Consumer Federation of America
1620 I Street, N.W., Suite 200 * Washington, DC 20006

Consumers Union

TESTIMONY OF

TRAVIS B. PLUNKETT,
LEGISLATIVE DIRECTOR

ON BEHALF OF
THE CONSUMER FEDERATION OF AMERICA AND
CONSUMERS UNION

BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

H.R. 5244, THE CREDIT CARDHOLDERS' BILL OF RIGHTS: PROVIDING NEW PROTECTIONS FOR CONSUMERS

APRIL 17, 2008

Chairwoman Maloney, Ranking Member Biggert, and members of the Subcommittee, my name is Travis Plunkett and I am the legislative director of the Consumer Federation of America (CFA.)[1] I am testifying today on behalf of CFA and Consumers Union, the publisher of Consumer Reports.[2] I appreciate the opportunity to offer our comments on H.R. 5244, the Credit Cardholders' Bill of Rights and on the effect of some current credit card industry practices on consumers.

Given the dramatic changes that have occurred in the credit card industry in recent years – and the harmful impact that some of these changes are having on consumers as this country slides into recession – no industry in America is more deserving of oversight by Congress. We applaud the Subcommittee for examining many questionable practices in the credit card industry over the last year, including the terms and conditions of credit card contracts, unjustified fees and interest rates and marketing and credit extension practices. It is particularly important that you are holding a legislative hearing today that includes testimony from cardholders who are being negatively affected by some of these practices. We look forward to working with you and the Subcommittee to enact legislation that will make this industry more consumer-friendly. In particular, Madame Chair, we urge this Subcommittee to mark-up legislation that you have proposed, the Credit Cardholders' Bill of Rights Act (H.R. 5244,) which takes an important first step in addressing many of the abuses I will speak about today.

H.R. 5244 curbs some of the most arbitrary, abusive, and unfair credit card lending practices that trap consumers in an unending cycle of costly debt, such as sharply escalating "universal default" interest rates that can double some cardholders monthly payments overnight. These tricks and traps have always been unfair, but now, at a time when consumers can least afford it, these practices produce devastating financial repercussions. Moderate-income families with little flexibility in their budgets are particularly hard hit if they have to pay more in unjustifiable fees and credit card interest. Signs that credit card delinquencies and defaults are on the rise should be a further warning that these practices have helped make credit card loans unsustainable for many Americans. The meltdown of the subprime mortgage market demonstrates the importance of ending abusive lending practices when warning signs arise. Congress should take steps now to rein in these practices to forestall an even greater economic crisis.

I will begin my remarks with an examination of recent credit card lending practices. We find that credit card issuers are expanding efforts to market and extend credit much faster than

---

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

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

Americans are taking on new credit card debt. This credit expansion has had a negative effect on the least sophisticated, highest risk and lowest income households. It has also resulted in both relatively high losses for the industry and record profits. That is because the industry has been very aggressive in implementing a number of new – and extremely costly – fees and interest rates. We also find that Americans are broadly -- nearly universally -- critical of many of these credit card practices.

I conclude that these new pricing policies cannot be justified by stating that creditors are simply leveling higher charges for consumers who represent higher financial risks. In fact, many of these fees and interest rates appear to be predatory; charging what the market will bear while ignoring the harmful impact this pricing has on many Americans. I will close by explaining in detail how H.R. 5244 takes an important first step in eliminating abusive pricing in the industry.

A. CONSUMERS HAVE SHOWN FAR MORE CAUTION IN TAKING ON CREDIT CARD DEBT THAN ISSUERS HAVE USED IN MARKETING AND EXTENDING CREDIT

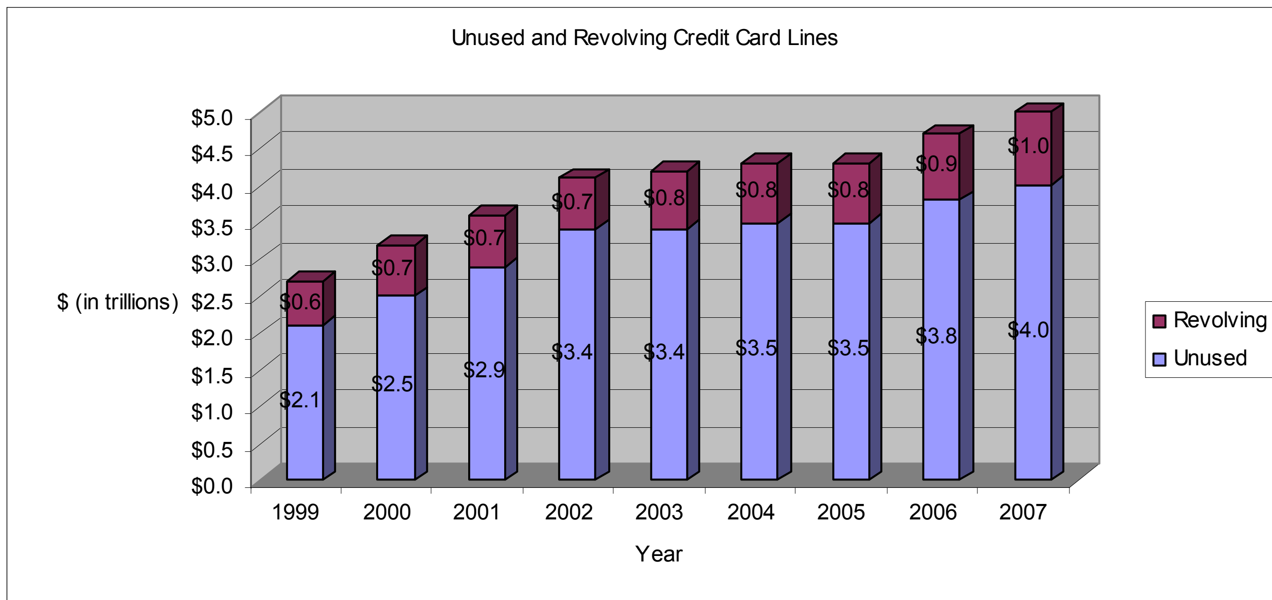
It is conventional wisdom that consumer demand has fueled the growth of revolving debt to about $950 billion.[3] However, a careful analysis of lending patterns by credit card companies shows that aggressive and even reckless lending by issuers has played a huge role in pushing credit card debt to record levels. Since 1999, creditor marketing and credit extension has increased about twice as fast as credit card debt taken on by consumers,[4] even though the rate of growth in credit card debt in 2007 was the highest it has been since 2000.[5]

---

[3] As of February 2008, the amount of revolving debt held by Americans was $951.7 billion. Although this figure is often used as a proxy for credit card debt, most experts believe that outstanding credit card debt is slightly lower. First, approximately 5 percent of consumer revolving credit is not on credit cards. Second, between 4 to 9 percent of the debt does not truly revolve. It is repaid to the credit card issuer before the next billing cycle starts. Taking these two factors into account, outstanding credit card debt is likely to be between $818.5 and $866 billion.

[4] VERIBANC, Inc. (www.VERIBANC.com) and Federal Reserve Consumer Credit Outstanding. According to Federal Reserve figures, consumer revolving debt grew by 50 percent from $627.5 billion in December 1999 to $941.4 billion in December 2007. According to VERIBANC, unused lines of credit grew at almost double the rate (90.5 percent) consumers increased their use of credit card lines, increasing from $2.1 trillion in 1999 to just under $4.0 trillion ($3,983,200,614) at the end of 2007.

