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Hearing on "Current Legal and Regulatory Requirements and Industry Practices for Card Issuers With Respect to Consumer Disclosures and Marketing Efforts"

Before the U.S. Senate Committee on

Banking, Housing, and Urban Affairs

The Honorable Richard Shelby, Chairman

10:00 a.m., Thursday, September 5, 2002 - Dirksen 538

I would like to thank Chairman Richard Shelby for providing this opportunity to share my views with the Committee on the increasingly important issue of deceptive credit card marketing and consumer contract disclosures during this rapidly changing period of banking deregulation. This Committee has a long tradition of examining and protecting consumer rights in the realm of financial services and I hope that this hearing will produce new relief to financially distressed and overburdened households as they cope with the increasingly opaque credit card policies and practices. In this endeavor, I have had the pleasure of contributing to Senator Paul S. Sarbanes' investigation of consumer debt among college students and the lack of financial literacy/education programs for America's financially vulnerable youth. In addition, I applaud the legislative initiatives of Senator Christopher Dodd, who has championed credit card marketing restrictions on college campuses along with critically needed financial education programs as well as directing greatly needed attention to ambiguous contract disclosures and deceptive marketing practices. Also, it is a pleasure to acknowledge the State of New York's senior Senator, Charles E. Schumer, whose efforts to protect consumers from deceptive marketing and contract disclosure practices of the credit card industry has simplified our lives through the summary of our key credit card contract information in our monthly statements. The twin issues of rising cost and levels of consumer debt together with shockingly low levels of financial literacy among our youth and their parents have grave implications to the continued economic well-being of the nation—especially as Americans age into debt and watch the erosion of their Social Security benefits. For these and many other reasons, I commend the Committee for accepting the daunting task of examining the increasingly serious problems that will be addressed today.

As an economic sociologist and faculty member in the Department of Finance in the College of Business at Rochester Institute of Technology, I have spent the last 19 years studying the impact of U.S. industrial restructuring on the standard of living of various groups in American society. Over the last 12 years, I have been particularly interested in the role of consumer credit in shaping the consumption decisions of Americans as well as the role of retail banking in influencing the profound transformation of the U.S. financial services industry. In regard to the latter, I have studied the rise of the credit card industry in general and the emergence of financial services conglomerates such as Citigroup during the deregulation of the banking industry beginning in the late 1970s.

In terms of the former, my research includes in-depth interviews and lengthy survey questionnaires with over 800 respondents in the 1990s and nearly 1500 in the 2000s. The results of this research are summarized in my book, *CREDIT CARD NATION: America's Dangerous Addiction to Consumer Credit (Basic Books, 2001*) and a forthcoming series of research articles. More recently, I have begun investigating the global expansion of deregulated consumer financial services with particular attention to comparative governmental policies that enforce consumer rights in Europe, Asia, and Latin America. My next book, *GIVE YOURSELF CREDIT* (Alta Mira/Taylor Publishers, 2006), presents an updated analysis of the deregulation of the credit card industry, major public policy issues, and practical guidance for consumers for more prudent use of consumer credit. These interests in public policy and financial literacy have inspired the development of my own internet-based financial literacy/education programs at www.creditcardnation.com.

BANKING DEREGULATION AND THE CONSUMER LENDING REVOLUTION:

Ascension of the Free Market or Nadir of Consumer Rights?

In mid 2004, the 185 million bank credit cardholders in the United States possessed an average of almost 7 credit cards (4 bank and 3 retail) and they charged an average of $8,238 during the previous year (Cardweb,com, 2004a; Card Industry Directory, 2004). In 2004, about 70 million (37.8%) were convenience users or what bankers disparaging refer to as *deadbeats* because they pay off their entire credit card balances each month.[1] In contrast, nearly 3 out of five cardholders (62.2%) were lucrative debtors or *revolvers*; 71 million (38.4%) typically pay more than the minimum monthly payment (typically 2% of outstanding balance) while 44 million (23.8%) struggle to send the minimum monthly payment (Cardweb.com, 2004a).

[1] Over the last six months, fueled by increasing popularity of home equity loans and the uneven economic expansion, the growth of convenience users has jumped to about 43 percent (CardWeb.com, 2005).

Over the last 10 years, which includes the longest economic expansion in American history, the total number of bank credit cards increased 62 percent, total charge volume by 162 percent, and net outstanding debt by 129 percent (Card Industry Directory, 2004, Ch 1). See Table 1. Today, early 2005, approximately three out of five U.S. households account for almost $685 billion in outstanding, "net" bank credit card debt plus almost another $100 billion in other revolving lines of credit (Card Industry Directory, 2004; Cardweb.com, 2004a; U.S. Federal Reserve, 2005). This reflects a meteoric rise in credit card debt—from less than $60 billion at the onset of banking deregulation in 1980. See Figure 1.

Overall, the average outstanding credit card balance (including bank, retail, gas) of debtor or "revolver" households with at least two adults has soared to over $12,000 (Card Industry Directory, 2004); approximately 75 percent of U.S. households have a bank credit card, up from 54 percent in 1989 (Canner and Luckett, 1992; Cardweb.com, 2004a). This is exclusive of "nonrevolving" consumer debt such as auto, home equity, furniture, debt consolidation, and student loans, which total over $1.3 trillion in 2005, plus over $7.2 trillion in home mortgage loans. Table 2 reports the sharp increase in consumer debt ("revolving" and "installment") over the last 25 years (doubling over the last 10 years) and the rapid rise of credit card debt—from 19.5% of installment debt in 1980 to 43.8% in 1990 peaking at 70.4% in 1998 and dropping to 61.9% in 2004. In terms of consumer debt levels per capita, each of the more than 295 million residents of the United States owes an average of over $31,000, which helps to explain how consumer spending accounts for over two-thirds of U.S. Gross Domestic Product (GDP) or total domestic economic activity (U.S. Federal Reserve, 2005; U.S. Census, 2005). As illustrated by these startling statistics, the last two decades have witnessed the birth of the Credit Card Nation and the ascension of the debtor society (Manning, 2000; Sullivan, Warren, and Westbrook, 2000; Warren and Tyagi, 2003; Leicht and Fitzgerald, 2006).

Banking Deregulation and the Ascent of Retail Financial Services: What's Consumer Debt Got to Do With It?

