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Hearing: Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers

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Thank you for the opportunity to join this discussion about credit cards. I come to you as someone who sees the value in credit cards. I use a credit card—rather frequently. I also believe deeply in the power of free markets.

But today I am here to talk about a market that is not working – at least not for the millions of Americans who find themselves on the wrong end of a credit card "deal". The credit card market is broken.

A growing number of card issuers increase their profits by loading their credit cards with tricks and traps so that they can catch consumers who stumble or mistake those traps for treasure and find themselves caught in a snare from which they cannot escape. Once they are trapped, they are bled with 29% interest rates, late fees, over limit fees, double cycle billing, disappearing grace periods, $15 phone payment charges, and every other possible way to run up the bills and keep the customer paying and paying and paying.

Credit card agreements are incomprehensible. They make it impossible for customers to avoid companies that will impose outrageous fees and penalties. The result is a race to adopt practices that will slam consumers the hardest, knowing full well that such behavior will increase company profits dramatically while it costs the card issuers nothing as they recruit new customers.

The credit card market is broken, and consumers pay a steep price in this non-functioning market. But it doesn't have to be this way.

Why is the Credit Card Market Broken?

Substantial parts of the credit card market work. Consumers have access to a system that is convenient. Credit card issuers compete for customers' business. Innovative products permit people to earn frequent flier miles or contribute to their favorite charities when they use their cards for purchases.

But the basic structure of the credit card market is awry. Companies can make a lot of money from the basic transaction in which the customer uses a card, the company sends a bill and the customer pays in full. In 2005, such activities generated $24 billion in revenues for the card companies, and cash advance fees and enhancements added another $5 billion to the bottom line. Twenty-nine billion dollars would be impressive revenues in most industries in the U.S.

But the credit card companies do not stop there. These companies know they can make higher profits if the customers finance their purchases over time, paying their credit card bills a little at a time—some of them for a lifetime. And the companies knew that they could make truly extraordinary profits if the customers stumbled and the company loaded up on default rates of interest and penalty fees. In 2005, interest and penalty fee revenues alone added up to a staggering $79 billion.[1]

Although some credit card issuers focus the business model on revenues from interchange payments and annual fees, it is clear that the sweet spot is the customer who stumbles and pays late fees and high rates of interest. Nearly eight out of every ten dollars of revenue comes from the customers who cannot pay off their bills in full every month.

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[1] Currently, credit card companies earn revenues from six sources:

Interest	$71.13 billion
Interchange fees	20.62 billion
Penalty Fees	7.88 billion
Cash-Advance Fees	5.26 billion
Annual Fees	3.26 billion
Enhancements	0.85 billion
Total	$109.00 billion

Source: *Cards & Payments*, reproduced in *Bank Card Profitability, 2005-2004*, CardWeb (2006)

To capture this high-yield customer, many credit card issuers now use a two-tier business model. First, they place as many credit cards in the hands of as many customers as possible. Last year the companies mailed more than six billion pre-approved solicitations, in addition to widespread advertising and direct marketing on college campuses, in suburban malls, and especially around military bases. They also purchased the customer accounts of other card issuers, paying prices that ranged from $200 to $1800 per customer just to have the chance to put their own cards in the wallets of these customers. For each of these customers, the card issuer can count on a stream of revenue—money from the merchants each time the customer used the credit card, annual fees from some of the customers, and a chance to sell enhancements, such as credit insurance and tax preparation assistance. It is a profitable business.

But the most valuable customers are not those who pay in full each month. Instead, the customers who generate the real profits for the credit card companies are those who stumble and slide, who make payments and miss payments, and who end up paying default rates of interest and penalty fees. To maximize profits from this group, the credit card issuers have a second tier to their business model: they load their initial card agreements with tricks and traps so that they can maximize income from interest rates and fees.

This is where the market breaks down. In a perfectly competitive market, both firms and consumers have the information they need to make sound economic decisions. Because these tricks and traps are effectively hidden from customers—invisible until they bite, that is—credit card issuers face no economic penalty in the marketplace for including them in card agreements. If the consumer can't tell a safe card from a dangerous one, then the marketplace will not reward the safe card issuer by increasing volume. It is a little like selling all cars in big black boxes that the customers could open only after they take them home. Luxury cars and go-karts without brakes would sell for the same price. There might be a big difference in use and safety down the line, but when consumers can't tell which they have before a crash, then the market cannot reward a manufacturer who produces a safer product.