[5] The amount of revolving debt increased by 7.8 percent in 2007, which was the sharpest increase since revolving debt grew by 11.6 percent in 2000. Federal Reserve, Statistical Release, Consumer Credit Outstanding, Table G.19.



Source: VERIBANC, Federal Reserve.

The total amount of credit made available by issuers is now about $5 trillion.[6] The average amount of credit available per household is $43,007.[7] Of that amount, only 24 percent has been taken on as debt by consumers. According to figures from VERIBANC Inc., there were about $4 trillion in unused credit lines in the fiscal quarter ending in September 2006. Between December 1999 and December 2007, revolving debt grew by 50 percent, but unused credit card lines made available by creditors grew by 90.4 percent, almost twice as fast.[8]

A similar trend is evident when examining the consumer response to massive increases in marketing by creditors. The most significant form of marketing for creditors remains solicitation by mail. Over half of credit cards held by consumers are the result of mail solicitation.[9]

Issuers increased the number of mailed credit card offerings by six-fold from 1990 to 2005, from just over 1.1 billion to a record 6.06 billion.[10] Since then, solicitations have dropped to 5.8 billion in 2006 and 5.2 billion in 2007.[11] Wealthier families receive the highest number of credit card mailings, but low-income families are more likely to open the solicitations they

---

[6] As of December 2007, the total amount was $4.92 Trillion. VERIBANC, Inc. and Federal Reserve Consumer Credit Outstanding, Table G.19.
[7] There are 114.4 million households in the U.S., U.S. Census Bureau, "American's Families and Living Arrangements: 2006.
[8] VERIBANC, Inc. and Federal Reserve Consumer Credit Outstanding, Table G.19.
[9] Vertis Inc. press release, "Financial Direct Mail Readers Interested in Credit Card Offers," January 25, 2005; "Card Marketing 101," *CardTrack*, September 2002.
[10] Synovate Mail Monitor, press release, "Mail Monitor Reports Record Six Billion Credit Card Offers Mailed in U.S. during 2005," April 27, 2006.
[11] Synovate Mail Monitor, press release, "U.S Credit Card Mail Volume declined in 4th Quarter 2007 as Troubled Issuers Pull Back," February 2008. The drop in solicitations in 2006 occurred primarily because of the merger between Bank of America and MBNA. Synovate stated that the decline in 2007 occurred because some issuers were "straining from the fall-out due to the mortgage crisis and concern about an uncertain economy." However, some issuers like JP Morgan Chase that have not been as affected by economic problems actually increased their mail marketing in 2007.

receive.[12] The table at right indicates that issuer interest in marketing credit cards has grown much faster than consumer interest in accepting new cards. The consumer response rate to mail solicitations declined seven-fold from 2.1 percent in 1990 to .3 percent in 2005, picking up slightly to .5 percent in 2006 and 2007. This means that for every 250 solicitations consumers receive, they reject more than 249. The tiny response rate demonstrates that the vast majority of consumers are being responsible when offered unsolicited credit.

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

Issuers also spend extremely large sums on many other forms of marketing and advertising, through television, telemarketing, the internet, radio, print and even outdoor billboards. *Nielsen Monitor* reported that credit card companies were among the top advertisers nationally and the fastest growing segment of purchased advertising in 2004, with credit card television advertising growing to $1.7 billion in 2004, a $438 million and 32.4 percent increase over 2003.[13] These figures are before the fourth largest credit card issuer, MBNA, started its first national advertising campaign during the 2005 Super Bowl.[14]

	Solicitations (billions)	Response Rate
1990	1.1	2.1%
1991	0.99	2.4%
1992	0.92	2.8%
1993	1.5	2.2%
1994	2.5	1.6%
1995	2.7	1.4%
1996	2.38	1.4%
1997	3.01	1.3%
1998	3.44	1.2%
1999	2.54	1.0%
2000	3.54	0.6%
2001	5.01	0.6%
2002	4.89	0.5%
2003	4.29	0.6%
2004	5.23	0.4%
2005	6.06	0.3%
2006	5.8	.5%
2007	5.2	.5%

Source: Synovate Mail Monitor

Credit cards also promote and advertise their cards by establishing significant networks of co-branded affinity relationships, which offer credit cards with the logo and affiliation of a sports team, university, association or non-profit. This allows credit card companies to gain access to mailing lists and market the credit card branded with the group's logo directly to the group's membership. Organizations are paid a bounty for each account that is opened as well as revenue from any open balances on the affinity cards. Once a consumer relationship is established with the affinity card, the credit card issuers can market other lending products including student loans, home equity loans or auto loans to their affinity card customers.[15]

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

The growth of revolving debt in this country to $950 billion has obviously not affected all Americans equally. The extraordinary expansion of the credit card industry in the 1990s was fueled by the marketing of credit cards to populations that had not had widespread access to

[12] Kidane, Amdetsion and Sandip Mukerji, Howard University School of Business, "Characteristics of Consumers Targeted and Neglected by Credit Card Companies," *Financial Services Review*, Vol. 13, No. 3, 2004 at 186.
[13] Nielsen Monitor, "U.S. Advertising Spending Rose 6.3% in 2004, Nielseon Monitor-Plus Reports," March 1, 2005.
[14] Sidel, Robin, "Card Issuer MBNA lets the Public Take a Peek at Its Hand," *Wall Street Journal*, January 20, 2005 at C1.
[15] *Ibid.*

mainstream credit, including lower- and moderate-income households, consumers with seriously blemished credit histories, college students, older Americans and minorities.

In a practice widely known as risk-based pricing, creditors charged riskier consumers more to cover potential losses, usually in the form of higher interest rates. To make the assumption of debt more attractive to these households – and to entice them into carrying debt for longer periods – creditors lowered minimum payment balances from around five percent of principal to just over two percent. As a result, an estimated eighty percent of all households now have at least one card.[16] According to the Federal Reserve Board, about 42 percent of cardholding households pay their credit card bill in full every month,[17] which means that the remaining 50 million or so families that carry debt owe an average of about $17,000.[18]

Moderate and lower income households that are more financially vulnerable shoulder a higher level of debt relative to their incomes. In the current economic climate, these households are also under financial pressure from many external factors, such as flat wages, rising unemployment, skyrocketing home foreclosures and increasingly unaffordable health insurance. In other words, the "democratization of credit" has had serious negative consequences for many Americans, putting them one unexpected financial emergency away from bankruptcy.

Lower-Income and Minority Households

Close to half of all minority families in the U.S. carry credit card debt.[19] Although lower and moderate-income households are less likely to have bank credit cards than more affluent families, they are more likely to carry over debt from month-to-month. Sixty one percent of the lowest income households with a card carry balances, compared to 45 percent of higher income families.[20] Credit card debt also represents a significant portion of lower-income families' income. A 2004 Gallup poll found that families with credit card debt earning under $20,000 a year owed 14.3 percent of their income in credit card debts, those earning between $20,000 and $29,999 owed 13.3 percent and those earning between $30,000 and $39,999 owed 11.0 percent. Compare this to the 2.3 percent of their income owed by families earning over $100,000.[21] The increase in credit card debt has contributed to alarmingly high overall levels of debt for many of

---

[16] Cardweb.com

[17] "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore, *Federal Reserve Bulletin*, vol. 92 (February 2006), p. 31.

[18] CFA calculation based on estimated credit card (as opposed to revolving) debt of $850 billion. If a conservative estimate of 75 percent of 114.4 million households have credit cards, and only 58 percent of these households carry debt, then the remaining 49.7 million households have an average of $17,103 in debt.