The debate over the origins of the consumer lending "revolution" tend to focus on either the "supply" or "demand" side of this extraordinary phenomenon. This section explores how statutory and regulatory reforms over the last three decades have fundamentally changed the structure of the U.S. banking industry and the subsequent "supply" of financial services. During this period, the institutional and organizational dynamics of American banking have changed profoundly as well as the "supply" of financial services in terms of their use, cost, and availability. Indeed, the intensifying economic pressures of globalization (U.S. industrial restructuring, Third World debt crisis, downward pressure on U.S. wages) together with new forms of competition in the U.S. financial services industry (rise of corporate finance divisions, growth of corporate bond financing, expansion of mortgage securitization) precipitated a dramatic shift from "wholesale" (corporate, institutional, government) to "retail" or consumer banking (Brown, 1993, Dymski, 1999; Manning, 2000: Ch 3). And, as explained later, consumer credit cards played an instrumental role in this process.

The basic public policy assumption of banking "deregulation" is that reducing onerous and costly government regulation invariably unleashes the productive forces of intercompany competition that yield a profusion of direct benefits to consumers. The most salient are lower cost services, greater availability of products, increased yields on investments, product innovation, operational efficiencies, and a more stable banking system due to enhanced industry profitability (Brown, 1993, GAO, 1994; Rougeau, 1996; Dymski, 1999; Manning, 2000: Ch 3). This "free market"-based prescription for miraculously satisfying both the profit objectives of financial services executives and the cost/availability interests of consumers belies the inherent political asymmetries that have militated against the distribution of industry efficiencies over the last 20 years. It is the intractable conflict between corporate profit maximizers in the banking industry and consumer rights advocates that constitutes the focus of this analysis.

According to Jonathan Brown, Research Director of *Essential Information*, there are three systemic contradictions of *laissez-faire*-driven banking deregulation that limit "broad-based" consumer benefits. In brief, they are [1] excessive risk-taking by financial institutions that are facilitated by publicly financed deposit insurance programs (FDIC) and publicly subsidized corporate acquisitions of insolvent financial institutions (Savings and Loan crisis of early 1980s); [2] increased industry concentration and oligopoly pricing policies (in the absence of a strong anti-trust policy) that limits cost competition over an extended period of time; and [3] diminished access to competitive, "mainstream" financial services for lower income households as corporations focus their resources on more affluent urban and suburban communities. Brown concludes by underscoring the paradox of “free market”-driven banking deregulation, “strong prudential control [by government and consumer organizations] becomes even more important because deregulation increases both the opportunities and the incentives for risk-taking by banking institutions [in the pursuit of optimizing profits rather than public use]” (Brown, 1993: 23). For our current purposes, the latter two trends merit further discussion.

The first distinguishing feature of the early period of banking deregulation is the sharp increase in the growth and profitability of retail banking in comparison to wholesale banking. During the early 1980s, wholesale banking activities experienced a sharp decline in profitability, especially in the aftermath of the 1982-83 recession. These include massive losses on international loans, large real-estate projects, and energy exploration/extraction companies. Furthermore, traditional bank lending activities faced new and intensified competition such as Wall Street securities firms underwriting cheaper bond issues, corporate finance affiliates offering lower-cost credit for “big ticket” products (automobiles), and the integration of home mortgage loans into the capital market via the sale of asset-back securities (mirrored in the explosive growth of Fannie Mae) which contributed to downward pressures on bank lending margins. In addition, many consumers with large bank deposits shifted their funds into higher yield mutual funds that were managed by securities firms. This increased the cost of bank funds since they were forced to offer certificates of deposits (CDs) with higher interest rates which further reduced their profit margins (Brown, 1993; Nocera, 1994; Manning, 2000).

As astutely noted by Brown, the response of U.S. banks to these intensifying competitive pressures was predictable, “[F]inancial deregulation tends to lower profit margins on wholesale banking activities… where large banks have suffered major losses on their wholesale banking operations, the evidence suggests that they tend to increase profit margins on their retail activities in order to offset their wholesale losses” (Brown, 1993: 31). Indeed, corporate borrowers have been the major beneficiaries of banking deregulation over the last two decades. This is evidenced by the sharp increase in the cost of unsecured consumer debt such as bank credit cards; see Manning (2000:19) for a cost comparison of corporate-consumer lending rates in the 1980s and 1990s.[2]

[2] The real cost of “revolving” credit card loans, exclusive of introductory or low “teaser” rates and inclusive of penalty fees, has nearly tripled since the early phase of banking deregulation in the 1980s.

The magnitude of this shift in interdivisional profitability within large commercial banks is illustrated during the 1989-91 recession. For example, Citicorp reported a net income of $979 million from its consumer banking operations in 1990 whereas its wholesale banking operations reported a $423 million loss. Similarly, Chase Manhattan's retail banking activities produced $400 million in 1990 whereas its wholesale banking activities yielded a $734 loss (Brown, 1993: 31). Not unexpectedly, bank credit cards played a central role in fueling the engine of consumer lending in the 1980s. The average "revolving" balance on bank card accounts jumped six-fold--from $395 in 1980 to $2,350 in 1990 (Manning, 2000:11). According to economist Lawrence Ausubel, in his analysis of bank profitability in the period 1983-88, pretax return on equity (ROE) for credit card operations among the largest U.S. commercial banks was 3-5 times greater than the industry average (1991:64-65). Hence, the ability to increase retail bank margins in the early 1980s (to be discussed in greater detail) led to the sharp growth in consumer marketing campaigns and the rapid expansion of consumer financial services beginning in the mid-1980s (Mandell, 1990; Nocera, 1994; Manning, 2000).

