with that, I look forward to hearing from today's witnesses and I yield back.

Chairwoman MALONEY. The Chair recognizes Chairman Frank—and thanks him for his leadership on this issue and so many others—for as much time as he may consume.

The CHAIRMAN. I thank the chairwoman. I admire the energy she has put into this.

I would say to my friends in the industry, it is a busy morning, and if you want to know whether this is a serious legislative effort, look at the membership. I am the chairman, so I am always here when there is a full committee hearing.

Sometimes I am by myself; sometimes there are only one or two people; sometimes I have all the Republicans and not many Democrats; sometimes Democrats and not Republicans. Frankly, even by ethnicity, the turnout may vary depending on the issue. You have the most broadly representative membership of this committee. This is an issue that counts.

For better or worse, credit card practices have engaged the interest of America's middle class. And this is an issue that has an impact with them. They are more capable of voicing their opinions than some other sectors of our economy, so you should know this is a serious issue.

It is also manifested, and the gentlewoman from Illinois mentioned regulation. I am interested to note that two of the financial regulators are in fact engaged in this now. When Chairman Bernanke testified before us a few weeks ago at the Humphrey-

Hawkins hearing, he said something I hadn't heard in my 28 years in this body, a Chairman of the Federal Reserve Board uttering the words, "consumer protection." It had not happened since 1981. I have been at every one of the meetings.

And he is, as you know, in the process of talking about regulations with regard to credit cards that go beyond disclosure, that go beyond the Truth in Lending Act into substance.

Similarly, I have been very pleased to see Mr. Reich, the Director of the OTS, going forward with promulgating a code of unfair and deceptive practices and including some very specific things here. And part of the reason for that is—and, you know, you get sometimes the consequences of what you wish for.

Many of the bank issuers of credit cards were successful in persuading the Comptroller of the Currency and the Office of Thrift Supervision to preempt a great number of State laws so that in many cases there are—well, not in many cases—there are virtually no State consumer protection laws that would be bank-specific that apply to the credit card issuers who are national banks.

I had differences with that on its own. But it was clearly a problem because it left a vacuum. And the vacuum in regulation, we ought to be clear: Nature may abhor a vacuum, but the people who used to be regulated are kind of fond of it.

We now have the need for the Federal regulators to step in and fill part of the vacuum that they created. Both the OTS and the Federal Reserve are doing this, and the Federal Reserve's authority covers all the other bank authorities.

Finally, I would say that I believe the gentlewoman's bill, which I am glad to cosponsor, makes some very important distinctions. It does not set rates. We are not in the rate-setting business. There are people here who would set rates, and I think, frankly, there is a lot of support in this body and in the other body for setting rates.

We are not setting rates. We are saying, however, and I think this is one of the guidance principles, that retroactivity is a bad idea. My friends in the business community have generally been very staunch in pointing out the unfairness of retroactivity.

I urge them to realize that this is a principle that covers both sides of this equation. And retroactive impositions on borrowers, that is, things affecting balances already incurred, violate the principle of retroactivity. We need to deal with that.

I would also advise them—I am not sure, you are a consultant, and given the ethics rules, I never will be because it is too much trouble later on—but if I were in the business, I would be cognizant of the unhappiness.

I mean, there are people in America who are convinced that you have a personal algorithm for each of us that lets you know when to send the bill so we are least likely to be able to pay it on time. You know when we are sleeping and you know when we are awake and you know when we are on vacation and you know when there may not be somebody checking the mailbox. I know it is not true, but if I were in that position, I would be unhappy if people thought that.

So I urge you to cooperate with us. We are not setting rates. We are not going to alter your ability, I hope, if this bill goes through

to do things going forward with a lot of notice. But there is a good deal of unhappiness there.

And the final thing I would say is this: Obviously, the competitive model is an important one. This is a committee that I think on both sides has shown its support for the free market system. But given the number of credit card issuers, we don't have an equal competitive situation. You cannot rely here wholly on the market for the kinds of things we are talking about. And that is why I think this legislation should go forward.

Thank you, Madam Chairwoman.

Chairwoman MALONEY. Thank you.

The Chair now yields 4 minutes to the distinguished ranking member of the full committee, Representative Bachus.

Mr. BACHUS. Thank you, Chairwoman Maloney, for holding this hearing on your legislation which would restrict certain credit card industry practices. Whenever our committee considers bills of this magnitude, legislation that has the potential to significantly restructure a market that has benefitted hundreds of millions of American consumers and businesses, Members must fully understand the consequences, both intended and inadvertent, of our actions.

Over the past 30 years, Americans' use of credit cards to conduct their everyday financial transactions, as well as address unexpected financial emergencies, has exploded. The GAO has reported that Americans now hold more than 690 million credit cards. So I will assume, when Ms. Biggert asked people to raise their hand if they had a credit card and two-thirds of the people raised their hand, I would assume the other third weren't listening.

[Laughter]

Mr. BACHUS. Because I think we all have a credit card, or two or three.

The GAO also found that between 1980 and 2005, the amount that Americans charged to their credit cards grew from an estimated $69 billion per year to more than $1.8 trillion, quite an increase.

While the legislation covers a wide range of industry practices, at its core it is an attempt to impose limitations on creditors' ability to offer their products according to the risk posed to the individual consumers. As with any government intervention in the free market, the bill presents a real danger of restricting the range of products and services that credit card issuers currently offer, which could result—and I believe will result—in cutting off credit to some and raising the price of credit for all.

Consumers could see increased minimum payments, reduced credit limits, and less access to credit cards. And some would say that is good. But here in America, we let people make those choices, not normally the government.

The current economic uncertainty and the banks' need to preserve capital in the face of significant mortgage-related losses has already combined to reduce the amount of credit available to consumers and small businesses. That is the complaint we hear most often, is lack of credit, lack of availability of credit. We hear almost no complaints of too much credit from consumers. No matter how

well-intended, ill-conceived legislation could make a serious credit crunch far worse.

Now, we can all share stories where someone has had a problem with a credit card or difficulty as a result of using a credit card. With 690 million credit cards, there would have to be problems. But think a minute if we suddenly took 200 million of those credit cards away, or 300 million. I believe that would present problems and difficulties for the American people also.

And that may be what we are talking about. We may be talking, in this bill, about limiting the number of Americans who will be offered credit cards and will certainly increase the amount. Precipitous congressional action could be particularly counterproductive at a time when the Federal banking regulators are near completion of far-reaching proposals on the very same issues that H.R. 5244 seeks to address.

Chairwoman MALONEY. The Chair grants the gentleman an additional minute.

Mr. BACHUS. I thank you. Two weeks ago, Chairman Bernanke updated the committee on the status of the Federal Reserve's forthcoming revisions on Regulation Z for credit card disclosures. Everyone agrees that disclosures regarding the terms and conditions of credit card products are too complex. The Fed's Regulation Z revisions, once finalized, will go a long way towards alleviating consumer confusion and helping credit card customers make informed choices.

To complement its rewrite of Regulation Z, the Fed announced last month that it will soon exercise its authority on the Federal Trade Commission to write regulations to root out unfair and deceptive acts or practices in the credit card industry. These proposals from the Fed will be based on extensive consumer testing as well as the Fed's 40 years of experience.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. BACHUS. I thank the chairwoman for the extra time.

Chairwoman MALONEY. Thank you.

The Chair yields 2 minutes to Congressman Ackerman.

Mr. ACKERMAN. Thank you, Madam Chairwoman, for your leadership on this issue.

There is little doubt that providing consumers access to credit is a critically important component of our economy, particularly now, as our economy may have already tipped over into a recession. With the sputtering economy, Americans across the country are becoming more dependent upon their credit cards to pay their bills and sometimes to just put food on their tables.

But with practices such as any time/any reason pricing, pay to pay fees, universal default, restrictions on paying off high balances, and I could go on and on, the consumer credit market seems to be unfairly weighted against credit card customers.

Indeed, as the ramifications of relaxed underwriting standards and unrealistic repayment terms within the mortgage industry threaten millions of homeowners and our economy as a whole, I believe we in Congress must ask the question: Is practically universal access to credit under the present conditions and practices truly beneficial to our economy? Or, if we continue along the path of per-

mitting credit card companies to keep pushing the bounds of sound credit practices, will we soon find ourselves in another credit crisis?

It strikes me that with all the fees and stipulations attached, with eye-bursting fine print, credit cards are becoming like the carefully fine-tuned products of the tobacco industry. They have just enough nicotine in them to get you hooked, but not enough to kill you, at least not right away.

Ensnarled by unfair and unsound credit practices, American consumers find themselves suffering through years of mounting debt, increasing interest rates, and for many, financial ruin.

It is my contention that credit card users deserve the right to know, with sufficient notice, that their interest rate is increasing. And they deserve an explanation as to why. Credit card users deserve the right to decide how a bill payment is applied to their account if they have multiple outstanding balances.

Credit card users deserve the right to pay their bills on time in whatever manner they may choose without being charged extra. And furthermore, I believe it is critically important to the health of our economy to grant credit card customers these rights as well as the others included in H.R. 5244 as soon as possible so that we may prevent the second—

Chairwoman MALONEY. The gentleman's time has expired.

Mr. ACKERMAN. I thank the chairwoman for her leadership.

Chairwoman MALONEY. Thank you. The Chair recognizes Congressman Garrett for 2 minutes.

Mr. GARRETT. I thank the Chair for holding the hearing today, and I welcome all the witnesses and appreciate your coming and the testimony that we are about to hear from you.

You know, as we move now into the 21st Century, the financial products that become available to us are rapidly changing and expanding at the same time. Credit cards, as others have said already, really do provide an essential service to millions of Americans.

The ability to establish credit, borrow money, has basically become fundamental to our economy. So whether it is buying a new washing machine or, as I just had to do, putting a new transmission in your car, or maybe, as some other people do, use your credit cards to start a home business, literally start up from scratch, they allow us to finance needed goods. It also allows us to pay it over time, and also, through some of the credit card companies, to track those costs as well on a monthly, quarterly, or at the end of the year basis.

Unfortunately, we have heard a number of instances in news stories—like in today's paper; I guess they must have known you all were going to be here—and some from constituents as well where folks feel that they have maybe been misled or just didn't understand what they were getting into with these cards.

But I think there are really probably a lot more stories out there that are left untold that aren't in today's paper of how credit cards have significantly helped people through some of their tough times, and also helped those people who are trying to start a business.

So I think we need to sit back and wait a little bit and hear and consider. As we push to address the concerns of some of the consumers who have been negatively impacted, we can't really over-

react and wind up eliminating credit for those people or raising costs for the creditworthy Americans who really do rely on credit cards for their daily lives.

We are in tough economic times right now. We hear talk of recession. We hear talk of credit tightening. So if we pass legislation that prevents issuers from beginning to price for risk, I am afraid we will either tighten the credit market on the riskier borrowers or drive up prices on the rest of Americans.

And I would just advise this committee to do what the chairman of the committee has done with regard to SOX, and to step back where another entity, in this case the Federal Reserve, is taking action on it. Let's see how—

Chairwoman MALONEY. The gentleman's time has expired.

Mr. GARRETT. —they deal with it before we act precipitously.

And with that, I yield back.

Chairwoman MALONEY. The Chair recognizes Congressman Moore for 2 minutes.

Mr. MOORE. Thank you, Chairwoman Maloney, for convening this hearing and for your leadership in calling attention to this important issue which affects millions of Americans.

Like many of the members on this committee, I have heard concerns from consumers about a lack of clarity from credit card issuers in explaining account features, terms, and pricing on their accounts. I believe it is very important that we take the necessary steps to improve disclosures and protect consumers from unexpected fees or rate increases.

I also know that our Nation is experiencing a significant credit crunch at this time and that credit cards remain a lifeline for millions of Americans who would otherwise be unable to pay for basic services to meet their daily needs. That is why I believe we must take a careful, measured approach in addressing this very important issue to ensure that nothing we do here in Congress has unintended consequences for the marketplace or for the consumer.

I practiced law for 28 years before I came to Congress, and for 12 of those years, I served as a district attorney. In that time, I learned that there are at least two sides to every story, and sometimes many more. The best legal and policy decisions, I believe, are made when we have all the facts before we make a decision, and all the information is on the table.

Again, I thank the witnesses for being here today. I look forward to hearing your testimony and to talking to you about this issue further in the future. Thank you, Madam Chairwoman.

Chairwoman MALONEY. The Chair recognizes Congressman Price for 3 minutes.

Mr. PRICE OF GEORGIA. I thank the Chair, and I thank you for holding this hearing. I want to thank the ranking member for her tireless work on this effort as well. I want to thank all the witnesses.

I read an article last week by former Senator George McGovern—yes, Senator George McGovern—who wrote in the Wall Street Journal that, "The real question for policymakers is how to protect those worthy borrowers who are struggling without throwing out a system that works fine for the majority of its users."

We all support more clear and transparent disclosure. There is no doubt about it. And I don't have any doubt that the legislation that we are discussing today was written with a desire to help borrowers who use credit cards.

However, not allowing for pricing for risk individually will mean a higher cost of credit for every single American. In fact, not allowing pricing for risk individually I believe to be a form of price controls.

The proposed bill also dictates how card companies must treat the payment of multiple balances at different interest rates. This will mean American borrowers, all borrowers, can say goodbye to low introductory interest rate offers and balance transfers.

If this legislation were to become law, credit card issuers would no longer offer these products. Some of us remember when interest rates for credit cards were 18 to 20 percent; that was all you could get. Those days will return, I would suggest, if this legislation is adopted.

Fortunately, we don't operate in a bubble. We can learn lessons from our friends in the United Kingdom, where the Office of Fair Trading ordered credit card providers to halve penalty fees by setting a maximum charge. An article in the Daily Telegraph then said that several companies reintroduced annual fees, a practice that is minimal in the United States due to the individually risk-based pricing.

We can also look back to our own history. In 1980, President Carter imposed price controls. In 1990, an analysis of that by the Federal Reserve in Richmond said that we learned three lessons from that: One, they may not deliver the desired results; two, they may have unintended and unforeseen adverse effects; and three, polices may tempt policymakers to impose credit controls again despite unfortunate previous experiences with such policies. The translation of that is: Americans lost the opportunity for the credit.

It would be wise for us to learn from our experience in 1980. Again, as Senator McGovern pointed out so eloquently, the nature of freedom of choice is that some people will misuse their responsibility and hurt themselves in the process. We should do our best to educate them, but without diminishing choice for everyone else.

Madam Chairwoman, I have a copy of Senator McGovern's complete op-ed, and I commend it for everybody's reading, and also ask unanimous consent that it be included in the record.

Chairwoman MALONEY. Without objection, it is so ordered.

Mr. PRICE OF GEORGIA. And I will close, finally, with the quote that I began with from Senator McGovern's article, and that was, "The real question for policymakers is how to protect those worthy borrowers who are struggling without throwing out a system that works fine for the majority of its users."

I yield back the balance of my time.

Chairwoman MALONEY. I now recognize Congresswoman Waters for 2 minutes.

Ms. WATERS. Thank you, Madam Chairwoman.

Let me start by saying that I am proud to be an original cosponsor of H.R. 5244, the Credit Cardholders' Bill of Rights. This legislation is long overdue in light of some of the outrageous billing

practices that have spread through the credit card industry recently.

Contrary to the claims of the credit card and banking industry, H.R. 5244 is a measured response to these practices. I will say, however, that you are indeed brave, Madam Chairwoman, for taking on these lucrative practices of such a powerful industry.

As chairwoman of the Subcommittee on Housing and Community Opportunity, I have certainly felt their wrath in the context of the foreclosure crisis. I have heard many of the same "the sky is falling" arguments about why even the most modest regulation can drive up the price of credit unacceptably. I don't buy it, and I am glad you, Madam Chairwoman, don't either.

Indeed, I think the practices of the credit card industry may even be more troubling in some ways than those in the subprime mortgage market. Some have referred to the subprime adjustable rate mortgages at the heart of the mortgage crisis as exploding mortgages because of the substantial rate resets that occur after 2 or 3 years. But at least it was apparent to a borrower that the rate would increase even if the loan originator failed to do due diligence on its long-term affordability absent significant appreciation in the price of the house in question.

By contrast, I think we could label credit card agreements landmine loans because it is not at all clear to consumers if, how, and when their interest rates are going to increase. And yet increase they do, for many reasons.

I join with the chairwoman in believing they should either ban outright, or significantly limit such a so-called universal default, where companies can penalize a cardholder for payment behavior that has nothing to do with their particular card. Similarly, on-time payment is no guarantee against additional fees being imposed through double-cycle billing.

Finally, the companies do their best to complicate what timely payment is, often—

Chairwoman MALONEY. The gentlewoman's time has expired.

Ms. WATERS. Thank you very much. I yield back the balance of my time.

Chairwoman MALONEY. The Chair recognizes Congressman Castle for 2 minutes. And I thank him for his work in a bipartisan way with the many meetings and roundtable discussions that we had leading up to this bill. Representative Castle.

Mr. CASTLE. Thank you, Madam Chairwoman. And while I have an open mind about reform, I also think it is very important to keep some basic facts in our subsequent discussions in perspective.

We are a nation with about 225 million credit-active Americans. According to the Federal Reserve, around 640 million credit cards are in circulation in this country. The Fed published a report a few years ago that said the average American consumer has 5 credit cards; and 1 in 10 consumers has more than 10 credit cards in their wallet. I have seen a study that shows that most consumers keep their credit cards a minimum of 7 years, and frequently much, much longer.

My point is this: Consumers overall are a pretty savvy group. If they find a good deal, they stick with it. If they find a bad deal or are treated poorly, they drop that product or service in a heartbeat.

Since the overwhelming majority, about 90 percent of the public, pays its credit card bills on time, I worry that well-intended legislative efforts might go too far, especially since the finally updated version of Federal Reserve Regulation Z will address many of the provisions included in H.R. 5244. And it is scheduled for release soon.

Chairman Bernanke, at our most recent hearing which he attended, when discussing the unfair and deceptive practices, he indicated that other steps are going to be announced in the next couple of months that would pertain to this as well.

Let me be clear so our witnesses and the public can have a better appreciation for all that the Federal Reserve has done relative to these soon-to-be-released regulations. The professional staff of the Federal Reserve has put out for comment several different consumer-tested ideas related to credit cards that were developed in part with the help of consumer focus groups. They have been very deliberate in their approach to these issues, and have gone so far as hiring consumer focus groups to test proposed disclosure and billing ideas.

Subsequently, as this process has unfolded, the Fed has had to review over 2,500 comments from banks, consumers, consumer groups, lawyers, and so forth concerning these issues and proposed solutions. All this work will come to an end later this year, and I would prefer to see what final changes are proffered by the Fed before pursuing any legislative proposals.

Madam Chairwoman, our economy is struggling. And while I want to do everything I can to make certain consumers are dealt a fair hand and our financial services industry thrives, I look forward to the testimony today and the important work the Federal Reserve will release later this year.

I yield back the balance of my time.

Chairwoman MALONEY. The Chair now recognizes Congressman Hodes for 1.5 minutes.

Mr. HODES. Thank you, Madam Chairwoman. I am happy to be here at this hearing. And I have taken a relatively restrained approach so far to this issue. I am not yet a cosponsor on the bill because I am interested to hear what the representatives here have to say and what the testimony divines.

I will say I am here with—I brought a document which is a slightly redacted bill that I got from Bank of America. I would ask unanimous consent that after my remarks, this be included in the record, Madam Chairwoman.

This bill shows a charge to me of $16.50, and says it was a purchase and adjustment. But of course, it was a late fee. And the late fee was because I posted the payment that was due on the 22nd of February—apparently it wasn't received till the 23rd. So I was charged $15. And then $1.50 on top of that is the minimum finance charge. And the front of the bill shows that my annual percentage rate for the billing is 47.37 percent. What a surprise to me.

Then when I turned the bill over on the back and read through the small print, I found that my payment due date can change any time at the whim of the company. And I found that interesting because the discussion that I had with my wife prior to this billing

period was, let's get our bill in on time and make sure we send it early—

Chairwoman MALONEY. The gentleman's time has expired.

Mr. HODES. —in order to make sure that we don't get hit with these kinds of payments. So I will be very interested to hear the testimony from folks about these kinds of practices.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. HODES. Thank you, Madam Chairwoman.

Chairwoman MALONEY. The Chair now recognizes Representative Hensarling for 2 minutes.

Mr. HENSARLING. We are here today to consider H.R. 5244, a distinctly anti-consumer piece of legislation. I believe the bill begins to turn back the clock to an era where there was little competition, and a third fewer Americans had access to credit cards. And those that did paid the same high universal rate regardless of whether they paid their bills on time.

I fear the bill represents another assault on personal economic freedom, and will certainly exacerbate the credit crunch that threatens our economy already. Instead of attacking risk-based pricing and competition, we should be celebrating it.

Since credit card issuers have adopted risk-based pricing, interest rates have fallen substantially. We have seen the virtual disappearance of consumer-hated annual fees and a flowering of fringe benefits, from cash back to product protection to free plane tickets, just to mention a few. And I also note that credit cards are a vital tool for our Nation's 26.8 million small businesses, and so testifies the SBA.

Now, I don't come here today to defend all credit card companies and all of their practices. In fact, when I have not liked terms, both my wife and I have changed credit cards. And there is one particular company that we refuse to do business with. But competition has allowed this. And so I come here today to defend economic liberty, risk-based pricing, consumer empowerment, and a competitive marketplace.

We should all know the terms of the credit cards that we have. If we don't, I suspect either: One, we were misled by a credit card company, in which case there are existing legal recourses, like Regulation Z and the Fair Credit Reporting Act; two, maybe we tried to read the terms but we couldn't understand them because of misguided government mandates that gave us voluminous disclosure written in legalese, as opposed to effective disclosure written in English; and three, maybe we just didn't bother to read the terms, and have nobody to blame but ourselves.

I fear again that if we adopt the provisions of this, too many Americans will either be denied credit or see their credit card costs skyrocket, and no longer be able to pay for the bills they need in their everyday lives.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. HENSARLING. I yield back.

Chairwoman MALONEY. The Chair recognizes Congressman Green for 30 seconds.

Mr. GREEN. Thank you, Madam Chairwoman. With 30 seconds, let me just say that I am eager to hear from the witnesses that we

have assembled. I too have received many comments from persons concerning things that are happening in the industry.

And I will yield back some time to you, Madam Chairwoman. Thank you.

Chairwoman MALONEY. The Chair recognizes Congressman Neugebauer for 2 minutes.

Mr. NEUGEBAUER. Thank you, Madam Chairwoman.

I would just make a couple of points here. I think when we saw a number of people raise their hands a while ago who have credit cards, I think we have to understand what credit card credit is. One, it is unsecured credit. Basically, it is unsupervised credit. And it is unrestricted credit for most of us.

So I would be interested—and I am not going to do this to you, but we saw how many hands that were raised that have credit cards. But I wonder how many hands would raise if I said, could you call a family member today and say, would you loan me $15,000, unsecured, and they asked you, what are you going to do with it, and you said, well, I really don't know, but I might go to Las Vegas. Might buy my wife a new—

And so what it is is these lending institutions are taking on an unsupervised, unsecured position. And there are things built into those credit card contracts that encourage good behavior, and there are things that are built into them that discourage poor behavior, because basically they are basically depending on just the desire of the person holding that card to pay that card back.

I think what we have seen and will hear is a lot of people are confused. And the question is, today, are we trying to come up with some kind of consumer protection? And what are we actually trying to protect the consumer from? And I would say—

Chairwoman MALONEY. The gentleman's time has expired.

Mr. NEUGEBAUER. That was 2 minutes?

[Laughter]

Chairwoman MALONEY. Yes. Yes, it was. It was a quality 2 minutes. Thank you.

The Chair recognizes Congressman Scott for 1 minute and 30 seconds.

Mr. SCOTT. Thank you so much, Madam Chairwoman. This is indeed an important hearing, a very timely hearing. We are a credit card nation, and have been for some time.

But this issue is so important now because of the subprime mortgage meltdown. Folks are now using their credit cards just for the basic essence of survival. Many are even paying their home mortgages on credit cards.

So this is very timely. There are issues of major concern that I think we need to address. One of major importance is universal default. I think we need to more clearly look at that for an example. I think also we have to look at stopping credit card companies from making—voluntarily changing the rates on their own.

And in that regard, I think I ought to take a minute to give a tip of the hat to Citigroup, who is already making those changes because they see it as being unfair to the consumer.

I am also very concerned about one major issue: After a customer has paid off all their fees, overdraft and the like, why is it so difficult to close the account? When all the debt is paid, why are addi-

tional fees added on when there isn't even any money in the account, and the customer has further requested that it be closed?

There are a number of very serious practices that the industry is doing that certainly need to be stopped. And those of you in the industry who are voluntarily moving in this direction certainly need to be commended.

But we have a very serious issue. It is a timely issue. And we must look at it with as clear a jaundiced eye as we possibly can. The consumers across America are expecting this committee to do it. I look forward to your testimonies.

Chairwoman MALONEY. Thank you. And finally, the Chair recognizes Congressman Udall for 1 minute.

Mr. UDALL. I thank the chairwoman for letting me sit in on this important hearing. And I would ask unanimous consent that my entire statement be included in the record.

And if I might, I just want to acknowledge a fellow Coloradan, Susan Wones, who came all the way here to testify, and she will not be able to do so. She has a very important story to tell us about the treatment she has received from her credit card company, and I hope at some point she will be able to be heard because, after all, this is about Americans who are using credit in their daily lives.

I want to commend the chairwoman for holding this hearing, and I know we are all going to look forward to working to bring fair and real reform that makes sense for consumers and the credit card companies alike. Thank you again, Madam Chairwoman, and I will yield back any time I have remaining.

Chairwoman MALONEY. That concludes our opening statements. I would like to note that everyone has 5 days to put their opening statements in the record.

I would now like to recognize our distinguished panelists. We will begin with Ms. Elizabeth Warren, who is the Leo Gottlieb Professor of Law at Harvard Law School. She will be followed by: Greg Baer, deputy general counsel, regulatory and public policy, Bank of America; Adam J. Levitin, associate professor of law, Georgetown University Law Center; John Finneran, general counsel, Capital One; Lawrence Ausubel, professor, Department of Economics, University of Maryland; Carter Franke, Marketing Executive, JPMorgan Chase; Oliver I. Ireland, partner, Morrison & Foerster; and Katherine M. Porter, associate professor, the University of Iowa College of Law.

Thank you all for coming. Each of you will be recognized for 5 minutes. Your entire testimony will be part of the official hearing record. So please begin, Ms. Warren, and thank all of you for coming here and preparing your testimony today.

STATEMENT OF ELIZABETH WARREN, LEO GOTTLIEB PROFESSOR OF LAW, HARVARD LAW SCHOOL

Ms. WARREN. Madam Chairwoman, thank you for the opportunity to join in this discussion.

We are here today to consider modest changes to the rules governing credit cards. In fact, we are here to discuss banning practices that many responsible lenders have already renounced. As a result, much of this discussion is about ensuring that all lenders

follow best practices, practices that permit profitability for issuers and safety for customers.

We are not here to regulate credit cards. This is not a hearing to discuss interest rate caps, fee regulation, or any restraint on free and competitive markets. And, contrary to some of the frenzied lobbying claims, we are most certainly not here to engage in price-fixing.

Instead, this is a hearing about tricks and traps that undermine a competitive market. Lenders employ thousands of lobbyists, lawyers, marketing ad agencies, public relations firms, statisticians, and business strategists to help them maximize their profits.

Customers need a little help, too. They need some basic protection to be certain that the products they buy meet minimum safety standards. Personal responsibility will always play a critical role in dealing with credit cards. But no family should be brought low by schemes designed to prey on the unwary.

I want to speak for just a minute about the importance of credit card reforms in a time of economic uncertainty. The crisis in the subprime mortgage market has served as a bitter reminder of what can happen when lending terms are not transparent.

When lenders are careless in screening their customers, when customers are unable to evaluate fully the risks associated with borrowing, the result is a series of risky loans, raising the eventual specter of high levels of default and economic upheaval.

The events of recent months have reminded us we are all in this economic boat together. Credit markets affect everyone, and high risk lending can have an impact on prudent lenders and people who never borrow. Without careful regulation to support prudent lending, we face an increased risk that a credit card bubble will further destabilize both families and the larger economy.

Nearly half of all credit cardholders missed payments in 2006, the latest year we have data on. This makes them obvious targets for the most aggressive and unfair tactics. Sending in a payment that arrives one day late can cost a family an average of $28, when the cost to the company is measured in pennies.

Under the rubric of universal default, customers have been hit with huge increases in interest rates, customers who have scrupulously met every single term of their credit card contracts. Anxiety has become a constant companion for Americans struggling with debt.

Listen to these numbers: Today, one in every seven American families is dealing with a debt collector. Forty percent of families worry whether they can make their payments every month. One in five Americans is losing hope, saying they expect to die still owing on their bills.

Credit card contracts have become a dangerous thicket of tricks and traps. Part of the problem is that disclosure has become a way to obfuscate rather than to inform. According to the Wall Street Journal, in the early 1980's, the typical credit card contract was a page long. By the early 2000's, it was more than 30 pages long.

The additional language was designed in large part to add unexpected and incomprehensible language that favors the credit card companies. H.R. 5244 begins to clear a path through this tangle.

All-purpose cards generated $115 billion in revenues in 2006. Profits were a handsome $18.4 billion, a 45 percent jump from the year before. There is, of course, no breakdown in the interest and fee categories to explain how much of the industry revenue came from universal default, double-cycle billing, and other unscrupulous practices. But it is possible to gain some sense of the need for such tricks and traps by noting the number of highly profitable card issuers who have publicly renounced such practices.

Companies should be commended for moving in the right direction on credit card terms. It is now the task of this committee to move their less ethical competitors into similar practices. Congresswoman Maloney and Chairman Frank and the 39 cosponsors have taken an important first step toward ending practices that put both families and markets at risk. They deserve our thanks and our support.

[The prepared statement of Professor Warren can be found on page 153 of the appendix.]

Chairwoman MALONEY. I thank the gentlelady. We now have 82 cosponsors. And we appreciate very much your testimony.

Mr. Baer.

STATEMENT OF GREGORY BAER, DEPUTY GENERAL COUNSEL, REGULATORY AND PUBLIC POLICY, BANK OF AMERICA

Mr. BAER. Good morning, Chairwoman Maloney, Ranking Member Biggert, and members of the subcommittee. My name is Greg Baer, and I am deputy general counsel at Bank of America. I appreciate the opportunity to present our views today. Let me say a few words about risk-based pricing at Bank of America, and then turn to H.R. 5244.

Risk-based pricing is first employed when we receive an application from a consumer and consider FICO score and general credit history. That information is useful, but as the years go by, the original information tells us less and less about the risks we are running. But our ongoing experience with the customer tells us quite a lot. We use that information to reprice in two ways.

First, at Bank of America, we default reprice a customer if the customer violates his contract with us by going late or over limit not once but twice within a 12-month period. However, not all customers who hit our default triggers are necessarily repriced. We look at these customers individually and determine whether the default truly indicates higher risk.

Second, when we see that a customer is exhibiting other risky behavior, such as maxing out credit lines or defaulting on other loans, we may seek to charge the customer a higher rate. But the customer always has notice and choice. The customer can simply decline the higher rate and repay the existing balance under the old rate.

The only thing we ask the customer to do in return is to stop making additional charges on the card. This notice and choice is of course the distinction between risk-based pricing and universal default, a practice in which Bank of America has never engaged.

I should note that our experience shows that nothing makes customers angrier than an increase in the interest rate. We have seen evidence of that today. At Bank of America, where our goal is to

make a credit card customer a mortgage, a deposit, and a retirement savings customer, we have all the more reason to keep our customers satisfied. Thus, looking at our 2007 portfolio, the overwhelming majority of customers—nearly 94 percent—had the same or lower rate than they did at the beginning of the year.

So why would we ever raise rates? First, because for these customers we are confident that we bear real increased risk. Rigorous testing shows that our models are extraordinarily predictive of consumer behavior.

Furthermore, when we reprice customers, we find that many manage their credit more wisely, making larger monthly payments and paying down their debt faster. Thus, a higher interest rate not only allows us to earn income to compensate for greater risk, it can actually reduce the risk we are managing.

There is a third type of repricing known as any time/any reason repricing generally done when market interest rates rise or an issuer is not earning a sufficient return. Because we use risk-based pricing, we believe that Bank of America has been less likely to have to use this type of repricing.

Now let me turn to H.R. 5244. We are very concerned that this bill would significantly hinder our ability to price the risks of lending, and would result in less credit being made available to creditworthy borrowers, with generally higher prices for those who do receive credit. Let me highlight two of the concerns described in my written testimony.

First, H.R. 5244 would prohibit risk-based repricing of existing debt at any time, even with notice and choice. It is important to note that in the great majority of cases, we learn about an increase in a customer's risk after the customer has run up a large balance, not before. Thus, the risk lies in that existing balance, not in future charges.

Second, in addition to letting them opt out of risk-based repricing, H.R. 5244 would provide customers the ability to opt out of default repricing, that is, allow customers to breach their credit agreement but suffer no consequence for it. The bill thereby would take significant steps to reduce the customer's incentive to manage credit wisely.

Recent experience suggests that this course is not a wise one. There is general consensus that a major cause of the mortgage crisis was an originate-to-distribute model where some participants in the system had incentives to externalize risk. A clear lesson of the past year has been that both lenders and consumers suffer when lenders do not sufficiently consider risk.

Before closing, I would like to react to some testimony suggesting that the credit card industry is not competitive on price and does not risk-base price. We find this difficult to understand. For example, we have a team of approximately 30 associates who engage solely in new account marketing, constantly evaluating new competitive strategies. They offer a variety of products with different interest rates, features, and benefits to see how they do.

In 2007, we sent out approximately 111 million test pieces in over 500 tests, of which 36 million were price tests, trying to see how changes in rate can affect market share. The same competition

occurs for existing customers. We fight for balance transfers through promotional rates and other offers.

Customers often call us to inform us of an offer from a competitor at a lower rate than they are paying us, and our associates have discretion to match those rates when appropriate. And even when customers call in for reasons unrelated to rate, our associates check to see if they have balances with competitors, and offer them price incentives to transfer those balances.

In short, any legislation premised on this industry not being highly competitive on price and terms would be based on a false premise.

That concludes my remarks. I look forward to answering any questions that you might have.

[The prepared statement of Mr. Baer can be found on page 91 of the appendix.]

Chairwoman MALONEY. I thank the gentleman for his testimony, and note that both Ms. Warren and Mr. Baer pointed out in their testimony that many credit card companies do not engage in universal default and some of the other abuses that we are trying to correct in this legislation.

And Mr. Levitin.

STATEMENT OF ADAM J. LEVITIN, ASSOCIATE PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. LEVITIN. Madam Chairwoman, members of the subcommittee, I am pleased to testify today in support of the Credit Cardholders' Bill of Rights. I am here to address a major argument put forth by the credit card industry against any form of regulation, namely that it would dissipate the benefits of so-called risk-based pricing.

Credit card issuers contend that since the early 1990's, they have engaged in risk-based pricing and that risk-based pricing has benefitted creditworthy consumers in the form of lower costs of credit and subprime consumers in the form of greater availability of credit. Card issuers argue that any regulation of their billing practices would negate the benefits of risk-based pricing.

It is important that the subcommittee understand that there are three problems with the card industry's risk-based pricing story. First, credit card pricing is, at best, only marginally risk-based. Credit cards have an astounding array of price points—annual fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default interest rates, late fees, overlimit fees, balance transfer fees, cash advance fees, international transaction fees, telephone payment fees, and so on. I think I missed a few.

Of this multitude of fees, only a couple—base interest rates and late fees—have any relation to consumers' credit risk. And even then, it is not narrowly tailored. Most issuers offer only a couple tiers of pricing for base rates and late fees. But consumer credit risk does not come just in sizes large and small.

The majority of credit card pricing has no relation to cardholder risk whatsoever. Instead, the pricing is a function of the card issuer's ability to load on fee after fee after fee to customers who

are locked into using the card because of high costs in switching cards.

Not surprisingly, as the graph I have up shows, there is virtually no difference in the average effective interest rate for platinum cards, gold cards, and standard cards, even though these cards are issued to consumers with very different credit profiles. Viewed as a whole, credit card pricing is not risk-based. It only reflects risk on the margins.

The second problem with the risk-based pricing story is that it cannot be connected to lower costs of credit for creditworthy consumers. It is far from clear that overall credit costs have declined, much less that any decline could be attributed to risk-based pricing, since the early 1990's.

Credit card pricing has become a game of three-card Monte. Card pricing has shifted away from the up-front visible price points, like annual fees and base interest rates, and shifted to back-end fees that consumers are likely to ignore or underestimate.

For example, even as base interest rates have fallen, a host of new fees have sprouted up, and other fees, like late fees and overlimit fees, have soared. According to the GAO, from 1990 to 2005, late fees have risen an average of 160 percent and overlimit fees have risen an average of 115 percent. For creditworthy consumers, many credit card costs have risen since the advent of risk-based pricing.

The one credit card price point that has declined for creditworthy consumers are base interest rates. This decline, however, is not attributable to risk-based pricing. Instead, virtually the entire decline is attributable to the decline in card issuers' cost of funds. The net interest margin, displayed on the graph, is the spread between the card issuers' cost of funds and the base interest rate at which they lend.

This rate has remained basically static since the early 1990's, indicating that base interest rates have declined at roughly the same rate as the cost of funds. In other words, the decline in base rates is due to the decline in issuers' cost of funds, not risk-based pricing.

Even if credit card pricing were actually risk-based in a meaningful way, there is no evidence that connects it to lower pricing for creditworthy consumers. The third problem with the risk-based pricing story is that there is no evidence that connects it to greater availability of credit for subprime consumers.

The availability of credit for subprime consumers has grown since the early 1990's, but this is a function of securitization rather than of risk-based pricing. Several years ago, Alan Greenspan told the Senate Banking Committee that, "Children, dogs, cats, and moose are getting credit cards." It is hard to reconcile a story of risk-based pricing with cards being issued to toddlers and pets.

The greater availability of credit is instead a function of securitization. Securitization increases lenders' lending capacity and lets them pass off default risk onto capital markets. Securitization, not risk-based pricing, is the explanation for growth in lending to subprime consumers.

Even if credit card pricing were truly risk-based, and even if it had the benefits claimed by the card industry, nothing in the Credit Cardholders' Bill of Rights implicates the risk-based pricing

model. The Cardholders' Bill of Rights is about banning abusive and manipulative billing tricks, nothing more and nothing less. It does not regulate interest rates or fee amounts, and it leaves card issuers with at least five ways of accounting for risk.

Because the practices banned by the Cardholders' Bill of Rights are at best incidental to issuers' profitability, we should not expect to see the result in higher costs of credit, or lower availability of credit, or affect asset-backed securities markets.

Instead, this legislation will help clarify credit card pricing, which is a prerequisite for an efficient, competitive market. H.R. 5244 will help consumers and will make for a fair and more efficient credit economy, and I strongly urge Congress to pass it into law.

[The prepared statement of Professor Levitin can be found on page 117 of the appendix.]

Chairwoman MALONEY. Thank you.

Mr. Finneran?

STATEMENT OF JOHN G. FINNERAN, JR., GENERAL COUNSEL, CAPITAL ONE

Mr. FINNERAN. Thank you, Chairwoman Maloney, Ranking Member Biggert, and members of the subcommittee. I want to thank you for inviting me back to testify before the subcommittee, this time about pending credit card legislation.

This subcommittee has played a constructive role in identifying problems that consumers have had with their credit cards. Capital One has been a willing and active participant in the dialogue about how to improve on the remarkable value delivered to millions of American consumers by credit card products.

With respect to the practices that have been central to the debate, Capital One has worked diligently to establish a high standard of customer sensitivity. We do not engage in any form of universal default repricing. We have never done two-cycle billing.

We have a single clear penalty repricing policy. We will impose a penalty rate on a consumer only if the consumer pays late twice, by 3 days or more, in a 12-month period with respect to that specific card. We will provide the customer with a prominent warning on the billing statement after the first infraction. In many cases, we choose not to reprice the customer even if the customer pays us late twice in the 12-month period. If a customer is repriced but pays us on time for 12 consecutive months, we will take that customer back to the prior rate. This unrepricing is automatic.

We have supported the Federal Reserve's proposed 45-day notice for penalty repricing, and have gone beyond the Fed's proposal to urge that customers be given the opportunity to reject any repricing, close the account, and pay down the outstanding balance at the old rate over time. We provide our customers notice and the ability to opt out of overlimit transactions.

Across our entire portfolio of customers, more than 30 million, we work very hard to provide important notices in plain English that capture their attention at critical moments. We do so because we believe, as Chairman Bernanke said to this committee, that cardholders must understand the terms under which they are bor-

rowing and be empowered to manage their credit wisely, as the overwhelming majority of our customers do.

Capital One has never been a voice for the status quo. We have long advocated for changes in the way credit cards are marketed to consumers. We believe that the banking regulators have the statutory authority right now to implement an advanced consumer choice regime that effectively solves the most critical credit card problems identified by this committee with minimal risk of oversteering or unintended consequences.

Toward that end, we have led the industry in recommending that consumers have clear, conspicuous 45-day notice and the right to opt out of all types of repricing. And we believe that such a regulatory initiative may be on the horizon.

But, Madam Chairwoman, we also believe that it is unwise, especially at this time, to enact broad legislation that sets payment formulas in statute, redefines critical product features, and limits the tools of risk management for consumer credit. Capital One must therefore oppose H.R. 5244, and we do so for three fundamental reasons.

First, the legislation sets multiple statutory limits on a lender's ability to price for the cost of credit. For example, under the heading of eliminating double-cycle billing, the bill actually redefines the concept of grace period and arbitrarily expands the degree to which all issuers, even those who don't engage in double-cycle billing, must extend credit interest-free. Other provisions of the bill also raise the specter of price controls.

Second, the consequences of so sweeping a bill would be to force the industry to raise the cost of credit for everyone, even those who present less risk of default to the lender, and reduce the availability of credit for those consumers who present a greater risk of default.

Third, this result would be exactly the wrong policy prescription, particularly in this economic environment. As the mortgage crisis has unfolded, we have had a progressive tightening in the credit markets, and many believe we are near or in a recession.

To ease the impact of a slowdown on our economy, the Fed has aggressively lowered the Federal funds rate, and Congress has passed a bipartisan stimulus package. H.R. 5244 could significantly counteract the positive effects of both of those policy initiatives. Madam Chairwoman, that would be especially unfortunate since the regulators, those policymakers uniquely positioned to evaluate the complex and dynamic credit card industry, are poised to address all of the issues targeted by H.R. 5244.

Under its new Regulation Z rule, the Fed proposes a 45-day notice period for all types of repricing. The new rule also offers improved disclosure requirements for payment allocation, minimum payment, and interest rates. And that is just a partial list.

Equally importantly, Chairman Bernanke has confirmed before this committee that the Fed will supplement its Reg Z rule with new credit card rules under its UDAP authority. It seems likely that those rules will go to the core of the committee's concerns. We believe that such rules may provide the best, safest, and most direct road to reform.

Capital One has publicly called for balanced, reasoned change that can be implemented quickly, would improve disclosure, and enhance customer choice. We have also sought to work cooperatively with you and the committee. Though we must respectfully disagree about the impact of H.R. 5244, I want to thank you again for the opportunity to express our views.

[The prepared statement of Mr. Finneran can be found on page 101 of the appendix.]

Chairwoman MALONEY. And thank you very much for your testimony.

Mr. Ausubel?

STATEMENT OF LAWRENCE M. AUSUBEL, PROFESSOR, DEPARTMENT OF ECONOMICS, UNIVERSITY OF MARYLAND

Mr. AUSUBEL. Chairwoman Maloney, Ranking Member Biggert, and members of the subcommittee, my name is Lawrence Ausubel, and I am a professor of economics at the University of Maryland. I am honored by the invitation to appear before you today.

Credit card debt poses a common pool problem. Since it is not secured by any collateral, and since recoveries will be allocated pro rata under bankruptcy, each card issuer is motivated to try to collect from the common pool, and the attempt to collect by one issuer may pose a negative externality to others.

When a consumer becomes financially distressed, each credit card lender has an incentive to try to become the first to collect. A useful explanation of penalty interest rates and universal default clauses is that each issuer is seeking to maximize its own individual claim on this common pool of debt.

To the extent that the financially distressed consumer is still able to repay any debt, a high penalty rate, such as 29.9 percent, takes advantage of the situation and provides incentives for this issuer to be repaid in front of other lenders. And to the extent that the consumer repays no debt, the high penalty rate maximizes the issuer's nominal loan balance, and therefore the issuer's pro rata share of recoveries following bankruptcy.

Since every credit card issuer has this unilateral incentive to charge a high penalty rate, the likely outcome is inefficiently high penalty rates. As such, this common pool problem may be viewed as a market failure, yielding scope for Congress to intervene in useful ways.

Universal default clauses arise in similar fashion. Each issuer individually has the incentive to impose penalty pricing when a consumer misses a payment to somebody else in order to collect first from the common pool. This prisoner's dilemma-like game has the result that all issuers impose universal default, but no issuer is any better off if all have it than if none have it.

Indeed, they may all be made worse off; an overextended consumer suffering a setback is often best dealt with by relaxing the terms of the loan and giving the consumer an opportunity to get back on his feet. Instead, penalty pricing and universal default create an explosion of finance charges from which it is difficult for the consumer to emerge.

Given the current turmoil in credit markets and in real estate, additional pressure on consumers from credit card debt would be

particularly unfortunate. Such pressures could be reduced if the proposed bill becomes law in a timely fashion.

While it is almost axiomatic that consumers who have triggered penalty rates are greater risks than consumers who have not, I am unaware of any empirical evidence that the magnitude of higher rates bears any close relation to the magnitude of enhanced risk. Quite to the contrary; it is evident from other aspects of credit card pricing that the levels of many fees are based more on the relative insensitivity of consumer demand than on any particular relation to cost.

Good examples are the 3 percent surcharges recently imposed by most issuers on credit card transactions made in foreign currencies, the $39 late fees imposed irrespective of the number of days payment is late, etc.

As part of my written statement, I have included a new paper, co-authored with Professor Amanda Dawsey of the University of Montana, developing an economic model of the issue. While our analysis is very preliminary and incomplete, the penalty interest rate appears to be higher under universal default, and the higher interest rate appears to exceed the enhanced credit risk associated with missing a payment.

A second result is that the probability of full repayment after missing a minimum payment is lower under universal default.

Third, it appears that social welfare is frequently lower with universal default than without it.

Separately from these issues, let me briefly observe that any time/any reason repricing would appear to be detrimental to competition in the credit card market. This conclusion comes from standard considerations in industrial organizations, such as search costs and switch costs.

How can a consumer comparison shop if all he is told about future pricing is, we may change your APR and fees "based on information in your credit report, market conditions, business strategies, or for any reason?" That is a quote from the current Bank of America disclosure.

Thank you.

[The prepared statement of Professor Ausubel can be found on page 76 of the appendix.]

Chairwoman MALONEY. Thank you.

Ms. Franke?

STATEMENT OF CARTER FRANKE, MARKETING EXECUTIVE, JPMORGAN CHASE

Ms. FRANKE. Madam Chairwoman, and members of the committee, good morning. My name is Carter Franke and I am a senior vice president at JPMorgan Chase. I am proud to represent today the 20,000 Chase card service employees who serve the needs of more than 100 million Chase card customers each and every day.

Chase believes that building solid customer relationships is the best approach to long-term success in the credit card or in any industry, and we have worked to deepen those relationships for a number of years.

Last year we articulated before Congress and in many other venues our belief that the appropriate use of credit cards involves

a shared responsibility between banks and their customers. We said that credit cardholders need to use their cards responsibly, only purchasing what they can afford, never exceeding their credit limits, and making their payments on time.

For banks like Chase, our responsibilities include the need to listen and respond to customer needs, to communicate clearly about our products, to make sure customers understand the terms of our agreement, and to go further by helping them live up to those terms.

That is why early last year we developed our Clear & Simple program, to make sure that customers have clear information and to help simplify their relationship with us. Clear & Simple provides tools that help customers manage their accounts and use those tools and therefore virtually eliminate the possibility of ever paying a penalty fee.

Also last year, after listening to our customers, we decided to make a major policy shift. As of March 1st of this year, we no longer use credit bureau information to initiate a reset of a customer's rate with us. We very much appreciated your announcement applauding our change, Madam Chairwoman. We believe that both in principle and practice, we share your concerns for consumers who use credit cards.

However, in order to avoid the unintended consequences of higher interest rates and decreased access to credit for consumers, we believe that great caution must be exercised in the process of turning these concerns into complex new legislation.

Even though Chase does not engage in a number of the practices the bill would prohibit—for example, two-cycle billing and bureau-based repricing—we do believe that the overall impact of the legislation would be to lessen our ability to price according to the individual risk profile of our customers, which is the bedrock of the competitive credit card industry today.

Study after reputable study, including those by the GAO, the Federal Reserve, and just last month by the Congressional Research Service, have concluded that the ability to measure and price according to individual risk has significantly lowered average interest rates and brought credit cards to millions of Americans who could not have gotten them 15 years ago.

While the bill has the admirable goal of protecting consumers, it seeks to do so through complex, expansive rules and restrictions that would micromanage the banks' ability to charge or change interest rates based on indicators that we know significantly raise a customer's risk of default. At Chase, for example, we know that 30 percent of customers who are late twice in one year will eventually default on their loans, an expensive process that raises cost for other customers.

Without the ability to mitigate risk, banks will have to reduce the number of people they are able to make loans to, depriving many families access to mainstream credit and possibly driving them to subprime markets where interest rates are exorbitant.

We believe that the Federal Reserve Board's process to put more information and greater control in the hands of consumers, combined with a commitment to ban practices that are unfair or deceptive, is preferable to the legislation currently under discussion, and

that Congress should let the Fed's process continue to determine its effectiveness.

In summary, let me quote Chairman Bernanke, speaking to the committee several weeks ago: "Onerous regulations that create reductions in credit availability unconnected with the issues of disclosure would be a negative in the current environment." That is our point.

We are concerned that this bill would reduce the availability of credit at the very time when Congress is doing all it can to increase credit availability and stimulate the economy.

Thank you very much, and I look forward to your questions.

[The prepared statement of Ms. Franke can be found on page 105 of the appendix.]

Chairwoman MALONEY. Thank you very much.

We have been called for two votes, and there are 8 minutes left in the vote. I did want to note that Chase did voluntarily incorporate some of the best practices that were in our Bill of Rights, and we congratulate you for that, and Bank of America, too, for those actions.

But we are going to break now for two votes, and we will be right back. Thank you so very, very much, and I apologize for this inconvenience.

[Recess]

Chairwoman MALONEY. The hearing will be called to order. Will the witnesses please take their seats, and we can resume in a few moments with Mr. Oliver I. Ireland.

STATEMENT OF OLIVER I. IRELAND, PARTNER, MORRISON & FOERSTER

Mr. IRELAND. Chairwoman Maloney, Ranking Member Biggert, and members of the subcommittee, I am a partner in the Washington office of Morrison & Foerster. I was an Associate General Counsel at the Federal Reserve Board for over 15 years. And I have worked on credit card issues since 1975. I am pleased to be here today to discuss H.R. 5244, the Credit Cardholders' Bill of Rights Act of 2008.

The current credit card disclosure regime has not kept up with the market. Recognizing this, in June 2007, the Federal Reserve Board proposed a comprehensive revision to the credit card provisions of its Regulation Z that address many of the issues raised by H.R. 5244.

In addition, the Board is exploring additional credit card issues under its unfair and deceptive acts and practices authority. It is premature to address credit card practices in legislation until these initiatives are completed, probably later this year.

The regulation of consumer credit is highly technical, and the risks from acting on inadequate information or simply imperfect drafting are significant. Unfortunately, I believe that H.R. 5244 reflects some of these problems.

H.R. 5244 may lead to increased rates and reduce credit availability. For example, H.R. 5244 would limit risk-related increases in APRs on existing balances, would prolong the payoff of these balances, limit changes in terms generally, and require 45 days' ad-

vance notice and an additional 90-day opt-out period for rate increases.

The Federal Reserve Board's proposal is far simpler. It would require 45 days' prior written notice before increasing rates that applies to both changes in terms and default pricing. These prior notices in the Board's proposal would give a cardholder ample opportunity to seek a better rate elsewhere.

In addressing double-cycle billing, H.R. 5244 appears to mandate grace periods that are not now provided for and to outlaw current interest rate calculation practices that are not considered to be double-cycle billing. Under the Board's proposal, double-cycle billing would continue to be disclosed in solicitations and account opening disclosures. If this does not fully address concerns, additional disclosures could address the issue without outlawing unrelated practices.

H.R. 5244 would require pro rata allocation of payments to balances that are subject to different rates, thereby discouraging low promotional rates that can help customers to change accounts when their rates on existing accounts are increased. Under the Board's proposal, credit card issuers would be required to make a new payment allocation disclosure for discounted cash advance or balance transfers. This disclosure could be broadened to other circumstances where different rates apply to different unpaid balances.

H.R. 5244 would require statements to be sent at least 25 calendar days before the due date, a 75 percent increase over current Regulation Z requirements. This would discourage grace periods or require higher rates to address lost income. The Board's proposal would improve disclosures on due dates, cutoff times, and fees for late payments, and therefore, I think, addresses the issue.

I think H.R. 5244's impact could go beyond consumer credit. Significantly, America's small businesses, which account for over 50 percent of the domestic workforce, rely heavily on credit cards. Over 77 percent of small businesses use credit cards to pay business expenses, and nearly 30 percent use cards to help finance their business operations. Not only is H.R. 5244 likely to affect rates and availability of credit for consumers, but it is also likely to raise rates and reduce the availability of credit for small businesses.

Finally, a significant source of funding for credit cards is derived from asset-backed securities. In an environment where market confidence has been shaken, any market perception that the risk profile of credit card receivables is changing could lead to a reduced access to this source of funding for card issuers that would require issuers to further tighten credit standards and raise rates.

Thank you for the opportunity to be here today. I would be happy to answer any questions.

[The prepared statement of Mr. Ireland can be found on page 108 of the appendix.]

Chairwoman MALONEY. Thank you so much for your testimony.

And our final witness is Ms. Porter.

STATEMENT OF KATHERINE M. PORTER, ASSOCIATE PROFESSOR, THE UNIVERSITY OF IOWA COLLEGE OF LAW

Ms. PORTER. Madam Chairwoman and members of the subcommittee, my testimony explains two key benefits of enacting H.R. 5244. First, it would provide Congress with timely, reliable, and complete data about credit card markets. Currently, such information is virtually nonexistent. The second focus of my testimony is explaining the innovative and important ways that this bill would empower consumers to responsibly use their cards.

As Members of Congress, you work to ensure that our laws promote sound financial behavior and encourage positive economic growth. Effective lawmaking about credit cards requires knowledge, yet Congress and other agencies have almost no information about the actual functioning of credit card markets.

Even the most powerful regulators or investigative agencies, like the OCC or GAO, cannot reliably answer basic, key questions about how American families use credit cards. How many households pay overlimit fees each month? What is the average actual interest rate charged to a revolving account balance?

Similarly, very little is known about the profit structure of credit card issuers. Without such information, it is impossible to guard against a credit bubble and to ensure appropriate underwriting. Congress cannot rely solely on the card industry, consumer advocates, academic researchers, or Federal agencies to provide the necessary data.

Such information will be at best only partially complete and at worst perhaps self-serving or unreliable. Without the legal mandate for data contained in H.R. 5244, Congress cannot fully understand and monitor credit cards, despite their powerful role in our economy.

This bill would dramatically improve knowledge by gathering data on the types of transactions that incur fees or specialized interest rates by measuring how many cardholders pay such fees or rates and by documenting how issuers earn their revenue.

Armed with such data, Congress and Federal regulators can monitor the economic wellbeing of American families and the financial stability of card issuers. Congress needs timely and comprehensive data to regulate effectively. Enacting H.R. 5244 would give you such information, allowing you to assess whether our credit card policies need further reform.

H.R. 5244 takes a moderate approach. At its core, this bill is about ensuring that consumers who try to use their cards in a responsible manner are able to succeed. It empowers cardholders to avoid default and to honor the terms of their card agreements. This bill would encourage responsible card use in at least three ways.

First, it would commit consumers to set a firm limit for their cards. Issuers would have to honor these limits, and could not charge an overlimit fee if they extended additional credit in contravention of a consumer's express desire. Helping consumers stay within their credit limits is a sound financial practice that reduces the risks to consumers and issuers.

The bill also limits issuers to imposing an overlimit fee only one time in a billing cycle. Issuers can manage their risk by refusing to authorize transactions that would exceed the bill. The law would

merely prevent companies from churning overlimit fees for profit if they voluntarily take on additional risk.

The bill also would reward consumers who do not overspend after exceeding the limit because such consumers could only be penalized for two subsequent months after initially exceeding a limit.

The bill also empowers consumers to pay their credit card bills on time by creating standardized billing practices. Consumers who have the means to pay on time and intend to do so should be able to succeed in that goal, and not be tripped up by confusing and varying rules. The bill proposes a uniform rule that payment is timely if received by 5 p.m., and would prohibit issuers from imposing a late fee if a consumer could show the payment was mailed 7 days before the due date.

The final way the bill promotes consumer responsibility is its requirement that the most vulnerable consumers pay the up-front costs of obtaining a card. Subprime cards typically have very low credit limits of $250. Half or more of this amount is normally subsumed with fees charged at account opening. An annual fee, a program fee, an account setup fee, and a participation fee are all common.

If such fees exceed 25 percent of the total credit limit, the bill would require the consumer to pay these fees before the card may be issued. This would prevent vulnerable, high-risk consumers from becoming trapped with an inappropriate card they cannot afford.

By empowering consumers to stay within their credit limits, by helping them succeed in paying on time, and by ensuring that consumers can afford the high fees of their cards, H.R. 5244 would promote financial responsible practices that would benefit everyone.

[The prepared statement of Professor Porter can be found on page 140 of the appendix.]

Chairwoman MALONEY. Thank you very much for your testimony. We literally just received an endorsement letter from the National Small Business Association in support of the legislation, and I would like unanimous consent to place it in the record, along with various newspaper editorials in support of the bill.

Thank you. Thank all of you. And one of the provisions—actually, Ms. Porter touched on it—that is in this bill that I like very much because it is simple and I believe it is very needed, as she testified, and it is the last provision requiring better data collection.

We have had trouble getting basic data. For example, I would like to ask the issuers and Mr. Ireland and anyone else who would like to comment: How much revenue do card issuers make from each of the billing practices that H.R. 5244 directly regulates? Would any issuer like to comment?

Mr. BAER. I will just say that I don't have that data.

Chairwoman MALONEY. You don't have it? Well, then, I think it is fair to ask, then: How can you say that the bill will have a negative impact on your profits if you don't have the data?

Mr. BAER. Chairwoman Maloney, I think our central concern with the bill is less directed directly to profits but more just the ability to put into practice the risks that we measure and see in

the marketplace. In fact, one could argue that the effect of the bill will simply be to change the way banks and issuers make profits. But our central concern is whether we can price for risk for customers who are exhibiting higher risk.

Chairwoman MALONEY. Well, does any other issuer have a comment on this, of having the data? No one? Mr. Ireland? Any academic? No one wants to comment? Mr. Ausubel?

Mr. AUSUBEL. The only comment that I would make is that the last time that I was privy to such things, Visa, the organization, collected such numbers, aggregated them over all issuers, and distributed it to their members, including Bank of America. The title of the document at the time was the "Visa Profitability Analysis Report," and it gave breakdown according to finance charges versus fees.

Chairwoman MALONEY. Well, thank you. Mr. Levitin?

Mr. LEVITIN. I do not have direct knowledge of the profitability of issuers for any of these practices myself. However, I would bring to the committee's attention that I recently saw a resume from a senior vice president at HSBC, and one of the lines on her resume was that she previously worked at MBNA, which is now part of Bank of America, and she had headed up their risk-based repricing initiative.

The resume boasted that this initiative brought in $52 million of net income before tax to MBNA. What I think is interesting about it is that this resume did not phrase this in terms of, we were just covering loss. Instead, this was seen as—this was being boasted as, I am making the bank more profitable, that this is a profit center rather than just hedging against risk.

Chairwoman MALONEY. Well, in response to Mr. Baer's testimony that they were just pricing for—looking at risk-based pricing. And I really would like to ask, based really on the testimony that you gave, Mr. Levitin, where you said that toddlers and pets are issued credit cards, and certainly many parents complain to many of us that their teenagers and college students are getting credit cards—but seriously, what evidence is there that pricing is based on risk and that it is done with any competence?

Senator Levin held a compelling hearing earlier this Congress in which he made a good case that credit card companies increase rates with no basis in fact. He had witnesses who had multiple rates from the same cardholder. And how do multiple rates for the same cardholder show any reflection of the risk of the cardholder?

Again, I ask any issuer or Mr. Ireland or any academic to respond.

Mr. BAER. Chairwoman Maloney, I would like to respond, I guess, to the toddlers and pets point, as I think it represents a fundamental misunderstanding of the difference between marketing and credit extension at issuers.

We send out millions of pieces of mail, obviously, in order to market our credit cards. We purchase lists in order to find out who we should be marketing to. That may mean that we end up sending a marketing solicitation, for example, to a toddler. Say, for example, a toddler signs up on the Carolina Panthers Web site as a fan. If we have a Carolina Panthers card, we may send that toddler a card, even more likely if the toddler lies about his or her age.

That is not to say, however, that toddler is ever granted credit. The toddler would have to send in an application. That application would ask for their age. And then once the application was received, we would check on that toddler's credit score. We would pull a bureau report, we look at their credit history, and we would see that they had no credit history.

So although that toddler or pet might get a mailer, there are really three reasons they would not get a card: First, because it is illegal; second, because they have no credit history and are unlikely to repay; and third, especially with the pets, we find that they have trouble pulling the cards out with their little paws.

[Laughter]

Chairwoman MALONEY. But then to the more serious point: How do multiple rates for the same cardholder show any reflection of the risk of the cardholder? That was a point that was made in the Levin hearing and other hearings, and that is made really by individuals to our offices.

Mr. BAER. I will let the other issuers have a turn as well. But I think that is reflective of the competition in the industry. A given customer might receive a better rate as a result of a promotion, which again we are trying to take market share from a competitor.

If the customer is part of an affiliate group—for example, a Panthers fan or a member of the National Education Association or a medical practice group—that affiliation might get them a better rate. So it is really a reflection of competition that we will offer different rates based on how someone qualifies for a solicitation. But I will let others talk as well.

Chairwoman MALONEY. Would anyone else like to comment before—

Mr. IRELAND. Just a short comment, Chairwoman Maloney. The analysis of risk is an attempt to predict future behavior, and that is necessarily imprecise. And I would be kind of surprised to see multiple issuers, for example, agreeing 100 percent on the risk of any individual person who wasn't in bankruptcy or wasn't, at the other end of the scale, in super-prime territory.

The question is not, it seems to me, whether that works all the time. The question ought to be: Is that a good idea, and should people be doing that? And I think, economically, pricing for risk is a very sound principle and is a key to market economies.

Chairwoman MALONEY. Well, the question was on the same cardholder having different cards with the same issuer with different rates. I guess another way of asking it is: What data do any issuers have to support the argument that repricing is based on risk? Anyone? Any comments from anyone?

Ms. FRANKE. I would be glad to respond to that, in that we would love to share with the committee, for furthering the education of everyone, the statistical probability that we see, which is difficult to discuss in detail here. But again, we would be more than happy to share that information that is indicated by the reasons that a customer goes into default with one of our credit card companies.

And we can assure you that there are indications that a customer is more risky, which will lead us to make a pricing change. And at Chase, we only reprice a customer now if they do not live up to the terms of their agreement with us. And we can show you

indeed that if a customer defaults on their agreement with us, that their risk has increased and that we need to take an appropriate price change to cover that risk.

Chairwoman MALONEY. Mr. Ausubel? And then my time is expired.

Mr. AUSUBEL. The point that I think is worth emphasizing is that there is no reason under economic theory that you would expect that the issuer is simply going to assess the exact amount of extra risk and then price equal to that amount.

Suppose you have a customer whom you believed had a 5 percent extra probability of default. But suppose your model told you that you could raise their rate by 10 percent and they probably wouldn't leave you. Then you will do it. They are not interested in simply coming up with the number and then setting their price equal to the cost.

Chairwoman MALONEY. Yes. That was the point that was made in Ms. Warren's testimony earlier.

Would you like to augment?

Okay. Ms. Biggert.

Mrs. BIGGERT. Thank you, Madam Chairwoman.

I would like to continue a little bit on this risk issue. Let's say we have—and maybe, first of all, Ms. Franke, because you said you don't include FICO scores or anything as far as looking at somebody's credit. But let's say somebody has had a card with one of the issuers for a long time.

One of the cardholders has an income of $45,000. They have just defaulted on a car loan. They have defaulted on three other cards. And they have not paid their mortgage in 3 months. And the other person has maybe—could be the same amount of money, but let's say they have a higher income and they have one card, and they always pay the full balance on time.

Do you think that the risk of the customer paying back the card, the one who has defaulted and had all the problems, do you think that risk stays the same? Does it go up, or does it go down?

Ms. FRANKE. We would believe that risk was greater with a customer who has indicated a difficulty in meeting their obligations.

Mrs. BIGGERT. But you are saying then that that should not be taken into account, whether to raise the interest rate?

Ms. FRANKE. We are saying that at Chase, we believe that the best way for us to deal with our customer is to limit our pricing actions to those things that the customer understands would cause them to be in default with us. And that is missing a payment, exceeding their credit limit, or writing us a check that does not have sufficient funds.

I do believe, however, that as a statistical indicator, that risk would be increased if someone is significantly in default on other obligations.

Mrs. BIGGERT. But you would just keep them on the—as long as they paid your card, there is no—

Ms. FRANKE. That is correct. At Chase we believe that we can adequately manage the risk based upon their behavior with us.

Mrs. BIGGERT. Okay. Mr. Ireland, would you comment on that?

Mr. IRELAND. Well, I would like to go back just a moment to Congresswoman Maloney's example because it shows, I think, part of the difficulty with the bill.

If I am a card issuer and I give multiple cards to the same person and my system is working right, I ought to be charging them the same rate on different cards, I think. I think the way the bill works, as I read the language of the bill where you make changes going forward based only on the performance of that account, that the bill would actually create a situation where it is much more likely that you would be charging the same cardholder different rates on different accounts because you couldn't consider the performance in another account for the individual account. And to the extent that is viewed as a problem, it aggravates that problem.

Mrs. BIGGERT. Thank you.

Mr. Baer, what would you do with do with the two separate cases?

Mr. BAER. Sure. I think it is worth noting here that, again, there are two different ways where customers primarily get repriced. One is through trigger-based default repricing. At Bank of America, we will only do that based on two types of events, late or overlimit, not bounced check; and we will only do it, again, if they do it twice within a 12-month period. And even then, we do an individualized risk assessment.

But I think it is fair to say that is how most people get repriced across the industry, is by default repricing. We also—and this is one of the reasons we can be more forgiving with respect to default repricing—we also do look at someone who is, as you described, defaulting to other issuers.

Again, 94 percent of our customers for 2007 ended up with a lower or the same rate as at the beginning of the year. But there were a percentage of customers—I think it was actually 2 to 3 percent—who we risk-based repriced because of behaviors such as defaulting with other issuers, maxing out their credit lines.

Again, we hesitate to do that because this is a competitive market and we don't want to lose customers and they don't like it. But in those cases, we feel there is genuine risk that merits that repricing. And I think to Ms. Franke's point, I mean, our numbers show that if you identify that group of people with those risks, they actually default at a 50 percent higher rate than our average customers.

So that again to us demonstrates the predictability of the models and the fact that this is legitimate risk-based pricing.

Mrs. BIGGERT. What about the customer who always pays the minimum balance, never pays off any of it? Doesn't that exponentially raise the—well, the monthly payments go that it compounds interest at such a high rate that eventually they are just going to run into their credit limit.

Mr. Baer?

Mr. BAER. First let me stress that is an unusual case. I think we have looked at our numbers, and we have only about 1 percent of our customers who are paying only the minimum payment for, I think, 6 months in a row. So that is very unusual behavior.

And I think most of our customers—in fact, you could say 99 percent of our customers—understand that the responsible way to

manage credit is not just by making the minimum payment every month. So that is certainly a risk flag.

But I think when you look at the way that we model, it would be unusual for someone—perhaps even rare—for someone to be repriced on a risk basis solely because they are making minimum payments. It is generally going to take a lot more than that.

Mrs. BIGGERT. Would you be happy if the Fed acts to solve the issues of concern? Does it matter to the issuers whether the regulators make changes or Congress?

Mr. Ireland?

Mr. IRELAND. Well, my experience is that in technical areas like this, the regulators will go in with a scalpel and do it more precisely and with less error. And I think one of the debates that has been going on here is how to separate out what some people consider inappropriate practices from dealing with legitimate risks. And I think that the regulators have—are better equipped to do that than the Congress is.

Mrs. BIGGERT. Ms. Franke?

Ms. FRANKE. We believe that the regulatory process should be allowed to continue, and that it will accomplish a great deal of what the legislation is attempting to accomplish.

Mrs. BIGGERT. Mr. Finneran?

Mr. FINNERAN. Yes, Congresswoman. We agree that the Fed has all the power. And in fact, they are three-quarters of the way through addressing a lot of these issues in their proposal to revamp the disclosure rules on Reg Z. And again, with the latest comments by Chairman Bernanke, they are going to take it further and consider taking action under their unfair and deceptive acts and practices authority with respect to some of the problems that we have been talking about here with the committee.

Mrs. BIGGERT. Mr. Baer?

Mr. BAER. The same.

Mrs. BIGGERT. And Ms. Warren, would you think that could be solved by regulation?

Ms. WARREN. Well, the problem is, I think, as we heard, they haven't regulated. If you have regulators whose principal responsibility is to ensure the profitability of the banks rather than to protect the customers, then we end up with the circumstances we have that Chairman Frank started with.

And that is we don't hear the words "consumer protection" spoken by a Federal Reserve Chairman for just about 27 years. And I don't think we can afford to go another 27 years of letting the banks make up the rules on what kinds of credit card practices they want to engage in.

Mrs. BIGGERT. But when he said in the testimony this time, it was consumer protection.

Ms. Porter?

Ms. PORTER. I would just echo Ms. Warren, that he said consumer protection. And he may be the Federal Reserve Chairman for another year or 2 years or 3 years or 4 years, but our Congress is charged with making laws that endure and stand the test of time, and with balancing the rights of consumers and regulators.

The Federal Reserve's primary responsibility is to ensure the stability of the banking system. I am glad that Chairman Bernanke

is going to also embrace, for the first time in basically my lifetime, the obligation to use the unfair and deceptive practices authority.

Mrs. BIGGERT. Well, these regulations will be out at the end of this year, so I think that will be an issue that will be taken care of by then.

I yield back.

Chairwoman MALONEY. Mr. Watt?

Mr. WATT. Thank you, Madam Chairwoman, and thank you for this hearing because I think this is a complicated area and the need for hearings on the bill extremely important.

Let me just deal with one thing about the variation changes in payment dates, particularly for people like me who pay bills only once a month. When somebody changes my payment date, it is a major, major problem.

Is there some business justification for that? I think all three of the representatives of companies here testified that your company doesn't do it. That is a different question. But is anybody prepared to make a business case, a justification case, for being able to just change a payment date?

Mr. BAER. I guess I would make more of a calendar case than a business case. For us, as I understand it—and this gets down into the weeds—we basically try to keep a 30-day cycle. But it is—and it ideally would be the first business day of one month to the first business day of the next. The problem arises, though, that you have Saturdays and Sundays, and we don't have them come due on Saturdays and Sundays. Same for holidays.

So depending on what month you are in, how many days there are in the month, depending on how many holidays there are in that month, it is going to move around a little bit. But we certainly don't try to move it around—

Mr. WATT. I understand. That is not the question I am asking. I am asking, is there some real overwhelming business justification for having the right to change a date, a payment date, arbitrarily? Well, "arbitrarily" is a bad word, but to change a payment date?

Mr. BAER. Again, I think the only reason our payment date would move around, other than as you might expect it, is for the reason I have given. But otherwise, we don't do that.

Mr. WATT. All right. Let me see if I can zero in on this Visa report that Mr. Ausubel talked about.

What year did that cover? Do you remember?

Mr. AUSUBEL. It was getting published annually, and it may still exist.

Mr. WATT. So is that something you could get access to and provide to the committee to help us evaluate the relative benefits that are coming from late payment fees or other kinds of fees versus interest rates?

Mr. AUSUBEL. My assumption is that you would have to make a formal request to a bank that is a member of Visa or a request to Visa itself.

Mr. WATT. Bank of America is a member of Visa. So is that something you all could get access to and provide to the committee?

Mr. BAER. I don't know about the particular report, but we are certainly happy to work with the committee and get that kind of information if it is available.

Mr. WATT. On this issue of fees versus rates, the obvious appearance to the whole world is that the credit card industry, everybody in it, is making a lot of money on fees versus rates. Is that the case or—I mean, you know from your own personal bank's experience surely how much you are making on fees versus actual interest, don't you?

Mr. BAER. Yes. No, I don't know the exact—

Mr. WATT. I am not asking you the exact amount. But you are making a profit on late fees, aren't you?

Mr. BAER. Actually, if you look at the amount that we gain in late and overlimit fees, it is a fraction of the amount that we lose in credit losses. So our late and overlimit fees are—I'm just guessing—

Mr. WATT. But credit losses are supposed to be priced by interest rates, aren't they?

Mr. BAER. Well, that is what I am saying, is—

Mr. WATT. I mean, isn't that the risk-based that—am I missing something here? The risk-based analysis is supposed to get you to a rate that covers credit losses. Isn't that right?

Mr. BAER. Exactly, Congressman. What I am saying is that the late and overlimit fees are not sufficient to cover our losses. That is why we rely upon interest, including risk-based interest, in order to recoup those losses and earn a reasonable risk-adjusted—

Mr. WATT. I guess the question I am asking is: Should you be relying on late payment fees to cover those before you are relying on interest rates? You are saying you rely on interest rate adjustments to cover those losses because late payment or other fees don't cover them. Shouldn't it be the reverse, I guess is the question I am asking.

Mr. BAER. Well, and again, this speaks to the competitive market. I mean, it would be nice to be able to rely, for example, on annual fees. But what our customers show is that they don't like high late and overlimit fees, and they will change issuers if we charge them. So that is why we tend to rely more on interest. There may be other dynamics at work, but I think that is one.

Mr. WATT. My time is up—5 minutes goes so fast—and I have a whole list of questions. But I will yield back.

Chairwoman MALONEY. Mr. Ausubel had his hand up. Did you want to make a comment on his testimony?

Mr. AUSUBEL. I think, to give a fairly direct answer to the questions that Mr. Watt was asking, there is no doubt in my mind that issuers have erected an array of policies meant to induce consumers to accidentally miss payment—for example, delaying the mailing of statements, and giving a fairly short time for them to send checks in.

I, myself, was subject—I paid a bill one day late last month and was assessed a $38 late fee and a finance charge of around $40.

Mr. WATT. I think that has happened to every single one of us at one time or another, including myself in the last month. So I don't think there is any dispute about that, which is one of the things that troubles people. And it was as a result of a change in the payment date. That is what is troubling to people, I think.

So I personally don't have any problem with assessing risk and charging interest based on that assessment of risk. But I think

what is troubling here to a lot of people is that the interest rate that is being charged is really not reflective of anything any more because, to the extent that risks are being covered, they are really being covered, as Mr. Baer said, primarily by late payment fees rather than having an interest rate that factors in the actual risk that is being taken.

So I am sorry, Madam Chairwoman. I had already yielded back.

Chairwoman MALONEY. I thank the gentleman. That is an important point, and as you know, the bill sets a specific pay date and a specific time so that people will not be tripped up in the future.

Mr. Castle?

Mr. CASTLE. Thank you, Madam Chairwoman.

Let me start by asking for unanimous consent to submit a chart that shows revenues and profits of credit card issuers and a card industry directory for $100 credit card assets. And this was done in October of 2006. It reflects 2004, and it is GAO's, "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," sort of in response to your earlier question about some of the numbers which I have. You may want to examine it.

Chairwoman MALONEY. Without objection, it is so ordered.

Mr. CASTLE. This is sort of an unusual panel as I sit here and listen to you and read your testimony. Unfortunately, I had to be out while most of you spoke. Generally speaking, the banking institutions represented here seem to have much better practices, if not excellent practices, in this area, and perhaps some of these changes we are talking about have already been made by many of your institutions.

There is some disagreement about the best methodology of regulating, and I am going to try to examine this because I am concerned that we are jumping ahead of both Regulation Z and the unfair and deceptive practices policies which the Federal Reserve is getting ready to make public in the next couple of months, at least according to what Chairman Bernanke told us when he was here.

I tend to agree with what Mr. Ireland said, that regulators may balance interests more precisely and are better equipped to do it than we are on some subjects. I worry about broad legislative proposals when perhaps a better way to protect consumers could be done by regulation in a more precise way.

So let me just start, Mr. Ireland, by asking you: Does the Federal Reserve Board have sufficient authority to rewrite card disclosures to address current concerns?

Mr. IRELAND. Yes.

Mr. CASTLE. And Ms. Porter, you mentioned that you are concerned this has gone on for years without regulation. I think we all share that concern. I don't think anyone up here thinks that we shouldn't be doing this. It is a question of how we are going to do it.

But have you factored in that they are looking closely at Regulation Z and what they have said about the unfair and deceptive practices at the Federal Reserve?

Ms. PORTER. I think that it is possible that a Federal regulator could attempt to correct many, although not all, of the practices covered in H.R. 5244. But those regulations are more easily

changed, and the fundamental focus of the Federal Reserve has not been on ensuring consumer protection.

And indeed, the Federal Reserve, unless it acts—has authority to supervise certain kinds of banks. But it also has authority to implement Regulation Z. But its past actions for the last 30 years have emphasized disclosure, disclosure, disclosure. And many of the provisions that H.R. 5244 would ban are not related to disclosure.

Mr. CASTLE. Well, you can't—I mean, I would imagine, like me, you would like to see all this before we go too far. I mean, I just—you may be right about what you are saying. I don't know. But I am sort of curious as to what is going to be in Regulation Z and what is going to be in this unfair and deceptive practices report that they are going to give so we can determine if what you are saying is correct. It may well be, but I think that is something that we need to do.

Mr. Ireland, can the consumers avoid the fees that many have complained about here today?

Mr. IRELAND. I think generally the answer is yes. If the consumers understand their accounts, pay attention to their accounts, and deal with them carefully, I think they can avoid the fees. I personally cannot recall incurring one of those fees, so it is at least possible for somebody to do that. And I charge on my credit card in preference to any other means of payment because of additional rights I get in terms of claims and defenses under the Truth in Lending Act.

Mr. CASTLE. Did you say you personally can't recall incurring any of those fees just now?

Mr. IRELAND. That is correct.

Mr. CASTLE. You are probably the only person in this room who hasn't incurred any of those fees somewhere or other.

The credit card industry believes that the legislation before us, as I understand it, is inflexible and micromanages things in a way that is likely to increase interest rates for everybody else and reduce the availability of credit.

Could any of the credit card companies indicate specifically what you are concerned about?

Mr. FINNERAN. Yes. There were several provisions, I think, that were mentioned in our various testimony. One was redefining the grace period, which extends for all consumers an interest-free period where there would be no interest at all charged with respect to the loans that are made under credit cards. This changes the existing practices quite dramatically.

I believe another provision was the requirement that payments be allocated in a particular order, which again is a change from most of the practice and indeed something that at least we have found that consumers fully understand and have shown themselves capable of taking advantage of many of the offers that the competitors in the marketplace make.

And I believe Mr. Ireland had a few other provisions that he mentioned as well.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. CASTLE. Thank you.

Chairwoman MALONEY. Unless, Ms. Franke, did you want to make a comment on this?

Ms. FRANKE. I was just going to make one comment, which was I would like to add to the point of the consumer enjoying the benefit of low rate offers that we do today through what we call balance transfers. And I do think, if we are not permitted to allocate those payments to the lowest rate, you will see those offers eliminated in the market. And we would be able to tell you that the consumer would be very disappointed if that were to happen.

Mr. CASTLE. Thank you. Thank you, Madam Chairwoman.

Chairwoman MALONEY. Mr. Ackerman?

Mr. ACKERMAN. Thank you, Madam Chairwoman.

This whole thing is really a real mess. And the comfort level of consumers is not improving any, from what I can see, except for some people maybe around the margins, depending on which credit card company they might be dealing with.

But one of our colleagues who expressed some concern earlier in saying that he was concerned about supporting this legislation because it would—and I will quote him—he said he "feared too many Americans would be denied credit" if we reined in some of the vagaries and uncertainties that consumers face fathoming this.

To quote the Pope when he spoke at Gdansk to the boatyard workers, "Be not afraid." They will find you and they will give you credit. If you can't afford a house, if you have lost your job, if you can't verify your income, there are people marketing that they are going to buy you a house if you sign on the dotted line.

There is no way that you are not going to get offers of credit. Last calendar year, these are solicitations to me and my wife. That is last calendar year. At the end of the year, we moved. I can't tell you what that does. But one of the things it does is it triggers everybody—as soon as you pay off a mortgage or apply for a new mortgage, every credit card company sees you in the crosshairs and you start getting more and more notices.

I don't know how they found us so quickly. I couldn't change my address on the GPS, and I got to the mailbox at my new place and I had credit card offers up the wazoo. The interesting thing is I get some and my wife gets some, sometimes from the same institution, offering us different rates on identical word for word until you get to the rate part. And if we are both on the hook for the same card, I don't know how that works.

My mom has been gone for 10 years. They found her now at my new address, and you should see: Her credit rating is better in the past couple of years than it was for her whole entire life, there are so many offers.

And if you take a look at the confusion that these things have, it is absolutely astonishing. I mean, you could pick one out of the pile and read the back of it, with asterisks and swords and notes and crosses and everything else you could imagine. And you could actually read it verbatim one night at the comedy club and walk away with first prize. It is astonishing.

It is a time for raising hands, I guess, earlier in the meeting. And I mean, there are people—I try to understand these and I try to read it to see if there is a good deal because I like a good deal when I can get one. I don't find it very often.

But sometimes it is hard to understand what I have to pay in these great deals that are advertised all over the envelope in 12

different colors and things. And the zero is always the biggest thing on the thing, both on the envelope and in iridescent colors and what have you.

But to figure out what it means and to find out what you are really paying is befuddling. Even if you are a Congressman who has been elected 13 times, are on the Financial Services Committee, taught mathematics, was an investigative reporter, and thought he was an educated consumer, not knowing half as much as any of you on the panel, can't figure out in 5 minutes what he would be paying if he borrowed $1,000 on a promotion that ended in 3 months, except if you paid one of the checks that they give you with your name already printed on it so it is really easy to get into this thing.