[19] Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," *Federal Reserve Bulletin*, vol. 92, February 2006, pg. 24.

[20] 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," submitted to the Congress pursuant to section 1229 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, June 2006 at 9 Table 6.

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

these lower and moderate-income families. More than one-quarter of the lowest income families spent over 40 percent of their income on debt repayment in 2001.[22]

Younger and Older Americans

Starting in the early 1990's, credit card issuers targeted massive marketing efforts at college campuses throughout the country, resulting in a sharp growth of credit card debt among college-age and younger Americans. CFA and Dr. Robert Manning were among the first to document the serious consequences of this trend.[23] Since Dr. Manning's report for CFA in 1999, this issue has been the subject of much public and media scrutiny. And yet, Americans under 35 years-of-age continue to show more signs of trouble managing credit card debt than any other age group. The amount of credit card debt held by students graduating from college more than doubled to $3,262 between the mid-1990s and 2004.[24] Americans under 35 are less likely to pay off their credit card balances every month than average Americans,[25] are paying more for debt obligations than in the past and are increasingly likely to pay more than 40 percent of their incomes on credit card debt.[26] Not surprisingly, more young Americans are declaring bankruptcy than in the past.[27] Moreover, there is increasing evidence that issuers are now targeting high school students with credit card offers.[28] They are also marketing branded debit cards to adolescents, in part to encourage these young consumers to use similarly branded credit cards when they are older.[29]

The growth of credit card debt among older households is also troubling. Although these households were long thought to be the most frugal and resistant to consumer debt, changing economic conditions – especially declining pension and investment income coupled with rising health care and prescription costs – have made credit card debt a more serious financial issue for older Americans. Between 1992 and 2001, Americans over age 65 saw their credit card debt nearly double from $2,143 to more than $4,000.[30] The number of seniors filing for bankruptcy

---

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

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

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

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

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

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

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

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

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

more than tripled from 1991 to 2001.[31] Other warning signs are also evident. The proportion of income spent to pay off debts by households headed by individuals 65 to 74 years of age has risen steadily over the past decade[32] while about one in seven senior households paid more than 40 of their income towards their debts in 2001.[33]

Seniors have fewer credit cards than other age groups and are more likely to pay their credit cards in full every month, but a greater proportion of older Americans also have lower incomes.[34] This means that credit card debt has a more severe impact on this age group. For example, credit card debt can threaten older homeowners, who stand to lose their home – and their most significant hedge against poverty – if they use home equity to pay off credit card debt.

The Downsizing of Minimum Payments

As credit card issuers dramatically expanded their marketing and extension of credit in the 1990s, they lowered monthly minimum payment amounts. By reducing the minimum payment, issuers could offer more credit, encourage consumers to take on more debt, and ensure that consumers would take far longer to pay off their debts, thus making them more profitable for the industry.[35] Monthly minimum payment rates were reduced from around 5 percent of principal owed in the 1970s to just over 2 percent by the turn of the century.[36] In 2005, 19 million credit card borrowers make only the minimum payments.[37]

The number of consumers paying just above the minimum rate is even larger. In a representative survey conducted for the Consumer Federation of America by Opinion Research Corporation in November of 2005, 34 percent of those questioned said that they usually pay the minimum rate or somewhat more. More than 40 percent of respondents earning less than $50,000 a year said they paid the minimum rate or somewhat more, while 45 percent of African Americans and 51 percent of Hispanics did so.[38] An examination by the Credit Research Center of 310,000 active credit card accounts over 12 consecutive months in 2000 and 2001 found similar results. Just under one-third of the accounts paid 5 percent or less per month of the total amount due.[39] Moreover, payment habits for many cardholders are not static over time.

---

[31] Sullivan, Theresa A., Deborah Thorne and Elizabeth Warren, "Young, Old, and In Between: Who Files for Bankruptcy?" *Norton Bankruptcy Law Advisor*, Iss. No. 9A, September 2001, at 5. The number of older Americans declaring bankruptcy during this period rose from 23,890 to 82,207.

[32] Aizcorbe, Kennickell and Moore 2003 at 28, Table 14. According to the Federal Reserve Survey of Consumer Finances, the median debt services ratio of households aged 65-74 grew by 54% from 9.8% in 1992 to 15.1% in 2001 and the debt services ratio for households 75 and older grew 169% from 2.6% to 7.0% in 2001.

[33] *Ibid*. 13.9% of households aged 65-74 and 14.3% of households aged 75 and over spent more than 40 percent of their income on debt service.

[34] Hanway, Steve, Gallup News Organization, "Do Credit Card Habits Improve with Age?" May 18, 2004. Nearly half (48%) of households over 65 years old have incomes below $30,000, compared to 16% of those aged 30-49 and 18% of those aged 50-64.

[35] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.

[36] Kim, Jane J., "Minimums Due on Credit Cards are on the Increase," *Wall Street Journal*, March 24, 2005.

[37] Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.

[38] Opinion Research Corporation, "Consumer Financial Services Survey," November 3-7, 2005.

[39] Credit Research Center, McDonough School of Business, Georgetown University.

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

However, paying only the minimum on credit cards can increase the length of time the debt is carried and significantly add to the interest cost of the credit card loan. Julie Williams, the First Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency (OCC) has noted that reduced minimum payments "dig borrowers into an ever deeper hole, requiring increasingly more difficult measures" for consumers to get out of debt.[40] CFA has concluded that reduced minimum payments were a significant cause of increasing bankruptcies in the last decade.[41]

One way to alert consumers to the consequences of paying off credit card balances at the minimum rate is to offer each consumer a personalized notice on the billing statement about how long it would take to pay off the balance at the minimum rate, and what would be the total costs in interest and principal.[42] Such a personalized disclosure is, unfortunately, not included in the recent bankruptcy law, which requires consumers to call a toll-free number to get information about how long it would take to pay off their balances.[43] No specific information would be offered on the total cost of paying at the minimum rate. This bankruptcy law requirement will likely have no impact on the millions of consumers paying at or near the minimum rate who will not call a toll-free phone number.

One positive development regarding credit card minimum payments is that regulatory guidance issued by federal banking regulators in January 2003 directed credit card lenders to set minimum payments that "amortize the current balance over a reasonable period of time" and noted that prolonged negative amortization would be subject to bank examiner criticism.[44] Many major credit cards began increasing their minimum payments requirements in 2005, including Bank of America, Citibank, Discover and JP Morgan Chase,[45] in some cases to as high as 4 percent.[46] All issuers were required to fully phase in the changes by the end of 2006.[47]

---

[40] OCC, Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel before the Risk Management Association's Retail Risk Management Conference on Regulatory Concerns about Certain Retail Banking Practices, Chicago, June 3, 2003, in "Speeches and Congressional Testimony," *OCC Quarterly Journal*, Vol. 22, No. 3, September 2003 at 107.
[41] Consumer Federation of America, "Consumer Restraint Pressures Lenders to Reduce Credit Card Marketing and Credit Extension," January 18, 2000.
[42] Proposed in S. 1176 by Senators Akaka, Durbin, Leahy and Schumer.
[43] Public Law 109-8.
[44] Joint press release of Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices," January 8, 2003, see attached "Account Management and Loss Allowance Guidance" at 3.
[45] American Financial Services Association, "Credit Card Minimum Payments Going Up," *Spotlight on Financial Services*, April 2005.
[46] Warnick, Melody, "Credit Card Minimum Payments Doubling," *Bankrate.com*, May 3, 2005. Citibank and Bank of America have announced they are doubling their minimum payment requirements from 2% to 4% of the balance.
[47] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