Not incidentally, the escalating demand for increasingly expensive consumer credit was not ignored by nonfinancial corporations. Growing numbers of manufacturers and retailers established their own consumer finance divisions such as General Motors, General Electric, Circuit City, Pitney Bowes, and Target. In many cases, like the dual profit structures of the banking industry, the traditional operations of these major corporations (manufacturing, retailing) encountered mounting competitive pressures through globalization and subsequently experienced sharp declines in their "core" operating margins. Escalating revenues in their financing divisions (especially consumer credit cards) compensated for these declines and, in especially aggressive corporations like General Electric, were spun-off into enormously profitable global subsidiaries such as GE Financial (Manning, 2000: Ch 3). In fact, the financing units of Deere & Co. and General Electric accounted for 21 and 44 percent, respectively, of corporate earnings in 2004 and all of Ford's pretax profits in 2002 and 2003 (Condon, 2005). Today, financial companies account for 30 percent of U.S. corporate profits, up from 18 percent in the mid-1990s and down from its peak of 45 percent in 2002 (Condon, 2005).[3] As a result,

[3] The success of corporate finance operations has led to more aggressive involvement with high-risk, speculative investments including "junk" bonds. For example, the sharp decline in the Federal Reserve's "discount" interest rate in 2001 led many of these finance divisions to invest heavily in the "carry trade" whereby companies borrow at low, short-term rates and invest in higher yield, long-term bonds or asset-backed (e.g. mortgages, credit cards) securities. Today, with interest rates rising, the enormous profits

there is growing concern that shrinking bank profits derived from commercial loans to corporate borrowers, together with declining profits from the speculative "carry trade" (long-term hedging of short-term interest rates such mortgage bonds), will exacerbate pressure to increase profits on retail lending activities and thus raise the cost of borrowing on consumer credit cards.

As the consumer lending revolution shifted into high gear in the late 1980s, rising profits and rapid market growth (number of clients and their debt levels) fueled the extraordinary consolidation of American banking and especially the credit card industry. In 1977, before the onset of banking deregulation, the top 50 banks accounted for about one-half of the credit card market (Mandell, 1990). This is measured by outstanding credit card balances or "receivables" of each card issuing bank. Fifteen years later, 1992, the top ten card issuers expanded their control to 57 percent of the market, prompting a formal U.S. Congressional inquiry into the "competitiveness" of the credit card industry (GAO, 1994). Over the next decade, bank mergers and acquisitions proceeded at a breakneck pace, propelling the concentration of the credit card industry to oligopolistic levels.

For example, Banc One's acquisition of credit card giant First USA in 1997 was followed in 1998 by Citibank's purchase of AT&T's credit card subsidiary--the eighth largest card issuer. Over the next eighteen months, MBNA bought SunTrust and PNC banks, Fleet merged with BankBoston, Bank One acquired First USA, NationsBank merged with Bank of America, and Citibank bought Mellon Bank. Today, the ongoing concentration of the credit card industry features the mergers of increasingly larger corporate partners. In 2003, Citibank purchased the troubled $29 billion Sears MasterCard portfolio (Citibank, 2003). This was followed in 2004 with Bank of America's acquisition of Fleet Bank (tenth largest U.S. credit card company) and J.P Morgan Chase's purchase of Bank One (third largest credit card company). As a result, the market share of the top 10 banks climbed from 80.4 percent in 2002 to 86.7 percent in 2003 and then to over 91 percent in 2004 (Card Industry Directory, 2004). Overall, the top three card issuers (Citibank, MBNA, J.P. Morgan Chase) control over 55 percent of the market. See Table 3. Not surprisingly, as market expansion and industry consolidation approaches its limits in

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made from these bond purchases in 2002 and 2003 will soon be replaced with losses following the decline in this favorable interest rate "spread." As a result, corporate finance affiliates must offset these losses by increasing the volume of more costly corporate loans which is problematic with current market conditions. This will increase pressure to raise lending margins on their consumer financial services.

the United States, several top megabanks have begun aggressively promoting their consumer financial services in international markets through corporate acquisitions, mergers, and joint ventures. These include Citibank, MBNA, Capitol One, GE Financial, and HSBC.

Not only has U.S. banking deregulation transformed the market structure of the US and eventually the global financial services industry but it has also facilitated the rise of the "conglomerate" organizational form. This second distinguishing feature of the recent deregulated banking era is a profit maximizing response to the maturation of industry consolidation trends. In brief, the limits of organizational growth through horizontal integration, even with its economic efficiencies of scale and oligopolistic pricing power, entails that future growth can only be sustained by expansion into new product lines and consumer markets. This multidivisional corporate structure, guided by "cross-marketing" synergies offered by "one-stop" shopping via allied subsidiaries for the vast array of consumer financial services, was initially attempted by Sears and American Express in the 1970s and 1980s with generally disappointing results (Nocera, 1994; Manning, 2000).

By the late 1990s, two financial services behemoths sought to bridge the statutory divide between commercial banking and the insurance industry by combining their different product lines into a single corporate entity: Citigroup. Technically, the 1998 merger of Citibank and Travelers' Insurance Group was an illegal union that required a special federal exemption until the enactment of the *Financial Services Modernization Act* (FSMA) of 1999 (Manning, 2000: Chapter 3).[4] With cost-effective technological advances in data management systems together with U.S. Congressional approval of corporate affiliate sharing of client information (FSMA) and the continued erosion of consumer privacy laws (*Fair Credit and Reporting Act* of 2003), Citigroup became the first trillion dollar U.S. financial services corporation that offered the "one-stop" supermarket model for all of its clients' financial needs. These include retail and wholesale banking, stock brokerage (investment) services, and a wide-array of insurance products for its customers in over 100 countries. Again, bank credit cards played a crucial role through the collection of household consumer information, the cross-

[4]Also referred to as the Gramm-Leach-Biley Act (GLBA) of 1999.

marketing of Citigroup products and services, and its high margin cash flow that helped in offsetting costly merger and integration-related expenses (Manning, 2000: Ch 3).[5]

A third distinguishing feature of banking deregulation is the widening institutional gap or bifurcation of the U.S. financial services system. That is, the distinction between "First-tier" or low-cost mainstream banks and "Second-tier" or 'fringe' banks such as pawnshops, rent-to-own shops, "payday" lenders, car title lenders, and check-cashers. This widening institutional division between these consumer financial services sectors has dramatically increased the cost of credit among immigrants, minorities, working poor, and heavily indebted urban and increasingly suburban middle-classes (Caskey, 1994; 1997; Hudson, 1996; 2003; Manning, 2000: Chapter 7; Peterson, 2004). Indeed, the usurious costs of financial services in the second-tier reflect the ideological zeal of regulatory reformers whose goal is to rescind interest rate ceilings, loan "quotas" imposed on mainstream banks for disadvantaged communities, and vigorous enforcement of financial disclosure laws. Shockingly, the cost of credit typically exceeds 20 percent per month for consumers who often earn poverty-level incomes and less.