And then you take out a cash advance a month later on the same $1,000. You pay half of it by the date the thing expires. With category A, B, C, and D on the back, how much in real interest would you be paying if there is a 3 percent transaction fee up front?

And if any of you sitting there are representing a credit card company, I have your notice in here because I read who you are. So everybody is represented and then some. So if anybody would answer the question that I just posed, I will bring the pile to you, pick out one. You can use a calculator and tell me, at the end of 13 months, what your real interest rate would pay or how much in dollars you are paying. You have the balance of my time. Anybody?

Mr. LEVITIN. I can't tell you the balance. But you know what? It doesn't matter because even if I could calculate that, there is probably an any time/any reason term change in there.

Mr. ACKERMAN. Yes.

Mr. LEVITIN. That means whatever I calculate could be wrong.

Mr. ACKERMAN. So even if you were a much better consumer than me or any other consumer and really understood the legality, the fact that they all say, for any reason, if you didn't pay—if you defaulted on your Sears card and didn't pay for your socks—that is not stocks; that is socks—that your whole life starts to change on all the credit that you have been issued that you have ever had and all the cards that you had.

So it really doesn't matter because any time, any place, anywhere, and for almost any reason, as long as you get notified—and notified, my goodness, what we have done requiring notification and privacy. You get three or four notices for each one of these every year as to the privacy. You can't keep up with the reading. And your eyesight doesn't get better.

It is a real mess. The question I have, and everybody seems to think that for the most part, Regulation Z is a good thing—the question is: What good is all this disclosure if all the disclosure does is tell you the ways that your credit card company can screw you, but it does it in bolder print or puts it in a box? What good is the disclosure? Anybody?

Chairwoman MALONEY. Any comments?

Mr. ACKERMAN. We need more witnesses or I will yield back the balance of my time.

Ms. FRANKE. I would say that the disclosure—

Mr. ACKERMAN. I am sorry. Pull your microphone over.

Ms. FRANKE. Excuse me. The disclosure helps the consumer to make an informed decision. It is a highly competitive industry. The disclosure will allow the customer to understand what product they are buying and what features they want to select.

[Laughter]

Mr. ACKERMAN. People are chuckling up here and back there. It seems that the disclosure is a further attempt to obscure and obfuscate what you are trying to figure out.

Chairwoman MALONEY. And they always have the any time/any reason tied to it.

Mr. ACKERMAN. Mr. Ausubel?

Chairwoman MALONEY. Okay. Mr. Ausubel, and then we must go to Mr. Garrett.

Mr. AUSUBEL. Another example that would support what you are saying is double-cycle billing. As I understand it, there are proposals—

Mr. ACKERMAN. I paid one payment 2 months ago, left New York, came back to Washington, and had to race back home because my wife said we had another bill and it was going to be late.

Mr. AUSUBEL. There are these proposals to disclose better double-cycle billing. Now, if you are going to do your hand-raising question, how many people could sit down with a calculator and compute double-cycle billing? Or, for that matter, how many people really know what double-cycle billing is in the United States? What good would disclosing do?

So my read of the regulatory history is that the regulators have been lax in enacting consumer protections except under the threat of legislation. So if I am hearing now that some regulations will be promulgated under the threat of legislation, it tells me you need legislation.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. Garrett?

Mr. ACKERMAN. Let me just say something. I didn't mean to embarrass anybody here or any of the companies because you are among the better that are represented. Thank you.

Chairwoman MALONEY. Thank you.

Mr. Garrett?

Mr. GARRETT. I thank the panel and I thank you for the opportunity.

Just on the closing notes over here, I presume, just as in your contracts there is any time/any reason that you may make those changes, there is an any time/any reason that I as a customer can just void this contract—or not void this contract, but pay my bill and, in essence, be out of it.

But again, as I said at the very beginning, I appreciate your testimony. I really have found it all interesting from all sides. Mr. Levitin, I really found yours quite interesting. I will be reading through it a little more so I can follow it all. But everyone here, I do appreciate it.

This issue here with credit cards is really part of a larger issue that I referenced before, and that is the overall economic issue and the recession and the problems that we face right now. So I am going to digress for just a moment to face that larger issue. And we have Mr. Baer here that I want to throw out this question from.

We are having a tougher time with credit markets and toughening in the credit lending in general. Can you give me your thoughts, your two cents, if you will, on the potential for banks to issue something called covered bonds to address this issue?

My understanding is this is something that is already going on over in Europe. It is akin to what we do over here with the GSEs. It might be a way to open up some of the market and provide more flexibility and get the credit going again. And it does so, if I understand it correctly—and I will close on this—it does so in a way that keeps it with the banks, keeps more adjustability by the banks, and keeps the capital requirements there with the banks, if I am understanding it correctly. But correct me if I am wrong.

Mr. BAER. Sure, Congressman. I think you have it correct. Covered bonds are actually a $2 trillion market in Europe. They are a primary, maybe the primary, means by which mortgage finance is financed in Europe. Yet in the United States, there have only actually been two issuers, we being one of them, who have gone to market. And there is a legal, almost technical legal obstacle, which I will get to.

Mr. GARRETT. Yes.

Mr. BAER. But basically, the way cover bonds work is it is issued by a bank under its own name, so in that way it is like straight corporate debt. However, in the event that the issuer fails, there is a cover pool of mortgages that stay on balance sheet but that are identified as collateral in the event of failure.

That makes this a very high credit quality issuance because you not only have the bank's name but then, in the event of default, you have the cover pool. It is important to understand it is different from asset-backed securities because with an asset-backed security or mortgage-backed security, you are looking to the underlying mortgages to generate the cash flows. But here you are looking to the bank to make the payments just the way it would on corporate debt. And you are only looking at those mortgages in the event of insolvency.

Furthermore, unlike ABS, the issuer is required to refresh that pool of mortgages and always keep current, non-prepaid, non-defaulted mortgages in that pool. So it is a very high credit quality issuance.

The only obstacle that we have seen to a large, potentially huge market in the United States around this is the question about what happens in the event of an issuer default, particularly with respect to a 90-day automatic stay that occurs in the event of a receivership in the United States.

This question is largely up to the FDIC, and I know Chairman Bair has indicated that she is taking the lead in looking at this issue. I think other regulators—I note Secretary Paulson mentioned it today—have also looked at it. But we understand the FDIC has this under advisement and is considering whether some guidance in this area would potentially yield a potentially very large source of credit for mortgages.

Mr. GARRETT. Okay. At the beginning of your comments, there were impediments to implementing going forward with this. It is over at the FDIC. Is there anything that we need to be doing—first, doing what we are doing here, having a hearing on it in more

detail? And second, is there something congressionally, legislatively, that we should be looking at, or is that just all over there?

Mr. BAER. Well, in Europe, and I think as of this month in the U.K. to the extent it is not part of Europe, there is a legislated covered bond program that is—these bonds are issued pursuant to legislation which the market takes as a good associate that they will continue to receive payments in the event of a default, that is, during the resolution of the institution, and that they can still look to that mortgage collateral.

The FDIC could, and may want to just as an initial step, issue regulatory guidance on that. They have a fair amount of discretion. I won't speak for them, but they could certainly tell you some discretion about how they would act during an automatic stay period.

So it may be they want to take a regulatory step before a legislative step and then decide how much legislation is necessary. But I would defer to the FDIC with respect to those judgments.

Mr. GARRETT. And I know we have other—this is a little bit far afield, but it is still on the credit issue. There are other economists and professors here as well. Is there anyone else that has a thought on it? And if not, I appreciate your insight.

I see the chairman is not here. But does this chairman appreciate consideration for a hearing at some point on the topic? And there is that red light. Thank you. I didn't get into my other—I may submit some other questions that I do have for a couple of people. So thank you.

Chairwoman MALONEY. Thank you. The Chair recognizes Mr. Sherman, Congressman Sherman.

Mr. SHERMAN. Thank you, and thank you for putting forward this bill.

I know that there is this kind of Ayn Rand model of the universe where you have two equal parties free from government control negotiating their independent contract. The problem you have here is that on the issuer's side, you spend about $5 million—I am making up a number—to do the legal research, to figure out your position, and to program your computers.

And then the consumer spends about 25 minutes of time trying to figure out which credit card to use. And if we were to value the time the consumer can put in by their billing rate as a bookkeeper or whatever level of financial experience they have, you may have $5 worth of time being invested. And then we are told, well, this is an equal bargain, one side putting in $5 million worth of transactions cost, the other one putting in an amount of time worth about $5.

The banks have put forward the idea that somehow, these oppressive provisions—and there are oppressive provisions in some of these contracts—benefit other consumers because while rates would be higher—

Chairwoman MALONEY. Excuse me. Congressman, can you take the chair? I am going to run and vote and keep the hearing going so that we can conserve time.

Mr. SHERMAN. Okay. Sure.

Chairwoman MALONEY. Thank you so much. We have been called to one vote, but we are going to keep going.

Mr. SHERMAN. [presiding] So the theory is that I won't be the victim of some sort of rate increase and that I will be the beneficiary of it because you will give me lower rates.

Can someone tell me what is the average rate of interest imposed today on those who have balances on their credit cards? I mean, I tend to see it as between 15 and 20 percent. Do we have a different number?

Mr. FINNERAN. I think the GAO report that was issued about 18 months ago, I believe the figure was somewhere in the 12 percent range.

Mr. SHERMAN. The 12 percent range? So it is—oh, I didn't see you there.

Ms. PORTER. I would just respond that the GAO report was issued 18 months ago, and I think it is important that Congress and regulators have more up-to-date information than that; and also that the GAO report relied on voluntary disclosures of only select issuers and may not be representative of the entire industry.

Mr. SHERMAN. Yes. I have seen an awful lot of cards being issued at over 25 percent. Yes?

Mr. LEVITIN. I believe it is also important to note that the GAO report, I believe, did not include subprime issuances in its population. So the number is probably inflated.

Mr. SHERMAN. In any case, it is hard to say that America's consumers are somehow benefitting from wonderfully low rates because a few of their friends may be paying more into the system as a result of some these oppressive provisions.

One thing that isn't in the bill that I am thinking of suggesting to the author is the idea that every credit card statement on which there is a balance should disclose: "Dear consumer, if you make the minimum payment, you will be paying this balance off for this amount of time, and you will be paying not only the principal amount of X but a total interest of Y. So this is how long it will take you, and this is how much interest you are going to pay us—assuming we don't change the rate—if you choose to just pay the minimum balance."

Does anybody have a comment on whether that should be included at the bottom of each statement? Yes?

Ms. WARREN. Congressman, yes, I do. I think consumers want this. I think one way we know this, that we have seen it tested, is the State of California passed a law requiring precisely this. And I think it gives us an insight into now our regulatory agencies in Washington have worked.

Not only did the banks come in, the credit card issuers come in, and ask that the bill be overturned, the grounds on which they wanted it done was that any attempt to require them to disclose any information about whether or not—how much it would cost a consumer if they financed over time was preempted.

And the OCC came in not on behalf of the consumers but on behalf of the credit card issuers to take the position that their nonrequirement of information be the standard for requirement. And the Ninth Circuit Court of Appeals bought that argument.

Mr. SHERMAN. It is rare that the Ninth Circuit—every other circuit would have probably ruled that way. I am surprised at the Ninth. But I will point out it does make sense to have a single na-

tional rule. It is either good for consumers in California and Texas, or it is bad for consumers in California and Texas.

And what California was responding to was the total failure to have good national standards. I mean, I am sure there are quite a number of witnesses who could explain how burdensome it would be to have 50 different standards of this. But sometimes California feels the need to act when the Federal Government doesn't, perhaps even on greenhouse gases. But that is a different issue.

I believe my time has expired. Please proceed.

Mr. HENSARLING. Thank you, Mr. Chairman. Although I have only been here for about 6 years and not 10 or 15, I can't help but note the irony of how people are decrying the excess amount of credit offerings that exist in America today when I know, I know in this very room, 10 to 15 years ago, many of these representatives of credit card companies were hauled before Congress because they weren't giving enough credit out to low- and middle-income Americans. And I do wish to note that irony.

As I look at the historical record, I see where there was a significantly fewer number of Americans who had access to credit, and they seemingly paid a universally high rate before the advent of competition and risk-based pricing.

I also note that approximately 20 years ago, the fringe benefits that we see today weren't around. I know today that I have the opportunity to get different rates, different fees, cash back, car rental insurance, donations to my favorite charity, frequent flyer miles, and, if I pay my bill on time, I get an interest-free, unsecured loan from the time of purchase. Such a deal.

The first question I have is—and anybody who has the answer, I would be happy to hear it—how many customers paid the highest interest rate 20 years ago, and how many pay it today? Do we have anybody on the panel who has knowledge of that?

[No response]

Mr. HENSARLING. If not, we will move on. How many customers might have paid no transactional cost last year? I would even be happy with a ballpark figure. Any takers on that one?

[No response]

Mr. HENSARLING. I apparently seem to be stumping the band at the moment. Let me move—yes?

Mr. LEVITIN. On that one, I may not be giving you exactly the figure you are looking for, but I can say that I have seen data that says about 39 percent of consumers did not consistently revolve a balance over the course of 2006.

Mr. HENSARLING. So a little less than half, then, would be your best recollection. Thank you.

I know that, not unlike a balloon, when you push in on one side, something pushes out on the other side. When I look at—I must admit, philosophically I have trouble with telling informed consumers, assuming there is proper disclosure, that somehow we are going to outlaw consensual commercial transactions.

But when I look at history before the advent of risk-based pricing, and I look at where we are today, it seems to be a far improved industry. But I notice that in the U.K., they seemingly have had a similar experience. In 2006, they decided that credit card de-

fault fees were too high and ordered card issuers to cut them or face legal action.

In February 2007, two of the three largest issuers in the U.K. promptly imposed annual fees on their cardholders. Nineteen card issuers have raised interest rates. And by one estimate, credit standards are now so tight that 60 percent of new applicants are being rejected.

Well, if it happened there, it seems to me that it can happen here. Would somebody on the panel like to tell me why we are not going to have the U.K. experience? Or does somebody fear the U.K. experience? I have very few takers on the panel today.

Ms. WARREN. No, Congressman, I would be glad to. Part of what you have to remember here is that they don't plan to lose money on this. Why do you think credit card companies give zero balance transfers? It is not because they are in the business of giving away money. They give zero balance transfers because they count on the fact that there will be some number of people who won't get it right.

And that is, they will use that credit card after they got a zero balance transfer. They will get dinged at 22 percent interest. And every payment they make that goes into it will be paying down the zero balance transfer.

Those are profit centers for the issuers. They are not good deals for the customers. I would—

Mr. HENSARLING. Well, I hope they are profit centers. I don't know—

Ms. FRANKE. I would like to respond to that.

Mr. HENSARLING. Certainly, Ms. Franke.

Ms. FRANKE. Because the consumer has the ability to make the choice as to whether they want to take low cost credit or not. When the consumer makes the decision that they want to take advantage of a low cost credit offer, it is to their benefit. And in the vast majority of instances, they are able to enjoy that opportunity.

We want the consumer to be able to benefit from those things that we put in front of them. And I think that if we were not able to do that any longer because we were restricted in our ability to price for risk, you will indeed see two things happen, an increased cost of credit, and reduced access to credit to those people who need it most.

Mr. HENSARLING. With 6,000 credit cards out there, I assume if I don't like my terms, I can reject the terms and I can go and pick up somebody else's credit card.

Ms. FRANKE. That is exactly correct.

Mr. HENSARLING. I see I am out of time. Thank you, Mr. Chairman.

Mr. SHERMAN. Thank you. I will point out that all those freebies you get on the credit card aren't completely free. The merchants end up paying for those. And I just want to inform this committee that the Judiciary Committee is thinking of hearings on the other side of this transaction, which is the relationship between the merchants and the credit cards. Maybe this committee wants to get ahead of that or maybe you want to have them take over because we don't really care about our turf. We will see.

With that, let me turn it over to Mr. Moore to ask his questions and to serve as temporary chair.

Mr. MOORE. [presiding] Thank you, Mr. Chairman. And I have just one question to ask, and then I am going to have to go vote. I understand Chairwoman Maloney is on her way back and should be here soon, but I would like to hear your answer, if you have an answer, to this question.

A question for the credit card issuers on the panel with regard to what is called universal default: I understand that some issuers have voluntarily banned the use of an individual credit score in repricing a card account. As you know, the underlying bill attempts to ban the practice of universal default by restricting the ability of credit card issuers from raising interest rates based on any information other than how the individual is performing on that particular card account.

I do have concerns about the lack of clarity that consumers often receive regarding account features, terms, and pricing, and I think we need to examine how to do a better job of ensuring that consumers don't get caught with unexpected fees or rate increases.

But I also have some concerns about how this provision would affect businesses' ability to accurately price for risk. Given that some of you have voluntarily taken this step, can you explain to me what are some of the other sources of information you look to in order to predict the risk of your customers? And do you believe that the way the bill is currently written, it would have any effect on those who would offer credit in the future?

Any responders here? Mr. Baer?

Mr. BAER. Sure. As we—and I think traditionally the understanding of universal default has been—is basically a default that is automatic, no choice, repricing based on off-us behavior, that is, not with the issuer. Bank of America has never engaged in universal default.

What we do do, though, is we will reprice customers with notice and choice if we observe an increase, a material increase, in their risk profile. That can take various forms. It could include maxing out their credit lines with us and other issuers, defaulting on a mortgage, defaulting to other issuers, and all types of behavior like that that, when you put them together in terms of our internal modeling, demonstrate a materially greater risk of charge-off.

Mr. MOORE. Thank you. Does anyone else wish to respond to this question?

Mr. FINNERAN. Sir, I would just note that I think this really highlights one of the issues with the bill. Capital One does not engage in universal default and handles risk based pricing differently than Bank of America does. But I think the key is that what Mr. Baer is saying is that they only do it with respect to people to whom they give appropriate notice and an opportunity to opt out, which is exactly what we have been advocating with respect to all forms of repricing.

I think a single targeted fix that can be best done by the Federal Reserve will address so many of the issues associated with change in terms for customers, that is clearly the way to go. And then you don't have to get into the nuances of trying to define what universal default is and what it isn't.

Mr. MOORE. Thank you. I am going to—Mr. Ausubel, I am going to have to go vote. We have been told that I now have less than 2 minutes, and I need to run over there. Mr. Perlmutter is going to come up and take over the chair here. Is that right?

Mr. PERLMUTTER. Yes, I will take the chair, and I will behave myself.

Mr. MOORE. And I won't say the real chair, the regular chair, Ms. Maloney, should be back soon. So thank you very much. And I will—if you care to respond, I promise you I will look at your response later. Thank you.

Mr. PERLMUTTER. [presiding] And the last shall be first.

[Laughter]

Mr. PERLMUTTER. I always get the chance to bring up the caboose because I have the least seniority of this entire committee. And I just want to thank the panel. This has been an outstanding panel, both representing the industry as well as representing academia, that has questions about where we have come from. And I just want to say a couple of things.

I think from my point of view, and I think one of the professors mentioned this, or a couple, I mean, our job is to give a broad direction and then allow the regulators to work with the industry as to the specifics of what a universal default is, what a double-billing cycle is, how many fees can be charged, from late fees to annual fees and all that sort of stuff.

I represented, just as disclosure, banks, credit card companies. I am a consumer who has suffered, having thought he terminated a card. Got an annual fee. Got a penalty on the annual fee. Got penalty interest on the annual fee and the penalty. So coming at it from both sides.

I think we have to make a decision in the broad decision. And I think somebody said 27 years ago was the last time there had been an effort or consumer protection was brought up. I think the bigger question, and the one that is a moral question, is, you know, the other side of credit is debt. And do we want more debt?

And whether it is a biblical kind of an approach or Thomas Jefferson or Teddy Roosevelt or whomever, in 1982, we passed the Garn-St Germain Act. I couldn't remember the name, but our very able staff found it for me. It basically loosened regulations and gave the industry the ability to work in these areas and to really control its fate and develop profit.

I think the broader question for the Congress is: Where are we now? And there have been a number of folks up here who have complained about a particular practice or whatever. You know, the industry is there to earn profits for its shareholders, and I don't think we can deny that.

But the question is—I think, Professor Warren, you said that rates—should there be limits on rates? You said that was off-limits. Well, I am not sure. We used to have usury laws in this country. And I certainly don't want to see that, but I want to give some instruction to the regulators as to, look. Keep an eye on this. Just because there has been a democratization of credit, is that good? From a societal point of view, is that good? So I do have some questions, and I will stop pontificating.

Mr. Baer, with respect to the customer has notice and choice, which is what your testimony was, if that customer has already run up a bill—you know, you have given him a $10,000 credit line, say, and they have now spent $5,000 against that credit. And you now see something—either there was a default or, if there wasn't a default, you see problems in their credit outside.

When the customer has a notice and choice, is that what you are saying, look, we are going to up your rate. You can leave. You can pay this off and leave us. Is that what you mean by—

Mr. BAER. They have two choices. First, they can accept the higher rate, which going forward will be applied to everything they owe us because we consider this a new loan every month. Or, alternatively, they can opt out and they can repay the existing balance under the original rate, no questions asked. All we ask is that they no longer use the card for new purchases.

Mr. PERLMUTTER. I think a new loan every month, I think that is an interesting approach. And it is a 30-day loan or whatever it is. But for most people, especially as you—to the lower income stratas or other folks who are using the credit card for their basic stuff, they are going to be in real trouble to be able to pay that on a 30 day/30 day/30 day.

Mr. BAER. Yes. Actually, I mean, to your larger point, I mean, I think we would certainly agree. There are people out there who are having trouble managing their finances and who should be borrowing less.

The difficult question, I think, for this subcommittee and the Congress is: Can you identify those people through legislation first, without having an overlap effect where you are cutting off credit to people who can repay responsibly? And then the second very difficult question is: This bill would only cut off credit card credit to those people. So the question is: Would those people stop borrowing, or would they look to payday loans, rent-to-own, installment lending, or other types of much higher rate, much lower transparency forms of credit?

And that is why where we come out on this is because the credit card industry is a highly competitive one where you can rest relatively assured that people are getting competitive rates, and because we have the Federal Reserve coming out with a Regulation Z that more than ever before is going to allow informed comparison shopping, and thereby allow consumers to take advantage of that competition—because that is a hallmark of perfect competition; you have to have informed consumers—we think when you put those two things together, this is a good time to let the market continue to work, aided by a disclosure regulation from the Federal Reserve.

Mr. PERLMUTTER. Professor Warren?

Ms. WARREN. I just want to say one thing about informed consumers. I think the practices that Bank of America announces, where they say they will let people pay off over time, is a good practice, and we want to remember that is not the practice of all of the issuers. Many issuers say, no, the whole $5,000 is due right now if you don't want to have to pay the elevated interest rate.

But the question of what constitutes an informed consumer troubles me deeply here. I listen to Bank of America describe how well they take account of this, and they measure this, and they weigh

that, and they finally come up with a number. "We are not going to do something we call universal default, but we are going to do something out there that is magic."

I have read my Bank of America statement, and I can't figure out how it is that they make the decision when I will be the one who receives the next arrow through the heart, that my interest rate has jumped from 11 percent to 29 percent.

And to describe this as a market that consumers understand, low-priced credit that we talk about, I must have two dozen zero balance transfer offers in the last couple of months alone. Not one says, by the way, here is how we plan to make money off of you on this one. And that is the hope that you will use this credit card, not understand how the repayment is going to work, and we will manage to suck 20 percent interest rates out of you over the period of time that you try to pay back this balance.

So it is fine to say we put a lot of words that are incomprehensible in a credit card statement. But the idea that we have consumers who are fully informed about these obscure practices simply does not represent reality.

Mr. PERLMUTTER. And I would agree with that. I don't begrudge the industry—first of all, they probably had a lawsuit or two that has caused some of the addition of the language. So I respect that.

I mean, I think again there has been—for the last 27 years the conversation has been about the free market and allowing opportunities for profit with people. And that is fine. But I think that the conversation now has to move back to debt. Is this something as a societal function we want more debt? And consumer protection.

My time has expired, and I see the gentleman from Tennessee has—oh, I am. The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman. Before I get to my couple of questions, I would like to ask unanimous consent to enter the GAO report entitled, "Credit Cards Increase Complexity in Rates and Fees."

Chairwoman MALONEY. Without objection.

Mr. CAMPBELL. Thank you, Madam Chairwoman.

My first question is to the three representatives of the bank's credit card issuers. Mr. Levitin showed a chart that as far as risk-based pricing, that indicated that there was not a lot of price difference or interest rate difference charged based on someone's credit score, FICO score, or whatever it might be.

Do you accept that chart? Is that correct? And if it is or it isn't, is there a situation in credit card charging because of what the rates are, where people with higher FICO stores, higher credit scores, will borrow money from other places because they can get it cheaper, and other people with lower credit scores will tend to not pay off their credit card every month? Any one of the three of you want to take that?

Mr. FINNERAN. I mean, I will try. I am sorry, I didn't really get a chance to study the specific chart, but I can certainly share with you our practice at Capital One. We do differentiate based on credit score at the time of account acquisition, and offer varying interest rates depending upon the likelihood of those consumers to pay us back and handle their credit appropriately.

Mr. CAMPBELL. Do the rest of you agree with that?

Ms. FRANKE. I would totally agree with that, and would say that we would love to be able to put forth the right analysis, with enough time to do it, that would show that you would absolutely see a decrease substantially in interest rates that much exceeds the decrease in cost of funds over the same period of time.

Chairwoman MALONEY. Mr. Levitin? A response?

Mr. LEVITIN. The chart I showed is from a subscription data source that gathers its data from card issuers directly. It is not representing any particular issuer, so Capital One may be different. What it is showing is a composite of the entire credit card industry.

And while we have some of the prettiest faces in the card industry up here saying that, you know, we don't do this practice and we don't do that one, it is rather irrelevant because this bill is about regulating the worst practices in the industry. And just looking at the best actors in the industry doesn't tell us what we need to know.

Mr. CAMPBELL. Okay. Then my next question is to the prettiest faces of academia, to the academicians that are up there. There has been a lot of talk today about the ads for credit cards, whether they are on television, whether they are the things you get in the mail, whatever, and what would appear to be a pretty intense competitive market for the credit card issuers to issue credit cards and get customers on their credit cards.

Do you all believe, when you take into account the various cost aspects of credit cards—all of them, you know, the initial fee, the late fees, the interest rates, the bonuses or benefits you get—in academia, do you believe that there is price-fixing in the credit card industry, or do you believe that the market is working—or that there is a market in which there is price competition? I guess first Mr. Levitin, and then we will go to you, sir.

Mr. LEVITIN. Well, let's start with, I mean, different aspects of credit card pricing. On the merchant side, I think there is a very good argument that there is price-fixing going on. There is major antitrust litigation about this right now pending in the Eastern District of—

Mr. CAMPBELL. On the merchant side relative to Visa and MasterCard?

Mr. LEVITIN. Well, and also the issuers because the issuers are part of the—or alleged to be part of the price-fixing conspiracy as members of Visa and MasterCard. Really, Visa's only function—

Mr. CAMPBELL. Okay. I don't think that is subject to this bill.

Mr. LEVITIN. It is not, but there is an important link, Congressman. Merchants are the ones who finance rewards programs, and the rewards programs are really the—it is like a Venus flytrap. That is the honey that sucks in the flies and then gets them into the—consumers into interest rate traps and late fee traps and overlimit traps. And the fixing on the merchant side encourages overuse of credit cards, that more people come into that flytrap.

Mr. CAMPBELL. Okay. Yes, sir?

Mr. AUSUBEL. The vast proliferation of offers is an indication of high profits for every offer that is accepted. I mean, that is the simple truth of it. If the industry were unprofitable, 4 billion solicitations a year would not be mailed out. And—

Mr. CAMPBELL. But do you believe that there is price competition between them in those offers? Do you believe that that is one of the ways in which they are competing?

Mr. AUSUBEL. Here is a quick way of understanding it. There are three or four terms of the credit card offer that consumers understand. They understand the introductory rate. I think they probably understand the post-introductory rate. They understand the annual fee.

They have no notion of what double-cycle billing means. They have no idea what any reason type thing is. They have absolutely no idea what their penalty rate is or the terms that would trigger it. They have no notion what happens with their credit score in terms of increasing their interest rate. And they don't pay attention to most of the fees.

So they compete, the issuers compete, on interest rate. But it is very profitable because a number of the other relevant terms are not salient, and consumers don't comparison shop.

Mr. CAMPBELL. And I will yield back, just with a final comment that if you look at the volume of advertising for the—I was in the retail car business, which does lots and lots of advertising. It is one of the smallest margin businesses out there, just slightly ahead of food.

So I think it just indicates that it is a competitive marketplace, and that there is business out there, and you are looking for ways to get it. I don't think it necessarily indicates that it is a high profitability—I mean, it is profitable or else people wouldn't go for the business at all. But I don't think it indicates how much, or not directly correlates.

Sorry. I yield back, Madam Chairwoman.

Chairwoman MALONEY. Thank you. And I would like to thank the gentleman for submitting the GAO report into the record. And I would like to note that this GAO report, as well as a Federal Reserve report of 2005, noted that the number one reason credit card interest rates have gone down is because the cost of money has gone down.

I now recognize Mr. Scott.

Mr. SCOTT. Thank you very much, Madam Chairwoman. And again, my compliments to you for having this hearing. It is very, very informative and very, very timely, as I said.

I would like to ask Ms. Franke—is it Franke or Franke?

Ms. FRANKE. Franke.

Mr. SCOTT. Franke. Very good. I found your testimony to be very, very interesting and intriguing. You said that this bill is complex, expansive, and it restrains credit availability.

I would like for you to tell us exactly how—give us some examples within the bill that this bill does that. And I also want to get your opinion, and others may comment on this as well, in light of your concerns about the bill, just how we address this practice of universal default.

This is a major, major concern. I would like to know your thoughts on that. And would it make sense to consider repricing a customer's interest rate only if they default on the company that issued the card instead of penalizing these people because of their behavior regarding different financial commitments, their specific

history with other lenders, or information obtained from a credit report?

And if a customer has made a late payment or goes over their credit limit, wouldn't it make sense to ensure that a person receives adequate notice to any changes that are made to that customer's rate and its status? And furthermore, wouldn't it be prudent for a credit card company to alert their customers of changes in terms?

That, and also this one also: The concern about the clarity of credit card agreements with regard to what little information they are currently providing with minimum payments and only paying the small amount each month, customers are further penalized as the debt continues to balloon so that when a customer logs onto their account, why can't we ensure that the full amount is in the payment box instead of the small minimum payment?

I feel that with this change, it may help encourage the credit card user to pay off more of the debt or pay in full each month. But by only making a minimum payment, say, on a $1,000 balance, as minimum as that, for example, that can lead to a debt that could take 15 years to pay off, if not longer.

So my point is, I wanted to point out those areas where it is obvious there is a problem we need to address. And I wanted you to maybe answer that in light of your own opposition to this legislation. Can't you see some middle ground here where we need to move to address these particular concerns?

Ms. FRANKE. Let me see if I can make an attempt to cover those topics. Let me do it in a couple of ways.

First and foremost, I think we believe that there are changes that need to be made in the credit card industry. We believe that the regulatory actions that are being taken will be appropriate to handle those issues. They will address things such as disclosure, and how the customer has a keen understanding of their relationship with the credit card issuer.

Starting at the end with your minimum payment question, if you were to go to the Chase Clear & Simple tools, you would find today a minimum pay calculator. We do believe that it is important for the consumer to be able to understand the time it will take for them to pay off their balance if they simply make the minimum payment.

We don't believe, however, that should be legislated, and this is probably a longer conversation than we have to discuss today, because of what would be required for us to display that on each individual statement. It is quite difficult.

We do think, though, that we need to promote to the consumer how they can easily get that information. So what is really important is that the customer understand how long it would take for them to pay their bill if they only make their minimum payment. We want to make sure we provide that information to them.

Why don't we support this legislation? To us it is very simple. It gets to our ability to be able to price for risk. We believe that it is critical that we are able to continue to price for risk. And there are aspects of this bill that would limit our ability to do that.

You asked about universal default. Universal default allows folks to use bureau-based information that informs their decisions as to

someone who is risky. We at Chase, as we have said many times today, no longer believe that is in our customers' best interest. Our customers have told us that they would prefer to understand the clear circumstances under which we will raise their rate. And we have agreed that we will only do that in three circumstances.

You did ask, though, about advance notice of that. Because that is the only tool we at Chase have today to make sure that we manage risk, it is important that we are able to take that pricing action at the time that the customer defaults on their agreement with us.

If we are not able to do that for 135 days, as is outlined in this bill, it will significantly impair our ability to manage that risk, and it will therefore limit our ability to offer the vast majority of Americans the lowest rates available, and to offer credit to more Americans.

So we believe that it is important that we have the permission to price for risk and that we are able to do that in a timely fashion.

Mr. SCOTT. All right. Yes, Mr. Levitin?

Mr. LEVITIN. I think it is important to point out that H.R. 5244 does not prohibit all use of external off-us information. The only thing that H.R. 5244 prohibits is retroactive increase of interest rates based on off-us behavior.

Section 2(a) of H.R. 5244 still allows issuers to increase rates prospectively based on off-us behavior. And the existing balance should have already been priced. That is the deal you had with the card company when you charged a balance. It shouldn't be able to be repriced retroactively.

Chairwoman MALONEY. Thank you. And now the Chair recognizes Mr. Bachus, Ranking Member Bachus.

Mr. BACHUS. Thank you. You might be aware that there was to be a panel preceding your panel of consumers who had various credit card complaints. The chairman and I discussed this yesterday when our staffs discovered that the credit card companies, without a waiver, could not respond because initially the hearing was going to be some consumers saying, this is what happened to me, and we felt like that the—and he and I agreed that the card issuers should have a right to then respond or answer because the first panel would actually be making charges against the companies.

We had that agreement. We had a further agreement that we would postpone those hearings because it wouldn't be fair. And Ms. Maloney said this in her opening statement. It would not be fair for these customers to come, announce what had happened to them, and not have the credit card companies have a right, if they were going to be used as examples, to respond.

I consider that as an agreement, which was really proposed to me. I believe if you make an agreement, you ought to keep it. That is part of what we have talked about today, what those agreements do. Is there a meeting of the minds?

But unfortunately, we have had a Member release a press release detailing all the complaints that these witnesses had and all the charges, and making them available to the press, which really goes against the claims that—and I know the chairman, I think, is equally chagrined, that we all agreed we wanted a fair process where both sides could respond.

And probably the most unfair thing and the most inaccurate thing is that some press is reporting that the credit card companies insisted that these witnesses did not testify. And I can tell you, as ranking member of this committee, that no credit card company—no credit card company—did that.

So I hope in the future that when we make agreements—and I do not think the chairman is involved in that—but I think when we reach across the aisle in a bipartisan way and an arrangement is proposed, that it be honored.

Ms. Warren, you are raising your hand?

Ms. WARREN. Thank you. I just have a question because I am just trying to understand this. I had never heard this before I arrived this morning.

And the question I have is whether or not those same rules apply to the credit card companies. We have heard a lot of information today about how Bank of America does its risk-based pricing. We have heard many representations about how Chase conducts its business and what proportion of customers are paying and what proportion of its customers are not paying, and so on.

That is information that is not publicly available. My testimony comes from a set of footnotes. It is all publicly available. The same is true for Professor Levitin. The same is true for Professor Ausubel. The same is true for Professor Porter.

If it is a concern about whether or not people can say, all right, if you are going to testify about something that is private information, that information should be available to everyone.

Mr. BACHUS. No. Well, actually—

Ms. WARREN. I just wanted to know, is that going to be the new rule?

Mr. BACHUS. Yes. Dr. Warren, I think you make a good argument. Let me say this. Their practices, all the three credit card issuers here today, they have issued their best practices. And those practices are, in fact—and I know in your opening statement you acknowledged that most of the major credit card issuers are playing by the rules. In fact, you said several major credit card companies have dropped these practices; they should be commended. You pointed out that the majority of credit card issuers are not guilty of these practices.

And what we had intended to do, and what was going to happen until this arrangement was proposed, is these witnesses were going to testify at the first hearing, and then the credit card companies would have been able to respond.

But because we felt it would be unfair—and no, these credit card companies cannot talk about an individual and what happened in an individual case without that individual giving a waiver. And they were prepared. They were prepared to discuss individuals if the individuals had testified and given waivers, as we first anticipated.

Ms. WARREN. And I cannot discuss the practices of Bank of America, Chase, or any other issuer unless they make those data available. They come here and get to engage in a game of they show a little that reflects the best light. They come to this hearing and testify. They have testified in front of this committee that they

do not engage in universal default, and yet they describe a practice that many people would describe as universal default.

Mr. BACHUS. Well, now, it is not a question of that they don't publish that. That is available to you and I both. In fact, in preparation for this hearing, I read what their practices were. And as you have said, you said that—you came in and said these tricks and traps, that several major issuers weren't doing that.

Ms. WARREN. At least we don't know if they are doing them. What we have is we have their testimony, but no revealed information.

Mr. BACHUS. I agree totally. We didn't know. And for that reason, we were going to have five people say, this is what they did to me. And then—

Chairwoman MALONEY. Mr. Ausubel would like to testify.

Mr. BACHUS. And then we were going to have—they were going to sign a waiver, and then the credit card companies could have said, you know, this is what happened in their case. In other words, there would have been an accusation and a chance to defend themselves. And that didn't happen because it was proposed that there wasn't enough time. But that was not our proposal.

Chairwoman MALONEY. Mr. Ausubel?

Mr. AUSUBEL. Regardless of whether consumers are allowed to testify or not, I think an important point that has to come before this hearing is that just as it has been remarked that there are, I don't know, 3 million subprime mortgages that are ticking time bombs, there are also millions of credit cards in circulation that have universal default clauses in them right now, that have penalty interest rates as high as 29.99 percent in them. And those are ticking time bombs as well.

Mr. BACHUS. And let me say—

Mr. AUSUBEL. And you can see the contagion effect that could have on the economy. And whether the consumers can—

Chairwoman MALONEY. The gentleman's time has expired. Mr. Cleaver?

Mr. BACHUS. If I could at least respond. Professor, I will agree we hear stories from time to time of people saying, this is what happened. So this hearing was designed—all the things you are talking about, this hearing was designed for five people or six people to come before the Congress and say, as opposed to anecdotal or somebody told me or this thing—for them to come before us and testify, this is what happened to me. And then the credit card companies would have—you know, we asked them to appear and explain whether or not this in fact happened.

And yesterday it was a consensus. In fact, the chairman of the committee said it wouldn't be fair to do what—

Chairwoman MALONEY. Reclaiming my time, we do want to focus on substance and not on process. I now recognize Mr. Cleaver.

Mr. BACHUS. This is pretty—

Chairwoman MALONEY. Mr. Cleaver is recognized.

Mr. CLEAVER. Thank you, Madam Chairwoman.

One of the major credit card companies sent a credit card to Herman, Junior. He is my cousin. I wouldn't have given him a credit card. I would have given him anything but a credit card. He is one

of the most irresponsible people I know. In fact, he is in jail now. I hope they took the credit card before they locked him up.

But we have almost a one point below credit—I am sorry, savings rate in the country. Zero. Which means that we can't borrow money domestically. And it would seem to me that we all have a responsibility of trying to reverse that because if we don't, we are damaging unborn generations. We all owe right now about $30,000 on the U.S. debt, $9 trillion.

And so is there any redeeming social value in sending credit cards to college students or people like Herman, Junior? One of the credit card companies.

Mr. BAER. Well, I had said earlier—I don't know if you were here Congressman—

Mr. CLEAVER. I am sorry. I have been going back and forth between two committee hearings.

Mr. BAER. I understand. Two issues. One I think is minors, and the other is college students, because I think they are very different cases.

With respect to minors, while they may receive solicitations in the mail because they are on a marketing list, that is not at all to say they will actually be granted a card. They will still have to be verified that they are age-eligible and that they have sufficient credit to receive a card. So it does happen, and it is our loss because we can never finalize a transaction, that we will solicit someone. That doesn't necessarily mean we grant.

With respect to—

Mr. CLEAVER. Excuse me, because my time is limited. So are you saying that college students are not receiving credit cards if they are not creditworthy?

Mr. BAER. I started by saying there is a distinction between minors on the one hand and college students on the other. Let me now turn to college students.

We are actually a very large lender to college students. We consider college students potentially our best customers because we want to take them from being a credit card customer to a deposit customer to a home mortgage to retirement savings 50 years from now. We have no incentive with regard to college students for them to default because that makes them dislike us. It makes them less able to take all those other products for us.

So what we do with college students, we have a max. We will not lend to any college student more than $1,500. The average line for a freshman is $500. The average line for a senior is $1,000. What we do with college students, and I think we are the largest lender to college students, we give them very small lines of credit that we think they can manage.

Furthermore, we provide a phenomenal amount of financial literacy to them in terms of education about how to manage their credit. We do not risk-base reprice college students. We are more lenient on all of our fees towards college students. In other words, we set college students up to succeed when they get a credit card from us.

Mr. CLEAVER. Thank you. I am not finished, no. But there is no requirement for the new cardholder to provide information to the

lender that he or she does in fact have a backstop in the event that they can't make the payments?

Mr. BAER. I am not sure how exactly the credit metrics work. But certainly they get some credit for the fact that they are in college. On the other hand, they get very low credit lines.

Mr. CLEAVER. No, no, no, no. No. Do you require that a college student provide information that they can in fact—they have the financial wherewithal to make the payments? Is there a person with a job someplace who signs off on the credit card and declares that he or she will make the payments if the credit cardholder cannot?

Mr. BAER. Do you mean do we require college students to have cosigners for their credit cards? If that is the question, the answer is no.

Mr. CLEAVER. Yes. That is where I was going.

Mr. BAER. I am sorry. I misunderstood. The answer is no.

Mr. CLEAVER. Yes. Sometimes I am inarticulate. One of the things that I am concerned about is that college students do get these cards. It is the antithesis of saving. It is, go get in debt. You know, let's—I mean, right after 9/11, the President said, let's go shopping.

And so we are just pushing it. Get in debt. A minus .6 savings rate in the United States. And do you think that process of sending credit cards to students is helping the Nation?

Mr. BAER. Well, Congressman, we think it is helping those college students because they are being given very low credit lines—

Mr. CLEAVER. But if you have no job, even if it is 1 percent, you can't pay it.

Mr. BAER. Well, I think our experience has been that actually, college students do not default on their credit cards at any greater rate than our general customers.

Mr. CLEAVER. I apologize for not bringing the article here. It was about 3 months ago in the Washington Post, almost a full-page story about a woman who did just that, received a credit card in college. And I can't remember how much—she is about $5- to $7,000 in debt right now. It was a full-page story, and I am going to try and get it before you leave.

Chairwoman MALONEY. The gentleman's time has expired. You can place this information in the record. And I would like to note that the Congressman is the author of a very thoughtful credit card reform bill that includes credit cards for college students.

We now recognize Mr. Feeney. Congressman Feeney.

Mr. FEENEY. Thank you, Madam Chairwoman.

You know, this is a little bit of deja vu all over again from my perspective. I remember, long before I got to Congress, watching in the 1960's and 1970's and 1980's, the lending industry in general being beat up because they were denying mortgage loans, for example, to people that were considered to have risky credit behind them.

There were even implications that some of those decisions were made not based on profitability or risk, but based on ethnicity or race or gender. It seems to me that when you are chasing a profit, most capitalists, pure capitalists, anyway, are sort of neutral in

terms of where they earn that profit from in a free society. But I suspect some of that happened.

And there was a great deal of badgering that went on for a period of decades about how we ought to make capital more accessible so that everybody could aspire to the American dream of owning a home.

And as a consequence of that, oh, for the last 5 years especially, there has been some very easy credit access to people of risky ability to pay back. Some of that has been through no-documentation loans. Some of that has been through 100 percent or in excess of 100 percent financing of the asset. Some of it has been simply because there were a lot of interested investors in getting a good return on their capital.

But now we had the subprime bubble. That is often what happens, whether because of monetary policy we inflate the currency or whether because the credit access caused a stock market bubble. In 1929, it took 15 years for this country to recover, largely because Congress jumped all over the place to hyper-regulate and hyper-tax every productive industry in the country, publicized a lot of formerly private utilities, and so forth.

And I think we are going down that path. We are going to turn a recession into a deep depression if we are not careful, all because of the law of unintended consequences. It is not that anybody wants to do evil to the consumers out there. It is in the name of protecting consumers and protecting small individuals throughout the country that we do these abuses.

I was thrilled. I think it was Congressman Price who mentioned earlier that Senator McGovern, not known as a limited government radical like some of us are, talked about the forgotten man when we regulate based on a policy of how we help half a percent or 2 or 4 percent of the population.

And what I am afraid of in this bill is that we are going to—in the name of helping a few people, we are going to deny access to the best available credit rates to the 95 percent of the population who have made great use of this.

Mr. Baer, I mean, let's take the other extreme. Supposing we just abolished credit cards in this country and everybody had to use cash or a debit card or a check. What do you think would be the impact on the American economy if we just took this horrible dangerous instrument that people carry around in their wallets with them away? We could just go to an all-cash economy. Can you give us a rough estimate of what the impact would be to our $13 trillion economy?

Mr. BAER. I don't think I am qualified to give a numerical estimate. But, I mean, I would say because the vast majority of people who use credit cards are doing so responsibly, are using that to fund worthwhile purposes, even invest in businesses, that would obviously be a tremendous loss.

And also, even if you abolished credit cards, as I think I had mentioned earlier, that is not to say that people would stop borrowing. They may start borrowing through less regulated, higher cost, less transparent forms.

Mr. FEENEY. Mr. Ausubel, if you can be brief, I will let you—remember my question. What would be the impact on a $13 trillion economy of going to all debit cards or cash?

Mr. AUSUBEL. The answer that I would give is that I think the various warnings that have been going out are rather alarmist. I mean, for example, the Senate bill bans 3 percent foreign transaction—

Mr. FEENEY. Well, if I can—I don't mean to be impolite, but I have 5 minutes and that is unresponsive. It may be a very interesting collateral observation, but it is unresponsive to the question I asked.

Look. I think we want fair and full disclosure. I think we want economic literacy. And I wish some of the do-gooder advocates out there who don't have their own cash on the line making loans would be doing more to advance the cause of making sure that every single American student got a good education in how to protect himself and herself when they are making financial decisions.

But when it comes down to what the risk is to our system and what the risk is to investors and how they will respond to overzealous regulations, you will forgive me if I believe the capitalists and the investors, without which we won't have any credit when they tell me what the potential response.

All of the panelists today from the private sector have said they don't engage in several of these practices—universal default, two-cycle billing, and some of the other abuses. Nonetheless, even though their competitors do and they are at a competitive disadvantage, they think it will be foolish for the American economy if we regulate things through congressional legislation.

I happen to at this point buy that argument. With that, I will yield back the balance of my time.

Chairwoman MALONEY. The gentleman's time has expired. But both Ms. Porter and Mr. Ausubel wanted to respond to his comments, so I would like to give them that opportunity.

Ms. PORTER. I can say that based on a study of five national economies that Professor Ronald Mann did, large national economies similar to the U.S. economy, dollar for dollar, moving people from credit card spending onto debit card spending, moving people from card borrowing onto non-card borrowing, would lower the bankruptcy rate.

Chairwoman MALONEY. Mr. Ausubel, do you have a comment?

Mr. FEENEY. Well, now, if I can, the chairman has been gracious enough, and I am happy to have that response. I didn't ask about the bankruptcy rate. I asked about the effect on a $13 trillion goods and services economy. That is—you know, there may be some good things that happen as a result of killing your economy. Bankruptcy—

Chairwoman MALONEY. I would just say, reclaiming my time, Congressman, no one is advocating abolishing credit cards. We all acknowledge the important tool they are to our economy. And as one who represents a great number of retailers, they are absolutely essential for commerce in the district that I represent. What we are talking about is more notice and allowing cardholders to pay off their balances at the rate that they agreed to.

I now recognize Mr. Davis.

Mr. DAVIS OF TENNESSEE. Madam Chairwoman, thank you very much.

As we engage in this debate and this discussion, it would seem to me there is a reason for you folks being here today. If everything was apple pie and a pot of gold at the end of the rainbow, and we could find it, you wouldn't be here today. So there is obviously something happening in the financial world that the average person who lives in my district has complained about.

I represent the fourth most rural residential congressional district in America. I have the third highest number of low wage earners and blue collar workers, who have a tough time having health care, and paying almost $4 a gallon for gasoline to drive to a job that just barely pays more than minimum wage, which we raised recently. So when we talk about the issues here today, in my district, we are engaged. We are connected. And we do feel the pain.

I heard someone say a moment ago that credit card companies offer credit unsupervised. I am a farm boy. When we start moving cattle from one stall to another or from one field to another or loading them for market, we have a little stick. On the end of it, it has—excuse me, those who might not agree with this—it has a little shock on the end of it. And we are able to supervise livestock with that.

A lot of folks in my district feel like they have been shocked by the bill that they get from the credit card companies. I am one of those, and I will explain in a moment why I feel that way.

I also like to ride horses, now mainly mules because they are more safer to get on. Occasionally I put on a pair of spurs. And when I touch that animal in the side, it is to give supervision to that animal. A lot of my constituents back home have felt the pain of the spur in their ribs and in their wallet.

Now, you might not follow what I am saying, but folks back home understand what I am saying. When we talk about high risk credit, those in this room have done more to establish the credit rating of most Americans than any other financial institution in America, either good or bad. So it seems to me real easy before you send out one of those I have heard as many as 8 billion solicitations, all you have to do is check their credit report and see if that is a good risk.

So really, if you are sending high risk out, it is your fault. You should know whether or not these folks are good credit risks or not. All you have to do is click on—get the report, and then you are not taking much risk any more. So for me, I don't agree with some of the statements I am hearing today, and I do believe that it is supervised credit because we have felt some of the stings of it back home.

When I also look at those 8 billion solicitations, or 4, I heard earlier, but I have come to believe that it is 8 billion, if it costs 15 cents to send those out, including the printing and everything else and postage, you are talking about $120 million. Some folks say a trillion dollar business; some folks say $2.3 to $2.4 trillion. I don't know what that figure is. Perhaps collectively you all could arrive at that.

That seems like an awful lot. But I will tell you how one of my staff members disciplines and supervises credit card companies.

When he gets one of those solicitations—and he just told me this earlier—he takes it to the mailbox, tears it open, folds everything else back up, and puts it in the return envelope. And it costs 41 cents for you to get it back. So he is doing the best he can to discipline you all.

So as we look at this thing, there are a lot of issues that we need to talk about, a lot of questions. Everything is not rosy. I wish it was. You provide a wonderful service. In the late 1970's, my wife and I got our credit cards, and we cut them up and we burned them. As I engaged in business that took me a long way from home in 1991, I applied for credit cards.

I have two credit cards. One of those is listed on it, since 1991. I have never paid interest on it. I have never paid a late fee on it. I pay it off every month. I have another one that is smaller that has absolutely aggravated and wore me out, and that is why I feel something has to happen.

When I called one day after being here, quite frankly, on the smaller amount that I had—it was less than $100—realized I had not paid it and it was due the next day, I called to see if I could pay it by phone. You can. It is $29. I owed $50-something. It is $29. What is the late fee? $29. I am not going to pay you over the phone. I will send it to you.

So when you tell me everything is fine and rosy, it really is not for some of us. So what I want to do is be sure that we work in a way to where that credit cards continue to be what they have been, a source for individuals to be able to use to be a consumer in this country. And that is what this hearing is about today.

One of the questions I want to ask you is that $29 fee that someone was going to charge me by paying by phone, how much was that going to cost you? Because the other one I call in at the end of every month, I do it by phone. The phone says, tell me your card number. What is your mother's birthday? Do you want to pay it all off or do you want to pay—so in essence, they don't charge me anything for doing that.

But most credit card companies do. So how much does it cost you to take that automated phone call, and how much should you charge for it? Anyone who wants to answer that.

Ms. FRANKE. I can't.

Mr. DAVIS OF TENNESSEE. Do you have an idea what it costs?

Ms. FRANKE. What I can tell you is that 98 percent of the payments are made for free. There are many, many options to pay your bill without ever incurring a charge. And we would always encourage our customers to take advantage of the ways that they can pay their bills on time without incurring any penalty fees. And again, 98 percent of all of our payments are made for free.

Mr. DAVIS OF TENNESSEE. I have a college degree. It is in agriculture. And I am a Member of Congress. When I start reading what is on the back of that card, before I get angry with it, I tear it up and throw it away. I mean, I don't think anybody reads what is on the back of those cards. We trust you. Literally, we trust you to be fair and honest with us. And that is what we have always done with our banks and others.

So I don't want people to start distrusting a valuable source for us in this country. So if you could somehow maybe talk with other

folks and see if you can tell me about what it would have cost me, had I agreed to pay the $29, what it would cost you to charge me $29 on less than a $60 bill.

Chairwoman MALONEY. Can any of the issuers answer his question, or can any of the academics answer his question, of how much does it cost the issuer to take a payment by phone? Can anyone answer that in relation to the fee?

Mr. BAER. I don't know the exact amount. I do know it is our highest cost way of accepting a payment. But I don't know the relative cost.

Chairwoman MALONEY. Could you get it back to us in writing later after you have analyzed it?

Mr. BAER. If we have it, we will give it to you.

Mr. DAVIS OF TENNESSEE. Can I—

Chairwoman MALONEY. Can all of the issuers respond to his question? Sure.

Mr. DAVIS OF TENNESSEE. I would like to make an announcement. For all folks who have credit cards and you get a request in the mail, send them back like my staff does and it costs them 41 cents.

Chairwoman MALONEY. Yes. Would any other issuer like to comment? Mr. Ireland first, or—okay. Then the academics. Mr. Levitin?

Mr. LEVITIN. I can't speak to the issuer's overhead costs involved in accepting a payment by telephone. But they should be able to do it through an automated clearinghouse transaction that would cost them 5 cents. That is 5 pennies for the automated clearinghouse.

Chairwoman MALONEY. Can anyone else answer his question?

Mr. IRELAND. I would just like to comment. Automated clearinghouse transaction, to clear the transaction once you have formatted it and put it into the system, the interbank fee is on the order of 5 cents.

To actually take in the transaction, link it up with the right account, account for it, and so on in a different environment is going to be significantly more than five cents. I don't know what the actual numbers are, but people have said they will bring them.

Chairwoman MALONEY. Go ahead.

Mr. AUSUBEL. There are other nuisance fees that are much easier to trace down the cost of. So like if you take the foreign currency fees I think everyone at this table charges, any transaction that is paid in foreign currency they surcharge 3 percent. That is on top of the conversion fees that Visa and MasterCard assess. So I would say that one it is clear the cost is literally zero.

Mr. BAER. If I may just respond?

Chairwoman MALONEY. The Chair recognizes the gentleman for an additional minute. I do want to note that Mr. Davis is the author of a very comprehensive credit card reform bill, which does include price limits and price fees.

Go ahead. An additional minute, in recognition of your hard work on your own bill.

Mr. DAVIS OF TENNESSEE. Okay. As you answer those questions concerning the fees for a phone call, what does it cost you to process me sending it in through my internet, through an e-mail, where

I actually go online and pay you online? Is there a difference in that and an automated phone call? And if I send you a check, in comparison for you to take the check out of the envelope, have the folks process that and enter that, which of the three would be the most expensive and which would be number one, two, and three?

Mr. FINNERAN. I don't know the precise numbers, Congressman. But I think in order of expense, the cheapest is the internet because that is the most highly automated. I think the second least expensive is through the mail, simply because of the volume of people who actually choose to pay in that way.

And the most expensive by a fair amount, although again I don't have the precise figure, is over the phone because few people choose to do it that way, and you have to have the people to take the phone call or to make sure that the automated aspects of it work and make all the linkages that Mr. Ireland referred to.

For Capital One, and I know probably the other issuers at the table as well, notwithstanding some of the anecdotes that people like to pass around regarding billing due dates, we send our bills out a good 25 days before the due date. And we certainly encourage and provide multiple ways for people to pay on time. We spend a lot of time and effort to try to encourage people to not wait for the last day.

Mr. DAVIS OF TENNESSEE. I hate to interrupt you. But how long have you had that 25 day period when you send out your bills? Is this recently or is it—

Chairwoman MALONEY. Reclaiming my time, what our bill is approaching is all practices with all credit card companies. Many companies have very fine practices that give a great deal of notice, the 25-day limit, which many of my colleagues on the other side of the aisle requested be placed in the bill.

I now recognize Mr. Clay for 5 minutes. And he will be followed by Mr. Ellison.

Mr. CLAY. Thank you so much, Madam Chairwoman.

Since no one in authority will call the current economic straits of the country a recession or a depression, I will say that we are in an informal recession, that is, a recession that is felt by the millions that are losing all of their wealth, their homes, and in many cases their families.

This has been caused by the outsourcing of jobs overseas, the replacement of workers in this country with cheaper laborers, the grand larceny of the housing mortgage community and various other credit and payment schemes, criminally high energy costs, and a few other economic burdens.

At what point will it be determined that the consumer cannot pay all of the increases in interest rates, the additional fees and costs associated with credit? At what point will there be the realization that reasonable profit is better than the destruction of the consumer base that it is depending upon for the maximized profits that are being sought?

When will the concept of losing money stop being confused with the concept of not meeting profit projections? And I will start right here. When do we concede that we must start—or that we must realize that consumers may not be able to pay all of these bills? I will start with you, ma'am.

Ms. WARREN. Congressman, I think we should be there right now. And I will just say, I will hit just a few of the numbers. One in every seven American families is dealing with a debt collector. Forty percent of American families worry whether or not they are going to be able to make their bills at the end of the month. And the one that truly breaks my heart is that one in every five American families says, I believe I will die still owing my bills.

Congressman, how much worse does it have to get before we start taking some action to clean this up?

Mr. CLAY. And it is about what cost they incur now. People trying to heat their homes, fill their gas tanks up. On top of all of that, they are being pursued by companies wanting to collect on the debt.

How about you, Mr. Baer? Any comment?

Mr. BAER. Sure. Obviously it is a large topic. I mean, I would make one point, though, which is that in contrasting credit card lending to mortgage lending, there is a rather significant difference, which is credit card lending is wholly unsecured lending. So there is a rather significant constraint on our willingness to extend credit to people, namely, that if they do not repay it, there is no car. There is no home. There is no security at all.

And I think that is why—and you may have the wrong group of lenders here because I think these are the lenders who are probably managing credit the most responsibly and intelligently and why, of course, we are interested in risk-based pricing.

But we have every incentive not to have customers paying interest rates they can't repay or levels of debt that they can't repay because we bear 100 percent of the loss in the event that they don't repay. That is not to say we suffer the anguish, the personal anguish, that they might feel in that case, and the longer term potential bad ramifications of poor credit. But in terms of the immediate dollar financial loss, we feel 100 percent of it.

So you should feel some assurance that at least the issuers here—

Mr. CLAY. Okay. I appreciate the response. But when will the concept of losing money stop being confused with the concept of not meeting projected profits? How about that? Do you have any response to that? There is a difference, don't you think?

Mr. BAER. Yes. Now—

Mr. CLAY. Losing money compared to projected profits.

Mr. BAER. I mean, our interest obviously is not in losing money, and our interest is in earning a reasonable risk-based return on capital, which in this case means lending to people we believe can repay it.

Mr. CLAY. Based on paying out bonuses at the end of the year and making sure your values are up in the stock market and all that. Correct?

Mr. BAER. Well, again, if our customers aren't repaying us and we are suffering credit losses, that will not help our stock value.

Mr. CLAY. How about you, Mr. Levitin? Do you have any comment?

Mr. LEVITIN. I think it is interesting what you point out about executive compensation and bonuses, that they are very often tied to short-term profits. And those short-term profits are—a good way

of increasing short-term profits is by squeezing consumers through really dirty billing tricks.

You can bump up profits a little bit in a quarter, and that beats the market's expectation by a penny, and walk away with a large golden parachute. And certainly looking at executive compensation practices is, I think, part of the picture here, and making sure that they are decoupled from things like billing practices and the profits generated by them.

Mr. CLAY. Thank you so much.

Chairwoman MALONEY. The gentleman's time has expired. Mr. Ellison, and I want to congratulate his hard work throughout four different hearings and a roundtable discussion that we had on this with issuers.

Mr. ELLISON. Well, Madam Chairwoman, I just want to thank you. I think that your leadership in this area is tremendous. Obviously there are powerful forces who are trying to stop us from protecting the consumers, and I just thank you for your courage and commitment.

How profitable is the credit card business these days, Ms. Warren?

Ms. WARREN. The most recent data we have available is that they made about $18.4 billion in 2006. That was a 45 percent jump over the year before. We haven't seen the 2007 data.

Mr. ELLISON. $18.4 billion?

Ms. WARREN. $18.4 billion with a "B."

Mr. ELLISON. That is a lot of money. What is the percentage of profitability? Does that term—do you understand what I am asking you?

Ms. WARREN. Yes. The revenues were about $115 billion. So you can sort of figure it out from that one. Not bad.

Mr. ELLISON. Yes. And of course, you may not know this and we may need to come back for it. How much did the CEO at Capital One make?

Ms. WARREN. Oh, gosh. A lot more than I did.

Mr. ELLISON. Yes. Does anybody know?

Ms. WARREN. It is outside my range.

Mr. ELLISON. Mr. Finneran, do you know that? Your CEO, how much did he get?

Mr. FINNERAN. Our CEO has not taken a salary since 1997. All of his compensation is in equity in the company, therefore what he makes is entirely dependent upon the success of the company.

Mr. ELLISON. Mr. Finneran, how much did he get paid last year?

Mr. FINNERAN. Pardon me?

Mr. ELLISON. How much did he get paid last year? I am not asking you if it was salary or—I am asking you how much compensation did he receive?

Mr. FINNERAN. Well, in our most recent proxy disclosure, I believe it was $17 million worth of equity grants.

Mr. ELLISON. $17 million. And how about the CEO of JPMorgan Chase, ma'am?

Ms. FRANKE. I don't know.

Mr. ELLISON. You don't know that? Well, I will commend you on being extremely well-prepared on everything else. Bank of America?

Mr. BAER. I don't know my CEO's exact compensation, or even his approximate compensation, for that matter.

Mr. ELLISON. Mr. Baer, come on.

Mr. BAER. I don't.

Mr. ELLISON. Okay. Does anybody else know?

[No response]

Mr. ELLISON. You know what? In 1980, the average CEO made about 41 times the average worker. In 2005, it was about 411 times. So it is interesting how—it is too bad folks don't know what their boss made.

I introduced—well, let me just skip that one.

Demos has noted in a study that African American and Latino credit cardholders with balances are more likely than whites to pay interest rates higher than 20 percent. Why do you think that is? Well, is it true? And why do you think that might be? Mr. Ausubel, have you looked at this? Have you heard about this, Professor Warren? Haven't heard about that one?

Ms. WARREN. Oh, yes. No, I cited it in my testimony.

Mr. ELLISON. Oh, yes. Could you elaborate on that, please?

Ms. WARREN. Well, they looked at a survey of consumer finance data. But I don't think there is any question about the accuracy of the data.

Mr. ELLISON. Right.

Ms. WARREN. And they simply analyzed it by race. They also looked at the effects on single women. They looked at family income. And the people who are carrying the heavy burdens here are disproportionately African American, Latino, single mothers, and people in lower income categories.

Mr. ELLISON. Professor Warren, maybe you could help me with this. You know, I am just a simple guy, and I hear these financial people using big words like risk-based pricing and stuff like that. It sounds really important.

Are they basically saying that these people are riskier, so we get to charge them more?

Ms. WARREN. They may be saying that, but—

Mr. ELLISON. But is that what they are saying?

Ms. WARREN. But in fact, that is not what they are doing. I mean, this is the point that Professor Levitin has really emphasized, and I want to be sure to highlight his research on this.

Mr. ELLISON. Would you please do that?

Ms. WARREN. Professor Levitin?

Mr. LEVITIN. Sure. Most of the overall price that you pay on a credit card has nothing to do with your individual risk profile. It has to do with the cost to the issuer of borrowing money from the capital markets. It has nothing to do with whether you are risky or whether you are going to pay on time. Only at the very margins does it have any impact.

Mr. ELLISON. Basically, the pricing reflects what they can get from a consumer, right?

Mr. LEVITIN. Very much so.

Mr. ELLISON. So it is pretty much about just getting money?

Mr. LEVITIN. This is a—as they note, it is a competitive market and they want to squeeze every last drop of profit they can.

Mr. ELLISON. I am glad you said that about the competitive market thing, because I was talking to somebody just yesterday, and they told me that, well, I shouldn't worry about these credit card practices that seem so egregious to me because if people don't like it, they can just call somebody else.

But then have you ever tried to call a credit card company? Could you just—Ms. Warren, Professor Levitin, have you tried to actually talk to these people and get them on the phone to discuss your bill?

Ms. WARREN. Of course not. That is why we all laugh. That is like the punch line to a joke, to call a credit card company.

Mr. ELLISON. Right.

Ms. WARREN. But I want to make the point here even so, even if you could reach someone, by the time you recognize most of these things have happened to you, they have happened to you.

Mr. ELLISON. Right.

Ms. WARREN. This is not about understanding in advance, golly, I have one of those cards that is going to have a new due date on it, or that they are going to switch me every 6 months on the date that my payment is due. This is about things that you only know you have been bitten after the teeth are well sunk in. And then it is too late to do anything about it.

Mr. ELLISON. Let me ask you this. On this issue of the moving target of the payment date, it was pointed out to me yesterday that, hey, we don't want to have—

Chairwoman MALONEY. The gentleman's time has expired. And the moving target date is one that we end in this legislation that is before us today.

I would like to thank all of my colleagues and the witnesses for your testimony today. We are moving forward with legislation. This bill is on four previous hearings and roundtable discussions with issuers and consumers and academics. And the next hearing will be held on April 9th.

We look forward to passing legislation that will put into place reforms that will enable responsible consumers to better control their financial affairs, and will bar some of the most abusive practices that drive responsible cardholders further into debt. Our legislation is balanced and sensible, and I look forward to our next hearing.

I do want to note that Members, if they have additional questions, and my colleague Mr. Ellison, can put his additional questions in writing to the panel. Without objection, the hearing will remain open for additional comments and questions for 30 days.

And again, I want to thank the witnesses and thank everyone here. We will get your responses into the record. This meeting is adjourned. Thank you.

[Whereupon, at 2:15 p.m., the hearing was adjourned.]

A P P E N D I X

March 13, 2008

U.S. Congresswoman
Ginny Brown-Waite
Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Subcommittee on Financial Institutions and Consumer Credit
Hearing
"The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers"
March 13, 2008
Statement for the Record

Thank you Madam Chairwoman for holding this hearing. And I appreciate the witnesses being here today.

Several of my colleagues from the other side of aisle are forecasting that the next great financial crisis in America is in the credit card market. They hypothesize that once the subprime crisis shakes out, defaults in credit card debt will rise to staggering levels.

I am concerned with this too. Considering Americans held roughly $787.5 billion in credit card debt in 2004, this is obviously something Congress should address. It is no secret that Americans have one of the lowest savings rates of any industrialized nation in the world, and with only half of Americans paying their credit card balances off every month, that statistic is not going to change anytime soon.

Like any industry, there have been some bad players, and I understand we are going to hear several witnesses today complain about their atrocities with credit card companies. I know I hear regularly from constituents who complain of credit card providers raising rates even if they have been on time or have not gone over the limit. Other practices, such as "double-cycle billing" and purposely confusing disclosures, should be eradiated.

However, I question why this subcommittee is addressing legislation to legally prohibit any of this before the regulators have released their new rules, Regulation Z. The Fed, who Congress tasked to oversee credit card providers, has been working on extensive new disclosure rules for cardholders for over a year. Regulation Z is meant to educate further consumers who decide to take out revolving credit so they may make informed decisions of what they can or cannot afford. To pass laws prohibiting practices before Congress can even determine whether Regulation Z is helping is premature.

Furthermore, I know many of the witnesses here and those representing the lending institutions will use our floundering economy as an excuse to prohibit reforms, contending they could restrict credit. However, I disagree with the philosophy that encouraging credit card use, or making it easier by loosening credit, is the way to stimulate America's faulty economy. Providing choices and lifelines to consumers who need help, as credit cards do, is one thing. However, the way a person, college graduate, family and our economy gets back on a financial track is by living within our means, not going further into debt.

I look forward to hearing from the constituents and other presenters' testimony today and thank you again Madam Chairwoman for allowing Members to present their views on the credit card industry.

Opening Statement of Representative Michael N. Castle (DE)
March 13, 208
Subcommittee on Financial Institutions and Consumer Credit
Hearing on "The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers"

Good morning. Credit cards are the focus of our hearing and we will hear today and in the coming weeks from witnesses -- consumers, regulators, and businesses -- about a range of issues. While I have an open mind about ideas for reform, I also think it is very important to keep some basic facts and our subsequent discussions in perspective:

- We are a nation with about 225 million credit active Americans
- According to the Federal Reserve, around 640 million credit cards are in circulation in this country
- The Fed published a report a few years ago that said the average American consumer has 5 credit cards; One in ten consumers has more than 10 credit cards in their wallet
- And, I have seen a study that shows that most consumers keep their credit cards a minimum of 7 years and frequently much, much longer.

My point is this: Consumers, overall, are a pretty savvy group. If they find a good deal, they stick with it. If they find a bad deal or are treated poorly, they drop that product or service in a heartbeat. And since the overwhelming majority...about 90% of the public pays its credit card bills on time, I worry that well intended legislative efforts might go too far -- especially since the final, updated version of Federal Reserve Regulation Z will address many of the provisions included in H.R. 5244 and is scheduled for release soon.

Let me be clear about this so our witnesses and the public can have a better appreciation for all that the Federal Reserve has done relative to these soon-to-be-released regulations:

The professional staff at the Federal Reserve has put out for comment several different consumer tested ideas related to credit cards that were developed in part with the help of consumer focus groups. The Fed has been very deliberate in their approach to these issues and has gone so far as hiring consumer focus groups to test proposed disclosure and billing ideas. Subsequently, as this process has unfolded, the Fed has had to review over 2,500 comments from banks, consumers, consumer groups, lawyers and so forth concerning these issues and proposed solutions. All of this work is coming to an end later this year and I would prefer to see what final changes are proffered by the Fed before pursuing any legislative proposals.

Madame Chair, our economy is struggling. And while I want to do everything I can to make certain consumers are dealt a fair hand and our financial services industry thrives, I look forward to the testimony today and the important work the Federal Reserve will release later this year.

WRITTEN STATEMENT OF
PROFESSOR LAWRENCE M. AUSUBEL
DEPARTMENT OF ECONOMICS
UNIVERSITY OF MARYLAND

Before the
Subcommittee on Financial Institutions and Consumer Credit
of the Committee on Financial Services
of the United States House of Representatives

Hearing on "The Credit Cardholders' Bill of Rights:
Providing New Protections for Consumers"

Thursday, March 13, 2008, 10:00 a.m.

BIOGRAPHICAL INFORMATION

Lawrence M. Ausubel is Professor of Economics at the University of Maryland at College Park. He received his A.B. in mathematics from Princeton University and his Ph.D. in economics from Stanford University. He is the author of "The Failure of Competition in the Credit Card Market" (*American Economic Review*, 1991), regarded by many as the best-known article on credit cards in the economics literature. He also authored the entry on "Credit Cards" in the *New Palgrave Dictionary of Money and Finance*. Other related papers by him include "Credit Card Defaults, Credit Card Profits, and Bankruptcy" (awarded the Editor's Prize for the best article in the *American Bankruptcy Law Journal* in 1997), "Adverse Selection in the Credit Card Market," "Informal Bankruptcy" (joint with Amanda Dawsey) and "Time Inconsistency in the Credit Card Market" (joint with Haiyan Shui). He has testified on bankruptcy before the U.S. House of Representatives Subcommittee on Commercial and Administrative Law, the U.S. Senate Subcommittee on Financial Institutions and Regulatory Relief, and the National Bankruptcy Review Commission, and he has served as an expert witness in litigation involving credit cards. Professor Ausubel also specializes in microeconomic theory, game theory and industrial organization. In particular, he is a leader in the fields of auction theory and market design, authoring some of the best known academic articles on multi-unit auctions and holding eight U.S. patents related to auction technology. He is President of Market Design Inc. and Chairman of Power Auctions LLC, firms which specialize in the design and implementation of high-stakes auctions. In this capacity, he recently served as Auction Manager for the ISO – New England Forward Capacity Auction, a $1.75 billion auction for electricity generation capacity in the New England region. He served as a member of the National Science Foundation Economics Panel in 2004 and 2005. He is a Fellow of the Econometric Society.

EXECUTIVE SUMMARY OF WRITTEN STATEMENT

My written statement comprises this "executive summary" together with a preliminary paper, "Penalty Interest Rates, Universal Default, and the Common Pool Problem of Credit Card Debt" (jointly authored with Amanda E. Dawsey of the University of Montana), which is attached.

1. Credit card debt poses a common-pool problem

It is now reasonably well understood that unsecured credit such as credit card debt poses a common-pool problem. Since it is not secured by any collateral and since recoveries will be allocated pro rata under bankruptcy, each credit card issuer is motivated to try to collect from the "common pool" — and the attempt to collect by one issuer may pose a negative externality to other issuers. When a consumer becomes financially distressed, each credit card lender has an incentive to try to become the first to collect. For example, a lender may engage in aggressive collection efforts even if they may result in the consumer seeking protection under bankruptcy law: the benefits of collection accrue to this lender alone, while the consequences of a bankruptcy filing are distributed over all credit card lenders and other creditors.

2. The common-pool problem leads to penalty interest rates and universal default clauses

A useful explanation and interpretation of penalty interest rates and universal default clauses in credit card contracts is that each issuer is seeking to maximize its own individual claim on the common pool of unsecured debt of a financially-troubled consumer. To the extent that the

consumer repays any debt, a high penalty rate (such as 29.99%) provides incentives for the credit-card issuer to be repaid before other lenders. And to the extent that the consumer repays no debt, the high penalty rate maximizes the issuer's nominal loan balance and therefore the issuer's pro-rata share of recoveries following bankruptcy. Since every credit-card issuer has this unilateral incentive to charge a high penalty rate and to impose a severe universal default clause, the likely outcome in the absence of threatened or actual regulation is inefficiently-high penalty rates together with inefficiently-broad and unforgiving universal default clauses. As such, the common-pool problem of unsecured debt may be viewed as a market failure, yielding scope for the U.S. Congress to intervene in useful ways.

The attached preliminary paper develops an economic model that is useful for studying these issues and obtains some suggestive results.

3. Would the bill help cardholders to extricate themselves from debt? What impact would it have on consumer spending?

An unfortunate byproduct of penalty rates, universal default clauses and "any time, any reason" repricing is that they tend to increase the difficulty for consumers to emerge from debt without serious defaults or bankruptcy. This follows from general principles and is also a preliminary conclusion of the attached paper. Given the current turmoil in credit markets and real estate, additional pressure on consumers from credit card issuers is particularly unfortunate, but such pressure could be reduced if the proposed bill becomes law in a timely fashion.

The bill's impact on consumer spending seems to be ambiguous, but in any event, its impact on consumer spending seems to be of very small magnitude.

4. "Any time, any reason" repricing is detrimental to competition

"Any time, any reason" repricing would appear to be detrimental to competition in the credit card market, owing to standard considerations in industrial organization, such as search costs and switch costs. The simple reason is the difficulty posed to comparison-shopping, if the future course of pricing is difficult for consumers to foresee. The same critique would appear also to apply to penalty terms that are difficult for consumers to understand or take into account at the time that they shop for credit cards. Federal limitations on repricing and penalty terms could be expected to improve the competitive process.

5. Is there evidence that the magnitude of risk-based repricing is commensurate with the magnitude of enhanced risk?

While it is almost axiomatic that consumers who have triggered penalty terms are greater credit risks than consumers who have not triggered penalty terms, I am unaware of any empirical evidence that the magnitude of higher prices imposed bears any close relation to the magnitude of enhanced risk faced by the issuers. Quite to the contrary, it is evident from other aspects of current credit card pricing that the levels of many fees are based more on the relative insensitivity of consumer demand than on any particular relation to cost. Good examples are: the 3% surcharges recently imposed by most issuers on credit card transactions made in foreign currencies; the $39 late fees imposed irrespective of the number of days the payment is late; and overlimit fees imposed on consumers for whom the issuer is happy to increase the credit line.

The attached preliminary paper develops an economic model in which it appears that, even under perfect competition and perfectly optimizing behavior by consumers, universal default

clauses may result in penalty interest rates exceeding the enhanced risk faced by the issuers. Certainly, without perfect competition and perfectly optimizing behavior by consumers, it would be easy for penalty interest rates to arise that exceed the enhanced risk associated with the triggering events.

6. Is there evidence that penalty pricing or "any time, any reason" repricing has led to lower prices generally for cardholders?

Similarly, I am unaware of any empirical evidence that penalty pricing or "any time, any reason" repricing of credit cards has led to lower prices (i.e. interest rates and fees) generally for cardholders. In the perfectly-competitive model of the attached paper, the existence of penalty pricing results in lower interest rates, absent missed payments, but higher interest rates, following missed payments. The combination nets out to be about the same, but aggregate consumer welfare and aggregate social welfare appears to be reduced under universal default (including "any time, any reason" repricing"). In the real world, there is evidence that the credit card market is less than perfectly competitive and that consumers may be less than perfectly optimizing; under such circumstances, one would expect that penalty pricing or "any time, any reason" repricing of credit cards would likely lead to higher overall prices.

7. Are the issuers or financial regulators likely to address these issues in the absence of legislation?

Credit card issuers are unlikely on their own to address or remedy the issues prompting the proposed legislation, owing to the common-pool problem that leads them to act unilaterally in the opposite direction. My read of the regulatory history is that the financial regulators have been lax in acting to protect consumers in this regard, except under the threat of legislation.

8. Would the bill be effective? Does it go far enough?

The current bill, if enacted, would be helpful in protecting consumers, particularly financially distressed consumers, and in improving competition in the credit card market. Given the current credit crisis, it would seem helpful for the legislation to become effective sooner than the one-year anniversary of enactment specified in the current text of the bill. While the bill addresses the ability of an issuer to impose penalties triggered by the consumer's late payment of other lenders, it might usefully go further in limiting severe penalties following minor transgressions to the lender itself. The bill might also usefully limit what are often termed "junk fees": terms of the account other than the most salient pricing terms (e.g., other late payment fees, surcharges for purchases in foreign currencies, and overlimit fees).

DISCLOSURE OF FEDERAL GRANTS, CONTRACTS OR SUBCONTRACTS

Professor Ausubel was the Principal Investigator on National Science Foundation Grant SES-05-31254 ("Dynamic Matching Mechanisms," with P. Cramton), Co-Principal Investigator on National Science Foundation Grant IIS-02-05489 ("Rapid Response Electronic Markets for Time-Sensitive Goods," with G. Anandalingam, P. Cramton, H. Lucas, M. Ball and V. Subrahmanian), and Co Principal Investigator on a Federal Aviation Administration Grant ("Slot Auctions for U.S. Airports," with M. Ball, P. Cramton and D. Lovell), all grants to the University of Maryland. While each of these grants, broadly speaking, relates to the study of economics, the specific subject matter of these grants bears no relation to the topic of the current hearing.

Penalty Interest Rates, Universal Default, and the Common Pool Problem of Credit Card Debt

Lawrence M. Ausubel and Amanda E. Dawsey*

March 12, 2008

Very Preliminary and Incomplete

1 Introduction

It is now reasonably well understood that unsecured credit such as credit card debt poses a common-pool problem. Since it is not secured by any collateral and since recoveries will be allocated pro rata under bankruptcy, each credit card issuer is motivated to try to collect from the "common pool" — and the attempt to collect by one issuer may pose a negative externality to other issuers. When a consumer becomes financially distressed, each credit card lender has an incentive to try to become the first to collect. For example, a lender may engage in aggressive collection efforts even if they may result in the consumer seeking protection under bankruptcy law: the benefits of collection accrue to this lender alone, while the consequences of a bankruptcy filing are distributed over all credit card lenders and other creditors.

This paper attempts to explore the recent proliferation of penalty interest rates and universal default clauses in credit card contracts. By a *penalty interest rate*, we mean the following: The fairly standard credit card offering in 2008 includes an introductory interest rate on new purchases of 0% for the first several billing periods, followed by a post-introductory interest rate on new purchases of 9.99% to 15.99%. However, if payment is received late once during the introductory period, the interest rate reverts to the post-introductory APR; and if payment is received late twice within any 12 billing periods, the interest rate reverts to a "default APR" of typically 23.9% to 29.99%. In addition to the increase in interest rate, the cardholder generally is also assessed a late payment fee of typically $39.

By a *universal default* clause, we mean the following: Many credit card contracts provide that the penalty interest rate is triggered by late payments to this credit card issuer, but it may also be triggered by late payments to other creditors. Depending on the issuer's particular practices, universal default may also be triggered by deterioration in the consumer's FICO score,

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exceeding a credit limit, utilizing a credit line beyond a particular percentaget, or more generally, "based on information in your credit report." [1]

An issuer can accomplish the same effect (and more) with an *"any time, any reason" repricing* clause. An example of the relevant language is: "Account and Agreement terms are not guaranteed for any period of time; all terms, including the APRs and fees, may change in accordance with the Agreement and applicable law. We may change them based on information in your credit report, market conditions, business strategies, or for any reason." [2] Bills recently introduced in the U.S. Congress propose to regulate penalty interest rates, universal default clauses, and "any time, any reason" repricing.[3]

A useful explanation and interpretation of penalty interest rates and universal default clauses in credit card contracts is that each issuer is seeking to maximize its own individual claim on the common pool of unsecured debt of a financially-troubled consumer. To the extent that the consumer repays any debt, a high penalty rate (such as 29.99%) provides incentives for the credit-card issuer to be repaid before other lenders. And to the extent that the consumer fails to repay the debt, the high penalty rate increases the issuer's nominal loan balance and therefore the issuer's pro-rata share of recoveries following bankruptcy. Since every credit-card issuer has this unilateral incentive to charge a high penalty rate and to impose a severe universal default clause, the likely outcome in the absence of threatened or actual regulation is inefficiently-high penalty rates together with inefficiently-broad and unforgiving universal default clauses. As such, the common-pool problem of unsecured debt may be viewed as a market failure, yielding possible scope for government intervention in useful ways.