The Office of the Comptroller of the Currency (OCC) has warned banks that increasing minimum payments may need to be accompanied by a reduction in Annual Percentage Rates (APRs) or eliminating fees to ensure that cardholders can actually reduce their balances and not just tread water with higher minimum bills.[48] Since the increases took effect, consumers with interest rates above 20 percent have had to cope with payments that have roughly doubled.[49]

Targeting Consumers on the Brink of Financial Distress

Nothing illustrates the perverse incentives (and dangers) of the credit card market better than the marketing of cards to consumers with tarnished credit histories, or even worse, to those who are literally on their way to or just coming out of bankruptcy. For example, in the first half of 2007, as home mortgage foreclosures shot up and signs of a serious economic slowdown started to appear, some of the nation's largest credit card issuers increased the number of solicitations they mailed to sub-prime consumers by 41 percent compared to the first half of 2006.[50]

Other major issuers and many smaller companies market high-cost, sub-prime cards to those with blemished credit histories. This population of cardholders can be profitable for the industry. Credit card industry consultant Andrew Kahr estimates that average sub-prime consumers will make two or three late payments a year, from which the industry can generate a separate fee, and that these fees can greatly exceed the interest payments on the small lines of credit themselves.[51]

Sub-prime consumers haven't just encountered high-cost offers of credit, but deceptive marketing practices. In 2000, Providian was required to pay more than $300 million in restitution to its sub-prime cardholders for unfair and deceptive practices.[52] Cross Country Bank, the sub-prime and secured credit card issuer that has been investigated by state and federal regulators for misleading consumers about the terms of its sub-prime credit card accounts and engaging in abusive collection practices, has advertised on late-night and daytime television when more unemployed potential sub-prime customers are more likely to be watching television.[53]

Consumers exiting bankruptcy are often swamped with offers at prime terms – low interest rates and without annual fees.[54] Many bankruptcy attorneys believe these offers are being made because consumers leaving bankruptcy court cannot erase their debts for another six years. Under the new bankruptcy legislation consumers will not be able to wipe away any credit card debts for eight years. Some categories of credit card debt will not be "dischargeable" at all, no matter how long the consumer waits.[55]

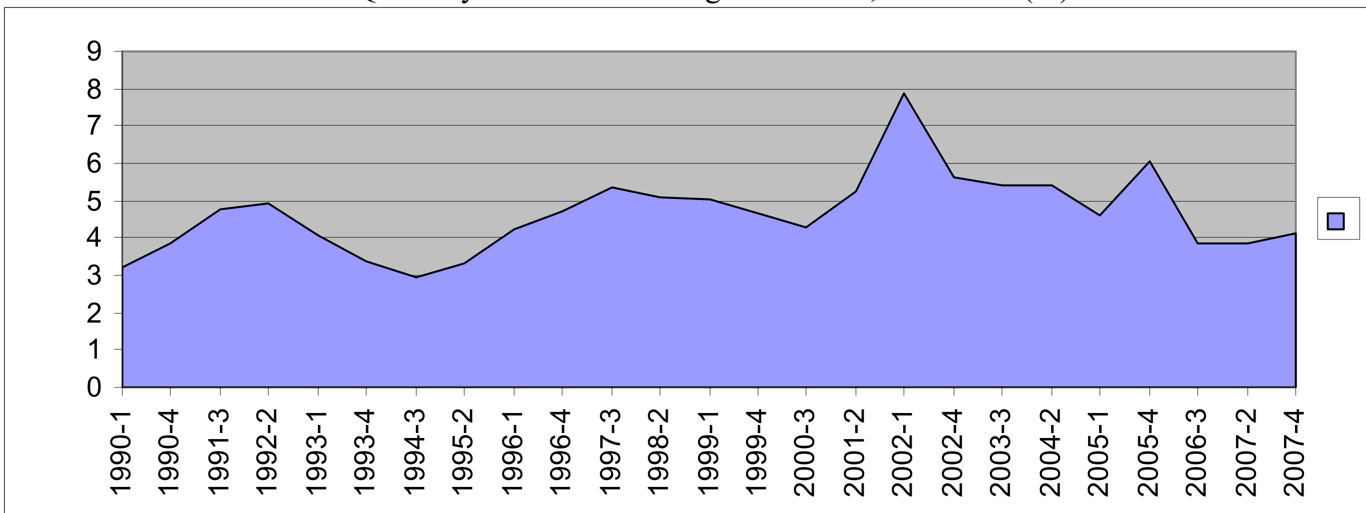
---

[48] Der Hovanesian, Mara "Tough Love for Debtors," *Business Week*, April 25, 2005.
[49] "Minimum Payments," *CardTrack*, September 6, 2006.
[50] Gavin, Robert, "Credit Card Companies Pursue Subprime Borrowers," *Boston Globe*, September 5, 2007.
[51] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.
[52] OCC, Statement of Comptroller of the Currency John D. Hawke J., June 28, 2000.
[53] Pacelle, Mitchell, "Pushing Plastic," *Wall Street Journal*, November 5, 2004.
[54] Mayer, Caroline E., "Bankrupt and Swamped with Credit Offers," *Washington Post*, April 15, 2005.
[55] *Ibid*.

C. CARDHOLDERS SHOW SERIOUS SIGNS OF ECONOMIC STRESS WHILE ISSUERS REAP RECORD PROFITS

As the economy has worsened and home foreclosures have increased to record levels, consumers are increasingly having difficulty paying their credit card bills. Credit card charge-offs, the percentage of the value of credit card loans removed from the books (net of recoveries), or "written off," have been persistently high for most of the last twelve years. During the decade between the end of 1995 and the start of 2006, credit card charge-offs were not below 4 percent in a single quarter.[56] They increased to more than 4 percent in the fourth quarter of 2006 and broke 4 percent again during the later half of 2007. There is a very good chance that charge-offs will keep rising because the number of delinquent credit card payments – an early sign of payment difficulty – are approaching historically high levels. Thirty-day credit card delinquencies are now at their highest point in five years, since the last economic recession ended.[57] The difficulty that many families are having affording their credit card bills may have been exacerbated by the mortgage crisis. As home values have dropped sharply, Americans have been unable to use home equity loans and home refinancing to pay off their credit card debts.[58] Moreover, despite rising credit card delinquencies, there is evidence that some families are staying current on their credit card loans but not their mortgage payments, a shift in behavior from past economic crises.[59]

Quarterly Credit Card Charge-Off Rates, All Banks (%)[60]



[56] Federal Reserve Board, Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks, available at www.federalreserve.gov/release/chargeoff, accessed January 19, 2007. Most experts attribute lower charge-offs in 2006 to the surge of bankruptcy filings (and corresponding increase in charge-offs) that occurred in the third and fourth quarters of 2005.

[57] 30-day credit card delinquencies during the fourth quarter of 2007 were 4.54 percent, the highest since the last quarter of 2002. Federal Reserve Board, Charge-Off and Delinquency Rates on Loans and Leases at 100 Largest Commercial Banks.

[58] Westrich, Tim and Weller, Christian E., "House of Cards, Consumers Turn to Credit Cards Amid the Mortgage Crisis, Delaying Inevitable Defaults," Center for American Progress, February 2008.

[59] Chu, Kathy, "More Americans Using Credit Cards to Stay Afloat," *USA Today*, February 28, 2008.