The significance of this trend is two-fold. First, the systematic withdrawal of First-tier banks from low-income communities restricts the access of these residents to reasonably priced financial services. Although morally reprehensible, banks frequently justify their actions in terms of economic efficiencies and profit utility functions that are arbitrated by "free-market" forces. The political reality, however, it that this policy is a defiant rejection of the affirmative obligation standard of the *Community Reinvestment Act* (CRA) of 1977 (Brown, 1993, Fishbein, 2001; Carr, 2002). That is, the banking industry receives enormous public subsidies through (1) depositor protection programs/policies, (2) access to low-cost loans through the Federal Reserve System's lender of last resort facility, and (3) privileged access to the national payments/transactions system (Brown, 1993). The *quid-pro-quo* for satisfying this affirmative obligation standard has been an understanding that banking institutions have a duty to provide access to financial services to disadvantaged groups within their local communities, to engage in active marketing programs for promoting these financial

[5] Citigroup's consumer financial services companies have outperformed the insurance division in growth and profit margins—especially after 2001. As a result, Citigroup has retreated from its one-stop, financial supermarket concept and has agreed to sell its Travelers Life & Annuity division to Metlife Inc for $11.5 billion in winter of 2005 (Reuters, 2005b).

services and products, and, in the process, to absorb some of the administrative expenses and costs of their financial products/services. By ignoring their responsibility to CRA, First-tier financial institutions have invariably increased the population of "necessitous" consumers whose limited resources exacerbates their reliance on "Second-tier" financial services and their vulnerability to predatory lenders.

Second, the tremendous price differential between the two banking sectors increases the financial incentive for First-tier banks to abandon low-income and minority communities and return directly or indirectly through financial relationships with Second-tier financial institutions (Hudson, 1996; 2003; Manning, 2000:Ch 7; Peterson, 2004). This is becoming an increasingly common practice of the largest banks. For instance, Citibank purchased First Capital Associates in 2000 which had been penalized by federal regulators from the Office of the Comptroller of the Currency (OCC) for its past predatory lending policies and was again recently chastized by the Federal Reserve for originating predatory home mortgages, HSBC's purchase of Household Bank in 2000 was delayed following the negotiation of a $400 million predatory lending settlement, and Providian Bank was fined $300 million by the OCC in 2000 for its unfair and deceptive practices in the marketing of its "subprime" card cards (Manning, 2001; 2003).

As the growth of traditional financial services markets stagnates, major banks are aggressively promoting "subprime" consumer lending programs with triple digit finance charges (effective APRs) such as HSBC's partnership with H&R Block's Rapid Advance Loan (RALs) and Capital One Bank's fee-laden credit cards such as its "EZN" card which imposes $88 in fees for $112 line of credit. It is the desperation of consumers who depend on credit for household needs, especially after personal bankruptcy or an economic calamity (job loss, medical expenses, divorce), that leads them to "trustworthy,' major financial institutions whom they expect to offer the best financial rates on consumer loans. However, instead of receiving "No Hassle" credit cards with moderate interest rates, unsuspecting Capital One customers often receive subprime cards with little credit and unjustifiably high fees.[6] In the case of First Premier Bank, the $250

[6]See *Foster v. Capital One Bank, et al* for ongoing class action lawsuit regarding deceptive marketing and excessive fees for the "*Capital One* Visa Permier" credit card that features O% introductory APR on all purchases and a variety of fees including $39 annual membership and $49 "refundable security deposit.

line of credit at 9.9% features $178 in fees. See Appendix for copies of credit card contracts.

Not surprisingly, the credit card industry continues to report record profits this year. In 2003, pre-tax profit (Return on Investment) of $17.1 billion climbed 32.4% from 2002 even though interest revenue declined slightly from $66.5 to $65.4 billion (Card Industry Directory, 2004). According to the June 2003 FDIC report on bank profits, [First Quarter 2003] "is the largest quarterly earnings total ever reported by the [banking] industry... [and] the largest improvement in profitability was registered by credit card lenders [with] their average Return-On-Assets (ROA) rising to 3.66 percent from 3.22 percent a year earlier;" The Card Industry Directory (2004) reports 2003 ROA at 4.02 percent and credit card industry analyst R.K. Hammer Investment Bankers report it at an even more impressive 4.40 percent. The extraordinary profitability of consumer credit cards is illustrated by comparing the ROA of credit card issuers with the overall banking industry. According to the FDIC, the increase in the ROA for the banking industry rose from 1.19% in 1998 to 1.40% in 2003 (First Quarter) or 17.6%. According to the U.S. Federal Reserve Board, ROA for the credit card industry was 2.13% in 1997 and has risen impressively to 2.87% in 1998, 3.34% in 1999, 3.14% in 2000, 3.24% in 2001, 3.5% in 2002, and 3.66% in 2003. This is largely due to lower cost of borrowing funds (widening "spread" on consumer loans), decline in net charge-offs ($911 million or 18.5 percent lower in 2003 than 2002),[7] decline in delinquent accounts ($919 million or 14.3 percent lower in 2003 than 2002), cross-marketing of low-cost insurance and other financial services, and dramatic increase in penalty and user fees.

[7] Historically, about 60% of bad consumer debt or bank "charge-offs" is due to unsecured credit card or "revolving" loans. According to the *Card Industry Directory* (2004: 11), card industry "charge-offs" declined from $35.4 in 2002 to $33.2 billion in 2003 or less than one-half of total bank charge-offs. This constitutes about 5 percent of net outstanding credit card balances at the end of 2003 (Cardweb, 2004). Note, this is not the same as the outstanding loan principal "charge-offs" since banks typically do not classify delinquent debt as in "default" until 90 to 120 days. For example, based on the following conservative estimates, one-third of this gross "charge-off" amount is attributed to: [a] delinquent interest rates over the last 4 months (about $2.0 billion at 23.9% APR) plus [b] late fees (about $0.9 billion at $35 per month) together with [c] overlimit and cash advance fees ($0.3 billion at $35 per month and 3% per transaction) plus [d] 12 months of interest prior to delinquency ($4.5 billion at 17.9%APR) and [e] legal/collection fees ($0.8 billion at $140 per account). In addition, recently "discharged" credit card debt is selling for 6.5 to 7.0 percent "face value" on the secondary market (*Card Industry Directory*, 2004: 11). Overall, the data suggest that the "true" loss of capital to the major credit card issuing banks is approximately 60 percent of the reported "charge-off" value. These estimates assume that at over one-fourth of these "charge-off" amounts are due to late fees, overlimit fees, accrued finance charges, and collection related fees which are subsequently sold on the secondary market.