2 Related Literature

The premise of an externality imposed by competing creditors is related to the idea of sequential banking studied by Bizer and DeMarzo (1992). The difference here is that the externality in our model results from competition to collect from a defaulting borrower, rather than as a consequence of an increase in risk as the borrower acquires additional loans. The idea that creditors have an incentive to grab payment from borrowers, even when doing so hurts the borrower's ability to repay her total debt, is one of the fundamental principles underlying much of the US bankruptcy system.[4] Thomas H. Jackson, along with Douglas Baird and Robert Scott, has formalized this idea in a series of articles using economic models to examine the effects of these externalities.[5] Under the Jackson regime, bankruptcy can actually increase the welfare of creditors

[1]The particular language of "based on information in your credit report" is taken from the disclosure associated with a Bank of America online credit card offering. The associated URL, accessible on March 12, 2008, is: https://wwwa.applyonlinenow.com/USCCapp/Ctl/display?pageid=disclosure&cp=.

[2]This language is taken from the same Bank of America disclosure as referenced in the previous footnote.

[3]*See* H.R. 5244 ("Credit Cardholders' Bill of Rights Act of 2008"') and S. 1395 ("Stop Unfair Practices in Credit Cards Act of 2007").

[4]*See*, for example, Tene (2003).

[5]*See*, for example, Jackson (1985 and 1986), Baird and Jackson (1990) and Jackson and Scott (1989).

by forestalling destructive creditor collection and mitigating the negative externality, and these savings are passed along to the borrower in the form of lower interest rates.

Several authors have argued that Jackson's approach is overly theoretical and unsubstantiated by empirical evidence.[6] In response to this criticism, Dawsey (2007) provides an empirical test. It shows that, holding debt level constant, increasing a borrower's number of creditors increases the probability a borrower files for bankruptcy and decreases the probability she chooses informal bankruptcy, defined as long-term default without a formal bankruptcy filing. These results lend support to Jackson's hypothesis that when a creditor attempts to collect from a distressed borrower, his efforts reduce the likelihood a borrower will repay her other loans and increase her probability of filing for bankruptcy.

A few papers have examined policy tools other than bankruptcy that may reduce the negative externality of competitive collections. Williams (1998) finds some evidence that credit counseling services, by facilitating coordination among lenders, decreases competitive collections efforts. Brunner and Krahnen (2004) observe that bank pools, a legal mechanism for allowing coordination among creditors in Germany, also decrease destructive competition among creditors. Franks and Sussmen (2005) find that the British contractualist system mitigates the incentive of multiple lenders to prematurely liquidate a distressed firm.

Like Bizer and DeMarzo, the small group of papers examining the effects of "cross default" clauses have focused on the borrower's increased riskiness due to multiple loans. Like universal default clauses, cross default clauses specify that default on one loan results in default on all loans covered by the clause. Using comparative statistics, Childs et al (1996) find that cross default clauses in commercial mortgage contracts substantially reduce default risk. In the Childs model, cross default gives creditors access to additional collateral which yields diversification benefits, decreasing default frequency and severity. The Childs model differs from the one presented here in two important respects. First, the cross default clause gives the creditor access to additional collateral, which would not be a factor for the unsecured creditor in our model. Second, the Childs approach is to consider only cases involving a single creditor and borrower; the contention of this paper is that when the model is broadened to allow the borrower to interact with more than one creditor, any benefits of cross-default are mitigated by the negative externality it imposes.

Two purely theoretical papers find results that are similar to Childs'. Mohr and Thomas (1997) present a model in which a sovereign nation enters into both a loan contract and an environmental agreement, and a cross-default clause reduces the risk of default on either obligation. Mohr (1995) finds a similar result when a country is both in debt and involved in international environmental permit markets. These results are driven by the borrower's desire to avoid the double punishment that would result from defaulting on two contracts rather than only one. Again, these papers focus on borrower riskiness rather than externalities involved in collection.

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[6] *See* Block-Lieb (1993) and Rothschild (2007).

3 The Model

A consumer wishes to consume over three periods. He earns income only in the second and third periods, and so has a consumption-smoothing motive to borrow on credit cards. More specifically, the consumer's utility is given by $U = \sum_{t=1}^{3} \delta^{t-1} u(c_t)$, where $u(c_t) = c_t^{\gamma}$ $(\gamma < 1)$, $\delta = \frac{1}{1+r_m}$ denotes the discount factor between periods, c_t denotes the consumer's consumption in period t (t = 1, 2, 3), and r_m denotes the market interest rate. The consumer's income in period 1, denoted I_1, equals zero. The consumer's income in periods 2 and 3, denoted I_2 and I_3 respectively, are drawn independently from uniform distributions on the interval $[0, \overline{I}]$. The consumer does not learn I_2 until period 2 and does not learn I_3 until period 3.

The consumer borrows on his credit card(s) in period 1 so as to maximize his expected utility. If the consumer chooses to consume c_1 in period 1, then he runs up a credit card balance of c_1, which with application of an interest rate r becomes a balance of $(1+r)c_1$ in period 2. To simplify the solution of the model, the consumer is permitted to borrow on his credit card(s) only in period 1. In addition, if the consumer borrows from two cards in period 1, then it is assumed that he borrows equal amounts on each of the two cards, i.e. amounts of $\frac{1}{2}c_1$ each. In period 2, the consumer's actions are limited to repaying his credit card balances (in whole, in part, or not at all). Let ρ denote the fraction of his balances that he repays in period 2. If the consumer repays fraction ρ in period 2, that requires him to pay $\rho(1+r)c_1$, leaving him $c_2 = I_2 - \rho(1+r)c_1$ in consumption for period 2.

The interest rate applied to the consumer's credit card balances from period 2 to period 3 may be a regular interest rate r or a penalty interest rate r^p. With one credit card lender, the regular interest rate is applicable if the consumer meets a required minimum payment α, i.e. if $\rho \geq \alpha$. However, if the consumer does not meet the required minimum payment, i.e. if $\rho < \alpha$, then the penalty rate is applicable. With two credit card lenders, the rate depends on which (if any) lenders have received the required minimum payment, and on whether a universal default clause applies to the given credit card. These conditions are elaborated below.

In period 3, the terminal period, the consumer has no decision problem to solve. Instead, the consumer simply consumes out of his income (if any) net of debt repayment. Thus, if the consumer was subject to the regular interest rate from period 2 to period 3, then his consumption in period 3 is $c_3 = \max\{0, I_3 - (1+r)(1-\rho)(1+r)c_1\}$. However, if the consumer was subject to the penalty interest rate from period 2 to period 3, then his consumption in period 3 is $c_3 = \max\{0, I_3 - (1+r^p)(1-\rho)(1+r)c_1\}$. Note that the "$\max\{0, \bullet\}$" terms in the previous expressions reflects that the credit card lender(s) cannot collect more than I_3 from the consumer; the money simply is not there to collect. Period 3 marks the end of the model. With two credit card lenders, their respective interest rates (including penalty rates, when triggered) are applied to their respective balances; and if the period 3 income is less than the balances owed, the income is applied pro rata between the two lenders.

There are n credit card issuers ($n \geq 3$) competing to lend to a consumer. A consumer is permitted to accept at most two credit cards at the stated terms. A credit card offer by issuer i consists of a pair of interest rates, (r_i, r_i^P), where r_i is the regular interest rate and r_i^P is the penalty interest rate. Each of these values is chosen from the closed interval $[0, \bar{r}]$, where $\bar{r}$ is the maximum interest rate that an issuer might select (e.g. a 29.99% APR). The other relevant terms of a credit card are its credit limit, $\bar{L}$, and its required minimum payment, α, in period 2. For simplicity, n, $\bar{L}$ and α are constants that are exogenous to the model — and $\bar{L}$ is specified so that the consumer wishes to borrow from two credit cards in period 1.

3.1 Own default

By *own default*, we refer to the contract term that a consumer is subject to a penalty interest rate on a credit card if he has not made the minimum repayment on that credit card. (By contrast, under universal default, the consumer is subject to the penalty rate if he has not made the minimum repayment on that credit card or on any other credit card. This case is treated in the next subsection.)

Under a rule of own default, there are three relevant possibilities:

(1) The consumer makes at least the minimum payment on both cards. In that event, he is subject to the regular interest rate on both cards.

(2) The consumer makes the minimum payment on card i but not on card j. In that event, he is subject to interest rate r_i on card i, but subject to interest rate r_j^P on card j.

(3) The consumer does not make the minimum payment on either card. In that event, he is subject to interest rate r_i^P on card i and to interest rate r_j^P on card j.

In our preliminary results, it appears that an optimizing consumer will generally repay at least the minimum payment on a given card or else will repay zero (but will not repay an amount in between). Moreover, in the case where the consumer makes the minimum payment on only one card and the penalty rates on the two cards are different, the optimizing consumer will make the minimum payment on the card with the *higher* interest rate (i.e., it is advantageous for the consumer to repay high-interest debt before low-interest debt).

3.2 Universal default

Under universal default, the consumer is subject to the penalty rate if he has not made the minimum repayment on that credit card or on another credit card. Under a rule of universal default, there are three relevant possibilities:

(1) The consumer makes at least the minimum payment on both cards. In that event, he is subject to the regular interest rate on both cards.

(2) The consumer makes the minimum payment on card i but not on card j. In that event, he is subject to interest rate r_i^P on card i and to interest rate r_j^P on card j.

(3) The consumer does not make the minimum payment on either card. In that event, he is again subject to interest rate r_i^P on card i and to interest rate r_j^P on card j.

Repaying one card but not the other does not avert any penalty interest rates at all. In our preliminary results, and for parameter values in the relevant range, it appears that an optimizing consumer will generally repay at least the minimum payment on both cards or else will repay zero on both cards (but will not repay one card, under universal default, or repay an amount in between).

4 Tentative General Results

RESULT 1. *It is never an equilibrium for the penalty rate to equal the regular rate.*

REASONING. Suppose not. Since missing a minimum payment signifies that the consumer received a low realization of income, the firm's expected profits conditional on a consumer missing a minimum payment to either firm is negative. If the firm unilaterally raises its penalty interest rate by ε, then to the extent that it induces early repayment, it is therefore profitable. And, to the extent that raising the penalty interest rate by ε does not induce early repayment, it simply yields higher revenues. ■

RESULT 2. *Symmetric equilibria under "own default" satisfy one of the following conditions:*

(a) *The penalty interest rate ≤ the maximum allowable interest rate, and the firm is indifferent between being repaid in period 2 and not being repaid in period 2.*

(b) *The penalty interest rate = the maximum allowable interest rate, and the firm strictly prefers being repaid in period 2 to not being repaid in period 2.*

REASONING. Consider all possible penalty rates in the interval from the regular interest rate to the maximum allowable interest rate. By the same reasoning as for Result 1, at the regular interest rate, default results in negative expected profits, and therefore the firm strictly prefers being repaid in period 2 to not being repaid in period 2. Suppose that the firm also strictly prefers being repaid in period 2 to not being paid in period 2 at all higher interest rates in the interval (where the associated regular interest rate has been chosen to be the equilibrium interest rate). Then either firm would profitably deviate by raising its penalty rate by ε whenever possible, making the maximum allowable interest rate the unique equilibrium penalty interest rate (Case (b)). Conversely, suppose that there exists a penalty interest rate in this interval such that the firm does not strictly prefer being repaid in period 2 (where the associated regular interest rate has been chosen to be the equilibrium interest rate). Then, let r^P denote the lowest such penalty interest rate. Then with a penalty interest rate of r^P (and the associated regular interest rate chosen to be the regular interest rate), a continuity argument implies that the firm is indifferent between being repaid in period 2 and not being repaid in period 2 (Case (a)). ■

5 Preliminary Results from Simulations

Our preliminary simulations are done with the following parameter values:

$\gamma = 0.5$ (parameter in utility function)
$\overline{I} = 1$ (income is distributed on interval [0, 1])
$\overline{L} = 0.2$ (credit limit on a given card)
$\alpha = 0.2$ (minimum payment as percentage of balance)
$r_m = 8\%$ (market interest rate)
$\overline{r} = 30\%$ (maximum allowable penalty interest rate)

Repaying one card but not the other does not avert any penalty interest rates at all. In our preliminary results, it appears that an optimizing consumer will generally repay at least the minimum payment on both cards or else will repay zero on both cards (but will not repay one card, under universal default, or repay an amount in between).

5.1 Simulations under own default

Under own default, a candidate equilibrium in which the penalty interest rate equals the maximum allowable interest rate (Case (b) in Result 2) can first be simulated. In the simulation, we find that:

$r = 12.60\%$ (regular interest rate)
$r^P = 30\%$ (penalty interest rate)
$P_2 = 54.67\%$ (probability of full repayment after missing payments on 2 cards)
$P_1 = 61.67\%$ (probability of full repayment after missing payments on 1 card)
$EU = 147.47$ (expected utility over all states of the world × 100)

However, the candidate equilibrium of Case (b) is not a true equilibrium, for the following reason. The high penalty interest rate more than offsets the expected default losses (as a percentage of balances loaned). The firm strictly prefers *not* to be repaid in period 2 over being repaid in period 2. Thus, the firm could profitably deviate by offering a slightly lower penalty interest rate.

An interior solution, i.e., a candidate equilibrium in which the penalty interest rate is less than the maximum allowable interest rate (Case (a) in Result 2) can also be simulated. In the simulation, we find that:

$r = 14.11\%$ (regular interest rate)
$r^P = 18.89\%$ (penalty interest rate)
$P_2 = 57.40\%$ (probability of full repayment after missing payments on 2 cards)
$P_1 = 62.40\%$ (probability of full repayment after missing payments on 1 card)
$EU = 147.56$ (expected utility over all states of the world × 100)

The candidate equilibrium of Case (a) appears to be a true equilibrium. The penalty interest rate reflects the expected default losses (as a percentage of balances loaned), making the firm

indifferent between being repaid in period 2 and not being repaid in period 2. This is the requirement for equilibrium in this situation.

It is illuminating to see the consumer's debt level after period 2 (and implied repayment in period 2). This is graphed in the first panel of Figure 1. At low levels of income realization, the consumer misses the minimum payment on both cards. At the next interval of income realizations, the consumer makes the minimum payment on one card but no payment on the other. At the next interval of income realizations, the consumer makes the minimum payment on both cards, but no additional repayment. Finally, at the highest income realizations, the consumer's repayment increases in income, until full repayment occurs.

5.2 Simulations under universal default

Under universal default, a candidate equilibrium in which the penalty interest rate equals the maximum allowable interest rate (Case (b) in Result 2) can be simulated using the same parameter values. In the simulation, we find that:

$r = 12.79\%$ (regular interest rate)
$r^p = 30\%$ (penalty interest rate)
$P_2 = 54.80\%$ (probability of full repayment after missing payments on 2 cards)
P_1 : not applicable (prob. of full repayment after missing payments on 1 card)
$EU = 147.43$ (expected utility over all states of the world × 100)

The candidate equilibrium of Case (b) appears to be a true equilibrium. The high penalty interest rate more than offsets the expected default losses, and the firm strictly prefers *not* to be repaid in period 2 over being repaid in period 2. However, under universal default, this does not imply that either firm has a profitable deviation. The explanation appears to be that the consumer generally does not make a minimum payment on a single card under universal default, as the consumer would still be subject to penalty interest rates on both cards. Therefore, a modest reduction on a firm's penalty interest rate has negligible effect on the probability of repayment — but serves to reduce the firm's revenues.

It is illuminating to see the consumer's debt level after period 2 (and implied repayment in period 2). This is graphed in the second panel of Figure 1. At low levels of income realization, the consumer misses the minimum payment on both cards. There is *no* interval where the consumer makes the minimum payment on one card but no payment on the other. At the next interval of income realizations, the consumer makes the minimum payment on both cards, but no additional repayment. Finally, at the highest income realizations, the consumer's repayment increases in income, until full repayment occurs.

6 Discussion

Subject to the caveat that our results are only preliminary, let us compare the regimes of own default and universal default simulated in the previous section and make some observations. First, the penalty interest rate appears to be higher under universal default, and the higher interest

rate exceeds the enhanced credit risk associated with missing a payment. Second, the probability of full repayment following missing the minimum payment is lower under universal default, i.e., universal default clauses tend to increase the difficulty for consumers to emerge from debt without serious defaults or bankruptcy. Third, the expected utility of consumers over all states of the world appears to be lower in the equilibrium that we have constructed under universal default, as compared to under own default. Finally, since the firms' expected profits have been held constant in this exercise, it can also be said that social welfare is expected to be lower under universal default than under own default. In short, the simulations appear to favor limitations on the practice of universal default.

Our confidence in these results needs to be tempered by their preliminary nature and by the possibility that there are other parameter values for which these results may be reversed. Still, there appears to be present a tight argument why lenders would impose universal default clauses, but society as a whole (including lenders) would benefit from a collective choice to eliminate them.

The analysis in this paper may be limited in that consumers have been assumed to make fully-optimizing decisions (subject to their uncertain future incomes). However, there exists longstanding evidence that consumers may tend to underestimate their future borrowing (see, for example, Ausubel, 1991) or otherwise be overly optimistic about their future financial prospects. Under such scenarios, consumers would likely take insufficient account of the penalty interest rates that they might face. As such, the effects and conclusions described in this paper would likely be amplified.

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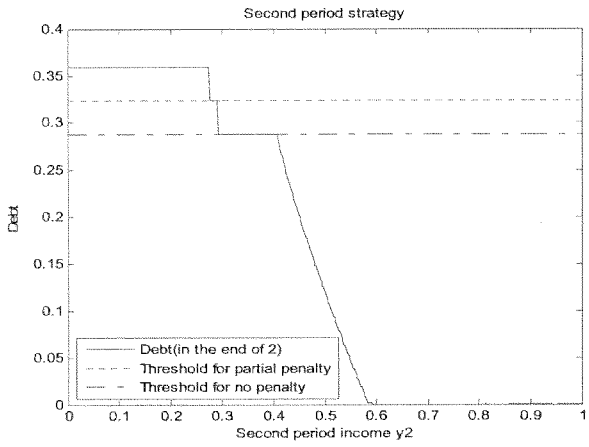
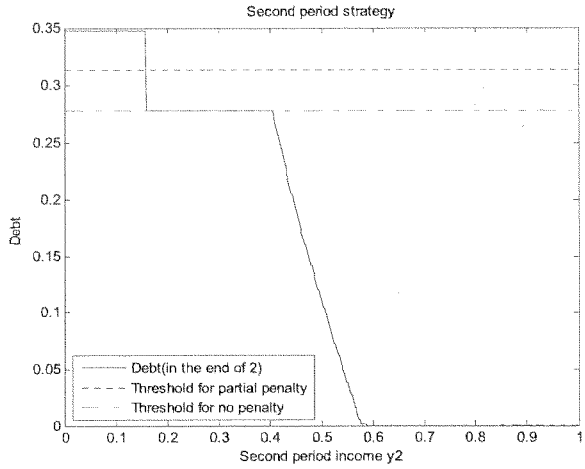
Figure 1: Consumer Debt in Simulations



Simulation under "Own Default"



Simulation under "Universal Default"

Testimony of Gregory Baer
Deputy General Counsel
Bank of America

Before the House Financial Services
Subcommittee on Financial Institutions & Consumer Credit
Hearing on the Credit Cardholders' Bill of Rights, H.R. 5244

March 13, 2008

Introduction

Good morning, Chairwoman Maloney, Ranking Member Biggert and Members of the Subcommittee. My name is Gregory Baer and I am a Deputy General Counsel at Bank of America focusing on Regulatory and Public Policy. I appreciate the opportunity to discuss our views on the Credit Cardholders' Bill of Rights Act of 2008, H.R. 5244.

This is Bank of America's second appearance before the subcommittee on these issues, and we had the opportunity to participate in your credit card summit as well. We are pleased that the subcommittee intends multiple hearings on the legislation and will hear from regulators, various issuers and other experts. While we understand most of the major issuers will at some point testify, we also encourage the subcommittee to hear from smaller issuers that target specific economic segments of the population that could be more vulnerable during these current economic conditions. The issues being discussed today are of great importance to our economy, and the risk of unintended consequences, both to consumers and to the overall economy, is significant.

Bank of America provides a full range of financial services to individual consumers, small- and middle-market businesses, large corporations and government entities. In the retail space, Bank of America Card Services has more than 40 million active customers and more than $200 billion in managed loans. At Bank of America, we believe that we have this volume of customers because we listen to them – more than 90 million calls per year – and work hard to meet their needs, minimize mistakes and continuously improve.

Today, I will focus my comments on how H.R. 5244 would affect our ability to serve consumers. First, I will discuss the current competitive and regulatory environment for credit cards. Then, I will highlight the likely impact of particular provisions of the bill.

In sum, we believe that H.R. 5244 would significantly hinder the ability of financial institutions to price the risks of credit card lending, and would result in less credit being made available to creditworthy borrowers, with generally higher prices for those who do receive credit. Because we see the card industry as a highly competitive one, we do not believe that legislation setting terms and, implicitly, prices is necessary to protect consumers, who generally benefit from competitive financial markets. H.R 5244 is also likely to have other unintended effects.

Overview of the Industry

A credit card relationship offers consumers unique flexibility and choice. Every time a consumer uses a credit card, for any reason, the customer is receiving an unsecured loan that the lender grants based largely on the customer's earlier promise to repay. If the customer wishes to charge additional items or is unable to repay the loan immediately, the lender has agreed in advance to allow the customer to revolve a balance on the loan up to a pre-determined amount and repay a portion each month, thereby avoiding the need to apply for a new loan. The amount revolved and the length of repayment is

largely up to the consumer. But this flexibility for the customer means real challenges for issuers who must earn a reasonable risk-based return and operate safely and soundly. Before risk-based pricing, card companies simply charged all cardholders a relatively higher rate at the outset, and declined credit to those who presented more risk.

Risk-based pricing has revolutionized the credit card industry. Issuers have developed sophisticated modeling capabilities that combine internal data with credit bureau information to predict future performance and price loans accordingly. Such innovations, coupled with the law that this Committee crafted (the FACT Act) to help make sure credit history information is more reliable, have helped lenders manage risk better than in the past. The result has been democratized access to credit – allowing lenders to offer affordable, mainstream credit to consumers who previously might have been denied from receiving bank loans or other traditional forms of credit. The GAO recently documented these benefits as part of an exhaustive study, which also noted that this transition, combined with vigorous competition among issuers, lowered rates for vast segments of credit card users.

Risk-based pricing is first employed when we receive an application from a consumer. We pull a credit bureau report, and consider the consumer's FICO score and general credit history. That information is useful, but as the years go by, and the customer's financial situation changes, sometimes significantly, the original score tells us less and less about the risks we are actually running when we lend to the customer each month. But our actual experience with the customer, and information about the customer's ongoing behavior with other lenders, tells us quite a lot. We can thereby offer lower rates to customers who manage their credit well and relatively higher rates to those who don't. We take experience into account in two ways:

Default re-pricing

Default pricing (sometimes called penalty pricing) occurs when a customer is late or overlimit on an account, and the APR is increased as a result of that default event. Default pricing is disclosed upfront as a part of the Schumer Box and is set out in the credit card agreement. The change, therefore, is made in the context of the existing agreement. Our practice at Bank of America is that a customer must be late or overlimit not once but twice within a 12-month period on his or her Bank of America credit card account before default pricing can be applied. (Some issuers treat a bounced payment check as an event of default, but Bank of America does not.) However, not all customers who hit our default triggers are necessarily re-priced and, of those who are re-priced, not all go to the full default rate. We look at these customers individually, and determine whether the default truly indicates heightened risk.

Risk-based re-pricing

When we see that a customer is exhibiting risky behavior — and this may include high utilization (maxing out credit cards) or delinquency with other lenders — we may seek to charge the customer a higher interest rate. But the customer always has notice and

choice. If the customer does not wish to pay the higher rate, he or she can simply decline the proposed change in terms and repay the existing balance under the old interest rate; the only thing the customer need do in return is stop making additional charges on the card. (The customer's right to say no is the crucial distinction between risk-based pricing and universal default, in which Bank of America has never engaged.)

I should note that our experience shows that nothing frustrates customers more than an increase in their interest rate. At Bank of America, where our goal is to make a credit card customer a mortgage, deposit, brokerage and retirement savings customer, we have all the more reason to maintain competitive prices and keep customers satisfied. Looking at our 2007 portfolio, the overwhelming majority of customers – nearly 94% – had the same or lower rate at the end of the year than they did at the beginning, and four times as many customers had a lower rate than a higher one.

So, why would we ever raise rates? First, because for these customers, we are confident that we bear real, increased risk. Repeated, rigorous testing shows that our internal models, supplemented by FICO scores, are extraordinarily predictive of consumer behavior. GAO and other studies have confirmed as much.

Furthermore, when we re-price customers, we find that the repricing itself does not cause any significant increase in default – in other words, for two groups of borrowers with a given risk profile or score, those who accept a change in terms to a higher, risk-based rate do not default more than a control group who are kept at a lower rate. But both groups default 50% more frequently than our average customers – confirming that our models are truly predictive of eventual customer default. Many repriced customers tend to manage their credit more wisely, making larger monthly payments and paying down their debt faster. Thus, from our perspective, a higher interest rate not only allows us to earn income to compensate for greater risk, it actually reduces the risk we are managing and causes the customer to manage credit more wisely.

Some of the borrowers to whom we propose a change in terms exercise their right to opt out of a higher rate – an option Bank of America offers for any risk-based re-pricing. And of course there are others who do not opt out but simply transfer their balance to another issuer. This is the market at work. Either we have over-priced the risk of this borrower, and are losing a valuable customer, or our competitor has under-priced the risk of this borrower, and is taking on undue risk.

In some cases, borrowers do have problems paying the higher rate, because they are in genuine financial distress. If a customer falls behind on an account, our experience tells us it is likely due to circumstances outside his or her control. In our Customer Assistance division, we believe each account should be reviewed on an individual basis by using "account recognition" skills. Account recognition means taking all the customer's information into consideration before determining the best way to resolve the situation. If assessment of a customer's financial situation determines that he or she is unable to maintain the minimum monthly payments, we will offer several options to assist with the

repayment of the loan. The right program is determined by understanding whether the customer is experiencing short- or long-term financial difficulties.

In addition, on an annual basis, we award approximately $6 million to non-profit credit-counseling agencies that help people work their way out of financial distress. We work hand-in-hand with these agencies to tailor customized loan arrangements to fit individual circumstances and to help people get back on a solid financial footing.

Second, charging higher rates to our riskiest customers allows us to hold down interest rates and fees on our less risky customers – those who manage their accounts responsibly. Thus, a large segment of our accounts – those who pay off their balance each month – pay no interest or fees for the benefits of their cards. These so-called "transactors" pay their balances in full each month and receive the benefit of a grace period, whereby they receive an interest-free loan provided that they repay in full each month, thereby demonstrating themselves to be very low risk customers. The emergence of this option demonstrates the level of competition in the market place. Risk-based pricing allows us to reward less risky consumers by charging them relatively less.

And of course the market here is dynamic. If a significant number of consumers demonstrate that they are intolerant of the possibility of rate increases, someone will innovate to meet that need, and profit from it. Such innovation is going on right now. But H.R. 5244 would inhibit innovation by setting in legislation important terms around which issuers now innovate.

Regulation Z and Unfair and Deceptive Practices Regulations

Of course, innovation in the market place depends in large part on customers understanding the differences among issuers, making informed choices about the products they select and how they use them. With the increase in flexibility and eligibility, the job of describing how the product works has become more complex. To address these concerns, the Federal Reserve Board has proposed substantial revisions to Regulation Z, which implements the Truth in Lending Act. We believe that the proposed revision is thorough and well crafted. The quality of the proposal reflects the fact that the Board conducted numerous focus groups with consumers in order to determine their preferences and needs. This work has resulted in the Board's proposal being shaped by those who will directly benefit from it. As a result, the regulation will provide customers meaningful disclosures in an even clearer format, and it will facilitate comparison shopping and better assist consumers in modifying their behavior, potentially reducing their costs.

More recently, Chairman Bernanke announced that the Federal Reserve also will promulgate additional consumer protections addressing specific credit card practices. We would encourage Congress to allow that process to move forward before enacting legislation. We believe the Fed's rulemaking provides a dynamic approach in such a rapidly evolving industry.

Effects of Legislation

Now let me turn to H.R. 5244, and express some of the more significant concerns that Bank of America has about the bill.

Risk-based pricing

As we read Section 1 of the bill, it would make four fundamental changes to our ability to price and manage risk.

First, it would prohibit risk-based re-pricing of existing debt at any time, even with notice and choice. For purposes of evaluating the impact of this provision, it is important to note that in the great majority of cases, we learn about an increase in a customer's risk *after* the customer has run up a large balance and utilized a large part of a credit line, not before. Thus, ***the risk lies in that existing balance, not future charges*** (which may not even be permitted if the customer has reached or exceeded the card's credit limit).

Thus, under H.R. 5244 once a customer ran up a balance of, for example, $9,000, then the interest rate applicable at the time of the charges – say, 9.9% – would continue to apply until the loan is repaid. Currently, we propose a higher interest rate to customers but tell them that they have the right to say no – to opt out of the increase and repay the existing balance under the old rate, so long as they stop using the card – but H.R. 5244 would say that they can keep the old rate *and* continue using the card at the new rate by accepting the proposed "change in terms" with no consequence.

As already noted, we have found that an increased interest rate causes borrowers to repay their outstanding balances in larger amounts and more quickly, thereby reducing our risk and their exposure. Under H.R. 5244, this tool would be taken away and the result would be higher prices and less credit available at the outset and throughout the relationship.

Second, in addition to letting them opt out of risk-based re-pricing, H.R. 5244 would provide customers the ability to opt out of default re-pricing – that is, allow customers to breach their agreement but suffer no consequence for it. Under H.R. 5244, a consumer could keep the loan open, making only a minimum payment; so, if interest rates rose, and the customer's credit rating fell and prevented him from obtaining other credit, the customer could repay as slowly as possible.

H.R. 5244 thereby would take significant steps to reduce a customer's incentive to manage credit wisely – to both the issuers detriment and the customers. A customer who consistently paid late or overspent would be given the opportunity to opt out of the higher rate that the customer agreed to pay in the event of such misbehavior. This customer's risk would be subsidized by those other customers who do not default on their contracts.

Third, as we read the bill, issuers would generally be prohibited from re-pricing except at the expiration of the term of the card. At that point, they could re-price by amendment for any reason – *except risk.*

Last, the notice mechanics of H.R. 5244 would seriously impede the ability of banks to respond to risk when that risk is identified. In aggregate, provisions of H.R. 5244 would give customers an extraordinary 135 days to decide whether to accept a higher interest rate or take their business elsewhere. This extended period and a lack of incentive for customers to pay in a timely fashion would significantly increase risk.

In sum, Section 1 of H.R. 5244 would increase issuers' risk and take away important tools they use to manage it. The results are not hard to predict. H.R. 5244 would at least in the short term reduce the cost of credit for existing consumers with damaged or deteriorating credit. However, it would reduce the ability of such consumers to obtain credit in the future. Knowing that any charges incurred by a consumer will continue to carry the same interest rate indefinitely, lenders – as a matter of both profitability and safety and soundness – would be required to restrict availability and raise rates for such borrowers. Finally, and most importantly, because it is difficult to predict at the outset which borrowers will end up defaulting, rates and fees are highly likely to rise for all borrowers.

Of course, one could respond that fewer Americans having credit cards, or being able to borrow less, is just what the doctor ordered, and that government-sponsored reductions in the amounts that consumers can borrow is appropriate. But of course this bill focuses only on credit cards. There is no reason to believe that consumers denied credit through credit cards will not choose to turn to payday lenders or other higher-cost, lower transparency sources of credit. And H.R. 5244 would also raise prices on the great majority of customers who are managing their credit responsibly, and currently benefiting from risk-based pricing.

Recent experience suggests that this course is not a wise one. There is general consensus that the major cause of the mortgage crisis was an originate-to-distribute model where players in the system had incentives to externalize or not fully consider risk. A clear lesson of the past year has been that both lenders *and consumers* suffer when lenders do not sufficiently consider risk in pricing loans.

As a credit card lender, we internalize risk. Credit card lending is unsecured, and if a customer defaults, we suffer the loss. The customer emerges with damaged credit, but loses no assets. H.R. 5244 would exacerbate this problem by limiting our ability to adjust terms to meet risk.

There is another area where a comparison of mortgage and credit card legislation is worthwhile. The major credit card companies fund more than 50% of their portfolios through securitization – currently more than $400 billion of receivables are funded through asset-backed securities. Investors in card receivables have taken comfort from the underwriting discipline of issuers, including their ability to adjust on a real-time basis for changes in risk. Obviously, the availability of funds would shrink or rise in cost to the extent that issuers' ability to price for risk was degraded, with this cost passed along to borrowers.

In considering legislation on mortgage lending, the Committee wisely continues to consult with a wide range of secondary market participants to determine the potential impact on already damaged credit markets. We believe this bill has the potential to have similar significant impacts on such markets, and would urge at least as much consultation before so profoundly changing the way credit cards are priced and managed.

Pro-rata Payment Allocation

As card lending has developed, customers frequently carry balances on which they carry higher interest rates. Cash advances, for example, carry higher rates than purchases; initial, promotional rates offered to encourage balance transfers often carry a lower, even 0% rate. Section 3(f) of the bill requires that any payment made by a customer be assigned pro rata to each balance; so a $100 payment by a customer with a $500 cash advance balance at 19.9 percent, $300 purchase balance at 9.9%, and $200 promotional rate balance at 0%, will be assigned $50, $30, and $20 respectively. Currently, most issuers would apply the $100 payment solely to the promotional rate balance.

Such an allocation scheme seems rational; however, the market should be left to produce such a structure, rather than having Congress mandate it by legislation. A clear downside of such an allocation system – and perhaps why the market has *not* produced it – is that it would severely curtail the use of promotional rates that have proven popular with, and valuable to, customers. Under the Fed's proposed Regulation Z, disclosure of payment allocation practices will be improved, and competitors will have an incentive to move towards pro rata allocation if there is genuine demand for it (and a corresponding lack of demand for promotional rates). It is worth noting that a customer who intends to pay off a balance after a couple of months would more rationally choose the former, but would be denied that choice by H.R. 5244.

Average Daily Balance

At its most elemental, lending means extending funds to a borrower in exchange for the payment of interest. Interest is assessed against the amount owed for the amount that the loan is outstanding, at an agreed-upon rate. Thus, if credit card lending were like all other types of lending, a cardholder would begin to pay interest at the time credit was extended – for example, at the time a purchase was made – and would pay interest for the use of those funds until repaid. In competing for borrowers, however, credit card issuers combined the benefits of a charge card – where customers were required to pay in full each month – with the ability to revolve a balance each month to create a unique exception to this rule: basically, that a loan would be interest-free in the event that the borrower repaid it in full at the end of the billing cycle. So, even if a customer borrowed money on the first day of the month and repaid it on the last – 30 days worth of borrowing, and 30 days of credit risk for the lender – no interest would be charged.

There was nothing foreordained about this outcome. It is not required by law; indeed, it is hard to imagine a law requiring banks to lend money interest free. It is certainly not

the market norm: one does not receive a refund of each month's mortgage interest if the principal payment is repaid; borrowers are not rebated interest they pay on a car loan if they repay the principal. Indeed, this outcome is rather extraordinary – and represents a major financial sacrifice by lenders, who could earn substantially more interest income under traditional practice. That, of course, is why its benefits have been limited to one type of borrower: the borrower who consistently repays in full each month, and thus represents the lowest risk.

For borrowers who do revolve a balance, issuers charge interest against the average daily balance over the cycle. Borrowers who revolve a balance – that is, do not repay in full – pay an interest rate that is multiplied by the average amount they borrowed during the month. That method is universal, relatively simple to understand, and, we thought, uncontroversial.

Under the average daily balance method, interest is owed on the average amount borrowed over the course of the previous period. Suppose, for example, that a customer with a 10% interest rate begins the January period with a carryover $1,000 outstanding balance, makes a $500 purchase halfway through the month and then pays $500 at the very end of the cycle. The 10% interest rate would be applied to the $1,000 for the first half of the month, and to $1,500 for the second half.

As we read the bill, Section 3 invalidates the average daily balance method of calculating interest owed on an account. Section 3 would, in effect, allocate the payment to the new purchases and dictate that the customer pay interest on only $1,000 for every day of the month - in other words, that $500 of the $1,500 in credit offered for the month be an interest-free loan. The section is self-described as prohibiting double-cycle billing, but would not prohibit double-cycle billing but rather single-cycle billing. (Double cycle billing - a practice in which Bank of America has never engaged - occurs when a customer who has been paying in full each month decides to begin revolving a balance; in a month where the customer began owing nothing, the interest rate is assessed against charges made in that month as well as the following month – that is, assessed in two cycles.)

As noted earlier, we currently make interest-free loans to our customers who pay off each month; H.R. 5244 would also require us to make interest-free loans to customers who revolve a balance, if they choose to pay off at the end of the month.

Credit Cycle

H.R. 5244 would mandate that there must be at least 25 days between the date the statement is mailed and the payment due date (as opposed to 14 days, under current law). Given that it takes us 3-6 days to generate and mail statements after the closing date (and given that months have 28-31 days), we would simply be unable to comply with this provision, absent the elimination of grace periods. Furthermore, in effect, this section would mandate that any grace period provided by an issuer – that is, any interest free loan – last a minimum of 25 days plus processing time – as opposed to 14 days plus

processing time currently. By mandating the length of a grace period, this provision would either further endanger the continuance of grace periods or cause other prices or fees to rise. Given the absence of any empirical evidence that customers need a time for mailing of greater than 14 days, we cannot support the government setting this term of the agreement.

Fraud Risk

Section 3(d) would prohibit issuers from reporting to a credit bureau the fact that a consumer has recently opened new credit card accounts until the card is used or activated by the consumer. This seemingly innocuous provision will significantly increase so-called "bust-out risk" – that is, what happens when an identity thief, or a customer facing a financial crisis, applies for multiple cards at the same time, with the goal of maxing them all out immediately. If our lenders see such behavior going on, they will not issue a card. But under H.R. 3244, they will be blinded to this risk until it is too late.

We have other, more technical, concerns about the bill, which we would be pleased to discuss with Committee staff.

Conclusion

Based on our own experience with each customer and on the experience of other creditors, it is imperative that we take risk into account when making lending decisions. Doing so makes good financial sense, and makes credit readily available at more competitive prices to more customers. Every credit card company uses different pricing strategies based on what it thinks best serves its customers and what makes it the most competitive in a highly competitive market place. We strongly believe ours is what provides the most credit at the least cost to more of our customers while fairly pricing for risk.

Thank you for the opportunity to share our views today. I look forward to any questions from the panel.

Testimony of John G. Finneran, Jr. General Counsel, Capital One Financial Corporation
Before the United States House Subcommittee on Financial Institutions
March 13, 2008

Chairwoman Maloney, Ranking Member Biggert, and members of the Committee, my name is John Finneran. I am the General Counsel of Capital One Financial Corporation. I want to thank you for inviting me back to testify before the Subcommittee, this time about pending credit card legislation. As you may recall, I testified before you in June of 2007, and participated in the Credit Card Summit hosted by Chairwoman Maloney, in July.

This Subcommittee has played a constructive role in identifying problems that consumers have with their credit cards. We have been a willing, active participant in the dialogue about how to improve on the remarkable value delivered to millions of American consumers by credit card products.

With respect to the practices that have been central to the debate, Capital One has worked diligently to establish a high standard of customer sensitivity.

- We do not engage in any form of "Universal Default" repricing.
- We have never done 2-cycle billing.
- We have a single, clear penalty repricing policy. We will impose a penalty rate on a customer only if the customer pays late twice by three or more days in a twelve month period with respect to that specific card. We will provide the customer with a prominent warning on the billing statement after the first infraction. In many cases, we choose not to reprice a customer even if the customer pays us late twice in a twelve month period. If a customer is

repriced, but pays us on time for 12 consecutive months, we will take the customer back to the prior rate. This "unrepricing" is automatic.

- We have supported the Federal Reserve's proposed 45-day notice for penalty repricing, and have gone beyond the Fed's proposal to urge that customers be given the opportunity to reject any repricing, close the account, and pay down the outstanding balance at the old rate over time.
- We provide our customers notice and the ability to opt out of overlimit transactions.

Across our entire portfolio of customers—more than 30 million--we work very hard to provide important notices in plain English that capture attention at critical moments. We do so because we believe—as Chairman Bernanke said to this Committee--that card holders must understand the terms under which they are borrowing, and be empowered to manage their credit wisely—as the overwhelming majority of our customers do.

Capital One has never been a voice for the status quo. We have long advocated for changes in the way credit cards are marketed to consumers. We believe that the banking regulators have the statutory authority right now to implement an advanced consumer choice regime that effectively solves the most critical credit card problems identified by the Committee with minimal risk of over steering or unintended consequences.

Toward that end, we have led the industry in recommending that consumers have clear, conspicuous 45-day notice and the right to opt out of all types of repricing. And we believe that such a regulatory initiative may be on the horizon.

But Madame Chairwoman, we also believe that it is unwise—especially at this time—to enact broad legislation that sets payment formulas in statute, redefines critical product features, and limits the tools of risk management for consumer credit.

Capital One must therefore oppose H.R. 5244 and we do so for three fundamental reasons:

1. The legislation sets multiple statutory limits on a lender's ability to price for the cost of credit. For example, under the heading of eliminating "double cycle billing," the bill actually redefines the concept of "grace period" and arbitrarily expands the degree to which all issuers--even those that don't engage in double cycle billing--must extend credit interest-free. Similarly, the bill mandates a formula for allocating a customer's payments for different types of borrowing in a way that will certainly result in reducing the availability of deeply discounted introductory and balance transfer rates. Other provisions also raise the specter of price controls.
2. The consequence of so sweeping a bill would be to force the industry to raise the cost of credit for everyone, including those who present less risk of default to the lender, and reduce the availability of credit for those customers who present a greater risk of default.
3. This result would be exactly the wrong policy prescription, particularly in this economic environment. As the mortgage crisis has unfolded, we've had a progressive tightening in the credit markets and many believe we are near or in a recession. To ease the impact of a slow-down in our economy, the Fed has aggressively lowered the federal funds rate and the Congress has passed a

bipartisan stimulus package. H.R. 5244 could significantly counteract the positive effects of both of those policy initiatives.

Madame Chairwoman, that would be especially unfortunate since the regulators—those policy makers uniquely positioned to evaluate the complex and dynamic credit card industry—are poised to address all of the issues targeted by H.R. 5244.

Under its new Reg Z rule, the Fed proposes a 45-day notice period before all types of repricing. The new rule also offers improved disclosure requirements for payment allocation, minimum payment, and "fixed" and introductory interest rates. And that's just a partial list.

Equally important, Chairman Bernanke has confirmed before this Committee that the Fed will soon supplement its Reg Z rule with new credit card rules under its UDAP authority. It seems likely that those rules will go to the core of the Committee's concerns. We believe that such rules may provide the best, safest and most direct road to reform.

Capital One has publicly called for balanced, reasoned change that can be implemented quickly, would improve disclosure and enhance consumer choice. We have also sought to work cooperatively with you and the Committee. Though we must respectfully disagree about the impact of H.R. 5244, I want to thank you for this opportunity to express our views.

# # #

Testimony of Carter Franke
House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit
March 13, 2008

Madam Chairman, Members of the Committee, good morning. My name is Carter Franke; I am a senior vice president at JPMorgan Chase.

I am proud to represent, today, more than 20,000 Chase Card Service employees who serve the needs of more than 100 million Chase credit card relationships every day.

Chase believes that building solid customer relationships is the best approach to long-term success in the credit card or any industry, and we have worked to deepen those relationships for a number of years. This is our third appearance before Congress in the last 14 months, and we have listened carefully to the points of view that have been raised. More important, we have listened closely to our customers, and as a response to their needs and concerns, we have made changes in our practices to align with them.

Last year we articulated before Congress and in other venues our belief that the appropriate use of credit cards involves a shared responsibility between card issuing banks and their customers. We said that credit card holders need to use their cards responsibly. That means they should only purchase goods and services they can afford; they should not exceed their credit limits; they should make payments on time; and they should avoid behavior that lowers their overall credit worthiness.

For banks like Chase, our responsibilities include the need to communicate clearly and transparently about our products, to help customers understand the terms of our agreements – and to go further by helping them live up to those terms.

That is why, early last year, we developed our *Clear & Simple* program, to make sure customers have clear information and to simplify their relationship with us. Our *Clear & Simple* web site contains tools and access to programs that help customers manage their accounts and avoid late and over-limit fees. Through *Clear & Simple* customers may, for example, stop courtesy approval of over-limit charges, thereby assuring they will never be charged an over-limit fee. They may also sign up for free payment-due alerts and choose their own payment due date. They may also sign up for automatic payments, virtually assuring they will never be charged a late fee. The *Clear & Simple* site also contains educational resources for groups such as students and seniors to help them understand personal finance and the limits necessary to use credit cards wisely.

Last year, Madam Chairman, we participated in your roundtable process to develop a set of "Gold Standard" Credit Card Principles. We were pleased to be included in the roundtable and gratified that we could contribute to the Principles. In general, we believe that a broad set of clear, customer-friendly principles makes great sense and can serve as a guide to responsible behavior.

Also last year, as we examined our policies and practices through the lens of our *Clear & Simple* principles and in response to customer comments, we decided to make a major policy shift. We announced in November that, as of March 1st of this year, we would no longer use credit bureau information to re-set a customer's interest rate.

We very much appreciated your announcement applauding our change, Madam Chairman. We believe that in both principle and practice, we share your concerns for consumers who use credit cards.

However, we also believe that great caution must be exercised in the process of turning these concerns into complex new legislation. That is particularly true since good regulatory alternatives exist, namely the Fed's Regulation Z, which is well under way and promises to include certain features that will greatly benefit consumers, accomplishing much of what HR 5244, the Credit Card Bill of Rights Act of 2008, contemplates.

The Fed's far-reaching overhaul, while not perfect as we noted in our comment letter, will significantly improve consumer disclosures and consumers' control over contract terms. It is the result of extensive research and exhaustive consumer input involving 2,000 public comment letters, 900 pages of proposed changes, and significant interview and focus group research with consumers around the country. When the revised regulations are in place, we believe they will accomplish much of what policymakers want without the unintended consequence of harming the great majority of consumers with higher interest rates, about which I will speak in a moment.

I would also like to remind this Committee that Fed Chairman Bernanke, appearing here on February 27th, not only addressed the importance of Reg Z for consumers, but he also referred to the Fed's authority under the Unfair or Deceptive Acts and Practices authority to "ban specific practices which are unfair or deceptive for the consumer." This proposal is expected to be circulated soon.

At Chase, we believe that the Federal Reserve Board's process to put more information and greater control in the hands of consumers, combined with a commitment to ban practices that are unfair or deceptive, is preferable to the legislation currently under discussion and that Congress should let the Fed's process continue to determine its effectiveness.

We urge caution and great restraint with HR 5244 today and ask the various elements of our society represented here today – elected representatives, consumers, and industry – to consider the real and ultimate goal we are trying to achieve. If you see that goal, as we do, to be the continued availability of unsecured credit to the broadest group of Americans at the lowest average cost, then we all need to step back and see what impact this legislation would likely have.

Even though Chase does not engage in a number of the practices the bill would prohibit – for example, two-cycle billing and bureau-based re-pricing – we are still concerned about the unintended consequences for consumers that will result from legislation that would significantly reduce our ability to price our product according to the individually tailored profiles of our customers. This individualized pricing based on a customer's risk profile is the bedrock of our competitive credit card industry today. The ability to price for individual risk and make attractive offers for consumers' business based on competitive interest rates has significantly lowered the average rate paid by the vast majority of consumers, while at the same time making credit available to many who would never have qualified for a card only 15 years ago.

Turning back the clock on individualized pricing will reverse the most beneficial trend for consumers, as chronicled in a number of studies, in the past 20 years – bringing credit cards to many more people at much lower average prices.

The 2006 GAO report, requested by Senator Levin, found that credit card interest rates had declined from around 20 percent in 1990 to 12.3 percent in 2005. Federal Reserve data shows a similar drop in interest rates in the same period – from 18.23 percent at the end of 1990 to 12.58 percent at the end of 2005. Most studies relate these declines to the development of risk-based pricing and subsequent competition.

According to the Federal Reserve "Report on Practices," "advances in the technology of credit-risk assessment and the breadth and depth of the information available on consumers' credit experiences have made it possible for creditors to quickly and inexpensively assess and price risk and to solicit new customers." The result has been to unleash competitive forces that have lowered the interest rates on the majority of credit cards to close to that of the cost of funds.

Yet the current bill would undermine the competitive individual pricing model through a number of sub-provisions that essentially micro-manage a bank's ability to charge interest and to change an interest rate whenever a customer does not keep a promise, such as failing to pay a bill or going substantially over their credit limit. These are important parts of our agreement, and we have always made the consequences clear to our customers both at application and when they receive their card. The bill also requires that a bank follow payment terms which cost a great deal to implement – costs that will be passed on to consumers -- and will virtually end competitive efforts to win business through low or zero interest offers.

At Chase, our experience is that consumers appreciate these offers and take advantage of them. Many have become our long-term, valued customers.

Credit card issuing banks are constantly evaluating which of these loans may lead to a costly default or non payment. Whenever a bank's ability to adjust pricing at the first sight of default indicators is diminished, our experience tells us that expensive defaults will rise. For example, at Chase, approximately 30 percent of late payers eventually default on their loans. This results in costs being driven up and passed on to consumers in the form of higher interest rates and avoiding taking on customers with riskier individual profiles, cutting off access to mainstream credit for many Americans. When this happens, these families may be forced to turn to payday lenders and sub-prime credit sources where interest rates can be extraordinarily high.

Please keep in mind that these comments come from a bank that has already taken extraordinary steps to increase the control its customers have over their accounts, including most notably our recent pricing policy change that we no longer use credit bureau information to initiate an increase to a customer's rate – *ever*. We believe that especially in times of economic uncertainty, our customers appreciate knowing that whatever financial strain they might face, we won't add to it, as long as they remain in good standing with us.

We also very strongly believe the context in which HR 5244 is being put forward argues for considerable restraint on this legislation.

In this uncertain economy, with credit markets already much tighter than they have been in many years, prudence would seem to dictate extreme caution with legislation that has the potential to further restrict consumers' access to credit. Access to unsecured credit through credit cards has become so important to consumers that there is significant anecdotal evidence that many are paying their credit card bills before other forms of credit, including mortgage and automobile loans. There is clear indication that restricting credit cards would likely have painful consequences for consumers and small businesses – and eventually for the US economy.

With these comments, I want to say again that I am pleased to represent Chase Card Services and its employees today and look forward to your questions.

WRITTEN STATEMENT

OF

OLIVER I. IRELAND

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

March 13, 2008

Good morning Chairwoman Maloney and Ranking Member Biggert. I am a partner in the law firm of Morrison & Foerster LLP, and I practice in the firm's Washington, D.C. office. Prior to joining Morrison & Foerster, I was an Associate General Counsel in the Legal Division of the Board of Governors of the Federal Reserve System ("Board") for over 15 years. Prior to that, I worked at the Federal Reserve Banks of Boston and Chicago. In all, I have over 30 years of experience working in banking and financial services, including working on various issues relating to credit cards. During that time, I have had the opportunity to be intimately involved in both drafting and interpreting regulations as a regulator and in advising financial institutions on how to interpret and comply with regulations. I have witnessed first hand the changes in industry practices brought about by various regulatory modifications and other difficulties incurred in compliance. I am pleased to appear before you today to discuss H.R. 5244, the Credit Cardholder's Bill of Rights Act of 2008.

Credit Cards Benefit Consumers

Today, credit cards are among the most popular and widely accepted forms of consumer payment in the world. In 2005, the total value of credit card transactions charged by U.S. consumers alone exceeded 1.8 trillion dollars. Credit cards can be used at millions of merchants worldwide. As a result of the convenience, efficiency, security and access to credit that credit cards provide to American consumers, credit cards have become a driving force behind the consumer spending upon which our national economy is largely based. Credit cards also have facilitated the development of new markets, such as the Internet, where credit cards play an essential role.

Credit cards offer other benefits to consumers including consolidation of transactions into a single statement payable once a month, the ability to accurately track expenses and freedom

from cash dependency when shopping locally or when traveling around the world. In addition, consumers typically enjoy protections that are unavailable in cash transactions when they use credit cards, including protection from loss or theft and preservation of claims and defenses that a consumer may have against the merchant. Credit cards also offer other benefits, such as product warranties and rewards, including, for example, cash back and airline frequent-flier miles. Moreover, approximately half of all cardholders pay their balances in full every month and, therefore, enjoy interest-free loans.

Although fees, and card issuer revenues from fees, have increased in recent years, because of vigorous competition among credit card issuers and the use of individualized pricing models, consumers are enjoying lower interest rates and more access to credit than in the past. For example, according to a recent Government Accountability Office report on credit card disclosure practices ("GAO Report"), the average credit card interest rate 15 years ago was approximately 20 percent and credit cards often had annual fees in excess of $20.[1] Today, according to the same GAO Report, the average interest rate is approximately 12 percent and nearly 75 percent of credit cards have no annual fees. In addition, although there has been much concern about levels of credit card debt, the GAO found that credit card debt is a small portion of overall consumer debt and has actually declined as a portion of overall consumer debt.

Despite the benefits that credit cards offer, in recent years, credit card practices, such as so-called "universal default" and "double-cycle billing," have been criticized as unfair to consumers in large part because these practices are inconsistent with consumers' expectations for their credit card accounts. These criticisms call into question whether the current credit card disclosure regime has kept up with the market. Simply put, it has not.

[1] http://www.gao.gov/new.items/d06929.pdf.

Recognizing this, in June 2007, the Board proposed a comprehensive revision to the credit card provisions of its Regulation Z, which implements the Truth in Lending Act ("TILA"). This proposal addressed many of the issues addressed in H.R. 5244. Moreover, the Board has recently announced that it is exploring additional credit card issues under its unfair and deceptive acts and practices authority. I believe that it is premature to address credit card practices in legislation until these regulatory initiatives are completed, probably sometime later this year. The regulation of consumer credit is highly technical and the risks of unintended consequences from acting on inadequate information or simply imperfect drafting are significant. I believe that H.R. 5244 demonstrates these problems.

H.R. 5244

The Credit Cardholders' Bill of Rights Act of 2008 would impose significant and far-reaching restrictions on the credit card industry that could have significant and adverse unintended consequences for consumers, the industry and, potentially, the U.S. economy. On balance, H.R. 5244 would significantly curtail the ability of credit card issuers to accurately price for risk on existing accounts, substantially reducing their ability to modify pricing to reflect changes in the creditworthiness of borrowers and changing market conditions.

The impact of these restrictions could be significant. Current credit card pricing is based on individual risk factors. Individual pricing allows a credit card issuer to provide credit cards with lower rates to lower-risk cardholders while still providing credit cards at higher rates to higher-risk consumers who otherwise might be unable to obtain credit. Under H.R. 5244, the current risk-based pricing model for credit cards is likely to be restructured to one in which cardholders with good credit histories who pay their bills on time would subsidize higher risk cardholders. It is also likely to lead to a tightening of credit availability for lower income

cardholders, or for those in acute financial stress, since many issuers may simply avoid offering credit to this segment of the market rather than increasing costs to other cardholders. This would reduce the availability of credit at a time when economic stimulus, not tightening, is needed.

The Board's proposal involves targeted initiatives that promote consumer control, choice and understanding with respect to the use of credit cards. In addition, the Board's efforts to address alleged unfair or deceptive practices are likely to go to the concerns being raised with respect to various credit card practices, but in a way that should limit unintended consequences that may hurt consumers and the U.S. economy.

In contrast, H.R. 5244 likely would result in a number of significant unintended consequences. For example, section 2(a) of H.R. 5244 would prohibit increases in APRs that are based on negative information that is not directly related to account performance. This provision would encourage credit card issuers to charge higher rates initially in order to take into account the potential deterioration in cardholder creditworthiness. The effect of this provision would be compounded by section 3(f) on payment allocation, which would prolong the pay-off of existing balances. In addition, section 2(b) would limit changes in terms to specific reasons and subject to specific limitations in the credit card agreement. Moreover, section 2(c) generally would require 45 days advance notice, and an additional 90 day opt-out period, for any rate increase on a credit card account. This provision would delay credit card issuers from re-pricing for risk at the time that risk has become readily apparent, thus requiring them to account for that risk in other ways, including, for example, by pricing accounts higher at the outset.

I believe that the Board's proposal should address the concerns inherent in these provisions—the fairness of changes in terms at any time for any reason with little prior notice. The Board's proposal would require that credit card issuers provide 45 days prior written notice

before changing rates or charges or increasing minimum payment requirements disclosed in the account-opening disclosure. This 45-day notice period would apply to both changes in terms and default pricing. These prior notices would give a cardholder ample opportunity to seek a better rate elsewhere.

Section 3(a) of H.R. 5244 would prohibit the application of interest to credit card balances that have been paid within the so-called "grace period," if the credit card issuer provides such a grace period—a practice that the bill refers to as "double-cycle billing." This provision, for example, would discourage credit card issuers from providing grace periods for anyone (*i.e.*, eliminate the interest-free loan aspect of credit cards even for those that pay on time and in full), or encourage them to impose higher rates on all accounts if they continue to offer grace periods. In addition, section 3(a) may outlaw current interest rate calculation practices that are not considered to be double-cycle billing. Under the Board's proposal, double-cycle billing would continue to be disclosed in solicitations and account-opening disclosures. This disclosure would be directly below the disclosure table. Although this proposal may not fully address all concerns about double-cycle billing, additional disclosures could alert consumers to the practice effectively without disrupting other existing billing practices that have not been the subject of controversy.

Section 3(f) of the bill would require pro-rata allocations of payments to different balances that are subject to different rates. This provision would significantly change industry pricing models and would, for example, discourage credit card issuers from offering low promotional rates, thereby reducing competition in the marketplace. In practice, these rate options would provide added incentives for consumers to change accounts in response to notices of rate increases or other changes in terms. Under the Board's proposal, credit card issuers

would be required to add a new disclosure to credit card solicitations and account-opening disclosure tables stating that any discounted cash advance or balance transfer rate does not apply to purchases, that payments will be allocated to balances subject to the discounted rate before being allocated to any purchases and that the consumer will be charged interest on the purchases until the entire account balance is paid off. This type of disclosure could be broadened to other circumstances where different rates apply to different unpaid balances.

Section 3(g) of H.R. 5244 would require that each periodic statement be provided to a cardholder at least 25 calendar days before the due date identified in the statement, representing more than a 75 percent increase over the time currently required by section 163 of TILA. This provision would discourage credit card issuers from offering grace periods or require card issuers to charge higher rates to address the income lost due to extended grace periods. In light of the fact that TILA currently requires that periodic statements be mailed at least 14 days prior to the due date and also requires the prompt crediting of payments, I believe that issues with late payments are more appropriately addressed through improved disclosures. In this regard, the Board's proposal would require that the periodic statement disclose the due date, cut off time on the due date for the receipt of payments if it is before 5 p.m. and any late payment fees or penalty rate that will apply due to a late payment. These disclosures would be grouped together on the first page of the periodic statement.

Section 4 of H.R. 5244 would give consumers the right to opt out of over-the-limit transactions where an over-the-limit fee may be imposed and, more generally, restrict the imposition of over-the-limit fees even where consumers have not opted out. This provision would encourage card issuers to deny transactions that might, but will not necessarily exceed, credit limits making it more difficult for a consumer to rely on the ability to use his or her credit

card for emergencies or as he or she may otherwise choose. In addition, compliance with this provision would create significant operational difficulties for credit card issuers and would require consumers to continually monitor their account balances to determine if an anticipated purchase will exceed the limit and be declined. Under the Board's proposal, credit card issuers would be required to disclose specified fees, including over-the-limit fees, in credit card solicitations and account-opening disclosure tables. In addition, fees would be grouped separately on periodic statements under the heading "Fees" and labeled as transaction fees or fixed fees. The periodic statement also would include a year-to-date total for fees.

Small Businesses

An often overlooked point is that the vast majority of America's small businesses rely on credit cards for their everyday operations. According to a 2007 SBA report to the President, small businesses account for over 50.9 percent of the domestic work force, 50.7 percent of the non-farm gross product and all of the net job growth in 2004.[2] In 2003, the Board surveyed small business finances and found that over 77 percent of small businesses used credit cards to pay business expenses and nearly 30 percent used cards to help finance their business operations.[3] H.R. 5244 could have a direct and adverse impact on small businesses, raising interest rates and reducing the availability of credit for this very important segment of the U.S. economy.

[2] http://www.sba.gov/advo/research/sb_econ2007.pdf.
[3] *See* http://www.federalreserve.gov/pubs/oss/oss3/ssbf03/ssbf03home.html.

Financial Markets

Finally, in addition to likely increasing rates for consumers and small businesses, H.R 5244 may have other adverse affects that are more difficult to assess but that could be even more significant. In a retail market, such as credit cards, where a significant source of funding is derived from asset-backed securities, and in an environment where market confidence in asset-backed securities has been shaken, any market perception that the risk profile of credit card receivables is changing could well lead to a reduced appetite for assets backed by credit card receivables that would, in turn, require issuers to tighten credit standards and raise rates even further.

I appreciate the opportunity to appear before you today, and I would be pleased to answer your questions.

GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Associate Professor of Law

Testimony of

Adam J. Levitin
Associate Professor of Law
Georgetown University Law Center

Before the
Subcommittee on Financial Institutions and Consumer Credit
of the Financial Services Committee
of the United States House of Representatives,

Hearing: The Credit Cardholders' Bill of Rights:
Providing New Protections for Consumers

March 13, 2008

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Witness Background Statement

Adam J. Levitin in an Associate Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he specializes in bankruptcy and commercial law and directs the Georgetown-Hebrew University in Jerusalem Executive LLM Program in Business and Commercial Law. Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges LLP in New York. He also served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin's research focuses on financial institutions and their role in the consumer and business credit economy, including credit card regulatory and competition issues, mortgage lending, identity theft, DIP financing, and bankruptcy claims trading. His work has appeared in the law reviews and journals of Harvard, Stanford, Columbia, University of California-Berkeley, University of California Los Angeles, and University of Pennsylvania, as well as in the *American Bankruptcy Law Journal*, the *Banking Law Journal*, the Journal *of Bankruptcy Law and Practice*, and the *Journal of Financial Transformation*. Professor Levitin has been cited on consumer credit issues in numerous publications, including *The New York Times*, *USA Today, The Chicago Tribune*, *The Boston Globe*, *The Atlanta Journal-Constitution, The Economist*, *CNNMoney,* and *Time Magazine*. He is a regular commentator on *Credit Slips*, a blog devoted to credit and bankruptcy issues, and is the winner of the 2007 Editors' Prize of the *American Bankruptcy Law Journal*.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College, all with honors.

Professor Levitin has not received any Federal grants or contracts, nor has he received any compensation in connection with his testimony.

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Madam Chairwoman, Members of the Subcommittee:

I am pleased to testify in support of H.R. 5244, the Credit Cardholders' Bill of Rights, legislation that would end many unfair and abusive billing practices within the credit card industry.[1]

There are four major points I wish to make in my written testimony. First, I want to underscore for the Subcommittee the unusual and confusing nature of credit card pricing and how deceptive and manipulative billing practices exacerbate the situation. Credit card billing practices function as hidden price points that increase the effective cost of credit to consumers, warp competition within the card industry, obstruct consumers' attempts to exercise responsible control of their finances, negatively impact the consumer goods and services economy, and contribute to bankruptcy filings. By banning various unfair and deceptive billing practices, H.R. 5244 would help improve the fairness and the efficiency of the consumer credit economy.

Second, I want to emphasize the inadequate state of the current regulatory regime for credit cards, and explain why it is important that Congress act to fill the regulatory void. Third, I wish to address a central argument put forth by the credit card industry against any form of regulation, namely that it would dissipate the benefits of risk-based pricing. This argument against regulation is inconsistent with the evidence on credit card pricing and is ultimately inapplicable to H.R.5244's very moderate provisions. And finally, I would like to suggest that H.R. 5244 be expanded to prohibit an additional trio of unfair and abusive billing practices.

I. THE COMPLEXITY OF CREDIT CARD PRICING AND THE INADEQUACY OF THE CURRENT REGULATORY REGIME

Most consumer credit products, such as auto loans, mortgages, and student loans have only one or two price points. These price points do not vary except in relation to an objective index, such as the Federal Funds Rate or LIBOR. Unlike other common consumer credit products, however, credit cards have an astounding array of price points: annual fees, merchant fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default interest rates, late fees, overlimit fees, balance transfer fees, cash advance fees, international transaction fees, telephone payment fees, etc. These are all explicit prices points, disclosed in Truth-in-Lending schedules. The sheer number of explicit prices points that make it difficult for consumers to accurately and easily gauge the total cost of using credit cards.[2]

This difficulty is compounded by credit cards' hidden price points in the form of billing practices such as universal cross-default, unilateral term changes, two-cycle billing, unlimited overlimit fees, application of payments to the lowest interest rate balance, non-standard use of terms like "fixed rate" and "Prime rate," and unclear policies as to precisely when a payment is due. These billing practices make credit card pricing to vary based not only on objective indices, but also on the card issuers' subjective whim. Credit card billing practices alter the application of the explicit price points and make the effective cost of using credit cards higher than

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[1] This testimony derives from Adam J. Levitin, *A Critique of the American Bankers Association's Study of Credit Card Regulation*, Georgetown Law and Economics Research Paper No. 1104327, *at* http://ssrn.com/abstract=1104327. All source data for graphs in this testimony may be downloaded from http://www.law.georgetown.edu/faculty/levitin/documents/ABADATA.xls/.

[2] Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Fed. Res. Bank of Phila., Jan. 2003, at 19.

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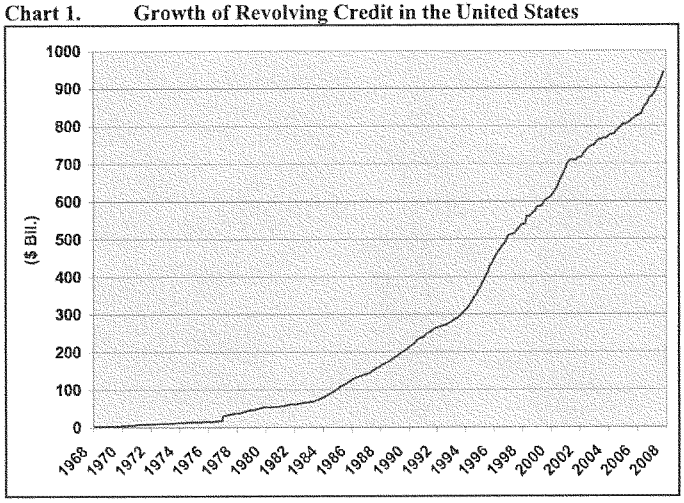
disclosed. These billing practices further obfuscate the true cost of using credit and make it virtually impossible for a consumer to make a fully informed decision about whether to use credit and, if so, which credit card product to use.

By concealing the true cost of using credit cards, these billing practices encourage higher levels of credit card debt than would occur if there were clear and transparent pricing. A fundamental economic theory, the price theory of demand, tells us that consumer demand for credit products is shaped by the price of credit. When consumers cannot accurately gauge the net price of credit, however, they will use inefficient amounts of it. In particular, when consumers underestimate the costs of using credit cards, as occurs when consumers do not notice hidden price points, they will overuse credit cards. Accordingly, unfair and deceptive credit card billing practices have contributed to the soaring level of consumer card debt, which is rapidly approaching one trillion dollars (see Chart 1, below).

Chart 1. Growth of Revolving Credit in the United States



Source: Federal Reserve Bank Statistical Release G.19.[3]

By banning billing practices that function as covert price points, H.R. 5244 will promote greater competition in the card industry, help consumers exercise control of their finances responsibly, encourage productive consumer spending, and help decrease bankruptcy filings. Currently credit card issuers do not compete with each other on the net price of cards (benefits minus costs). Instead, they compete on selectively highlighted price points, such as teaser interest rates or bundled benefits, like frequent flier miles.[4] Any issuer that attempted to

[3] Federal Reserve Statistical Release G.19 measures revolving credit, which is primarily, but not exclusively credit card debt. Mark Furletti & Christopher Ody, *Measuring U.S. Credit Card Borrowing: An Analysis of the G.19's Estimate of Consumer Revolving Credit*, Fed. Res. Bank of Phila. Discussion Paper, April 2006, at 24. There is no governmental statistic measuring just credit card debt, much less credit card debt accruing interest, a serious shortcoming in the Federal Reserve's statistical collection.

[4] Adam J. Levitin, *Priceless? The Competitive Costs of Credit Card Merchant Restraints*, 55 UCLA L. REV (forthcoming 2008).

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advertise its total price would suffer in the market because its total price advertisements would line up against the zero percent teaser rates and triple bonus miles offered by other issuers. It is easier for issuers' to push price points away from easily comparable, up-front costs, like annual fees, toward delayed back-end price points like penalty interest rates, late fees, and overlimit fees. Competition within the card market leads to obfuscated pricing with price points away in fine print billing practices. Eliminating hidden price points encourages card issuers to compete on the basis of *total* price, which will make the credit card market more efficient.

H.R. 5244 will also empower consumers to exercise control of their financial affairs responsibly, both by making the price of credit more easily understandable and by permitting cardholders to opt-out of certain rate increases and opt-out of the ability to exceed their charge limit. Additionally, H.R. 5244 will help the economy by promoting productive consumer spending. The higher levels of credit card debt service fostered by hidden price points in credit card billing practices come at the expense of other parts of the economy, as every dollar spent paying off credit card debt is a dollar that cannot be spent on new goods and services.[5] High levels of credit card debt also discourage savings for future contingencies and retirement. Eliminating these hidden price points will foster productive consumer spending and help the economy overall.

Disguised credit card price points also contribute to bankruptcy filings. Concealed pricing encourages higher credit card use than would otherwise occur, which leads, inexorably, to more credit card debt. Dollar for dollar, a consumer with credit card debt is more likely to file for bankruptcy than a consumer with any other type of debt.[6] Debt is of course a sine qua non of bankruptcy, but credit card debt has a particular and peculiar relationship with bankruptcy filings that other types of debt do not have. H.R. 5244 may help limit bankruptcy filings, the costs of which are borne by all creditors, including the government, and thus by all taxpayers. By eliminating hidden credit card prices points, H.R. 5244 will make credit card markets more efficient and will help consumers and the economy.

II. H.R. 5244 Fills a Major Regulatory Void

H.R. 5244 is an important step in establishing fundamental fairness and efficiency in the credit card market and fills a major regulatory void. Credit cards are among the most ubiquitous consumer financial products. Credit cards' share of consumer payment volume is higher than cash, checks, or debit cards.[7] More than one of every four dollars of consumer transactions in 2006 was done using a credit card.[8] By 2011, the number is expected to be closer to one in three.[9] In 2006 there were over $1.871 trillion dollars in credit card transactions in the United States, a number projected to rise to $2.8 trillion by 2011.[10]

Yet the credit card industry is only minimally regulated and is among the least transparent in the financial services sector. State usury laws, the historical bulwark of consumer

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[5] Adam J. Levitin, *Priceless? The Social Costs of Credit Cards*, 45 HARV. J. ON LEGIS. 1, 46 (2008).

[6] RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD NETWORKS AROUND THE WORLD 66 (2006).

[7] Nilson Report #890, Oct. 2007, at 10-11

[8] *Id.*

[9] *Id.*

[10] *Id.*

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credit regulation, were gutted by the Supreme Court on federalism grounds.[11] Binding mandatory arbitration has closed off the courts to consumers and has largely precluded the judiciary from ensuring even basic modicum of fairness in the card industry.[12] State legislatures and banking regulators who have sought to curb abusive credit card billing practices have found themselves running up against preemption by federal banking law.

Federal law provides for little beyond barebones disclosure regulation, cardholder liability limits, and a minimum interest free grace period. Moreover, federal banking regulators have shown a remarkable indifference to consumer protection,[13] which is fundamentally at tension with their primary safety-and-soundness mission. This indifference manifests itself both in terms of lax enforcement of existing regulations, and resistance to enacting of anything other than disclosure regulations. As a result, there is today no effective mechanism for regulating a leading consumer financial services product. It is important that Congress take the lead in filling this regulatory void in order to ensure fair and efficient consumer credit markets.

H.R. 5244 will not resolve all of the problems of the credit card industry; it does not address deep-seeded problems of price structure, rewards programs, antitrust, merchant fees, or identity theft prevention, among other issues. The card industry might well find new ways to impose hidden price points. Nonetheless, H.R. 5244 is an important first step to reining in an industry that has run wild in a regulatory no-man's land of outdated and threadbare federal laws, preempted state laws, and somnolent consumer protection by federal banking regulators. The Credit Cardholders' Bill of Rights is an important piece of consumer protection legislation that will help shield consumers from the worst abuses of the card industry and that will make credit markets fairer and ultimately more efficient.

III. THE MYTH OF RISK-BASED CREDIT CARD PRICING

An important argument put forth by the credit card industry against any form of regulation is that it would negate the benefits of risk-based pricing.[14] Risk-based pricing means that credit cards are priced according to individual consumers' creditworthiness. Credit card issuers contend that since the early 1990s they have engaged in risk-based pricing. Card issuers claim that risk-based pricing has benefited creditworthy consumers in the form of lower costs of credit and subprime consumers in the form of greater availability of credit. Card issuers contend that any regulation, including of their billing practices, would negate the benefits of risk-based pricing.

I wish to highlight four problems with the card industry's risk-based pricing story: (1) credit card pricing is not actually risk-based, (2) risk-based pricing does not explain unfair and deceptive billing practices, (3) neither creditworthy consumers nor subprime consumers have not benefited from putative risk-based pricing; and (4) H.R. 5244 does not interfere with card issuers' ability to price for risk.

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[11] Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299, 309 (1978) (national banks are subject only to the usury laws of the state in which they designate as their location). *See also* Smiley v. Citibank (S.D.), N.A, 517 U.S. 735 (1996) (late fees are subject to *Marquette*'s limitations on state usury limits).

[12] Public Citizen, *The Arbitration Trap: How Credit Card Companies Ensnare Consumers* (Sept. 2007).

[13] *See e.g.*, Stephanie Mencimer, *The Nefarious Bureaucrat Who's Helping Banks Rip You Off*, THE NEW REPUBLIC, Aug. 27, 2007.

[14] *E.g.*, Jonathan M. Orszag & Susan H. Manning, *An Economic Assessment of Regulating Credit Card Fees and Interest Rates*, Commissioned by the American Bankers Association, October, 2007.

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A. Credit Card Pricing Is Not Risk-Based

Overall, credit card pricing is not risk-based. Only some components of credit card pricing relate to individual cardholder risk, and imprecisely so at that. Of the astounding array of explicit and covert credit card price points, only some interest rates and late fees are arguably risk-based. Most have no relation to risk.

There are two factors in determining cardholder repayment risk. First is the size of the cardholder's balance. The second is likelihood of the cardholder not repaying the balance (the "risk profile"). All else being equal, a cardholder with a large balance presents a greater risk to a card issuer than one with a smaller balance because in the event of a default, the card issuer's loss will be greater for the cardholder with the higher balance. It is important to remember that risk profiles, derived largely from credit reports and "on-us" payment history, are not the sole factor in determining risk to the card issuer; fully risk-based pricing should account for both the likelihood of default *and* the size of the issuer's exposure. Only some components of credit card pricing relate to either one or the other of these two risk components, and imprecisely so at that.

None of the many credit card interest rates vary depending on the size of a consumer's balance. On the fee side, only overlimit and late fees sometimes vary depending on the size of a consumer's balance, but even then it is within two or three tiers that do not permit for precise tailoring to risk. Likewise, some interest rates and late fees depend in part on issuers' perception of individual cardholders' default risk, but again are not narrowly tailored.

1. Interest Rates

Credit cards carry a variety of interest rates. Many cards have introductory teaser rates, often at 0%. They also typically have a base rate for purchases, a base rate for cash advances, a base rate for balance transfers, a base rate for overdraft advances, and a default or penalty interest rate. Introductory teaser rates, which typically last several months, are not risk-based; they are flat 0% rates for all borrowers, regardless of their risk.

Although the base interest rate for purchases is only one of many price terms that affect the total cost of revolving a balance on a credit card, it is often perceived as the most important price point; it is the first term listed in the Schumer Box and in larger font than any other term in the Schumer Box.[15] Base interest rates are not particularly sensitive to individual consumers' evolving risk profiles.

Most issuers offer only two or three pricing tiers for non-introductory base interest rates. Credit risk, however, does not come just in sizes small, medium, and large. These rates do not change with the percentage of the cardholder's credit limit that is used, even though there is a greater risk posed by identical cardholders, one of whom has a balance of $200 and another with a balance of $20,000. Base interest rates do change, however, with the cardholder's risk profile (excluding balances). When a consumer's risk profile changes, based either on "on-us" events, related to the cardholder's use of the card or other services from the issuer or on "off-us" events, related to the cardholder's other credit behavior, many card issuers apply default and penalty interest rates retroactively to existing balances.

Empirical data indicates that interest rates are, at best, marginally risk-based. The Federal Reserve tracks the average interest rates offered by commercial banks both on all credit

[15] 12 C.F.R. Pt. 226a5(b)(1); 12 C.F.R. Pt. 226, App. G-10(A)-(B).

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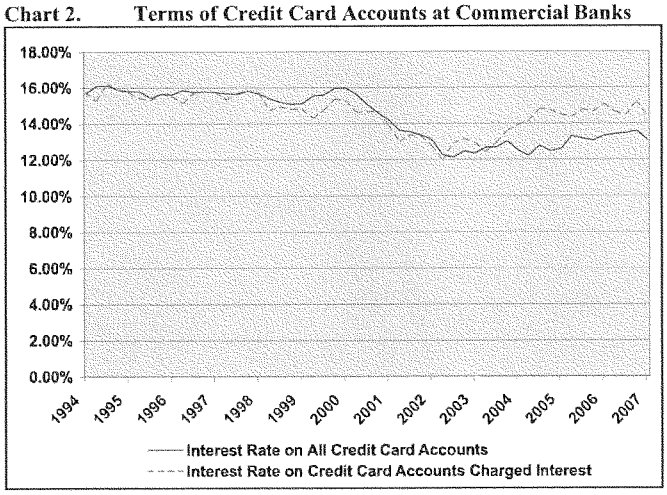
card accounts and on accounts on which interest was charged. Accounts on which interest is charged are an inherently riskier subset of all credit card accounts.

If card interest rates were risk-based, then one would expect interest rates on accounts charged interest to be consistently higher than on cards in general. But as the Chart 2 shows, the interest rates on accounts charge interest have alternatively been higher and lower than card accounts in general. This flip-flopping indicates that, at least until 2004—fourteen years in the so-called risk-based pricing era—pricing was not risk-based. Only since 2004 has the expected for rate gap emerged, and it is quite small, in the nature of 1%.[16] In other words, there is scant evidence that low-risk transactors are offered lower interest rates than higher-risk revolvers.

Chart 2. Terms of Credit Card Accounts at Commercial Banks



Source: Federal Reserve Statistical Release G.19.

Likewise, as Chart 3 shows, the spread in the effective interest rate charged between Platinum cards (issued to the most creditworthy cardholders), Gold cards (issued to less creditworthy cardholders), and standard cards (issued to even less creditworthy cardholders) is negligible. The effective rate charge includes penalty rates, but excludes promotional teasers. The difference in effective interest rates charged on Platinum Cards and Standard Cards, weighted for market share, was .41% in February 2008.[17] Even for base interests, arguably the most risk-sensitive and important component of credit card pricing, it is hard to discern anything more than a negligible risk-based pricing spread.

[16] Federal Reserve Statistical Release G.19.
[17] CardData, www.carddata.com (subscription data source).

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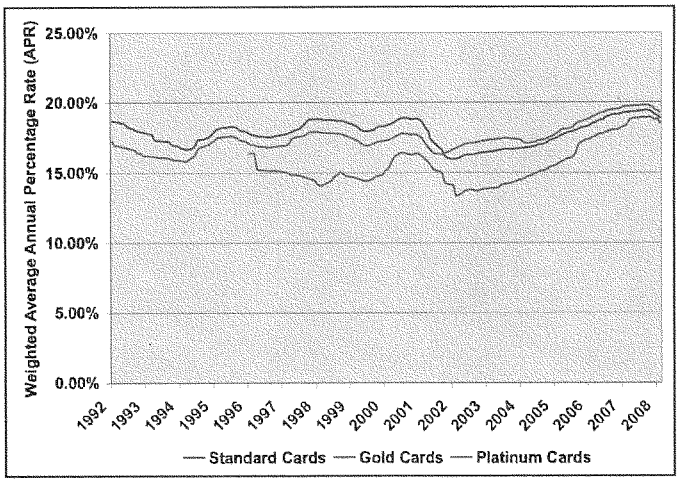
Chart 3. Base Interest Rate APR by Card Type (Weighted by Market Share of Outstandings)



Source: CardData (subscription data source).

2. *Late Fees and Overlimit Fees*

Late fees and overlimit fees are also only marginally risk-based. Many issuers have up to three tiers of late fees, depending on the size of the late balance, but these tiers are much less exact at reflecting risk than if the fee were a simple percentage of late balance. Nor do late fees account for important risk factors like how late a payment is—the fee is the same whether it is received one hour or one month late. Nor are late fees based on the cardholder's individual risk profile. For example, Capital One, fourth largest card issuer in terms of total cards,[18] has the same late fee for consumers regardless of their credit profile.[19] Capital One's late fee is tiered based solely on the account balance at the time the fees are applied.[20]

Likewise, overlimit fees bear no connection with the risk posed to the card issuer. Overlimit fees are typically flat fee amounts that do not vary by credit profile. A consumer who goes one penny over the limit pays the same amount as a consumer who goes $200 over the limit. Some issuers vary overlimit fees by the amount of consumers' credit limits, which are a function of credit risk profiles, among other factors, but even then it is within a limited number of tiers.

For example, some of Capital One's cards do not have overlimit fees at all. For other cards, Capital One has three tiers of late fees, one for consumers with credit limits under $500, another for those with credit limits of at least $500, but less than $1,000, and a third for

[18] Nilson Report #896 (Feb. 2008), at 9.

[19] *See* Capital One Card Lab, *at* http://www.capitalonecardlab.com/ (disclosure statements by credit profile on file with the author).

[20] *Id.*

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consumers with credit limits over $1,000. A cursory perusal of consumer bankruptcy filings and claims shows that even consumers who are serious credit risks often end up with credit limits well over $1,000.[21] Tiered overlimit fees based on credit limits are only vaguely risk-based, and when considered with the absence of overlimit fees on some cards, it is hard to see overlimit fees as being a risk-based pricing mechanism. If card issuers were truly concerned about the risk from overlimit transactions, they would either not permit overlimit transactions or make overlimit fees a percentage of the amount overlimit. Most issuers' overlimit fees are penalties, not risk-compensation.

The structure of late and overlimit fees makes it impossible for them to relate to individual consumer risk profiles. Similarly, other credit card price points, such as annual fees, merchant fees, transaction fees, and other back-end fees have no relation whatsoever to consumers' credit risk. To the extent that some credit card price points are risk-based, they are incredibly blunt instruments. Overall, credit card pricing is only marginally sensitive to consumer credit risk.