The tricks and traps list is lengthy, but it includes universal default, default rates of interest, late fees, over-limit fees, fees for payment by telephone, repeated changes in the dates bills are due, changes in the locations to which bills should be mailed, making it hard to find the total amount due on the bill, moving bill-reception centers to lengthen the time it takes a bill to arrive by mail, misleading customers about grace periods, and double cycle billing—just to name the most easily understood.

The GAO has identified just a handful of these practices,[2] concluding that the companies themselves keep customers in the dark: "Contrary to usability and readability best practices, disclosures buried important information in the text, failed to group and label related material, and use small typefaces." Little wonder that the GAO interviews with

[2] Government Accountability Office, *Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers* (September 2006).

consumer revealed 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."

The vice-president of Booz Allen Hamilton, Inc., a top-line international business consulting group, summarized the current state of bank products as "too complex for the average consumer to understand."[3] He was correct. Anyone who has ever tried to read a credit card agreement knows that the terms are simply incomprehensible. The inserts sent along with monthly bills to amend the card agreements are filled with language even a lawyer would have difficulty parsing. In such an environment, the average consumer doesn't have a prayer.

Customers are kept in the dark about these practices, until it is too late. According to the Wall Street Journal, in the early 1980s, the typical credit card contract was a page long. But by the early 2000s, that contract had grown to more than 30 pages of incomprehensible text.[4] The additional terms were not designed to make life easier for the customer.

This is not risk-based pricing. A risk-based pricing model is about the lender's assessment of the likelihood of repayment at the inception of the loan, with subsequent calibration as more information is available. Anyone who has a small child, a dog, or a dead relative who has received a pre-approved credit card offer understands that the initial loan is not risk-based. Instead, the model posits putting cards in the hands of every consumer, then maximizing revenues with every possible trick and trap once the customer has begun using the card. Charges for late fees or over-limit fees reflect a price the company believes it can charge without causing the consumer to cancel the card. Interest rate increases may be related to changes in credit, but they may also be related to factors that bear no relationship to the likelihood of repayment or, in some cases, to no change at all in the customer's risk profile. The tricks and traps are profit-taking, pure and simple.

One of the few bits of protection for consumers was eroded with the change in the bankruptcy laws in 2005. Prior to that time, any customer who was facing outrageous interest charges and penalty fees could credibly threaten to file bankruptcy. This threat from consumers had both the effect of curtailing some of the most aggressive credit practices and it encouraged lenders to do some—albeit limited—screening before issuing pre-approved credit cards. With the change in the bankruptcy laws, however, many consumers no longer see bankruptcy as an option. Whether they are right or wrong doesn't matter. Even though most of them remain eligible for bankruptcy, some now listen to debt collectors who bully them and tell them that bankruptcy is illegal and others are discouraged when they encounter higher attorneys fees and filing fees. As a result,

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[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] 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.).

the lenders can sweat them for payments longer, keeping them trapped in a monthly payment cycle that these customers can never pay off. After the new bankruptcy law went into effect, a market that was already broken got worse for the family in trouble.

Is This Just a Problem of Consumer Mis-Use?

Many people don't worry about credit card tricks and traps. About 40% of families pay in full every month,[5] and they rarely notice the mysterious increase in interest rates or the unexpected charges when a payment takes nine days to make it across country. Others enter the credit card market as a gladiator once entered battle, looking for leverage in zero-interest teaser rates and grace period floats and taking pride in their ability to carry a credit balance while dancing around the ever-present traps. But for the 23 million of those who are unable to make more than the minimum monthly payments on their cards,[6] the tricks and traps keep them on the financial ropes, collectively shelling out billions to the credit card companies and never quite getting back on their feet.

Credit cards are unsafe. Part of the reason rests with the consumer: Just as people can drive cars too fast or stick firecrackers in toaster, they can behave irresponsibly with credit cards. Spending sprees and living beyond one's means can leave someone in a deep hole with credit card debt. For those mistakes, people need to take responsibility. I cannot emphasize this point enough.