One of the most striking features of the deregulation of the U.S. banking industry is the sharp increase in the cost of “revolving” credit (Ausubel, 1991; 1997; Manning, 2000). For instance, the ‘real’ cost of borrowing on bank credit cards has more than doubled due to widening interest rate “spreads” (doubled from 1983 to 1992) in addition to escalating penalty and user fees. The former is a result of the 1978 US Supreme Court (Marquette National Bank of Minneapolis v. First National Bank of Omaha) decision that permitted banks to relocate their corporate headquarters simply to find a “home” where they could essentially “export” high interest rates across state boundaries and effectively evade state usury regulations (GAO, 1994; Rougeau, 1996; Manning, 2000; Evans, and Schmalensee, 2001; Lander, 2004). The largest credit card issuers, led by Citibank, swiftly moved to states without interest rate ceilings. See Figure 2. The dramatic increase in fee revenues is attributed to the 1996 U.S. Supreme Court decision, Smiley v Citibank, which ruled that credit card fees are part of the cost of borrowing and thus invalidated state imposed fee limits (Macey and Miller, 1998; Evans, and Schmalensee, 2001). Overall, penalty and cash advance fees have climbed from $1.7 billion in 1996 to $12.0 billion in 2003—12,4% of total credit card revenues in 2003. The average late fee has jumped from $13 in 1996 to over $30 in today. Incredibly, combined penalty ($7.7 billion) and cash advance ($4.3 billion) fees exceed the after-tax profits of the entire credit card industry ($11.13 billion) in 2001. See Table 4.

In conclusion, banking deregulation has produced an economic boom for the U.S. financial services industry. In the 1990s, it recorded eight successive years of record annual earnings (1992-1999) and rebounded with five successive years of record profits since the end of the 2000 recession, (FDIC, 2004; Daly, 2002). In fact, the assets of the ten largest U.S. banks total $3,552 billion at the end of June 2003—an astounding increase of 509 billion from 2002 (16.7%). Overall, the assets of the ten largest U.S. banks exceed the cumulative assets of the next 150 largest banks (American Banker, 2003). And, this trend does not appear to be abating. Today, rising interest rates (most credit cards feature variable interest rates), higher fee schedules, and improving debt “quality” underlie projections for new record profits for the banking industry (Reuters, 2005a). As will be discussed in Section Three, the skyrocketing profits of the credit card industry underlie this trend with increasing capricious pricing policies and deteriorating customer service.

Seduction, Indulgence, or Desperation?
The Explosion of Consumer Credit and Debt

The increasing societal dependence on consumer credit since the onset of banking deregulation is staggering. Between November 1980 and November 2003, revolving "net" credit card debt has climbed twelve-fold, from about $51 billion to over $636 billion. Similarly, installment debt has jumped from $297 billion in 1980 to $1,264 billion today. Overall, U.S. household consumer debt (revolving, installment, student loan) has soared from $351 billion in 1980 to over $2,100 billion in 2005. Together with home mortgages, total consumer indebtedness is about $9 trillion at the end of 2003 (Federal Reserve, 2004). This trend is especially significant since the U.S. post-industrial economy has been fueled by consumer related goods and services that account for over 2/3 of America's economic activity (Gross Domestic Product). Indeed, U.S. households have not restrained their consumption even though real wages have been stagnant (from mid-1970s to late 1990s and again today), job benefits (health, pension) have declined, prices of major purchases have increased dramatically (housing, autos, college), temporary or "contingent" work continues to increase, and over 2.5 million jobs have disappeared over the last three years.

Several factors help to explain the record-setting debt burden of American households—especially middle class families. First, as measured by share of disposable income, the 1980s and 1990s feature the unprecedented growth of consumer debt—from 73.2 percent of personal income in 1979 to a staggering 114.5 percent in 2001. As shown in Table 5, the overwhelming proportion (75.7%) of this new level of debt is due to escalating home mortgages. Between 1979 and 2001, the share of household income allocated to housing jumped from 46.1 percent in 1979 to 85.0 percent in 2003 (Mishel, Bernstein, and Allegretto, 2005). This enormous increase in housing costs has diverted previous discretionary income that was used for other personal or family needs. Although mortgage debt is the least expensive consumer loan, this sharp increase has squeezed the ability of households to pay for other purchases and/or finance unexpected expenditures such as health care or auto repairs.

Not surprisingly, most American households have steadfastly responded by maintaining their standard of living and financing their expenditures with lower personal savings and higher credit card and installment loans. In fact, as the U.S. personal savings rate fell to record lows in the late 1990s—near zero in 1998—credit cards became the financial "safety net" for financially distressed and economically vulnerable households. In 1980, three-fourths (74.5%) of nonmortgage consumer debt was financed through installment loans such as for furniture, appliances, and electronics. During and immediately after the 1989-91 recession, revolving credit card debt soared—from 37.9 percent of installment debt in 1989 to 54.9 percent in 1992. This was accompanied by mass marketing campaigns that promoted credit card use for "needs" as well as "wants" such as groceries, rent and mortgage payments, and even income taxes. By 1998, outstanding credit card debt was 70.4 percent of outstanding installment debt. This proportion has fallen due to new debt consolidation options such as mortgage refinancings, home equity loans, and aggressive marketing of low-interest auto loans. Indeed, home equity loans were not even available to consumers in the late 1980s. By 2003, home equity loans account for over one-tenth (10.9%) of disposable personal income. See Table 5.