[60] Federal Reserve Board, Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks, available at www.federalreserve.gov/releases/chargeoff/chgallsa.htm , accessed April 14, 2008.

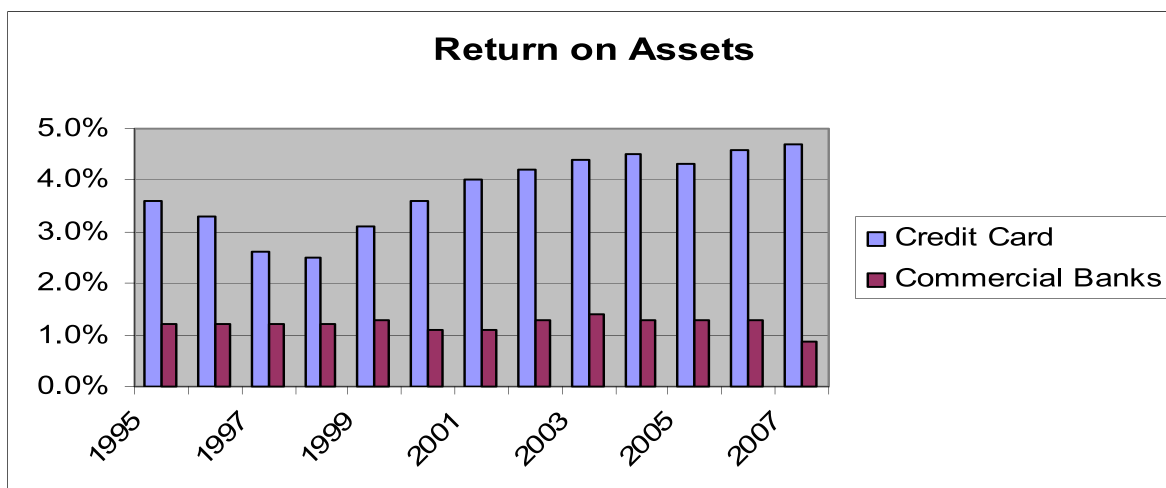
Despite these losses, the credit card industry continues to be the most profitable in the banking sector, earning a return on assets (ROA) since 1995 that is more than three times greater than that for commercial banks overall.[61] Because of the high mortgage losses that many large banks experienced in 2007, there was more than a five-fold difference between bank and credit card profits.[62] Credit card issuers reaped their highest return on assets ever in 2007, exceeding the record year of 2006. In fact, the credit card industry's return on assets grew every year between 1998 and 2004, and in 2007 was almost 90 percent higher than in 1998.[63]

According to credit card industry consultant Andrew Kahr, the basic profitability of the credit card industry is tied to those who carry revolving debt. Borrowers who pay off their balances in full and on time each month do not earn as much profit for the industry.[64] With revolving debt nearly quadrupling since 1990, credit card companies' profitability should remain strong.

Second, credit card issuers earn a significant piece of their revenues from penalty fees alone. In 2007, issuers collected $18 billion in penalty fees, up from $10.7 billion in 2002.[65] Credit card analysts have consistently predicted that the trend toward "repricing" of products and new and higher fees will continue, especially the use of higher late and over-limit fees, and universal default provisions that trigger higher penalty interest rates.[66]

---

[61] "Card Profits 04," *CardTrak*, January 24, 2005; "Banner Year," *CardTrak*, February 2004; FDIC, *FDIC Quarterly Banking Profile*, Third Quarter 2006 at 5, Table I-A; FDIC, *FDIC Quarterly Banking Profile*, Fourth Quarter 2000 at 4, Table I-A. Commercial banks average return on assets between 1995 and 2004 was 1.23 percent, less than one third the size of the credit card industry average return on assets of 3.73 percent over the same period, according to R.K. Hammer and Associates.
[62] ROA for credit card issuers in 2007 was 4.65%, R.K Hammer and Associates, January 2008. ROA for commercial banks in 2007 was .86%, FDIC, "Banks and Thrifts Earned $105.5 billion in 2007," February 26, 2008.
[63] R.K Hammer and Associates, January 2008. The industry's ROA was 2.5% in 1998, 3.1% in 1999, 3.6% in 2000, 4.0% in 2001, 4.2% in 2002, 4.4% in 2003, 4.5% in 2004, 4.3% in 2005, 4.6% in 2006 and 4.65% in 2007.
[64] Interview with Andrew Kahr, credit card industry consultant, "The Secret History of the Credit Card," *Frontline*, November 2004.
[65]CardTrak, "Card Costs," http://www.cardtrak.com/news/2008/01/18/card_fees. Card issuers charged an estimated $30 billion in fees in 2007, about six percent higher than in 2006. More than half, or $18 billion, were penalty fees. Late fees accounted 70 percent of the penalty fees charged. R.K. Hammer and Associates found that $8 billion of the penalty fees were for cash advances. Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.
[66] "Card Profits 04," *CardTrak*, January 24, 2005.



Source: *CardTrak*, FDIC, RK Hammer and Associates

Bankruptcy legislation enacted by Congress in 2005 could further improve the bottom line for credit card companies. By preventing some consumers from eliminating their credit card debts, various estimates show that credit card companies could recover an additional $3 billion to $40 billion annually from households in bankruptcy.[67]

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

There is considerable evidence linking the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. For example, research by Professor Ronald Mann of Columbia University has found that an increase in credit card spending in the U.S. and four other countries has resulting in higher credit card debt, which is strongly associated with an increase in bankruptcy filings.[68] To make matters worse, credit card companies have become far more aggressive in implementing questionable fees and interest rate practices in recent years. The upshot of these practices is that penalty interest rates, high and accumulating fees and interest on fees can push consumers with high debts over the financial brink into bankruptcy.[69] In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges, as in principal.

High fees and interest rates can often result in negative amortization, where the principal owed on credit card debt continues to rise despite making payments. Negative amortization in effect traps credit card borrowers on a debt treadmill that keeps moving faster. Although they are making regular payments, their debts continue to mount. In 2004, a Cleveland judge ruled against Discover Card's efforts to collect debts from a cardholder whose balance nearly tripled

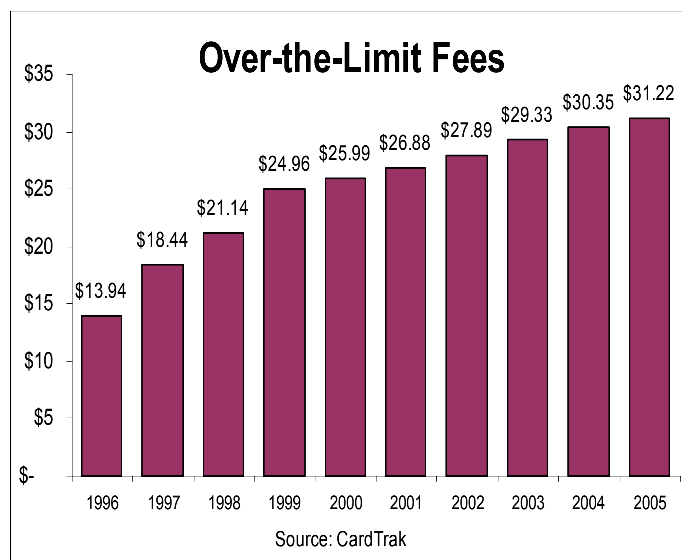
[67] Heller, Michelle, "Gauging the Bottom-Line Effects of Bankruptcy Bill," *American Banker*, April 15, 2005.
[68] Mann, Ronald J., "Credit Cards, Consumer Credit and Bankruptcy," Law and Economics Research Paper No. 44, The University of Texas School of Law, March 2006.
[69] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

from $1,900 to $5,564 without making additional purchases because of fees and penalties, including $1,158 in over-limit fees alone. [70]