3. Flawed Credit Scores Constrain Card Issuer's Ability to Accurately Price for Risk

When one considers the data from which credit risk is assessed—consumer credit reports—it is apparent why the credit card industry has no real interest in implementing true risk-based pricing. Consumer credit reports are seriously flawed as data sources.

Credit reports contain only certain reported (not actual) debts and lines of credit. They are both over- and under-inclusive in their listing consumers' debts, often fail to include positive payment information, contain no information whatsoever on consumers' assets and income, and may not be updated to reflect changes in risk profile in a timely manner. 70% are riddled with errors, including false delinquencies and mismatched accounts.[22]

There is no requirement that creditors file reports with credit reporting agencies,[23] so credit reporting may not show the full picture of a consumer's financial activity. This means credit reports can make consumers look either riskier or less risky than they actually are as borrowers. Moreover, most creditors are not required to file any particular information with reporting agencies when they do file.[24] Often they will file only negative information or omit key elements of data, such as credit limits.[25] And some creditors are reluctant to file information about certain types of consumers, out of competition concerns.[26]

It would be irresponsible for a card issuer to rely on such a flawed source for determining its prices. Indeed, both Citibank and JPMorgan Chase Bank have announced that they ware ceasing to use credit bureau information to adjust credit card interest rates.[27] If two of the largest

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[21] 2007 Riverside-San Bernardino Bankruptcy Project data (on file with the author).

[22] U.S. Public Interest Research Group, *Mistakes Do Happen: Credit Study Errors Mean Consumers Lose*, March 1998.

[23] Federal Trade Commission and Board of Governors of the Federal Reserve System, *Report to Congress on the Fair Credit Reporting Act Dispute Process*, August 2006., at 8.

[24] *Id.*

[25] *Id.* at 9.

[26] *Id.*

[27] Press Release, Citigroup, *Citi Announces Industry Leading Changes to its Credit Card Practices,* March 1, 2007, *at* http://www.citigroup.com/citigroup/press/2007/070301b.htm; Press Release, Chase Card Services, *Chase Announces Clearer, Simpler Credit Card Pricing Approach: Chase Will No Longer Increase Rates Based on Credit-Bureau Information*, Nov. 19, 2007, *at* http://biz.yahoo.com/bw/071119/20071119006007.html?.v=1.

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and most sophisticated card issuers in the country have determined that credit bureau information is a poor source of consumer risk data, we should be chary of other card issuers' reliance upon such data.

B. Risk-Based Pricing Does Not Explain Abusive Billing Practices

The total cost of credit card usage for cardholders is shaped not just by explicit price points, but also by covertly through billing practices. Even if the credit card industry were truly engaged in risk-based pricing, risk-based pricing does not explain abusive and exploitative billing practices, such as: two-cycle billing; any-time, any-reason changes in terms; retroactive changes in interest rates; multiple applications of overlimit fees in a single billing-cycle; allocation of payments to the lowest interest rate debt; and universal cross-default. When one looks at the entirety of credit card pricing to consumers, not just the base interest rate, it is clear that card pricing is not risk-based overall. Instead, card pricing and billing structures are designed to exploit card issuers' market power in order to extract rents from locked-in and often unaware card users.

1. Two-Cycle Billing

Two-cycle billing means that when a cardholder revolves a balance, interest accrues not just on the actual balance being revolved, but also on the entire balance from the previous billing cycle, even if it has already been paid off. To illustrate, in month one a cardholder charge $500 and pays off $450 off at the end of the month. In month two, the cardholder charges $500 and pay off $400. Interest accrues as if on a balance of $600, even though the cardholder only owes $150 ($50 balance from month one plus $100 balance from month two).

The result is that the cardholder pays a far higher effective interest rate than is disclosed under Truth-in-Lending provisions. In this example, the cardholder would be paying an effective interest rate four times higher than that disclosed in the cardholder agreement. Two-cycle billing is neither risk-based nor even cost-based, as it computes interest based on balances that have already been paid off, where there is no risk whatsoever. Instead, two-cycle billing merely exploits card issuers' market power to squeeze more dollars out of unwitting cardholders.

2. Unilateral Term Changes

Many cardholder agreements permit the issuer to change the terms of the agreement, including the interest rate, unilaterally, at any time, for any reason. Applied purely prospectively, this is could be a risk-based provision that allows card issuers to adjust future pricing based on changed risk-profiles. In practice, however, these terms are often applied in ways that have no relation to changes in risk. For example, opening of a new low-limit charge account is often an act that can trigger an increase in interest rates, such as the application of a default interest rate that can easily be twice as large as the base rate. Surely, though, the cardholder's likelihood of default has not doubled merely by opening an additional line of credit. There is nothing that restricts unilateral any-time/any-reason terms to being risk-based repricing.

Even if unilateral any-time/any-reason terms were applied sensibly in relation to risk they are still problematic because of the significant lock-in effect for card users. I commend to the Subcommittee a recent study by Professor Lawrence Ausubel that estimates the average cost of

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switching cards at $150.[28] Not only does it take a week or so to get a new card, during which the consumer's cash management might be severely constricted, but switching cards hurts a consumer's credit rating, and affects not only the price at which the consumer can get further cards, but also the price at which the consumer can get any form of credit. Given the lock-in effect of credit card borrowing, unilateral any-time any-reason terms are more like rent-extraction devices than risk-based pricing terms.

The card industry contends that risk-based repricing is necessary to negate the moral hazard that would exist if consumers did not incur costs for becoming riskier borrowers.[29] When someone does not bear the full costs of his actions, he is likely to engage in riskier behavior than he would otherwise. This situation is moral hazard. Moral hazard could exist in the credit card context because a person who knows that the cost of borrowing funds will not change if his credit risk increases may be less motivated to maintain good credit.[30]

The moral hazard argument is flawed, however, because issuers often determine credit risk by factors that are out of the control of the individual, and that may well be inaccurate. A consumer simply cannot know whether opening up an additional line of credit will result in a higher interest rate or not under unilateral term change provisions. Likewise, a *bona fide* dispute with a landlord might be viewed as risky. The consumer cannot know whether pursuing her rights against the landlord, such as withholding rent, will result in higher interest rates on credit cards. Because of the lack of clarity of what constitutes risky behavior and the lack of consumer control over many risk factors, it is unlikely that risk-based repricing will effectively dissuade risky credit behavior.

If card issuers were truly concerned about moral hazard they would make the trigger events to term changes very clear and apply them scrupulously. They do not. Unilateral any-time/any-reason term changes are devices to squeeze additional payments out of cardholders rather than to deter moral hazard.

3. Retroactive Application of Interest Rate Increases

Many card issuers apply increases in interest rates retroactively to existing balances. Combined with two-cycle billing, this can even be applied retroactively to balances that have been paid off. This is not risk-based pricing. Risk-based pricing means that the pricing has to be fixed *before* the risk materializes. The whole idea of risk-based pricing is that it is supposed to be prospective risk-based pricing. Risk is a prospective concept; after-the-fact pricing is at the very least cost-based, and can easily be used to milk cardholders by pricing at a level far above cost. After-the-fact pricing is not risk-based.

The classic financial services example of risk-based pricing is insurance. Insurers offer premiums based on the individual risk-profile of the insured. An insurer cannot decide to change the premium required for past coverage after the coverage event occurs; there would be no risk-

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[28] Haiyan Shui & Lawrence M. Ausubel, *Time Inconsistency in the Credit Card Market*, 14th Annual Utah Winter Finance Conference, *at* http://ssrn.com/abstract=586622. *See also* Paul S. Calem *et al.*, *Switching Costs and Adverse Selection in the Market for Credit Cards: New Evidence*, 30 J. BANKING & FIN. 1653 (2006) ("information based barriers to switching have remained relevant in the credit card market despite the many changes seen in the market over the past decade.").

[29] ABA Study, *supra* note 14, at 12.

[30] *Id.*

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involved. It would be unconscionable for an insurer to base coverage for a past event on the payment of higher premiums, retroactively applied; the whole reason people purchase insurance is so they do not have to pay the full costs of the event they are insuring against.

Insurance is just lending upside down. Lenders and insurers both gamble on risk. The insurer is paid premiums up front and pays out *after* the risk materializes. The lender pays out up front, but receives its payments later *if the risk of default does not materialize*. The timing of payments and the risk contingency differs between lending and insurance, but the core economics is the same—a gamble on whether a risk materializes. Doing cost-based or cost-plus-rent-extraction-based pricing defeats the benefits of true risk-based pricing for consumers.

Retroactive application of interest rates means that instead of paying according to risk, which would limit moral hazard, cardholders who revolve pay whatever the issuer decides, regardless of their risk profile. Again, retroactive application of interest rates provides an example of card issuers' exploiting their market power over cardholders, not risk-based pricing.

4. Universal Cross-Default

Many cardholder agreements contain universal cross-default clauses that provide that the cardholder's account is default if the cardholder is declared in default (accurately or not and with notice or not) by any other creditor, even if the cardholder has been making payments on time to the card issuer. Cross-default clauses are common in the corporate lending world, although the default triggers are usually limited to defaults on bonds or other lines of credit, not any possible contract dispute.

Universal cross-default appears at first blush to be a risk-based pricing mechanism. But there is no obligation for issuers to verify the fact of a default. The typical source of issuers' knowledge of a default are credit reports, but credit report entries are made without consumers' knowledge and hence ability to contest. The Fair Credit Reporting Act[31] does not require any notification of the consumer of the entry of negative information in a credit report. Thus, as a measure of real risk, universal default is problematic.

5. Multiple Applications of Overlimit Fees in One Billing Cycle

Some card issuers will charge a cardholder an overlimit fee for every overlimit transaction in a single billing cycle. This practice is not risk-based because it has no relation to the total amount of overlimit spending. A single $200 overlimit transaction will produce only one overlimit fee, whereas three $20 overlimit transactions (or $60 total overlimit) will produce five overlimit fees. This system can often result in pricing that is actually *inverse* to risk.

6. Allocation of Payments to Lowest Interest Rate Balances

If a cardholder has balances accruing interest at different rates, such as a purchase balance and a cash advance balance, many card issuers apply payments to the lowest interest rate balance. This is not risk-based pricing. The risk should be reflected in the interest rates, not in the payment allocation because the card issuer cannot know when lending how the balances will be paid—they could be paid off in full in one cycle, or it might take a while. This uncertainty does not relate to the cardholder's risk profile and cannot be accounted for in the payment

[31] 15 U.S.C. § 1681 *et seq.*

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allocation method. Any method other than pro rata is simply rent-extraction, not risk-based pricing.

The total cost of credit card usage for cardholders is shaped not just by explicit price points, but by billing practices, many of which are not risk-based, but instead designed to exploit card issuers' market power in order to extract additional payments from locked-in card users.

C. The Ephemeral Benefits of "Risk-Based" Credit Card Pricing

1. "Risk-Based" Pricing Has Dubious Benefits for Creditworthy Consumers

Even if the card industry's pricing were meaningfully risk-based pricing, it is far from clear whether either creditworthy or subprime consumers benefit from it.

a. Card Benefits Have Declined for Transactors

There are two types of creditworthy cardholders. First, there are cardholders who never revolve a balance. They use credit cards merely to transact and enjoy the "float" during the interest-free grace period. Second, there are cardholders who revolve balances, but generally make at least the minimum payment on time.

For cardholders who never revolve balances, there are no direct costs of credit other than possibly annual fees. Annual fees are less common than they once were, but cardholders have never needed to pay annnal fees, so for savvy transactors, there really has been no change in the direct cost of cards. What is relevant to transactors, however, is the length of the float or interest-free grace period before repayment.

Card issuers are required, by law, to have a 14-day interest-free repayment period.[32] Traditionally, issuers permitted a significantly longer period, often 30-days. As Chart 4 shows, since the early 1990s the average float period has declined from around 30 days to 20 days. One-third of the major benefits of credit card usage to creditworthy non-revolving cardholders have disappeared since the onset of risk-based pricing. If pricing were truly risk-based, it is hard to understand why card issuers needed to cut their float exposure by a third. Rather than explicitly raising prices on creditworthy transactors, card issuers have done the economic equivalent by reducing the benefit given to them.

[32] 12 C.F.R. Part 226.5(b)(ii).

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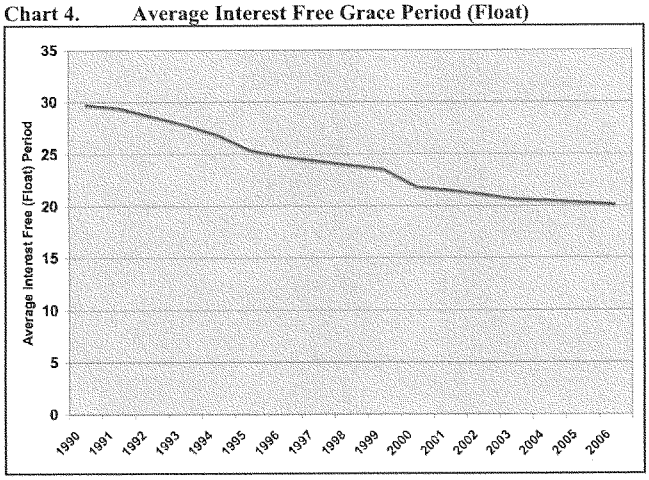
Chart 4. Average Interest Free Grace Period (Float)



Source: CardData (subscription data source).

Declining float also increases the potential likelihood that of a creditworthy consumer making a late payment and getting hit with late fees and penalty interest rates. And as soon as creditworthy consumers start paying interest and fees, their creditworthiness declines.

b. The Drop in Base Interest Rates Is Due to a Drop in Issuers' Cost of Funds

Creditworthy cardholders who revolve balances have supposedly benefited from risk-based pricing in the form of lower base interest rates. The decline in base interest rates, however, is attributable to a decline in card issuers' cost of funds and has been offset by higher backend fees. Because credit cards have multiple price points, one cannot gauge the cost of credit merely by looking at one price point. Credit card pricing is designed in such a way that it is near impossible to calculate the total cost of carrying balances on a card, but overall, it appears that the costs of revolving balances on credit cards might have gone up since the advent of risk-based pricing.

Since 1990, when risk-based pricing supposedly began, base interest rates on credit cards have dropped. There is some dispute over the amount of the drop, in part because of the inadequate nature of official credit card statistics.[33] Nevertheless, empirical data strongly indicates that the decline in base interest rates is largely attributable to card issuers' lowered cost of funds.[34] The proof is that between 1990 and present, card issuers' net interest margin—the

[33] *See* Levitin, *supra* note 1.

[34] Board of Governors of the Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions*, (Washington, D.C.: June 2005). This decline in the cost of funds may be due, in part, to the ability of credit card lenders to tap international securities markets for funds by securitizing card receivables. Board of Governors of the Federal Reserve System, 11-12. A 2006 GAO Report considered possible causes for the decline in interest rates, but was unable to pinpoint a cause. United States Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, Study to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and

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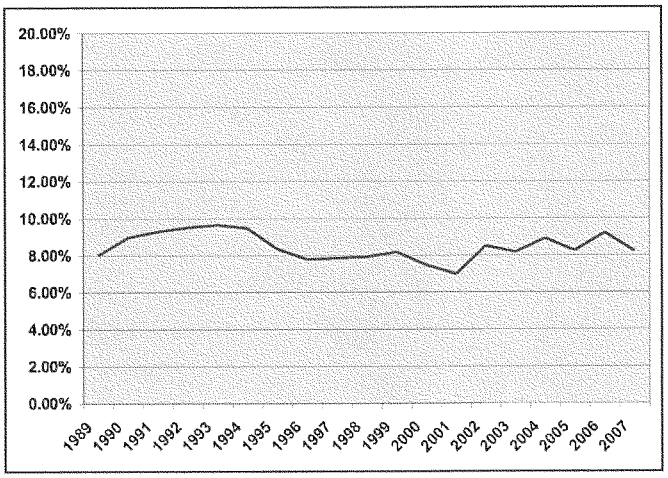
difference between the interest rate charged consumers and the cost of funds of card issuers—has remained static since before 1990, as shown below in Chart 5.[35] The multi-panel time series data showing static net interest margins proves that changes in base interest rates largely reflect changes in card issuers' cost of funds, not so-called "risk-based" pricing. Cost of funds, and not risk-based pricing explains virtually the entire decline in credit card interest rates since 1990.

Chart 5. Net Interest Margin of Credit Card Lenders



Source: FDIC Quarterly Banking Profiles, Net Interest Margin by Asset Concentration Group.

2. *Three Credit Card Monte for Revolvers' Pricing*

The decline in base interest rates since 1990 has been offset by increases in other credit card fees that do not distinguish between creditworthy and riskier cardholders, so there is no net benefit to creditworthy consumers. As Chart 6 shows, late fees and over-limit fees are up an average of 160% and 115%, respectively, from 1990 to 2005.[36] As Professor Ronald Mann has noted, the aggregate amount of late an overlimit fees "as a share of outstanding debt, has doubled since 1990, increasing from about 70 basis points per year in 1990 to 140 basis points per year in 2004."[37] Additionally, credit cards now feature many charges and fees that did not exist in 1990, such as penalty interest rates, cash advance fees, balance transfer fees, telephone payment fees,

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Governmental Affairs, U.S. Senate (Sept. 2006), GAO-06-929, at 15, 17, 35-51 (*hereinafter*, "GAO"). The GAO Report mentioned, as possible factors, risk-based pricing, along with increased competition from the entry of monoline card issuers (Capital One and MBNA) to the market, greater consumer awareness of interest rates because of the implementation of the Schumer box, and a decline in the cost of funds.

[35] FDIC Quarterly Banking Profile, Net Interest Margin by Asset Concentration Group.

[36] United States Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, Study to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate (Sept. 2006), GAO-06-929, at 18.

[37] Ronald J. Mann, *Bankruptcy Reform and the "Sweatbox" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 389 (2007).

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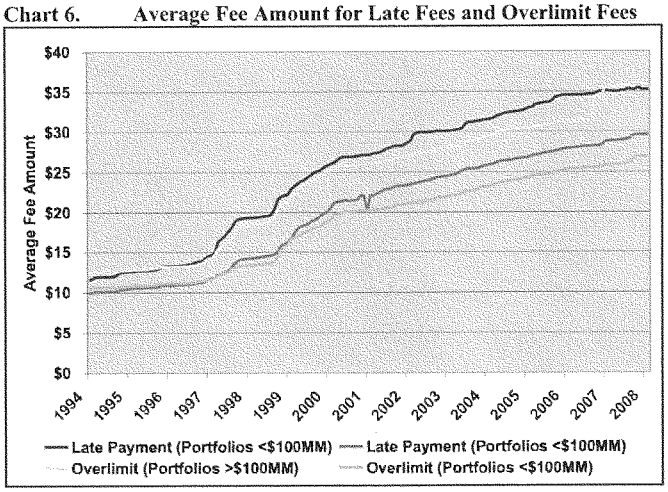
stop payment fees, additional card fees, convenience check fees, money transfer fees, statement copy fees, and foreign transaction fees.[38] Moreover, minimum finance charges have increased, and the definition of certain transactions, such as cash advances have been broadened to apply to more transactions.[39]

Chart 6. Average Fee Amount for Late Fees and Overlimit Fees



Source: CardData (subscription data source).

When one nets out lower base interest rates with increases in other fees, it becomes clear that creditworthy consumers who pay fees might actually be worse off. For example, on a $500 balance, paid off over six months with 20% annual interest compounded daily and a $10 late fee, the consumer would pay a total of $562.85. By contrast, with 10% annual interest compounded daily and a $45 late fee, the consumer would pay a total of $572.54.

This shows that base interest rates are not a useful metric for measuring the actual cost of credit cards. A better metric is weighted average interest rates, including penalty rates. When penalty rates are included in weighted average interest rates, there is only a 0.41% spread between standard cards (for those who are just above subprime) and platinum cards (for the far more creditworthy).[40] On a $500 balance, this spread would amount to a savings for the Platinum cardholder of $2.05, less than the cost of a gallon of gasoline or a cup of coffee. There is good cause to think that many creditworthy cardholders may not have benefited from changes in card pricing and some may have even been harmed by the shift away from upfront interest rates and toward backend fees and penalty interest rates.

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[38] Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Fed. Res. Bank of Phila., Jan. 2003, at 26.

[39] *Id.*

[40] CardData, Monthly Pricing Averages, U.S. Standard Card Weighted and Platinum Card Weighted. There is no standard definition of subprime, but a rule of thumb is that consumers with FICO scores beneath 600 are subprime, and above 650 are not. Definition varies by lender between 600 and 650. *See* Dana Dratch, *Buyer Beware on Subprime Loans*, BankRate.com, *at* http://www.bankrate.com/brm/news/debt/debtmanageguide/beware-subprime1.asp. There is no data on average subprime card rates.

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3. Subprime Consumers Have Not Benefited from Risk-Based Pricing

In recent years there has been a dramatic growth in the availability of credit, including credit cards, to subprime consumers. This growth has been fueled by securitization, rather than risk-based pricing. Securitization is a financing method in which card issuers bundle large numbers of cardholder receivables and selling them to specially created trusts. These trusts pay for the accounts receivable by selling securities, which are secured by and paid off from the receivables' revenue stream. The card issuer typically serves as the servicer for the accounts receivables in the trust in exchange for a fee.[41]

Securitization allows card issuers to obtain cash now for debts that will take a while to collect. It also allows them to transfer credit risk to the trust (and ultimately the investors in the trust).[42] Securitization also lets card issuers increase their lending capacity. Federal and state banking regulations require the banks and thrifts that issue credit cards to maintain certain reserves of capital as a provision against loan losses. The more loans a financial institution has outstanding, the more capital it has to keep on hand in liquid form earning little return. Securitization enables card issuers to underwrite more debt without maintaining higher reserve requirements.

Reserve requirements only apply to the receivables a card issuer carries on its books; once the receivables are sold to a securitization trust, the reserve requirements do not apply, and the card issuer's capital is available for underwriting additional loans. Likewise, securitization of risky debt helps credit card lenders avoid the even higher reserve requirements caused by 180-day delinquent revolving debts.[43] Securitization allows card issuers to move debt (and especially delinquent debt) off their books and avoid "charge-offs" and thus maintain lower reserve levels. Thus securitization has by itself dramatically increased banks lending capacity. Since banks can lend more, it is not surprising that they would be willing to extend more credit to more marginal consumers.

Securitization also shifts much of the repayment risk from the card issuer to the securitization trust.[44] This reduces the incentive for card issuers to have careful underwriting standards. Moreover, the master securitization trust structure (or more recently issuance trust structure) used for credit card securitization encourages lower underwriting standards. A master securitization trust continually acquires credit card receivables against which it issues securities.[45] This means that a master securitization trust will hold billions of dollars in credit card receivables, so that a higher initial default rate on any batch of millions of dollars of receivables it purchases from the issuer has little effect on the total return. Uncollected receivables reduce the excess spread that goes to the servicer-issuer, but it appears to be more profitable for issuers to screen out poor credit risk consumers *after* lending by looking at their payment history, than to screen them out *before* lending via underwriting diligence. Loans made to true deadbeats can be siphoned out by several months of seasoning more cheaply for the issuer

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[41] STEVEN L. SCHWARCZ *ET AL.*, SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 145 (2004).

[42] *Id.*

[43] *See* 12 C.F.R. Pt. 3, App. C, Pt. 1 § 31(e) (national banks); 12 C.F.R. Pt. 567, App. C, Pt. 1 § 31(e) (federal savings associations); 12 C.F.R. Pt. 325, App. D, Pt. 1 § 31(e) (state member banks); 12 C.F.R. Pt. 208, App. F, Pt. 1 § 31(e) (insured state non-member banks).

[44] SCHWARCZ *ET AL.*, *supra* note 41.

[45] FDIC CREDIT CARD SECURITZATION MANUAL , *at* http://www.fdic.gov/regulations/examinations/credit_card_securitization/ .

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than through careful upfront underwriting. Developments in the form of securitization have made it more profitable for some issuers to screen out the worst credit risks by payment history *after* issuing cards than by careful and diligent underwriting before issuing cards.

Securitization encourages card issuers to issue cards without regard to consumers' ability to repay because they do not bear the ultimate repayment risk from securitized accounts. Accordingly, card issuers are incentivized to lower underwriting standards and make credit cards available to subprime consumers who present serious credit risks. Indeed, the card solicitation and approval process appears to be so indiscriminate that as former Federal Reserve Board Chairman Alan Greenspan testified to the Senate Banking Committee "Children, dogs, eats and moose are getting credit cards."[46] It is hard to reconcile credit cards issued to toddlers and pets with risk-based pricing.

Securitization of credit card receivables was introduced in 1987[47] and has soared since 1989, when the Federal Reserve began compiling data on it, as shown by Chart 7. As Chart 8 shows, in recent years the volume of outstanding securitized revolving debt has matched or exceeded that of non-securitized revolving debt.[48] Around 60% of all credit card debt is currently held in securitized pools.[49] Chart 7 does not prove a causal relationship between securitization growth and lowered standards for access to credit, but it provides at least as compelling an explanation of increased access to credit for subprime consumers as does non-existent "risk-based" pricing.

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[46] *Credit Cards at 50: The Problem of Ubiquity*, N.Y. TIMES, Mar. 12, 2000, at C11. *See also, e.g.*, *Dog Issued Credit Card*, NBC San Diego, Jan. 28, 2004, *at* http://www.nbcsandiego.com/money/2800173/detail.html; Jane Hughes, *Toddler Issued Platinum Card*, BBC News, Aug. 11, 1999, *at* http://news.bbc.co.uk/2/hi/americas/417131.stm.

Section 1229 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 directed the Federal Reserve to "conduct a study of (1) consumer credit industry practices of soliciting and extending credit—(A) indiscriminately; (B) without taking steps to ensure that consumers are capable of repaying the resulting debt; and (C) in a manner that encourages consumers to accumulate additional debt; and (2) the effects of such practices on consumer debt and insolvency." In 2006, the Federal Reserve published the required study. The study concluded that "as a matter of industry practice, market discipline, and banking supervision and enforcement, credit card issuers do not solicit customers or extend credit to them indiscriminately or without assessing their ability to repay." Board of Governors of the Federal Reserve System, *Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency* (June 2006), 5.

Unfortunately, the Federal Reserve's conclusion is based solely on two short paragraphs of analysis that contain neither citations nor statistics, *id.* at 22, and fly contrary to common sense and the statement of Chairman Greenspan. There is no evidence that card solicitation and extension of credit is in fact based on consumers' ability to repay.

[47] Mark Furletti, *An Overview of Credit Card Asset-Backed Securities*, Discussion Paper, Fed. Res. Bank of Phila., Dec. 2002, at 1.

[48] Revolving debt is largely, but not entirely credit card debt, but securitized revolving debt is almost entirely credit card debt. *See* note 3, *supra.*

[49] Darryl E. Getter, *The Credit Card Market: Recent Trends, Funding Cost Issues, and Repricing Practices*, Congressional Research Service CRS 4-5 (Feb. 27, 2008).

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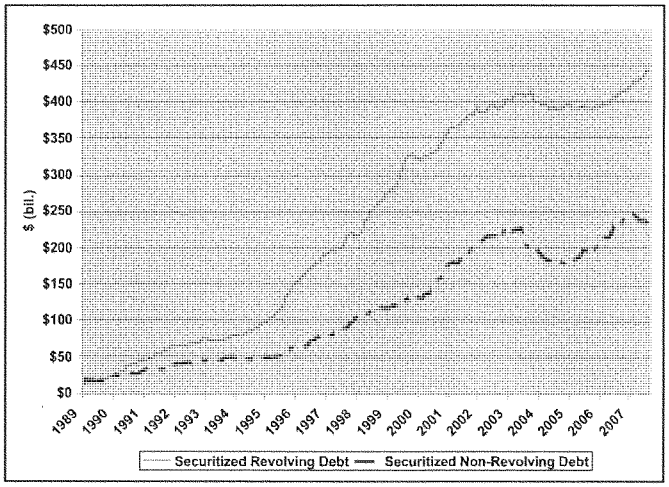
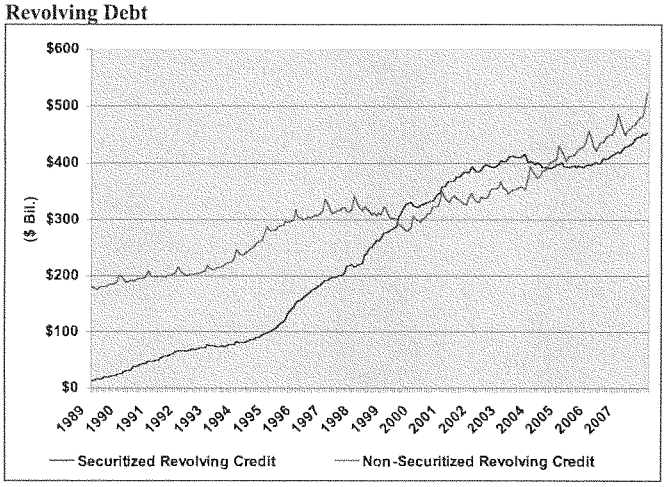
Chart 7. Growth of Securitized Debt in the United States



Source: Federal Reserve Bank Statistical Release G.19.

Chart 8. Growth of Securitized Revolving Debt Compared to Non-Securitized Revolving Debt



Source: Federal Reserve Bank Statistical Release G.19.

3. *The Dubious Benefits of Predatory Credit to Consumers: Fee Harvester Cards*

It is also far from clear whether subprime consumers really end up better off from access to credit cards. Access to credit is valuable only if one has the ability to repay. Otherwise, it is a

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Trojan horse. It is worthwhile considering the terms found on so-called subprime "fee harvester" cards.[50] These cards have credit limits of $200-$300, but they come with substantial upfront fees when the consumer opens the card account. These fees are charged to the card and thus potentially accrue interest and late fees. The upfront fees also reduce the cardholders' initial available credit to a mere $50-$100. The effective APRs on these subprime cards are often in the range of 300%-500%, rates that approach or exceed the cost of a payday loan.[51]

For example, the First Bank of Delaware's Continental Finance Classic MasterCard comes with a $300 credit limit.[52] But there is a $99 Account Set-Up Fee, an $89 Participation Fee, a $49 Annual Fee, and a $10 monthly Account Maintenance Fee.[53] The initial total useable credit on the card is $53, and the opening balance is $247, with a 19.92% APR, compounded daily. In other words, the cardholder has incurred $247 dollars in debt simply for the opportunity to borrow an additional $53 at 19.92%. Assuming there are no overlimit fees, the effective APR is for this $53 of available credit is 819%![54]

The terms of subprime cards speak for themselves; it is hard to imagine that anyone is better off borrowing at an 819% APR. Subprime lending invites predatory lending practices because of the presumed lower financial sophistication of subprime consumers. To the extent that anyone bothers to listen to what subprime consumers themselves say, it turns out that many don't think much of gaining access to credit cards. Sociological studies show that if the marginal subprime consumers did not have access to credit cards they would either borrow from friends and family or not borrow at all rather than turn to less desirable forms of credit (such as loan sharks).[55]

The recent housing bubble burst shows how many (not just subprime) households can be hurt when they are lured into lending arrangements that they cannot reasonable finance. It also shows how there are collateral costs ("externalities") to the entire financial system. Increased access to credit for subprime households beyond reasonable ability to repay is of dubious benefit to subprime consumers themselves and to society as a whole.

D. The Impact of H.R. 5244 on Risk-Based Pricing

H.R. 5244 proposed only modest and moderate regulation on the card industry. It leaves card issuers free to charge whatever interest rates they want and to price fees at whatever level they wish. Issuers can also continue to account for risk in their lending in five ways under H.R. 5244:

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[50] *See* National Consumer Law Center, *Fee-Harvesters: Low-Credit High-Cost Cards Bleed Consumers*, Nov. 2007.

[51] *National Consumer Law Center*, *supra* note 50, at 20.

[52] First Bank of Delaware, Continental Finance Terms & Conditions, https://www.cfcapply.com/gold1mc/fbd-terms.htm (last viewed November 28, 2007).

[53] *Id.*

[54] This figure was arrived at by compounding daily 19.92% interest on an initial balance of $300 over the course of 365 days, broken down into a regular calendar year with a $10 monthly service fee added to the compounding balance on the first day of each month. Over the course of a 365-day year, the initial $300 balance plus monthly service fees will accumulate to $486.96. In other words, the consumer will have paid $433.96 in interest and fees in order to borrow $53.

[55] Angela K. Littwin, "Comparing Credit Cards: An Empirical Examination of Borrowing Preferences Among Low-Income Consumers," *available at* http://ssrn.com/abstract=101446.

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- First, card issuers can control for risk by controlling the credit line. If issuers become concerned about the increasing financial risk of a cardholder, they can freeze or reduce the amount of credit that is offered.

- Second, card issuers can engage in more careful initial underwriting. Issuers could make more careful decisions upon issuance of a card, regarding whether to grant the card, how much credit to grant and at what rate.

- Third, issuers would still be able to increase rates *prospectively* for "off-us" behavior. If issuers became concerned that a cardholder were becoming a greater financial risk because of activity or behavior involving other creditors, or because of a decline in the cardholder's credit score, they could raise rates prospectively.

- Fourth, issuers could continue to increase rates retroactively for "on-us" violations of the cardholder agreement. If a cardholder is late or exceeds the credit limit, issuers could raise interest rates retroactively. Nothing in H.R. 5244 prevents retroactive rate increases for "on-us" behavior.

- Finally, issuers can always develop a workout plan with the cardholder in order to ensure ultimate repayment. As always, the issuer can develop a workout plan, as long as it meets the applicable banking regulator's guidelines, to lower interest rates, reduce principal, elongate payments, etc.

In short, card issuers do not need the deceptive billing practices targeted by H.R. 5244 to account for risk; H.R. 5244 leaves them with multiple effective methods of controlling cardholder risk.

IV. WAYS IN WHICH H.R. 5244 COULD BE IMPROVED

H.R. 5244 could be improved by banning a trio of additional unfair billing practices.

A. Banning the Accrual of Interest on Balances Before the Posting Date of Transactions

First, the bill could be improved by banning the accrual of interest on balances before the transaction is posted. Some issuers apply finance charges from the date of transactions, rather than the posting date of the purchase. Issuers do not advance credit, however, until the posting date. Issuers should not be able to earn interest before they have paid merchants for the transaction. Until the posting date, it is the merchant, not the issuer, extending credit to the cardholder, so for the issuer to collect finance charges in this period is unjust enrichment. The issuer is charging money for a period for which it has incurred no risk or cost. Moreover, by applying finance charges from the transaction date, rather than the posting date, issuers are charging a higher effective APR than disclosed in Truth-in-Lending disclosures. This practice should be banned.

B. Banning the Accrual of Interest on Fees Applied Within a Billing Cycle

Second, the bill could be improved by banning the accrual of interest on fees applied within a billing cycle. Some issuers apply overlimit fees on the date of the overlimit transaction, rather than at the end of the billing cycle. This means interest accrues on the overlimit fee for part of the billing cycle, which functionally increasing the amount of the overlimit fee beyond what is disclosed; the cardholder pays not only the stated overlimit fee, but an overlimit fee that

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consists of the fee plus interest on it. The cardholder has not borrowed the overlimit fee amount from the issuer, so it is unfair for the cardholder to pay interest on the fee.

C. Banning the Application of Residual Interest

Third, H.R. 5244 could be improved by banning the application of residual interest. Residual interest is interest that accrues in the period between when a billing statement is generated and when the payment is received. The existence of residual interest means that if a revolving cardholder submits a payment for the entire balance indicated on the billing statement, there will still be a remaining residual interest balance to pay the next month. Residual interest can actually create a financial Zeno's paradox, in which the cardholder can never eliminate the balance, except by overpaying the issuer or closing the account.

To illustrate, suppose a cardholder had an interest rate of 10%, compounded daily, and a revolving balance of $1000. The customer mails in a payment for $1000, which is received by the issuer 25 days after the statement was generated. The cardholder would then receive a bill the next month for $6.87, that is 25 days worth of interest. The cardholder then sends in $6.87, say another 25 days later and thinks that the bill is paid off in full finally. But the next month, the cardholder receives a bill for $1.00. Interest has accrued on the residual balance of $6.85 for 25 days, which should be 5¢, but because the card issuer has a minimum finance charge of $1.00, the cardholder is billed for $1.00. At this point, assuming that there are no further charges made and no double-cycle billing, the cycle repeats itself again and again. The cardholder pays $1.00, but and less than a penny of interest accrues, but the cardholder is charged $1.00.

Theoretically this can go on forever; the only way the cardholder can pay off the balance is to overpay by a sufficient amount to cover the residual interest in a month or to close the account. Cardholders should not find themselves in the Groundhog's Day of residual interest and have to either overpay or close their account in order to eliminate all balances. H.R. 5244 could be improved by forbidding issuers to assess finances charges on for the period between a billing statement date and the timely receipt of a payment of the statement balance in full.

V. CONCLUSION

"Risk-based" pricing's "benefits" are not a reason for Congress to shrink from regulating the credit card industry's abusive pricing and billing practices. If the card industry were required to price its products in a straightforward manner, and it were less costly for consumers to switch cards, deceptive practices would be harder to maintain, Truth-in-Lending disclosures would be more effective, as consumers would be able to easily compare cards and make informed decisions about card usage, and competitive pressures would push down total card prices, forcing the card industry to operate more efficiently, benefiting all consumers.

Even if credit card pricing were truly risk-based and even if it had the benefits claimed by the card industry, nothing in H.R. 5244, the Credit Cardholders' Bill of Rights, implicates the risk-based pricing model. The Credit Cardholders' Bill of Rights is about banning abusive and manipulative tricks from credit card billing, nothing more and nothing less. It does not regulate interest rates or fee amounts. Instead, all it does it ban or limit certain unfair and exploitative billing practices that have no relationship whatsoever to consumer risk. Because these practices are, at best, incidental to issuers' profitability, H.R. 5244 will not result in higher costs of credit or lower availability of credit. Instead, this legislation will help clarify credit card pricing, which is a prerequisite for an efficient, competitive market. H.R. 5244 will help consumers and will make for a fairer and more efficient credit economy, and I strongly urge this Congress to pass it.

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The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers

Written Testimony
of

Katherine Porter
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Before the
United States House of Representatives
Subcommittee on Financial Institutions
and Consumer Credit

March 13, 2008

Witness Background

I am an Associate Professor of Law at the University of Iowa College of Law.[1] I joined the faculty in 2005. I received my J.D. degree *magna cum laude* from Harvard Law School and my B.A. degree *cum laude* from Yale College. I teach bankruptcy, commercial law, and consumer law and have published empirical research on consumer credit in several respected journals, including the *Michigan Law Review*, the *Cornell Law Review*, the *Wisconsin Law Review*, and the *American Bankruptcy Law Journal*.[2] My research on credit cards has examined how credit card practices affect a household's financial well-being and how families who have filed for bankruptcy use credit cards. I served as Project Director of the 2001 Consumer Bankruptcy Project and am one of the principal investigators in the ongoing 2007 Consumer Bankruptcy Project. I also am a co-investigator in the Mortgage Study, a national empirical study of mortgages in consumer bankruptcy cases.

I have not received any federal grants or contracts relevant to this testimony.

Introduction

Credit cards are an extremely popular financial product in America. More than three-fourths of consumers have one or more credit cards,[3] and by dollar volume, total credit card spending exceeds 13% of the United States' gross domestic product.[4] While card-based payment systems have substantial advantages over traditional products like paper checks,[5] credit cards present particular challenges because of their complexity.[6] Most consumer financial products are either payment-only devices (cash, debit cards, etc.) or borrowing-only devices (mortgages, signature loans, etc.). Credit cards are unique because they combine the ability to spend and borrow in a single financial instrument.[7] The proposed legislation, The Credit Cardholders' Bill of Rights (H.R. 5244),[8] preserves the rights of credit card issuers to control risk and earn profits while giving consumers the tools they need to understand and comply with credit card contracts.

My testimony focuses on two aspects of H.R. 5244. First, I explain how the bill's modest regulations would empower consumers to exercise self-discipline in their financial practices. If enacted, the bill would help consumers avoid over-the-limit fees, late charges, and inappropriate subprime cards by giving consumers the opportunity to manage their card use in a responsible manner. Second, I describe the lack of reliable, neutral data about credit card practices and explain why such data are critically important to enabling Congress and regulatory agencies to monitor our nation's credit card practices, thus ensuring the stability of the financial markets and the well-being of American families.

Part I
Allowing Consumers To Manage Their Card Use Responsibly

On an aggregate level, credit cards are associated with financial distress.[9] At the household level, however, millions of families benefit from credit cards. The goal of credit card reform is to retain the advantages of credit cards while limiting their harmful effects. H.R. 5244 achieves this goal by giving consumers the ability to manage their credit cards responsibly. It does so in three key ways: it allows consumers to control their credit card limits; it establishes standardized due date practices so that consumers can pay on time; and it requires the riskiest consumers to bear the costs of opening a credit card account. These regulations would reduce consumer mismanagement in using credit cards, while retaining the ability of issuers to manage risk.

A. Over-the-limit Fees

In 2004, penalty fees represented an estimated 9% of revenue for card issuers.[10] Most commonly, these fees include charges for exceeding a credit limit or for late payment. H.R. 5244 does not ban the imposition of such fees when a consumer engages in the trigger behavior nor does it cap the amount of such fees. Instead, the bill would put consumers in charge of avoiding such fees. By improving the ability of consumers to manage their credit card practices, the bill rewards responsible consumer behavior. Better financial practices by consumers will reduce risk to credit card issuers and reduce the likelihood that credit cardholders suffer serious financial distress.

Section four of H.R. 5244 pertains to over-the-limit fees.[11] It allows consumers to elect in advance whether they want to avoid receiving credit in excess of the amount authorized on the account. In this way, the bill helps consumers use their accounts responsibly by limiting their available credit and avoiding escalating debts. Issuers who complain about charge-off rates and losses when consumers mismanage their debts should support a system that would encourage consumers to stay within the limits of their credit agreements.

If a consumer makes an election not to exceed the credit limit, the issuer may not complete the over-the-limit transaction and may not charge an over-the-limit fee if such a transaction is processed despite the consumer's election. This provision ensures that issuers do not have a financial incentive to exceed the prearranged terms of card agreements. Issuers currently have the ability to deny credit card transactions that exceed the limit; H.R. 5244 merely requires them to avoid penalizing a consumer who did not wish to receive additional credit. Under the bill, if issuers voluntarily authorize an over-the-limit transaction, they bear the risk. An issuer cannot impose an expense on a consumer when an over-the-limit transaction results from a mistake or the issuer's own choice to authorize such credit over the consumer's stated preference for a fixed amount of credit. In particular, older and younger Americans may be more likely to make mistakes in monitoring their credit card accounts and to exceed their limits.[12] Yet, these very same consumers are more likely to have fixed incomes and low assets than middle-aged consumers, making it harder for older and younger Americans to pay over-the-limit fees and cope with penalty interest rates. These vulnerable groups would particularly benefit if H.R. 5244 were enacted into law because they could elect to avoid exceeding their credit limits.

H.R. 5244's other provision on over-the-limit transactions would restrict the number of times that an issuer could impose an over-the-limit fee. The bill preserves the right of issuers to collect an initial penalty if a consumer exceeds a limit but bans the practice of churning over-the-limit fees for profit. Specifically, the bill would permit an over-the-limit fee to be imposed only one time during each billing cycle. Under current law, consumers may be charged an over-the-limit fee each time they conduct a transaction after initially exceeding their limit.[13] Such fees can amount to hundreds of dollars after only a handful of transactions. Yet, because current law does not require point-of-sale disclosures when a purchase would exceed a credit limit, consumers may not be aware that they have exceeded their limits.[14] Recognizing the difficulty that consumers face in monitoring their account balances, H.R. 5244 puts some responsibility on issuers to control transactions. Issuers have nearly complete and instantaneous computerized access to consumers' account charges and are better positioned to enforce agreed-upon credit limits.

H.R. 5244 also takes aim at an over-the-limit fee practice that some courts have already determined is unconscionable and unfair under longstanding principles of contract law.[15] Under

current law, if consumers exceed their limits, they can be assessed an over-the-limit fee each month that their accounts remain over the limit, even if the consumers are making the required minimum payments and avoiding any further transactions. In some instances, consumers pay thousands of dollars in over-the-limit fees as a consequence of a single, modest, over-the-limit transaction.[16] If enacted, the bill would permit issuers to impose over-the-limit fees in only two subsequent billing cycles after the initial over-the-limit transaction (assuming the consumer did not make additional transactions). Given that the issuer does not put any further capital at risk during the subsequent months, it is hard to justify even the additional two months of fees as necessary elements of risk management. In my judgment, an over-the-limit fee should be permitted only in the initial month of such a transaction and should not be allowed in subsequent months when it serves as a penalty that is unrelated to additional risk. However, the bill merely seeks to eliminate the most egregious practices that violate traditional contract law.

The over-the-limit provisions of H.R. 5244 would empower consumers to control their card spending by establishing firm credit limits. Over-the-limit fees remain available to issuers as a legitimate risk-management technique, but issuers cannot penalize consumers for the issuers' own decisions to approve transactions that exceed credit limits. In these ways, the bill encourages cardholders and industry to work together to engage in responsible card practices that reduce the potential of credit cards to increase financial distress.

B. Due Date and Billing Practices

Credit card late fees have generated considerable consternation in recent years. In 2006, about half of consumers mad a late payment.[17] The amount that issuers charge as a late fee has escalated sharply in the last decade.[18] In the United Kingdom, regulators have responded with a fixed cap on late fees that is designed to ensure that such fees actually compensate for risk.[19] In America, the industry has claimed that it must have flexibility in assessing late fees to manage risk.[20] H.R. 5244 permits issuers to set the amount of late fees and trusts the market to price this term appropriately. The bill merely seeks to make sure that consumers who have the means and desire to pay on time are able to do so. It would accomplish this by eliminating confusing and complicated due date and billing practices. Such changes to current card contracts would encourage consumers to pay on time by protecting them from fees and default charges that are incurred despite responsible efforts to meet billing deadlines.

H.R. 5244 would create standardized rules for due dates. First, the bill establishes uniform rules for timely payment. Consumers who mail their bills not less than seven days before the due date or whose payments reach the issuers by 5 p.m. EST on the due date would be protected from late fees. Because these are clear rules, consumers would know what they must do if they wish to avoid late fees. The multiplicity of due date rules in current card contracts makes it very difficult for even the most diligent consumers to know with any assurance that they can avoid late fees. Consumers who want to pay on time should be able to do so without the harms of due date traps. Fees from mere mistakes or arbitrary rules are not an element of legitimate risk-based pricing. Late fees should reflect circumstances that correspond to actual consumer difficulty in meeting payment obligations. As Professor Ronald Mann has concluded, "[i]t is hard to see that a bright-line rule [for repayment deadlines] would impose any burden on legitimate business models."[21]

The second standardized term in H.R. 5244 would require issuers to mail billing statements twenty-five days before the due date. Current law already imposes an industry-wide standard on the mailing of billing statements.[22] The bill would expand the time for consumers to

open, read, and submit payment from fourteen days to twenty-five days. By giving consumers ample time to respond to periodic statements, consumers who have the means to pay on time are empowered to do so. The bill would also require issuers to provide a phone and internet address for the consumer to access a payoff balance. This is particularly useful for consumers who wish to prepay their accounts in advance of a billing statement but otherwise have to wait for a statement and respond within the tight timeline under current law. It is sound policy to encourage consumers to use their cards responsibly by paying them off on time and in full. H.R. 5244 supports consumers' efforts to manage their cards successfully and would help prevent Americans from becoming trapped in default-based pricing by accident or confusion when the consumers have the intention and ability to repay their charges.

C. Subprime Card Fees

The moderate approach of H.R. 5244 is exemplified in its proposals on subprime credit cards. Rather than banning such cards or limiting their marketing, the legislation requires consumers to demonstrate that they can afford the costs of a subprime card. Like the provisions on over-the-limit fees and billing practices, H.R. 5244's focus is on helping consumers use financial products in ways that are appropriate for their circumstances.

Subprime cards are issued to high-risk borrowers, including those with adverse credit reports or low incomes. The availability of such cards has exploded in recent years.[23] In my research, I found that in the first year after filing Chapter 7 bankruptcy 96% of debtors received credit card offers.[24] While new credit may be useful to such families, there is a grave risk of harm if families do not understand or manage the high-cost credit that is heavily marketed to them.

Subprime cards usually have very low initial credit limits, often $250 or $500. Because of the very small amount of credit extended, issuers will earn few dollars from merchant fees. To compensate for this lost revenue, issuers impose very high upfront fees on subprime cards.[25] In addition to an annual fee, such cards often charge a one-time account "set-up" fee, a "program" fee, and monthly "service" fee.[26] These fees reduce the available amount of credit. For example, the Gold Tribute Mastercard offers a maximum credit limit of $300 but has initial fees of $150. Under current practice, the available credit at account opening is only $150.[27]

H.R. 5244 does not tackle the issue of whether the very high fees for subprime cards are appropriate devices for managing risk. Instead, it seeks to ensure that consumers can afford such fees. Thus, it encourages responsible use of credit without regulating the market for card pricing. The bill specifies that if card fees exceed 25% of the total amount of credit authorized under the account, the card could not issue until the consumer paid such fees.[28] The payment of these fees could not be financed by the card itself. If a consumer cannot or does not pay such fees, the card cannot be issued.

This rule would impose an obligation on consumers to fund their decision to obtain a subprime card. Consumers would remain free to choose the high-cost credit of subprime cards; issuers would remain free to earn the profits from such customers. The bill's focus on upfront fees merely requires consumers to bear the cost of obtaining a card before it is issued. Such a rule would ensure that consumers understand the full cost of subprime costs.

H.R. 5244 would prevent the issuer from reporting the opening of a subprime card account to credit reporting agencies until the upfront fees were paid. This rule prevents consumers from being trapped into maintaining a card that they cannot afford for fear of worsening their credit. Such a rule would also deter issuers from marketing these cards merely to

earn fees. Such industry behavior does not legitimately expand access to credit to low-income or high-risk consumers. The bill's balanced approach acknowledges and respects the industry's assertions about the importance of default-based pricing, while ensuring that the most vulnerable consumers can bear the cost of a subprime card.

The bill's prohibition on an issuer sending a card and reporting the card to credit reporting agencies until the consumer has paid the upfront fees is analogous to the cooling-off periods used in other consumer contexts. The point of such regulation is not to hinder the freedom to contract contracts but to ensure that consumers have adequate time to digest the costs and benefits of their decisions. The complexity of credit card contracts and the unusual fee structure of subprime cards make it particularly appropriate to eliminate the adverse consequences of applying for a high-fee card. If a consumer cannot afford the upfront costs of such a card, the responsible path is to allow the consumer to avoid receiving the card without an adverse consequence to their credit for merely completing an application.

D. Disclosure Cannot Substitute for the Benefits of Standardized Terms

The general approach to credit card regulation in America is disclosure.[29] While the Truth in Lending Act mandates disclosures in credit card solicitations, agreements, and periodic statements, disclosure is an inappropriate response to practices that are fundamentally unfair or that consumers do not understand or consider in selecting and using cards.[30] Rather than mandate disclosures, H.R. 5244 regulates in other narrow ways. It singles out the most egregious industry practices, and it gives consumers the tools that they need to use their cards responsibly.

Disclosure suffers from several well-documented problems. Consumers may not read the disclosures. If they do, they may not alter their behavior in light of the disclosures.[31] Serious cognitive barriers hinder consumers from making effective use of disclosures, including a tendency to underestimate the likelihood that they will encounter a penalty under the contract.[32] To overcome the limits of disclosure, the bill proposes to standardize certain key terms of credit card agreements. For example, under current law, consumers must know, understand, and remember numerous rules in order to pay their bills on time. Rather than having to master the different due date policies on each of several cards (timely if paid by 10 a.m. EST; timely if paid by midnight CST, etc.), H.R. 5244 would require consumers to know only a single, standardized rule—that by law, a payment is timely if made before 5 p.m. EST.[33] Similarly, a consumer need not study each issuer's definition of "prime rate" because the bill would create a standardized definition for the term. By limiting the ability of issuers to impose irregular and varying administrative practices or contract terms, H.R. 5244 should improve cardholders' understanding of the terms of their contracts.

Credit card agreements in America are truly unique for their lack of standard terms.[34] The focus in H.R. 5244 on standard terms is an appropriate adjunct to disclosure. It does not supplant the importance of consumers taking responsibility for honoring their contracts but rather helps consumers to achieve that outcome. Standardizing just a few modest terms of credit card contracts would eliminate unwitting mistakes by consumers, empower consumers to comply with their obligations, and focus consumer attention on comparing the key aspects of cards such as interest rates that could vary. In these ways, standardized terms will improve the usefulness and efficacy of disclosure. Merely giving consumers additional information at the time of contracting would be much less effective in improving consumers' financial practices.

Part II
Improving Policymakers' Understanding of Credit Card Markets

Credit cards have a tremendous impact on the health of America's economy and on the well-being of individual American families. In 2004, total bank credit card debt in the United States amounted to $800 billion.[35] Given their economic importance, regulators and policymakers need access to timely and reliable information about credit card markets. Section five of H.R. 5244 would require financial institutions to disclose information about credit card practices to the Board of Governors of the Federal Reserve System (Federal Reserve), who would make such information available to Congress.

A. Existing Data on Credit Card Practices Are Woefully Inadequate

The existing data on credit cards are woefully inadequate to assess the functioning of the market and its impact on consumers. The current provisions of the Truth in Lending Act require select financial institutions to disclose to the Federal Reserve only one specific piece of information about actual, completed credit card transactions—the annual percentage rate.[36] The remaining disclosures can be read, and apparently are so interpreted by the Federal Reserve, to apply only to data about credit card offers.[37] While that information may be useful to evaluate credit card marketing, it is wholly insufficient to assess *actual* credit card practices.

The existing data on credit card offers are inadequate because credit card contracts permit issuers to raise fees or rates after the initial contract. Current data only inform us about the charges made in credit card solicitations. No data measure whether the industry routinely raises fees on such accounts or on how many consumers actually pay the fees. Additionally, card issuers may impose new types of fees by amending the terms of the contracts. Such changes are not captured by data on initial credit offers. Regulators also have inadequate information about the actual interest rates imposed on consumers. These rates may be sensitive to market fluctuations but in a way that is too opaque to allow regulators to reliably measure how a change in costs of funds may relate to consumer rates. Additionally, many card issuers offer introductory "teaser" interest rates or impose "default" interest rates. The current data provisions do not capture how frequently or for how long consumers pay at a teaser or default rate or the extent to which issuers rely on such rates for revenue. Merely knowing the base rate that the largest financial institutions offer customers is inadequate.

The second problem with existing credit card data is that they do not capture information on actual habits of consumers. That is, even if the fees or rates in credit card offers did not change, such data still do not reflect how often such fees or rates are imposed. Under the existing disclosure regime, regulators cannot answer basic questions such as "how many cardholders pay late fees each month?" or "how many consumers revolve balances and incur interest rate charges?" Yet, answering these questions is essential for regulators to monitor the economic health of American families. Policymakers are also handicapped in assessing the relative advantages and disadvantages in the expansion of the consumer credit market if they do not know how many consumers are paying subprime interest rates or penalty fees. Congress cannot determine whether alternate payment systems such as debit cards would impose fewer costs on American consumers and businesses and should be encouraged by federal policy if they do not know the true costs to consumers of using credit cards.

The third problem is that existing data do not facilitate the Federal Reserve's oversight of the actual practices of issuers. This issue is distinct from knowing how consumers use their

cards. The focus here is on enabling regulators to identify particular issuers whose business models may be unusually reliant on particular revenue streams. To ensure the stability of such issuers, the Federal Reserve needs to know how card issuers earn revenue. On an aggregate level, such data would help policymakers safeguard against undue risk-taking and could aid in preventing financial instability. In the event of an overall market downturn, available and consistent data on credit card profits would save valuable time in deciphering the functioning of the market before designing effective responses to help issuers and consumers.

Congress and regulatory agencies cannot effectively monitor credit card markets with the existing data gathered under the Truth in Lending Act. The Federal Reserve currently produces a "Survey of Credit Card Plans,"[38] which contains information only on the largest issuers and others who "wish to participate."[39] The data points are very few—annual fee, grace period, and interest rate.[40] Frankly, an internet search produces in a few seconds more complete information on the variety of available credit card terms than the Federal Reserve chooses to collect under the existing Truth in Lending Act. The Federal Reserve's interest in studying credit cards has been consistently lackluster. For example, despite a statutory mandate in the 2005 amendments to the Bankruptcy Code to study the card industry's practices of soliciting and extending credit "indiscriminately" or "in a manner that encourages consumers to accumulate additional debt," the Federal Reserve's final report contained not a shred of new data and has no citations to support many of its assertions.[41] Congress needs and deserves better information.

The federal government cannot rely on private actors or agencies to fill these information gaps. Neither industry nor academic researchers nor administrative agencies can ensure that Congress gets the data that it needs. The most prudent course of action is for Congress to enact H.R. 5244 to arm itself with a robust understanding of credit card markets.

The credit card industry will not voluntarily provide data on its practices in a useful and reliable format. First, no particular issuer has an incentive to disclose if other issuers will not follow. That issuer may fear that it will put itself at a competitive disadvantage, attract negative publicity, or become a target for regulatory intervention. Second, even when and if issuers do disclose information about their practices, the emerging picture will be incomplete and potentially deceptive. For example, while some issuers have publicly promised that they do not engage in double-cycle billing,[42] this admission does not mean that the same issuer does not rely on other punitive practices to earn a disproportionate share of its revenue. Allowing issuers to have complete control over disclosures sets the stage for manipulative marketing or disclosures driven only by public relations concerns. Third, issuers will not use uniform and consistent methodology in making voluntary disclosures. Without clear rules for when and how the data must be revealed, issuers' practices cannot be compared fairly against each other. If consumers are going to engage in free choice to select a particular issuer, they must have access to comparable information about issuers' practices to make an informed decision. The industry's occasional and self-serving disclosures are neither transparent nor complete enough to be useful.

Academic researchers are unable to provide policymakers with a robust picture of credit card markets without federal data. Credit card agreements are private contracts; they are not publicly available. Issuers are not obligated to comply with requests from researchers to provide information. They may either flatly refuse to do so or may selectively provide data to only selected researchers whose proclivities they perceive to be favorable to the industry. If the industry will not disclose, the remaining option for researchers is to rely on consumers themselves to provide data about credit card use. While some researchers have proceeded this

way,[43] the costs of original data collection are very high. Further, the risks of sampling bias are significant.[44]

The same criticism can be leveled against the government's data collection from consumers about credit cards. The Federal Reserve Board's Survey of Consumer Finances (SCF) is a triennial survey of households' financial practices.[45] Although the SCF may be the best and most popular data on credit card use,[46] it has serious shortcomings.[47] Further, the SCF's focus on household behavior does not provide insights on different issuers. The identities of issuers or their practices are not covered in SCF data collection.

An additional barrier to government data collection is the fractured regulatory framework for credit card issuers. States frequently have to contend with arguments about federal preemption, even when just seeking to gather data.[48] At the federal level, regulators may refrain from investigating credit card practices because they believe it is appropriate to defer to another agency. Because credit card issuers may be different types of financial institutions, several separate agencies have oversight authority for credit card practices.[49] A cycle of non-action results with no agency thus far having taken the lead in gathering detailed credit card data. The result is that Congress remains deprived of uniform, consistent data about credit card practices. Indeed, American lawmakers operate with much less information about card markets than their peers in other countries.[50]

B. Improvements in Data Collection under H.R. 5244

Section five of H.R. 5244 would strengthen our collective knowledge about credit card markets. The additional data would remedy many of the inadequacies with existing data. With more information about card practices, Congress would be better equipped to evaluate any future legislative proposals about credit cards. The bill would require the Federal Reserve to gather three key kinds of information from issuers: 1) a list of the types of transactions that incur fees or interest rates; 2) the number of cardholders who are subject to such fees or rates; and 3) a breakdown of the revenue that issuers earn from such practices.

H.R. 5244 would require the Federal Reserve to obtain a list of each type of transaction or event for which card issuers impose a separate interest rate[51] and a list of each type of fee that card issuers impose upon cardholders.[52] If enacted into law, these provisions would permit Congress to understand the pricing mechanism for credit cards and to assess the extent to which credit card pricing is risk-based.[53] Further, the language about "each type" ensures that the Federal Reserve's data would stay abreast of changing credit card practices rather than attempt to anticipate in advance the names of new fees or the reasons that issuers impose them.[54] As credit card issuers implement new practices, Congress would be aware of such fees.

The second kind of information that H.R. 5244 would require to be disclosed is the extent to which consumers are being charged certain interest rates or fees. For each different rate, issuers would have to report how many cardholders were charged a particular interest rate during the prior calendar year.[55] A similar provision applies to fees.[56] These data could be used to monitor whether a growing proportion of American consumers are paying late fees, an early indicator of rising household financial distress. These data would also reveal how Americans use their cards by documenting the number of cardholders who take out cash advances, exceed their credit limits, or use their card to obtain foreign currency. Such information is useful for measuring the extent to which credit cards are being used for borrowing, rather than as spending devices for convenience. This knowledge is critically important to determining whether Americans' preference for credit cards over debit cards is optimal.[57]

If enacted, H.R. 5244 would give Congress timely and regular information about the overall revenue structure of credit card issuers. The Federal Reserve would gather data on the total amount of interest and the total amount of fees that each issuer imposed upon cardholders.[58] These data would be supplemented with an annual, public report by the Federal Reserve of the approximate, relative percentage of income that each issuer derives from interest, cardholder fees, merchant fees, or other material sources of income. Existing research suggests that late fees alone are the third largest revenue stream for card issuers,[59] and that overall fee income may be 35% of total revenues.[60] The economic importance of such revenue sources to the financial stability of issuers requires that the Federal Reserve and Congress be knowledgeable about any dramatic changes in issuers' profits.

C. Effective Regulatory Oversight Requires Information

The sheer size of the credit card market makes it vitally important to the stability of the American economy. To monitor the health of card issuers and American households, Congress needs basic information about actual credit card use and revenue. Without such information, Congress cannot fairly evaluate the functioning of the credit card market, and regulators cannot effectively exercise their duties. For example, regulators must know how issuers actually earn revenue if they are to monitor issuers' risk and to protect consumers against unconscionable practices.[61] Data on rates and fees at the time of application or solicitation are not appropriate for such tasks, which require the improved data that H.R. 5244 would collect. Data on how many consumers pay certain interest rates or fees is useful to Congress as it assesses the overall economic health of American families and considers proposals to reform the laws pertaining to credit cards. Such data reflect how successfully American families are managing their access to credit and the extent to which issuers are relying on financial distress to earn revenue.

The industry should welcome the data provisions in H.R. 5244. Issuers have repeatedly asserted that certain legislative reforms such as price controls would do severe harm to the business model for credit cards,[62] but Congress has been hamstrung in assessing the validity of such concerns by a lack of reliable, neutral government data about card revenue. Neither consumers nor industry should be content with legislative activity that is the result of confusion or misunderstanding. Indeed, the industry should benefit if Congress understands its practices because lawmakers will regulate with a fuller appreciation of the consequences of changes. H.R. 5244's improvements to data collection would enrich the debates about consumer credit by creating shared data that could used to assess the soundness of proposed reforms.

Conclusion

Credit cards can be useful spending and borrowing devices. However, their complexity and their widespread use in America impose heightened risks on consumers and create additional challenges for regulators. H.R. 5244 would improve the ability of consumers to successfully manage their card use. By standardizing administrative practices, consumers can pay on time. By allowing consumers to set firm credit limits, consumers can avoid over-the-limit fees and stay within their means. Such responsible credit card practices not only limit the risks to individual consumers of financial distress from credit card use but also help insulate the economy from an overall credit bubble that could occur if consumers become highly leveraged with credit card debt. If enacted, H.R. 5244 would give Congress and regulators improved data about credit cards with which they could monitor the industry's stability and better weigh the impact of further regulation on credit card markets and consumers.

[1] Additional biographical information and my curriculum vitae are available at my faculty page at the University of Iowa College of Law at http://www.law.uiowa.edu/faculty/katie-porter.php.
[2] My research papers may be downloaded from my SSRN author page at http://ssrn.com/author=509479.
[3] Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL., Mar. 22, 2006, at A1, A31, *available at* http://www.federalreserve.gov/Pubs/oss/oss2/2004/bull0206.pdf; Liz Pulliam Weston, *The Truth about Credit Card Debt*, MSN MONEY, http://moneycentral.msn.com/content/Banking/creditcardsmarts/P150744.asp (last visited Mar. 10, 2008); José A. Garcia, *Borrowing to Make Ends Meet: The Rapid Growth of Credit Card Debt in America*, DEMOS: A NETWORK FOR IDEAS & ACTION 5 (2007), *available at* http://demos.org/pubs/stillborrowing102407.pdf.
[4] RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 77 fig.6.4 (2006).
[5] *Id.* at 39.
[6] Credit Card Practices: Current Consumer and Regulatory Issues: Hearing Before the H. Comm. on Fin. Servs., Subcomm. on Fin. Insts. and Consumer Credit, 110th Cong. (Apr. 26, 2007) (statement of Oliver Ireland) ("[T]he flexibility and features that support the benefits of credit cards also result in credit cards being inherently complex products.").
[7] MANN, *supra* note 4, at 23.
[8] H.R. 5244, 110th Cong. (2008).
[9] MANN, *supra* note 4, at 66 ("Even if credit card spending and consumer debt are held constant, an increase in credit card debt—a shift of consumer borrowing from noncard borrowing to card borrowing—is associated with an increase in bankruptcy filings."). This effect was consistent in five large economies, suggesting that the risks of credit cards cannot merely be attributed to cultural factors.
[10] MANN, *supra* note 4, at 23.
[11] H.R. 5244, 110th Cong. § 4 (2008).
[12] Sumit Agarwal, John Driscoll, Xavier Gabaix & David Laibson, *The Age of Reason: Financial Decisions Over the Lifecycle* (Feb. 11, 2008), *available at* http://ssrn.com/abstract=973790. The researchers controlled for observable risk characteristics such as income levels and credit scores, yet still found measurable age-related effects in over-the-limit transactions.
[13] MANN, *supra* note 4, at 162 n.34 (citing U.S. Overlimit Fees Monthly Averages Among > $100M Portfolios – Current, *available at* http://www.cardweb.com/carddata/charts/overlimit_fees.amp (subscription only) (last visted Mar. 10, 2008) ($31.29 average in December 2005 for issuers with portfolios greater than $100 million)).
[14] Professor Ronald Mann proposes that issuers be required to disclose whether a consumer would exceed the limit and the amount of the over-the-limit fee at the point-of-sale. He notes that such "[d]isclosures would help to the extent those fees reflect an imperfect ability to manage the credit card account." MANN, *supra* note 4, at 162.
[15] Discover Bank v. Owens, 822 N.E.2d 869, 873–74 (2004).
[16] *Id.* at 872 (bank assessed Ms. Owens $1518 in over-the-limit fees over a period of six years despite no new customer activity on the account).
[17] Walechia Konrad, *How Americans Really Feel About Credit Card Debt*, Bankrate.com (Survey 2006).
[18] U.S. Gov't. Accountability Office, *Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures*, 18 & 19, Fig. 4 (2006), *available at* http://www.gao.gov/new.items/d06929.pdf?source=ra_.
[19] MANN, *supra* note 4, at 152.
[20] Jonathan M. Orszag & Susan H. Manning, *An Economic Assessment of Regulating Credit Card Fees and Interest Rates*, Oct. 2007, at 11.
[21] MANN, *supra* note 4, at 152.
[22] 15 U.S.C. § 1637(b) (fourteen days).
[23] Interview of Andrew Kahr, *Frontline: Secret History of the Credit Card*, Jan. 5, 2005, *available at* http://www.pbs.org/wgbh/pages/frontline/shows/credit/interviews/kahr.html (describing emergence of subprime card market in last ten years).
[24] Katherine Porter, *Bankrupt Profits: The Credit Industry's Business Model for Postbankruptcy Lending*, 94 IOWA L. REV. (forthcoming 2008).
[25] *See, e.g.*, Continental Finance Mastercard terms, *at* https://www.cfcapply.com/classic1mc/fbd-terms.htm; Cor Trust Banker Mastercard terms, *at* https://www.cortrustcard.com/Terms/.
[26] *See, e.g.,* Centennial card terms, *at* https://www.centennialapplication.com/Default.aspx?appid=PI0803091734SC6GR (stating that the following fees

will be billed to the first statement: Annual Fee of $48, Account Set-Up Fee of $29, Program Fee of $95, Monthly Servicing Fee of $7, and an Additional Card Fee of $20 per card (if applicable)).

[27] Gold Tribute Mastercard terms, *at* https://www.mytributecard.com/apply/?xml=%3CCSCODE%3E5QLBC1%3C/CSCODE%3E. However, the card advertises that a consumer will have a $170 of "available credit" because the consumer is required to make a $20 minimum payment before the card may be used. I do not see how a $20 payment by a consumer constitutes a credit extension by the issuer, but that is how the card is marketed.

[28] H.R. 5244, 110th Cong. § 6 (2008).

[29] MANN, *supra* note 4, at 140 (concluding that the lack of existing law to regulate credit card agreements is "striking" in light of general approach to consumer contracts in American law).

[30] *Id.* at 145.

[31] William C. Whitford, *The Functions of Disclosure Regulation in Consumer Transactions*, 1973 WIS. L. REV. 400 (1973).

[32] Thomas Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARVARD L. REV. 1393 (1983); Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. OF ECON. 500 (2006).

[33] H.R. 5244, 110th Cong. § 3(e) (2008).

[34] MANN, *supra* note 4, at 149 ("Credit card agreements stand out as one of the rare types of consumer financial transactions that do not proceed on some set of preapproved terms.").

[35] Mark Furletti & Christopher Ody, *Measuring U.S. Credit Card Borrowing: An Analysis of the G.19's Estimate of Consumer Revolving Credit*, FEDERAL RESERVE BANK OF PHILADELPHIA, Apr. 2006, *available at* http://www.philadelphiafed.org/pcc/papers/2006/DG192006April10.pdf.

[36] 15 U.S.C. § 1646(a) ("The Board shall collect, publish, and disseminate to the public, on a demonstration basis in a number of standard metropolitan statistical areas to be determined by the Board, the annual percentage rates charges for representative types of nonsale credit by creditors in such areas.").

[37] 15 U.S.C. § 1646(b) (requiring Board to collect "credit card price and availability information, including the information required to be disclosed under section 1637(c) of this title, from a broad sample of financial institutions which offer credit card services"). The reference to "credit card price information" could include a variety of data about actual charges to consumers, but the Federal Reserve Board has restricted its efforts to the specific credit card offer information in 1637(c), thus doing the bare minimum required by the statute.

[38] Federal Reserve Board, *Survey of Credit Card Plans*, *available at* http://www.federalreserve.gov/pubs/shop/survey.htm.

[39] Issuers who charge unusually steep rates or penalties can apparently escape public scrutiny by refusing to complete the survey. Thus, the Survey of Credit Card Plans is totally useless as a tool for identifying egregious practices.

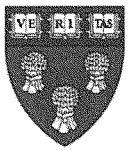
[40] The rate information consists of the annual percentage rate, whether such rate is fixed, variable or tiered, and the index used for variable rates.

[41] Federal Reserve Board, *Report to Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and Their Effects on Consumer Debt and Insolvency* (June 2006), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/bankruptcy/bankruptcybillstudy200606.htm; Post of Elizabeth Warren to *Credit Slips* blog, *Fed Says We're All Doing Great with Credit Cards* (Aug. 8, 2006), *at* http://www.creditslips.org/creditslips/2006/08/fed_says_were_a.html.

[42] Testimony of John P. Carey, Chief Administrative Officer of Citi Cards, 9 at Credit Card Practices: Current Consumer and Regulatory Issues: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the Committee on Financial Services, 110th Cong. 2 (2007).

[43] *See, e.g.*, Angela Littwin, *Beyond Usury: A Study of Credit-Card Use and Preference Among Low-Income Consumers*, 86 Tex. L. Rev. 451 (2008); TERESA A. SULLIVAN, ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2000); Katherine Porter, *Bankrupt Profits: The Credit Industry's Business Model for Postbankruptcy Lending*, 93 IOWA. L. REV. (forthcoming 2008); Michael S. Barr, *Detroit Area Study on Financial Services: What? Why? How?*, Law Quadrangle Notes 48(1), 72–77 (Summer 2005), *available at* http://wwwpersonal.umich.edu/~msbarr/2005_Law_Quad_Notes_Detroit_Area_Study_on_Financial_Services.pdf; Joseph Lupton & Frank Stafford, *Five Years Older: Much Richer or Deeper in Debt?*, INSTITUTE FOR SOCIAL RESEARCH (Jan. 2000), *available at* http://psidonline.isr.umich.edu/Publications/Papers/FiveYearsOlder.pdf.

[44] MANN, *supra* note 4, at 61 ("The problem with survey data, however, is that they are likely to be inaccurate for families that do not understand the significance of the amounts that they are spending and borrowing.").
[45] Federal Reserve Board, About the Survey of Consumer Finances, http://www.federalreserve.gov/pubs/oss/oss2/about.html.
[46] Arthur B. Kennickell, *Currents and Undercurrents: Changes in the Distribution of Wealth, 1989-2004*, FEDERAL RESERVE BOARD (Jan. 2006), *available at* http://www.federalreserve.gov/pubs/oss/oss2/papers/concentration.2004.5.pdf; Ian Domowitz & Robert L. Sartain, *Determinants of the Consumer Bankruptcy Decision*, 54 J. Fin. 403 (1999); Jennifer Wheary & Tamara Draut, *Who Pays?: The Winners and Losers of Credit Card Deregulation*, DEMOS: A NETWORK FOR IDEAS & ACTION 2 (2007), *available at* http://www.demos.org/pubs/whopays_web.pdf.
[47] MANN, *supra* note 4, at 61 ("[A] study by an independent research organization found that data from the SCF appear to understate credit card receivables by about 25%.").
[48] In a recent example, several mortgage servicers declined to provide data on loss mitigation activity to the Foreclosure Prevention Working Group of state attorneys general, saying that they were acting on the advice or direction of the Office of the Comptroller of the Currency to refuse to provide data. *See* Ruth Simon, *States Say Mortgage Companies Fall Short on Loan Modification*, WALL ST. J. D3 (Feb. 7, 2008).
[49] The primary federal regulator could be the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Trade Commission, or the National Credit Union Administration. *See* Fed'l Trade Comm'n, *Choosing and Using Credit Cards, available at* http://www.ftc.gov/bcp/conline/pubs/credit/choose.shtm (listing agencies with jurisdiction over credit cards).
[50] MANN, *supra* note 4, at 261 n.35 ("We have little empirical data about the operation of the card system in the United States. The regulatory authorities in other countries (Australia and the United Kingdom in particular) have considerably more accurate historical and current information about payment systems than we have in the United States.").
[51] H.R. 5244, 110th Cong. § 5(1)(B) (2008).
[52] *Id.*
[53] *Cf.* Adam Levitin, *All But Accurate: A Critique of the American Bankers Association's Study on Credit Card Regulation* (2007) *available at* http://ssrn.com/abstract=1029191, with Jonathan M. Orszag & Susan H. Manning, *An Economic Assessment of Regulating Credit Card Fees and Interest Rates* (commissioned by American Bankers Ass'n) (2007), *available at* http://www.aba.com/aba/documents/press/regulating_creditcard_fees_interest_rates 92507.pdf.
[54] Additionally, the bill would permit the Board to collect "any other information related to interest rates, fees, or other charges that the Board deems of interest." H.R. 5244, 110th Cong. § 5(1)(B) (2008).
[55] *Id.*
[56] H.R. 5244, 110th Cong. § 5(1)(B) (2008).
[57] MANN, *supra* note 4, at 120.
[58] H.R. 5244, 110th Cong. (2008).
[59] Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, FEDERAL RESERVE BANK OF PHILADELPHIA, Jan. 2003, *available at* http://www.philadelphiafed.org/pcc/papers/2003/CreditCardPricing_012003.pdf.
[60] MANN, *supra* note 4, at 23 fig.2.2.
[61] Katherine Porter, *The Debt Dilemma*, 106 MICH. L. REV. 1167, 1189 (2008) (arguing that agencies charged with regulating credit cards cannot intelligently evaluate the utility and safety of credit cards if they do not have meaningful knowledge of how those products are used).
[62] Testimony of James A. Huizinga, 2 at Improving Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the Committee on Financial Services, 110th Cong. 2 (2007) ("I think it is critically important that, for the most part, the proposal avoids price controls and similar restrictions. Price controls seldom work.").



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Testimony of

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Before the
Sub-Committee on Financial Institutions and Consumer Credit
Of the Committee on Financial Services
of the United States House of Representatives

Hearing: The Credit Cardholders' Bill of Rights:
New Protections for Consumers

March 13, 2008

Credit Card Practices that Undermine Consumer Safety

Thank you for the opportunity to join this discussion about H.R. 5244 and credit cards.[1]

We are here today to consider modest changes to the rules governing credit cards. Ironically, we are here to discuss banning practices that many responsible lenders have already renounced. As a result, much of this discussion is about ensuring that banks that claim to embrace clean practices are, in fact, following their own promises. It is also about ensuring that the most shameless creditors do not engage in practices that both borrowers and lenders have agreed are unfair.

We are not here to regulate credit cards. This is not a hearing to discuss interest rate caps, fee regulation or any restraint on free and competitive markets.

Instead, this is a hearing about the kinds of tricks and traps that undermine a competitive market. Markets in which customers are bound to terms to which they did not agree, are not free and competitive. Markets in which the terms of an agreement are not revealed until after the customer signs on, are not free and competitive. Markets that permit traps concealed in unreadable jargon, are not free and competitive.

For too long, the most aggressive credit card issuers have had a free rein to craft new terms to ensnare unsuspecting customers. In the absence of baseline rules such as those proposed in H.R. 5244, some credit card issuers have boosted profits by developing new terms that are unfair, often devious, and sometimes legally deceptive. This is a hearing about banning those practices to ensure real freedom and competition in the credit card market.

The events of recent months remind us that we are all in credit markets together. Customers and lenders of all stripes are affected by the lending and borrowing habits of everyone else. Without careful regulation to support prudent lending, the risk increases that a credit card bubble will further destabilize both families and the larger economy.

The Proposals

Billing Practices

To prepare for the hearing this morning, I read an entire credit card agreement in full before coming here. I could not find any clear information about billing practices, other than the due date and a promise of a grace period. There was certainly no mention in the agreement of universal default, double-cycle billing, or other such practice. But those billing practices can produce substantial revenues for some aggressive lenders. H.R. 5244 stops the scams. The bill

- bans due date tricks
- bans double-cycle billing
- bans imposition of repeated fees for a single over-limit violation
- requires pro-rata allocation of payments when customers have loans at different interest rates

These are modest changes that end practices that, quite frankly, serve no purpose except to mislead customers. Practices that would be banned, such as requiring payment before noon or using fine print to shorten the due date for long-time customers, are deceptions, not legitimate business practices. They should not be permitted. The same is true about

double-cycle billing, which is used to collect interest on money that the customer has already repaid.

Creditors are hard-pressed to defend these practices. In fact, several major credit card issuers have announced that they will drop practices such as double-cycle billing and unlimited penalties for over-limit violations. These issuers are on record stating that their customers should not be treated this way. They should be commended. They also show us that the changes proposed here should not be controversial.

Violations of Basic Contract Law

Other amendments are designed to curb violations of the basic principles of contract law, principles that we have taught at Harvard Law School and other law schools around the country for decades. They include:

- Eliminating universal default and any-time, any-reason re-pricing
- Requiring advance notice of rate increases
- Giving consumers a chance to read the card terms before the card is issued
- Making sure that terms such as "fixed rate" and "prime rate" carry their ordinary, plain English meaning
- Limiting the issuer's ability to change the credit limits without the consent of the customer

Contract law is based on the consent of *both* parties. When one party attempts to reserve to itself the right to change prices or terms unilaterally—without the consent of the other party—the contract is deemed illusory and neither party can enforce it. No party can meaningfully consent to terms that did not exist when the contract was formed or to terms that were not revealed until later. Yet some credit card issuers routinely use written agreements that violate these foundational principles of contract law.

Once again, credit card issuers are hard-pressed to defend these practices. Some won't even try. When card issuers take advantage of contract terms they inserted in order to bind consumers, but refuse to bind themselves to the same agreement, they engage in the kind of heads-I-win-tails-you-lose game that contract law has banned for more than two centuries. Restoring the basic principles of contract law to credit card transactions is an important step toward restoring integrity and competition to the credit card market.

Encouraging Customers to Meet their Obligations

Finally, one of the proposals involves a practice that aims toward helping more customers meet their financial obligations and avoid default. This proposal benefits both consumers and the credit industry. It involves giving consumers a clear path to financial rehabilitation

This is an important measure to strengthen both the credit card industry and our national economy. When consumers fall behind on their credit card payments, the result is an increase in their fees and interest rates, but their mounting debt also affects the consumer's family, other creditors who are doing business with the consumer, merchants who hope to sell to the consumer, and the employer who needs the consumer to concentrate on work matters. A weakened consumer has trouble meeting all of these obligations.

No one is helped when consumers in financial trouble cannot recover their financial footing. Giving the customer a clear path to financial rehabilitation is good not only for the customer, but also for everyone who relies on the financial health of that customer.

Credit Card Reform in a Time of Economic Uncertainty

The crisis in the subprime mortgage market has served as a bitter reminder of what can happen when lending terms are not transparent. When lenders are careless in screening their customers and when customers are unable to evaluate fully the risks associated with borrowing, especially without meaningful government oversight, the result is a series of risky loans, raising the specter of mass defaults and economic upheaval.

Dramatic and sustained weakness in consumer confidence and consumer spending make it imperative that Congress act to build confidence in credit card products. Financial markets need to be reassured that the lending on which the U.S. economy is based have been made prudently and are likely to be repaid. In a time of national economic turbulence, the credit card market should be a pillar of stability, not a shell game based on tricking consumers into spending more than they had intended.

Tricks, Traps and Bank Profitability

Some credit card contracts have become a dangerous thicket of tricks and traps. Part of the problem is that disclosure has become a way to obfuscate rather than to inform. In the early 1980s, the typical credit card contract was a page long; by the early 2000s, that contract had grown to more than 30 pages of incomprehensible text.[2] The additional language was designed in large part to add unexpected—and unreadable—language that favors the card companies. In a recent memo aimed at bank executives, a Vice President of the consulting firm Booz Allen Hamilton observed that most bank products are "too complex for the average consumer to understand."[3] That is an impressive understatement.