In the decade since the end of the 1989-91 recession, during the longest economic expansion in US history, "net" credit card debt surged from about $251 billion in 1992 to over 685 billion at the end of 2004 while installment debt jumped from $532 billion to $1.3 trillion. Significantly, scholars disagree over whether these new debt levels can be restrained. Juliet Schor (1998) has received national attention for asserting that much of this debt is avoidable since the pressures of competitive consumption are social and thus can be resisted by embracing traditional values that discourage consumption such as thrift, frugality, and material simplicity. Hence, she asserts that "keeping up with the Jones" is a voluntary decision that can be rejected by "downshifting" to a simpler, less expensive lifestyle. On the other hand, Elizabeth Warren and Amelia Warren Tyagi (2003) argue that the debt arising from the "two-income trap" is primarily due to middle-class necessities such as housing, automobiles, medical care, education, and insurance. Their highly influential work contends that households have no recourse but to assume higher debt burdens as a rational response to increasing economic pressures such as health care, job loss/interruption, family crises, insurance, and education-related costs.

The role of structural factors in influencing the decision of middle class households to assume higher levels of debt is suggestive. Two other measures of financial distress as measured by the U.S. Federal Reserve Board are households with high debt burdens (40% or more of household income) and late payment (60 days or more) of bills. Between 1989 and 1998, the lower income, middle-class reported the most economic difficulty. For instance, the high debt service burdens of modest income households ($10,000 to $24,999) rose from 15.0% to 19.9% while moderate income households ($25,000 to 49,999) rose from 9.1% to 13.8%; households with incomes over $50,000 increased marginally to about 5% while those under $10,000 rose from 28.6 percent to 32.0 percent. Similarly, late payments increased marginally among households with at least $50,000 annual income to about 4.4 percent (most increase since 1992) while the $25,000 to $49,999 group nearly doubled from 4.8 percent in 1989 to 9.2 percent in 1998; households with modest income ($10,000 to $24,999) remained unchanged at 12.3 percent (Mishel, Bernstein, and Boushey, 2003).

Since the sharp decline in consumer interest rates beginning in late 2000, lower finance costs have provided some measurable financial relief to American households. However, as summarized in Table 6, the greatest beneficiaries of this low interest rate period have been the groups with the highest family incomes. Between 1992 and 2001, middle-income households ($40,000 - $89,000) have experienced an aggregate increase in their debt service burden (as a share of household income) whereas upper income households have experienced a significant decline (28.6%)—from 11.2 percent to 8.0 percent. Overall, the debt service burden of the upper income earning households is about one half of the lower- and middle-income households (8.0% versus 16.0%). This is consistent with the cost of credit card debt during the current era of financial services deregulation whereby convenience users receive free credit (plus loyalty rewards such as free gifts and cash) and revolvers pay double-digit interest rates and soaring penalty fees. In comparison, the working poor have witnessed a modest decline in their debt service burden, from 15.8 percent in 1992 to 15.3 percent in 2001 (Mishel, Bernstein, and Allegretto, 2005). It is important to note, moreover, that various important sources of financial liabilities are not included by the Federal Reserve in its reports on outstanding nonmortgage consumer debt and thus understates the degree of household economic distress—especially among lower income families. These include car leases, payday loans, pawns, and rent-to-own contracts. As a result, the data indicate that during the recent decade of robust economic growth, the lower and middle income households utilized increasing levels of consumer credit while straining to service their escalating debt levels. This is consistent with the findings of Teresa Sullivan, Elizabeth Warren, and Jay L. Westbrook (2000) in their pathbreaking study of consumer bankruptcy in the 1990s.

Not surprisingly, the aggressive marketing of bank and retail credit cards to traditionally neglected groups, such as college students and the working poor, encouraged the assumption of new levels of consumer debt. For example, the Survey of Consumer Finance reports that the largest increase in consumer credit card debt was among households with a reported annual income of less than $10,000. Between 1989 and 1998, the average credit card debt among debtor households soared 310.8 percent for the poorest households and 140.9 percent among the oldest households (Draught and Silva, 2003). See Table 7. The overall average for all debtor households during this period is 66.3 percent. Similarly, credit card debt jumped sharply among college students and young adults.

During the late-1980s, when banks realized that students would use summer savings, student loans (maximum limits raised in 1992), parental assistance, part-time employment, and even other credit cards to service their consumer debts, the spike in college credit limits contributed to the surge in “competitive consumption” across college campuses that has redefined the lifestyle of the “starving” student and provided an opportunity for college administrators to continue increasing the cost of higher education (Manning, 1999; 2000: Ch. 6; Manning and Smith, 2005). Today, credit card issuing banks are aggressively competing in this new “race to the bottom” marketing campaign as the moral boundary that has traditionally impeded brazen solicitations of teenagers has been broached with sophisticated marketing campaigns aimed at high school and even junior high students (Manning, 2003(b); Mayer, 2004; Manning and Smith, 2005; Ludden, 2005). Long gone are the days when parents were required to co-sign a credit card account. Instead, banks have learned that students will assume higher levels of consumer debt at a much faster rate if their consumptive behavior is shielded from their parents.

Although credit card industry sponsored research has sought to minimize the social problems associated with rising student consumer debt levels, typically with flawed quantitative methodologies that are based on propriety data that “unfriendly” researchers are not permitted to examine (c.f. Barron and Staten, 2004; Manning and Kirshak, 2005), the growth of consumer debt at younger ages are undeniable trends among America's youth. For parents and higher education professionals, this intensifying marketing of credit and gift cards to high school students provides both an opportunity to introduce/expand personal financial literacy programs as well as pose a daunting challenge in confronting college age social problems that are rapidly expanding into secondary schools. As a result, the marketing of credit cards to high school seniors and college freshmen suggests that their debt capacities will be stretched at much earlier ages which will increase the likelihood of not completing college as well as the possibility of consumer bankruptcy in their early to mid-twenties with its age-specific biases such as the nondischargeability of student loans. Recent studies suggest that the fastest growing groups of consumer bankruptcy filers are those that have previously registered the lowest rates: senior citizens and young adults under 25 years old (Sullivan, Warren, and Westbrook, 2000; Sullivan, Thorne, and Warren; 2001; Manning and Smith, 2005).

A final factor concerns consumer confidence and perception of household wealth. Over the last two decades, middle class households have become active participants in the stock market, either indirectly through their employer pension portfolios or directly through personal investment accounts. When consumers are optimistic about the future, such as their job prospects or accumulation of wealth, they are likely to spend more financial resources--even if their current economic situation is unfavorable. As the stock market soared in the late 1990s, especially the NASDAQ, the psychological "wealth effect" encouraged many families to assume new financial obligations that exceeded their household income. This is illustrated in Table 8 which reports stocks, other assets, total debt, and net worth by wealth class from 1962 to 2001.