In another case, a bankruptcy court in North Carolina ordered a credit card company to itemize the claims it files in chapter 13 bankruptcy cases.[71] In its findings in support of the Order, the bankruptcy judge listed claims filed in eighteen separate cases broken down between principal and interest and fees. On average, interest and fees consisted of more than half (57 percent) of the total amounts listed in the claims. In one case, the card company filed a claim in the amount of $943.58, of which $199.63 was listed as principal and $743.95 was listed as interest and fees. In another case, a claim of $1,011.97 consisted of $273.33 in principal and $738.64 in interest and fees. It is almost certain that pre-bankruptcy payments in these cases had more than paid off the real charges made by the consumers.[72]

<u>Penalty Fees</u>

Traditionally, penalty fees were designed to deter irresponsible cardholder behavior, but in recent years these fees have become primarily a revenue enhancer for credit card issuers. An analysis by the United States Governmental Accountability Office (GAO) found that, "…typical cards today now include higher and more complex fees than they did in the past for making late payments, exceeding credit limits, and processing returned payments."[73] The GAO also identified several new fees that issuers have begun using in recent years, some of which they are not required to disclose to consumers in advance. One example of such a fee is for the payment of bills by telephone, which can range from 5 to 15 dollars.[74]



A substantial number of Americans are paying these fees. Thirty-five percent of the credit card accounts from the six largest issuers that the GAO examined had at least one late fee in 2005,[75] representing about 242 million credit cards. [76] Thirteen percent of all accounts – or about 90 million cards – were assessed over-limit fees in 2005.

Late fees have been steadily rising over the past decade and can easily exceed monthly payments for consumers paying low minimum balances.[77] In 1996, a Supreme Court decision

---

[70] National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.
[71] *In re* Blair, No. 02-1140 (Bankrate. W.D.N.C. filed Feb. 10, 2004)
[72] National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.
[73] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 18.
[74] *Ibid*, p. 23.
[75] *Ibid*, p. 1.
[76] CFA calculation based on 691 million credit cards, as reported in, *Ibid*, p. 9.
[77] "The Ugly Issuer," *Credit Card Management*, September 2004.

prohibited states from setting limits on the fees credit card companies could charge their cardholders. Prior to this court ruling, credit card late fees were commonly around five to ten dollars, but have risen sharply since the decision.[78] The GAO analysis found that late fees jumped sharply after the court ruling. The GAO examined fee data collected by CardWeb.com and found that late fees jumped by 160 percent from $12.83 in 1995 to $33.64 in 2005. The GAO also found a sharp fee increase from data collected by Consumer Action, which showed a 119 percent increase from $12.53 in 1995 to $27.46 in 2005.[79] Even more striking, the GAO found that late fees paid by borrowers with typical balances were an average of $37 in 2005.[80] This is important to note as credit card issuers are increasingly assessing "tiered" fees based on the borrower's balance.

Credit card issuers used to reject transactions that exceeded a cardholder's credit limit, but it has become common for issuers to accept the transaction and then apply an over-limit fee on cardholders who exceed their credit limits.[81] These fees are often applied by issuers in addition to a higher "penalty" interest rate charge for exceeding the credit limit or carrying a high balance.[82] These monthly fees are charged every month a consumer carries a credit balance higher than their credit limit. According to the GAO report, data collected by Consumer Action shows a 114 percent increase in over-limit fees between 1995 and 2005.[83] Critics of this practice argue that issuers should not assess a penalty fee when they can simply enforce the credit limit if they wish to prevent consumers from exceeding it.

Penalty Interest Rates

The vast majority of credit card issuers also increase interest rates for credit card account holders who pay their bills late, even by a few hours. In 2005, Consumer Action found that 78.7 percent of issuers charged penalty rates for late payments on their cards.[84] For example, representatives for one large issuer told the GAO that they automatically increase a customer's interest rate if this person pays late or exceeds the credit limit. The GAO found that all but one of the 28 cards from the six largest issuers they reviewed charged default rates in 2005. The average default rate was 27.3 percent, up from 23.8 percent in 2003.[85] Some consumers with low-rate cards could have their interest rates double overnight for being late on one payment to their credit card.[86] Some issuers also say that they will charge default interest rates for exceeding

---

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

the credit limit on the card or for returned payments, or that they will increase interest rates for cash advances and balance transfers for violations of card terms.[87]

There is increasing evidence that those who can least afford these higher interest rates – financially vulnerable families – are most likely to be paying them. A study by the research organization Demos found that cardholders that carry debt who earn less than $50,000 a year are more than twice as likely to pay interest rates above 20 percent as the highest income Americans who carry debt. African-American and Latino credit card holders with balances are more likely than whites to pay interest rates higher than 20 percent.[88]

Retroactive Application of Penalty Rates

All issuers also apply penalty interest rates retroactively to prior purchases. This has the effect of increasing the price on purchases already made but not paid off.[89] Some cards even apply penalty rates to debts that were already paid at a lower rate.[90] There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance. There is no other industry in the country that is allowed to increase the price of a product once it is purchased. Issuers have already assessed a consumer's risk of not repaying the loan and presumably offered an interest rate based on that risk. Issuers should be required to allow a consumer to pay off his or her existing balance at that interest rate.

Universal Default

Universal default clauses in credit card contracts allow credit card companies to raise interest rates on debtors who have problems with other creditors or whose credit scores decline. The increases are triggered not just by a late mortgage or credit card payment to other lenders but also to payment disputes with other types of creditors, like utilities or book clubs.[91] A review of credit card disclosures issued in October 2006 by Consumer Action found five major issuers that said they reserved the right to assess universal default interest rates. Since that time, Citigroup and JP Morgan Chase have said that they will not use the practice. On the other hand, representatives for Bank of America and Discover testified before the Senate late last year that they still use consumer credit scores, at least in part, to trigger higher default interest rates.[92]

It is fundamentally unfair to impose a penalty interest rate on a consumer who has not made a late payment or defaulted on an obligation, especially when this rate increase is applied

---

[87] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 25.
[88] Wheary, Jennifer, Draut, Tamara, "Who Pays? The Winners and Losers of Credit Card Deregulation," Demos, August 1, 2007.
[89] Draut, Tamara, Director of the Economic Opportunity Program Demos, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 16-17.
[90] McGeehan, Patrick, "The Plastic Trap," *New York Times*, November 21, 2004. Discover disclosed to its customers that it had changed the terms of its interest rates from a low of zero to 19.99% for a single late payment, but it applied that rate increase for late payments from 11 months prior to the disclosure of the changing interest rate terms.
[91] Burt, Bill, "Pay One Bill Late, Get Punished by Many," *Bankrate.com*, January 20, 2004.
[92] Credit Card Practices: Unfair Interest Rate Increases, U.S. Senate Permanent Subcommittee on Investigation, December 4, 2007.

retroactively. Another concern with using credit reports to trigger a penalty rate is the problems with inaccuracies in credit scoring and credit reporting that CFA and other organizations have documented.[93] Moreover, issuers who impose sharp interest rate increases on consumers who are meeting their obligations often fail to provide any rationale – much less a legitimate one -- for the increase. In January, Bank of America began increasing interest rates on some cardholders to as high as 28 percent but did not inform consumers the reason for the increase in the notification they mailed.[94]

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

Indiscriminate, Undisclosed Changes in Rates and Fees

Many credit card companies reserve the right to change the terms of their credit card contract at any time and for any, *or no*, reason. This allows credit card companies to arbitrarily raise interest rates even for cardholders in good standing and with perfect credit histories. Media reports of recent rate hikes by Bank of America demonstrate the unfairness of any-time/any-reason changes: some consumers saw their interest rates triple without explanation.[95] The result of these unfair clauses is that consumers can't depend on the interest rate promised to them.