But credit cards are unsafe for another, very different reason: They are unsafe because they are designed to be unsafe. The customer who has paid on time for years can – through misstep or misfortune - find themselves hit with increases in interest rates and fees that will cost them dearly and, unless they are very lucky, can cause them to lose their financial footing.

Occasionally the economics of credit cards are exposed in public records. Mrs. Josephine McCarthy provides one example. Twenty-four months before she ended up in court, she owed her credit card company about $2200 dollars. In the ensuing two years, she made payments of $2000. But with interest charges and fees, her new balance was $2607. Mrs. McCarthy could pay nearly 100% of what she owed every year for the rest of her life, and thanks to the traps built in to her credit card, she would keep paying until she died—and still not pay off her card.[7]

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[5] Estimate calculated from these data: Between 2000 and 2004 the percentage of cardholders who paid their card debt off in full and on time fluctuated between 38 and 44 percent. See CardTrak, Free Loaders (Apr. 8, 2005),
http://www.cardweb.com/cardtrak/news/2005/april/8a.html.
[6] Cambridge Consumer Credit Index (March 7, 2005). In 2004, 46% of American families reported carrying a balance on their credit cards. Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finance, Table 11. Family Holdings of Debt, Federal Reserve Bulletin (2006). The two data sources combine to suggest that approximately 51 million households are carrying credit card debt, and approximately 23 million families are making the minimum monthly payment.
[7] In re McCarthy, Case No. 04-10493 (N.D. Va. 2004).

Ms. McCarthy is not alone. A court case in North Carolina for eighteen credit card holders showed an even more egregious pattern: For every dollar that the credit card companies said their customers owed two years ago, they now demanded two more dollars in interest and penalty fees.[8]

This isn't about irresponsibility. This is about customers who slipped and then could not free themselves from the credit card trap.

For many consumers who carry a credit card balance, debt was not the natural result of too many trips to the mall or too many nice vacations. A new report by Demos, for example, documents that 29% of families carrying credit card debt explain that medical expenses contributed to their debt loads.[9] Families with medical problems had credit card debts that were, on average, about $4,000 larger than their counterparts with no medical problems. Families with children and families with no health insurance were particularly hard hit.

Students trying to finance an education are also struggling with credit card debt. As the costs of a college education has risen and grant aid has fallen, more students are taking on more debt of all kinds. From 2001 to 2006, student credit card debt balances increased by 24%.[10] Older Americans were also targeted, with the result that they have the dark distinction of being the fastest growing age group filing for bankruptcy.

Credit card debt is the single most-often listed debt in bankruptcy, comprising a huge fraction of the non-mortgage debts these families are carrying. Why are these families in credit traps? Two-thirds explain that they lost their jobs, half had a serious medical problem and about one in five has suffered through a divorce or death in the family.[11] Once again, families with children are particularly vulnerable.[12]

For some, the story of credit card debt is one of profligacy. For others, the story is misfortune. Others could tell stories of misplaced optimism—starting a small business or believing the promise that a layoff was nearly over and new job offer was in the works. For still others, the problem is less about volition, and more about living. Credit card companies have become masters at probing every human trait—failure to scrutinize bills, willingness to try to help an alma mater, inability to make correct calculations on present discounted value of various card terms. The card companies employ teams of people whose sole job is to jigger and re-jigger credit card terms so that more money drains out of consumers' pockets—and, with a little luck, the consumer won't even notice until it is too late.

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[8] In re Blair, Case No. 02-11400 (W.D. N.C. 2004).

[9] Cindy Zelman and Mark Rukavina, *Borrowing to Stay Healthy: How Credit Card Debt Relates to Medical Expenses* (Demos 2007).

[10] Analysis by Experian for USA Today, reported in Mindy Fedderman and Barbara Hansen, *Young & In Debt*, USA Today (August 2006)

[11] Elizabeth Warren and Amelia Warren Tyagi, The Two-Income Trap: Why Middle Class Mothers and Fathers Are Going Broke (Basic 2003).