The data is surprising. It reveals that only a small proportion of the US population has benefited from the enormous wealth that was generated during the longest economic expansion in U.S. history (Wolff, 2003). For example, between 1989 and 2001, the bottom 40 percent of American households increased their stock holdings from an average of only $700 to $1,800 while the next 20% (the middle income (41%-60%) households) increased modestly from $4,000 to $12,000 or about $667 per year. In comparison, the upper middle income families (61% - 80%) experienced an increase of from $9,700 to $41,300 in stock assets. Similarly, most wealth accumulated by working and middle income households during this period is attributed to housing appreciation. The bottom 40% of American families witnessed an increase in "other assets" from $21,000 to $26,600 and the middle 20 percent rose from $96,800 to $113,500; the next 20% of American households reported an increase from $201,500 to $234,600 (Mishel, Bernstein, and Allegretto, 2005).

The most striking trend in the wealth data, for the majority of U.S. middle-class families, is that the accumulation of consumer debt exceeds the growth of stock investments. For the bottom 40 percent, household debt declined marginally (2.3%) while for the next 20 percent of U.S. households (41%-60%) consumer debt rose from $37,000 to $50,500. If U.S. housing prices had not appreciated so sharply over the last decade, nearly 60 percent of American families—on average--would not have been able to accumulate any net assets during this period. Clearly, the economic winners during this period are the most affluent families; household net worth rose $147,100 (42.9%) for the next top 10 percent (81%-90%) of American households and a staggering $635,400 (65.1%) for the next top 9 percent (Mishel, Bernstein, and Allegretto, 2005). In comparison, the financial boom of the '90s has become an increasingly costly debt burden for most American families today.

Assessing the Consumer Lending Revolution:
Rising Tides and Sinking Ships

The distinguishing features of the deregulation of consumer financial services include: (1) the profound shift in bank lending activities from corporate to consumer loans, (2) fundamental transformation of the industry structure (consolidation, conglomeration), dominant institutional form (conglomerate such as Citigroup), and geographic location, (3) profound shift from state to national regulatory system (US Congress, Office of Comptroller of the Currency) with the ascension of Federal Preemption (Manning, 2003(c) Furletti, 2004; Lander, 2004), (4) dramatic increase in the aggregate levels of household debt, (5) sharp increase in the inequality of the cost of unsecured consumer loans such as credit cards (especially in comparison to installment loans), (6) institutional pressure to continue rapid growth of unsecured consumer loans by expanding into new demographic markets such as students, seniors, and the working poor; and (7) the historically unprecedented growth of consumer bankruptcies.

Figure 3 highlights the two most important contemporary trends in consumer bankruptcy over the last 20 years. First, the soaring growth of unsecured credit card debt takes off in the mid-1980s and is accompanied by the dramatic increase in consumer bankruptcies; between 1985 and 1990, consumer bankruptcy filings more than doubled from 343,099 to 704,518. In the aftermath of the 1989-91 recession, consumer bankruptcy filings closely follow the effect of rising unemployment through 1992 (steadily rising to 946,783) and then fall moderately with declining unemployment rates through 1995 (843,941). In 1995, however, consumer bankruptcy filings exhibit a profoundly different relationship with fluctuations in the rate of unemployment. Indeed, this underscores the second salient feature of contemporary American bankruptcy filing trends: an inverse correlation with unemployment levels. That is, the robust economic expansion of the late 1990s, which generated over 220,000 new jobs each year, produced a substantial drop in U.S. unemployment AND a sharp increase in U.S. consumer bankruptcy filings. This historically unprecedented relationship persisted through 1998 when bankruptcies registered an all-time high of 1,418,954. Since 1999, the traditional relationship between macro-economic conditions and consumer bankruptcy resumed, as filings fell to 1,376,077 in 2001 and then steadily rose to1,493,461 in the aftermath of the 2000 recession. Following the sluggish economic recovery, however, consumer bankruptcies have risen to new record highs of 1,638,804 in 2003 and 1,624,272 in 2004 while unemployed has dipped (U.S. Bankruptcy Courts, 2005). The dramatic increase in consumer bankruptcy rates is underscored when the number of eligible bankruptcy filers per capita is calculated during this period. Between 1985 and 2004, it soared from less than 200 filings per 100,000 to over 1,000 per 100,000. See Table 9.

As previously discussed, the shift from state-chartered community banks to federally chartered national banks was accompanied by a fundamental shift in risk tolerance and bank underwriting standards which led to a profusion of new and more costly consumer financial services such as revolving credit cards. Indeed, when the last major reform of the federal bankruptcy code was enacted in 1978, consumer installment lending reigned supreme as bank underwriting standards were relatively rigidly defined by outstanding debt (household liabilities) to income (household revenues) ratios. Indeed, U.S. bankruptcy law reflected the reality that household debt was largely collateralized installment loans that linked levels of indebtedness to the existent level of household income. Hence, federal law consecrated the Constitutional right that “necessitous” debtors—truly worthy indigents—could either seek a reasonable repayment plan (Chapter 13) or discharge their debts (Chapter 7) by liquidating their assets with only a relatively moderate financial disadvantage to creditors who received a *pro rata* distribution of debtors’ assets.

Over the last 25 years of banking deregulation, bank underwriting standards and the cost of unsecured consumer loans have changed dramatically. Today, household debt “capacity” is stretched by extended repayment schedules (from 15 to 40 year mortgages) and, more instructively, by multiple sources of household wealth/revenues: two or more incomes, asset formation through home ownership (housing equity), and wealth accumulation through stock market investments. Unlike the pre-1980 regulated era, American households can leverage three or more sources of revenue to qualify for secured and unsecured consumer loans. This explains how aggregate household debt—as measured by its share of disposable income—has climbed an extraordinary 56.4 percent over this period: from 73.2 percent in 1979 to 114.5 percent in 2003 (Mishel, Bernstein, and Allegretto, 2005). The major problem for most families is that it is easier to secure a loan than it is to generate greater revenues (with the exception of selling one’s home). For households perilously close to insolvency, both large (job loss, medical care, divorce) and small (rising interest rates, high energy costs, medications) economic factors can precipitate a financial collapse.