Pricing Tricks: Double Cycle Billing and Manipulation of Payment Order

The GAO found that two of six major creditors are using a practice called double-cycle billing, which results in illegitimate interest charges on balances that have already been paid on time.[96] Since then, one of these issuers, JP Morgan Chase, has announced that it will no longer use double-cycle billing. With this practice, issuers consider two billing cycles in assessing interest. A consumer who begins with no balance and pays off most but not all of the purchases he or she makes in the first month would still be charged interest for the entire amount of the balance in the second month. A fair billing process would only result in an interest charge on the amount of the unpaid balance.

The GAO also determined that for 23 of the 28 large issuer cards they reviewed, cardholder payments were first allocated to the balance assessed at a lower rate of interest.[97] This practice is problematic for the many cardholders who now carry balances at different rates

---

[93] Consumer Federation of America and National Credit Reporting Association, "Credit Score Accuracy and Implications for Consumers," December 17, 2002. CFA and NCRA reviewed over 500,000 credit files and found that 29 percent of consumers have credit scores that differ by at least 50 points between the credit bureaus.
[94] "A Credit Card You Want to Toss," *Business Week,* February 7, 2008.
[95] Ibid.
[96] "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," U.S. Government Accountability Office, September 2006, p. 27.
[97] *Ibid*.

of interest, such as introductory “teaser” rates, cash advance rates, and balance transfer rates. The lower interest rate balances must first be paid off before the issuer will allocate payments to higher rate balances. Allocating payments to lower interest rate balances first unfairly extends the length of time it takes consumers to pay down their balances while increasing the finance charges that issuers earn.

Fewer Consumers Benefit From Lower Interest Rates As Issuers Switch to Fixed Rate Cards

For many years, analysts and observers of the credit card industry have noted a phenomenon called “sticky” interest rates. This typically refers to the fact that creditors are often slow to pass on savings when the cost of funds decline, but quicker to increase rates when cost rise. As a result, the “spread” between the credit card issuers’ cost of funds and the interest rates charged to cardholders have tended to benefit the credit card companies, regardless of the direction of the interest rate changes. For example, although interest rates were at historical lows at the turn of the century, issuers did not pass the cost savings completely through to their customers.[98]

Over the past six years, it appears that the distribution of credit cards between variable and fixed rates is related to the interest rate picture. As interest rates increase, issuers tend to switch consumers over to variable rate cards. As interest rates began to increase from historic lows, *CardTrak* reported in November 2004 that more than half (55 percent) of credit card debt was carried on variable interest rate cards, a major change from three years earlier when rates were declining and card issuers were shifting to fixed rate products.[99] As rates rose further in 2007, *CardTrak* reported that 86 percent of credit card balances were carried on cards with variable rates.[100] Now that rates are declining again, issuers are shifting back to fixed rate cards. Thirty-nine percent of credit card offers mailed in October of 2007 included fixed rate offers, compared to 29 percent during the third quarter of the year.[101]

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

Penalty fees and interest made up more than three-quarters of credit card issuers revenues throughout 2002 and 2003. Credit card issuers earned $65.4 billion in interest and $7.7 billion in penalty fees in 2003 or 75.7 percent of the total $96.5 billion in revenue.[102] In 2002, penalty fees and interest made up 76.8 percent of the industry’s $97.1 billion in revenues. For the approximately 88 million credit cardholding households, penalty fees and interest on their credit card debt cost an average of $830 in 2003.[103]

---

[98] “The Ugly Issuer,” *Credit Card Management*, September 2004.
[99] “5% Prime,” *CardTrak*, November 10, 2004.
[100] “Rate Gap,” *CardTrak*, January 18, 2007.
[101] Synovate Mail Monitor, press release, “Synovate Mail Monitor Shows Credit Card Terms Improve, More Fixed Rate Offers, “ December 2007.
[102] Daly, James J., “Smooth Sailing,” *Credit Card Management*, May 2004 at 31.
[103] CFA calculation from Daly, James J. 2004 and Census Bureau figures.

E. AMERICANS ARE HIGHLY CRITICAL OF MANY CURRENT CREDIT CARD PRACTICES

Our organizations regularly conduct public opinion surveys regarding consumer attitudes and behavior. We have rarely encountered the kind of broad, nearly universal condemnation that Americans have for many common practices used by credit card issuers regarding interest rates, fees and the extension of credit.

For example, a nationally representative poll of 1,005 adults conducted by the Opinion Research Corporation for the Consumer Federation of America from September 13 to September 16, 2007 found that:

- 82 percent of Americans think it is unfair to offer several credit cards to a student with little income. (62 percent believe it is very unfair.)
- 91 percent of Americans think it is unfair to raise interest rates or fees at any time for any reason. (76 percent believe it is very unfair.)
- 83 percent of Americans think it is unfair to increase the interest rate on one card because of a person's payment history on another card. (62 percent believe it is very unfair.)
- 84 percent of Americans think it is unfair to apply interest rate increases not only to new balances but also to past balances. (61 percent believe it is very unfair.)
- 85 percent of Americans think it is unfair to increase an interest rate to 30 percent for making two late payments. (64 percent believe it is very unfair.)
- 76 percent of Americans think it is very unfair to charge $30 for making a late payment. (51 percent believe it is very unfair.)
- 82 percent of Americans think it is unfair to charge a $30 fee each month if a balance is over the credit limit when a person is no longer using the card. (64 percent believe it is very unfair.)
- 90 percent of Americans think it is unfair to charge $10 for payment by phone. (72 percent believe it is very unfair.)
- 80 percent of Americans think it is unfair to not allow a person to pay off higher-interest rate debt first, such as on a cash advance, but instead applying payments first to lower-rate debt. (54 believe it is very unfair.)
- 81 percent of Americans think it is unfair to have only one week between the time a person receives a monthly statement and the time he or she must mail the payment. (54 percent believe that it is very unfair.)
- 93 percent of Americans think it is unfair to charge a late fee even though a person has mailed the payment a week or more in advance of the due date. (79 percent believe that it is very unfair.)
- 71 percent of Americans think it is unfair to require that disputes be settled by mandatory arbitration without being allowed to go to court. (45 percent believe that it is very unfair.)

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

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

issuers still receive substantial fee income from merchant “interchange” fees and, in some cases, from annual fees.

The key question is whether interest rates and fees charged to riskier consumers are fair and can be legitimately related to the actual financial risk incurred by creditors. There is increasing evidence that the answer to this question is “no.” It is becoming more apparent that many of the most abusive fees and interest rates are assessed simply because it is what the market will bear.