For an example of a trick hidden in a credit card, I turned to a mailing from a prominent credit card company. To determine the interest rate the card would carry, the customer would have to wade through a discussion referencing unfamiliar terms such as "LIBOR" and "Cash Equivalent Transactions." But even the most diligent reader would labor in vain. After 47 lines of almost incomprehensible text about various rates, the fine print concludes, "We reserve the right to change the terms at any time for any reason."[4] Evidently, all that convoluted language was there only to obscure the bottom line: The

company will charge whatever it wants. In effect, lenders won't be bound by any term or price that becomes inconvenient for them, but they will expect their customers to be bound by whatever terms the lenders want to enforce—and will count on the courts to back them up.

Bankcard issuers generated record-breaking revenues in 2006, the latest year for which data are available. All-purpose cards generated $115 billion in revenues in 2006, up from $110 billion the year before.[5] Profits were a handsome $18.4 billion, a 45% jump from the year before.[6]

The breakdown in card income shows that most money comes from those customers who cannot pay in full each month.[7]

Interest	$75.15MM
Interchange	22.18MM
Penalty fees	6.44MM
Cash advance fees	5.65MM
Annual fees	4.00MM
Enhancements	0.92MM

There is, of course, no breakdown in the interest and fee categories to explain how much of the industry revenue came from raising interest rates on customers who were making all their payments in full and on time or how much came from charges based on double-cycle billing for debt that had already been paid. But it is possible to gain some sense of the need for such tricks and traps by noting the number of highly profitable card issuers that have publicly renounced such practices.

- Bank of America has testified before this committee that it has never engaged in universal default. The company's credit card profits nonetheless continue to grow.
- Capital One has testified before this committee that it does not engage in universal default.[8] The company's credit card profits nonetheless continue to grow.
- Citibank has testified before this committee that it would ban universal default practices during the time a credit card was outstanding.[9] The company's credit card profits nonetheless continue to grow.
- J.P. Morgan Chase announced that it will stop all universal defaults.[10] The company's credit card profits nonetheless continue to grow.

This summer, Money Magazine observed: "Since last March, none of the five major issuers, which control 80% of the market, officially practiced universal default."[11]

With so many card issuers abandoning universal default, it is difficult to claim that such clauses are essential for profitability. But why is it necessary to ban the practice? This is a little like asking why it is necessary to ban toxic dumping if most companies don't do it. The simple answer is that banning the practice makes sure that a minority of card issuers

do not burn consumers with these practices. Discover is perhaps the most prominent of several lenders that still refuse to abandon this exploitative practice, despite the fact that their competitors remain quite profitable without this source of revenue.

H.R. 5244 is also important because it puts the force of law behind the pledges of Bank of America, Capital One, Citibank, and Chase. As it stands, nothing prevents these companies from quietly changing their policies. Consumers deserve better protection than the occasional benevolence of America's largest lenders.

While universal default has attracted the most attention, there are other practices that do not grab headlines, but that slice into customers' pocketbooks. Even here, major issuers have already abandoned some of the worst practices.

- Bank of America has testified before this committee that it has never engaged in double-cycle billing. It also limits the number of consecutive over-limit fees to three.
- Senator Coleman announced in hearings last year that Chase had agreed to "eliminate the odious practice known as double-cycle billing."[12] The Senator also said that Chase would not impose more than three over-limit fees per event.
- Capital One has testified before this committee that it does not engage in double-cycle billing, and that it has eliminated billing practices that would impose high interest rates when a customer is only a day late in paying.[13]

These companies may have abandoned other sharp practices as well, and they are to be commended. Their competitors may also have renounced double-cycle billing or repeat over-limit fees, but such information is not readily available. We know about these practices only because Congressional committees, led by Congresswoman Maloney and others, have asked. Otherwise, customers remain in the dark about such practices. So long as that is so, the market will not work. The only hope for restoring a competitive market that provides transparency to consumers is to send a clear signal that these disreputable stratagems have no place in the American financial system. Passing H.R. 5244 is an obvious way to end some of the most obvious forms of exploitation of consumers while maintaining the vibrancy of the American credit industry.

Economic Stimulus and Credit Cards

Money siphoned off in devious billing practices and hidden fees is money not spent on goods and services in this economy. Credit card debt now consumes a sizeable portion of a family's income, leaving families with less to spend elsewhere. Current data show an average of 9.2% of families' disposable income is taken up by credit card debt, money that is not used to purchase goods and services that can bolster the U.S. economy.[14]

It is ironic that Congress would pass a huge stimulus package, committing billions of dollars of taxpayer money to families in the hope that they will spend it on goods and services to give the economy a much-needed lift. If, instead, that money goes to paying interest on outstanding debts, the stimulus will fall flat. But Congress has other tools at

its disposal beyond spending taxpayer dollars. Families would have more to spend if they did not lose money to credit card issues through traps.

For a more detailed explanation of this phenomenon, I commend your attention to the work of my co-panelist, Professor Adam Levitin. He explains the larger economic impact of even small dollar differences that are multiplied by millions and millions of transactions.[15] H.R. 5244 gives Congress a chance to help strengthen the economy by strengthening family budgets.

Regulation and Credit Bubbles

As experience in the subprime market has taught us, so painfully, when lenders can increase their profits by promoting tricky products, they will make more loans with less regard for the customers' ability to repay them. At the margins, some loans will be made that should never have been approved. For a short time, this reckless lending looks like good news to the borrower who got money that he would not have otherwise obtained and to the lender that generates an extra profit on the loan and packages the debt for re-sale.

But the good news is always followed by bad news. Inflating lending through tricks and traps is classic bubble activity—artificially driving up the number and dollar amount of loans. Over time, a large fraction of the people who receive these loans will default on them. When they do, the bubble bursts.

Credit card activity is no longer funded exclusively by bank deposits and capital reserves. Instead, like mortgage loans, credit card receivables are passed along into securitized pools. Currently about 60% of all credit card debt is held in securitized pools, such as special purpose entities (SPEs in the parlance of the trade).[16] These debts are then moved off the card issuers' balance sheets so that they no long require capital reserves—and so that they are no longer so visible either to regulators or investors, let alone to consumers.

As the mortgage crisis has also taught us, the consequences of an exploding credit bubble are not confined exclusively to those who engaged in imprudent lending and borrowing. Instead, when a consumer fails financially, all of the people who do business with that person are also in jeopardy. Other, more prudent credit card issuers are not paid. Doctors' bills and dentists' bills go unpaid. Car loans break down. There is less money to pay rents and mortgages. Defaults and bankruptcies will not discriminate between prudent and imprudent lenders, and so thousands of responsible loans will become collateral damage of the easy money epidemic.

There are no publicly-available data documenting the magnitude of each of the particular practices identified in H.R. 5244. If they are rarely used, then the current markets are secure. Of course, if they are rarely used, then there will be little impact on the industry if they are eliminated entirely. H.R. 5244 will serve the valuable purpose of ending these pernicious practices before they spread.

If, however, the practices identified in H.R. 5244 are widespread, then it is imperative they be eliminated before they precipitate a financial crisis. Families cannot bear the strain of losing money to credit card tricks, and responsible lenders should not be forced to compete with those who are willing to boost their profits by taking advantage of customers. Given the current vulnerabilities of the national economy, a second credit crisis would almost certainly plunge us into a deeper and even more severe recession.

Who Get Hurts When Credit Card Markets Don't Work?

Credit cards are everywhere. As of 2004, the Survey of Consumer Finance documented that three-fourths (74.9%) of all households held at least one credit card, and 58% of those with credit cards carried balances.[17] In other words, about 43.5% of all households in the US carry a balance on their credit cards. For those who carry debt, the average debt per household in 2006 was reported as an astonishing $8,467.[18] Since then, debt has continued to grow. A household earning the median income would have to turn over every paycheck for nearly three months to pay that bill.[19] Of course, they would have to find a way to stop eating, stop paying rent, stop driving to work, stop making car payments, and, most importantly, stop the interest from continuing to accumulate on their debt loads.

The publicly-available data are aggregated, which means that it is not possible to identify particular lenders or particular practices. Many subtle and not-so-subtle ways of taking advantage of vulnerable groups can be covered up by combining data from multiple sources. Even so, the aggregated data reveal some deeply troubling trends.[20]

- Single women are nearly twice as likely to be paying penalty rates of interest as single men.
- African-American and Latino card holders who carry balances are more likely to be paying interest rates above 20% than are their white counterparts.
- Families with incomes in the bottom 40% are twice as likely to be paying penalty interest rates as families in the top 40%.

The cumulative effects of lower earnings and fewer accumulated assets leave many Americans vulnerable to the exploitative practices of credit card companies. Unlike those with more resources, they cannot always shrug off late fees or higher interest rates, paying them with no real effect on their financial security.

Nearly half of all credit-card holders missed payments in 2006 (the latest year for which data are available).[21] This makes them obvious targets for the most aggressive and unfair tactics. Sending in a payment that arrives one day late costs a family an average of $28, even though the cost to the company of a late payment can be measured in pennies.[22] More importantly, a single late payment can trigger a rise in interest rates on that card and on other outstanding cards that will make it far more difficult for the family to get any of its debts paid.

Anxiety has become a constant companion for Americans struggling with debt. Today about one in every seven families is dealing with a debt collector.[23] Forty percent of families worry whether they can make all their payments every month.[24] An additional 2.1 million families missed at least one mortgage payment.[25] In 2006, a then-record 1.3 million families received foreclosure notices, followed by another 2.2 million families who were in foreclosure in 2007.[26] One in five Americans is losing hope, saying that even when they don't count their mortgages, they expect to die still owing money to their creditors.[27]

What will happen to these families? Since 2000, families have filed nearly 10 million petitions for bankruptcy. In 2005, the National Opinion Research Council asked families about negative life events: the death of a child and being forced to live on the street or in a shelter topped the list, but filing for bankruptcy ranked close behind, more serious than the death of a close friend or separating from a spouse.[28] Of those who file for bankruptcy, 85 percent struggle to hide the fact from families, friends, or neighbors.[29]

Some Americans believe that their neighbors are drowning in debt because they spend and borrow recklessly—and there can be no doubt that some portion of the credit crisis is the result of foolishness and profligacy. But that is not the whole story. Lenders have deliberately built tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debt. With H.R. 5244, Congress has an opportunity to eliminate some of the most harmful practices.

Making Markets Work

Americans are justifiably angry about how they are treated by their credit card issuers. In 2007, 11,427 people filed complaints with the Office of the Comptroller of the Currency, which oversees only the subset of credit cards that are issued by federally chartered banks. Last summer, when the Federal Reserve opened its website for public comments on its proposal that lenders give 45-day notice before increasing interest rates, more than 2,500 consumers wrote in to support the rule change.

Lenders employ thousands of lawyers, lobbyists, marketing ad agencies, statisticians, and business strategists to help them increase profits. In a rapidly changing market, customers need some basic protection to be certain that the products they buy meet minimum safety standards. Personal responsibility will always play a critical role in dealing with credit cards, but no family should be brought low by tricks and traps designed to prey on the unwary.

Creating safer marketplaces begins with making certain that the financial instruments on which we depend are fair to consumers and sustainable over the long term. Terms hidden in the fine print or obscured with incomprehensible language, reservation of all power to the seller with nothing left for the buyer, and similar legally-sanctioned confidence games have no place in a well-functioning market.

Congresswoman Maloney and Chairman Frank have taken an important first step toward ending the practices that put families and markets at risk. They deserve our support and our thanks.

---

[1] In preparing this testimony, I received excellent research help from Adam Lebovitz, Harvard Class of 2010.
[2] Mitchell Pacelle, Putting Pinch on Credit Card Users, Wall Street Journal (July 12, 2004) (citing industry consultant Duncan MacDonald, formerly a lawyer for the credit-card division of Citigroup Inc.).
[3] Booz Allen Hamilton, Inc., *Innovating Customer Service: Retail Banking's New Frontier*, Strategy + Business, Knowledge@Wharton (December 22, 2006) (quoting Alex Kandybin, Vice President, Booz Allen Hamilton, Inc.).
[4] First BankCard offer. Copy on file.
[5] Jeffrey Green, Bankcard Profitability 2007, Cards & Payments at 27 (May 2007) www.cardsandpayments.net
[6] Id.
[7] Id.
[8] Testimony of John G. Finneran, Capital One, House Subcommittee Hearings, at 3-5 (June 7, 2007); Testimony of Ryan Schneider, Capital One, Permanent Subcommittee on Investigations (Levin), at 8-9 (December 4, 2007).
[9] Testimony of John P. Carey, Chief Administrative Officer, Citibank, House Subcommittee Hearings, at 9-10 (June 7, 2007).
[10] Reported in Sarah Mangla Ismat, "One Less Sneaky Credit-Card Policy," *Money*, Vol. 37, Issue 2 (February 2008); Jessica Silver-Greenberg, "Credit Cards: Battle in Congress," *Business Week Online*, December 5, 2007.
[11] Id.
[12] Senator Coleman, Opening Statement at Credit Card Hearing, at 3 (March 7th, 2007).
[13] Testimony of John G. Finneran, Capital One, House Subcommittee Hearings, at 3-5 (June 7, 2007); Testimony of Ryan Schneider, Capital One, Permanent Subcommittee on Investigations (Levin), at 8-9 (December 4, 2007).
[14] Calculations from Federal Reserve Bank, Flow of Funds Accounts (March 2008).
[15] Adam J. Levitin, Priceless? The Social Costs of Credit Card Merchant Restraints, 45 HARV. J. ON LEGIS. 1, 46 (2008).
[16] Darryl E. Getter, The Credit Card Market: Recent Trends, Funding Cost Issues, and Repricing Practices, Congressional Research Service CRS 4-5 (February 27, 2008).
[17] Other estimates place those with balances even higher. CardData reports that in 2006 the percentage of cardholders who *consistently* revolve a balance was 61.3%. www.carddata.com (2006).
[18] *Bank Credit Card Annual Revolving Balances Per Carded Households*," CardData.com (2006) (data are calculated excluding "balances paid-off before interest accrues; also excludes commercial cards, debit cards and private label credit cards").
[19] Median household income in the U.S. in 2007 was $48,201. http://www.census.gov/prod/2007pubs/p60-233.pdf at 4.
[20] Jennifer Wheary and Tamara Draut, "Who Pays? The Winners and Losers of Credit Card Deregulation," Demos Foundation 1-2 (2008).
[21] Walechia Konrad, *How Americans Really Feel About Credit Card Debt*, Bankrate.com (Survey 2006).
[22] Id. at 7.
[23] Tom W. Smith, Troubles in America: A Study of Negative Life Events, National Opinion Research Council (December 2005); Lucy Lazarony, Denying Our Debt, Bankrate.com (July 2006 (11% in collection on credit cards).
[24] Consumer Federation of America, Rising Energy Costs Dampen Holiday Spending Plans (November 19, 2007).
[25] Sandra Block, *Foreclosure Hurts Long after Home's Gone, So Cut a Deal While You Can,* USA Today quoting Mortgage Bankers Assn (March 23, 2007).

[26] Nationwide Foreclosures Jumped 75% in 2007, Credit & Collections World (February 8, 2008). http://www.creditcollectionsworld.com/article.html?id=20080129S4FTCWQT&from=creditandcollectionnews

[27] Smart Borrow Survey, Marketwise, prepared with support from Lending Tree, at 145 (April 2007).

28. TOM W. SMITH, NAT'L OPINION RES. CTR., TROUBLES IN AMERICA: A STUDY OF NEGATIVE LIFE EVENTS ACROSS TIME AND SUBGROUPS 10 (2005), *available at* http://www-news.uchicago.edu/releases/05/051228.troubles.pdf.

29. ELIZABETH WARREN & AMELIA TYAGI, THE TWO INCOME TRAP: WHY MIDDLE CLASS MOTHERS AND FATHERS ARE GOING BROKE, at 213 n.13, 74-75.

March 11, 2008

The Honorable Carolyn Maloney
United States House of Representatives
2331 Rayburn Office Building
Washington, D.C. 20510

Dear Representative Maloney:

The National Small Business Association is pleased to support *H.R. 5244, the Credit Cardholders' Bill of Rights*. Reaching 150,000 small-business owners across the nation, NSBA is the country's oldest small-business advocacy organization.

Credit cards are critical to America's small businesses. Many small and startup businesses lack the assets necessary for traditional bank loans, and on-going bank consolidation and the increased usage of personal credit ratings for business owners have resulted in fewer community and character-based loans. In turn, small businesses increasingly are obtaining vital business capital from credit cards.

In a nationwide NSBA survey, 44 percent of small- and mid- sized business owners identified credit cards as a source of financing that their company had used in the previous 12 months—more than any other source of financing, including business earnings. Although they are increasingly turning to credit cards for financing, more than half of small businesses report that the terms of their credit cards are worsening. This is not good news for America's economy, which is heavily reliant on a robust and thriving small-business community.

To this end, NSBA supports credit-card reform. For far too long, the credit-card industry has been allowed to engage in acts in direct violation of free-market capitalism and fundamental fairness. It is time to curtail or prohibit the more egregious examples of these practices.

Congress must remain vigilant, however, of any unintended consequences arising from efforts to reform the practices of the credit-card industry. Any enacted legislation must be carefully constructed and meticulously monitored to avoid further restricting small businesses' access to capital. For instance, proposals to require cardholders to demonstrate proof of income would be highly detrimental to aspiring entrepreneurs.

NSBA strongly encourages Congress and the administration to fully support small businesses as the true centers of growth in the U.S. economy and take the lead in ensuring that injurious credit-card practices are not inhibiting small-business growth and harming America's economy. NSBA applauds you for your leadership on this vital issue and for recognizing the important connection between needed credit-card reform and the essential role small business plays in the U.S. economy.

Sincerely,

Todd O. McCracken
President

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United States Government Accountability Office

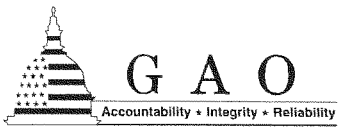
GAO

Report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

September 2006

CREDIT CARDS

Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers



GAO-06-929

September 2006

GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-06-929, a report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

CREDIT CARDS

Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers

Why GAO Did This Study

With credit card penalty rates and fees now common, the Federal Reserve has begun efforts to revise disclosures to better inform consumers of these costs. Questions have also been raised about the relationship among penalty charges, consumer bankruptcies, and issuer profits. GAO examined (1) how card fees and other practices have evolved and how cardholders have been affected, (2) how effectively these pricing practices are disclosed to cardholders, (3) the extent to which penalty charges contribute to cardholder bankruptcies, and (4) card issuers' revenues and profitability. Among other things, GAO analyzed disclosures from popular cards; obtained data on rates and fees paid on cardholder accounts from 6 large issuers; employed a usability consultant to analyze and test disclosures; interviewed a sample of consumers selected to represent a range of education and income levels; and analyzed academic and regulatory studies on bankruptcy and card issuer revenues.

What GAO Recommends

As part of revising card disclosures, the Federal Reserve should ensure that such disclosure materials more clearly emphasize those terms that can significantly affect cardholder costs, such as the actions that can cause default or other penalty pricing rates to be imposed. The Federal Reserve generally concurred with the report.

www.gao.gov/cgi-bin/getrpt?GAO-06-929.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at (202) 512-8678 or woodd@gao.gov.

What GAO Found

Originally having fixed interest rates around 20 percent and few fees, popular credit cards now feature a variety of interest rates and other fees, including penalties for making late payments that have increased to as high as $39 per occurrence and interest rates of over 30 percent for cardholders who pay late or exceed a credit limit. Issuers explained that these practices represent risk-based pricing that allows them to offer cards with lower costs to less risky cardholders while providing cards to riskier consumers who might otherwise be unable to obtain such credit. Although costs can vary significantly, many cardholders now appear to have cards with lower interest rates than those offered in the past; data from the top six issuers reported to GAO indicate that, in 2005, about 80 percent of their accounts were assessed interest rates of less than 20 percent, with over 40 percent having rates below 15 percent. The issuers also reported that 35 percent of their active U.S. accounts were assessed late fees and 13 percent were assessed over-limit fees in 2005.

Although issuers must disclose information intended to help consumers compare card costs, disclosures by the largest issuers have various weaknesses that reduced consumers' ability to use and understand them. According to a usability expert's review, disclosures from the largest credit card issuers were often written well above the eighth-grade level at which about half of U.S. adults read. Contrary to usability and readability best practices, the disclosures buried important information in text, failed to group and label related material, and used small typefaces. Perhaps as a result, cardholders that the expert tested often had difficulty using the disclosures to find and understand key rates or terms applicable to the cards. Similarly, GAO's interviews with 112 cardholders indicated that many failed to understand key aspects of their cards, including when they would be charged for late payments or what actions could cause issuers to raise rates. These weaknesses may arise from issuers drafting disclosures to avoid lawsuits, and from federal regulations that highlight less relevant information and are not well suited for presenting the complex rates or terms that cards currently feature. Although the Federal Reserve has started to obtain consumer input, its staff recognizes the challenge of designing disclosures that include all key information in a clear manner.

Although penalty charges reduce the funds available to repay cardholders' debts, their role in contributing to bankruptcies was not clear. The six largest issuers reported that unpaid interest and fees represented about 10 percent of the balances owed by bankrupt cardholders, but were unable to provide data on penalty charges these cardholders paid prior to filing for bankruptcy. Although revenues from penalty interest and fees have increased, profits of the largest issuers have been stable in recent years. GAO analysis indicates that while the majority of issuer revenues came from interest charges, the portion attributable to penalty rates has grown.

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Abbreviations

APR	Annual Percentage Rate
FDIC	Federal Deposit Insurance Corporation
OCC	Office of the Comptroller of the Currency
ROA	Return on assets
SEC	Securities and Exchange Commission
TILA	Truth in Lending Act

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United States Government Accountability Office
Washington, D.C. 20548

September 12, 2006

The Honorable Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate

Dear Senator Levin:

Over the past 25 years, the prevalence and use of credit cards in the United States has grown dramatically. Between 1980 and 2005, the amount that U.S. consumers charged to their cards grew from an estimated $69 billion per year to more than $1.8 trillion, according to one firm that analyzes the card industry.[1] This firm also reports that the number of U.S. credit cards issued to consumers now exceeds 691 million. The increased use of credit cards has contributed to an expansion in household debt, which grew from $59 billion in 1980 to roughly $830 billion by the end of 2005.[2] The Board of Governors of the Federal Reserve System (Federal Reserve) estimates that in 2004, the average American household owed about $2,200 in credit card debt, up from about $1,000 in 1992.[3]

Generally, a consumer's cost of using a credit card is determined by the terms and conditions applicable to the card—such as the interest rate(s), minimum payment amounts, and payment schedules, which are typically presented in a written cardmember agreement—and how a consumer uses

[1]CardWeb.com, Inc., an online publisher of information about the payment card industry.

[2]Based on data from the Federal Reserve Board's monthly G.19 release on consumer credit. In addition to credit card debt, the Federal Reserve also categorizes overdraft lines of credit as revolving consumer debt (an overdraft line of credit is a loan a consumer obtains from a bank to cover the amount of potential overdrafts or withdrawals from a checking account in amounts greater than the balance available in the account). Mortgage debt is not captured in these data.

[3]B.K. Bucks, A.B. Kennickell, and K.B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, March 22, 2006. Also, A.B. Kennickell and M. Starr-McCluer, "Changes in Family Finances from 1989 to 1992: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, October 1994. Adjusted for inflation, credit card debt in 1992 was $1,298 for the average American household.

a card.[4] The Federal Reserve, under the Truth in Lending Act (TILA), is responsible for creating and enforcing requirements relating to the disclosure of terms and conditions of consumer credit, including those applicable to credit cards.[5] The regulation that implements TILA's requirements is the Federal Reserve's Regulation Z.[6] As credit card use and debt have grown, representatives of consumer groups and issuers have questioned the extent to which consumers understand their credit card terms and conditions, including issuers' practices that—even if permitted under applicable terms and conditions—could increase consumers' costs of using credit cards. These practices include the application of fees or relatively high penalty interest rates if cardholders pay late or exceed credit limits. Issuers also can allocate customers' payments among different components of their outstanding balances in ways that maximize total interest charges. Although card issuers have argued that these practices are appropriate because they compensate for the greater risks posed by cardholders who make late payments or exhibit other risky behaviors, consumer groups say that the fees and practices are harmful to the financial condition of many cardholders and that card issuers use them to generate profits.

You requested that we review a number of issues related to credit card fees and practices, specifically of the largest issuers of credit cards in the United States. This report discusses (1) how the interest, fees, and other practices that affect the pricing structure of cards from the largest U.S. issuers have evolved and cardholders' experiences under these pricing structures in recent years; (2) how effectively the issuers disclose the pricing structures of cards to their cardholders (3) whether credit card debt and penalty interest and fees contribute to cardholder bankruptcies; and (4) the extent to which penalty interest and fees contribute to the revenues and profitability of issuers' credit card operations.

To identify the pricing structures of cards—including their interest rates, fees, and other practices—we analyzed the cardmember agreements, as

[4]We recently reported on minimum payment disclosure requirements. See GAO, *Credit Cards: Customized Minimum Payment Disclosures Would Provide More Information to Consumers, but Impact Could Vary*, GAO-06-434 (Washington, D.C.: Apr. 21, 2006).

[5]Pub. L. No. 90-321, Title I, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-1666).

[6]Regulation Z is codified at 12 C.F.R. Part 226.

well as materials used by the six largest issuers as of December 31, 2004, for 28 popular cards used to solicit new credit card customers from 2003 through 2005.[7] To determine the extent to which these issuers' cardholders were assessed interest and fees, we obtained data from each of the six largest issuers about their cardholder accounts and their operations. To protect each issuer's proprietary information, a third-party organization, engaged by counsel to the issuers, aggregated these data and then provided the results to us. Although the six largest issuers whose accounts were included in this survey and whose cards we reviewed may include some subprime accounts, we did not include information in this report relating to cards offered by credit card issuers that engage primarily in subprime lending.[8] To assess the effectiveness of the disclosures that issuers provide to cardholders in terms of their usability or readability, we contracted with a consulting firm that specializes in assessing the readability and usability of written and other materials to analyze a representative selection of the largest issuers' cardmember agreements and solicitation materials, including direct mail applications and letters, used for opening an account (in total, the solicitation materials for four cards and cardmember agreements for the same four cards).[9] The consulting firm compared these materials to recognized industry guidelines for readability and presentation and conducted testing to assess how well cardholders could use the materials to identify and understand information about these credit cards. While the materials used for the readability and usability assessments appeared to be typical of the large issuers' disclosures, the results cannot be generalized to materials that were not reviewed. We also conducted structured interviews to learn about the card-using behavior and knowledge of various credit card terms and conditions of 112 consumers recruited by a market research organization to represent a range of adult income and education levels. However, our sample of cardholders was too

[7]These issuers' accounts constitute almost 80 percent of credit card lending in the United States. Participating issuers were Citibank (South Dakota), N.A.; Chase Bank USA, N.A.; Bank of America; MBNA America Bank, N.A.; Capital One Bank; and Discover Financial Services. In providing us with materials for the most popular credit cards, these issuers determined which of their cards qualified as popular among all cards in their portfolios.

[8]Subprime lending generally refers to extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Such issuers could have pricing structures and other terms significantly different from those of the popular cards offered by the top issuers.

[9]Regulation Z defines a "solicitation" as an offer (written or oral) by the card issuer to open a credit or charge card account that does not require the consumer to complete an application. 12 C.F.R. § 226.5a(a)(1).

small to be statistically representative of all cardholders, thus the results of our interviews cannot be generalized to the population of all U.S. cardholders. We also reviewed comment letters submitted to the Federal Reserve in response to its comprehensive review of Regulation Z's open-end credit rules, including rules pertaining to credit card disclosures.[10] To determine the extent to which credit card debt and penalty interest and fees contributed to cardholder bankruptcies, we analyzed studies, reports, and bank regulatory data relating to credit card debt and consumer bankruptcies, as well as information reported to us as part of the data request to the six largest issuers. To determine the extent to which penalty interest and fees contributes to card issuers' revenues and profitability, we analyzed publicly available sources of revenue and profitability data for card issuers, including information included in reports filed with the Securities and Exchange Commission and bank regulatory reports, in addition to information reported to us as part of the data request to the six largest issuers.[11] In addition, we spoke with representatives of other U.S. banks that are large credit card issuers, as well as representatives of consumer groups, industry associations, academics, organizations that collect and analyze information on the credit card industry, and federal banking regulators. We also reviewed research reports and academic studies of the credit card industry.

We conducted our work from June 2005 to September 2006 in Boston; Chicago; Charlotte, North Carolina; New York City; San Francisco; Wilmington, Delaware; and Washington, D.C., in accordance with generally accepted government auditing standards. Appendix I describes the objectives, scope, and methodology of our review in more detail.

Results in Brief

Since about 1990, the pricing structures of credit cards have evolved to encompass a greater variety of interest rates and fees that can increase

[10]See Truth in Lending, 69 Fed. Reg. 70925 (advanced notice of proposed rulemaking, published Dec. 8, 2004). "Open-end credit" means consumer credit extended by a creditor under a plan in which: (i) the creditor reasonably contemplates repeated transactions, (ii) the creditor may impose a finance charge from time to time on an outstanding unpaid balance and (iii) the amount of credit that may be extended to the consumer is generally made available to the extent that any outstanding balance is repaid. 12 C.F.R. § 226.2(a)(20).

[11]Although we had previously been provided comprehensive data from Visa International on credit industry revenues and profits for a past report on credit card issues, we were unable to obtain these data for this report.

cardholder's costs; however, cardholders generally are assessed lower interest rates than those that prevailed in the past, and most have not been assessed penalty fees. For many years after being introduced, credit cards generally charged fixed single rates of interest of around 20 percent, had few fees, and were offered only to consumers with high credit standing. After 1990, card issuers began to introduce cards with a greater variety of interest rates and fees, and the amounts that cardholders can be charged have been growing. For example, our analysis of 28 popular cards and other information indicates that cardholders could be charged

- up to three different interest rates for different transactions, such as one rate for purchases and another for cash advances, with rates for purchases that ranged from about 8 percent to about 19 percent;
- penalty fees for certain cardholder actions, such as making a late payment (an average of almost $34 in 2005, up from an average of about $13 in 1995) or exceeding a credit limit (an average of about $31 in 2005, up from about $13 in 1995); and
- a higher interest rate—some charging over 30 percent—as a penalty for exhibiting riskier behavior, such as paying late.

Although consumer groups and others have criticized these fees and other practices, issuers point out that the costs to use a card can now vary according to the risk posed by the cardholder, which allows issuers to offer credit with lower costs to less-risky cardholders and credit to consumers with lower credit standing, who likely would have not have received a credit card in the past. Although cardholder costs can vary significantly in this new environment, many cardholders now appear to have cards with interest rates less than the 20 percent rate that most cards charged prior to 1990. Data reported by the top six issuers indicate that, in 2005, about 80 percent of their active U.S. accounts were assessed interest rates of less than 20 percent—with more than 40 percent having rates of 15 percent or less.[12] Furthermore, almost half of the active accounts paid little or no interest because the cardholder generally paid the balance in full. The issuers also reported that, in 2005, 35 percent of their active U.S. accounts were assessed late fees and 13 percent were assessed over-limit fees.

[12]For purposes of this report, active accounts refer to accounts of the top six issuers that had had a debit or credit posted to them by December 31 in 2003, 2004, and 2005.

Although credit card issuers are required to provide cardholders with information aimed at facilitating informed use of credit and enhancing consumers' ability to compare the costs and terms of credit, we found that these disclosures have serious weaknesses that likely reduced consumers' ability to understand the costs of using credit cards. Because the pricing of credit cards, including interest rates and fees, is not generally subject to federal regulation, the disclosures required under TILA and Regulation Z are the primary means under federal law for protecting consumers against inaccurate and unfair credit card practices.[13] However, the assessment by our usability consultant found that the disclosures in the customer solicitation materials and cardmember agreements provided by four of the largest credit card issuers were too complicated for many consumers to understand. For example, although about half of adults in the United States read at or below the eighth-grade level, most of the credit card materials were written at a tenth- to twelfth-grade level. In addition, the required disclosures often were poorly organized, burying important information in text or scattering information about a single topic in numerous places. The design of the disclosures often made them hard to read, with large amounts of text in small, condensed typefaces and poor, ineffective headings to distinguish important topics from the surrounding text. Perhaps as a result of these weaknesses, the cardholders tested by the consultant often had difficulty using these disclosures to locate and understand key rates or terms applicable to the cards. Similarly, our interviews with 112 cardholders indicated that many failed to understand key terms or conditions that could affect their costs, including when they would be charged for late payments or what actions could cause issuers to raise rates. The disclosure materials that consumers found so difficult to use resulted from issuers' attempts to reduce regulatory and liability exposure by adhering to the formats and language prescribed by federal law and regulations, which no longer suit the complex features and terms of many cards. For example, current disclosures require that less important terms, such as minimum finance charge or balance computation method, be prominently disclosed, whereas information that could more significantly affect consumers' costs, such as the actions that could raise their interest rate, are not as prominently disclosed. With the goal of improving credit card disclosures, the Federal Reserve has begun obtaining public and industry input as part of a comprehensive review of Regulation Z. Industry participants and others have provided various suggestions to improve

[13]TILA also contains procedural and substantive protections for consumers for credit card transactions.

disclosures, such as placing all key terms in one brief document and other details in a much longer separate document, and both our work and that of others illustrated that involving consultants and consumers can help develop disclosure materials that are more likely to be effective. Federal Reserve staff told us that they have begun to involve consumers in the preparation of potentially new and revised disclosures. Nonetheless, Federal Reserve staff recognize the challenge of presenting the variety of information that consumers may need to understand the costs of their cards in a clear way, given the complexity of credit card products and the different ways in which consumers use credit cards.

Although paying penalty interest and fees can slow cardholders' attempts to reduce their debt, the extent to which credit card penalty fees and interest have contributed to consumer bankruptcies is unclear. The number of consumers filing for bankruptcy has risen more than sixfold over the past 25 years—a period when the nation's population grew by 29 percent—to more than 2 million filings in 2005, but debate continues over the reasons for this increase. Some researchers attribute the rise in bankruptcies to the significant increase in household debt levels that also occurred over this period, including the dramatic increase in outstanding credit card debt. However, others have found that relatively steady household debt burden ratios over the last 15 years indicate that the ability of households to make payments on this expanded indebtedness has kept pace with growth in their incomes. Similarly, the percentage of households that appear to be in financial distress—those with debt payments that exceed 40 percent of their income—did not change much during this period, nor did the proportion of lower-income households with credit card balances. Because debt levels alone did not appear to clearly explain the rise in bankruptcies, some researchers instead cited other explanations, such as a general decline in the stigma associated with bankruptcies or the increased costs of major life events—such as health problems or divorce—to households that increasingly rely on two incomes. Although critics of the credit card industry have cited the emergence of penalty interest rates and growth in fees as leading to increased financial distress, no comprehensive data exist to determine the extent to which these charges contributed to consumer bankruptcies. Any penalty charges that cardholders pay would consume funds that could have been used to repay principal, and we obtained anecdotal information on a few court cases involving consumers who incurred sizable penalty charges that contributed to their financial distress. However, credit card issuers said that they have little incentive to cause their customers to go bankrupt. The six largest issuers reported to us that of their active accounts in 2005 pertaining to cardholders who had filed for

bankruptcy before their account became 6 months delinquent, about 10 percent of the outstanding balances on those accounts represented unpaid interest and fees. However, issuers told us that their data system and recordkeeping limitations prevented them from providing us with data that would more completely illustrate a relationship between penalty charges and bankruptcies, such as the amount of penalty charges that bankrupt cardholders paid in the months prior to filing for bankruptcy or the amount of penalty charges owed by cardholders who went bankrupt after their accounts became more than 6 months delinquent.

Although penalty interest and fees have likely increased as a portion of issuer revenues, the largest issuers have not experienced greatly increased profitability over the last 20 years. Determining the extent to which penalty interest charges and fees contribute to issuers' revenues and profits was difficult because issuers' regulatory filings and other public sources do not include such detail. Using data from bank regulators, industry analysts, and information reported by the five largest issuers, we estimate that the majority—about 70 percent in recent years—of issuer revenues came from interest charges, and the portion attributable to penalty rates appears to have been growing. The remaining issuer revenues came from penalty fees—which had generally grown and were estimated to represent around 10 percent of total issuer revenues—as well as fees that issuers receive for processing merchants' card transactions and other sources. The profits of the largest credit-card-issuing banks, which are generally the most profitable group of lenders, have generally been stable over the last 7 years.

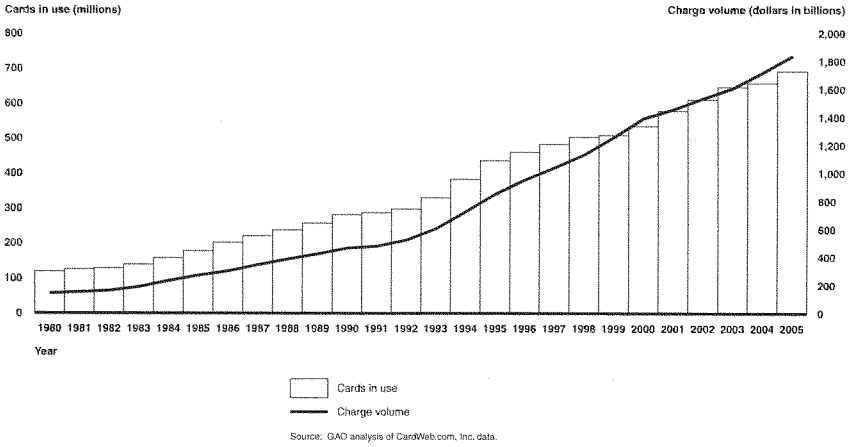
This report recommends that, as part of its effort to increase the effectiveness of disclosure materials, the Federal Reserve should ensure that such disclosures, including model forms and formatting requirements, more clearly emphasize those terms that can significantly affect cardholder costs, such as the actions that can cause default or other penalty pricing rates to be imposed. We provided a draft of this report to the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Trade Commission, the National Credit Union Administration, and the Office of Thrift Supervision for comment. In its written comments, the Federal Reserve agreed that current credit card pricing structures have added to the complexity of card disclosures and indicated that it is studying alternatives for improving both the content and format of disclosures, including involving consumer testing and design consultants.

Background

Credit card use has grown dramatically since the introduction of cards more than 5 decades ago. Cards were first introduced in 1950, when Diners Club established the first general-purpose charge card that allowed its cardholders to purchase goods and services from many different merchants. In the late 1950s, Bank of America began offering the first widely available general purpose credit card, which, unlike a charge card that requires the balance to be paid in full each month, allows a cardholder to make purchases up to a credit limit and pay the balance off over time. To increase the number of consumers carrying the card and to reach retailers outside of Bank of America's area of operation, other banks were given the opportunity to license Bank of America's credit card. As the network of banks issuing these credit cards expanded internationally, administrative operations were spun off into a separate entity that evolved into the Visa network. In contrast to credit cards, debit cards result in funds being withdrawn almost immediately from consumers' bank accounts (as if they had a written a check instead). According to CardWeb.com, Inc., a firm that collects and analyzes data relating to the credit card industry, the number of times per month that credit or debit cards were used for purchases or other transactions exceeded 2.3 billion in May 2003, the last month for which the firm reported this data.

The number of credit cards in circulation and the extent to which they are used has also grown dramatically. The range of goods and services that can be purchased with credit cards has expanded, with cards now being used to pay for groceries, health care, and federal and state income taxes. As shown in figure 1, in 2005, consumers held more than 691 million credit cards and the total value of transactions for which these cards were used exceeded $1.8 trillion.

Figure 1: Credit Cards in Use and Charge Volume, 1980-2005



Source: GAO analysis of CardWeb.com, Inc. data.

The largest issuers of credit cards in the United States are commercial banks, including many of the largest banks in the country. More than 6,000 depository institutions issue credit cards, but, over the past decade, the majority of accounts have become increasingly concentrated among a small number of large issuers. Figure 2 shows the largest bank issuers of credit cards by their total credit card balances outstanding as of December 31, 2004 (the most recent data available) and the proportion they represent of the overall total of card balances outstanding.

Figure 2: The 10 Largest Credit Card Issuers by Credit Card Balances Outstanding as of December 31, 2004

Card issuer	Outstanding receivables	Percent of total market
Citigroup Inc.	$139,600,000,000	20.2
Chase Card Services	135,370,000,000	19.5
MBNA America	101,900,000,000	14.7
Bank of America	58,629,000,000	8.5
Capital One Financial Corp.	48,609,571,000	7.0
Discover Financial Services, Inc.	48,261,000,000	7.0
American Express Centurion Bank	39,600,000,000	5.7
HSBC Credit Card Services	19,670,000,000	2.8
Providian Financial Corp.	18,100,000,000	2.6
Wells Fargo	13,479,889,059	1.9
	$623,219,460,059	**90.0**

Source: GAO analysis of Card Industry Directory data.

TILA is the primary federal law pertaining to the extension of consumer credit. Congress passed TILA in 1968 to provide for meaningful disclosure of credit terms in order to enable consumers to more easily compare the various credit terms available in the marketplace, to avoid the uninformed use of credit, and to protect themselves against inaccurate and unfair credit billing and credit card practices. The regulation that implements TILA's requirements is Regulation Z, which is administered by the Federal Reserve.

Under Regulation Z, card issuers are required to disclose the terms and conditions to potential and existing cardholders at various times. When first marketing a card directly to prospective cardholders, written or oral applications or solicitations to open credit card accounts must generally disclose key information relevant to the costs of using the card, including the applicable interest rate that will be assessed on any outstanding balances and several key fees or other charges that may apply, such as the

fee for making a late payment.[14] In addition, issuers must provide consumers with an initial disclosure statement, which is usually a component of the issuer's cardmember agreement, before the first transaction is made with a card. The cardmember agreement provides more comprehensive information about a card's terms and conditions than would be provided as part of the application or a solicitation letter.

In some cases, the laws of individual states also can affect card issuers' operations. For example, although many credit card agreements permit issuers to make unilateral changes to the agreement's terms and conditions, some state laws require that consumers be given the right to opt out of changes. However, as a result of the National Bank Act, and its interpretation by the U.S. Supreme Court, the interest and fees charged by a national bank on credit card accounts is subject only to the laws of the state in which the bank is chartered, even if its lending activities occur outside of its charter state.[15] As a result, the largest banks have located their credit card operations in states with laws seen as more favorable for the issuer with respect to credit card lending.

Various federal agencies oversee credit card issuers. The Federal Reserve has responsibility for overseeing issuers that are chartered as state banks and are also members of the Federal Reserve System. Many card issuers are chartered as national banks, which OCC supervises. Other regulators of bank issuers are FDIC, which oversees state-chartered banks with federally insured deposits that are not members of the Federal Reserve System; the Office of Thrift Supervision, which oversees federally chartered and state-chartered savings associations with federally insured deposits; or the

[14]Issuers have several disclosure options with respect to applications or solicitations made available to the general public, including those contained in catalogs or magazines. Specifically, on such applications or solicitations issuers may, but are not required to, disclose the same key pricing terms required to be disclosed on direct mail applications and solicitations. Alternatively, issuers may include in a prominent location on the application or solicitation a statement that costs are associated with use of the card and a toll-free telephone number and mailing address where the consumer may contact the issuer to request specific information. 12 C.F.R. § 226.5a(e)(3).

[15]The National Bank Act provision codified at 12 U.S.C. § 85 permits national banks to charge interest at a rate allowed by laws of the jurisdiction in which the bank is located. In *Marquette National Bank v. First of Omaha Service Corp. et al.*, 439 U.S. 299 (1978), the U.S. Supreme Court held that a national bank is deemed to be "located" in the state in which it is chartered. *See also Smiley v. Citibank (South Dakota)*, N.A., 517 U.S. 735 (1996) (holding that "interest" under 12 U.S.C. § 85 includes any charges attendant to credit card usage).

National Credit Union Administration, which oversees federally-chartered and state-chartered credit unions whose member accounts are federally insured. As part of their oversight, these regulators review card issuers' compliance with TILA and ensure that an institution's credit card operations do not pose a threat to the institutions' safety and soundness. The Federal Trade Commission generally has responsibility for enforcing TILA and other consumer protection laws for credit card issuers that are not depository institutions.

Credit Card Fees and Issuer Practices That Can Increase Cardholder Costs Have Expanded, but a Minority of Cardholders Appear to Be Affected

Prior to about 1990, card issuers offered credit cards that featured an annual fee, a relatively high, fixed interest rate, and low penalty fees, compared with average rates and fees assessed in 2005. Over the past 15 years, typical credit cards offered by the largest U.S. issuers evolved to feature more complex pricing structures, including multiple interest rates that vary with market fluctuations. The largest issuers also increased the number, and in some cases substantially increased the amounts, of fees assessed on cardholders for violations of the terms of their credit agreement, such as making a late payment. Issuers said that these changes have benefited a greater number of cardholders, whereas critics contended that some practices unfairly increased cardholder costs. The largest six issuers provided data indicating that most of their cardholders had interest rates on their cards that were lower than the single fixed rates that prevailed on cards prior to the 1990s and that a small proportion of cardholders paid high penalty interest rates in 2005. In addition, although most cardholders did not appear to be paying penalty fees, about one-third of the accounts with these largest issuers paid at least one late fee in 2005.

Issuers Have Developed More Complex Credit Card Pricing Structures

The interest rates, fees, and other practices that represent the pricing structure for credit cards have become more complex since the early 1990s. After first being introduced in the 1950s, for the next several decades, credit cards commonly charged a single fixed interest rate around 20 percent—as the annual percentage rate (APR)—which covered most of an issuer's expenses associated with card use.[16] Issuers also charged cardholders an annual fee, which was typically between $20 and $50

[16]Unless otherwise noted, in this report we will use the term "interest rate" to describe annual percentage rates, which represent the rates expressed on an annual basis even though interest may be assessed more frequently.

beginning in about 1980, according to a senior economist at the Federal Reserve Board. Card issuers generally offered these credit cards only to the most creditworthy U.S. consumers. According to a study of credit card pricing done by a member of the staff of one of the Federal Reserve Banks, few issuers in the late 1980s and early 1990s charged cardholders fees as penalties if they made late payments or exceeded the credit limit set by the issuer.[17] Furthermore, these fees, when they were assessed, were relatively small. For example, the Federal Reserve Bank staff member's paper notes that the typical late fee charged on cards in the 1980s ranged from $5 to $10.

Multiple Interest Rates May Apply to a Single Account and May Change Based on Market Fluctuations

After generally charging just a single fixed interest rate before 1990, the largest issuers now apply multiple interest rates to a single card account balance and the level of these rates can vary depending on the type of transaction in which a cardholder engages. To identify recent pricing trends for credit cards, we analyzed the disclosures made to prospective and existing cardholders for 28 popular credit cards offered during 2003, 2004, and 2005 by the six largest issuers (based on credit card balances outstanding at the end of 2004).[18] At that time, these issuers held almost 80 percent of consumer debt owed to credit card issuers and as much as 61 percent of total U.S. credit card accounts. As a result, our analysis of these 28 cards likely describes the card pricing structure and terms that apply to the majority of U.S. cardholders. However, our sample of cards did not include subprime cards, which typically have higher cost structures to compensate for the higher risks posed by subprime borrowers.

We found that all but one of these popular cards assessed up to three different interest rates on a cardholder's balance. For example, cards assessed separate rates on

- balances that resulted from the purchase or lease of goods and services, such as food, clothing, and home appliances;

[17]M. Furletti, "Credit Card Pricing Developments and Their Disclosure," Federal Reserve Bank of Philadelphia's Payment Cards Center, January 2003. In preparing this paper, the author relied on public data, proprietary issuer data, and data from a review of more than 150 cardmember agreements from 15 of the largest issuers in the United States for the 5-year period spanning 1997 to 2002.

[18]See *Card Industry Directory: The Blue Book of the Credit and Debit Card Industry in North America*, 17th Edition, (Chicago, IL: 2005). These issuers were Bank of America, Capital One Bank; Chase Bank USA; Citibank (South Dakota), N.A.; Discover Financial Services; and MBNA America Bank.

- balances that were transferred from another credit card, which cardholders may do to consolidate balances across cards to take advantage of lower interest rates; and

- balances that resulted from using the card to obtain cash, such as a withdrawal from a bank automated teller machine.

In addition to having separate rates for different transactions, popular credit cards increasingly have interest rates that vary periodically as market interest rates change. Almost all of the cards we analyzed charged variable rates, with the number of cards assessing these rates having increased over the most recent 3-year period. More specifically, about 84 percent of cards we reviewed (16 of 19 cards) assessed a variable interest rate in 2003, 91 percent (21 of 23 cards) in 2004, and 93 percent (25 of 27 cards) in 2005.[19] Issuers typically determine these variable rates by taking the prevailing level of a base rate, such as the prime rate, and adding a fixed percentage amount.[20] In addition, the issuers usually reset the interest rates on a monthly basis.

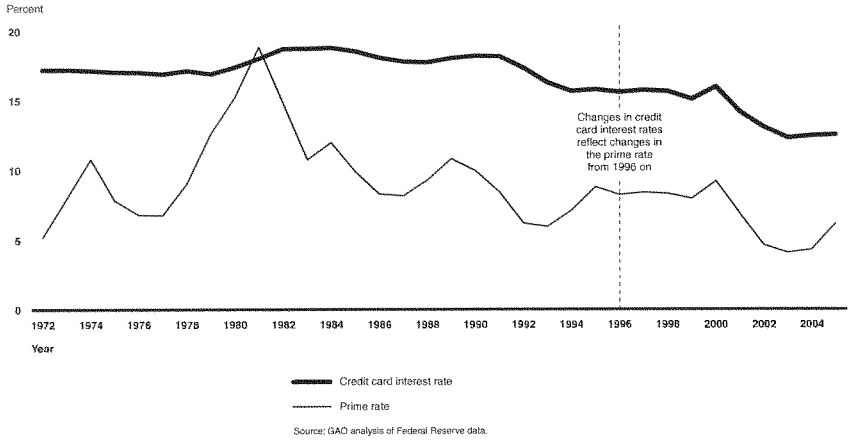
Issuers appear to have assessed lower interest rates in recent years than they did prior to about 1990. Issuer representatives noted that issuers used to generally offer cards with a single rate of around 20 percent to their cardholders, and the average credit card rates reported by the Federal Reserve were generally around 18 percent between 1972 and 1990. According to the survey of credit card plans, conducted every 6 months by the Federal Reserve, more than 100 card issuers indicated that these issuers charged interest rates between 12 and 15 percent on average from 2001 to 2005. For the 28 popular cards we reviewed, the average interest rate that would be assessed for purchases was 12.3 percent in 2005, almost 6 percentage points lower than the average rates that prevailed until about 1990. We found that the range of rates charged on these cards was between about 8 and 19 percent in 2005. The average rate on these cards climbed slightly during this period, having averaged about 11.5 percent in 2003 and about 12 percent in 2004, largely reflecting the general upward movement

[19]Although we reviewed a total of 28 card products for 2003 to 2005, we did not obtain disclosure documents for all card products for every year.

[20]The prime rate is the rate that commercial banks charge to the most creditworthy borrowers, such as large corporations for short-term loans. The prime rate reported by *The Wall Street Journal* is often used as a benchmark for credit card loans made in the United States.

in prime rates. Figure 3 shows the general decline in credit card interest rates, as reported by the Federal Reserve, between about 1991 and 2005 compared with the prime rate over this time. As these data show, credit card interest rates generally were stable regardless of the level of market interest rates until around 1996, at which time changes in credit card rates approximated changes in market interest rates. In addition, the spread between the prime rate and credit card rates was generally wider in the period before the 1980s than it has been since 1990, which indicates that since then cardholders are paying lower rates in terms of other market rates.

Figure 3: Credit Card Interest Rates, 1972-2005



Source: GAO analysis of Federal Reserve data.

Recently, many issuers have attempted to obtain new customers by offering low, even zero, introductory interest rates for limited periods. According to an issuer representative and industry analyst we interviewed, low introductory interest rates have been necessary to attract cardholders in the current competitive environment where most consumers who qualify

for a credit card already have at least one. Of the 28 popular cards that we analyzed, 7 cards (37 percent) offered prospective cardholders a low introductory rate in 2003, but 20 (74 percent) did so in 2005—with most rates set at zero for about 8 months. According to an analyst who studies the credit card industry for large investors, approximately 25 percent of all purchases are made with cards offering a zero percent interest rate.

Increased competition among issuers, which can be attributed to several factors, likely caused the reductions in credit card interest rates. In the early 1990s, new banks whose operations were solely focused on credit cards entered the market, according to issuer representatives. Known as monoline banks, issuer representatives told us these institutions competed for cardholders by offering lower interest rates and rewards, and expanded the availability of credit to a much larger segment of the population. Also, in 1988, new requirements were implemented for credit card disclosures that were intended to help consumers better compare pricing information on credit cards. These new requirements mandated that card issuers use a tabular format to provide information to consumers about interest rates and some fees on solicitations and applications mailed to consumers. According to issuers, consumer groups, and others, this format, which is popularly known as the Schumer box, has helped to significantly increase consumer awareness of credit card costs.[21] According to a study authored by a staff member of a Federal Reserve Bank, consumer awareness of credit card interest rates has prompted more cardholders to transfer card balances from one issuer to another, further increasing competition among issuers.[22] However, another study prepared by the Federal Reserve Board also attributes declines in credit card interest rates to a sharp drop in issuers' cost of funds, which is the price issuers pay other lenders to obtain the funds that are then lent to cardholders.[23] (We discuss issuers' cost of funds later in this report.)

[21]The Schumer box is the result of the Fair Credit and Charge Card Disclosure Act, Pub. L. No. 100-583, 102 Stat. 2960 (1988), which amended TILA to provide for more detailed and uniform disclosures of rates and other cost information in applications and solicitations to open credit and charge card accounts. The act also required issuers to disclose pricing information, to the extent practicable as determined by the Federal Reserve, in a tabular format. This table is also known as the Schumer box, named for the Congressman that introduced the provision requiring this disclosure into the legislation.

[22]Furletti, "Credit Card Pricing Developments and Their Disclosure."

[23]Board of Governors of the Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions*, (Washington, D.C.: June 2005).

Our analysis of disclosures also found that the rates applicable to balance transfers were generally the same as those assessed for purchases, but the rates for cash advances were often higher. Of the popular cards offered by the largest issuers, nearly all featured rates for balance transfers that were substantially similar to their purchase rates, with many also offering low introductory rates on balance transfers for about 8 months. However, the rates these cards assessed for obtaining a cash advance were around 20 percent on average. Similarly to rates for purchases, the rates for cash advances on most cards were also variable rates that would change periodically with market interest rates.

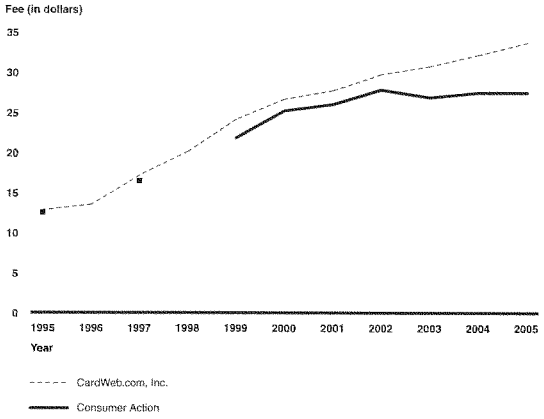
Credit Cards Increasingly Have Assessed Higher Penalty Fees

Although featuring lower interest rates than in earlier decades, 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. One penalty fee, commonly included as part of credit card terms, is the late fee, which issuers assess when they do not receive at least the minimum required payment by the due date indicated in a cardholder's monthly billing statement. As noted earlier, prior to 1990, the level of late fees on cards generally ranged from $5 to $10. However, late fees have risen significantly. According to data reported by CardWeb.com, Inc., credit card late fees rose from an average of $12.83 in 1995 to $33.64 in 2005, an increase of over 160 percent. Adjusted for inflation, these fees increased about 115 percent on average, from $15.61 in 1995 to $33.64 in 2005.[24] Similarly, Consumer Action, a consumer interest group that conducts an annual survey of credit card costs, found late fees rose from an average of $12.53 in 1995 to $27.46 in 2005, a 119 percent increase (or 80 percent after adjusting for inflation).[25] Figure 4 shows trends in average late fee assessments reported by these two groups.

[24]Dollar values adjusted using the Gross Domestic Product (GDP) deflator, with 2005 as the base year.

[25]Consumer Action analyzed more than 100 card products offered by more than 40 issuers in each year they conducted the survey, except in 1995, when 71 card products were included.

Figure 4: Average Annual Late Fees Reported from Issuer Surveys, 1995-2005 (unadjusted for inflation)



Source: GAO analysis of Consumer Action Credit Card Survey, CardWeb.com, Inc.

Notes: Consumer Action data did not report values for 1996 and 1998.

CardWeb.com, Inc. data are for financial institutions with more than $100 million in outstanding receivables.

In addition to increased fees a cardholder may be charged per occurrence, many cards created tiered pricing that depends on the balance held by the cardholder.[26] Between 2003 and 2005, all but 4 of the 28 popular cards that we analyzed used a tiered fee structure. Generally, these cards included three tiers, with the following range of fees for each tier:

- $15 to $19 on accounts with balances of $100 or $250;
- $25 to $29 on accounts with balances up to about $1,000; and

[26]Based on our analysis of the Consumer Action survey data, issuers likely began introducing tiered late fees in 2002.

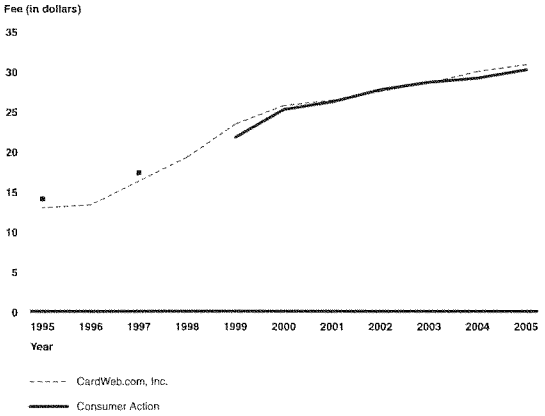
- $34 to $39 on accounts with balances of about $1,000 or more.

Tiered pricing can prevent issuers from assessing high fees to cardholders with comparatively small balances. However, data from the Federal Reserve's Survey of Consumer Finances, which is conducted every 3 years, show that the median total household outstanding balance on U.S. credit cards was about $2,200 in 2004 among those that carried balances. When we calculated the late fees that would be assessed on holders of the 28 cards if they had the entire median balance on one card, the average late fee increased from $34 in 2003 to $37 in 2005, with 18 of the cards assessing the highest fee of $39 in 2005.

Issuers also assess cardholders a penalty fee for exceeding the credit limit set by the issuer. In general, issuers assess over-limit fees when a cardholder exceeds the credit limit set by the card issuer. Similar to late fees, over-limit fees also have been rising and increasingly involve a tiered structure. According to data reported by CardWeb.com, Inc., the average over-limit fees that issuers assessed increased 138 percent from $12.95 in 1995 to $30.81 in 2005. Adjusted for inflation, average over-limit fees reported by CardWeb.com increased from $15.77 in 1995 to $30.81 in 2005, representing about a 95 percent increase.[27] Similarly, Consumer Action found a 114 percent increase in this period (or 76 percent, after adjusting for inflation). Figure 5 illustrates the trend in average over-limit fees over the past 10 years from these two surveys.

[27]Dollar values adjusted using the Gross Domestic Product (GDP) deflator, with 2005 as the base year.

Figure 5: Average Annual Over-limit fees Reported from Issuer Surveys, 1995-2005 (unadjusted for inflation)



Source: GAO analysis of Consumer Action Credit Card Survey, CardWeb.com, Inc.

Notes: Consumer Action did not report values for 1996 and 1998.

CardWeb.com, Inc. data are for financial institutions with more than $100 million in outstanding receivables.

The cards we analyzed also increasingly featured tiered structures for over-limit fees, with 29 percent (5 of 17 cards) having such structures in 2003, and 53 percent (10 of 19 cards) in 2005. Most cards that featured tiered over-limit fees assessed the highest fee on accounts with balances greater than $1,000. But not all over-limit tiers were based on the amount of the cardholder's outstanding balance. Some cards based the amount of the over-limit fee on other indicators, such as the amount of the cardholder's credit limit or card type. For the six largest issuers' popular cards with over-limit fees, the average fee that would be assessed on accounts that carried the median U.S. household credit card balance of $2,200 rose from $32 in 2003 to $34 in 2005. Among cards that assessed over-limit fees in 2005, most charged an amount between $35 and $39.

Not all of the 28 popular large-issuer cards included over-limit fees and the prevalence of such fees may be declining. In 2003, 85 percent, or 17 of 20 cards, had such fees, but only 73 percent, or 19 of 26 cards, did in 2005. According to issuer representatives, they are increasingly emphasizing competitive strategies that seek to increase the amount of spending that their existing cardholders do on their cards as a way to generate revenue. This could explain a movement away from assessing over-limit fees, which likely discourage cardholders who are near their credit limit from spending.

Cards also varied in when an over-limit fee would be assessed. For example, our analysis of the 28 popular large-issuer cards showed that, of the 22 cards that assessed over-limit fees, about two-thirds (14 of 22) would assess an over-limit fee if the cardholder's balance exceeded the credit limit within a billing cycle, whereas the other cards (8 of 22) would assess the fee only if a cardholder's balance exceeded the limit at the end of the billing cycle. In addition, within the overall limit, some of the cards had separate credit limits on the card for how much a cardholder could obtain in cash or transfer from other cards or creditors, before similarly triggering an over-limit fee.

Finally, issuers typically assess fees on cardholders for submitting a payment that is not honored by the issuer or the cardholder's paying bank. Returned payments can occur when cardholders submit a personal check that is written for an amount greater than the amount in their checking account or submit payments that cannot be processed. In our analysis of 28 popular cards offered by the six largest issuers, we found the average fee charged for such returned payments remained steady between 2003 and 2005 at about $30.

Cards Now Frequently Include a Range of Other Fees

Since 1990, issuers have appended more fees to credit cards. In addition to penalties for the cardholder actions discussed above, tbe 28 popular cards now often include fees for other types of transactions or for providing various services to cardholders. As shown in table 1, issuers assess fees for such services as providing cash advances or for making a payment by telephone. According to our analysis, not all of these fees were disclosed in the materials that issuers generally provide to prospective or existing cardholders. Instead, card issuers told us that they notified their customers of these fees by other means, such as telephone conversations.

Table 1: Various Fees for Services and Transactions, Charged in 2005 on Popular Large-Issuer Cards

Fee type	Assessed for:	Number of cards that assessed fee in 2005	Average or range of amounts generally assessed (if charged)
Cash advance	Obtaining cash or cash equivalent item using credit card or convenience checks	26 of 27	3% of cash advance amount or $5 minimum
Balance transfer	Transferring all or part of a balance from another creditor	15 of 27	3% of transfer amount or $5 to $10 minimum
Foreign transaction	Making purchases in a foreign country or currency	19 of 27	3% of transaction amount (in U.S. dollars)
Returned convenience check	Using a convenience check that the issuer declines to honor	20 of 27	$31
Stop payment	Requesting to stop payment on a convenience check written against the account	20 of 27	$26
Telephone payment	Arranging a single payment through a customer service agent	N/A[a]	$5-$15
Duplicate copy of account records	Obtaining a copy of a billing statement or other record	N/A[a]	$2-$13 per item
Rush delivery of credit card	Requesting that a card be sent by overnight delivery	N/A[a]	$10-$20

Source: GAO.

Note: Cash equivalent transactions include the purchase of items such as money orders, lottery tickets and casino chips. Convenience checks are personalized blank checks that issuers provide cardholders that can be written against the available credit limit of a credit card account.

[a]We were unable to determine the number of cards that assessed telephone payment, duplicate copy, or rush delivery fees in 2005 because these fees are not required by regulation to be disclosed with either mailed solicitation letters or initial disclosure statements. We obtained information about the level of these fees from a survey of the six largest U.S. issuers.

While issuers generally have been including more kinds of fees on credit cards, one category has decreased: most cards offered by the largest issuers do not require cardholders to pay an annual fee. An annual fee is a fixed fee that issuers charge cardholders each year they continue to own that card. Almost 75 percent of cards we reviewed charged no annual fee in 2005 (among those that did, the range was from $30 to $90). Also, an industry group representative told us that approximately 2 percent of cards featured annual fee requirements. Some types of cards we reviewed were more likely to apply an annual fee than others. For example, cards that offered airline tickets in exchange for points that accrue to a cardholder for using the card were likely to apply an annual fee. However, among the 28 popular cards that we reviewed, not all of the cards that offered rewards charged annual fees.

Recently, some issuers have introduced cards without certain penalty fees. For example, one of the top six issuers has introduced a card that does not charge a late fee, over-limit fee, cash-advance fee, returned payment fee, or an annual fee. Another top-six issuer's card does not charge the cardholder a late fee as long as one purchase is made during the billing cycle. However, the issuer of this card may impose higher interest rates, including above 30 percent, if the cardholder pays late or otherwise defaults on the terms of the card.

Issuers Have Introduced Various Practices that Can Significantly Affect Cardholder Costs

Popular credit cards offered by the six largest issuers involve various issuer practices that can significantly affect the costs of using a credit card for a cardholder. These included practices such as raising a card's interest rates in response to cardholder behaviors and how payments are allocated across balances.

Interest Rate Changes

One of the practices that can significantly increase the costs of using typical credit cards is penalty pricing. Under this practice, the interest rate applied to the balances on a card automatically can be increased in response to behavior of the cardholder that appears to indicate that the cardholder presents greater risk of loss to the issuer. For example, representatives for one large issuer told us they automatically increase a cardholder's interest rate if a cardholder makes a late payment or exceeds the credit limit. Card disclosure documents now typically include information about default rates, which represent the maximum penalty rate that issuers can assess in response to cardholders' violations of the terms of the card. According to an industry specialist at the Federal Reserve, issuers first began the practice of assessing default interest rates as a penalty for term violations in the late 1990s. As of 2005, all but one of the cards we reviewed included default rates. The default rates were generally much higher than rates that otherwise applied to purchases, cash advances, or balance transfers. For example, the average default rate across the 28 cards was 27.3 percent in 2005—up from the average of 23.8 percent in 2003—with as many as 7 cards charging rates over 30 percent. Like many of the other rates assessed on these cards in 2005, default rates generally were variable rates. Increases in average default rates between 2003 and 2005 resulted from increases both in the prime rate, which rose about 2 percentage points during this time, and the average fixed amount that issuers added. On average, the fixed amount that issuers added to the index rate in setting default rate levels increased from about 19 percent in 2003 to 22 percent in 2005.

Four of the six largest issuers typically included conditions in their disclosure documents that could allow the cardholder's interest rate to be reduced from a higher penalty rate. For example some issuers would lower a cardholders' rate for not paying late and otherwise abiding by the terms of the card for a period of 6 or 12 consecutive months after the default rate was imposed. However, at least one issuer indicated that higher penalty rates would be charged on existing balances even after six months of good behavior. This issuer assessed lower nonpenalty rates only on new purchases or other new balances, while continuing to assess higher penalty rates on the balance that existed when the cardholder was initially assessed a higher penalty rate. This practice may significantly increase costs to cardholders even after they've met the terms of their card agreement for at least six months.

The specific conditions under which the largest issuers could raise a cardholder's rate to the default level on the popular cards that we analyzed varied. The disclosures for 26 of the 27 cards that included default rates in 2005 stated that default rates could be assessed if the cardholders made late payments. However, some cards would apply such default rates only after multiple violations of card terms. For example, issuers of 9 of the cards automatically would increase a cardholder's rates in response to two late payments. Additionally, for 18 of the 28 cards, default rates could apply for exceeding the credit limit on the card, and 10 cards could also impose such rates for returned payments. Disclosure documents for 26 of the 27 cards that included default rates also indicated that in response to these violations of terms, the interest rate applicable to purchases could be increased to the default rate. In addition, such violations would also cause issuers to increase the rates applicable to cash advances on 16 of the cards, as well as increase rates applicable to balance transfers on 24 of the cards.

According to a paper by a Federal Reserve Bank researcher, some issuers began to increase cardholders' interest rates in the early 2000s for actions they took with other creditors.[28] According to this paper, these issuers would increase rates when cardholders failed to make timely payments to other creditors, such as other credit card issuers, utility companies, and mortgage lenders. Becoming generally known as "universal default," consumer groups criticized these practices. In 2004, OCC issued guidance to the banks that it oversees, which include many of the largest card

[28]Furletti, "Credit Card Pricing Developments and Their Disclosure."

issuers, which addressed such practices.[29] While OCC noted that the repricing might be an appropriate way for banks to manage their credit risk, they also noted that such practices could heighten a bank's compliance and reputation risks. As a result, OCC urged national banks to fully and prominently disclose in promotional materials the circumstances under which a cardholder's interest rates, fees, or other terms could be changed and whether the bank reserved the right to change these unilaterally. Around the time of this guidance, issuers generally ceased automatically repricing cardholders to default interest rates for risky behavior exhibited with other creditors. Of the 28 popular large issuer cards that we reviewed, three cards in 2005 included terms that would allow the issuer to automatically raise a cardholder's rate to the default rate if they made a late payment to another creditor.

Although the six largest U.S. issuers appear to have generally ceased making automatic increases to a default rate for behavior with other creditors, some continue to employ practices that allow them to seek to raise a cardholder's interest rates in response to behaviors with other creditors. During our review, representatives of four of these issuers told us that they may seek to impose higher rates on a cardholder in response to behaviors related to other creditors but that such increases would be done as a change-in-terms, which can require prior notification, rather than automatically.[30] Regulation Z requires that the affected cardholders be notified in writing of any such proposed changes in rate terms at least 15 days before such change becomes effective.[31] In addition, under the laws of the states in which four of the six largest issuers are chartered, cardholders would have to be given the right to opt out of the change.[32] However, issuer representatives told us that few cardholders exercise this right. The ability of cardholders to opt out of such increases also has been questioned. For example, one legal essay noted that some cardholders may not be able to reject the changed terms of their cards if the result would be a requirement

[29]Credit Card Practices, OCC Advisory Letter AL 2004-10 (Sept. 14, 2004).

[30]At least one of the six largest issuers may automatically increase a cardholder's rates for violations of terms on any loan the cardholder held with the issuer or bank with which it was affiliated.

[31]12 C.F.R. § 226.9(c).

[32]States in which issuers have a statutory obligation to afford cardholders an opportunity to opt-out or reject a change-in-terms to increase the interest rate on their credit card account include Delaware, South Dakota, New Hampshire, Florida and Georgia.

to pay off the balance immediately.[33] In addition, an association for community banks that provided comments to the Federal Reserve as part of the ongoing review of card disclosures noted that 15 days does not provide consumers sufficient time to make other credit arrangements if the new terms were undesirable.

Payment Allocation Method

The way that issuers allocate payments across balances also can increase the costs of using the popular cards we reviewed. In this new credit environment where different balances on a single account may be assessed different interest rates, issuers have developed practices for allocating the payments cardholders make to pay down their balance. For 23 of the 28 popular larger-issuer cards that we reviewed, cardholder payments would be allocated first to the balance that is assessed the lowest rate of interest.[34] As a result, the low interest balance would have to be fully paid before any of the cardholder's payment would pay down balances assessed higher rates of interest. This practice can prolong the length of time that issuers collect finance charges on the balances assessed higher rates of interest.

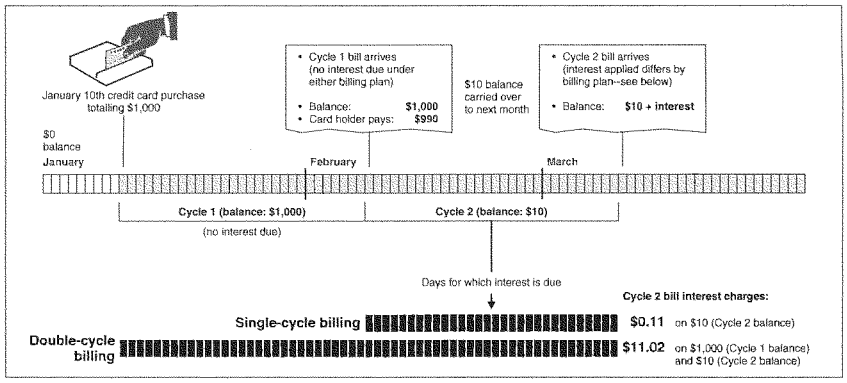
Balance Computation Method

Additionally, some of the cards we reviewed use a balance computation method that can increase cardholder costs. On some cards, issuers have used a double-cycle billing method, which eliminates the interest-free period of a consumer who moves from nonrevolving to revolving status, according to Federal Reserve staff. In other words, in cases where a cardholder, with no previous balance, fails to pay the entire balance of new purchases by the payment due date, issuers compute interest on the original balance that previously had been subject to an interest-free period. This method is illustrated in figure 6.

[33]Samuel Issacharoff and Erin F. Delaney, "Symposium: Homo Economicus, Homo Myopicus, and the Law and Economics of Consumer Choice," *University of Chicago Law Review* 73 (Winter: 2006).

[34]Issuers of the remaining five cards would apply cardholder payments in a manner subject to their discretion.

Figure 6: How the Double-Cycle Billing Method Works



Days with no balance carried on credit card
Days with balance carried on credit card
Days for which interest is due

Sources: GAO analysis of Federal Reserve Bank data; Art Explosion (images).

Note: We calculated finance charges assuming a 13.2 percent APR, 30-day billing cycle, and that the cardholder's payment is credited on the first day of cycle 2. We based our calculations on an average daily balance method and daily compounding of finance charges.

In our review of 28 popular cards from the six largest issuers, we found that two of the six issuers used the double-cycle billing method on one or more popular cards between 2003 and 2005. The other four issuers indicated they would only go back one cycle to impose finance charges.

New Practices Appear to Affect a Minority of Cardholders

Representatives of issuers, consumer groups, and others we interviewed generally disagreed over whether the evolution of credit card pricing and other practices has been beneficial to consumers. However, data provided by the six largest issuers show that many of their active accounts did not pay finance charges and that a minority of their cardholders were affected by penalty charges in 2005.

Issuers Say Practices Benefit More Cardholders, but Critics Say Some Practices Harm Consumers

The movement towards risk-based pricing for cards has allowed issuers to offer better terms to some cardholders and more credit cards to others. Spurred by increased competition, many issuers have adopted risk-based pricing structures in which they assess different rates on cards depending on the credit quality of the borrower. Under this pricing structure, issuers have offered cards with lower rates to more creditworthy borrowers, but also have offered credit to consumers who previously would not have been considered sufficiently creditworthy. For example, about 70 percent of families held a credit card in 1989, but almost 75 percent held a card by 2004, according to the Federal Reserve Board's Survey of Consumer Finances. Cards for these less creditworthy consumers have featured higher rates to reflect the higher repayment risk that such consumers represented. For example, the initial purchase rates on the 28 popular cards offered by the six largest issuers ranged from about 8 percent to 19 percent in 2005.

According to card issuers, credit cards offer many more benefits to users than they did in the past. For example, according to the six largest issuers, credit cards are an increasingly convenient and secure form of payment. These issuers told us credit cards are accepted at more than 23 million merchants worldwide, can be used to make purchases or obtain cash, and are the predominant form of payment for purchases made on the Internet. They also told us that rewards, such as cash-back and airline travel, as well as other benefits, such as rental car insurance or lost luggage protection, also have become standard. Issuers additionally noted that credit cards are reducing the need for cash. Finally, they noted that cardholders typically are not responsible for loss, theft, fraud, or misuse of their credit cards by unauthorized users, and issuers often assist cardholders that are victims of identity theft.

In contrast, according to some consumer groups and others, the newer pricing structures have resulted in many negative outcomes for some consumers. Some consumer advocates noted adverse consequences of offering credit, especially at higher interest rates, to less creditworthy consumers. For example, lower-income or young consumers, who do not have the financial means to carry credit card debt, could worsen their financial condition.[35] In addition, consumer groups and academics said that

[35]We previously reported on the marketing of credit cards to students and student experiences with credit cards. See GAO *Consumer Finance: College Students and Credit Cards*, GAO-01-773, (Washington, D.C.: June 20, 2001).

various penalty fees could increase significantly the costs of using cards for some consumers. Some also argued that card issuers were overly aggressive in their assessment of penalty fees. For instance, a representative of a consumer group noted that issuers do not reject cardholders' purchases during the sale authorization, even if the transaction would put the cardholder over the card's credit limit, and yet will likely later assess that cardholder an over-limit fee and also may penalize them with a higher interest rate. Furthermore, staff for one banking regulator told us that they have received complaints from consumers who were assessed over-limit fees that resulted from the balance on their accounts going over their credit limit because their card issuer assessed them a late fee. At the same time, credit card issuers have incentives not to be overly aggressive with their assessment of penalty charges. For example, Federal Reserve representatives told us that major card issuers with long-term franchise value are concerned that their banks not be perceived as engaging in predatory lending because this could pose a serious risk to their brand reputation. As a result, they explained that issuers may be wary of charging fees that could be considered excessive or imposing interest rates that might be viewed as potentially abusive. In contrast, these officials noted that some issuers, such as those that focus on lending to consumers with lower credit quality, may be less concerned about their firm's reputation and, therefore, more likely to charge higher fees.

Controversy also surrounds whether higher fees and other charges were commensurate with the risks that issuers faced. Consumer groups and others questioned whether the penalty interest rates and fees were justifiable. For example, one consumer group questioned whether submitting a credit card payment one day late made a cardholder so risky that it justified doubling or tripling the interest rate assessed on that account. Also, as the result of concerns over the level of penalty fees being assessed by banks in the United Kingdom, a regulator there has recently announced that penalty fees greater than 12 pounds (about $23) may be challenged as unfair unless they can be justified by exceptional factors.[36] Representatives of several of the issuers with whom we spoke told us that the levels of the penalty fees they assess generally were set by considering various factors. For example, they noted that higher fees help to offset the increased risk of loss posed by cardholders who pay late or engage in other

[36]Office of Fair Trading, *Calculating Fair Default Charges in Credit Card Contracts: A Statement of the OFT's Position*, OFT842 (April 2006).

negative behaviors. Additionally, they noted a 2006 study, which compared the assessment of penalty fees that credit card banks charged to bankruptcy rates in the states in which their cards were marketed, and found that late fee assessments were correlated with bankruptcy rates.[37] Some also noted that increased fee levels reflected increased operating costs; for example, not receiving payments when due can cause the issuer to incur increased costs, such as those incurred by having to call cardholders to request payment. Representatives for four of the largest issuers also told us that their fee levels were influenced by what others in the marketplace were charging.

Concerns also have been expressed about whether consumers adequately consider the potential effect of penalty interest rates and fees when they use their cards. For example, one academic researcher, who has written several papers about the credit card industry, told us that many consumers do not consider the effect of the costs that can accrue to them after they begin using a credit card. According to this researcher, many consumers focus primarily on the amount of the interest rate for purchases when deciding to obtain a new credit card and give less consideration to the level of penalty charges and rates that could apply if they were to miss a payment or violate some other term of their card agreement. An analyst that studies the credit card industry for large investors said that consumers can obtain low introductory rates but can lose them very easily before the introductory period expires.

Most Active Accounts Are Assessed Lower Rates Than in the Past

As noted previously, the average credit card interest rate assessed for purchases has declined from almost 20 percent, that prevailed until the late 1980s, to around 12 percent, as of 2005. In addition, the six largest issuers—whose accounts represent 61 percent of all U.S. accounts—reported to us that the majority of their cardholders in 2005 had cards with interest rates lower than the rate that generally applied to all cardholders prior to about 1990. According to these issuers, about 80 percent of active accounts were assessed interest rates below 20 percent as of December 31, 2005, with

[37]Massoud, N., Saunders A., and Scholnick B., "The Cost of Being Late: The Case of Credit Card Penalty Fees," January 2006. Published with financial assistance from the Social Sciences Research Council of Canada and the National Research Program on Financial Services and Public Policy at the Schulich School of Business, York University in Toronto, Ontario (Canada). This study examined data from the Federal Reserve's survey of U.S. credit card rates and fees and compared them to bankruptcy rates across states.

more than 40 percent having rates below 15 percent.[38] However, the proportion of active accounts assessed rates below 15 percent declined since 2003, when 71 percent received such rates. According to issuer representatives, a greater number of active accounts were assessed higher interest rates in 2004 and 2005 primarily because of changes in the prime rate to which many cards' variable rates are indexed. Nevertheless, cardholders today have much greater access to cards with lower interest rates than existed when all cards charged a single fixed rate.

A large number of cardholders appear to avoid paying any significant interest charges. Many cardholders do not revolve a balance from month to month, but instead pay off the balance owed in full at the end of each month. Such cardholders are often referred to as convenience users. According to one estimate, about 42 percent of cardholders are convenience users.[39] As a result, many of these cardholders availed themselves of the benefits of their cards without incurring any direct expenses. Similarly, the six largest issuers reported to us that almost half, or 48 percent, of their active accounts did not pay a finance charge in at least 10 months in 2005, similar to the 47 percent that did so in 2003 and 2004.

Minority of Cardholders Appear to Be Affected by Penalty Charges Assessed by the Largest U.S. Issuers

Penalty interest rates and fees appear to affect a minority of the largest six issuers' cardholders.[40] No comprehensive sources existed to show the extent to which U.S. cardholders were paying penalty interest rates, but, according to data provided by the six largest issuers, a small proportion of their active accounts were being assessed interest rates above 25 percent—which we determined were likely to represent penalty rates. However, this proportion had more than doubled over a two-year period by having increased from 5 percent at the end of 2003 to 10 percent in 2004 and 11 percent in 2005.

[38]For purposes of this report, active accounts refer to accounts of the top six issuers that had had a debit or credit posted to them by December 31 in 2003, 2004, and 2005.

[39]CardWeb.com, Inc.

[40]Our data likely undercounted the cards and cardholders that were affected by these charges because our data was comprised of active accounts for the six largest U.S. issuers. Although these issuers have some subprime accounts (accounts held by less-creditworthy borrowers), we did not include issuers in our sample that predominantly market to subprime borrowers.

Although still representing a minority of cardholders, cardholders paying at least one type of penalty fee were a significant proportion of all cardholders. According to the six largest issuers, 35 percent of their active accounts had been assessed at least one late fee in 2005. These issuers reported that their late fee assessments averaged $30.92 per active account. Additionally, these issuers reported that they assessed over-limit fees on 13 percent of active accounts in 2005, with an average over-limit fee of $9.49 per active account.