As the tremendous increase in highly profitable "revolving" debt has transformed "good" loans into "bad" or unperforming loans, many households whom can no longer afford the minimum payments on their financial obligations have resorted to the U.S. bankruptcy court. Indeed, many financially responsible families have faithfully serviced their major financial obligations until the financial duress of unexpected revenue loss/expenses and/or the escalating weight of unsecured loans force them into an economic abyss.[8] One of my many criticisms of the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, is that it fails to significantly encourage either responsible lending by creditors or responsible repayment by debtors. That is, by shifting the cost of administering the process of debt collection to the bankruptcy filer and the public sector, it indirectly discourages responsible lending by subsidizing the cost of making loans to potentially risky clients. In this way, the new law could have the unintended consequence of increasing future bankruptcy filing rates.

Similarly, the failure of Congress to fundamentally reform the historic Chapter 13/Chapter 7 binary of debtor repayment/discharge has the unintended consequence of discouraging responsible debt repayment behavior by overindebted borrowers. That is, the reality of the current period of banking deregulation is that a small but growing third group of necessitous debtors has emerged that can not repay all of their debts through a costly 3-5 year Chapter 13 repayment program and do not want to evade their financial responsibilities through a Chapter 7 liquidation program. Instead, Congress has been blinded by the demands of the creditor lobby to effect a truly radical reform of the federal bankruptcy code that could serve the interests of both consumers (who wish to enter into a program of "responsible debt relief") and creditors who currently receive little if any *pro rata* distribution of debtor assets through a Chapter 7 liquidation. This situation is illustrated in Table 10 which compares the traditional three-year repayment programs (CCCS, Chapter 13) with an alternative debt negotiation program. For financially distressed consumers who struggle to make their minimum credit card payments, column 2 shows the futility of ever repaying their high cost credit card debts. Overindebted

[8] For those interested in comparative studies of consumer bankruptcy or whom wish to address the fundamental causes of the U.S. bankruptcy "crisis," the first step is a major overhaul of the American health system. Indeed, while the U.S. has severely tightened its consumer bankruptcy codes in 2005, the Western European countries are liberalizing their bankruptcy laws even though their national health care systems virtually preclude the possibility of personal financial insolvency due to medical expenses. Furthermore, a more generous unemployment compensation system entails less European dependence on the credit card financial "safety-net."

consumers who wish to be responsible for their financial obligations and enter into a voluntary CCCS repayment program are shocked when they realize that nonprofit Consumer Credit Counseling Services are funded by creditors and their repayment programs are even more costly and difficult to complete. Chapter 13 reorganization programs, which are the objective of the "means testing" provision of the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, are a less financially costly than the CCCS option but with long-term consequences for future consumer borrowing. Significantly, less than one-fourth of Chapter 13 filers successfully complete their programs. Ironically, a third informal option which offers consumers "responsible debt relief," by enabling debtors to negotiate an informal payoff of between 20 and 45 percent, satisfies the creditors demands for obtaining a significant payment from debtors with the economic means to pay some of their financial obligations while satisfying the desire of debtors to satisfy their creditors to the best of their ability while avoiding the emotional devastation of filing for personal bankruptcy. It is my estimate that approximately 150,000 to 250,000 bankruptcy filers could qualify for such a program each year which would lessen the demands on the overburdened bankruptcy system and increase financial distributions to creditors by $2.5 to $4.0 billion each year. These potential informal 13 participants are those whom fail to complete their Chapter 13 program as well as Chapter 7 filers that would prefer to offer a negotiated debt settlement in order to avoid filing for bankruptcy.

Policy Recommendations:
Consumer Rights Or Privileges

In response to queries as to appropriate regulatory responses to deceptive marketing and predatory pricing policies of the credit card industry, I propose the following recommendations:

[1] Limit lines of credit to college students without an independent source of income and whose parents/guardians will not co-sign a revolving credit card contract to $500. If the credit card account is in good standing, then line of credit could be increased an additional $500 per year up to a maximum of $2500.

[2] Exclusive Credit Card Marketing Agreements with public colleges and universities must be competitively bid and the final contract must be made available for

public review. The criteria for selection of vender must be specified and the agents of the public college or university whom negotiated the contract must be identified.

[3] Respect for personal privacy must be explicitly specified in the contract with public colleges and universities. The card issuing banks must adhere to an “opt-in” provision whereby personal identifying information of staff, students, and alumni must not by obtained without securing permission. This includes student identification numbers (especially social security numbers), phone numbers, and email addresses.

[4] Banks should not be allowed to raise interest rates to punitive levels (over average rates) simply due to the consumer not using the credit card for a limited period of time. For example, Chase has a policy of raising interest rates on credit card to over 20.0% APR that have not been recently used in an attempt to induce customers to close the infrequently used account.

[5] Consumers should be granted a 60 notice for implementing “universal default” provision of their contract which triggers as sharp increase in the finance charges (e.g. from 5.9% to 22.8%) due to reported credit payment patterns on other accounts. Also, consumers should be informed of the specific reasons for invoking the “universal default” provision and what they have to do as well as how long it will take to receive the original interest rate

[6] When a person sends in a pre-approved credit card application for a specified line of credit and interest rate and is approved for a credit card with much less favorable terms (e.g. from $10,000 to $5,000 line of credit and from 5.9% introductory rate APR to 18.9% APR), a letter should be sent informing the consumer of the changes in the expected credit card with the option to cancel the account before receiving the card. This is a practice commonly known as “bait and switch.”

[7] Doubling billing cycles, popularized by MBNA, should be eliminated and replaced with a single date that is designated for balance payoffs as well as payment due dates.

[8] Some credit card companies such as Citibank specify a particular hour of the day that payment must be received in order not to incur a late fee. Due to vagaries of postal delivery, the posted time for incurring a late fee should be 12 pm.

[9] Fees for subprime credit cards should not exceed 15% of the available line of credit up to a maximum of $100.

[10] The cost of credit for subprime credit cards should include mandated fees in calculating the APR in consumer disclosure information.

[11] Consumers should have the right to terminate a subprime credit card without incurring activation fees within 30 days of opening the credit card account.

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