The amount of fees and penalty interest rates do not appear to be proportional to the risk or cost incurred by issuers. For many years, issuers have justified “sticky” interest rates that rise faster than they decline by stating that these higher interest rates were necessary to compensate for increased risk. As issuers have increased the number and amount of fees and penalty interest rates they charge, it seems that higher baseline interest rates alone are not sufficient anymore to compensate for risk. There is very little evidence that relatively modest problems, like one or two late payments – significantly increase a consumer’s chances of default. It would appear to be impossible to justify charging a consumer with a reasonably good credit history with a late payment fee of $35 and a default interest rate of 29 percent on prior purchases, in addition to the finance charge the consumer would already pay on a fairly high interest rate, such as 17 percent. One sign that default rates may not be truly reflective of costs or risk incurred by issuers is that the “fixed amount” that issuers add to the index rate in setting default rates rises when the cost of funds declines. The GAO found that this fixed amount increased from about 19 percent in 2003 to 22 percent in 2005 on the 28 large issuer cards they evaluated.[104]

A rational market would lead lenders to limit their risk by restricting the credit available to consumers with riskier credit records or histories, instead of increasing this risk by leveling higher charges on consumers who may be in significant financial trouble. Allowing higher-risk consumers to continue borrowing at a more expensive, higher rate does not limit consumers’ risk of default, it increases it. If the cardholders are indeed higher-risk, lenders would limit their exposure by cutting off new purchases more frequently, preventing balances from increasing and helping to keep the cardholder out of default. However, in many cases, credit card issuers have not cut off credit, frozen credit limits or closed the accounts of cardholders that the issuers deem increased risk. Instead they have allowed borrowers to rack up more credit under more expensive terms,[105] making it more likely that the consumer might suffer serious financial consequences.[106]

---

[104] “Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers,” U.S. Government Accountability Office, September 2006, p. 24.

[105] Pacelle, Mitchell, “Growing Profit Source for Banks: Fees From Riskiest Card Holders,” *Wall Street Journal*, July 6, 2004.

[106] As the economy slows, there is evidence that some issuers are raising credit standards and tightening access to credit in ways that do not lead to further financial exposure for their existing cardholders. Others appear to be using old tricks, such as using credit scores to suddenly and sharply raise interest rates on existing balances, that will likely destabilize economically fragile households. A Credit Card You Want to Toss,” *Business Week,* February 7, 2008.

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

The assessment of retroactive interest rates is another sign of abusive rather than genuinely risk-based pricing. As stated above, interest rate increases that apply to past purchases cannot be justified under a true risk-based pricing model. Issuers assess risk based on the best information available on a consumer's credit history. If the risk profile of the consumer declines, the only way issuers could possibly justify a rate increase would be if it were legitimately related to the customer's increased risk, if it did not violate the creditor's agreement to offer credit under certain terms for a specific length of time, and if it were applied prospectively.

Increased expenditures on marketing when consumers reduce their use of credit is also a red flag that pricing in the credit card industry is skewed. As documented above, issuers increased their marketing expenditures significantly through 2005, even as consumers respond less frequently to mail solicitations and showed more caution in taking on new debt. A rational market response to this dynamic would be to pull back on marketing expenditures unless other factors existed that justified this spending, such as windfall profits resulting from abusive pricing.

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

G. H.R 5244 HELPS CURB MAJOR CREDIT CARD ABUSES

The "Credit Cardholders' Bill of Rights Act" helps restore fairness to the credit card marketplace. The bill would require credit card issuers to take a number of steps to treat consumers more fairly, including:

1. **Ending Bait and Switch Contract Clauses.** H.R. 5244 invokes the basic tenet of fair dealing by prohibiting credit card companies from changing contract rules in the middle of the game through "any time, any reason" interest rate and fee hikes. Instead, they must disclose, up front, the specific, material reasons for which they will unilaterally change contract terms.

2. **Limiting Retroactive Application of Rate Hikes for Consumers in Good Standing.** H.R. 5244 prohibits card issuers from applying "universal default" interest rate hikes retroactively to balances borrowed at a lower rate. As cited above, some issuers still use credit information not related to the account a consumer has with that company, such as a drop in a consumer's credit score, to raise interest rates. While consumers with a perfect

payment history with their credit card company are understandably outraged when their interest rate rises for these reasons, the devastating consequences of retroactive application of these increases is equally egregious. Minimum monthly payments rise, sometimes dramatically. The time to pay-off the balance increases, sometimes by many years, while the total cost of the debt skyrockets. H.R. 5244 limits these destabilizing impacts by prohibiting the retroactive application of rate hikes not related to the cardholder's credit card account.

3. **Preventing Credit Card Companies from Gaming Consumer Payments.** H.R. 5244 prevents card companies from playing costly games with consumer payments by requiring them to apply payments proportionately to card balances with different interest rates. As stated above, when consumers accept card offers for short-term teaser rates for balance transfers and cash advances and higher rates for other balances, credit card companies apply payments *first* to the lower-rate balance, preventing consumers from paying off higher interest balances and imposing unwarranted and costly finance charges. Issuers refuse to apply *any* portion of a consumer's payment to the higher interest rate balance, preventing consumers from paying down *any* portion of the high-cost balance until the lower interest rate balance is repaid. As a result, balances build up at the much costlier rate and finance charges accrue.

4. **Prohibiting Unfair and Hidden Interest Rate Charges on Balances Repaid During the Grace Period.** H.R. 5244 prohibits credit card companies from using "double-cycle billing" to charge interest on balances repaid during the grace period. As mentioned above, this practice allows credit card issuers to sap unwarranted finance charges from the wallets of consumers who usually do not carry balances. Although some credit card issuers have disavowed this practice, some still engage in it. This legislation makes clear that a grace period is a grace period.

5. **Ending Unfair Late Fees for On-Time Payments**. H.R. 5244 ends the classic late-fee gotcha. Consumers who mail their payments well in advance are often socked with a late fee of up to $40 because of card companies' own processing delays or arbitrary deadlines. The abuse has been exacerbated as credit card companies have shortened the time period in which consumers can make an on-time payment. Other consumers make electronic payments on the due-date, only to be hit with a late fee because they posted their payment five minutes after the issuer's arbitrary deadline on that day. The legislation provides that consumers demonstrating that they have paid their bill at least seven days before the due date are presumed to have paid on time and cannot be charged a late fee. It also sets a single uniform time of no earlier than 5 p.m. Eastern by which payments must be received on the due date to prevent companies from setting earlier and arbitrary deadlines that result in late fees. Issuers must also mail credit card bills 25 days before the bill is due, instead of the current rule requiring only 14 days, to help ensure that consumers will have enough time to pay.

We recommend that the Subcommittee include in H.R. 5244 several additional provisions that would enhance consumer protection not yet addressed by the bill, including: a ban on all universal default rate hikes; a prohibition on retroactive application of *any* rate hike to prior

balances; a requirement that the size of penalties charged by issuers be directly related to actual costs incurred; and a requirement that credit card issuers ensure that young consumers have the ability to repay the loans they are offered.

We also recommend that the Subcommittee eliminate a provision in H.R. 5244 allowing issuers to charge over-limit fees for three consecutive months, even if the cardholder only exceeds the credit limit with a single transaction. Instead, H.R. 5244 should prohibit issuers from charging over-limit fees if they choose to allow a cardholder to exceed the credit limit. Similarly, a provision requiring consumers to pay all charges for low-credit-limit, high-fees cards before they receive these cards is a well-intentioned effort to ensure that consumers really understand how expensive these cards are. There is a very good chance, however, that unscrupulous lenders will defraud consumers who might pay huge fees before receiving any credit. Therefore, we recommend that the Subcommittee either place significant limits on the fees that can be charged on these extremely expensive cards or give consumers meaningful rights to reject these cards before they are activated.