Weaknesses in Credit Card Disclosures Appear to Hinder Cardholder Understanding of Fees and Other Practices That Can Affect Their Costs

The disclosures that issuers representing the majority of credit card accounts use to provide information about the costs and terms of using credit cards had serious weaknesses that likely reduce their usefulness to consumers. These disclosures are the primary means under federal law for protecting consumers against inaccurate and unfair credit card practices. The disclosures we analyzed had weaknesses, such as presenting information written at a level too difficult for the average consumer to understand, and design features, such as text placement and font sizes, that did not conform to guidance for creating easily readable documents. When attempting to use these disclosures, cardholders were often unable to identify key rates or terms and often failed to understand the information in these documents. Several factors help explain these weaknesses, including outdated regulations and guidance. With the intention of improving the information that consumers receive, the Federal Reserve has initiated a comprehensive review of the regulations that govern credit card disclosures. Various suggestions have been made to improve disclosures, including testing them with consumers. While Federal Reserve staff have begun to involve consumers in their efforts, they are still attempting to determine the best form and content of any revised disclosures. Without clear, understandable information, consumers risk making poor choices about using credit cards, which could unnecessarily result in higher costs to use them.

Mandatory Disclosure of Credit Card Terms and Conditions Is the Primary Means Regulators Use for Ensuring Competitive Credit Card Pricing

Having adequately informed consumers that spur competition among issuers is the primary way that credit card pricing is regulated in the United States. Under federal law, a national bank may charge interest on any loan

at a rate permitted by the law of the state in which the bank is located.[41] In 1978, the U.S. Supreme Court ruled that a national bank is "located" in the state in which it is chartered, and, therefore, the amount of the interest rates charged by a national bank are subject only to the laws of the state in which it is chartered, even if its lending activities occur elsewhere.[42] As a result, the largest credit card issuing banks are chartered in states that either lacked interest rate caps or had very high caps from which they would offer credit cards to customers in other states. This ability to "export" their chartered states' interest rates effectively removed any caps applicable to interest rates on the cards from these banks. In 1996, the U.S. Supreme Court determined that fees charged on credit extended by national banks are a form of interest, allowing issuers to also export the level of fees allowable in their state of charter to their customers nationwide, which effectively removed any caps on the level of fees that these banks could charge.[43]

In the absence of federal regulatory limitations on the rates and fees that card issuers can assess, the primary means that U.S. banking regulators have for influencing the level of such charges is by facilitating competition among issuers, which, in turn, is highly dependent on informed consumers. The Truth in Lending Act of 1968 (TILA) mandates certain disclosures aimed at informing consumers about the cost of credit. In approving TILA, Congress intended that the required disclosures would foster price competition among card issuers by enabling consumers to discern differences among cards while shopping for credit. TILA also states that its purpose is to assure that the consumer will be able to compare more readily the various credit terms available to him or her and avoid the uninformed use of credit. As authorized under TILA, the Federal Reserve has promulgated Regulation Z to carry out the purposes of TILA. The Federal Reserve, along with the other federal banking agencies, enforces compliance with Regulation Z with respect to the depository institutions under their respective supervision.

In general, TILA and the accompanying provisions of Regulation Z require credit card issuers to inform potential and existing customers about specific pricing terms at specific times. For example, card issuers are

[41] 12 U.S.C. § 85.

[42] *Marquette National Bank v First of Omaha Service Corp. et. al*, 439 U.S. 299 (1978).

[43] *Smiley v. Citibank*, 517 U.S. 735 (1996).

required to make various disclosures when soliciting potential customers, as well as on the actual applications for credit. On or with card applications and solicitations, issuers generally are required to present pricing terms, including the interest rates and various fees that apply to a card, as well as information about how finance charges are calculated, among other things. Issuers also are required to provide cardholders with specified disclosures prior to the cardholder's first transaction, periodically in billing statements, upon changes to terms and conditions pertaining to the account, and upon account renewal. For example, in periodic statements, which issuers typically provide monthly to active cardholders, issuers are required to provide detailed information about the transactions on the account during the billing cycle, including purchases and payments, and are to disclose the amount of finance charges that accrued on the cardholder's outstanding balance and detail the type and amount of fees assessed on the account, among other things.

In addition to the required timing and content of disclosures, issuers also must adhere to various formatting requirements. For example, since 1989, certain pricing terms must be disclosed in direct mail, telephone, and other applications and solicitations and presented in a tabular format on mailed applications or solicitations.[44] This table, generally referred to as the Schumer box, must contain information about the interest rates and fees that could be assessed to the cardholder, as well as information about how finance charges are calculated, among other things.[45] According to a Federal Reserve representative, the Schumer box is designed to be easy for consumers to read and use for comparing credit cards. According to a consumer group representative, an effective regulatory disclosure is one that stimulates competition among issuers; the introduction of the Schumer box in the late 1980s preceded the increased price competition in the credit card market in the early 1990s and the movement away from uniform credit card products.

Not all fees that are charged by card issuers must be disclosed in the Schumer box. Regulation Z does not require that issuers disclose fees unrelated to the opening of an account. For example, according to the Official Staff Interpretations of Regulation Z (staff interpretations), nonperiodic fees, such as fees charged for reproducing billing statements

[44]See generally 12 C.F.R. § 226.5a.

[45]See supra note 21.

or reissuing a lost or stolen card, are not required to be disclosed. Staff interpretations, which are compiled and published in a supplement to Regulation Z, are a means of guiding issuers on the requirements of Regulation Z.[46] Staff interpretations also explain that various fees are not required in initial disclosure statements, such as a fee to expedite the delivery of a credit card or, under certain circumstances, a fee for arranging a single payment by telephone. However, issuers we surveyed told us they inform cardholders about these other fees at the time the cardholders request the service, rather than in a disclosure document.

Although Congress authorized solely the Federal Reserve to adopt regulations to implement the purposes of TILA, other federal banking regulators, under their authority to ensure the safety and soundness of depository institutions, have undertaken initiatives to improve the credit card disclosures made by the institutions under their supervision. For example, the regulator of national banks, OCC, issued an advisory letter in 2004 alerting banks of its concerns regarding certain credit card marketing and account management practices that may expose a bank to compliance and reputation risks. One such practice involved the marketing of promotional interest rates and conditions under which issuers reprice accounts to higher interest rates.[47] In its advisory letter, OCC recommended that issuers disclose any limits on the applicability of promotional interest rates, such as the duration of the rates and the circumstances that could shorten the promotional rate period or cause rates to increase. Additionally, OCC advised issuers to disclose the circumstances under which they could increase a consumer's interest rate or fees, such as for failure to make timely payments to another creditor.

Credit Card Disclosures Typically Provided to Many Consumers Have Various Weaknesses

The disclosures that credit card issuers typically provide to potential and new cardholders had various weaknesses that reduced their usefulness to consumers. These weaknesses affecting the disclosure materials included the typical grade level required to comprehend them, their poor organization and formatting of information, and their excessive detail and length.

[46]Compliance with these official staff interpretations afford issuers protection from liability under Section 130(f) of TILA, which protects issuers from civil liability for any act done or omitted in good faith compliance with any official staff interpretation. 12 C.F.R. Part 226, Supp. I.

[47]Credit Card Practices, OCC Advisory Letter AL 2004-10 (Sept. 14, 2004).

Disclosures Written at Too High a Level

The typical credit card disclosure documents contained content that was written at a level above that likely to be understandable by many consumers. To assess the readability of typical credit card disclosures, we contracted with a private usability consultant to evaluate the two primary disclosure documents for four popular, widely-held cards (one each from four large credit card issuers). The two documents were (1) a direct mail solicitation letter and application, which must include information about the costs and fees associated with the card; and (2) the cardmember agreement that contains the full range of terms and conditions applicable to the card.[48] Through visual inspection, we determined that this set of disclosures appeared representative of the disclosures for the 28 cards we reviewed from the six largest issuers that accounted for the majority of cardholders in the United States. To determine the level of education likely needed for someone to understand these disclosures, the usability consultant used computer software programs that applied three widely used readability formulas to the entire text of the disclosures. These formulas determined the readability of written material based on quantitative measures, such as average number of syllables in words or numbers of words in sentences. For more information about the usability consultant's analyses, see appendix I.

On the basis of the usability consultant's analysis, the disclosure documents provided to many cardholders likely were written at a level too high for the average individual to understand. The consultant found that the disclosures on average were written at a reading level commensurate with about a tenth- to twelfth-grade education. According to the consultant's analysis, understanding the disclosures in the solicitation letters would require an eleventh-grade level of reading comprehension, while understanding the cardmember agreements would require about a twelfth-grade education. A consumer advocacy group that tested the reading level needed to understand credit card disclosures arrived at a similar conclusion. In a comment letter to the Federal Reserve, this consumer group noted it had measured a typical passage from a change-in-terms notice on how issuers calculate finance charges using one of the readability formulas and that this passage required a twelfth-grade reading level.

[48]We did not evaluate disclosures that issuers are required to provide at other times—such as in periodic billing statements or change in terms notices.

These disclosure documents were written such that understanding them required a higher reading level than that attained by many U.S. cardholders. For example, a nationwide assessment of the reading level of the U.S. population cited by the usability consultant indicated that nearly half of the adult population in the United States reads at or below the eighth-grade level.[49] Similarly, to ensure that the information that public companies are required to disclose to prospective investors is adequately understandable, the Securities and Exchange Commission (SEC) recommends that such disclosure materials be written at a sixth- to eighth-grade level.[50]

In addition to the average reading level, certain portions of the typical disclosure documents provided by the large issuers required even higher reading levels to be understandable. For example, the information that appeared in cardmember agreements about annual percentage rates, grace periods, balance computation, and payment allocation methods required a minimum of a fifteenth-grade education, which is the equivalent of 3 years of college education. Similarly, text in the documents describing the interest rates applicable to one issuer's card were written at a twenty-seventh-grade level. However, not all text in the disclosures required such high levels. For example, the consultant found that the information about fees that generally appeared in solicitation letters required only a seventh- and eighth-grade reading level to be understandable. Solicitation letters likely required lower reading levels to be understandable because they generally included more information in a tabular format than cardmember agreements.

Poor Organization and Formatting

The disclosure documents the consultant evaluated did not use designs, including effective organizational structures and formatting, that would have made them more useful to consumers. To assess the adequacy of the design of the typical large issuer credit card solicitation letters and cardmember agreements, the consultant evaluated the extent to which these disclosures adhered to generally accepted industry standards for

[49]1992 National Adult Literacy Survey. The 2003 National Assessment of Adult Literacy (renamed from 1992) found that reading comprehension levels did not significantly change between 1992 and 2003 and that there was little change in adults' ability to read and understand sentences and paragraphs.

[50]U.S. Securities and Exchange Commission, *Plain English Handbook: How to Create Clear SEC Disclosure Documents* (Washington, D.C.: 1998). The Securities and Exchange Commission regulates the issuance of securities to the public, including the information that companies provide to their investors.

effective organizational structures and designs intended to make documents easy to read. In the absence of best practices and guidelines specifically for credit card disclosures, the consultant used knowledge of plain language, publications design guidelines, and industry best practices and also compared the credit card disclosure documents to the guidelines in the Securities and Exchange Commission's plain English handbook. The usability consultant used these standards to identify aspects of the design of the typical card disclosure documents that could cause consumers using them to encounter problems.

On the basis of this analysis, the usability consultant concluded that the typical credit card disclosures lacked effective organization. For example, the disclosure documents frequently placed pertinent information toward the end of sentences. Figure 7 illustrates an example taken from the cardmember agreement of one of the large issuers that shows that a consumer would need to read through considerable amounts of text before reaching the important information, in this case the amount of the annual percentage rate (APR) for purchases. Best practices would dictate that important information—the amount of the APR—be presented first, with the less important information—the explanation of how the APR is determined—placed last.

Figure 7: Example of Important Information Not Prominently Presented in Typical Credit Card Disclosure Documents

Usability consultant's comments: Placing pertinent information, in this case the APR for purchases, near the end of sentences requires readers to wade through considerable amounts of text before reaching important information.

3.3.1.a: Purchases. The Annual Percentage Rate for Purchases, a variable rate, is the Index plus a Margin of 4.98%. Based on this formula, the APR as of May 4, 2005 is 10.99% (0.03011% corresponding Daily Periodic Rate).

Sources: UserWorks, Inc.; Information International Associates.

In addition, the disclosure documents often failed to group relevant information together. Although one of the disclosure formats mandated by law—the Schumer box—has been praised as having simplified the presentation of complex information, our consultant observed that the amount of information that issuers typically presented in the box compromised the benefits of using a tabular format. Specifically, the typical credit card solicitation letter, which includes a Schumer box, may be

causing difficulties for consumers because related information generally is not grouped appropriately, as shown in figure 8.

Figure 8: Example of How Related Information Was Not Being Grouped Together in Typical Credit Card Disclosure Documents

Annual Percentage Rate (APR) for Purchases[3]	0.0% fixed introductory rate until October 1, 2006;[1] thereafter, a variable APR, currently 13.49%. Current rate for purchases
Other APRs[3]	**Non-Check Balance Transfers:** 0.0% fixed introductory APR until October 1, 2006;[1] thereafter, together with all other Balance Transfers, a variable APR, currently 13.49%. **Cash Advances and Convenience Checks:** A variable APR, currently 22.49%. **Penalty APR:** A variable APR, currently up to 30.49%.[3]
Variable Rate Information[2]	All APRs (other than your introductory APRs) may vary. They are determined by adding the following margin to the Prime Rate: 6.99% for Purchases and Non-Check Balance Transfers; 15.99% for Cash Advances and Convenience Checks; and up to 23.99% for Penalty APRs. How the rate is determined
Balance Calculation Method for Purchases	Average Daily Balance (including new purchases)
Annual Fee	None
Grace Period for Purchases	At least 20 days
Minimum Finance Charge for Purchases	$1.50 (unless purchase Average Daily Balance is zero)

†The terms of your Account, including any APR (or how an APR is Calculated) are subject to change. Any changes will be made in accordance with the Cardholder Agreement.

[1]If an introductory rate is applicable to this product and we do not receive at least the Minimum Payment Due during any billing cycle, you exceed your credit limit or you close your account, any introductory rate on Purchases and Balance Transfers will terminate.

[2]The Prime Rate used in your APR calculations is determined on the last day of each month by taking the highest prime rate published in the Money Rates section of The Wall Street Journal in effect within the prior three months (the "Index Date(s)"). All Prime Rate changes will take effect on the first day of your Billing Cycle that ends in the calendar month following the Index Date. All variable rate disclosures are based on the Prime Rate of 6.50% in effect on August 10, 2005.

How the prime rate is determined

Usability consultant's comments:
Related information, in this case the APR for purchases, is not grouped together, potentially causing difficulties for readers.

Sources: GAO analysis of data from UserWorks, Inc.; Information International Associates.

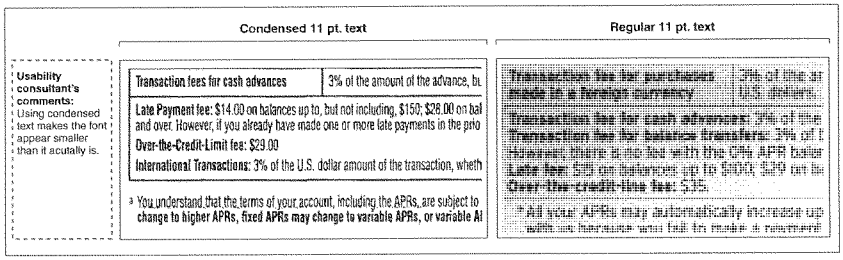
As shown in figure 8, information about the APR that would apply to purchases made with the card appeared in three different locations. The first row includes the current prevailing rate of the purchase APR; text that describes how the level of the purchase APR could vary according to an underlying rate, such as the prime rate, is included in the third row; and text describing how the issuer determines the level of this underlying rate is included in the footnotes. According to the consultant, grouping such related information together likely would help readers to more easily understand the material.

In addition, of the four issuers whose materials were analyzed, three provided a single document with all relevant information in a single cardmember agreement, but one issuer provided the information in separate documents. For example, this issuer disclosed specific information about the actual amount of rates and fees in one document and presented information about how such rates were determined in another document. According to the readability consultant, disclosures in multiple documents can be more difficult for the reader to use because they may require more work to find information.

Formatting weaknesses also likely reduced the usefulness of typical credit card disclosure documents. The specific formatting issues were as follows:

- *Font sizes.* According to the usability consultant's analysis, many of the disclosure documents used font sizes that were difficult to read and could hinder consumers' ability to find information. For example, the consultant found extensive use of small and condensed typeface in cardmember agreements and in footnotes in solicitation materials when best practices would suggest using a larger, more legible font size. Figure 9 contains an illustration of how the disclosures used condensed text that makes the font appear smaller than it actually is. Multiple consumers and consumer groups who provided comments to the Federal Reserve noted that credit card disclosures were written in a small print that reduces a consumer's ability to read or understand the document. For example, a consumer who provided comments to the Federal Reserve referred to the text in card disclosures as "mice type." This example also illustrates how notes to the text, which should be less important, were the same size and thus given the same visual emphasis as the text inside the box. Consumers attempting to read such disclosures may have difficulty determining which information is more important.

Figure 9: Example of How Use of Small Font Sizes Reduces Readability in Typical Credit Card Disclosure Documents



Sources: UserWorks, Inc.; Information International Associates.

Note: Graphic shown is the actual size it appears in issuer disclosure documents. Graphic is intentionally portioned off to focus attention to headings.

- *Ineffective font placements.* According to the usability consultant, some issuers' efforts to distinguish text using different font types sometimes had the opposite effect. The consultant found that the disclosures from all four issuers emphasized large amounts of text with all capital letters and sometimes boldface. According to the consultant, formatting large blocks of text in capitals makes it harder to read because the shapes of the words disappear, forcing the reader to slow down and study each letter (see figure 10). In a comment letter to the Federal Reserve, an industry group recommended that boldfaced or capitalized text should be used discriminately, because in its experience, excessive use of such font types caused disclosures to lose all effectiveness. SEC's guidelines for producing clear disclosures contain similar suggestions.

Figure 10: Example of How Use of Ineffective Font Types Reduces Readability in Typical Credit Card Disclosure Documents

Usability consultant's comments: By emphasizing all the text in a paragraph, nothing is emphasized.

7.14: AMENDMENT OF THIS AGREEMENT. WE MAY AMEND THIS AGREEMENT BY CHANGING, ADDING OR DELETING ANY TERM, CONDITION, SERVICE OR FEATURE ("NEW TERM") OF YOUR ACCOUNT OR OF THIS AGREEMENT AT ANY TIME. WE WILL PROVIDE YOU WITH NOTICE OF THE AMENDMENT TO THE EXTENT REQUIRED BY LAW. UNLESS WE STATE OTHERWISE, ANY NEW TERM WILL APPLY TO YOUR

ARBITRATION: PLEASE READ THIS PROVISION CAREFULLY. IT PROVIDES THAT ANY DISPUTE MAY BE RESOLVED BY BINDING ARBITRATION. ARBITRATION REPLACES THE RIGHT TO GO TO COURT. YOU WILL NOT BE ABLE TO BRING A CLASS ACTION OR SIMILAR PROCEEDING IN COURT, NOR WILL YOU BE ABLE TO BRING ANY CLAIM IN

Sources: UserWorks, Inc.; Information International Associates.

- *Selecting text for emphasis.* According to the usability consultant, most of the disclosure documents unnecessarily emphasized specific terms. Inappropriate emphasis of such material could distract readers from more important messages. Figure 11 contains a passage from one cardmember agreement that the readability consultant singled out for its emphasis of the term "periodic finance charge," which is repeated six times in this example. According to the consultant, the use of boldface and capitalized text calls attention to the word, potentially requiring readers to work harder to understand the entire passage's message.

Figure 11: Example of How Use of Inappropriate Emphasis Reduces Readability in Typical Credit Card Disclosure Documents

Usability consultant's comments: Repeated use of boldface and caps calls attention to a word, potentially requiring readers to work harder to understand the passage's message.

zero. We multiply the daily balance by the applicable Daily Periodic Rate, as stated in the Table of Interest Charges, to get your **Periodic FINANCE CHARGES** for that day. We then add these **Periodic FINANCE CHARGES** to your daily balance to get the beginning balance for the next day. For Purchases, we do the same thing for each day of the previous cycle to get the daily balance of Purchases for the previous billing cycle. However, the daily balance for previous billing cycle Purchases is considered to be zero for each day of the previous billing cycle if a **Periodic FINANCE CHARGE** was already imposed on Purchases itemized on your previous statement or you paid your **New** Balance on your previous statement in full by the payment due date.

To get your total **Periodic FINANCE CHARGE** for a billing cycle, we add all of the daily **Periodic FINANCE CHARGES** for all features. If you multiply the Average Daily Balance for each feature by the applicable Daily Periodic Rate and the number of days in the applicable billing cycle(s) and add the results together, the total will equal the **Periodic FINANCE CHARGES** for the billing cycle, except for minor variations due to rounding. To determine an Average Daily Balance, we add your daily balances and divide by the number of the days in the applicable billing cycle(s).

Sources: UserWorks, Inc.; Information International Associates.

- *Use of headings.* According to the usability consultant, disclosure documents from three of the four issuers analyzed contained headings that were difficult to distinguish from surrounding text. Headings, according to the consultant, provide a visual hierarchy to help readers quickly identify information in a lengthy document. Good headers are easy to identify and use meaningful labels. Figure 12 illustrates two examples of how the credit card disclosure documents failed to use headings effectively.

Figure 12: Example of Ineffective and Effective Use of Headings in Typical Credit Card Disclosure Documents

Ineffective heading use (shading added by GAO)

Section 2: USE OF YOUR ACCOUNT
2.1: Types of Transactions. You may use your Account for the following types of consumer transactions:
2.1.1: Purchases. Purchase goods or services with your Card.
2.1.2: Cash Advances. Obtain cash from a participating financial institution or merchant ("Cash Disbursement") or from an ATM ("ATM Advance"), write a Convenience Check for any legal purpose ("Convenience Check Advance") or purchase money orders, travelers checks, foreign currency, lottery tickets, casino chips, racetrack wagers, vouchers redeemable for cash or other items readily convertible into cash ("Quasi Cash"), or transfer funds from your Account to your personal checking account for overdraft protection ("Overdraft Protection").
2.1.3: Balance Transfers. Transferred balances to your Account from other creditors, except those made using a Convenience Check.
2.2: Limitations on Use

Payment Allocation: You agree that we are authorized to allocate your payments and credits in a way that is most favorable to or convenient for us. For example, you authorize us to apply your payments and credits to balances with lower **Annual Percentage Rates** ("APRs") (such as promotional APRs) before balances with higher APRs for all balances except promotional balances for Disney vacation packages.
Credit Line/Authorized Usage: Your credit line is shown on the folder containing your Card. Since we may change your credit line from time to time, your latest credit line will appear on your monthly statement. You agree not to make a Purchase or obtain a Cash Advance that would cause the unpaid balance of your Account to exceed your

Usability consultant's comments:

1 Headings are easy to identify, but are preceded by an unnecessary string of numbers that do not correspond to anything useful like a table of contents.

2 Headings are not substantially different from the text.

Effective heading use (shading added by GAO)

3 ***How We Determine the Balance:***
The total outstanding balance (the amount you owe us) appears as the "New Balance" on the billing statement. To determine the New Balance, we begin with the outstanding balance on your account at the beginning of each billing period, called the "Previous Balance" on the billing statement. We add any purchases or cash advances and subtract any credits or payments credited as of that billing period. We then add the appropriate finance charges and fees and make other applicable adjustments.

Annual Percentage Rates for Purchases and Cash Advances:
Your annual percentage rates and the corresponding daily periodic rates appear on the card carrier. A daily periodic rate is the appli-

Usability consultant's comments:

3 Headings are easy to distinguish from the surrounding text.

Sources: UserWorks, Inc.; Information International Associates.

In the first example, the headings contained an unnecessary string of numbers that the consultant found would make locating a specific topic in the text more difficult. As a result, readers would need to actively ignore the string of numbers until the middle of the line to find what they wanted. The consultant noted that such numbers might be useful if this document had a table of contents that referred to the numbers, but it did not. In the second example, the consultant noted that a reader's ability to locate information using the headings in this document was hindered because the headings were not made more visually distinct, but instead were aligned with other text and printed in the same type size as the text that followed. As a result, these headings blended in with the text. Furthermore, the consultant noted that because the term "Annual Percentage Rates" was given the same visual treatment as the two headings in the example, finding headings quickly was made even more difficult. In contrast, figure 12 also shows an example that the consultant identified in one of the disclosure documents that was an effective use of headings.

- *Presentation techniques.* According to the usability consultant, the disclosure documents analyzed did not use presentation techniques, such as tables, bulleted lists, and graphics, that could help to simplify the presentation of complicated concepts, especially in the cardmember agreements. Best practices for document design suggest using tables and bulleted lists to simplify the presentation of complex information. Instead, the usability consultant noted that all the cardmember agreements reviewed almost exclusively employed undifferentiated blocks of text, potentially hindering clear communication of complex information, such as the multiple-step procedures issuers use for calculating a cardholder's minimum required payment. Figure 13 below presents two samples of text from different cardmember agreements describing how minimum payments are calculated. According to the consultant, the sample that used a bulleted list was easier to read than the one formatted as a paragraph. Also, an issuer stated in a letter to the Federal Reserve that their consumers have welcomed the issuer's use of bullets to format information, emphasizing the concept that the visual layout of information either facilitates or hinders consumer understanding.

Figure 13: Example of How Presentation Techniques Can Affect Readability in Typical Credit Card Disclosure Documents

MINIMUM MONTHLY PAYMENT. The Minimum Payment Due each month will be the sum of any amount past due and the minimum monthly payment. The minimum monthly payment each month will be the greater of $10 or 1/50th of the New Balance, rounded to the next higher whole dollar amount. If any ANNUAL PERCENTAGE RATE applicable to your Account is greater than 22.99%, but less than 26.00%, your minimum monthly payment will be the greater of $10 or 1/45th of the New Balance, rounded to the next higher whole dollar amount. If any ANNUAL PERCENTAGE RATE applicable to your Account is 26.00% or greater, your minimum monthly payment will be the greater of $10 or 1/40th of the New Balance. Regardless of the Annual Percentage Rates on your Account, if the New Balance is less than $10.00, the minimum monthly payment will be the amount of the New Balance. We may also include in your minimum monthly payment all or a portion of the amount by which your outstanding balance exceeds your Account credit limit as of the last day of the billing period. Paying the Minimum Payment Due may be insufficient to bring

Usability consultant's comments:
Expressing a complicated, multistep process as prose makes it difficult to understand the relationships between steps.

Minimum Amount Due:
Each month you must pay a minimum amount that is calculated as follows. First, we begin with any amount that is past due and add to it any amount in excess of your credit line. Second, we add the largest of the following:

- The New Balance on the billing statement if it is less than $20;
- $20 if the New Balance is at least $20;
- 1% of the New Balance (which calculation is rounded down to the nearest dollar) plus the amount of your billed finance charges and any applicable late fee; or
- 1.5% of the New Balance (which calculation is rounded down to the nearest dollar).

However, the Minimum Amount Due will never exceed your New Balance. In calculating the Minimum Amount Due, we may subtract from the New Balance certain fees added to your account during the billing period.

Usability consultant's comments:
By using bullet points, it is much easier to see multiple steps broken out into individual steps and when they are applied.

Sources: UserWorks, Inc.; Information International Associates.

Excessive Complexity and Volume of Information

The content of typical credit card disclosure documents generally was overly complex and presented in too much detail, such as by using unfamiliar or complex terms to describe simple concepts. For example, the usability consultant identified one cardmember agreement that used the term "rolling consecutive twelve billing cycle period" instead of saying "over the course of the next 12 billing statements" or "next 12 months"—if that was appropriate. Further, a number of consumers, consumer advocacy groups, and government and private entities that have provided comments to the Federal Reserve agreed that typical credit card disclosures are written in complex language that hinders consumers' understanding. For example, a consumer wrote that disclosure documents were "loaded with booby traps designed to trip consumers, and written in intentionally impenetrable and confusing language." One of the consumer advocacy groups stated the disclosures were "full of dense, impenetrable legal jargon that even lawyers and seasoned consumer advocates have difficulty understanding." In addition, the consultant noted that many of the disclosures, including solicitation letters and cardmember agreements, contained overly long and complex sentences that increase the effort a reader must devote to understanding the text. Figure 14 contains two

examples of instances in which the disclosure documents used uncommon words and phrases to express simple concepts.

Figure 14: Examples of How Removing Overly Complex Language Can Improve Readability in Typical Credit Card Disclosure Documents

101 words

[3]If at any time during any rolling consecutive twelve billing cycle period you fail to make two Minimum Payments on a timely basis or exceed your Credit Limit twice we may elect to increase your Purchase, Cash Advance and/or Balance Transfer APRs to the Penalty APRs. All Penalty APRs will remain in effect until, in a subsequent rolling consecutive six billing cycle period, you do not exceed your Credit Limit at any time and you make all of your required Minimum Payments on a timely basis when, in your next billing cycle, all Penalty APRs will no longer apply.

50 words

Usability consultant's rewrite:
If you pay late or go over your credit limit twice in a year, the interest rate you pay on most things goes up to the default rate, currently 30.49%. It will go back down when you pay on time and do not go over your credit limit for six months.

69 words

Using Your Account: You may use your Card or Account to purchase or lease goods or services, or pay amounts you owe, wherever the Card is honored, transfer balances from other accounts or, if applicable, to obtain advances to cover an overdraft on your checking account with a affiliate under the terms of this Agreement and your Overdraft Protection Agreement, ("Overdraft Advances"). (Purchases, Balance Transfers and Overdraft Advances are collectively called "Purchases").

20 words

Usability consultant's rewrite:
You can use this card to buy things, pay off other accounts, transfer balances, or keep from bouncing a check.

Sources: UserWorks, Inc.; Information International Associates.

In addition, the disclosure documents regularly presented too much or irrelevant detail. According to the usability consultant's analysis, the credit card disclosures often contained superfluous information. For example, figure 15 presents an example of text from one cardmember agreement that described the actions the issuer would take if its normal source for the rate information used to set its variable rates—*The Wall Street Journal*—were to cease publication. Including such an arguably unimportant detail lengthens and makes this disclosure more complex. According to SEC best practices for creating clear disclosures, disclosure documents are more effective when they adhere to the rule that less is more. By omitting unnecessary details from disclosure documents, the usability consultant indicated that consumers would be more likely to read and understand the information they contain.

Figure 15: Example of Superfluous Detail in Typical Credit Card Disclosure Documents

Usability consultant's comments: This section provides superfluous information on how the prime rate is determined. For example, the explanation of the actions if the Wall Street Journal was to cease publication.

If any annual percentage rate is based on the U.S. Prime Rate plus a margin, we will calculate the rate for each billing period by adding the applicable margin that appears on the card carrier to the U.S. Prime Rate. For each billing period we will use the U.S. Prime Rate published in *The Wall Street Journal* two business days prior to your Statement/Closing Date for that billing period. Any increase or decrease in a variable annual percentage rate due to a change in the U.S. Prime Rate takes effect as of the first day of the billing period for which we calculate the variable annual percentage rate. If more than one U.S. Prime Rate is published, we may choose the highest rate. If *The Wall Street Journal* ceases publication or to publish the U.S. Prime Rate, we may use the U.S. Prime Rate published in any other newspaper of general circulation, or we may substitute a similar reference rate at our sole discretion. When a change in an applicable variable annual percentage rate takes effect we will apply it to any existing balances, subject to any promotional rate that may apply.

Sources: UserWorks, Inc.; Information International Associates.

Consumer Confusion Indicated That Disclosures Were Not Communicating Credit Card Cost Information Clearly

Many of the credit cardholders that were tested and interviewed as part of our review exhibited confusion over various fees, practices, and other terms that could affect the cost of using their credit cards. To understand how well consumers could use typical credit card disclosure documents to locate and understand information about card fees and other practices, the usability consultant with whom we contracted used a sample of cardholders to perform a usability assessment of the disclosure documents from the four large issuers. As part of this assessment, the consultant conducted one-on-one sessions with a total of 12 cardholders so that each set of disclosures, which included a solicitation letter and a cardmember agreement, was reviewed by 3 cardholders.[51] Each of these cardholders were asked to locate information about fee levels and rates, the circumstances in which they would be imposed, and information about changes in card terms. The consultant also tested the cardholders' ability to explain various practices used by the issuer, such as the process for determining the amount of the minimum monthly payment, by reading the disclosure documents. Although the results of the usability testing cannot

[51]According to the consultant, testing with small numbers of individuals can generally identify many of the problems that can affect the readability and usability of materials.

be used to make generalizations about all cardholders, the consultant selected cardholders based on the demographics of the U.S. adult population, according to age, education level, and income, to ensure that the cardholders tested were representative of the general population. In addition, as part of this review, we conducted one-on-one interviews with 112 cardholders to learn about consumer behavior and knowledge about various credit card terms and practices.[52] Although we also selected these cardholders to reflect the demographics of the U.S. adult population, with respect to age, education level, and income, the results of these interviews cannot be generalized to the population of all U.S. cardholders.[53]

Based on the work with consumers, specific aspects of credit card terms that apparently were not well understood included:

- *Default interest rates.* Although issuers can penalize cardholders for violating the terms of the card, such as by making late payments or by increasing the interest rates in effect on the cardholder's account to rates as high as 30 percent or more, only about half of the cardholders that the usability consultant tested were able to use the typical credit card disclosure documents to successfully identify the default rate and the circumstances that would trigger rate increases for these cards. In addition, the usability consultant observed the cardholders could not identify this information easily. Many also were unsure of their answers, especially when rates were expressed as a "prime plus" number, indicating the rate varied based on the prime rate. Locating information in the typical cardmember agreement was especially difficult for cardholders, as only 3 of 12 cardholders were able to use such documents to identify the default interest rate applicable to the card. More importantly, only about half of the cardholders tested using solicitation letters were able to accurately determine what actions could potentially cause the default rate to be imposed on these cards.

- *Other penalty rate increases.* Although card issuers generally reserve the right to seek to raise a cardholder's rate in other situations, such as when a cardholder makes a late payment to another issuer's credit card, (even if the cardholder has not defaulted on the cardmember

[52]We also used this data in a previous report to show cardholder preferences for customized information in their monthly billing statements about the consequences of making minimum payments on their outstanding balance. GAO-06-434.

[53]For more information about our scope and methodology, see appendix I.

agreement), about 71 percent of the 112 cardholders we interviewed were unsure or did not believe that issuers could increase their rates in such a case. In addition, about two-thirds of cardholders we interviewed were unaware or did not believe that a drop in their credit score could cause an issuer to seek to assess higher interest rates on their account.[54]

- *Late payment fees.* According to the usability assessment, many of the cardholders had trouble using the disclosure documents to correctly identify what would occur if a payment were to be received after the due date printed in the billing statement. For example, nearly half of the cardholders were unable to use the cardmember agreement to determine whether a payment would be considered late based on the date the issuer receives the payment or the date the payment was mailed or postmarked. Additionally, the majority of the 112 cardholders we interviewed also exhibited confusion over late fees: 52 percent indicated that they have been surprised when their card company applied a fee or penalty to their account.

- *Using a credit card to obtain cash.* Although the cardholders tested by the consultant generally were able to use the disclosures to identify how a transaction fee for a cash advance would be calculated, most were unable to accurately use this information to determine the transaction fee for withdrawing funds, usually because they neglected to consider the minimum dollar amount, such as $5 or $10, that would be assessed.

- *Grace periods.* Almost all 12 cardholders in the usability assessment had trouble using the solicitation letters to locate and define the grace period, the period during which the a cardholder is not charged interest on a balance. Instead, many cardholders incorrectly indicated that the grace period was instead when their lower, promotional interest rates would expire. Others incorrectly indicated that it was the amount of time after the monthly bill's due date that a cardholder could submit a payment without being charged a late fee.

- *Balance computation method.* Issuers use various methods to calculate interest charges on outstanding balances, but only 1 of the 12 cardholders the usability consultant tested correctly described average

[54]A credit score is a number, roughly between 300 and 800, that reflects the credit history detailed by a person's credit report. Lenders use borrowers' credit scores in the process of assigning rates and terms to the loans they make.

daily balance, and none of the cardholders were able to describe two-cycle average daily balance accurately. At least nine letters submitted to the Federal Reserve in connection with its review of credit card disclosures noted that few consumers understand balance computation methods as stated in disclosure documents.

Perhaps as a result of weaknesses previously described, cardholders generally avoid using the documents issuers provide with a new card to improve their understanding of fees and practices. For example, many of the cardholders interviewed as part of this report noted that the length, format, and complexity of disclosures led them to generally disregard the information contained in them. More than half (54 percent) of the 112 cardholders we interviewed indicated they read the disclosures provided with a new card either not very closely or not at all. Instead, many cardholders said they would call the issuer's customer service representatives for information about their card's terms and conditions. Cardholders also noted that the ability of issuers to change the terms and conditions of a card at any time led them to generally disregard the information contained in card disclosures. Regulation Z allows card issuers to change the terms of credit cards provided that issuers notify cardholders in writing within 15 days of the change. As a result, the usability consultant observed some participants were dismissive of the information in the disclosure documents because they were aware that issuers could change anything.

Federal Reserve Effort to Revise Regulations Presents Opportunity to Improve Disclosures

With liability concerns and outdated regulatory requirements seemingly explaining the weaknesses in card disclosures, the Federal Reserve has begun efforts to review its requirements for credit card disclosures. Industry participants have advocated various ways in which the Federal Reserve can act to improve these disclosures and otherwise assist cardholders.

Regulations and Guidance May Contribute to Weaknesses in Current Disclosures

Several factors may help explain why typical credit card disclosures exhibit weaknesses that reduce their usefulness to cardholders. First, issuers make decisions about the content and format of their disclosures to limit potential legal liability. Issuer representatives told us that the disclosures made in credit card solicitations and cardmember agreements are written for legal purposes and in language that consumers generally could not understand. For example, representatives for one large issuer told us they cannot always state information in disclosures clearly because the increased potential that simpler statements would be misinterpreted would

expose them to litigation. Similarly, a participant of a symposium on credit card disclosures said that disclosures typically became lengthier after the issuance of court rulings on consumer credit issues. Issuers can attempt to reduce the risk of civil liability based on their disclosures by closely following the formats that the Federal Reserve has provided in its model forms and other guidance. According to the regulations that govern card disclosures, issuers acting in good faith compliance with any interpretation issued by a duly authorized official or employee of the Federal Reserve are afforded protection from liability.[55]

Second, the regulations governing credit card disclosures have become outdated. As noted earlier in this report, TILA and Regulation Z that implements the act's provisions are intended to ensure that consumers have adequate information about potential costs and other applicable terms and conditions to make appropriate choices among competing credit cards. The most recent comprehensive revisions to Regulation Z's open-end credit rules occurred in 1989 to implement the provisions of the Fair Credit and Charge Card Act. As we have found, the features and cost structures of credit cards have changed considerably since then. An issuer representative told us that current Schumer box requirements are not as useful in presenting the more complicated structures of many current cards. For example, they noted that it does not easily accommodate information about the various cardholder actions that could trigger rate increases, which they argued is now important information for consumers to know when shopping for credit. As a result, some of the specific requirements of Regulation Z that are intended to ensure that consumers have accurate information instead may be diminishing the usefulness of these disclosures.

Third, the guidance that the Federal Reserve provides issuers may not be consistent with guidelines for producing clear, written documents. Based on our analysis, many issuers appear to adhere to the formats and model forms that the Federal Reserve staff included in the Official Staff Interpretations of Regulation Z, which are prepared to help issuers comply with the regulations. For example, the model forms present text about how rates are determined in footnotes. However, as discussed previously, not grouping related information undermines the usability of documents. The

[55]Under Section 130(f) of the TILA, creditors are protected from civil liability for any act done or omitted in good faith in conformity with any interpretation issued by a duly authorized official or employee of the Federal Reserve System. 15 U.S.C. § 1640.

Schumer box format requires a cardholder to look in several places, such as in multiple rows in the table and in notes to the table, for information about related aspects of the card. Similarly, the Federal Reserve's model form for the Schumer box recommends that the information about the transaction fee and interest rate for cash advances be disclosed in different areas.

Finally, the way that issuers have implemented regulatory guidance may have contributed to the weaknesses typical disclosure materials exhibited. For example, in certain required disclosures, the terms "annual percentage rate" and "finance charge," when used with a corresponding amount or percentage rate, are required to be more conspicuous than any other required disclosures.[56] Staff guidance suggests that such terms may be made more conspicuous by, for example, capitalizing these terms when other disclosures are printed in lower case or by displaying these terms in larger type relative to other disclosures, putting them in boldface print or underlining them.[57] Our usability consultant's analysis found that card disclosure documents that followed this guidance were less effective because they placed an inappropriate emphasis on terms. As shown previously in figure 11, the use of bold and capital letters to emphasize the term "finance charge" in the paragraph unnecessarily calls attention to that term, potentially distracting readers from information that is more important. The excerpt shown in figure 11 is from an initial disclosure document which, according to Regulation Z, is subject to the "more conspicuous" rule requiring emphasis of the terms "finance charge" and "annual percentage rate."

Suggestions for Improving Disclosures Included Obtaining Input from Consumers

With the intention of improving credit card disclosures, the Federal Reserve has begun efforts to develop new regulations. According to its 2004 notice seeking public comments on Regulation Z, the Federal Reserve hopes to address the length, complexity, and superfluous information of disclosures and produce new disclosures that will be more useful in helping consumers compare credit products.[58] After the passage of the

[56]See generally 12 C.F.R. 225.5(a)(3) and the corresponding staff commentary.

[57]Notwithstanding the more conspicuous rule, Regulation Z expressly provides that the annual percentage rate for purchases required to be disclosed in the Schumer box must be in at least 18-point type. 12 C.F.R. § 226.5a(b)(1).

[58]Truth in Lending, 69 Fed. Reg. 70925 (advanced notice of proposed rulemaking, published Dec. 8, 2004).

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Bankruptcy Act) in October of that year, which included amendments to TILA, the Federal Reserve sought additional comments from the public to prepare to implement new disclosure requirements including disclosures intended to advise consumers of the consequences of making only minimum payments on credit cards.[50] According to Federal Reserve staff, new credit card disclosure regulations may not be in effect until sometime in 2007 or 2008 because of the time required to conduct consumer testing, modify the existing regulations, and then seek comment on the revised regulation.

Industry participants and others have provided input to assist the Federal Reserve in this effort. Based on the interviews we conducted, documents we reviewed, and our analysis of the more than 280 comment letters submitted to the Federal Reserve, issuers, consumer groups, and others provided various suggestions to improve the content and format of credit card disclosures, including:

- *Reduce the amount of information disclosed.* Some industry participants said that some of the information currently presented in the Schumer box could be removed because it is too complicated to disclose meaningfully or otherwise lacks importance compared to other credit terms that are arguably more important when choosing among cards. Such information included the method for computing balances and the amount of the minimum finance charge (the latter because it is typically so small, about 50 cents in 2005).

- *Provide a shorter document that summarizes key information.* Some industry participants advocated that all key information that could significantly affect a cardholder's costs be presented in a short document that consumers could use to readily compare across cards, with all other details included in a longer document. For example, although the Schumer box includes several key pieces of information, it does not include other information that could be as important for consumer decisions, such as what actions could cause the issuer to raise the interest rate to the default rate.

[50]Truth in Lending, 70 Fed. Reg. 60235 (request for comments; extension of comment period, published October 17, 2005).

- *Revise disclosure formats to improve readability.* Various suggestions were made to improve the readability of card disclosures, including making more use of tables of contents, making labels and headings more prominent, and presenting more information in tables instead of in text. Disclosure documents also could use consistent wording that could allow for better comparison of terms across cards.

Some issuers and others also told us that the new regulations should allow for more flexibility in card disclosure formats. Regulations mandating formats and font sizes were seen as precluding issuers from presenting information in more effective ways. For example, one issuer already has conducted market research and developed new formats for the Schumer box that it says are more readable and contain new information important to choosing cards in today's credit card environment, such as cardholder actions that would trigger late fees or penalty interest rate increases.

In addition to suggestions about content, obtaining the input of consumers, and possibly other professionals, was also seen as an important way to make any new disclosures more useful. For example, participants in a Federal Reserve Bank symposium on credit card disclosures recommended that the Federal Reserve obtain the input of marketers, researchers, and consumers as part of developing new disclosures. OCC staff suggested that the Federal Reserve also employ qualitative research methods such as in-depth interviews with consumers and others and that it conduct usability testing.

Consumer testing can validate the effectiveness or measure the comprehension of messages and information, and detect document design problems. Many issuers are using some form of market research to test their disclosure materials and have advocated improving disclosures by seeking the input of marketers, researchers, and consumers.[60] SEC also has recently used consumer focus groups to test the format of new disclosures related to mutual funds. According to an SEC staff member who participated in this effort, their testing provided them with valuable information on what consumers liked and disliked about some of the initial forms that the regulator had drafted. In some cases, they learned that

[60]Consumer testing can be conducted in several ways, such as focus groups, where consumers analyze products in a group setting, and conjoint analysis, which helps companies understand the extent to which consumers prefer certain product attributes over others.

information that SEC staff had considered necessary to include was not seen as important by consumers. As a result, they revised the formats for these disclosures substantially to make them simpler and may use graphics to present more information rather than text.[61] According to Federal Reserve staff, they have begun to involve consumers in the development of new credit card disclosures. According to Federal Reserve staff, they have already conducted some consumer focus groups. In addition, they have contracted with a design consultant and a market research firm to help them develop some disclosure formats that they can then use in one-on-one testing with consumers. However, the Federal Reserve staff told us they recognize the challenge of designing disclosures that include all key information in a clear manner, given the complexity of credit card products and the different ways in which consumers use credit cards.

Although Credit Card Penalty Fees and Interest Could Increase Indebtedness, the Extent to Which They Have Contributed to Bankruptcies Was Unclear

The number of consumers filing for bankruptcy has risen more than six-fold over the past 25 years, and various factors have been cited as possible explanations. While some researchers have pointed to increases in total debt or credit card debt in particular, others found that debt burdens and other measures of financial distress had not increased and thus cite other factors, such as a general decline in the stigma of going bankrupt or the potentially increased costs of major life events such as health problems or divorce. Some critics of the credit card industry have cited penalty interest and fees as leading to increased financial distress; however, no comprehensive data existed to determine the extent to which these charges were contributing to consumer bankruptcies. Data provided by the six largest card issuers indicated that unpaid interest and fees represented a small portion of the amounts owed by cardholders that filed for bankruptcy; however, these data alone were not sufficient to determine any relationship between the charges and bankruptcies filed by cardholders.

Researchers Cited Various Factors as Explanations for Rise in Consumer Bankruptcies

According to U.S. Department of Justice statistics, consumer bankruptcy filings generally rose steadily from about 287,000 in 1980 to more than 2 million as of December 31, 2005, which represents about a 609 percent

[61]Securities Exchange Act Release No. 33-8544 (Feb. 28, 2005).

increase over the last 25 years.[62] Researchers have cited a number of factors as possible explanations for the long-term trend.

Increase in Household Indebtedness

The total debt of American households is composed of mortgages on real estate, which accounts for about 80 percent of the total, and consumer credit debt, which includes revolving credit, such as balances owed on credit cards, and nonrevolving credit, primarily consisting of auto loans. According to Federal Reserve statistics, consumers' use of debt has expanded over the last 25 years, increasing more than sevenfold from $1.4 trillion in 1980 to about $11.5 trillion in 2005. Some researchers pointed to this rise in overall indebtedness as contributing to the rise in bankruptcies. For example, a 2000 Congressional Budget Office summary of bankruptcy research noted that various academic studies have argued that consumer bankruptcies are either directly or indirectly caused by heavy consumer indebtedness.

Rather than total debt, some researchers and others argue that the rise in bankruptcies is related to the rise in credit card debt in particular. According to the Federal Reserve's survey of consumer debt, the amount of credit card debt reported as outstanding rose from about $237 billion to more than $802 billion—a 238 percent increase between 1990 and 2005.[63] One academic researcher noted that the rise in bankruptcies and charge-offs by banks in credit card accounts grew along with the increase in credit card debt during the 1973 to 1996 period he examined.[64] According to some consumer groups, the growth of credit card debt is one of the primary explanations of the increased prevalence of bankruptcies in the United States. For example, one group noted in a 2005 testimony before Congress that growth of credit card debt—particularly among lower and moderate income households, consumers with poor credit scores, college students,

[62]Bankruptcy filings sharply increased recently, with filings in 2005 30 percent higher than in 2004. This increase likely resulted from the accelerated rate of filing that occurred in the months before the new Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which tightened eligibility for filing, became effective on October 17, 2005.

[63]In addition to capturing amounts outstanding on credit cards, the number reported in the Federal Reserve's survey of consumer debt for revolving debt also includes other types of revolving debt. However, Federal Reserve staff familiar with the survey's results indicated that the vast majority of the amount reported as revolving debt is from credit cards.

[64]L. Ausubel, "Credit Card Defaults, Credit Card Profits, and Bankruptcy," *The American Bankruptcy Law Journal*, 71 (Spring 1997).

older Americans, and minorities—was contributing to the rise in bankruptcies.[65]

However, other evidence indicates that increased indebtedness has not severely affected the financial condition of U.S. households in general. For example:

- Some researchers note that the ability of households to make payments on debt appears to be keeping pace. For example, total household debt levels as a percentage of income has remained relatively constant since the 1980s. According to the Federal Reserve, the aggregate debt burden ratio—which covers monthly aggregate required payments of all households on mortgage debt and both revolving and non-revolving consumer loans relative to the aggregate monthly disposable income of all households—for U.S. households has been above 13 percent in the last few years but generally fluctuated between 11 percent and 14 percent from 1990 to 2005, similar to the levels observed during the 1980s. According to one researcher, although the debt burden ratio has risen since the 1980s, the increase has been gradual and therefore cannot explain the six-fold increase in consumer bankruptcy filings over the same period.

- Credit card debt remains a small portion of overall household debt, even among households with the lowest income levels. According to the Federal Reserve, credit card balances as a percentage of total household debt have declined from 3.9 percent of total household debt in 1995 to just 3.0 percent as of 2004.

- The proportion of households that could be considered to be in financial distress does not appear to be increasing significantly. According to the Federal Reserve Board's Survey of Consumer Finances, the proportion of households that could be considered to be in financial distress—those that report debt-to-income ratios exceeding 40 percent and that have had at least one delinquent payment within the last 60 days—was relatively stable between 1995 and 2004. Further, the proportion of the

[65]Consumer Federation of America testimony before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, "*Examining the Current Legal and Regulatory Requirements and Industry Practices for Credit Card Issuers with Respect to Consumer Disclosures and Marketing Efforts*," 109th Congress, 2nd sess., May 17, 2005. We reported on issues relating to college students and credits in 2001. See GAO, *Consumer Finance: College Students and Credit Cards*, GAO-01-773 (Washington, D.C.; June 20, 2001).

lowest-income households exhibiting greater levels of distress was lower in 2004 than it was in the 1990s.

Other Explanations

With the effect of increased debt unclear, some researchers say that other factors may better explain the surge in consumer bankruptcy filings over the past 25 years. For example, the psychological stigma of declaring bankruptcy may have lessened. One academic study examined a range of variables that measured the credit risk (risk of default) of several hundred thousand credit card accounts and found that because the bankruptcy rate for the accounts was higher than the credit-risk variables could explain, the higher rate must be the result of a reduced level of stigma associated with filing.[66] However, others have noted that reliably measuring stigma is difficult. Some credit card issuers and other industry associations also have argued that the pre-2005 bankruptcy code was too debtor-friendly and created an incentive for consumers to borrow beyond the ability to repay and file for bankruptcy.

In addition to the possibly reduced stigma, some academics, consumer advocacy groups, and others noted that the normal life events that reduce incomes or increase expenses for households may have a more serious effect today. Events that can reduce household incomes include job losses, pay cuts, or having a full-time position converted to part-time work. With increasing health care costs, medical emergencies can affect household expenses and debts more significantly than in the past, and, with more families relying on two incomes, so can divorces. As a result, one researcher explains that while these risks have always faced households, their effect today may be more severe, which could explain higher bankruptcy rates.[67]

Researchers who assert that life events are the primary explanation for bankruptcy filings say that the role played by credit cards can vary. They acknowledged that credit card debt can be a contributing factor to a bankruptcy filing if a person's income is insufficient to meet all financial obligations, including payments to credit card issuers. For example, some individuals experiencing an adverse life event use credit cards to provide

[66]David B. Gross and Nicholas S. Souleles, "Explaining the Increase in Bankruptcy and Delinquency: Stigma Versus Risk-Composition." Mimeo, University of Chicago, (August 28, 1998).

[67]Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School, "The Growing Threat to Middle Class Families," *Brooklyn Law Review*, (April 2003).

additional funds to satisfy their financial obligations temporarily but ultimately exhaust their ability to meet all obligations. However, because the number of people that experience financially troublesome life events likely exceeds the number of people who file for bankruptcy, credit cards in other cases may serve as a critical temporary source of funding they needed to avert a filing until that person's income recovers or expenses diminish. (Appendix II provides additional detail about the factors that may have affected the rise in consumer bankruptcy filings and its relationship with credit card debt.)

The Extent to Which Credit Card Penalty Interest and Fees Contribute to Consumer Bankruptcies Remains Controversial in the Absence of Comprehensive Data

With very little information available on the financial condition of individuals filing for bankruptcy, assessing the role played by credit card debt, including penalty interest and fees, is difficult. According to Department of Justice officials who oversee bankruptcy trustees in most bankruptcy courts, the documents submitted as part of a bankruptcy filing show the total debt owed to each card issuer but not how much of this total consists of unpaid principal, interest, or fees. Similarly, these Justice officials told us that the information that credit card issuers submit when their customers reaffirm the debts owed to them—known as proofs of claim—also indicate only the total amount owed. Likewise, the amount of any penalty interest or fees owed as part of an outstanding credit card balance is generally not required to be specified when a credit card issuer seeks to obtain a court judgment that would require payment from a customer as part of a collection case.

Opinions on the Link between Credit Card Practices and Bankruptcies Vary

Although little comprehensive data exist, some consumer groups and others have argued that penalty interest and fees materially harm the financial condition of some cardholders, including those that later file for bankruptcy. Some researchers who study credit card issues argue that high interest rates (applicable to standard purchases) for higher risk cardholders, who are also frequently lower-income households, along with penalty and default interest rates and fees, contribute to more consumer bankruptcy filings. Another researcher who has studied issues relating to credit cards and bankruptcy asserted that consumers focus too much on the introductory purchase interest rates when shopping for credit cards and, as a result, fail to pay close attention to penalty interest rates, default clauses, and other fees that may significantly increase their costs later. According to this researcher, it is doubtful that penalty fees (such as late fees and over-limit fees) significantly affect cardholders' debt levels, but accrued interest charges—particularly if a cardholder is being assessed a

high penalty interest rate—can significantly worsen a cardholder's financial distress.

Some consumer advocacy groups and academics say that the credit card industry practice of raising cardholder interest rates for default or increased risky behavior likely has contributed to some consumer bankruptcy filings. According to these groups, cardholders whose rates are raised under such practices can find it more difficult to reduce their credit card debt and experience more rapid declines in their overall financial conditions as they struggle to make the higher payments that such interest rates may entail. As noted earlier in this report, card issuers have generally ceased practicing universal default, although representatives for four of the six issuers told us that they might increase their cardholder's rates if they saw indications that the cardholder's risk has increased, such as how well they were making payments to other creditors. In such cases, the card issuers said they notify the cardholders in advance, by sending a change in terms notice, and provide an option to cancel the account but keep the original terms and conditions while paying off the balance.

Some organizations also have criticized the credit card industry for targeting lower-income households that they believe may be more likely to experience financial distress or file for bankruptcy. One of the criticisms these organizations have made is that credit card companies have been engaging in bottom-fishing by providing increasing amounts of credit to riskier lower-income households that, as a result, may incur greater levels of indebtedness than appropriate. For example, an official from one consumer advocacy group testified in 2005 that card issuers target lower-income and minority households and that this democratization of credit has had serious negative consequences for these households, placing them one financial emergency away from having to file for bankruptcy.[68] Some consumer advocacy group officials and academics noted that card issuers market high-cost cards, with higher interest rates and fees, to customers with poor credit histories—called subprime customers—including some just coming out of bankruptcy. However, as noted earlier, Federal Reserve survey data indicate that the proportion of lower-income households—those with incomes below the fortieth percentile—exhibiting financial distress has not increased since 1995. In addition, in a June 2006 report that the Federal Reserve Board prepared for Congress on the relationship

[68]See above: Consumer Federation of America testimony before the Committee on Banking, Housing, and Urban Affairs of the United States Senate on May 17, 2005.

between credit cards and bankruptcy, it stated that credit card issuers do not solicit customers or extend credit to them indiscriminately or without assessing their ability to repay debt as issuers review all received applications for risk factors.[69]

In addition, representatives of credit card issuers argued that they do not offer credit to those likely to become financially bankrupt because they do not want to experience larger losses from higher-risk borrowers. Because card accounts belonging to cardholders that filed for bankruptcy account for a sizeable portion of issuers' charge-offs, card issuers do not want to acquire new customers with high credit risk who may subsequently file for bankruptcy. However, one academic researcher noted that, if card issuers could increase their revenue and profits by offering cards to more customers, including those with lower creditworthiness, they could reasonably be expected to do so until the amount of expected losses from bankruptcies becomes larger than the expected additional revenues from the new customers.

In examining the relationship between the consumer credit industry and bankruptcy, the Federal Reserve Board's 2006 report comes to many of the same conclusions as the studies of other researchers we reviewed. The Federal Reserve Board's report notes that despite large growth in the proportion of households with credit cards and the rise in overall credit card debt in recent decades, the debt-burden ratio and other potential measures of financial distress have not significantly changed over this period. The report also found that, while data on bankruptcy filings indicate that most filers have accumulated consumer debt and the proportion of filings and rise in revolving consumer debt have risen in tandem, the decision to file for bankruptcy is complex and tends to be driven by distress arising from life events such as job loss, divorce, or uninsured illness.

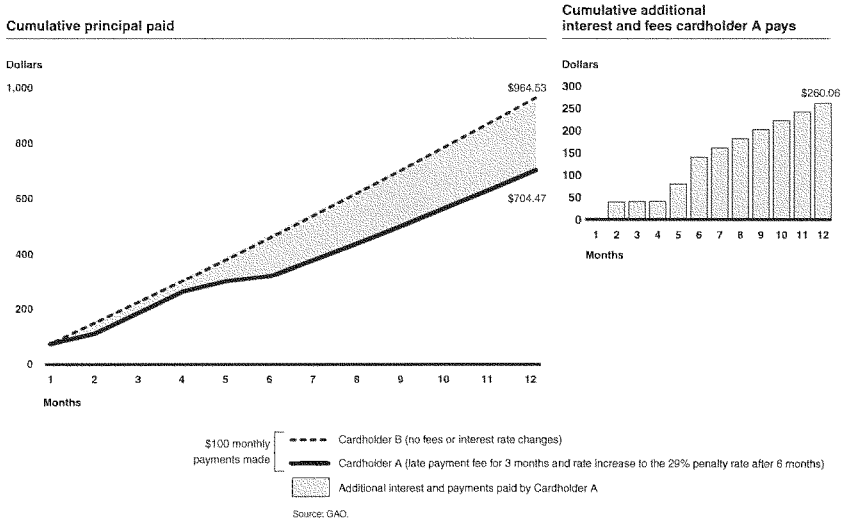
Penalty Interest and Fees Can Affect Cardholders' Ability to Reduce Outstanding Balances

While the effect of credit card penalty interest charges and fees on consumer bankruptcies was unclear, such charges do reduce the ability of cardholders to reduce their overall indebtedness. Generally, any penalty charges that cardholders pay would consume funds that could have been used to repay principal. Figure 16 below, compares two hypothetical

[69]Board of Governors of the Federal Reserve System, *Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency* (Washington, D.C.: June 2006).

cardholders with identical initial outstanding balances of $2,000 that each make monthly payments of $100. The figure shows how the total amounts of principal are paid down by each of these two cardholders over the course of 12 months, if penalty interest and fees apply. Specifically, cardholder A (1) is assessed a late payment fee in three of those months and (2) has his interest rate increased to a penalty rate of 29 percent after 6 months, while cardholder B does not experience any fees or penalty interest charges. At the end of 12 months, the penalty and fees results in cardholder A paying down $260 or 27 percent less of the total balance owed than does cardholder B who makes on-time payments for the entire period.

Figure 16: Hypothetical Impact of Penalty Interest and Fee Charges on Two Cardholders



Source: GAO.

In Some Court Cases, Cardholders Paid Significant Amounts of Penalty Interest and Fees

In reviewing academic literature, hearings, and comment letters to the Federal Reserve, we identified some court cases, including some involving the top six issuers, that indicated that cardholders paid large amounts of penalty interest and fees. For example:

- In a collections case in Ohio, the $1,963 balance on one cardholder's credit card grew by 183 percent to $5,564 over 6 years, despite the cardholder making few new purchases. According to the court's records, although the cardholder made payments totaling $3,492 over this period, the holder's balance grew as the result of fees and interest charges. According to the court's determinations, between 1997 and 2003, the cardholder was assessed a total of $9,056, including $1,518 in over-limit fees, $1,160 in late fees, $369 in credit insurance, and $6,009 in interest charges and other fees. Although the card issuer had sued to collect, the judge rejected the issuer's collection demand, noting that the cardholder was the victim of unreasonable, unconscionable practices.[70]

- In a June 2004 bankruptcy case filed in the U.S. Bankruptcy Court for the Eastern District of Virginia, the debtor objected to the proofs of claim filed by two companies that had been assigned the debt outstanding on two of the debtor's credit cards. One of the assignees submitted monthly statements for the credit card account it had assumed. The court noted that over a two-year period (during which balance on the account increased from $4,888 to $5,499), the debtor made only $236 in purchases on the account, while making $3,058 in payments, all of which had gone to pay finance charges, late charges, over-limit fees, bad check fees and phone payment fees.[71]

- In a bankruptcy court case filed in July 2003 in North Carolina, 18 debtors filed objections to the claims by one card issuer of the amounts owed on their credit cards.[72] In response to an inquiry by the judge, the card issuer provided data for these accounts that showed that, in the

[70]"Comments of the National Consumer Law Center et al. regarding Advance Notice of Proposed Rulemaking Review of the Revolving Credit Rules of Regulation Z," p. 7-9.

[71]*McCarthy vs. eCast Settlement Corporation et al.*, No.04-10493-SSM (Bankr. E.D. Va. filed June 9, 2004).

[72]*See Blair v. Capital One Bank*, No. 02-11400, *Amended Order Overruling Objection to Claim(s)s* (Bankr. W.D. NC filed Feb. 10, 2004) (disposing of, on a consolidated basis, similar objections filed in 18 separate Chapter 13 cases against a common creditor) (Additional docket numbers omitted.).

aggregate, 57 percent of the amounts owed by these 18 accounts at time of their bankruptcy filings represented interest charges and fees. However, the high percentage of interest and fees on these accounts may stem from the size of these principal balances, as some were as low as $95 and none was larger than $1,200.

Regulatory interagency guidance published in 2003 for all depository institutions that issue credit cards may have reduced the potential for cardholders who continue to make minimum payments to experience increasing balances.[73] In this guidance, regulators suggested that card issuers require minimum repayment amounts so that cardholders' current balance would be paid off–amortized–over a reasonable amount of time. In the past, some issuers' minimum monthly payment formulas were such that a full payment may have resulted in little or no principal being paid down, particularly if the cardholder also was assessed any fees during a billing cycle. In such cases, these cardholders' outstanding balances would increase (or negatively amortize). In response to this guidance, some card issuers we interviewed indicated that they have been changing their minimum monthly payment formulas to ensure that credit card balances will be paid off over a reasonable period by including at least some amount of principal in each payment due.

Representatives of card issuers also told us that the regulatory guidance, issued in 2003, addressing credit card workout programs—which allow a distressed cardholder's account to be closed and repaid on a fixed repayment schedule—and other forbearance practices, may help cardholders experiencing financial distress avoid fees. In this guidance, the regulators stated that (1) any workout program offered by an issuer should be designed to have cardholders repay credit card debt within 60 months and (2) to meet this time frame, interest rates and penalty fees may have to be substantially reduced or eliminated so that principal can be repaid. As a result, card issuers are expected to stop imposing penalty fees and interest charges on delinquent card accounts or hardship card accounts enrolled in repayment workout programs. According to this guidance, issuers also can negotiate settlement agreements with cardholders by forgiving a portion of

[73] *Credit Card Lending: Account Management and Loss Allowance Guidance* (January 2003), joint guidance issued under the auspices of the Federal Financial Institutions Examination Council by the Office of the Comptroller of the Currency (OCC Bulletin 2003-1), Federal Reserve (Supervisory Letter SR-03-1), Federal Deposit Insurance Corporation (Financial Institution Letter, FIL-2-2003), and Office of Thrift Supervision (OTS Release 03-01).

the amount owed. In exchange, a cardholder can be expected to pay the remaining balance either in a lump-sum payment or by amortizing the balance over a several month period. Staff from OCC and an association of credit counselors told us that, since the issuance of this guidance, they have noticed that card issuers are increasingly both reducing and waiving fees for cardholders who get into financial difficulty. OCC officials also indicated that issuers prefer to facilitate repayment of principal when borrowers adopt debt management plans and tend to reduce or waive fees so the accounts can be amortized. On the other hand, FDIC staff indicated that criteria for waiving fees and penalties are not publicly disclosed to cardholders. These staff noted that most fee waivers occurs after cardholders call and complain to the issuer and are handled on a case-by-case basis.

Data for Some Bankrupt Cardholders Shows Little in Interest and Fees Owed, but Comprehensive Data Were Not Available

Card issuers generally charge-off credit card loans that are no longer collectible because they are in default for either missing a series of payments or filing for bankruptcy. According to the data provided by the six largest issuers, the number of accounts that these issuers collectively had to charge off as a result of the cardholders filing for bankruptcy ranged from about 1.3 million to 1.6 million annually between 2003 and 2005. Collectively, these represented about 1 percent of the six issuers' active accounts during this period. Also, about 60 percent of the accounts were 2 or more months delinquent at the time of the charge-off. Most of the cardholders whose accounts were charged off as the result of a bankruptcy owed small amounts of fees and interest charges at the time of their bankruptcy filing. According to the data the six issuers provided, the average account that they charged off in 2005 owed approximately $6,200 at the time that bankruptcy was filed. Of this amount, the issuers reported that on average 8 percent represented unpaid interest charges; 2 percent unpaid fees, including any unpaid penalty charges; and about 90 percent principal.

However, these data do not provide complete information about the extent to which the financial condition of the cardholders may have been affected by penalty interest and fee charges. First, the amounts that these issuers reported to us as interest and fees due represent only the unpaid amounts that were owed at the time of bankruptcy. According to representatives of the issuers we contacted, each of their firms allocates the amount of any payment received from their customers first to any outstanding interest charges and fees, then allocates any remainder to the principal balance. As a result, the amounts owed at the time of bankruptcy would not reflect any previously paid fees or interest charges. According to representatives of

these issuers, data system and recordkeeping limitations prevented them from providing us the amounts of penalty interest and fees assessed on these accounts in the months prior to the bankruptcy filings.

Furthermore, the data do not include information on all of the issuers' cardholders who went bankrupt, but only those whose accounts the issuers charged off as the result of a bankruptcy filing. The issuers also charge off the amounts owed by customers who are delinquent on their payments by more than 180 days, and some of those cardholders may subsequently file for bankruptcy. Such accounts may have accrued larger amounts of unpaid penalty interest and fees than the accounts that were charged off for bankruptcy after being delinquent for less than 180 days, because they would have had more time to be assessed such charges. Representatives of the six issuers told us that they do not maintain records on these customers after they are charged off, and, in many cases, they sell the accounts to collection firms.

Although Penalty Interest and Fees Likely Have Grown as a Share of Credit Card Revenues, Large Card Issuers' Profitability Has Been Stable

Determining the extent to which penalty interest charges and fees contribute to issuers' revenues and profits was difficult because issuers' regulatory filings and other public sources do not include such detail. According to bank regulators, industry analysts, and information reported by the five largest issuers, we estimate that the majority of issuer revenues—around 70 percent in recent years—came from interest charges, and the portion attributable to penalty rates appears to be growing. Of the remaining issuer revenues, penalty fees had increased and were estimated to represent around 10 percent of total issuer revenues. The remainder of issuer revenues came from fees that issuers receive for processing merchants' card transactions and other types of consumer fees. The largest credit card-issuing banks, which are generally the most profitable group of lenders, have not greatly increased their profitability over the last 20 years.

Publicly Disclosed Data on Revenues and Profits from Penalty Interest and Fees Are Limited

Determining the extent to which penalty interest and fee charges are contributing to card issuer revenues and profits is difficult because limited information is available from publicly disclosed financial information. Credit card-issuing banks are subject to various regulations that require them to publicly disclose information about their revenues and expenses. As insured commercial banks, these institutions must file reports of their financial condition, known as call reports, each quarter with their respective federal regulatory agency. In call reports, the banks provide

comprehensive balance sheets and income statements disclosing their earnings, including those from their credit card operations. Although the call reports include separate lines for interest income earned, this amount is not further segregated to show, for example, income from the application of penalty interest rates. Similarly, banks report their fee income on the call reports, but this amount includes income from all types of fees, including those related to fiduciary activities, and trading assets and liabilities and is not further segregated to show how much a particular bank has earned from credit card late fees, over-limit fees, or insufficient payment fees.

Another limitation of using call reports to assess the effect of penalty charges on bank revenues is that these reports do not include detailed information on credit card balances that a bank may have sold to other investors through a securitization. As a way of raising additional funds to lend to cardholders, many issuers combine the balances owed on large groups of their accounts and sell these receivables as part of pools of securitized assets to investors. In their call reports, the banks do not report revenue received from cardholders whose balances have been sold into credit card interest and fee income categories.[74] The banks report any gains or losses incurred from the sale of these pooled credit card balances on their call reports as part of noninterest income. Credit card issuing banks generally securitize more than 50 percent of their credit card balances.

Although many card issuers, including most of the top 10 banks, are public companies that must file various publicly available financial disclosures on an ongoing basis with securities regulators, these filings also do not disclose detailed information about penalty interest and fees. We reviewed the public filings by the top five issuers and found that none of the financial statements disaggregated interest income into standard interest and penalty interest charges. In addition, we found that the five banks' public financial statements also had not disaggregated their fee income into penalty fees, service fees, and interchange fees. Instead, most of these card issuers disaggregated their sources of revenue into two broad categories—interest and noninterest income.

[74]In accordance with generally accepted accounting principles (Standards of Financial Accounting Statement 140), when card issuers sell any of their credit card receivables as part of a securitization, they subtract the amount of these receivables from the assets shown on their balance sheets.

Majority of Card Issuer Revenues Came from Interest Charges

Although limited information is publicly disclosed, the majority of credit card revenue appears to have come from interest charges. According to regulators, information collected by firms that analyze the credit card industry, and data reported to us by the five of the six largest issuers, the proportion of net interest revenues to card issuers' total revenues is as much as 71 percent. For example, five of the six largest issuers that provided data to us reported that the proportion of their total U.S. card operations income derived from interest charges ranged from 69 to 71 percent between 2003 and 2005.[75]

[75]One of the top six largest issuers, Discover, Inc., operates its own transaction processing network; the other issuers process card transactions through the networks operated by Visa International or Mastercard. Because this difference could have reduced the comparability of the data we obtained from these issuers, the information on revenue and profitability aggregated by the third party in response to our data request excludes Discover, Inc.

Credit card bank revenue sources

The sources of revenues for credit card banks are different than those of nonfinancial businesses. For example, the profits of a manufacturing business are determined by subtracting its production costs and the other expenses it incurs from the revenues it earns from selling the goods it produces. In contrast, banks' profits are generally derived by subtracting the interest expenses they incur on the sources of funds—such as savings deposits—that they use to make loans from the interest revenues they earn on those loans. The difference between banks' interest revenues and their interest expenses represents their net interest income. To determine the total net income from a bank's operations, any revenues from noninterest sources, such as fees, are added to its net interest income, and then all other expenses, including amounts owed on loans that now appear uncollectible—loan losses—and the expenses of operating the bank, including staff salaries and marketing expenses, are subtracted. Figure 17 shows a simplified example of a typical bank's income statement.

Figure 17: Example of a Typical Bank's Income Statement

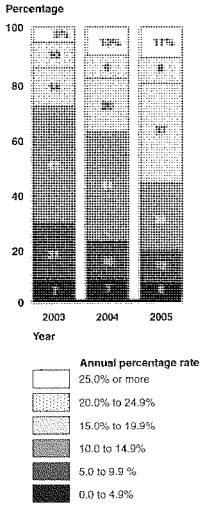
Revenue/expense category	Description
Interest charges ($)/yield (%)	Received from loans to corporate and consumer borrowers, credit card holders carrying balances, etc.
- Cost of funds	Paid on deposits or borrowings from other banks
Net interest income	
+ Noninterest income	From fees or other charges for services paid by borrowers or other customers
Total revenue from operations	
- Credit losses	From the writeoff of amounts of loans or card balances that will not be paid by borrowers who have defaulted
Net risk-adjusted revenue	
- Noninterest expenses	Operating expenses such as postage, utilities, etc., for staff and other noninterest expenses
- Fraud losses	
Noninterest expense + fraud losses	
+ Pre-tax income	
- Taxes	
Net income	

Source: GAO analysis of data reported by the six largest credit card issuers.

We could not precisely determine the extent to which penalty interest charges contribute to this revenue, although the amount of penalty interest that issuers have been assessing has increased. In response to our request, the six largest issuers reported the proportions of their total cardholder accounts that were assessed various rates of interest for 2003 to 2005. On the basis of our analysis of the popular cards issued by these largest issuers, all were charging, on average, default interest rates of around 27 percent. According to the data these issuers provided, the majority of cardholders paid interest rates below 20 percent, but the proportion of their cardholders that paid interest rates at or above 25 percent—which likely represent default rates—has risen from 5 percent in 2003 to 11 percent in 2005. As shown in Figure 18, the proportion of cardholders paying between 15 and 20 percent has also increased, but an issuer representative told us that this likely was due to variable interest rates on

cards rising as a result of increases in U.S. market interest rates over the last 3 years.

Figure 18: Proportion of Active Accounts of the Six Largest Card Issuers with Various Interest Rates for Purchases, 2003 to 2005



Source: GAO analysis of data reported by the six largest credit card issuers.

Although we could not determine the amounts of penalty interest the card issuers received, the increasing proportion of accounts assessed rates of 25 percent suggests a significant increase in interest revenues. For example, a cardholder carrying a stable balance of $1,000 and paying 10 percent interest would pay approximately $100 annually, while a cardholder carrying the same stable balance but paying 25 percent would pay $250 to the card issuer annually. Although we did not obtain any information on the

size of balances owed by the cardholders of the largest issuers, the proportion of the revenues these issuers received from cardholders paying penalty interest rates may also be greater than 11 percent because such cardholders may have balances larger than the $2,500 average for 2005 that the issuers reported to us.

Fees Represented the Remainder of Issuer Revenues

The remaining card issuer revenues largely come from noninterest sources, including merchant and consumer fees. Among these are penalty fees and other consumer fees, as well as fees that issuers receive as part of processing card transactions for merchants.

Penalty Fees Had Increased

Although no comprehensive data exist publicly, various sources we identified indicated that penalty fees represent around 10 percent of issuers' total revenues and had generally increased. We identified various sources that gave estimates of penalty fee income as a percentage of card issuers' total revenues that ranged from 9 to 13 percent:

- Analysis of the data the top six issuers provided to us indicated that each of these issuers assessed an average of about $1.2 billion in penalty fees for cardholders that made late payments or exceeded their credit limit in 2005. In total, these six issuers reported assessing $7.4 billion for these two penalty fees that year, about 12 percent of the $60.3 billion in total interest and consumer fees (penalty fees and fees for other cardholder services).[76]

- According to a private firm that assists credit card banks with buying and selling portfolios of credit card balance receivables, penalty fees likely represented about 13 percent of total card issuer revenues. According to an official with this firm, it calculated this estimate by using information from 15 of the top 20 issuers, as well as many smaller banks, that together represent up to 80 percent of the total credit card industry.[77]

[76]We were not provided information on the portion of revenues these issuers earned from these penalty fees and consumer fees.

[77]Although we were not able to completely assess the reliability of this organization's data and its methods for making its estimates of industry revenue components, we present this information because it appeared to be similar to the proportions reported by the top six issuers that provided us data.

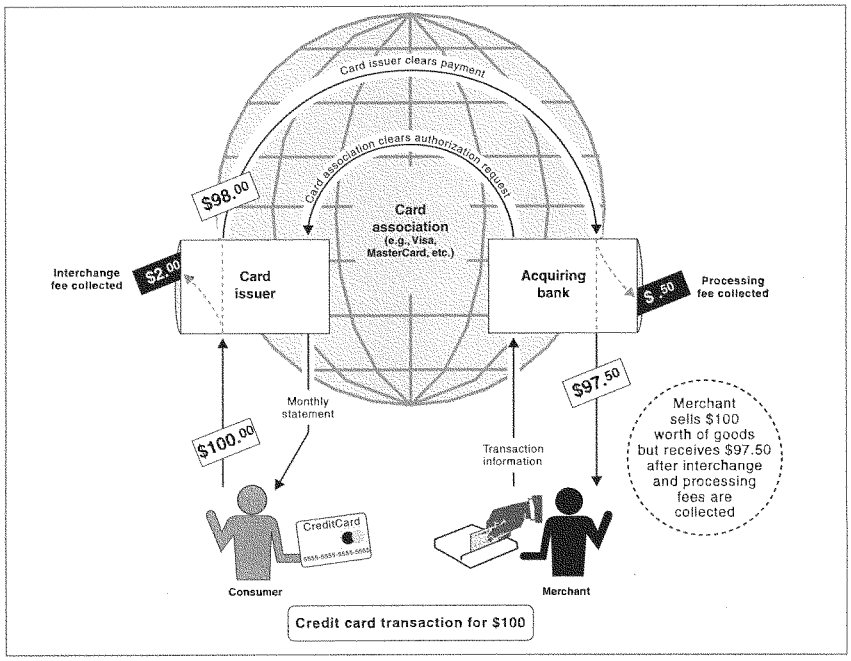
- An estimate from an industry research firm that publishes data on credit card issuer activities indicated that penalty fees represented about 9 percent of issuer total revenues.

Issuers Also Collect Revenues from Processing Merchant Card Transactions

When a consumer makes a purchase with a credit card, the merchant selling the goods does not receive the full purchase price. When the cardholder presents the credit card to make a purchase, the merchant transmits the cardholder's account number and the amount of the transaction to the merchant's bank.[78] The merchant's bank forwards this information to the card association, such as Visa or Mastercard, requesting authorization for the transaction. The card association forwards the authorization request to the bank that issued the card to the cardholder. The issuing bank then responds with its authorization or denial to the merchant's bank and then to the merchant. After the transaction is approved, the issuing bank will send the purchase amount, less an interchange fee, to the merchant's bank. The interchange fee is established by the card association. Before crediting the merchant's account, the merchant's bank will subtract a servicing fee. These transaction fees—called interchange fees—are commonly about 2 percent of the total purchase price. As shown in figure 19, the issuing banks generally earn about $2.00 for every $100 purchased as interchange fee revenue. In addition, the card association receives a transaction processing fee. The card associations, such as Visa or Mastercard, assess the amount of these fees and also conduct other important activities, including imposing rules for issuing cards, authorizing, clearing and settling transactions, advertising and promoting the network brand, and allocating revenues among the merchants, merchant's bank, and card issuer.

[78]The bank that a merchant uses to process its credit card transactions is known as the acquiring bank.

Figure 19: Example of a Typical Credit Card Purchase Transaction Showing How Interchange Fees Paid by Merchants Are Allocated



Sources: GAO (analysis); Art Explosion (images).

In addition to penalty fees and interchange fees, the remaining noninterest revenues for card issuers include other consumer fees or other fees. Card issuers collect annual fees, cash advance fees, balance transfer fees, and other fees from their cardholders. In addition, card issuers collect other

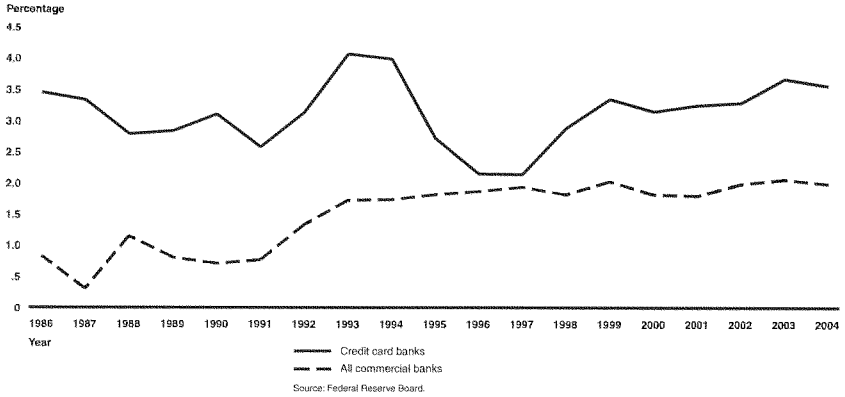
revenues, such as from credit insurance. According to estimates by industry analyst firms, such revenues likely represented about 8 to 9 percent of total issuer revenues.

Large Credit Card Issuer Profitability Has Been Stable

The profits of credit card-issuing banks, which are generally the most profitable group of lenders, have been stable over the last 7 years. A commonly used indicator of profitability is the return on assets ratio (ROA). This ratio, which is calculated by dividing a company's income by its total assets, shows how effectively a business uses its assets to generate profits. In annual reports to Congress, the Federal Reserve provides data on the profitability of larger credit card issuers—which included 17 banks in 2004.[79] Figure 20 shows the average ROA using pretax income for these large credit card issuers compared with pretax ROA of all commercial banks during the period 1986 to 2004. In general, the large credit card issuers earned an average return of 3.12 percent over this period, which was more than twice as much as the 1.49 percent average returns earned by all commercial banks.

[79]See Federal Reserve System, *Profitability of Credit Card Operations*, June 2005. The data included in these reports are for all commercial banks with at least $200 million in yearly average assets (loans to individuals plus securitizations) and at least 50 percent of assets in consumer lending, of which 90 percent must be in the form of revolving credit.

Figure 20: Average Pretax Return on Assets for Large Credit Card Banks and All Commercial Banks, 1986 to 2004



Source: Federal Reserve Board.

As shown in the figure above, the ROA for larger credit card banks, although fluctuating more widely during the 1990s, has generally been stable since 1999, with returns in the 3.0 to 3.5 percent range. The return on assets for the large card issuers peaked in 1993 at 4.1 percent and has declined to 3.55 percent in 2004. In contrast, the profitability of all commercial banks has been generally increasing over this period, rising more than 140 percent between 1986 and 2004. Similar to the data for all larger credit card issuers, data that five of the six largest issuers provided to us indicated that their profitability also has been stable in the 3 years between 2003 and 2005. These five issuers reported that the return on their pretax earnings over their credit card balances over this 3-year period ranged from about 3.6 percent to 4.1 percent.