[12] Families with children file for bankruptcy at about three times the rate of families without children. Id.

In a world in which real incomes are not rising, while mortgage costs, health insurance, child care and transportation continue their upward climb, credit card debt is not just about the profligate. It is about hard-working, play-by-the-rules families who are doing their best but who, in the ups and downs of everyday life, sometimes need credit. Only after they have seized the rope offered by the credit card companies, do some of them discover that the other end is tied to an anchor.

How Much Do the Tricks and Traps Cost?

The United States Supreme Court joins with nearly all economists in explaining that real interest rate includes both charges denominated as interest and the penalty fees that are imposed for late payments. While the 29% default rate of interest charged many customers today is breath-taking, it is important to remember that the real rate of interest is much higher. For a $100 balance with 29% default rate plus $39 late fee, the real rate of interest is 68%. Add in a $49 over-limit fee, and the real rate of interest jumps to 117%. Hit the debtor with compound interest on the fees and with over-limit fees for two or three months in a row, and the interest rates swell to 400% and higher.

The profitability of credit card operations is astonishing. One of America's largest credit card lenders, Citigroup, gives us an apples-to-apples comparison. For 2006, the company reported after-tax profits on their combined real estate mortgages, student loans, and car loans of 0.79%. The after-tax profits on their credit card operations—net of advertising, bad loans, and every other expense—was 6.17%. In other words, dollar-for-dollar, Citi earned nearly eight dollars on its credit card operations for every dollar it earned in other lending. The other operations were profitable enough for Citi to stay in business, but the credit card profits outshine every other part of their consumer operations.

Be clear: I picked Citi because the company is well known and they have large lending operations of different kinds, providing an apples-to-apples comparison on profits. But the company is neither the most profitable credit card operation nor are they the most aggressive lender. Many other lenders have tapped into the extraordinary profits of the credit card sweet spot.

Are There Solutions?

There are multiple approaches to repairing the broken credit card market. One starting place is to outlaw the most egregious practices. In no functioning market, should credit card issuers be able to change the terms of an agreement at will or to calculate interest due on money already paid. The Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act of 2005 that Senator Dodd introduced is an important first step to reign in abusive lending practices. Recent changes in the law that limit total interest rates charged to military families are another important step. These laws and proposals acknowledge that there are simply some practices that are wrong and should be banned.

Current regulatory oversight is weak, in part because regulators have not chosen to exercise their powers to protect consumers from the financial institutions they regulate. When asked, for example, about why the Office of the Controller of the Currency had not been more aggressive in developing basic consumer protection, the agency spokesperson responded, "We tend not to mandate things."[13] Encouraging more vigorous oversight from regulatory commissions so that they use the tools at their disposal more effectively would make a difference.

Existing regulation should also be strengthened. Conceptually, the current patchwork of multiple regulators, each with oversight of only a subset of credit card issuers creates a kind of regulatory arbitrage in which institutions can play off regulators and shift operations to different subsidiaries in order to choose the regulatory environments they find most congenial. So long as we have a fractured oversight, this problem will continue. Combining oversight of consumer credit products in a single regulatory commission would avoid the patchwork that currently exists, while it would also permit a single agency to develop expertise on all the new and emerging credit practices.

The industry has an important role to play. Today there are many providers of safe credit cards, but their voices are often lost among the very aggressive campaigns of their more dangerous counterparts. The industry can take steps to begin cleaning up itself and developing its own best practices. No company needs to wait for government intervention to begin giving Americans a safer credit card.

Improving the quality and effectiveness of consumer disclosures may improve this marketplace somewhat as well, but here it is important to add a note about what will not work. Adding more pages to the current 30-plus pages of credit card agreements helps no one. The limits of disclosure as an effective way to improve markets are becoming clear. No one needs to be an engineer to buy a toaster. No one needs to be a crash test scientist to buy a car. And no one should need to be a lawyer to take on a credit card.

Americans benefit from markets that work. If Congress repairs the busted credit card market, then Americans—consumers and businesses alike—will benefit as well.

[13] Plastic Shock, USA Today (January 2006) (quoting Barbara Grunkemeyer of the Office of the Comptroller of the Currency).