Because of the high interest rates that issuers charge and variable rate pricing, credit card lending generally is the most profitable type of consumer lending, despite the higher rate of loan losses that issuers incur on cards. Rates charged on credit cards generally are the highest of any consumer lending category because they are extensions of credit that are not secured by any collateral from the borrower. In contrast, other

common types of consumer lending, such as automobile loans or home mortgages, involve the extension of a fixed amount of credit under fixed terms of repayment that are secured by the underlying asset—the car or the house—which the lender can repossess in the event of nonpayment by the borrower. Collateral and fixed repayment terms reduce the risk of loss to the lender, enabling them to charge lower interest rates on such loans. In contrast, credit card loans, which are unsecured, available to large and heterogeneous populations, and repayable on flexible terms at the cardholders' convenience, present greater risks and have commensurately higher interest rates. For example, according to Federal Reserve statistics, the interest rate charged on cards by lenders generally has averaged above 16 percent since 1980, while the average rate charged on car loans since then has averaged around 10 percent. Borrowers may be more likely to cease making payments on their credit cards if they become financially distressed than they would on other loans that are secured by an asset they could lose. For example, the percentage of credit card loans that banks have had to charge off averaged above 4 percent between 2003 and 2005; in contrast, charge-offs for other types of consumer loans average about 2 percent, with charge-offs for mortgage loans averaging less than 1 percent, during those 3 years. (App. III provides additional detail about the factors that affect the profitability of credit card issuers.)

Conclusions

Credit cards provide various benefits to their cardholders, including serving as a convenient way to pay for goods and services and providing additional funds at rates of interest generally lower than those consumers would have paid to borrow on cards in the past. However, the penalties for late payments or other behaviors involving card use have risen significantly in recent years. Card issuers note that their use of risk-based pricing structures with multiple interest rates and fees has allowed them to offer credit cards to cardholders at costs that are commensurate with the risks presented by different types of customers, including those who previously might not have been able to obtain credit cards. On the whole, a large number of cardholders experience greater benefits—either by using their cards for transactions without incurring any direct expense or by enjoying generally lower costs for borrowing than prevailed in the past—from using credit cards than was previously possible, but the habits or financial circumstances of other cardholders also could result in these consumers facing greater costs than they did in the past.

The expansion and increased complexity of card rates, fees, and issuer practices has heightened the need for consumers to receive clear

disclosures that allow them to more easily understand the costs of using cards. In the absence of any regulatory or legal limits on the interest or fees that cards can impose, providing consumers with adequate information on credit card costs and practices is critical to ensuring that vigorous competition among card issuers produces a market that provides the best possible rates and terms for U.S. consumers. Our work indicates that the disclosure materials that the largest card issuers typically provided under the existing regulations governing credit cards had many serious weaknesses that reduced their usefulness to the consumers they are intended to help. Although these regulations likely were adequate when card rates and terms were less complex, the disclosure materials they produce for cards today, which have a multitude of terms and conditions that can affect cardholders' costs, have proven difficult for consumers to use in finding and understanding important information about their cards. Although providing some key information, current disclosures also give prominence to terms, such as minimum finance charge or balance computation method, that are less significant to consumers' costs and do not adequately emphasize terms such as those cardholder actions that could cause their card issuer to raise their interest rate to a high default rate. Because part of the reason that current disclosure materials may be less effective is that they were designed in an era when card rates and terms were less complex, the Federal Reserve also faces the challenge of creating disclosure requirements that are more flexible to allow them to be adjusted more quickly as new card features are introduced and others become less common.

The Federal Reserve, which has adopted these regulations, has recognized these problems, and its current review of the open-end credit rules of Regulation Z presents an opportunity to improve the disclosures applicable to credit cards. Based on our work, we believe that disclosures that are simpler, better organized, and use designs and formats that comply with best practices and industry standards for readability and usability would be more effective. Our work and the experiences of other regulators also confirmed that involving experts in readability and testing documents with actual consumers can further improve any resulting disclosures. The Federal Reserve has indicated that it has begun to involve consumers in the design of new model disclosures, but it has not completed these efforts to date, and new model disclosures are not expected to be issued until 2007 or 2008. Federal Reserve staff noted that they recognize the challenge of how best to incorporate the variety of information that consumers may need to understand the costs of their cards in clear and concise disclosure materials. Until such efforts are complete, consumers will continue to face

difficulties in using disclosure materials to better understand and compare costs of credit cards. In addition, until more understandable disclosures are issued, the ability of well-informed consumers to spur additional competition among issuers in credit card pricing is hampered.

Definitively determining the extent to which credit card penalty interest and fees contribute to personal bankruptcies and the profits and revenues of card issuers is difficult given the lack of comprehensive, publicly available data. Penalty interest and fees can contribute to the total debt owed by cardholders and decrease the funds that a cardholder could have used to reduce debt and possibly avoid bankruptcy. However, many consumers file for bankruptcy as the result of significant negative life events, such as divorces, job losses, or health problems, and the role that credit cards play in avoiding or accelerating such filings is not known. Similarly, the limited available information on card issuer operations indicates that penalty fees and interest are a small but growing part of such firms' revenues. With the profitability of the largest card issuers generally being stable over recent years, the increased revenues gained from penalty interest and fees may be offsetting the generally lower amounts of interest that card issuers collect from the majority of their cardholders. These results appear to indicate that while most cardholders likely are better off, a smaller number of cardholders paying penalty interest and fees are accounting for more of issuer revenues than they did in the past. This further emphasizes the importance of taking steps to ensure that all cardholders receive disclosures that help them clearly understand their card costs and how their own behavior can affect those costs.

Recommendation for Executive Action

As part of its effort to increase the effectiveness of disclosure materials used to inform consumers of rates, fees, and other terms that affect the costs of using credit cards, the Chairman, Federal Reserve should ensure that such disclosures, including model forms and formatting requirements, more clearly emphasize those terms that can significantly affect cardholder costs, such as the actions that can cause default or other penalty pricing rates to be imposed.

Agency Comments and Our Evaluation

We provided a draft of this report to the Federal Reserve, OCC, FDIC, the Federal Trade Commission, the National Credit Union Administration, and the Office of Thrift Supervision for their review and comment. In a letter from the Federal Reserve, the Director of the Division of Consumer and

Community Affairs agreed with the findings of our report that credit card pricing has become more complex and that the disclosures required under Regulation Z could be improved with the input of consumers. To this end, the Director stated that the Board is conducting extensive consumer testing to identify the most important information to consumers and how disclosures can be simplified to reduce current complexity. Using this information, the Director said that the Board would develop new model disclosure forms with the assistance of design consultants. If appropriate, the Director said the Board may develop suggestions for statutory changes for congressional consideration.

We also received technical comments from the Federal Reserve and OCC, which we have incorporated in this report as appropriate. FDIC, the Federal Trade Commission, the National Credit Union Administration, and the Office of Thrift Supervision did not provide comments.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this report. At that time, we will send copies of this report to the Chairman, Permanent Subcommittee on Investigations, Senate Committee on Homeland Security and Governmental Affairs; the Chairman, FDIC; the Chairman, Federal Reserve; the Chairman, Federal Trade Commission; the Chairman, National Credit Union Administration; the Comptroller of the Currency; and the Director, Office of Thrift Supervision and to interested congressional committees. We will also make copies available to others upon request. The report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or woodd@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

Sincerely yours,

David G. Wood

David G. Wood
Director, Financial Markets
and Community Investment

Objectives, Scope and Methodology

Our objectives were to determine (1) how the interest, fees, and other practices that affect the pricing structure of cards from the largest U.S. issuers have evolved, and cardholders' experiences under these pricing structures in recent years; (2) how effectively the issuers disclose the pricing structures of cards to their cardholders; (3) whether credit card debt and penalty interest and fees contribute to cardholder bankruptcies; and (4) the extent to which penalty interest and fees contribute to the revenues and profitability of issuers' credit card operations.

Methodology for Identifying the Evolution of Pricing Structures

To identify how the pricing structure of cards from the largest U.S. issuers has evolved, we analyzed disclosure documents from 2003 to 2005 for 28 popular cards that were issued by the six largest U.S. card issuers, as measured by total outstanding receivables as of December 31, 2004 (see fig. 2 in the body of this report). These issuers were Bank of America; Capital One Bank; Chase Bank USA, N.A.; Citibank (South Dakota), N.A.; Discover Financial Services; and MBNA America Bank, N.A. Representatives for these six issuers identified up to five of their most popular cards and provided us actual disclosure materials, including cardmember agreements and direct mail applications and solicitations used for opening an account for each card. We calculated descriptive statistics for various interest rates and fees and the frequency with which cards featured other practices, such as methods for calculating finance charges. We determined that these cards likely represented the pricing and terms that applied to the majority of U.S. cardholders because the top six issuers held almost 80 percent of consumer credit card debt and as much as 61 percent of total U.S. credit card accounts.

We did not include in our analysis of popular cards any cards offered by credit card issuers that engage primarily in subprime lending. Subprime lending generally refers to extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Such issuers could have pricing structures and other terms significantly different to those of the popular cards offered by the top issuers. As a result, our analysis may underestimate the range of interest rate and fee levels charged on the entire universe of cards. To identify historical rate and fee levels, we primarily evaluated the Federal Reserve Board's G.19 Consumer Credit statistical release for 1972 to 2005 and a paper written by a Federal Reserve Bank

staff, which included more than 150 cardmember agreements from 15 of the largest U.S. issuers in 1997 to 2002.[1]

To evaluate cardholders' experiences with credit card pricing structures in recent years, we obtained proprietary data on the extent to which issuers assessed various interest rate levels and fees for active accounts from the six largest U.S. issuers listed above for 2003, 2004, and 2005. We obtained data directly from issuers because no comprehensive sources existed to show the extent to which U.S. cardholders were paying penalty interest rates. Combined, these issuers reported more than 180 million active accounts, or about 60 percent of total active accounts reported by CardWeb.com, Inc. These accounts also represented almost $900 billion in credit card purchases in 2005, according to these issuers. To preserve the anonymity of the data, these issuers engaged legal counsel at the law firm Latham & Watkins, LLP, to which they provided their data on interest rate and fee assessments, which then engaged Argus Information and Advisory Services, LLC, a third-party analytics firm, to aggregate the data, and then supplied it to us. Although we originally provided a more comprehensive data request to these issuers, we agreed to a more limited request with issuer representatives as a result of these firms' data availability and processing limitations. We discussed steps that were taken to attempt to ensure that the data provided to us were complete and accurate with representatives of these issuers and the third party analytics firm. We also shared a draft of this report with the supervisory agencies of these issuers. However, we did not have access to the issuers' data systems to fully assess the reliability of the data or the systems that housed them. Therefore, we present these data in our report only as representations made to us by the six largest issuers.

Methodology for Assessing Effectiveness of Disclosures

To determine how effectively card issuers disclose to cardholders the rates, fees, and other terms related to their credit cards, we contracted with UserWorks, Inc., a private usability consulting firm, which conducted three separate evaluations of a sample of disclosure materials. We provided the usability consultant with a cardmember agreement and solicitation letter for one card from four representative credit card issuers—a total of four cards and eight disclosure documents. The first evaluation, a readability assessment, used computer-facilitated formulas to predict the grade level

[1]M. Furletti, "Credit Card Pricing Developments and Their Disclosure," Federal Reserve Bank of Philadelphia's Payment Cards Center, January 2003.

required to understand the materials. Readability formulas measure the elements of writing that can be subjected to mathematical calculation, such as average number of syllables in words or numbers of words in sentences in the text. The consultant applied the following industry-standard formulas to the documents: Flesch Grade Level, Frequency of Gobbledygook (FOG), and the Simplified Measure of Gobbledygook (SMOG). Using these formulas, the consultant measured the grade levels at which the disclosure documents were written overall, as well as for selected sections. Secondly, the usability consultant conducted an heuristic evaluation that assessed how well these card disclosure documents adhered to a recognized set of principles or industry best practices. In the absence of best practices specifically applicable to credit card disclosures, the consultant used guidelines from the U.S. Securities and Exchange Commission's 1998 guidebook *Plain English Handbook: How to Create Clear SEC Disclosure Documents*.

Finally, the usability consultant tested how well actual consumers were able to use the documents to identify and understand information about card fees and other practices and used the results to identify problem areas. The consultant conducted these tests with 12 consumers.[2] To ensure sample diversity, the participants were selected to represent the demographics of the U.S. adult population in terms of education, income, and age. While the materials used for the readability and usability assessments appeared to be typical of the large issuers' disclosures, the results cannot be generalized to materials that were not reviewed.

To obtain additional information on consumers' level of awareness and understanding of their key credit card terms, we also conducted in-depth, structured interviews in December 2005 with a total of 112 adult cardholders in three locations: Boston, Chicago, and San Francisco.[3] We contracted with OneWorld Communications, Inc., a market research organization, to recruit a sample of cardholders that generally resembled the demographic makeup of the U.S. population in terms of age, education levels, and income. However, the cardholders recruited for the interviews did not form a random, statistically representative sample of the U.S.

[2]According to the consultant, testing with small numbers of individuals can generally identify many of the problems that can affect the readability and usability of materials.

[3]We conducted these interviews when preparing our report on the feasibility and usefulness of requiring additional disclosures to cardholders on the consequences of making only the minimum payment on their cards.

population and therefore cannot be generalized to the population of all U.S. cardholders. Cardholders had to speak English, have owned at least one general-purpose credit card for a minimum of 12 months, and have not participated in more than one focus group or similar in-person study in the 12 months prior to the interview. We gathered information about the cardholders' knowledge of credit card terms and conditions, and assessed cardholders' use of card disclosure materials by asking them a number of open- and closed-ended questions.

Methodology for Determining How Penalty Charges Contribute to Bankruptcy

To determine whether credit card debt and penalty interest and fees contribute to cardholder bankruptcies, we interviewed Department of Justice staff responsible for overseeing bankruptcy courts and trustees about the availability of data on credit card penalty charges in materials submitted by consumers or issuers as part of bankruptcy filings or collections cases. We also interviewed two attorneys that assist consumers with bankruptcy filings. In addition, we reviewed studies that analyzed credit card and bankruptcy issues published by various academic researchers, the Congressional Research Service, and the Congressional Budget Office. We did not attempt to assess the reliability of all of these studies to the same, full extent. However, because of the prominence of some of these data sources, and frequency of use of this data by other researchers, as well as the fact that much of the evidence is corroborated by other evidence, we determined that citing these studies was appropriate.

We also analyzed aggregated card account data provided by the six largest issuers (as previously discussed) to measure the amount of credit card interest charges and fees owed at the time these accounts were charged off as a result of becoming subject to bankruptcy filing. We also spoke with representatives of the largest U.S. credit card issuers, as well as representatives of consumer groups and industry associations, and with academic researchers that conduct analysis on the credit card industry.

Methodology for Determining How Penalty Charges Contribute to Issuer Revenues

To determine the extent to which penalty interest and fees contributed to the revenues and profitability of issuers' credit card operations, we reviewed the extent to which penalty charges are disclosed in bank regulatory reports—the call reports—and in public disclosures—such as annual reports (10-Ks) and quarterly reports (10-Qs) made by publicly traded card issuers. We analyzed data reported by the Federal Reserve on the profitability of commercial bank card issuers with at least $200 million in yearly average assets (loans to individuals plus securitizations) and at

least 50 percent of assets in consumer lending, of which 90 percent must be in the form of revolving credit. In 2004, the Federal Reserve reported that 17 banks had card operations with at least this level of activity in 2004. We also analyzed information from the Federal Deposit Insurance Corporation, which analyzes data for all federally insured banks and savings institutions and publishes aggregated data on those with various lending activity concentrations, including a group of 33 banks that, as of December 2005, had credit card operations that exceeded 50 percent of their total assets and securitized receivables.

We also analyzed data reported to us by the six largest card issuers on their revenues and profitability of their credit card operations for 2003, 2004, and 2005. We also reviewed data on revenues compiled by industry analysis firms, including *Card Industry Directory* published by Sourcemedia, and R.K. Hammer. Because of the proprietary nature of their data, representatives for Sourcemedia and R.K. Hammer were not able to provide us with information sufficient for us to assess the reliability of their data. However, we analyzed and presented some information from these sources because we were able to corroborate their information with each other and with data from sources of known reliability, such as regulatory data, and we attribute their data to them.

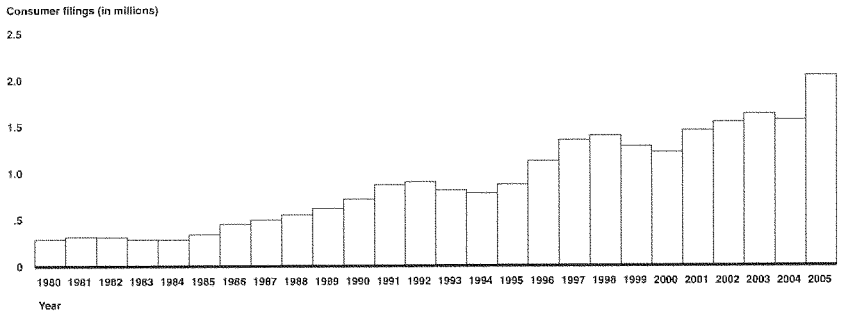
We also interviewed broker-dealer financial analysts who monitor activities by credit card issuers to identify the extent to which various sources of income contribute to card issuers' revenues and profitability. We attempted to obtain the latest in a series of studies of card issuer profitability that Visa, Inc. traditionally has compiled. However, staff from this organization said that this report is no longer being made publicly available.

We discussed issues relevant to this report with various organizations, including representatives of 13 U.S. credit card issuers and card networks, 2 trade associations, 4 academics, 4 federal bank agencies, 4 national consumer interest groups, 2 broker dealer analysts that study credit card issuers for large investors, and a commercial credit-rating agency. We also obtained technical comments on a draft of this report from representatives of the issuers that supplied data for this study.

Consumer Bankruptcies Have Risen Along with Debt

Consumer bankruptcies have increased significantly over the past 25 years. As shown in figure 21 below, consumer bankruptcy filings rose from about 287,000 in 1980 to more than 2 million as of December 31, 2005, about a 609 percent increase over the last 25 years.[1]

Figure 21: U.S. Consumer Bankruptcy Filings, 1980-2005



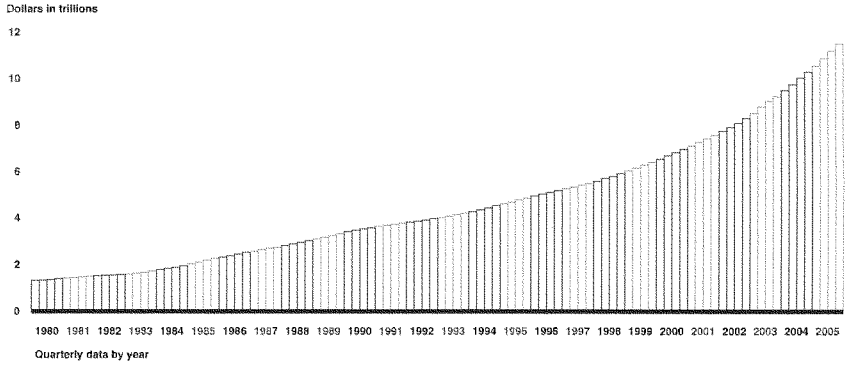
Source: GAO analysis of Congressional Research Service report and Administrative Office of the United States Courts data.

Debt Levels Have Also Risen

The expansion of consumers' overall indebtedness is one of the explanations cited for the significant increase in bankruptcy filings. As shown in figure 22, consumers' use of debt has expanded over the last 25 years, increasing more than 720 percent from about $1.4 trillion in 1980 to about $11.5 trillion in 2005.

[1]Of the filings in 2005, approximately 80 percent were Chapter 7 cases and the other 20 percent were Chapter 13 cases.

Figure 22: U.S. Household Debt, 1980-2005



Source: Board of Governors of the Federal Reserve System.

Some researchers have been commenting on the rise in overall indebtedness as a contributor to the rise in bankruptcies for some time. For example, in a 1997 congressional testimony, a Congressional Budget Office official noted that the increase in consumer bankruptcy filings and the increase in household indebtedness appeared to be correlated.[2] Also, an academic paper that summarized existing literature on bankruptcy found that some consumer bankruptcies were either directly or indirectly caused by heavy consumer indebtedness, specifically pointing to the high correlation between consumer bankruptcies and consumer debt-to-income ratios.[3]

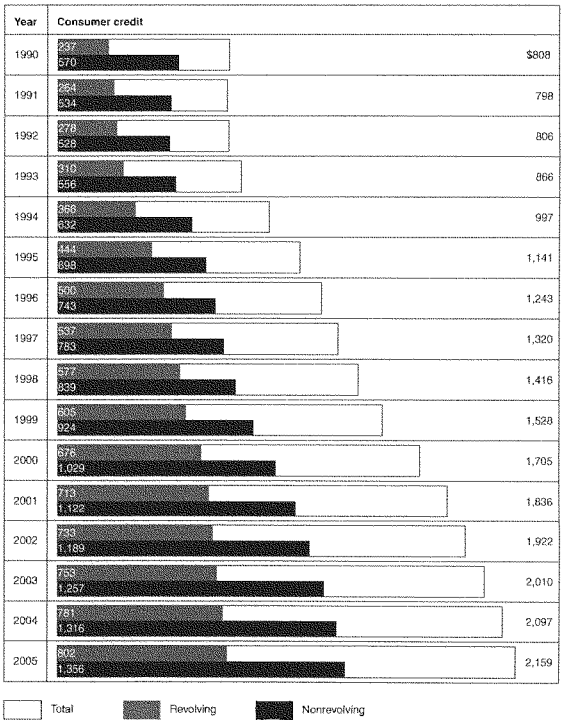
[2]Kim Kowalewski, "Consumer Debt and Bankruptcy," Congressional Budget Office testimony before the United States Senate Subcommittee on Administrative Oversight and the Courts, Committee on the Judiciary, 105th Congress, 1st sess., Apr. 11, 1997.

[3]Todd J. Zywicki, "An Economic Analysis of the Consumer Bankruptcy Crisis," *Northwestern University Law Review*, 99, no.4, (2005).

Beyond total debt, some researchers and others argue that the rise in bankruptcies also was related to the rise in credit debt, in particular. As shown in figure 23, the amount of credit card debt reported also has risen from $237 billion to about $802 billion—a 238 percent increase between 1990 and 2005.[4]

[4]In addition to capturing amounts outstanding on credit cards, the number reported in the Federal Reserve's survey of consumer debt for revolving debt also includes other types of revolving debt. However, Congressional Research Service staff familiar with the survey's results indicated that the vast majority of the amount reported as revolving debt is from credit cards.

Figure 23: Credit Card and Other Revolving and Nonrevolving Debt Outstanding, 1990 to 2005



Source: GAO analysis of Congressional Research Service report data.

Increased Access to Credit Cards by Lower-income Households Raised Concerns

Rather than total credit card debt alone, some researchers argued that growth in credit card use and indebtedness by lower-income households has contributed to the rise in bankruptcies. In the survey of consumer finances conducted every 3 years, the Federal Reserve reports on the use and indebtedness on credit cards by households overall and also by income percentiles. As shown in figure 24 below, the latest Federal Reserve survey results indicated the greatest increase of families reporting credit card debt occurred among those in the lowest 20 percent of household income between 1998 and 2001.

Figure 24: Percent of Households Holding Credit Card Debt by Household Income, 1998, 2001, and 2004

Percentile of income	1998	2001	2004
Less than 20	24.5	30.3	28.8
20-39.9	40.9	44.5	42.9
40-59.9	50.1	52.8	55.1
60-79.9	57.4	52.6	56.0
80-89.9	53.1	50.3	57.6
90-100	42.1	33.1	38.5
All	44.1	44.4	46.2

Source: Federal Reserve Board's Survey of Consumer Finances.

In the last 15 years, credit card companies have greatly expanded the marketing of credit cards, including to households with lower incomes than previously had been offered cards. An effort by credit card issuers to expand its customer base in an increasingly competitive market dramatically increased credit card solicitations. According to one study, more than half of credit cards held by consumers are the result of receiving

mail solicitations.[5] According to another academic research paper, credit card issuers have increased the number of mail solicitations they send to consumers by more than five times since 1990, from 1.1 billion to 5.23 billion in 2004, or a little over 47 solicitations per household. The research paper also found that wealthier families receive the highest number of solicitations but that low-income families were more likely to open them.[6] As shown in figure 25 above, the Federal Reserve's survey results indicated that the number of lower income households with credit cards has also grown the most during 1998 to 2001, reflecting issuers' willingness to grant greater access to credit cards to such households than in the past.

Levels of Financial Distress Have Remained Stable among Households

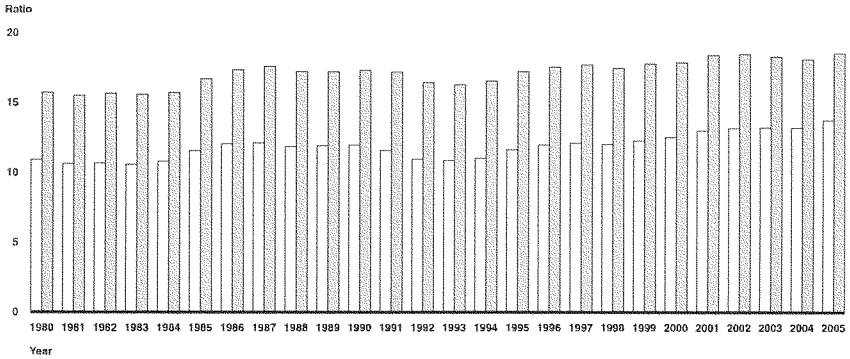
The ability of households to make the payments on their debt appeared to be keeping pace with their incomes as their total household debt burden levels—which measure their payments required on their debts as percentage of household incomes—have remained relatively constant since the 1980s. As shown below in figure 25, Federal Reserve statistics show that the aggregate debt burden ratio for U.S. households has generally fluctuated between 10.77 percent to 13.89 percent between 1990 to 2005, which are similar to the levels for this ratio that were observed during the 1980s. Also shown in figure 25 are the Federal Reserve's statistics on the household financial obligations ratio, which compares the total payments that a household must make for mortgages, consumer debt, auto leases, rent, homeowners insurance, and real estate taxes to its after-tax income. Although this ratio has risen from around 16 percent in 1980 to over 18 percent in 2005—representing an approximately 13 percent increase—Federal Reserve staff researchers indicated that it does not necessarily indicate an increase in household financial stress because

[5]Vertis, "*Financial Direct Mail Readers Interested in Credit Card Offers*," (Jan. 25, 2005), cited in the Consumer Federation of America testimony before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, "*Examining the Current Legal and Regulatory Requirements and Industry Practices for Credit Card Issuers with Respect to Consumer Disclosures and Marketing Efforts*," 109th Congress, 2nd sess., May, 17, 2005.

[6]Amdetsion Kidane and Sandip Mukerji, "Characteristics of Consumers Targeted and Neglected by Credit Card Companies," *Financial Services Review*, 13, no. 3, (2004), cited in the Consumer Federation of America testimony before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, "*Examining the Current Legal and Regulatory Requirements and Industry Practices for Credit Card Issuers with Respect to Consumer Disclosures and Marketing Efforts*," 109th Congress, 2nd sess., May 17, 2005.

much of this increase appeared to be the result of increased use of credit cards for transactions and more households with cards.[7]

Figure 25: U.S. Household Debt Burden and Financial Obligations Ratios, 1980 to 2005



Source: Federal Reserve.

In addition, credit card debt remains a small portion of overall household debt, including those with the lowest income levels. As shown in table 2, credit card balances as a percentage of total household debt actually have been declining since the 1990s.

[7]Board of Governors of the Federal Reserve System, *Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency* (Washington, D.C.: June 2006).

Table 2: Portion of Credit Card Debt Held by Households

Type of debt	1995	1998	2001	2004
Amount of debt of all families, distributed by type of debt				
Secured home loan	80.7	78.9	81.4	83.7
Lines of credit not secured by residential property	0.6	0.3	0.5	0.7
Installment loans	12.0	13.1	12.3	11.0
Credit card balances	3.9	3.9	3.4	3.0
Other	2.9	3.7	2.3	1.6
Total	**100**	**100**	**100**	**100**

Source: Federal Reserve.

Also, as shown in table 3, median credit card balances for the lowest-income households has remained stable from 1998 through 2004.

Table 3: Credit Card Debt Balances Held by Household Income[8]

	1998	2001	2004
Median value of holdings for families holding credit card debt			
All families	$1,900	$2,000	$2,200
Percentile of income			
Less than 20	$1,000	$1,100	$1,000
20-39.9	$1,300	$1,300	$1,900
40-59.9	$2,100	$2,100	$2,200
60-79.9	$2,400	$2,400	$3,000
80-89.9	$2,200	$4,000	$2,700
90-100	$3,300	$3,000	$4,000

Source: Federal Reserve.

As shown in figure 26 below, the number of households in the twentieth percentile of income or less that reportedly were in financial distress has remained relatively stable.

[8]The 1998 median credit card balance in 2001 dollars; 2001 and 2004 median credit card balances in 2004 dollars.

Figure 26: Households Reporting Financial Distress by Household Income, 1995 through 2004

Percentile of income	1995	1998	2001	2004
All	11.7	13.6	11.8	12.2
Less than 20	27.5	29.9	29.3	27.0
20-39.9	18.0	18.3	16.6	18.6
40-59.9	9.9	15.8	12.3	13.7
60-79.9	7.7	9.8	6.5	7.10
80-89.9	4.7	3.5	3.5	2.4
90-100	2.3	2.8	2.0	1.8

Source: Federal Reserve Survey of Consumer Finances.

As shown in figure 26 above, more lower-income households generally reported being in financial distress than did other households in most of the other higher-income groups. In addition, the lowest-income households in the aggregate generally did not exhibit greater levels of distress over the last 20 years, as the proportion of households that reported distress was higher in the 1990s than in 2004.

Some Researchers Find Other Factors May Trigger Consumer Bankruptcies and that Credit Cards Role Varied

Some academics, consumer advocacy groups, and others have indicated that the rise in consumer bankruptcy filings has occurred because the normal life events that reduce incomes or increase expenses for households have more serious effects today. Events that can reduce household incomes include job losses, pay cuts, or conversion of full-time positions to part-time work. Medical emergencies can result in increased household expenses and debts. Divorces can both reduce income and increase expenses. One researcher explained that, while households have faced the same kinds of risks for generations, the likelihood of these types of life events occurring has increased. This researcher's studies noted that the likelihood of job loss or financial distress arising from medical problems and the risk of divorce have all increased. Furthermore, more households send all adults into the workforce, and, while this increases their income, it also doubles their total risk exposure, which increases their likelihood of having to file for bankruptcy. According to this researcher,

about 94 percent of families who filed for bankruptcy would qualify as middle class.[9]

Although many of the people who file for bankruptcy have considerable credit card debt, those researchers that asserted that life events were the primary explanation for filings noted that the role played by credit cards varied. According to one of these researchers, individuals who have filed for bankruptcy with outstanding credit card debt could be classified into three groups:

- Those who had built up household debts, including substantial credit card balances, but filed for bankruptcy after experiencing a life event that adversely affected their expenses or incomes such that they could not meet their obligations.
- Those who experienced a life event that adversely affected their expenses or incomes, and increased their usage of credit cards to avoid falling behind on other secured debt payments (such as mortgage debt), but who ultimately failed to recover and filed for bankruptcy.
- Those with very little credit card debt who filed for bankruptcy when they could no longer make payments on their secured debt. This represented the smallest category of people filing for bankruptcy.

[9]Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School, "The Growing Threat to Middle Class Families," *Brooklyn Law Review*, (April 2003).

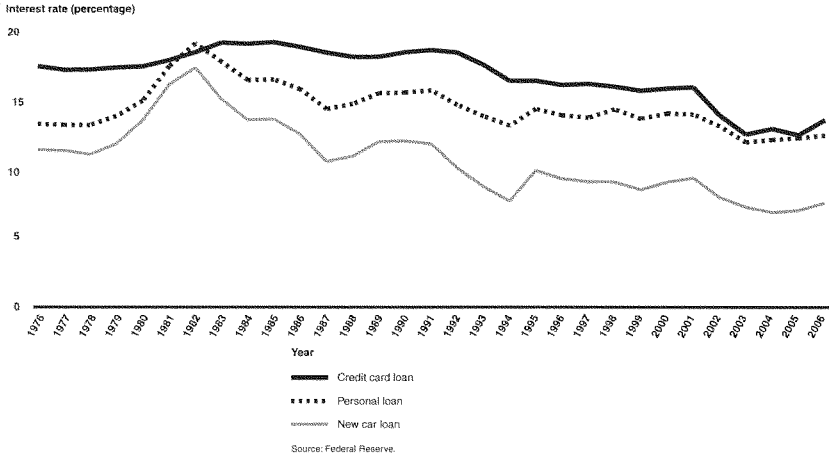
Appendix III

Factors Contributing to the Profitability of Credit Card Issuers

Various factors help to explain why banks that focus on credit card lending generally have higher profitability than other lenders. The major source of income for credit card issuers comes from interest they earn from their cardholders who carry balances—that is, do not payoff the entire outstanding balance when due. One factor that contributes to the high profitability of credit card operations is that the average interest rates charged on credit cards are generally higher than rates charged on other types of lending. Rates charged on credit cards are generally the highest because they are extensions of credit that are not secured by any collateral from the borrower. Unlike credit cards, most other types of consumer lending involve the extension of a fixed amount of credit under fixed terms of repayment (i.e., the borrower must repay an established amount of principal, plus interest each month) and are collateralized—such as loans for cars, under which the lender can repossess the car in the event the borrower does not make the scheduled loan payments. Similarly, mortgage loans that allow borrowers to purchase homes are secured by the underlying house. Loans with collateral and fixed repayment terms pose less risk of loss, and thus lenders can charge less interest on such loans. In contrast, credit card loans, which are unsecured, available to large and heterogeneous populations, and can be repaid on flexible terms at the cardholders' convenience, present greater risks and have commensurately higher interest rates.

As shown in figure 27, data from the Federal Reserve shows that average interest rates charged on credit cards were generally higher than interest rates charged on car loans and personal loans. Similarly, average interest rates charged on corporate loans are also generally lower than credit cards, with the best business customers often paying the prime rate, which averaged 6.19 percent during 2005.

Figure 27: Average Credit Card, Car Loans and Personal Loan Interest Rates



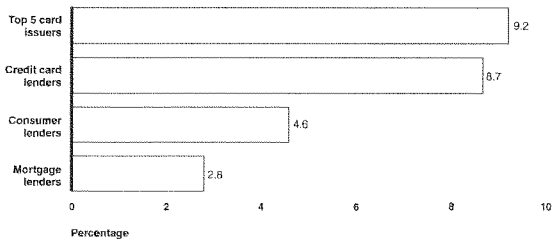
Source: Federal Reserve.

Moreover, many card issuers have increasingly begun setting the interest rates they charge their cardholders using variable rates that change as a specified market index rate, such as the prime rate, changes. This allows credit card issuers' interest revenues to rise as their cost of funding rises during times when market interest rates are increasing. Of the most popular cards issued by the largest card issuers between 2004 and 2005 that we analyzed, more than 90 percent had variable rates that changed according to an index rate. For example, the rate that the cardholder would pay on these large issuer cards was determined by adding between 6 and 8 percent to the current prime rate, with a new rate being calculated monthly.

As a result of the higher interest charges assessed on cards and variable rate pricing, banks that focus on credit card lending had the highest net interest margin compared with other types of lenders. The net interest income of a bank is the difference between what it has earned on its interest-bearing assets, including the balances on credit cards it has issued

and the amounts loaned out as part of any other lending activities, and its interest expenses. To compare across banks, analysts calculate net interest margins, which express each banks' net interest income as a percentage of interest-bearing assets. The Federal Deposit Insurance Corporation (FDIC) aggregates data for a group of all federally insured banks that focus on credit card lending, which it defines as those with more than 50 percent of managed assets engaged in credit card operations; in 2005, FDIC identified 33 banks with at least this much credit card lending activity. As shown in figure 28, the net interest margin of all credit card banks, which averaged more than 8 percent, was about two to three times as high as other consumer and mortgage lending activities in 2005. Five of the six largest issuers reported to us that their average net interest margin in 2005 was even higher, at 9 percent.

Figure 28: Net Interest Margin for Credit Card Issuers and Other Consumer Lenders in 2005



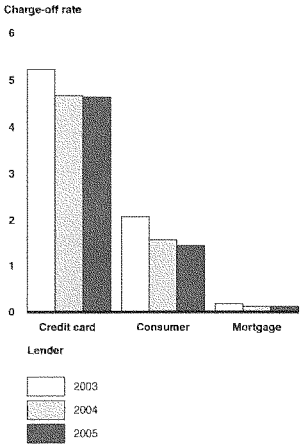
Source: GAO analysis of public financial statements of the five largest credit card issuers.

Credit Card Operations Also Have Higher Rates of Loan Losses and Operating Expenses

Although profitable, credit card operations generally experience higher charge-off rates and operating expenses than those of other types of lending. Because these loans are generally unsecured, meaning the borrower will not generally immediately lose an asset—such as a car or house—if payments are not made, borrowers may be more likely to cease making payments on their credit cards if they become financially distressed

than they would for other types of credit. As a result, the rate of losses that credit card issuers experience on credit cards is higher than that incurred on other types of credit. Under bank regulatory accounting practices, banks must write off the principal balance outstanding on any loan when it is determined that the bank is unlikely to collect on the debt. For credit cards, this means that banks must deduct, as a loan loss from their income, the amount of balance outstanding on any credit card accounts for which either no payments have been made within the last 180 days or the bank has received notice that the cardholder has filed for bankruptcy. This procedure is called charging the debt off. Card issuers have much higher charge-off rates compared to other consumer lending businesses as shown in figure 29.

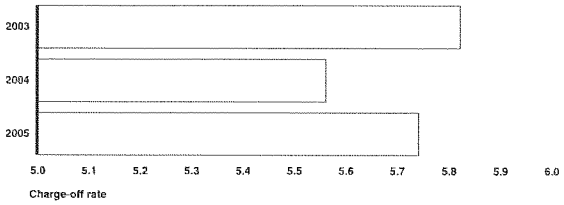
Figure 29: Charge-off Rates for Credit Card and Other Consumer Lenders, 2004 to 2005



Source: FDIC.

The largest credit card issuers also reported similarly high charge-off rates for their credit card operations. As shown in figure 30, five of the top six credit card issuers that we obtained data from reported that their average charge-off rate was higher than 5.5 percent between 2003 and 2005, well above other consumer lenders' average net charge-off rate of 1.44 percent.

Figure 30: Charge-off Rates for the Top 5 Credit Card Issuers, 2003 to 2005

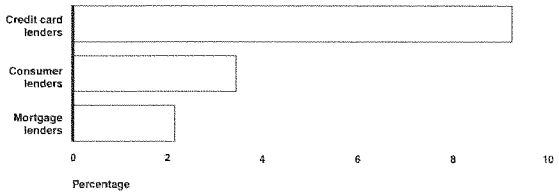


Source: GAO analysis of public financial statements of the five largest credit card issuers.

Credit card issuers also incur higher operating expenses compared with other consumer lenders. Operating expense is another one of the largest cost items for card issuers and, according to a credit card industry research firm, accounts for approximately 37 percent of total expenses in 2005. The operating expenses of a credit card issuer include staffing and the information technology costs that are incurred to maintain cardholders' accounts. Operating expense as a proportion of total assets for credit card lending is higher because offering credit cards often involves various activities that other lending activities do not. For example, issuers often incur significant expenses in postage and other marketing costs as part of soliciting new customers. In addition, some credit cards now provide rewards and loyalty programs that allow cardholders to earn rewards such as free airline tickets, discounts on merchandise, or cash back on their accounts, which are not generally expenses associated with other types of lending. Credit card operating expense burden also may be higher because issuers must service a large number of relatively small accounts. For example, the six large card issuers that we surveyed reported that they each had an average of 30 million credit card accounts, the average outstanding balance on these accounts was about $2,500, and 48 percent of accounts did not revolve balances in 2005.

As a result, the average operating expense, as a percentage of total assets for banks, that focus on credit card lending averaged over 9 percent in 2005, as shown in figure 31, which was well above the 3.44 percent average for other consumer lenders. The largest issuers operating expenses may not be as high as all banks that focus on credit card lending because their larger operations give them some cost advantages from economies of scale. For example, they may be able to pay lower postage rates by being able to segregate the mailings of account statements to their cardholders by zip code, thus qualifying for bulk-rate discounts.

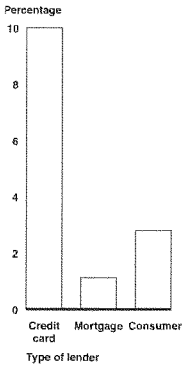
Figure 31: Operating Expense as Percentage of Total Assets for Various Types of Lenders in 2005



Source: FDIC.

Another reason that the banks that issue credit cards are more profitable than other types of lenders is that they earn greater percentage of revenues from noninterest sources, including fees, than lenders that focus more on other types of consumer lending. As shown in figure 32, FDIC data indicates that the ratio of noninterest revenues to assets—an indicator of noninterest income generated from outstanding credit loans—is about 10 percent for the banks that focus on credit card lending, compared with less than 2.8 percent for other lenders.

Figure 32: Non-Interest Revenue as Percentage of Their Assets for Card Lenders and Other Consumer Lenders



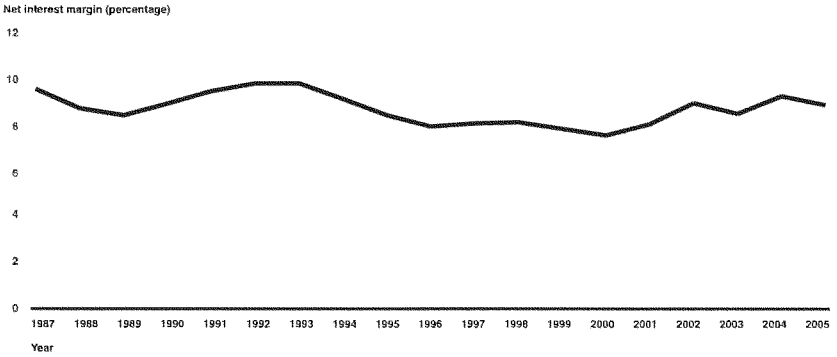
Source: GAO analysis of FDIC data.

Effect of Penalty Interest and Fees on Credit Card Issuer Profitability

Although penalty interest and fees apparently have increased, their effect on issuer profitability may not be as great as other factors. For example, while more cardholders appeared to be paying default rates of interest on their cards, issuers have not been experiencing greater profitability from interest revenues. According to our analysis of FDIC Quarterly Banking Profile data, the revenues that credit card issuers earn from interest generally have been stable over the last 18 years.[1] As shown in figure 33, net interest margin for all banks that focused on credit card lending has ranged between 7.4 percent and 9.6 percent since 1987. Similarly, according to the data that five of the top six issuers provided to us, their net interest margins have been relatively stable between 2003 and 2005, ranging from 9.2 percent to 9.6 percent during this period.

[1]The Quarterly Banking Profile is issued by the FDIC and provides a comprehensive summary of financial results for all FDIC-insured institutions. This report card on industry status and performance includes written analyses, graphs, and statistical tables.

Figure 33: Net Interest Margin for All Banks Focusing on Credit Card Lending, 1987-2005



Source: FDIC.

These data suggest that increases in penalty interest assessments could be offsetting decreases in interest revenues from other cardholders. During the last few years, card issuers have competed vigorously for market share. In doing so, they frequently have offered cards to new cardholders that feature low interest rates—including zero percent for temporary introductory periods, usually 8 months—either for purchases or sometimes for balances transferred from other cards. The extent to which cardholders now are paying such rates is not known, but the six largest issuers reported to us that the proportion of their cardholders paying interest rates below 5 percent—which could be cardholders enjoying temporarily low introductory rates—represented about 7 percent of their cardholders between 2003 and 2005. To the extent that card issuers have been receiving lower interest as the result of these marketing efforts, such declines could be masking the effect of increasing amounts of penalty interest on their overall interest revenues.

Although revenues from penalty fees have grown, their effect on overall issuer profitability is less than the effect of income from interest or other factors. For example, we obtained information from a Federal Reserve

Bank researcher with data from one of the credit card industry surveys that illustrated that the issuers' cost of funds may be a more significant factor for their profitability lately. Banks generally obtain the funds they use to lend to others through their operations from various sources, such as checking or savings deposits, income on other investments, or borrowing from other banks or creditors. The average rate of interest they pay on these funding sources represents their cost of funds. As shown in table 4 below, the total cost of funds (for $100 in credit card balances outstanding) for the credit card banks included in this survey declined from $8.98 in 1990 to a low of $2.00 in 2004—a decrease of 78 percent. Because card issuers' net interest income generally represents a much higher percentage of revenues than does income from penalty fees, its impact on issuers' overall profitability is greater; thus the reduction in the cost of funds likely contributed significantly to the general rise in credit card banks' profitability over this time.

Table 4: Revenues and Profits of Credit Card Issuers in Card Industry Directory per $100 of Credit Card Assets

Revenues and profits	1990	2004	Percent change
Interest revenues	$16.42	$12.45	-24%
Cost of funds	8.98	2.00	-78
Net interest income	7.44	10.45	40
Interchange fee revenues	2.15	2.87	33
Penalty fee revenues	0.69	1.40	103
Annual fee revenues	1.25	0.42	-66
Other revenues	0.18	0.87	383
Total revenue from operations	11.71	16.01	37
Other expenses	8.17	10.41	27
Taxes	1.23	1.99	62
Net income	2.30	3.61	57

Source: GAO Analysis of Card Industry Directory data.

Although card issuer revenues from penalty fees have been increasing since the 1980s, they remain a small portion of overall revenues. As shown in table 4 above, our analysis of the card issuer data obtained from the Federal Reserve indicated that the amount of revenues that issuers collected from penalty fees for every $100 in credit card balances outstanding climbed from 69 cents to $1.40 between 1990 and 2004—an

increase of 103 percent. During this same period, net interest income collected per $100 in card balances outstanding grew from $7.44 to $10.45—an increase of about 41 percent. However, the relative size of each of these two sources of income indicates that interest income is between 7 to 8 times more important to issuer revenues than penalty fee income is in 2004. Furthermore, during this same time, collections of annual fees from cardholders declined from $1.25 to 42 cents per every $100 in card balances—which means that the total of annual and penalty fees in 2004 is about the same as in 1990 and that this decline may also be offsetting the increased revenues from penalty fees.

Appendix IV

Comments from the Federal Reserve Board

BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SANDRA F. BRAUNSTEIN
DIRECTOR
DIVISION OF CONSUMER
AND COMMUNITY AFFAIRS

August 23, 2006

Mr. David G. Wood
Director, Financial Markets and Community
Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Wood:

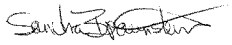
Thank you for the opportunity to comment on the GAO's draft report entitled Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers. As the report notes, the Federal Reserve Board has commenced a comprehensive rulemaking to review the Truth in Lending Act (TILA) rules for open-end (revolving) credit, including credit card accounts. The primary goal of the review is to improve the effectiveness and usefulness of consumer disclosures and the substantive protections provided under the Board's Regulation Z, which implements TILA. To ensure that consumers get timely information in a readable form, the Board is studying alternatives for improving both the content and format of disclosures, including revising the model forms published by the Board.

The draft GAO report specifically recommends that the Board revise credit card disclosures to emphasize more clearly the account terms that can significantly affect cardholder costs, such as default or other penalty pricing rates. We agree that increased complexity in credit card pricing has added to the complexity of the disclosures. To help address this, the Board has invited public comment on ways in which the disclosures required under Regulation Z can be made more meaningful to consumers. The Board is conducting extensive consumer testing to determine what information is most important to consumers, when that information is most useful, what language and formats work best, and how disclosures can be simplified, prioritized, and organized to reduce complexity and information overload. To that end, the Board has hired design consultants to assist in developing model disclosures that are most likely to be effective in communicating information to consumers. Importantly, the Board also plans to use consumer testing to assist in developing model disclosure forms. Based on this review and testing, the Board will revise Regulation Z and, if appropriate, develop suggested statutory changes for congressional consideration.

Mr. David G. Wood
Page 2

The Board's staff has provided technical comments on the draft GAO report separately. We appreciate the efforts of your staff to respond to our comments.

Sincerely,



c: Cody Goebel, Assistant Director, GAO

Appendix V

GAO Contact and Staff Acknowledgments

GAO Contact

Dave Wood (202) 512-8678

Staff Acknowledgments

In addition to those named above, Cody Goebel, Assistant Director; Jon Altshul; Rachel DeMarcus; Kate Magdelena Gonzalez; Christine Houle; Christine Kuduk; Marc Molino; Akiko Ohnuma; Carl Ramirez; Omyra Ramsingh; Barbara Roesmann; Kathryn Supinski; Richard Vagnoni; Anita Visser; and Monica Wolford made key contributions to this report.

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Source: GAO Analysis of Card Industry Directory data.

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THE WALL STREET JOURNAL. ONLINE

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March 7, 2008

OPINION

Freedom Means Responsibility

By GEORGE MCGOVERN
March 7, 2008; Page A15

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Nearly 16 years ago in these very pages, I wrote that "'one-size-fits all' rules for business ignore the reality of the market place." Today I'm watching some broad rules evolve on individual decisions that are even worse.

Under the guise of protecting us from ourselves, the right and the left are becoming ever more aggressive in regulating behavior. Much paternalist scrutiny has recently centered on personal economics, including calls to regulate subprime mortgages.

With liberalized credit rules, many people with limited income could access a mortgage and choose, for the first time, if they wanted to own a home. And most of those who chose to do so are hanging on to their mortgages. According to the national delinquency survey released yesterday, the vast majority of subprime, adjustable-rate mortgages are in good condition,their holders neither delinquent nor in default.

There's no question, however, that delinquency and default rates are far too high. But some of this is due to bad investment decisions by real-estate speculators. These losses are not unlike the risks taken every day in the stock market.

The real question for policy makers is how to protect those worthy borrowers who are struggling, without throwing out a system that works fine for the majority of its users (all of whom have freely chosen to use it). If the tub is more baby than bathwater, we should think twice about dumping everything out.

Health-care paternalism creates another problem that's rarely mentioned: Many people can't afford the gold-plated health plans that are the only options available in their states.

Buying health insurance on the Internet and across state lines, where less expensive plans may be available, is prohibited by many state insurance commissions. Despite being able to buy car or home insurance with a mouse click, some state governments require their approved plans for purchase or none at all. It's as if states dictated that you had to buy a Mercedes or no car at all.

Economic paternalism takes its newest form with the campaign against short-term small loans, commonly known as "payday lending."

With payday lending, people in need of immediate money can borrow against their future paychecks, allowing emergency purchases or bill payments they could not otherwise make. The service comes at the cost of a significant fee -- usually $15 for every $100 borrowed for two weeks. But the cost seems reasonable when all your other options, such as bounced checks or skipped credit-card payments, are obviously more expensive and play havoc with your credit rating.

Anguished at the fact that payday lending isn't perfect, some people would outlaw the service entirely, or cap fees at such low levels that no lender will provide the service. Anyone who's familiar with the law of unintended consequences should be able to guess what happens next.

Researchers from the Federal Reserve Bank of New York went one step further and laid the data out: Payday lending bans simply push low-income borrowers into less pleasant options, including increased rates of bankruptcy. Net result: After a lending ban, the consumer has the same amount of debt but fewer ways to manage it.

Since leaving office I've written about public policy from a new perspective: outside looking in. I've come to realize that protecting freedom of choice in our everyday lives is essential to maintaining a healthy civil society.

Why do we think we are helping adult consumers by taking away their options? We don't take away cars because we don't like some people speeding. We allow state lotteries despite knowing some people are betting their grocery money. Everyone is exposed to economic risks of some kind. But we don't operate mindlessly in trying to smooth out every theoretical wrinkle in life.

The nature of freedom of choice is that some people will misuse their responsibility and hurt themselves in the process. We should do our best to educate them, but without diminishing choice for everyone else.

Mr. McGovern is a former senator from South Dakota and the 1972 Democratic presidential candidate.

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Credit Controls: 1980

*Stacey L. Schreft**

I. INTRODUCTION

Government price control programs in the U.S. began over two hundred years ago. More recently, credit controls, which are a special case of price controls, entered the arsenal of policy instruments. Credit control programs involve regulation of either the price of credit—interest rates—or the quantity of credit extended for various purposes.[a] Credit controls can be *selective* or *general*. Selective controls affect the price or quantity of specific types of credit, whereas general controls are designed to affect the aggregate amount of credit used.[b]

The most recent implementation of credit controls in the U.S. was in the spring of 1980, under the Carter Administration. Surprisingly, to date there has been no comprehensive study of the 1980 experience. To fill this gap, this article focuses on the (1) 1980 credit control experience, (2) history of the legislation that made those controls possible, and (3) economic and political motivation for using such controls. The 1980 episode warrants close scrutiny because it teaches three lessons. First, credit controls may not deliver the desired results. Second, they may have unintended and unforeseen adverse effects. Third, political realities may tempt policymakers to impose credit controls again despite unfortunate previous experiences with such policies.

Section II provides a brief review of credit control experience before 1980. Selective credit controls were first imposed in 1941 and were used twice more before 1952. These programs were all similar in that they set minimum downpayments and maximum maturities for credit purchases of various consumer durables. Congress repealed the legislation that permitted the use of such credit controls in 1953 and reinstated the legislative authority in 1969 with the passage of the Credit Control Act that year. Section III examines the legislative history of the 1969 Act, which conferred upon the President the authority to direct the Board of Governors of the Federal Reserve System (hereafter, the Board) to control "any or all extensions of credit." The sole use of this authority occurred in March 1980, when President Carter invoked the Act. Section IV attempts to reconstruct, using internal Administration memoranda, the political and economic factors motivating Carter's decision to impose credit controls. The evidence suggests that Carter's advisers supported the use of selective credit controls focusing on consumer credit for political reasons.

Details of the Board's 1980 credit control program appear in Section V. Unlike the programs used in the 1941 to 1952 period, the Board's 1980 program left decisions regarding credit allocation to individual lenders. Section V argues that the program's scope and intent were not clearly communicated to the public and thus caused considerable confusion. Section VI documents the economy's response to the program, while Section VII argues that the control program might have made the 1980 recession more pronounced than it otherwise would have been, largely because of its effect on consumers' buying psychology. Congressional debates over repeal of the Credit Control Act in 1982 and subsequent repeated attempts to reenact the legislation are described in Section VIII. Finally, Section IX concludes by considering the likelihood of credit controls in the future.

NOTE: *Footnotes are indicated by letters. Endnotes are indicated by numbers and are located before the References. In general, endnotes contain only bibliographical information.*

* I would like to thank Robert Black, Kathryn Combs, Tim Cook, Marvin Goodfriend, Bob Hetzel, Tom Humphrey, Jeff Lacker, and Ray Owens for valuable comments on an earlier draft. They along with my other colleagues in the Research Department at the Richmond Fed, the library and statistics staffs of the Richmond Fed, the staff of the Jimmy Carter Library, the Freedom of Information Office of the Federal Reserve Board, Jeremy Duffield, Paul O'Brien, and Tom Simpson provided suggestions and assistance in locating essential research materials. Marc Morris deserves special mention for his diligent research efforts. The views expressed in this paper are the author's and do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

[a] Restrictions on the quantity of credit are a form of price control in that they are usually implemented through changes in the terms of lending that alter the effective interest rate.

[b] The term "credit control" is sometimes used synonymously with "credit allocation." "Credit control" as used in this paper refers only to policies that directly allocate credit, as in the case of selective credit controls. In contrast, "credit allocation" is more general, encompassing selective credit controls, but also referring to any policy that affects interest rates and thus indirectly alters the distribution of credit.

II.
THE U.S. EXPERIENCE WITH CREDIT CONTROLS BEFORE 1953

America's experience with price control programs began while the country was in its infancy. The New England colonies used wage and price controls as early as 1630. After winning independence from Great Britain, the Continental Congress and many of the states also experimented repeatedly with wage and price control programs. However, these policies all failed to meet their goal of checking the inflation generated by the printing of paper currencies to finance federal and state expenditures. In response to these failures, Congress passed a resolution on June 4, 1780, recommending that the states repeal all price controls because

> it hath been found by experience that limitations upon the prices of commodities are not only ineffectual for the purposes proposed, but likewise productive of very evil consequences to the great detriment of the public service and grievous oppression of individuals.[1]

These early attempts at price controls did not involve credit. In fact, America waited almost 150 years for its first taste of credit controls. In October 1917, to assist with the mobilization for World War I, Congress enacted the Trading with the Enemy Act (40 Stat. 415) that, under section 5(b), gave the President the authority to regulate credit during wartime. However, credit controls were not imposed during World War I, although wage and price controls were. President Roosevelt was the first to use the Presidential authority to regulate credit. On August 9, 1941, he issued Executive Order #8843 directing the Board to regulate consumer credit to ease the transition to a wartime economy. Presumably, by restricting consumer credit, overall credit use and consumer spending would be reduced, freeing resources for a military buildup while restraining inflationary pressures. Credit controls were viewed as necessary for fighting inflation because the Federal Reserve System (hereafter, the Fed) was committed to maintaining low interest rates, which made its standard tools unavailable for controlling inflation.

The Board responded to Roosevelt's executive order by issuing Regulation W on September 1, 1941.[2] Among its provisions, Regulation W set minimum downpayments and maximum maturities on credit purchases for consumer durables and semidurables. Regulation W (revised effective May 6, 1942) included an expanded list of commodities and covered all types of consumer credit (e.g. single-payment loans, installment loans and sales, and charge account purchases). Total consumer credit outstanding dropped by 50 percent over the first two years that Regulation W was in use. This reduction may in part have been caused by the unavailability of many consumer durable goods, rather than the credit control program. On August 8, 1947, while the controls were in place, Congress passed legislation (61 Stat. 921) removing as of November 1 the President's authority to impose credit controls unless the U.S. were again at war or a state of national emergency were declared.

On November 17, 1947, President Truman asked Congress for the authority to reinstate consumer credit controls to deal with the postwar inflation. This authority was granted on August 16, 1948 (62 Stat. 921), and controls were imposed again under Regulation W from September 20, 1948 until June 30, 1949, when the authority expired. This was the first and only peacetime use of credit controls before 1980.

Selective credit controls also were imposed during the Korean War. Congress granted the Board emergency authority for temporary controls through section 601 of title VI of the Defense Production Act of September 8, 1950 (89 Stat. 810).[3] Under this authority, the Board reestablished Regulation W, instituting minimum downpayment requirements ranging from 10 percent to 33⅓ percent of the purchase price and a maximum maturity of 18 to 30 months. These restrictions had fairly broad public support; 400 economists signed a letter to Senator Joseph O'Mahoney, dated January 21, 1951, urging the use of selective credit controls on consumer and real estate credit and loans for securities as a "first line of defense against inflation."[4] On May 7, 1952, the control program was lifted.

While the controls were in place, however, a congressional subcommittee studied the economic effects of the selective credit controls used between 1948 and 1951.[5] A majority of the subcommittee found that these controls had allocated credit inefficiently. The subcommittee's findings resulted in congressional repeal in 1953 of the President's authority to invoke mandatory controls under the Defense Production Act.[6] Congress did not grant the President this authority again until 1969.[7]

III.
THE CREDIT CONTROL ACT OF 1969: THE BASIS FOR THE 1980 EPISODE

From 1953, when the authority for standby credit controls expired, until 1969, House Representative

Leonor K. Sullivan was a driving force in the movement to reenact credit control legislation. She repeatedly argued that such authority would be needed in wartime. In 1966, with the U.S. mobilizing for the Vietnam War and inflationary pressures building, Sullivan and Representative Henry S. Reuss sponsored H.R. 14025, an amendment to the Defense Production Act that would reinstate the President's standby authority. The House defeated the bill, presumably in part because hearings were not held on the amendment.[8]

Congressional defeat of H.R. 14025 apparently did not weaken Sullivan's resolve to achieve passage of credit control legislation. She raised the issue again in August 1967, during congressional subcommittee hearings on the Consumer Credit Protection Act, and yet again in June 1969, during hearings on the increase in the prime interest rate. Finally, in late 1969, Sullivan and Reuss attached an amendment to H.R. 15091, a bill extending the authority of financial regulatory agencies to set interest rate ceilings on savings accounts, time deposits, and certificates of deposit.[9] A House report (from the Banking and Currency Committee) set forth the motivation for the amendment:

> The majority of the committee . . . believe[s] the present administration is about to achieve at one and the same time continuing inflation and a recession. By its monolithic super-tight-money attack on inflation, it is not only failing to cure inflation, on savings institutions, on small business, and [those] . . . who are now kept from gainful employment by the administration's policies. . . .
>
> . . . [The amendment to] H.R. 15091 would help correct this situation by providing discretionary authority to the President to authorize the Federal Reserve Board to control *extensions of credit, particularly consumer credit and unnecessary bank business lending*. This will enable specific attacks on inflationary areas, and thus make unnecessary the present across-the-board supertight money which threatens unemployment and recession.[10] [emphasis added]

The economic reasoning behind the legislation was the same as that for the earlier Sullivan-Reuss amendments. As explained in a Joint Economic Committee report,

> The use of general interest rate increases to fight inflation is not neutral in its effects on the economy. It tends to fall most heavily on small businessmen and on construction and other long-term investment and is not particularly effective in curbing speculative excesses.
>
> When businessmen begin to accumulate excess inventory because of anticipated price rises, or to overinvest in plant and equipment, their profit expectations are so high that only very large interest rate increases will deter them. In these sectors of the economy, interest rate increases may have an inflationary rather than a deflationary effect. On the other hand, residential construction, which we do not want to discourage, is hit much harder by higher rates.
>
> This committee believes that it would be preferable to concentrate on a prudent and limited *restriction of consumer credit as an alternative to general credit restraint*. Consumer credit, we know, is not dependent on interest costs because consumers think primarily in terms of the periodic payment they are required to make and, within broad limits, are not deterred or encouraged by interest rate changes.[11] [emphasis added]

Congress never determined whether the economic rationale for the amendment was sound. Time was not available for committee hearings on the amendment because the House was scheduled to consider the bill less than a week before December 21, 1969, the expiration date of the original authority to set interest rate ceilings. Sullivan argued that the issue of standby credit controls had been the subject of several hearings by the Committee on Banking and Currency, so the House should not postpone judgment on the amendment until further hearings could be arranged. Further support for the bill came from the Fed.[12] Apparently, Sullivan's argument was persuasive. What congressional debate did occur focused on the growth of consumer credit, its inflationary potential and the possible need for credit controls of the type Regulation W imposed.[13] The House and Senate passed a compromise version of the bill on December 19 without formal hearings, and President Nixon signed the legislation on December 24, 1969, making it Public Law 91-151.[c]

The Sullivan-Reuss amendment is Title II of P.L. 91-151 (12 U.S.C. 1901-1909 (1969)), commonly known as the Credit Control Act (CCA). Section 205 of Title II states that

> whenever the President determines that such action is necessary or appropriate for the purpose of preventing or controlling inflation generated by the extension of credit in an excessive volume, the President may authorize the Federal Reserve Board to regulate and control *any or all* extensions of credit. [emphasis added]

The CCA granted the President and the Board almost dictatorial power over credit use. As described by the minority view,

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[c] Conference Report No. 91-769 explains that the Senate's version of the interest rate ceiling legislation (S. 2577) contained a provision to permit the use of voluntary credit control agreements like those used during the Korean War. P.L. 91-151 granted standby credit control authority of the type included in both the House and Senate bills. The conference report states that both types of controls were included in the legislation so that "the President would be afforded the broadest possible spectrum of alternatives in fighting inflation, curbing unnecessary extensions of credit, and channeling credit into housing and other essential purposes." See "Banking—Interest Rate Ceilings—Credit Control: P.L. 91-151," p. 1522.

> Title II of the bill . . . would give the Federal Reserve Board power to regulate and control *any or all* extensions of credit including maximum amounts, terms and conditions, and maximum rates of interest which of course would establish a national usury law. The authority could only be activated by the President to the extent and for such period of time as he might determine.
>
> This is far broader credit control authority than has ever before been granted. . . .
>
> If fully invoked, it would be heady power for the Fed—complete credit control over all of our economy, nonbanking as well as banking institutions, whether creatures of State or Federal government, and all individuals. It would establish a complete credit police state.[14] [emphasis as in original]

The Nixon Administration had made clear that it did not want standby authority for consumer credit controls. President Nixon signed the legislation only because he wanted to extend the Board's authority to impose interest rate ceilings. In fact, he described the legislation as "unnecessary and undesirable" and warned that its use would move the country dangerously close to a centrally planned economy.[15]

IV. WHY DID PRESIDENT CARTER INVOKE THE CREDIT CONTROL ACT IN 1980?

Credit controls were discussed as a possible policy tool throughout Jimmy Carter's presidency, although they were not imposed until March 1980. The economic and political factors leading to Carter's imposition of selective credit controls under the CCA date back to January 1977, when he was inaugurated.[d]

Carter's First Two Years in Office

Carter's first year in office was the economy's third consecutive year of expansion. The Administration's stimulative programs increased government spending, which contributed to the mildness of a temporary mid-year slowdown. For the year as a whole, real GNP rose 4.9 percent, the unemployment rate averaged 7 percent, and real per capita disposable income was up 4.9 percent. Consumer installment credit outstanding, which consists of most short- and intermediate-term credit extended to individuals that is scheduled for repayment on at least two payment dates, grew 19 percent. The major failure in the economy's performance was the 6.4 percent annual inflation rate (December to December).[16]

The economic expansion continued at an uneven pace throughout 1978, although the long-run economic outlook dimmed. Inflation became the country's major economic concern, as the annualized inflation rate rose to over 9.4 percent in the second quarter.[17]

In May, Carter received a letter from George Meany, president of the AFL-CIO, expressing concern over the inflation problem and urging action:

> The AFL-CIO shares the concern that you and [Fed] Chairman Miller have expressed on the need to curb inflation. We are equally concerned about the pursuit of policies which have repeatedly led the country down the path of recession and unemployment. . . .
>
> . . . [W]e urge you to give serious consideration to authorizing the Federal Reserve to implement the Credit Control Act of 1969 . . . . If you authorized the use of that authority, the Federal Reserve Board could exercise selective credit regulation measures. Such policies would not entail ever-higher interest rates, with a concentrated impact upon housing which is in short supply, that would bring serious unemployment, along with continued inflation in housing prices and rents.
>
> I believe that selective credit regulation offers a potentially useful alternative to the extremes of either tight money/high interest rates, or wage and price controls, which you have wisely rejected because of their record of failure.[18]

Carter responded that, although he shared Meany's concerns, he believed credit controls to be "inefficient, inequitable and costly to administer."[19]

Despite Carter's aversion to credit controls, the Administration was said to have conducted an informal review of the Credit Control Act in the early fall of 1978 to appease the AFL-CIO.[20] In addition, Carter told the United Steelworkers in mid-September that he would soon announce a new anti-inflation program that might include voluntary wage-price standards.[21] Shortly after that, Meany's preference for selective credit controls was made public by *The Washington Post*.[22] In late October, Carter officially announced his program. It consisted of the voluntary wage and price standards to which he had alluded, along with Federal spending restraint and regulatory reform. Under the voluntary standards,

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[d] The Jimmy Carter Library does not yet have available the Presidential Handwriting Files that contain material written by Carter, including memoranda written to his advisers regarding policy proposals. The files are not expected to be available until January 1992 at the earliest. Consequently, this article presents material sent from Administration officials and others to Carter or his advisers. Some memos written by Carter's advisers contained space for him to check his approval or disapproval of a proposal; these memos, if returned to and filed by their authors, provide evidence of his position on the proposed action. Sometimes memos sent among Carter's advisers summarize his position. When such memos are not available, his position must be inferred from the historical record of his Administration's economic policies.

firms were asked to restrict their price increases to one-half percent less than their average rate of increase over 1976 and 1977.[23]

Talk of credit controls continued. *Barron's* reported on November 13, 1978 Townsend-Greenspan & Co.'s opinion on the likelihood of such controls, given that the President could implement the CCA:

> "At this stage, it is difficult to envisage any major move towards credit controls, certainly of a rigid type. However, it is not inconceivable to us that some restrictions on loans for mergers and acquisitions, and other, not necessarily definable 'non-productive' purposes, could be initiated."[24]

A few weeks later, on December 4, *The Wall Street Journal* quoted Alfred Kahn, chairman of the Council on Wage and Price Stability (COWPS), as endorsing credit controls as an anti-inflation device and planning to raise the prospect of controls with Charles Schultze, chairman of the Council of Economic Advisers (CEA), and G. William Miller, Federal Reserve Board Chairman. In response to *The Wall Street Journal*'s report, Orin Kramer, Associate Director for Housing and Urban Development, sent a memo to Stuart Eizenstat, Carter's Assistant for Domestic Affairs and Policy, warning that he (Kramer), Robert Carswell of the Treasury and Lyle Gramley of the CEA, were concerned about the effect Kahn's statement would have on the financial markets and thought that it should be retracted:

> *[W]hether or not controls are a good idea, it is extremely bad policy to talk about them publicly before the Administration had made a firm decision to introduce them.* The President has standby authority to permit the Federal Reserve Board to impose a wide range of credit controls. There is fear in the business and financial community that the President will use this power. *Kahn's statement, with the implication that the President might consider exercising this authority, will induce some corporations and sophisticated individuals to accelerate their borrowing out of fear that the 'window' will close. This increased borrowing will increase interest rates, increase credit aggregates, and give the Fed's hawks an argument to raise Fed rates further.* If the Fed failed to respond to higher money market rates by tightening up, the Fed would risk signalling 'weakness' to the international bankers, thereby jeopardizing the strength of the dollar.
>
> From Kahn's viewpoint, it would be best if he were to be the one to indicate that *his statements were purely hypothetical, and credit controls are not under active consideration. In any event, this should be the Administration's position—and quickly, before the pressure builds up.* [emphasis as in original]

Kramer also warned that the desirability of credit controls was "highly questionable":

> Beyond the obvious credit market distortions created by controls, it is difficult to create a control system which is effective. For example, Kahn suggested the possibility of limiting the amount of time consumers have to pay back debt to discourage the use of credit and reduce interest rates. The practical problem is that while the Fed can limit the terms on which banks extend credit, would such limitations apply to Sears and Roebuck and every retail merchant in the country? Likewise, it has been privately suggested that the Fed might prohibit financial institutions from extending credit to companies that violate the wage/price guidelines. The difficulty is that the sanction—the denial of credit—could put companies out of business or choke off desirable business investment. In short, the denial of credit to those violating our wage/price guidelines probably constitutes overkill. *Most importantly, if credit controls were effective, and credit demand in some or all sectors of the economy were reduced, the result would be to heighten the chances that our sought after 'soft landing' would become a harder crash. . . .* [P]ast history with such controls has usually produced unintended and undesirable consequences, and the subject should be addressed with extreme caution, if at all.[25] [emphasis as in original]

With rumors of credit and mandatory wage-price controls still circulating, 1978 ended. For the year as a whole, real GNP grew 4.5 percent, slightly under the 1977 rate, and the inflation rate was 9 percent, up over 2 percent from 1977. The Board attributed the behavior of economic activity in part to the continuing high inflation. The personal saving rate was extremely low by postwar standards, and consumer spending on durable goods was strong, perhaps because consumers anticipated future price rises. This spending behavior contributed to the ratio of aggregate household indebtedness to disposable personal income reaching a record level; consumer installment credit outstanding grew 19.4 percent. Business investment apparently slowed because of the greater uncertainty associated with rising inflation.[26] The Board found long-run economic prospects to be mixed and expected further weakening in consumer sentiment. Consumer spending and real GNP growth would slow accordingly. Inflationary pressures were predicted to remain strong.[27]

Should the Credit Control Act Be Used or Repealed?: The 1979 Political Debate

Debate over whether credit controls might be imposed continued into 1979. Financial analyst Don Conlan thought there was a 40 percent chance of credit controls being instituted, while *Barron's* editor Robert Bleiberg thought the probability was 60 percent.[28] Throughout the first half of the year, the Senate debated bill S. 35, legislation introduced by Senator Jesse Helms of North Carolina that would have repealed the CCA. In addressing the Senate in January, Helms expressed his opinion of the CCA:

> I find . . . that there remains on the books in the Federal Code an onerous piece of legislation which purports to be a means of "combating inflation." In fact, it is little more than

a means of providing total Federal control of the financial system of this country. I speak of . . . the Credit Control Act of 1969.[29]

On March 28 Helms added,

Only repeal of this onerous law can quiet this unrest [in financial markets]. Indeed, failure to repeal the law will accelerate speculation about control implementation. . . .

. . . [An] obvious objection to the Credit Control Act is political. The statute is so loosely drawn and confers such vast powers on the President and—through him—on the Federal Reserve Board that no credit transactions would be outside the purview of this law, once the authority is invoked by the President. The invocation of virtually unlimited power by the President is hardly consistent with the post-Watergate mood of Congress. . . .[30]

Just two days later, Treasury Secretary W. Michael Blumenthal sent a memo to Carter urging him to invoke the CCA and impose consumer credit controls:

It is the unanimous opinion of your economic advisors that our anti-inflation program needs the strengthening of a somewhat more restrictive monetary policy. Although growth in the money supply has been sluggish for several months, banks have been intensively exploiting other sources of funds to sustain a very rapid rate of expansion in bank credit. In the context of rising inflationary expectations, the overly-ample availability of credit is fueling a business scramble for inventories and adding to pressures on prices of materials.

Your advisors also agree unanimously that action should be taken to limit the most liberal terms on consumer credit. Such action would require you to invoke the Credit Control Act of 1969 and to request that the Federal Reserve Board take steps to put consumer credit controls into effect.

The Federal Reserve has been reluctant to increase restraint on the banking system; their analysis suggests more current and potential weakness in the economy than we perceive. Our concern is that much further delay in exercising restraint will permit and encourage a surge in both business and consumer spending that will add significantly to the already poor prospects for prices in the next few months. . . .

Given the Board's reluctance to take the initiative in restricting credit growth, it will be important that we convey not only our concern, but yours as well. . . .

A useful adjunct to a tightening of monetary policy would be to impose a modest tightening of terms on consumer credit. Since the effects of such controls on consumer spending are uncertain, a heavy-handed action would be inadvisable. Putting limits on the terms of credit can be justified, however, because competitive pressures are pushing lenders to move steadily toward more liberal terms. In the process, some consumers may be overextending their debt positions to an extent that is not desirable. *Our tentative thinking is to limit the maximum maturity on new car loans to 42 months, and to increase the minimum monthly repayment on revolving credit (charge cards) to 10 percent of the outstanding balance attributable to new loans.* [emphasis added]

The Credit Control Act of 1969 *permits* the Federal Reserve Board to impose such controls on your authorization, but you *cannot* order them to do so. The Board will have to be persuaded of the wisdom of this action. [emphasis as in original]

We request your approval for us to meet with Chairman Miller and the other members of the Federal Reserve Board to discuss these matters.

Carter gave his approval for preliminary discussions only.[31]

Apparently, the Administration was still debating use of the CCA in mid-May, when Kahn sent a memo to Carter's key advisers on credit controls as part of an anti-inflation strategy:

It is amazing to me how often these [direct controls on credit, especially consumer credit] continue to be suggested from both the right and the left. I recognize that the case for these on short-term macroeconomic grounds is weak: it is unclear that we need additional consumer credit restraint right now. . . .

I think the case is clearer as part of a longer-term policy of discouraging excessive consumption. There is widespread public acceptance of the notion that consumers are taking an excessively cavalier attitude toward incurring debt, and that the government ought to do something directly to discourage it. Certainly the imposition of direct credit controls would be widely perceived as a serious step to combat inflation.[32]

While the White House debated implementing credit controls, the Senate Committee on Banking, Housing, and Urban Affairs held hearings on S. 35, Helms's bill to repeal the CCA, and S. 389, a bill introduced by Senator John Tower, that would require the President to report to Congress when invoking the Act and require a concurrent resolution by Congress before the Fed implements the controls. Alan Greenspan, then president of Townsend-Greenspan & Co., gave testimony typical of those favoring repeal:

Curbing the growth of credit expansion is, in my view, the key to defusing the strong underlying inflationary forces which threaten the stability of our economy. However, rationing credit through statute or regulation is unlikely to be successful and to the extent that it is, would probably allocate credit in an undesirable manner.[33]

Witnesses testifying for the Administration and the Board, however, wanted to retain standby authority for credit controls. For example, a letter from CEA chairman Charles Schultze to Senator Proxmire was presented as evidence at the hearing. It read,

[R]epeal of [the CCA] would not be in the national interest.

The authority . . . is very broad and general. At the same time, the language of the Act provides safeguards that would effectively prevent it from being used in inappropriate ways. First, the Act specifically provides that the President's authority is limited to cases in which inflation is generated by an excessive volume of credit. . . .

Although the authority granted in that Act has been in existence for ten years, no Administration has sought to use it, and properly so, in my judgment. The sources of inflation during the past decade have been many and varied. . . . Nevertheless, there has been no time in the past decade when the expansion of credit could not have been controlled appropriately by the more general instruments of monetary policy. . . .

Under almost all conditions, selective credit controls are not a substitute for the general instruments of monetary policy, nor, indeed, can these two types of instruments complement one another effectively. But one can certainly conceive of circumstances in which resort to selective credit controls might be necessary. . . . [W]e might find that strong inflationary pressures were being generated by a substantial relaxation of terms on consumer credit, and that the resulting increase in consumer borrowing was threatening to put many consumers in a precarious financial position, as well as to heat up inflation. . . . A similar need for selective controls might arise if inflation were being generated by a wave of credit-financed scare buying by consumers because of threatening international developments, as was the case immediately following the beginning of the Korean war.[34]

The Board's stand on the CCA was similar to the Treasury's. Federal Reserve Board governor Nancy Teeters presented the Board's position to the Banking Committee:

Credit controls as an instrument of anti-inflationary policy have most appeal at times when fiscal and monetary policies cannot, for one reason or another, be employed flexibly. During World War II and for a while thereafter, monetary policy was constrained by a pledge to maintain a low interest rate on U.S. Treasury securities. As a result, the Federal Reserve could not effectively control growth in the monetary and credit aggregates since it had to supply as much bank reserves as needed to maintain an unchanged level of interest rates. Regulating nonrate terms of credit extensions seemed to be one of the few ways to discourage borrowing in such an environment. Thus, regulations limiting consumer credit were used on three occasions in this period. . . .

. . . . If credit controls are to be used, it would require circumstances when the need is clear and obvious—a national emergency, such as war, or a clearly perceived imbalance in the distribution of available credit. . . .

Selective credit controls might be effective in holding down a narrow category of spending and might be appropriate if there were shortages of particular goods, such as automobiles and other consumer durable goods during World War II. However, even if such shortages occurred, rationing or excise taxes might be a more effective and equitable means of treating the problem. . . .

. . . [A] large bureaucracy would probably have to be created to administer controls. In the absence of a national consensus as to their necessity, detection of violations would depend almost entirely on the regulators, since both the borrowers and the lenders may have an incentive to circumvent the controls. Regulatory staff also would be needed to decide on exemptions to the controls, as obvious inequities arose. Their cost also would include the paperwork and compliance burden borne by the lenders and the borrowers. These direct costs would likely escalate with the duration of the controls as they were extended to counter the ingenuity of the private sector. . . .

All these factors suggest that under most circumstances policies other than credit controls would have superior results with fewer undesirable side effects. . . .

There may be situations in the future, however, in which mandatory credit controls could be a useful component of national economic policy. One such circumstance could occur if it were necessary to undertake a major and rapid redirection of resource allocation in response to a national emergency, like an outbreak of war. . . .

The Credit Control Act of 1969 is useful to the extent that it provides a means for dealing with such contingencies promptly. . . .

. . . . Thus, if the act is to be retained, the changes suggested by S. 389 would seem unwise. . . .

The Federal Reserve position is basically that it sees no reason to repeal it.[35]

Neither S. 35 nor S. 389 ever reached the Senate floor, and Carter did not invoke the CCA then, although a May 1979 Gallup poll found most of the public supporting government control programs.[36]

By October, the economy was well on its way to attaining an annual inflation rate of 13.3 percent (measured by the change in the consumer price index, December to December).[37] On October 6, the Board announced several policy actions.[38] First, a shift in operating methods was undertaken. The Board in conducting monetary policy would in the future focus less on controlling the federal funds rate and more on controlling bank reserves. Second, it raised the discount rate, the rate at which it lends funds to commercial banks, from 11 percent to 12 percent. Third, the Board imposed upon domestic member banks and branches and agencies of foreign banks a marginal reserve requirement of 8 percent on increases in their managed liabilities above a specified base. The managed liabilities subject to the reserve requirement were time deposits of $100,000 and over with maturities of less than one year, Eurodollar borrowings, repurchase agreements against U.S. government and federal agency securities, and federal funds borrowings from nonmember institutions. Because such managed liabilities financed approximately 50 percent of the growth in bank credit between June and October, they were viewed as contributing to the inflation problem, even though they attracted credit mainly from other uses. When the reserve requirement was imposed, member banks were estimated to be holding $240 billion in managed liabilities.[e]

[e] The Board previously imposed supplemental marginal reserve requirements on managed liabilities in 1973. Its objective was to curb credit growth and moderate inflationary pressures without inducing tight credit conditions. Non-member banks were asked to cooperate with the program by holding special marginal reserves themselves. The supplemental requirements were gradually lifted. See *Federal Reserve Bulletin*, vol. 59, no. 5 (May 1973), pp. 375-376.

The Board's October 6 actions were prompted by the rapid growth rates of money and credit throughout 1979, the rise in inflation and upward revisions in inflationary expectations, and the speculative activity in the markets for gold, silver, and other commodities.[39] According to Paul Volcker, Chairman of the Federal Reserve Board, the actions were to signal an "unwillingness to finance an accelerating rate of inflation."[40]

Events in Early 1980 Preceding Carter's Action

Concern over the record inflation rates and the threat of recession made the economy a dominant issue in the 1980 presidential campaign. The year began with Senator Edward Kennedy predicted to be Carter's major opponent for the Democratic nomination. Kennedy, unlike Carter, endorsed the use of mandatory wage and price controls. In a campaign speech on January 28, Kennedy said,

> The time has come for a frank admission that under this President, the voluntary guidelines have run their course and failed.
>
> Inflation is out of control. There is only one recourse: the President should impose an immediate six month freeze on inflation—followed by mandatory controls, as long as necessary, across the board—not only on prices and wages, but also on profits, dividends, interest rates, and rent.[41]

The public seemed to share Kennedy's position.[f] A mid-January *New York Times*/CBS News poll showed that "65 percent of adult Americans were willing to 'have the Government enforce limits on both wage and price increases' to slow the inflation rate."[42]

By mid-February inflation data was available for January. The producer price index for finished goods rose at an annual rate of 19 percent, and the CPI climbed 18 percent.[43] On February 15, the Fed raised the discount rate from 12 to 13 percent.[44] The markets responded quickly. Banks raised the prime rate to 15¾ percent.[45] Precious metals prices fell, while financial futures prices rose.[46]

Also on February 15, *The New York Times* quoted Alfred Kahn as saying that the Administration was considering the use of selective credit controls. Kahn, who opposed wage and price controls, favored Regulation W-type restrictions on loan downpayments and maturities.[47] Four days later, Kahn, Eizenstat, and White House Staff Director Al McDonald sent a memo to Carter stating that

> [i]t is essential that we move again onto the offensive on the inflation front. The economic situation is critical and the public recognizes this. Working against us are the continuing bad reports, the growing support for controls, widening business assumptions that high inflation is with us indefinitely and public expectations that increased defense spending will fuel it more.
>
> To date the public has been reasonably understanding of your position. They recognize that you are not to blame for the high inflation rate, but they correctly demand to know what you plan to do about it. As soon as the international crisis recedes, this will be the nation's number one preoccupation.
>
> We have no time to lose. We must move out forcefully and visibly to reinforce the importance of the voluntary effort and to reemphasize your priority to bring this aspect of the economy under control.[48]

On February 21, Henry Kaufman, economist and general partner at Salomon Brothers, suggested restrictions on bank credit growth as part of a seven point plan to reduce inflation.[49]

Talk of control programs heated up in Congress in late February. Mandatory wage-price controls had vocal support. Nevertheless, they were unlikely to receive congressional authorization; Democratic Senator Bennett Johnston threatened to filibuster any Senate effort to enact such legislation.[50] Support for credit controls was somewhat stronger, primarily because the CCA allowed for their imposition without congressional consultation or approval. The Administration feared, as did many in Congress, that the mere request for authorization of wage and price controls would induce firms to borrow heavily and increase prices in anticipation of future restrictions on their ability to do so. In fact, rumors that credit controls might be imposed were having the same effect. A report in *The Wall Street Journal* on such borrowing activity quoted Donald DeLuca, treasurer of Pittsburgh-based Copperweld Corp., as saying that "he could 'smell' credit controls coming. He . . . phoned his New York bankers to accelerate agreement on a $50 million revolving credit."[51]

The issue of credit controls arose again on February 25, when Chairman Volcker was on Capitol Hill giving his semi-annual report on monetary policy as required by the Humphrey-Hawkins Act. Volcker was perceived as a forceful opponent of credit controls, arguing that credit was already slowing because of general market conditions and the restrictive actions the Fed had taken.[52] While testifying, Volcker

[f] Leonard Silk, "Uncertainty on Controls," *The New York Times*, February 22, 1980. Silk reports that Kennedy's position did not contribute much to his popular support. Although Kennedy was the only presidential candidate favoring wage and price controls, survey results found that 62 percent of the public was unaware of his position, while 8 percent believed that he opposed controls.

was questioned by Senator Proxmire about his position on selective credit controls. The following exchange ensued:

> Volcker: ". . . . I just don't know how they would be workable. . . . I'm no enthusiast of using direct controls in this area and think they can be counterproductive in that they lead to anticipation of inability to raise money and thereby actually increase demand."
>
> Proxmire: "Then you are opposed to invoking the Credit Control Act which is on the books now which the President could of course invoke? . . ."
>
> Volcker: "Yes."[53]

The Federal Reserve nevertheless chose to cooperate with the Administration. Volcker met with Carter on February 20 and 24.[g] After these meetings, on February 28, Carter received a memo from Treasury Secretary G. William Miller outlining possible components of the intensified anti-inflation program under discussion.[54] The memo listed several options to restrain credit growth:

> The Federal Reserve is considering actions which it will take independently (but with coordinated timing) to reinforce credit restraint consistent with already announced targets. These will be within the general framework of the October 6 actions, but, to the extent feasible, designed to maximize "*availability*" rather than "interest rate" effects. They could include:
>
> 1. Action to tighten existing marginal reserve requirements on liability expansion. These requirements, imposed in October, are not "binding" on most banks now.[h]
>
> 2. A more visible program of voluntary credit restraint, with reporting requirements, aimed primarily, but not entirely, at banks. This program will emphasize restraint on total lending, but with special accommodation of small business and mortgage lending to the extent feasible. Emphasis would be placed on discouraging "take-over" or "speculative" financing.

Also described in the memo were several actions that the Board might take if the CCA were invoked, along with the pros and cons of each:

> [T]he Federal Reserve would constrain credit not tied to autos, home repairs, or mobile homes . . . by a system of special reserve requirements of say, 10 percent, on any increase in outstanding amounts.
>
> *Pro*: Restraint on growth of consumer credit would directly carry the message to the American public of the need for restraint. Many credit card issuers might welcome official sanction for pulling back from business that is currently unprofitable, and there could be minor effects on consumer saving.
>
> *Con*: The Federal Reserve Board considers such action of relatively little importance substantively (depending on coverage, only $70 to $200 billion of credit is involved and borrowing would take different forms.)[i] It would be administratively highly cumbersome because tens of thousands of individual lenders are involved (many of which would have to be exempted).[55]

The Board, however, did not suggest to the Administration the use of consumer credit controls.[56]

Internal Fed memos confirm that the Board was preparing to undertake the actions described in Miller's correspondence. The dates and content of the memos suggest that the Board made the major decisions regarding which actions to take during February and had decided on all but a few details of its program by March 5. Actions that could be undertaken without the CCA appear to have been planned for at the Board's own initiative, rather than at the Administration's request. Where the initiative for the other actions originated is unclear.[57]

Word began spreading during the first week of March about the anti-inflation program the Administration was considering. Media attention turned away from whether credit controls would be imposed and toward what form they would take. Although business borrowing accounted for the bulk of total credit growth, the consensus view was that businesses could too easily evade credit controls through use of the bond and commercial paper markets, making controls on consumer credit more practical. A Washington specialist at an investment firm was quoted as saying that Volcker " 'may be prepared to acquiesce on consumer measures in return for Carter's people staying out of his hair on commercial lending restraints.' "[58]

The possibility of consumer credit controls did not please bankers, who publicly expressed their concern. *The New York Times* quoted a Citibank newspaper advertisement as reading " 'There may be policy makers who believe this [credit controls] to be in the national interest but it is doubtful that many citizens will find it to be in theirs.' "[59] Less than a week earlier, though, the Administration had

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[g] According to the Presidential Diary Office Files at the Jimmy Carter Library, the latter meeting, which concerned the economy, lasted just under two hours and was also attended by Energy Secretary Charles Duncan, Jr., Stuart Eizenstat, Alfred Kahn, Office of Management and Budget Director James McIntyre, Jr., G. William Miller, Press Secretary Jody Powell, Charles Schultze, and the First Lady. See President's Daily Diary, "2/24/80 Backup Material," Box PD-73, Presidential Diary Office, Jimmy Carter Library.

[h] See Section VI below for a discussion of the effectiveness of the Board's October 6 marginal reserve requirements on managed liabilities.

[i] With credit for automobiles and housing excluded from a control program, only about a quarter of total consumer credit would be subject to regulation.

received telephone calls from senior executives at two of the country's largest banks, stating that their banks "would be adversely affected by consumer credit controls. However, both agreed that the financial markets (bond markets) expect and would react favorably" to such controls.[60] And on March 6, Carter's counsel, Lloyd Cutler, forwarded to Carter's key advisers excerpts from a memo he had received from "the head of one of our largest financial institutions." The banker argued for mandatory restrictions on the annual growth rate of consumer credit, except credit for housing and automobiles. Such restrictions closely resembled the voluntary restrictions that the Board was considering.[61]

By Monday, March 10, information was circulating regarding meetings the Carter Administration had held with congressional leaders to discuss the President's economic policy. Carter was said to be planning a program whose economic costs would be borne primarily by consumers. Bank and retail credit cards and checking account overdrafts were rumored to be likely targets of a control program. The Board was thought to be preparing Regulation W-type restrictions that would set minimum downpayments and maximum maturities, limit the size of credit lines, and perhaps reduce grace periods.[j,62] Administration sources also hinted at a possible tightening of the marginal reserve requirement on managed liabilities. A program with rigid quantitative restrictions on the amounts of various types of credit extended was, however, definitely ruled out by both the Board and the White House.[63]

The markets did not respond well to this news as traders upped their expectations of a recession in the near future. Precious metals prices, which had begun falling three weeks earlier, all fell sharply, as did other commodities prices, while financial futures prices rose.[64]

Economic data released March 10 did not help matters. The Fed announced that all major components of consumer credit grew more slowly in January than December, with consumer installment credit growing at an annual rate of 5.3 percent. For January and December combined, the installment credit growth rate was the lowest since the expansion began in 1975. These credit conditions were accompanied by the first decline in retail sales in four months. Commerce Department data showed February's retail sales 0.7 percent lower than January's.[65]

[j] Recall that the memo from Treasury Secretary Blumenthal to Carter in March 1979 recommended credit controls of this form.

On March 12, Treasury Secretary G. William Miller sent Carter a memo consisting of a checklist of policies that could be part of the President's fourth anti-inflation program.[66] That afternoon, Carter held a meeting with his advisers in the Cabinet Room.[67] Carter chose to invoke the CCA to control consumer revolving credit (except credit for home mortgages and automobiles), credit extensions by depository and non-depository financial intermediaries, and the managed liabilities of banks that were not members of the Fed. Reporting by affected institutions would be required.

On Friday, March 14, *The New York Times* reported the opinions of several economists regarding consumer credit controls.[68] Otto Eckstein, a Harvard professor and president of Data Resources Inc., described such controls as " 'a symbolic gesture.' " Henry Kaufman thought the controls would have " 'at best . . . some marginal impact.' " S. Lees Booth, economist and senior vice president of the National Consumer Finance Association, wondered why controls would be placed on consumer credit, which is a small part of total credit in the economy. Another economist, former Board Chairman Arthur Burns, spent March 14 testifying before the Senate Banking Committee, at which time he gave his opinion of the CCA:

> I think it's one of the worst pieces of legislation ever written by the Congress. I hope that you [Sen. Proxmire] . . . would think seriously about having the piece of legislation rescinded.[69]

At 4:30 p.m. that day, in the East Room of the White House, Carter made a prepared statement announcing the fourth anti-inflation program of his presidency, and issued Executive Order 12201 invoking the CCA.[70]

V.
Anatomy of the 1980 Credit Restraint Program

An Overview of the Board's Credit Restraint Program

In his address from the White House on March 14, Carter announced his imposition of credit controls under the CCA:

> Just as our governments have been borrowing to make ends meet, so have individual Americans. But when we try to beat inflation with borrowed money, we just make the problem worse.
>
> Inflation is fed by credit-financed spending. Consumers have gone into debt too heavily. The savings rate in our nation is now the lowest in more than 25 years. . . .

> The traditional tools used by the Federal Reserve to control money and credit expansion are a basic part of the fight on inflation. But in present circumstances, those tools need to be reinforced so that effective restraint can be achieved in ways that spread the burden reasonably and fairly.
>
> I am therefore using my power under the Credit Control Act of 1969 to authorize the Federal Reserve to impose new restraints on the growth of credit on a limited and carefully targeted basis.[71]

Executive Order 12201, invoking the CCA, stated that the credit controls would be "in effect for an indefinite period of time and until revoked by the President."[72] Carter's political advisers hoped that the anti-inflation program would be accepted by the public, thus giving the President an advantage over the other presidential contenders for the Democratic nomination.[73]

After Carter announced his economic program, Volcker introduced the Board's Credit Restraint Program (CRP):

> [T]he Federal Reserve has . . . taken certain further actions to reinforce the effectiveness of the measures announced in October of 1979. . . .
>
> One consequence of strong demands for money and credit generated in part by inflationary forces and expectations has been to bring heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. At the same time, restraint on growth in money and credit must be a fundamental part of the process of restoring stability. That restraint is, and will continue to be, based primarily on control of bank reserves and other traditional instruments of monetary policy. However, the Federal Reserve Board also believes the effectiveness and speed with which appropriate restraint can be achieved without disruptive effects on credit markets will be facilitated by a more formal program of voluntary restraint by important financial intermediaries . . . .[74]

As Board Vice Chairman Schultz later said of the program,

> . . . [T]he overspending in the economy, . . . if there are excesses, appears to have been on the Government side and on the consumer side in terms of open-end credit. . . .
>
> So, are we going to slow this economy down. . . ? The answer to that is yes; I think we must.[75]

The Board's program consisted of six restrictive measures:

1. a voluntary credit restraint program under which all domestic commercial banks, bank holding companies, finance companies, and U.S. agencies and branches of foreign banks were expected to limit their total annual loan growth
2. a special deposit requirement of 15 percent for all lenders on increases in certain types of consumer credit
3. an increase from 8 percent to 10 percent in the marginal reserve requirement on managed liabilities of large banks
4. a special deposit requirement of 10 percent on the additions to the managed liabilities held by non-member banks
5. a special deposit requirement of 15 percent on any additional assets held by money market mutual funds
6. a surcharge on the discount window borrowings of large banks.

The special deposit requirements were simply reserve requirements applied to institutions not otherwise subject to such regulation. For example, the special deposit requirement on consumer credit mandated that lenders hold 15 cents with the Fed as non-interest-bearing reserves for each dollar of consumer credit extended over some predetermined amount.

The Federal Reserve Act grants the authority for actions 3 and 6, while the CCA confers authority for the others.[k] Failure to comply with the regulations could result in a maximum civil penalty of $1,000 (12 USC 1908), and a maximum criminal penalty of $1,000 and a year in jail (12 USC 1909). The Board informed the public of these potential penalties.[76]

The CRP bore little resemblance to the credit controls imposed previously and described in Section II. Consequently, a more detailed description of the program's components is warranted before proceeding to analyze its effects.

The Voluntary Credit Restraint Program

The first component of the Board's program restricted total loan growth by affected financial institutions (primarily banks) to a range of 6 percent to 9 percent over the period from December 1979 to December 1980. Other lenders, not specified in the program, were also requested to participate. To monitor the program, the Board required affected institutions to file reports of lending activity besides those normally required. All affected lenders with total assets of at least $1 billion filed monthly reports. Into this category fell 170 domestic commercial banks, 139 U.S. branches and agencies of foreign banks, 161 domestic affiliates of bank holding companies, and 15 finance companies.[77] In addition, banks with assets totalling at least $300 million but

[k] Board of Governors, Press Release, March 14, 1980. The inclusion of finance companies in action 1 required the CCA.

less than $1 billion filed quarterly reports, and smaller banks were exempt from the filing requirement. The base over which loan growth was calculated was the average for December 1979 for banks that normally filed weekly reports with the Fed, the average from the November and December reports for finance companies that typically reported monthly, and the level as of December 31 for non-member banks. All reports were filed with the lenders' district Federal Reserve Banks.[78]

The 6 percent to 9 percent growth range for total bank lending was thought to be consistent with the announced target ranges for growth of the monetary aggregates. The 9 percent upper bound was considerably lower than the growth rate of 13½ percent for the previous year, December to December, and the accelerated rate of 17¾ percent for January and February of 1980.[79] According to the Board, these growth rates

> could not continue without threatening achievement of the restrained growth in money and credit in 1980 which was deemed necessary to help curb inflation. . . . [A] supplemental program to restrain loan growth seemed appropriate, so long as the burden of the restraint did not fall on those classes of borrowers least able to bear it.[80]

No quantitative rules were given for how lenders should allocate available credit. Rather, the Board simply set forth a few broad qualitative guidelines. It discouraged banks from making unsecured loans to consumers, financing corporate takeovers or mergers, lending for speculative purposes (e.g. speculative purchases of commodities or precious metals), and approving back-up credit lines in support of credit raised with commercial paper. In contrast, funding for small businesses, farmers, homebuyers, and automobile buyers and dealers was strongly encouraged.[81] Board Vice Chairman Frederick Schultz explained,

> . . . [T]he Board expects that, in setting interest rates and other lending terms banks will, where possible, take account of the special needs of these borrowers. . . .
>
> . . . Large businesses are on notice that they should not turn to the commercial paper market to replace other credit, as such a shift would reduce the residual credit available for other borrowers.
>
> . . . [T]hese measures can not prevent small, and indeed all, businesses from encountering strains in coming months.[82]

Lenders were expected to ensure a continued flow of credit to borrowers without access to other forms of financing. The Board required reports on such activities to monitor the lenders' progress and would consult with those whose efforts were inadequate. Further, the nation's 365 nonfinancial corporations with at least $30 million of outstanding commercial paper or total annual revenue of at least $2 billion filed monthly reports on their commercial paper issues and their foreign borrowings.[83]

Consumer Credit Restraint

To restrain consumer credit growth, the Board imposed a special deposit requirement (SDR) on all increases in certain types of consumer credit. The SDR required that lenders hold with the Fed in non-interest-bearing accounts reserves equal to 15 percent of the amount of consumer credit extended over the amount of covered consumer credit outstanding on March 14, 1980.[l] Credit subject to the SDR included all open-end credit, secured or unsecured, and closed-end consumer credit either unsecured or secured by collateral not purchased with the credit. Open-end credit consisted of credit card, bank overdraft and revolving credit.[m] For calculating the required deposit, all open-end credit was presumed to be used for non-business purposes. Closed-end credit included unsecured personal loans, loans for which the borrower already owned the collateral, travel and entertainment card plans, retail merchant credit, and credit secured by financial assets other than savings deposits. Thus, car, mobile home, and mortgage loans were exempt from the SDR because the proceeds of the loans financed the purchase of the car or home.[84]

Any lender extending at least $2 million in covered credit was subject to the regulation. The $2 million cut-off exempted 1.7 million retail firms and 36,595 other firms from the SDR. There were 10,108 firms remaining, of which about 6,000 were banks; these firms extended about 85 percent of all covered credit.[85]

All non-exempt lenders based on their covered credit outstanding on March 14 had to file monthly reports with the Federal Reserve (the Federal Home Loan Bank Board for thrifts and the Federal Credit Union Association for credit unions). The reports determined the lenders' covered credit outstanding during the previous month based on the daily average amount outstanding or the amount outstanding on a date approved by the Board.[86] For multi-

[l] The base was later changed; see Section VI.

[m] Credit card credit includes credit arising from purchases on retail credit card plans and from cash advances extended through such plans. Revolving credit includes special installment overdraft credit and revolving credit arising from arrangements with travel and entertainment charge cards and other nonbank credit plans.

subsidiary firms, the parent company filed a single report that combined the covered credit issued by all its subsidiaries.[87]

The SDR was designed to raise the cost of credit extensions and thus discourage credit growth. At the end of 1979, $38.4 billion in credit was available to MasterCard holders, of which 31.6 percent was used, and credit lines totalling $27 billion were available to Visa cardholders, with 48 percent outstanding. Though the growth in consumer installment credit outstanding slowed considerably during the last half of 1979 and the first two months of 1980, the Board was concerned that the record inflation rates being experienced might induce credit card holders to make greater use of their cards' credit lines. Limiting credit use through price rationing was not possible because state usury ceilings prevented card issuers from raising credit card interest rates in response to inflation.[88]

Although the SDR was only one part of the Board's program, it probably had the broadest reach, touching almost every American consumer. Many economists, however, questioned the SDR's usefulness. They viewed it as a cosmetic measure because it applied only to a small fraction of total credit in the economy. In terms of credit use at the end of 1979, covered credit was 48 percent, or $184 billion, of the $381 billion of total consumer credit outstanding,[n] and total credit was measured to be approximately $4 trillion.[89] As a result, the SDR was not expected to have any effect on inflation.[90] There was also concern that consumers would be unduly harmed by the requirement because they had few alternative funding sources. Volcker shared that concern but believed that the requirement was needed:

> [T]hey do bite at the consumer, at certain types of consumer lending, but ultimately at consumer spending because that is considered under present conditions not to be an area of high priority, given that credit has to be restrained overall. . . .
>
> . . . . [The Board is] trying to get at uses of credit that are less immediately relevant to the problems of the economy today.[91]

[n] The $381 billion of total consumer credit consisted of all covered open- and closed-end credit plus credit for home improvement loans, automobiles, mobile homes, service credit (unpaid bills to providers of services), and purchases secured by the goods purchased with the loan proceeds. Mortgage debt is not included. See Memo from Axilrod, Kichline, and Petersen to the Board of Governors, "Proposed Consumer Credit Regulation."

Marginal Reserve Requirements on Managed Liabilities

As described in Section IV, on October 6, 1979 the Board imposed a marginal reserve requirement (MRR) on managed liabilities in addition to the reserve requirements already in place. The MRR was levied on domestic member banks and U.S. branches and agencies of foreign banks and applied to any increases in their managed liabilities over their bases. The base was the larger of $100 million and the average amount of managed liabilities held as of the two statement weeks ending September 26. Institutions with managed liabilities exceeding $100 million had to report their bases to the Fed and were subject to the program.

The objective of the MRR was to slow bank credit growth by raising the cost of funds used to finance lending activity. Bank credit growth had slowed considerably during the fourth quarter of 1979; however, the slowdown was attributed primarily to the drop in credit demand that accompanied an increase in the cost of funds and growing concern over recession prospects. As demand fell, banks subject to the MRR reduced their managed liabilities. When their managed liabilities fell below their bases, they became able to increase their lending without holding marginal reserves. This made the MRR less effective. Loan demand rose in January and February of 1980, but marginal reserves responded considerably less because many banks could finance their credit extensions without going over their bases.

The MRR also failed to restrain credit growth because of several loopholes. One loophole allowed large domestic commercial banks and U.S. agencies and branches of foreign banks to circumvent the MRR because it applied to *net* Eurodollar borrowings, borrowings net of balanees due to a bank's own non-U.S. branches. This loophole worked as follows. Consider a financial institution using Eurodollar borrowings to directly fund a loan. The MRR required reserves be held against such borrowings. To avoid holding reserves, however, a bank would switch its loan customers to a foreign affiliate and provide its affiliate with the funds to make the loan. This type of indirect funding created Eurodollar loans to offset Eurodollar borrowings, reducing net borrowings and required reserves.[92]

A second loophole existed because the MRR applied to large time deposits with maturities of less than one year; thus, banks could issue deposits with longer maturities without increasing their marginal

reserves. In addition, federal funds purchases from small member banks and agencies and branches of foreign banks that were below their bases, and so not subject to the MRR, were exempt from the requirement.[93] Banks apparently recognized these methods for evading the reserve requirement; as a chief financial officer of a major New York bank explained, " 'If someone really doesn't want to carry the extra reserves, he doesn't have to.' "[94]

As part of its March 14 credit restraint efforts, the Board tightened the MRR on member banks and U.S. agencies and branches of foreign banks and, under the CCA, extended its coverage to include non-member banks. The Board raised the MRR from 8 percent to 10 percent and reduced the base by the greater of either 7 percent or the decrease in a bank's domestic office loans to foreigners plus the gross balances due from foreign offices of other institutions that occurred between the original base period and the week ending March 12. A bank's base would be reduced even further by future drops in foreign lending.[95] The Board expected holdings of marginal reserves to increase by about $1.3 billion as a result of these changes.[96]

For non-member banks, the base was the greater of $100 million or marginal liabilities over the two-week period ending March 12. As for member banks, the base would decrease by the amount of future reductions in foreign loans. The reserve requirement was 10 percent.[97]

Restraint on Money Market Mutual Funds

As part of its credit restraint program, the Board required money market mutual funds (MMMFs) and other similar creditors to maintain a non-interest-bearing deposit with the Federal Reserve. The deposit was equal to 15 percent of a fund's increase in assets over its March 14 base level. The 15 percent requirement was expected to reduce the return on a brand new fund by approximately 2 percent. All managed creditors had to report their bases to the Board and, on a monthly basis, their daily average asset levels.[98]

The reserve requirement on MMMFs was designed to slow the outflow of funds from thrift institutions and smaller banks. The percentage change in the growth of consumer savings from January to September, 1979 relative to the same period in 1978 was 184.2 at MMMFs, −13.3 at commercial banks, −14.9 at savings and loan associations, −49.0 at credit unions. By slowing the flow of funds into MMMFs and thus the national money market, the Board hoped to reduce the supply of credit available for large borrowers while easing credit availability for borrowers with few alternative funding sources.[99]

The legality of the Board's regulation of MMMFs was questioned from the moment the program was announced. House Representative Reuss argued that the public's transfer of funds from thrifts to MMMFs did not contribute to an "extension of credit in excessive volume" as required for use of the CCA.[100] The Investment Company Institute, a trade association of mutual funds, considered filing a lawsuit against the Fed, charging that the CCA did not authorize the Board to hinder individuals' attempts to manage their savings wisely and that the deposit requirement, which was essentially a tax on the return to MMMF deposits, was unconstitutional because only Congress could impose taxes. The Institute ultimately decided against filing the lawsuit because it did not want " 'to disrupt the government's overall economic program and because the precise effects of the [B]oard's action' " were unclear. Instead, the Institute formally petitioned the Board to lift the deposit requirement.[101] The Board responded by exempting certain MMMFs from the regulation, although it began requiring weekly, rather than monthly, reporting.[o]

Discount Rate Surcharge

Acting on requests from the directors of the twelve Federal Reserve Banks, the Board added a 3 percent surcharge to the rate of 13 percent charged on discount window borrowings. The surcharge applied only to borrowing by banks with at least $500 million in deposits when the borrowing occurs in at least two consecutive weeks or more than four weeks in a quarter. Of the 5,459 Federal Reserve member banks, 270 had deposits of at least $500 million.[102]

The surcharge was imposed to discourage frequent discount window borrowing by the largest and most active users of the discount window. According to the Board, because the surcharge applied only to a segment of banks, it would have a smaller effect on short-term interest rates than would a general increase in the basic discount rate. It was not meant as a device for guiding market interest rates.[103]

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[o] Board of Governors of the Federal Reserve System, Press Release, April 11, 1980. Exempted were "bona fide" personal trusts, pension, retirement, and other tax-exempt accounts invested in MMMFs; tax-exempt assets of MMMFs that invested at least 80 percent of their assets in short-term tax exempt obligations; and funds with a base of under $100 million. Unit investment trusts were allowed to be "rolled over" without satisfying the deposit requirement.

VI.
THE ECONOMIC EFFECTS OF THE 1980 CREDIT RESTRAINT PROGRAM

The Immediate Market Response

The Board's announcement of its CRP was followed immediately by turmoil in the financial markets.[104] On Friday, March 14, the day of the announcement, the prime rate was 18½ percent. It rose to 19 percent Monday, March 17, the third increase in four business days. The rise was attributed to the increased cost of funds caused by the Board's modification of the marginal reserve requirement on managed liabilities.[105] The same day, Henry Kaufman predicted that " 'the peaks of credit stringency and of interest rates are still ahead of us.' "[106] A Fed official was reported as admitting that the CRP would affect the allocation of credit. "He added that 'rationing by price in the marketplace hasn't been well distributed, and demand for credit has been a lot stronger than we [the Fed] thought it would be.' "[107]

Between the end of February and the middle of March, the rate on 90-day Treasury Bills rose 150 basis points. Announcement of the CRP and heavy government supply caused it to rise another 120 basis points before the end of March. According to Donald Maude, a senior vice president at Merrill Lynch Government Securities, Inc., " '[T]he appetite of investors for anything with a maturity longer than two years is negligible at best.' "[108] By April, two weeks after the CRP began, the prime rate reached 20 percent, up 350 basis points in one month, and the federal funds rate exceeded 19 percent. The rise in the funds rate equalled about two-thirds of the discount rate surcharge on large banks and was not expected by the Board.[p]

Complying With the Program's Requirements

There was considerable confusion among consumers and businesses over how to comply with the program. Although the Board tried to keep the control program simple by letting lenders independently develop policies to allocate credit in ways consistent with the regulations, creditors required much more detailed instructions regarding reporting requirements, maintenance of special deposits, and monitoring of compliance with supposedly "voluntary" restrictions. As a result, the Board issued 9 press releases over 8 weeks, providing answers to commonly asked questions about all factors of the program. Daily conference calls were made by the Board to the Federal Reserve Banks, providing the latest interpretation of the regulations so that the regional Reserve Banks could handle the thousands of phone calls they received for additional information.[109]

On March 17, Chairman Volcker was in Washington, D.C. briefing 65 of the leading bankers on the CRP. According to *The New York Times*, he told them that the Board expected their cooperation with the program, and he drove home his point by suggesting that other government agencies "would be involved in assuring compliance with the program." After the meeting, the bankers expressed concern over having responsibility under the program for allocating credit among their customers.[110]

By mid-March, when the voluntary credit restraint program was imposed, loan growth at many banks was already close to, if not exceeding, the maximum 9 percent annual rate. Banks were especially concerned about their ability to comply with the voluntary credit restraint program because of their loan commitments. Unused commitments at large banks rose from $235.6 billion at the end of December 1979 to $248.4 billion at the end of February 1980, and rose even further before March 14. As of mid-March, business loans outstanding totalled $157.3 billion.[111] If businesses made full use of the committed funds, bank lending would increase much more than 9 percent, the maximum under the CRP. When banks expressed concern over this possibility, the Board suggested that the banks decide which prospective borrowers had legally binding commitments and encourage them to postpone takedowns or find alternative financing.[112]

Bankers, especially those from banks with a strong consumer orientation, were upset that the Board imposed the surcharge instead of raising the basic discount rate.[113] At the time, federally chartered banks were permitted to charge one percentage point more than the prevailing discount rate on loans made. Thus, an increase in the basic discount rate would have provided banks some relief from usury laws that

[p] Many banks offered small businesses a below-prime interest rate to satisfy the Board's request for special programs for these borrowers. In addition, the Board announced on April 17, a "temporary seasonal credit program" for banks with less than $100 million in deposits. Aggregate credit lines of $113 million were arranged under the program for 129 banks, primarily from the Midwest. A total of $1.5 million was actually borrowed by five banks. This low borrowing level is attributed to the steep decline in the federal funds rate after April 17. See Board of Governors, "Federal Reserve Credit Restraint Program," p. 17; Letter from Volcker to Chairman Nowak, August 20, 1980, in U.S. House, *Hearings on Federal Monetary Policy And Its Effect On Small Business (Part 3—Credit Controls and Availability of Credit)*, p. 329.

made consumer lending unprofitable given the federal funds rate of over 16 percent on March 14.[114]

The immediate effect of the tightening of the marginal reserve requirement on managed liabilities was an increase in the number of member banks with covered managed liabilities in excess of their base levels from 115 to 199 between February 27 and March 26. The number of U.S. branches and agencies of foreign banks having to hold such reserves rose from 19 to 44 over the same period; 43 nonmember banks were also affected by the program as of March 26. Overall, covered managed liabilities in excess of affected institutions' base levels rose from $4.0 billion to $21.2 billion between February 27 and March 26.[q]

As stated in Section V, the Investment Company Institute decided against filing a lawsuit over the 15 percent special deposit requirement levied on MMMFs. One factor behind this decision was the realization that the regulation, along with the Securities and Exchange Commission's corresponding requirement that MMMFs disclose the effects of the CRP on their funds, would not be as onerous as first thought.[115] James Benham, chairman of Capital Preservation Fund, was quoted as saying " 'At first, this [the CRP] looked very messy for all of us, but now I think the fund business is going to continue booming.' "[116] Many MMMFs initially responded to the program by stopping their advertising so as not to attract new investors. Many stopped accepting new accounts altogether but continued accepting deposits from existing shareholders. Existing funds expected that staying below their base level, and thus avoiding the 15 percent special deposit, would be easier than originally thought because the CRP coincided with income tax season, which could increase redemptions.[117] Managers of existing funds accepted that they would have to keep at least small amounts on deposit because of the normal errors in predicting weekly asset levels.

During the first four weeks following the CRP's announcement, MMMF assets declined over $1 billion.[118] The Board's March 28 exemption of certain funds from the special deposit requirement contributed to a resurgence of asset growth in the second half of April, as did the creation of new funds, called "clones." Clone funds were developed to allow MMMFs to accept new deposits without lowering the return to incumbent shareholders, and possibly exposing the mutual funds to legal challenges by these shareholders. The clones held portfolios resembling those of the first generation funds from which they derived. By late April, approximately 96 money-market funds were operating, of which 15 were clones with assets of about $329 million.[119] Of the 70 older funds sold to individual investors, 32 were still accepting additional investments. During their first few weeks of operation, the clones offered higher yields than the older funds. For example, as of April 16, clone funds offered a 30-day average yield of 17 percent while older funds offered only 15.3 percent.[120] This differential arose, despite the special deposit requirement, because clones that were set up quickly were invested heavily at the higher, post-controls interest rates. By the end of May, the older funds had a slight yield advantage. Special deposits by MMMFs with the Board peaked at $817 million and were $573 million, or 0.72 percent of assets, when the controls were lifted.[121]

Besides MMMF assets, increases in consumer credit were also subject to a 15 percent special deposit. Announcement of the deposit requirement on lenders of certain types of consumer credit brought complaints that the regulation was unfair and difficult to comply with because of existing state and federal laws. Specifically, creditors argued that the choice of March 14 as the base ignored the seasonality in their sales, and thus credit extensions.[122] Also, the Truth in Lending Act required that customers be notified of any changes in the terms of credit card agreements. Each state had its own notification laws, requiring between 15 and 105 days' notice.[123] Credit card issuers complained that these laws made changing card terms difficult. Moreover, changes that were made could not be applied only to new extensions of credit without great expense and delay; consequently, outstanding balances would be affected also.[124]

In response to these complaints, the Board made several technical changes in its consumer credit restraint regulations on April 2. First, the Board established a uniform national requirement that written notice of changes in charge account terms be given to account holders at least 30 days in advance. Second, account holders had to be given the option of paying their outstanding balances under the original account terms. Although the Board superseded state notification requirements, it chose not to waive state interest rate ceilings. Later on April 14, the Board did waive conflicting federal regulations on finance charges for oil company credit

[q] Board of Governors, "Federal Reserve Credit Restraint Program," pp. 40, 42. A few other non-member banks later became subject to the program.

programs.[125] Third, to adjust for the seasonality in sales, creditors were given an alternative method of calculating their bases. They could use either March 14 or the amount of outstanding covered credit for March 1979, scaled up by a factor based on the increase in the firm's covered credit between March 1979 and March 1980. The scaling factor would be reduced by one-twelfth each month to make the SDR applicable by March 1981 to any year-over-year increase in covered credit over the base level. Finally, responding to a petition by the Consumer Federation of America, the Board said that it would try, but could not promise, to give the public an opportunity to comment on rule changes before making a final decision.[126]

Lenders had reduced their issuing of credit cards for several months before the CRP because high market interest rates were bumping against usury ceilings.[127] Once the uniform 30-day notification requirement was imposed, they began modifying their charge account terms. A congressional subcommittee survey of 59 creditors offering 96 distinct charge cards found that the most frequent change in terms made in response to the CRP was the imposition of an annual fee. This change was made on 49 percent of the cards surveyed. Creditors stopped accepting credit card applications for 42 percent of the cards. Forty-one percent raised the standards for qualifying for credit; 41 percent changed the finance charge calculation method; 35 percent increased the annual percentage rate; and 23 percent increased the minimum monthly payment. Eighty-six percent of the cards had their changes applied retroactively to the account holder's outstanding balance. Among the most stringent actions were Exxon's announcement of a 50 percent increase in its minimum monthly charge and that, effective August 1, single purchases under $40 would be included in the minimum monthly payment. Even in 1980, a tank of gas cost less than $40.[128] To discourage credit card use more generally, a television advertisement ran in which Russell Hogg, president of the Interbank Card Association, which franchises MasterCards, discouraged use of MasterCards for anything other than " 'necessities and emergencies.' "[129]

The Big Surprise

On March 24, just ten days after the CRP began, the Administration saw the first sign of recession: an increase in unemployment benefit applications.[130] As the Administration later explained,

> Early in 1980 there were few signs of recession. If anything, activity seemed to be picking up. The evidence available at the time hinted that households . . . were on a buy-in-advance spending spree. . . .
>
> By early March there was fear that inflationary pressures . . . were mounting . . ., and that without some additional action these would . . . lead to an explosion of prices. . . . It was in this environment that . . . . the President authorized . . . selective controls on credit.[131]
>
> In retrospect, it appears that . . . interest rates finally had reached levels in late February and early March which were sufficient to discourage borrowing. However, data [available when the credit controls were planned] . . . did not show this development. . . . [N]ew home sales fell slightly in February and plunged in March, although the only information available in early March had shown that sales advanced in January.[132]

Additional evidence of recession soon followed the unemployment data. Statistics for March indicated that the narrow money aggregates fell sharply in late March; the Board attributed this to the increased opportunity cost of holding money caused by the reserve requirements on managed liabilities and the start of a recession.[133] Weekly data for large banks showed loan growth remaining strong through early March, but slowing considerably over the rest of the month. As a result, total bank loan growth for March fell to an adjusted annual rate of 2½ percent from rates of 15 percent to 20 percent earlier in the year. Consumer installment credit rose only 5 percent in March and 7 percent for the first quarter.[134] Housing starts suffered their largest fall in twenty years.[135] By April 11, market analysts were speculating that the Board would ease its credit controls soon because of the accumulating evidence suggesting that a severe recession was underway.[136]

One month after credit controls were imposed interest rates began a sharp decline. The prime rate was 19.5 percent on April 18, while the federal funds rate was 18.3 percent and the 3-month commercial paper rate was 16.2 percent. The 3-month Treasury bill rate, which had peaked at 16.5 percent at the end of March, was down to 13.8 percent, its lowest level since the beginning of March.[137] Traders rejoiced that the corporate bond market was reborn because companies once again began seeking long-term financing. Market analysts attributed the bond market's revival to anticipations that inflation would not be allowed to get out of control and to firms' attempts to replace bank loans with fixed-cost market financing.[138]

The consumer credit controls were largely symbolic and without teeth; however, they induced consumers to alter their buying behavior. Consumer spending, especially credit-financed expenditures, fell off dramatically. The country's major retailers

(e.g. The J.C. Penney Company, Sears, etc.) experienced declines of about 20 percent in charge account applications and 10 percent in credit sales during March and April.[139] Retail sales fell at the fastest rate in twenty-nine years.[140] According to economist S. Lees Booth, the program " 'may have been symbolic, but it was shocking.' " A *New York Times*/CBS News poll taken in April showed "58 percent of Americans . . . using credit cards less than they did . . . in [1979], while only 5 percent were using them more."[141] As President Carter described the situation, "[M]any [credit] card holders began to believe that it was almost unpatriotic to buy items on credit."[142] Typical of the letters Carter received from the public regarding the controls was one from Dennis Gordon of San Francisco, California. It read,

> We are supporting you sir, one-hundred percent. Your inflation fighting program has forced us into alternatives that we are not finding hard to live with. We are spending with more wisdom and not as frequently. We are drawing closer to each other during this fight against inflation. An evening once [spent] going "out on the town" is now enjoyed gathering in our home or the homes of friends. We have once again discovered parlour games, sing songs, lengthy walks and other means of "old fashioned" entertainment.
>
> I believe myself and my group of friends are not unique. I believe all across America we are pulling together to survive, and will do so quite nicely and to our surprise, comfortably.[143]

An informal *New York Times* survey of consumers in Ridgewood, New Jersey revealed similar attitudes.[144]

The decline in consumer spending, however, concerned the Federal Open Market Committee at its April 22 meeting. According to the Board's description of the meeting,

> The contraction in activity was projected to be somewhat larger than had been anticipated a month earlier and to be accompanied by a substantial increase in unemployment. . . .
>
> The degree of prospective weakness in consumer spending was viewed as a major source of uncertainty. The anti-inflationary measures announced on March 14 appeared to have curbed considerably spending in anticipation of price increases. It was noted in this connection that a rise in the saving rate from the abnormally low levels of the most recent two quarters to a more normal rate would imply a marked cutback in consumer spending. . . . However, it would be premature to conclude that inflationary attitudes and behavior had been fundamentally altered, especially in view of the prospect that the rapid rise in the consumer price index would persist for a number of months. . . .
>
> Several members noted their concern that if a large decline in interest rates were to occur over the next few weeks, it was likely to be perceived by some market participants . . . as an easing of monetary policy and could have very undesirable repercussions on inflationary psychology . . . .[145]

For the month of April, the narrow money aggregates again fell sharply, hitting below the lower end of the Federal Open Market Committee's long-run target range. Only three banks still had annual loan growth rates exceeding 9 percent. Total bank loans outstanding fell 5 percent (annualized).[146]

In May, interest rates plummeted, falling about one percentage point each week.[147] Bank loan growth declined further. The slowdown in bank loan growth in April and May reduced by over 100 the number of financial institutions having to hold reserves against managed liabilities.[r] By May 5, market analysts speculated that the end of the CRP was near because "the measures weren't needed in the first place," and the program was " 'scaring people away from the stores.' " The consumer controls were expected to be lifted within six weeks.[148]

The Board's first step toward easing the controls was elimination on May 7 of the 3 percent discount rate surcharge. While the surcharge was in place, few banks had to pay it because it had been imposed only two weeks before the first quarter ended. Consequently, at most seven banks paid the surcharge in any statement week, and almost all that did borrowed in two consecutive weeks. The surcharge was lifted just days before any banks could be subject to the surcharge for borrowing four weeks in any quarter.[s]

On May 14, Volcker announced that the Board could " 'legitimately look forward to dismantling' [the CRP]. . . . 'We have not wanted to move prematurely, we will not. . . . But equally, we are not interested in fostering any impression that credit allocation, formal or informal, can be any part of the basic, continuing armory of monetary policy.' "[149]

The Board eased the credit restraint measures considerably on May 22, the day lenders of consumer credit were to make their first special deposit. It cut the deposit requirement on consumer credit and MMMFs from 15 percent to 7.5 percent, cut the reserve requirement on managed liabilities from 10 percent to 5 percent, and revised its lending guidelines to make credit more available for certain

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[r] Board of Governors, "Federal Reserve Credit Restraint Program," pp. 40, 42. The excess of covered managed liabilities over base levels dropped by $11.1 billion over this period.

[s] Peter Keir, "Impact of Discount Policy Procedures on the Effectiveness of Reserve Targeting," in *New Monetary Control Procedures*, pp. 158-159 and Table 2. Those paying the surcharge borrowed an average of $80 million.

types of loans.[150] Treasury Secretary Miller, meanwhile, encouraged consumers to return to the stores.[151]

The May easing of the CRP did not slow the flow of bad economic news in June. Early in the month, data was released showing that unemployment rose 1.6 percentage points to 7.8 percent over April and May; it was the largest two-month increase ever.[152] In addition, consumer installment debt fell 8 percent in April, with the decline greatest for personal loans. This was the first decrease in consumer debt since May 1975.[153] On the bright side, producer prices rose only 0.3 percent in May. Economist Lawrence Chimerine, chairman of Chase Econometrics, called the credit controls " 'overkill,' " and saw the recession as being "very severe," with little chance of a quick recovery.[154] By the end of June, the National Bureau of Economic Research declared that the economy was in a recession that had begun in January.[155]

The economy was so weak by late June that the controls were nonbinding.[156] As a result, on July 3 the Board announced the phase-out of the CRP, and President Carter removed the Board's authority under the CCA except as needed to end the program. Carter warned that he retained the authority to impose controls and would invoke the CCA again if signs of excessive credit use reappeared.[t] Retailers were concerned that the psychological effect the controls had on consumers might not be reversed by simply lifting the controls.[157] They immediately began planning credit promotions in hopes of revitalizing charge sales, although they retained many of the more stringent credit policies they had adopted while the controls were in place (e.g. annual fees and higher minimum monthly payments) because they were "good business practices."[158]

Data released July 9 showed that consumer installment credit fell a record 13 percent in May. New consumer credit extensions were 25 percent lower than the September 1979 peak. These declines were attributed to the effect the CRP had on consumers. Between January and May, output of consumer goods fell 3.7 percent, while retail sales fell 10.3 percent. From April through June, preliminary data showed an 8.5 percent (annualized) decline in GNP. Inflation, however, was down to 11 percent by July, as was the prime rate.[159]

[t] Board of Governors, Press Release, July 3, 1980. Also "White House Credit Text," *The New York Times*, July 4, 1980. The reserve requirement on managed liabilities would be lifted July 10; the special deposit on consumer credit, July 23; and the deposits by MMMFs, July 28.

The Aftermath of the Controls Program: Another Surprise

After the precipitous drop in economic activity during the second quarter, economists generally expected the recession to last through the end of 1980 and be almost as severe as the 1974-75 recession. In reality, however, private sector demand "rebounded with surprising alacrity." The sharp drop in interest rates was a driving force in the recovery, stimulating housing and consumption. Housing starts rose 70 percent between May, their low point, and September; car sales also rebounded dramatically, increasing 28 percent between May and October. Although outstanding consumer installment credit experienced its largest decline in the postwar period during the second quarter, it began rising as soon as the controls were lifted, albeit at a slower pace than early in the year. The rise in credit use was accompanied by an increase in consumer spending. Real retail sales rose 17.8 percent in June and 27.3 percent in July. In the third quarter, real personal consumption expenditures rose 5.1 percent, compared with a record 9.8 percent second quarter decline.

The drop in interest rates in the spring was short-lived. As the economy strengthened and inflationary pressures intensified, the demands for money and credit increased and interest rates rose. The prime rate climbed from 11 percent in July to 21.5 percent in December. The federal funds rate hit 19.8 percent as the three-month commercial paper rate reached 19.5 percent.

Looking at 1980 in its entirety, the economy experienced a short but severe recession during the first half of the year and quickly recovered during the second half. Real GNP remained essentially unchanged, while the money aggregates were close to the upper end of the Federal Open Market Committee's fourth quarter-to-fourth quarter target ranges. Disposable income rose only 0.5 percent, but personal consumption fell 0.3 percent. Consequently, saving rose one percentage point over the previous year, fourth quarter to fourth quarter, to 5.7 percent. The CPI, excluding food, energy, and home purchase and finance, rose 9.0 percent between April and November, slower than the 12 percent rate during the first quarter, but higher than the 7.2 percent rate for the year ending November 1979.[160] In retrospect, the credit control program appears to have lowered interest rates and inflation only while it was in effect, and did so by worsening a recession that was already underway.

Data Resources, Incorporated conducted a preliminary study in 1980 of the CRP's overall economic impact.[161] DRI found that

> "the March 14 Credit Controls had some negative impact on the economy in the second quarter. . . . The credit controls did make the fall off in economic growth more severe."

In addition, DRI concluded that the CRP reduced real output, but not inflation; other factors accounted for the lower inflation rate during the second and third quarters.[u] DRI's simulations indicated that the CRP's total, long-run cost to society would be losses of $23 billion of GNP, $19 billion of total consumption, 300,000 man-years, 50,000 housing starts, and 500,000 new domestic car sales.

VII.
WHAT WENT WRONG?

Although the 1980 recession was underway before the CRP was imposed, the Board, the Administration, and the financial markets believed that the program contributed to the steep fall-off in economic activity beginning in March. This slowdown is apparent in the time series of the key macroeconomic variables, as Figures 1-10 show. This section addresses two questions: To what extent did the controls accomplish the Board's objectives? To what extent did they contribute to the recession?

Each component of the CRP had a different effect on the economy. Some accomplished what they were designed to do; others did not. Some were too effective at reducing credit use.

The reserve requirements on managed liabilities and the discount rate surcharge were not expected to affect market interest rates, but they did. The imposition of these measures immediately raised the cost of funds to large banks. This increased cost quickly led to increases in the prime and federal funds rates. Loan growth slowed as the rising interest rates priced borrowers out of the credit markets.

Also contributing to the decline in bank lending was the voluntary credit restraint program. According to the Board,

> It is difficult, if not impossible, to say how much of the weakness in bank loans [under the program was] . . . due to the recession, how much to reaction to fiscal announcements and general credit conditions (including expectational effects), how much to the cumulative effects of earlier overall restraints, and how much to the credit restraint programs. But the timing and abruptness of the change in loan growth trends suggest that announcement of the programs played a significant role. Indeed the immediate effect of the programs on bank lending may have been exaggerated by the initial reactions of lenders to these restraints, as they sought to evaluate what the Federal Reserve actions—especially the 6 to 9 percent limitation—would mean in their particular case . . . .[162]

In contrast, the special deposit requirement on MMMFs was designed not to reduce credit use but rather to alter the disintermediation from financial institutions. It did not accomplish its objective because, as explained in Section VI, it had a negligible effect on fund yields. Although assets at MMMFs fell during the first four weeks of the CRP, they quickly recovered, growing over 30 percent between mid-March and late July.[163]

Similarly, the consumer credit restraint program was not expected to have a major impact on credit use or consumer behavior because it focused primarily on charge card credit and personal loans and was imposed on lenders, rather than directly on consumers. Consequently, the declines in consumer installment credit, personal consumption expenditures, and retail sales were a big surprise. This surprise may have been caused in part by the response of charge card issuers to the restraint program. Despite the Board's announcements that the CRP would be in place only temporarily,[164] many of the changes in charge card terms made under the program were not designed for temporary use. The most effective, least costly, and easiest ways for creditors to temporarily reduce the growth of charge card use were to stop accepting card applications and reduce credit lines while the program was in place. These were not the steps most commonly taken in response to the controls. Rather, creditors more often introduced annual fees and changed the methods of calculating the minimum balance and finance charge, changes that were more costly to implement and inconsistent with the program's temporary nature. These changes also applied retroactively, thereby penalizing charge account holders generally rather than only those who used their cards while the controls were in force.[v] Because creditors decided individually how to respond to the CRP, the changes made in credit terms varied greatly across charge cards. The diversity in charge term changes, together with the failure of creditors to communicate these changes clearly, contributed to consumers' confusion over the impact of the program on their finances.[165]

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[u] The Chamber of Commerce's summary of DRI's results does not specify what these other factors might be.

[v] Many of these changes are still in place today.

Fig. 1 **Real GNP**
Annualized Percent Change

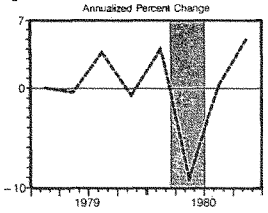


Fig. 2 **Total Consumption Expenditures (NIPA)**
Annualized Percent Change

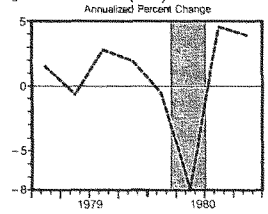


Fig. 3 **Fixed Investment and Change in Business Inventories (NIPA)**
Annualized Percent Change

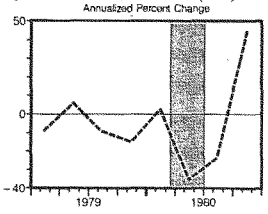


Fig. 4 **Consumer Installment Credit Outstanding**
Annualized Percent Change

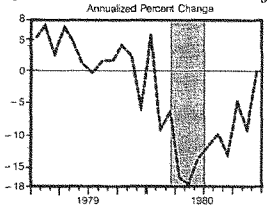


Fig. 5 **Retail Sales Excluding Automotive Group**
Annualized Percent Change

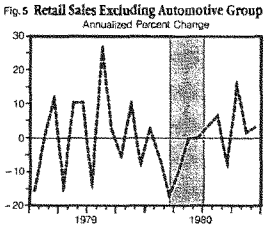


Fig. 6 **Market Interest Rates**
Percent Per Annum

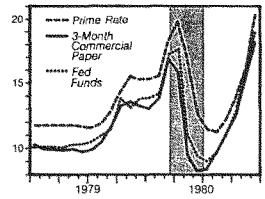


Fig. 7 **Treasury Interest Rates**
Percent Per Annum

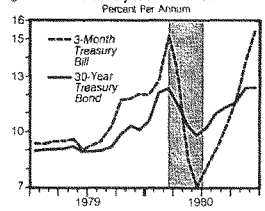


Fig. 8 **Unemployment Rate**
Percent for Month

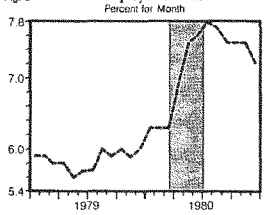


Fig. 9 **Consumer Price Index**
Annualized Percent Change

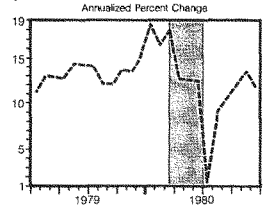
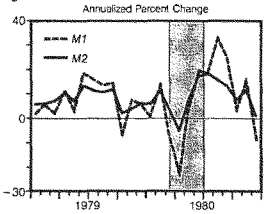


Fig. 10 **M1 and M2**
Annualized Percent Change



Figures 1, 2, and 3 use quarterly data, all others use monthly data. Data points are centered over their respective time periods, those periods represented by segments between tick marks.

Data for Figures 1-5, 8, and 9 are seasonally adjusted.

Gray shading indicates period of Credit Controls: March 14, 1980 - July 3, 1980.

As the preceding discussion indicates, the CRP led to an immediate rise in short-term interest rates and affected consumers' buying psychology. The rise in interest rates was only temporary; within a month after the CRP began, rates started falling. This suggests that the CRP resulted in an immediate decrease in the supply of credit, followed by a larger decrease in the demand for credit. The drop in demand was in addition to the decline that would have occurred even in the absence of credit controls because of the recession that was already underway.

Looking back on the CRP, Board Vice Chairman Schultz explained why it did not work as planned:

> We [the Board] learned in 1980 that it is exceedingly difficult to assess in advance the impact of controls on economic activity. When the Board enacted its program, we did not anticipate, and we had no reason to anticipate, the market impact it would have. *Given the limited coverage of the program, it would have been expected to have had a moderate effect on aggregate demand; however, we did not reckon correctly the dimensions of the psychological impact of the program on borrowers and lenders.* To be sure, some of this impact owed in part to a misunderstanding, especially at the beginning, about the scope and intent of the program, but beyond this, there was [a] remarkable shift in attitudes that led to a sudden contraction of credit flows. This contraction involved even those sectors that were explicitly exempted from the controls, and . . . *contributed to a sharp economic recession.* Then, when we removed the controls in the early summer, we were surprised once again by how quickly the economy snapped back.[166] [emphasis added]

Two events increased uncertainty concerning labor income in the first half of 1980. First, rumors began spreading in late 1979 that a recession was imminent, but its length and severity were unknown. This led to a slowdown in consumer credit use in late 1979 and early 1980. Second, the imposition of credit controls in mid-March increased consumers' uncertainty about their ability to use their charge cards and obtain personal loans. For consumers, charge cards and personal loans are a source of liquidity and a means to smooth their consumption expenditures over time because they enable consumers to access their future income. Consequently, the controls raised consumers' uncertainty about the amount of income accessible in the present, causing consumers to reduce current consumption even more sharply than they had before the controls became effective.[w]

Table I presents evidence supporting the claim that the 1980 recession was " 'the worst consumer recession since World War II.' "[167] The table, which is patterned after one by Barro,[168] shows the shortfall in real GNP for each recession since World War II and the percentage of the shortfall attributable to personal consumption and investment. The shortfall is calculated as the average over all quarters in a recession of the deviation of actual GNP from its trend level. For the 1980 recession, personal consumption accounted for 79.4 percent of the shortfall in real GNP; this is more than twice the average 34.8 percent contribution for all postwar recessions and is 36 percentage points greater than that for the 1973-1975 recession. The contribution of expenditures on durable goods alone is 37 percent, 3.3 times the average of 11.2 percent. In contrast, investment, defined as gross fixed investment plus the change in business inventories, contributed 64.9 percent of the shortfall in real output, compared with an average of 69.5 percent for all recessions considered.[x] Thus, this evidence suggests that the CRP contributed to the 1980 recession by inducing a greater reduction in consumption, especially consumption of durable goods, than that in the typical postwar recession.[y]

VIII.
The Fate of the Credit Control Act

Senator Helms's attempt to repeal the CCA in 1979 was not the last such attempt. In fact, while selective credit controls were in place in 1980, another effort was made at legislative repeal. In May 1980, Senator William Armstrong proposed an amendment to Senate bill S. 2352, which would extend authorization for the Council on Wage and Price Stability. The amendment would end the President's authority under the CCA as of July 1, 1981. According to the amendment's supporters,

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[w] Why would consumers alter their buying behavior as they did in response to restrictions on credit card use and extensions of personal loans? The economics literature shows that when faced with greater uncertainty regarding labor income increases (i.e. increases in the variance of expected future income), a risk-averse consumer will reduce current consumption and plan to increase future consumption. That is, the consumer behaves more prudently, saving more in the current period as a precaution against possible future misfortune. See Olivier Jean Blanchard and Stanley Fischer, *Lectures on Macroeconomics* (The MIT Press, 1989), pp. 279-291; Stephen P. Zeldes, "Optimal Consumption with Stochastic Income: Deviations from Certainty Equivalence," *The Quarterly Journal of Economics*, vol. 104, no. 2 (May 1989), pp. 275-298.

[x] For some recessions, the percentage contributions of consumption and investment to the GNP shortfall sum to over 100 percent. This occurs when government purchases and net exports combined had a stimulative effect, contributing to a reduction (i.e. a negative percentage change) in the GNP shortfall.

[y] There are methods, other than those used in Table I, for calculating the shortfall in real GNP. They result in consumption making an even greater contribution to the shortfall than shown here.

Table I

Breakdown of Shortfall in Real GNP During Postwar Recessions

Time Period of Recession									
Quarterly*	48:IV-49:III	53:II-54:II	57:III-58:I	60:II-61:I	70:I-70:IV	73:IV-75:I	80:I-80:II	81:III-82:IV	Mean for Postwar Recessions
Monthly	48:11-49:10	53:7-54:5	57:8-58:4	60:4-61:2	69:12-70:11	73:11-75:3	80:1-80:7	81:7-82:11	
Average Quarterly Shortfall of Real GNP**	9.56	17.66	28.03	13.61	22.08	38.17	48.29	41.20	27.32
Average Quarterly Real GNP	1114.53	1429.13	1534.97	1665.15	2417.53	2720.47	3195.25	3191.28	2158.54
Average Shortfall as a % of Average Trend Real GNP	0.86	1.24	1.83	0.82	0.91	1.40	1.51	1.29	1.23
% of Real GNP Shortfall accounted for by:									
Personal Consumption Expenditures	26.15	20.66	26.24	37.43	26.26	43.35	79.38	18.51	34.75
Durables	−14.45	4.70	10.15	16.33	19.57	16.02	37.02	0.59	11.24
Nondurables	19.52	17.54	12.88	19.22	4.67	21.98	24.66	9.41	16.23
Services	21.08	−1.58	3.21	1.88	2.02	5.36	17.71	8.50	7.27
Gross Fixed Investment plus Change in Business Inventories	129.41	27.86	48.03	107.99	38.36	72.02	64.94	67.50	69.51
Other***	−55.56	51.48	25.73	−45.41	35.39	−15.38	−44.32	14.00	−4.26

* Barro studies the period 1929-1982 and uses annual data; consequently, he combines the 1980 and 1981-82 recessions. Here, quarterly data are used. In determining the first and last quarter in a recession, we include quarters with at least two months of recession.

** The shortfall, measured in billions of 1982 dollars, is the average difference between trend GNP and actual GNP for each quarter in the recession. Trend GNP is determined by multiplying the actual GNP for the previous quarter by the trend quarterly growth rate of 0.8% + for the period studied.

*** "Other" consists of government purchases and net exports.

> Having suffered the inevitable inequities, costs and frustrations inherent in . . . [selective credit controls], a coalition of business and consumers want the March 14th program stopped and the Act repealed. . . .
>
> On paper, the credit control program was simple: direct bankers to restrain credit lending, allowing each to say how. In reality, the program has been a nightmare.[169]

During Senate debate of the amendment, Helms argued that

> [b]y leaving the Credit Control Act on the books, we make it almost mandatory that the President use it when he has a seemingly good excuse to use it. In other words, if he neglected to use it, some might say that he was not "doing all he could" to fight inflation. By leaving such an act on the books, we make the President more subject to pressures to "do something" even though "doing something" using credit controls is the wrong thing to do.[170]

The House considered its version of the bill in September. This bill did not include an amendment for sunsetting the CCA. In debate of the bill, Representative Annunzio suggested that the Senate's amendment was politically motivated to detract attention from the success of President Carter's anti-inflation program and hurt his chances in the upcoming election.[171]

A conference committee met to arrange a compromise between the House and Senate versions. The committee amended the Senate bill to sunset the CCA on June 30, 1982, a year later than originally proposed. The Senate approved the Armstrong amendment and S. 2352 by votes of 43-40 and 72-11, respectively, and the House gave its unanimous consent to S. 2352 as amended.[172] Carter signed the bill into law on December 9, 1980,[2] stating,

> I believe that abolishing the authorization granted to the President under the [CCA] . . . is highly unwise, because many of the act's provisions can be extremely helpful at critical periods in the fight against inflation. This is no time to strip a President of inflation-fighting powers. At the same time, I recognize that certain improvements to the Credit Control Act may be desirable. It is my hope that during the next 18 months Congress will enact a new Credit Control Act that saves the essential inflation-fighting powers that the act makes available.[173]

Thirteen days after the sunsetting of the CCA, the House held hearings on H.R. 6124, a bill "to reduce interest rates, control inflation, and ensure the availability of credit for productive purposes, and promote economic recovery by extending the Credit Control Act." Specifically, the bill would repeal the

[2] See Act of December 8, 1980, 94 Stat. 2748-9. Section 9 amends the CCA by adding to it Section 211, terminating the authority conferred by the CCA on June 30, 1982.

termination of the CCA (Sec. 211) and amend Section 205(a) to read

> "Whenever the President determines that such action is necessary or appropriate *to reduce high levels of unemployment in any sector of the economy, or to prevent or control inflation or recession*, the President may authorize the Board to regulate and control *any or all* extensions of credit." [emphasis added]

It also allowed for limiting credit for nonproductive purposes.[174]

Typical of the arguments given in support of H.R. 6124 were those by J. Morton Davis, president of D. H. Blair & Co., Inc., and J. C. Turner, general president of the International Union of Operating Engineers and chairman of the National Council for Low Interest Rates. Davis called the CCA a "spare tire" and wondered why anyone would not want to have a spare tire available. Turner argued that high interest rates were the "quicksand" of the 1981-1982 recession and that the CCA provided "the only avenue available for removing the crushing burden of high and volatile interest rates." He also supported the addition of unemployment and recession as "triggers" to allow use of the Act.[175]

The Board and the Reagan Administration opposed H.R. 6124. Preston Martin, Board Vice Chairman in 1982, testified,

> [The Board does not] believe that credit controls are an effective, efficient, or fair method to deal with [unemployment, recession, high interest rates or] . . . inflation when the more general instruments of monetary and fiscal policy can be used. Our experience with the administration of controls for a brief period in 1980 amply demonstrated the difficulties encountered in the application of credit controls.[176]

Former Board Vice Chairman Frederick Schultz concurred:

> Now, with the benefit of 20/20 hindsight . . ., I am convinced that controls were not the right way to address the economic problems we experienced in early 1980. . . .
>
> One reason some people have proposed that credit controls be used today is that they feel this would help to lower interest rates and aid the economy. . . . Certainly one does not lower interest rates by reducing credit supplies! So the lowering of rates must be achieved by reducing effective credit demands, which in the aggregate is not consistent with higher rates of spending and economic activity. . . .
>
> . . . We still found ourselves at the end of . . . 1980 with the need to deal with inflation, high interest rates, and languishing productivity. Indeed, I think that there is a considerable risk that the underlying problems of the economy will be found to be even more intense once a period of credit controls has been ended. . . . The quick-fix or the bandaid policy always looks attractive, but that is a cruel deception. This is why I oppose having credit controls available even on a standby basis, for emergency situations.[177]

On behalf of the Reagan Administration, Manuel Johnson, Acting Assistant Secretary for Economic Policy, reported that

> the Administration strongly opposes the use of credit controls, or any controls for that matter. . . .
>
> The recent experience with credit controls in 1980 exemplifies virtually all of the undesirable consequences of controls. . . . Key industries targeted for relief, such as housing and autos, collapsed under the weight of credit scarcity. Interest rates were temporarily reduced but the cutoff of credit at the lower rates produced rising unemployment and a general weakening of the economy that subsequently turned into a full scale recession from which we still have not fully recovered. And, instead of declining, inflation continued strong throughout the year.[178]

H.R. 6124 died in committee, but its fate and the testimony given opposing it did not prevent an extended version of the bill from being introduced as H.R. 1742 just one year later. In June 1983, the House Subcommittee on Economic Stabilization held a hearing on the bill, called the Credit Control Act of 1983. The bill amended the CCA of 1969 as H.R. 6124 would have and included a provision for the Board to review the financing of corporate acquisitions and mergers.[179] At the subcommittee hearing on the bill, Representative Norman Shumway asserted,

> I have read the bill. Certainly no one can quarrel with the stated purposes of it: to reduce interest rates, to control inflation, to ensure the availability of credit for productive purposes and to promote economic recovery.
>
> But I would suggest [that] . . . there is no evidence whatsoever that explicit control by the Federal Government of credit availability and allocation will contribute to the achievement of any of these objectives.
>
> In fact, the most recent experience we have had with credit controls under the past administration proved to be a disaster. It depressed an economy which was already headed for a period of lesser growth as a result of existing trends and policies. . . .
>
> Mr. Chairman, you know as well as I that although the bill before us provides the President standby authority only, this President neither wants nor needs such authority.
>
> He has indicated, in fact, that he will veto the legislation if sent to him. This, of course, is highly unlikely because the Senate has no intention whatsoever of considering the measure.
>
> I can only conclude, therefore, that the introduction of H.R. 1742 and today's hearing are both rather desperate attempts to embarrass the administration.
>
> In the face of the increasingly bright signs of a healthy recovery, I can perhaps understand the desire of my friends on the majority side to score partisan political points, but I don't understand why this senseless and rather meaningless proposal was chosen as the vehicle.[180]

The hearing was brief, and the bill never got out of committee.

No bills have been introduced subsequently to reenact the CCA of 1969. For now, the Presidential authority for selective credit controls conferred under the Act remains repealed.

IX. Could Credit Controls Be Part of Our Future?

The Carter Administration apparently decided to impose credit controls to signal that it was actively fighting inflation. The Board and the Administration designed the credit restraint program to have minimal economic impact on real production and employment. Contrary to their expectations, however, the program's immediate effect was to raise, not lower, short-term interest rates and to dramatically reduce consumer confidence. Interest rates started down within a month after the program began as a decline in consumer spending worsened the developing recession. The economy's recovery after the credit controls were lifted was as fast and sharp as its decline when they were imposed. Credit controls thus proved to be a blunt policy instrument whose economic impact was impossible to manage.

At present, there is no legislative authority for selective credit controls like those used in 1980.[181] The only Presidential authority to regulate credit is granted under section 5(b)(1) of the Trading With The Enemy Act of October 6, 1917 (40 Stat. 415). This act allows for the investigation, regulation, or prohibition of "transfers of credit or payments between, by, through, or to any banking institution" during wartime.[182]

Although no legislative authority now exists for credit controls, the U.S. experience with such controls probably has not come to a close. This experience suggests that in times of rising prices and interest rates, there are always voices advocating the use of credit controls. And in such times, Congress grants the authority for such controls, despite its own earlier recognition of the ineffectiveness and economic harm that credit controls have caused. The 1980 experience makes clear the dangers involved in using credit controls to fight inflation. This article has reconstructed the details of that experience in the hope that policymakers will be more aware of the dangers of credit controls in the future.

Endnotes

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14. "Banking—Interest Rate Ceilings—Credit Control: P.L. 91-151," p. 1516.
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The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers

Hearing Before the
United States House of Representatives
Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit

Prof. Adam J. Levitin
Georgetown University Law Center
March 13, 2008

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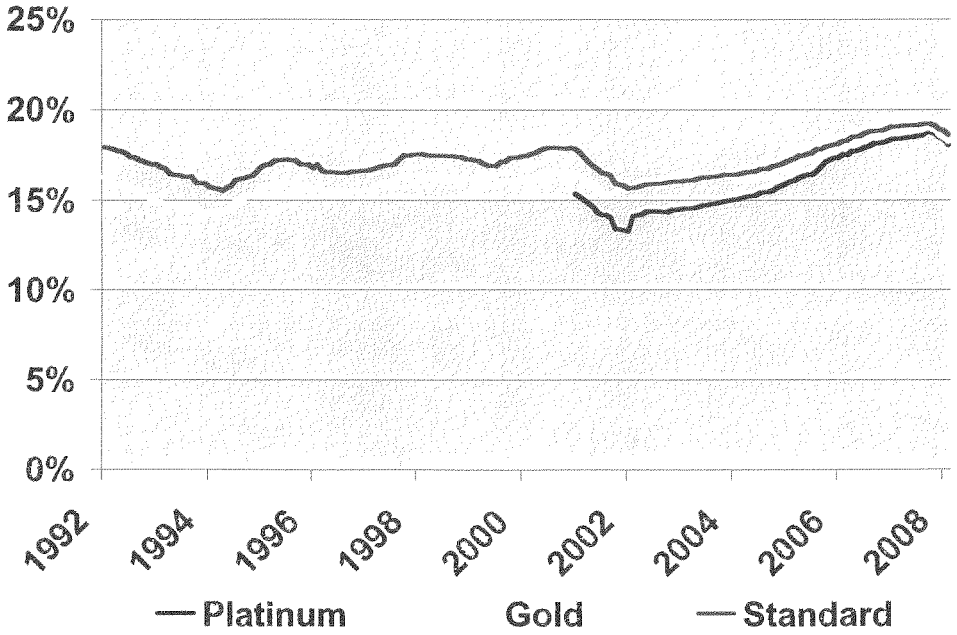
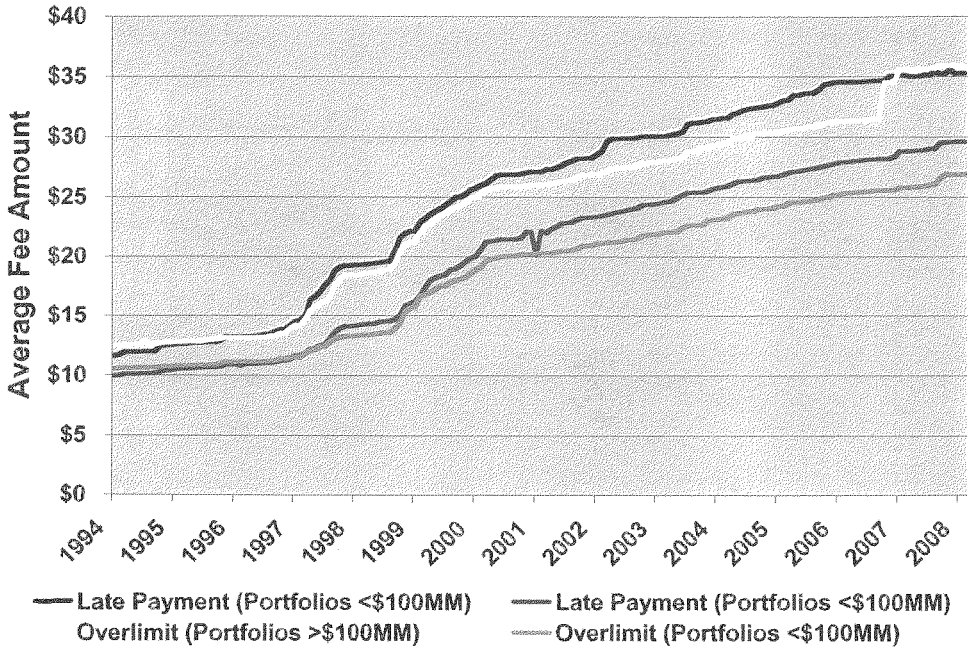
Effective Interest Rates by Card Type
(includes penalty rates and fees)



Source: CardData.com (subscription data source)

Growth in Late and Overlimit Fees



Source: CardData.com (subscription data source)

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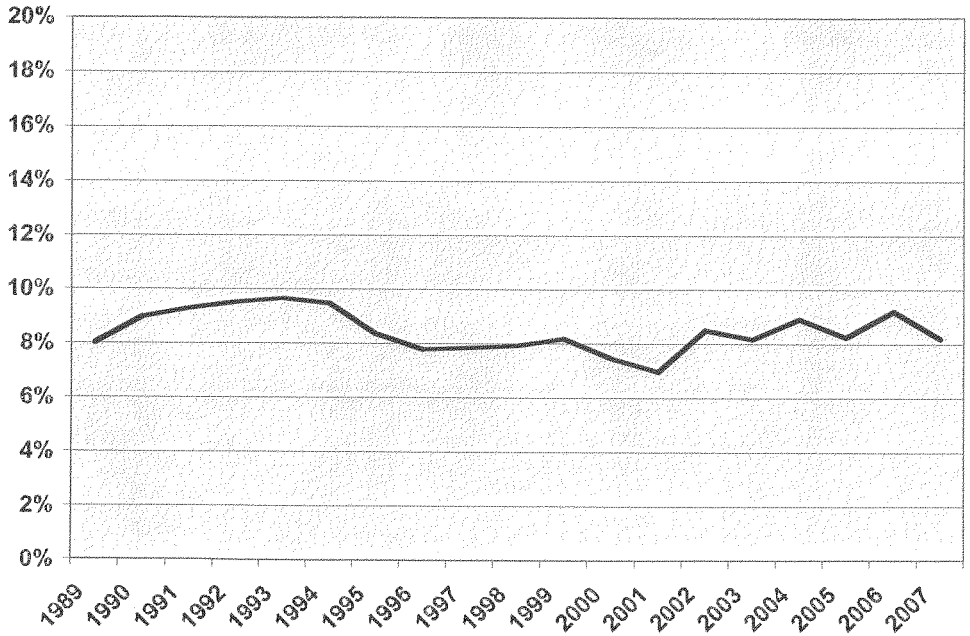
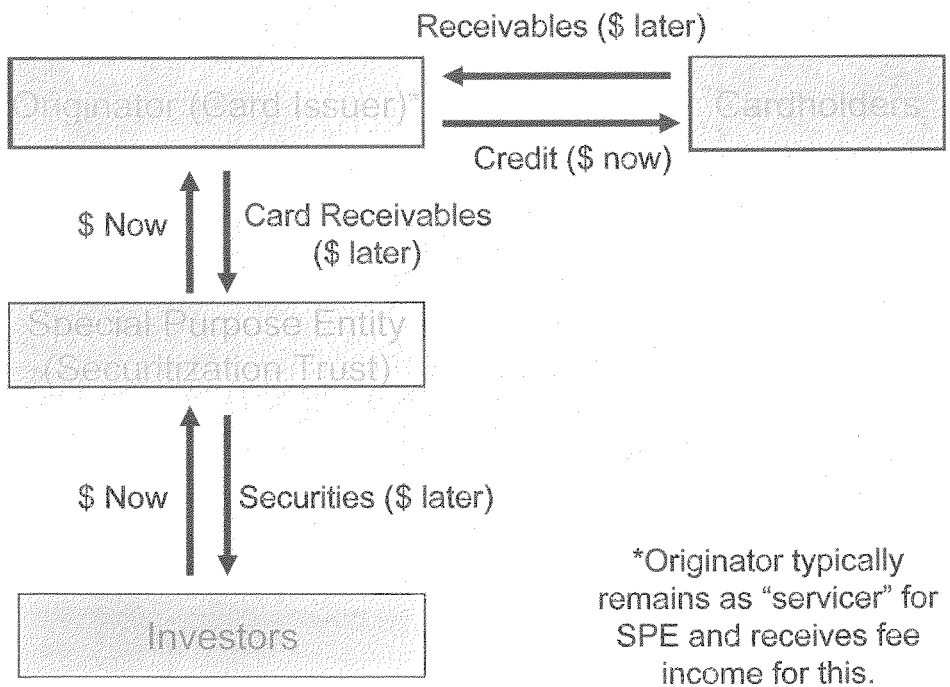
Card Issuers' Net Interest Margin

(Interest Rate of Card Loans Minus Cost of Funds)



Source: FDIC Quarterly Banking Profiles, Net Interest Margin by Asset Concentration Group

Basic Economics of Securitization



*Originator typically remains as "servicer" for SPE and receives fee income for this.

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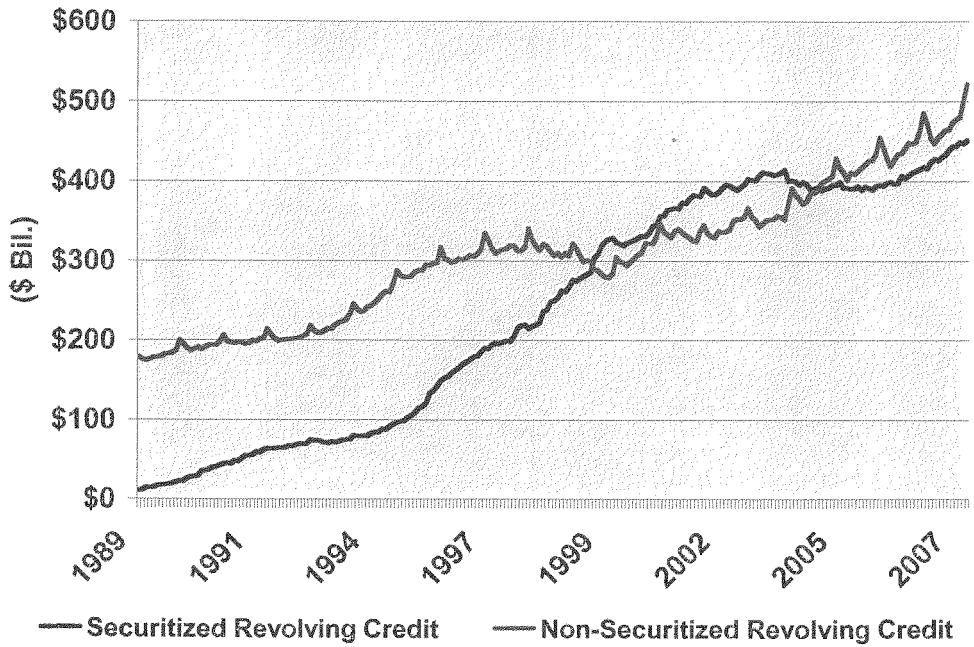
Growth of Securitization of Credit Card Debt



Source: Federal Reserve Statistical Release G.19 (not seasonally adjusted)

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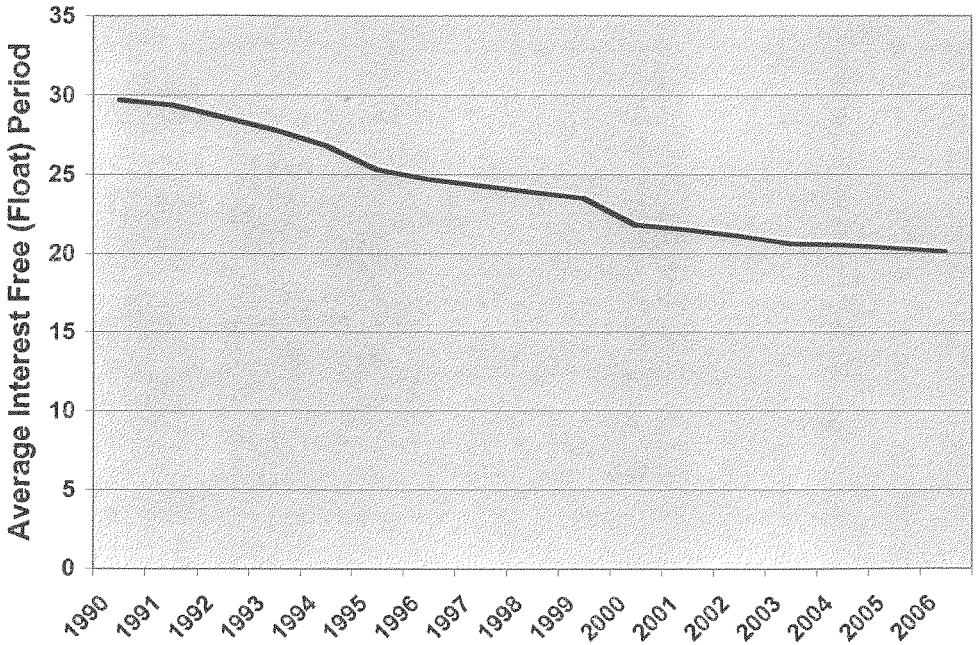
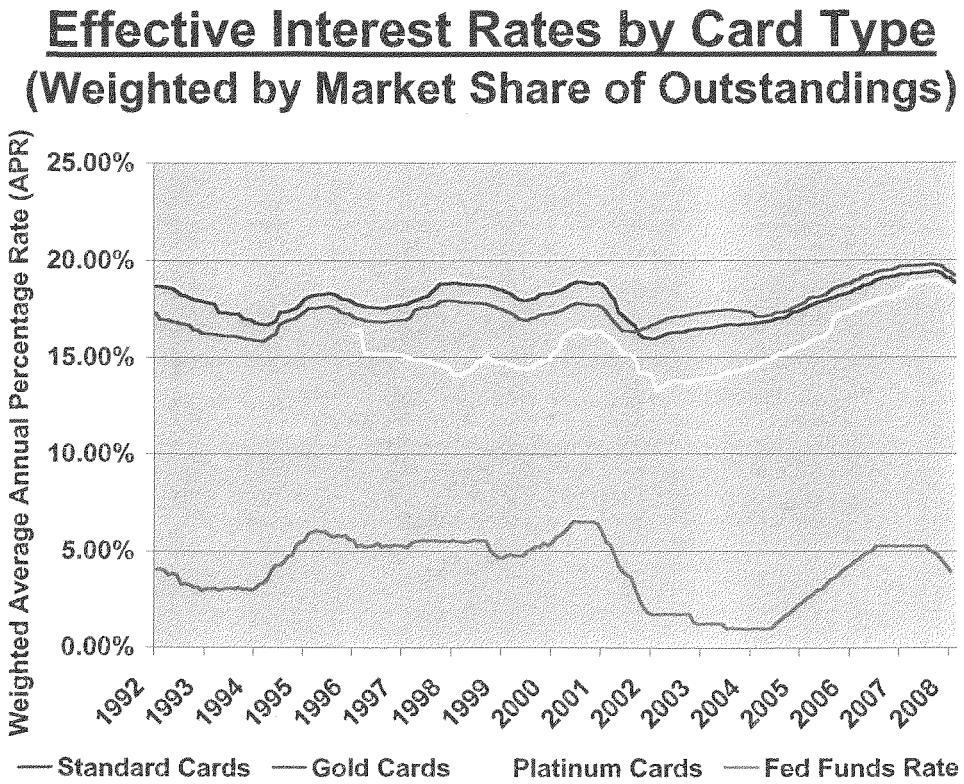
Declining Interest Free Grace Periods Means Less Benefit to Creditworthy Cardholders



Source: CardData.com (subscription data source)



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