



Consumer Federation of America

TESTIMONY OF

**TRAVIS B. PLUNKETT,
LEGISLATIVE DIRECTOR**

BEFORE THE

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

**“EXAMINING THE CURRENT LEGAL AND REGULATORY REQUIREMENTS AND
INDUSTRY PRACTICES FOR CREDIT CARD ISSUERS WITH RESPECT TO
CONSUMER DISCLOSURES AND MARKETING EFFORTS”**

MAY 17, 2005

Introduction

Mr. Chairman, Senator Sarbanes, and Members of the Committee, my name is Travis Plunkett and I am the legislative director of the Consumer Federation of America.¹ I appreciate the opportunity to offer CFA's comments on current credit card industry practices, as well as legal and regulatory requirements.

Given the dramatic changes that have occurred in the credit card industry in recent years – and the negative impact that some of these changes have had on consumers – perhaps no industry in America is more deserving of oversight by Congress. The U.S. Better Business Bureau reported more than 17,000 complaints about credit cards in 2004, the third highest source of consumer complaints after cellular phone services and new car dealers. There is clearly a need to examine many questionable practices in the industry including marketing, credit extension, the terms and conditions of credit card contracts and rising fees and interest rates. We applaud you for calling this important oversight hearing and look forward to working with you to make this industry more consumer-friendly.

I will begin my remarks with an examination of recent credit card lending practices. We find that credit card issuers are expanding efforts to market and extend credit much faster than Americans are taking on new credit card debt. This credit expansion has had a disproportionately negative effect on the least sophisticated, highest risk and lowest income households. It has also resulted in both relatively high losses for the industry 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.

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

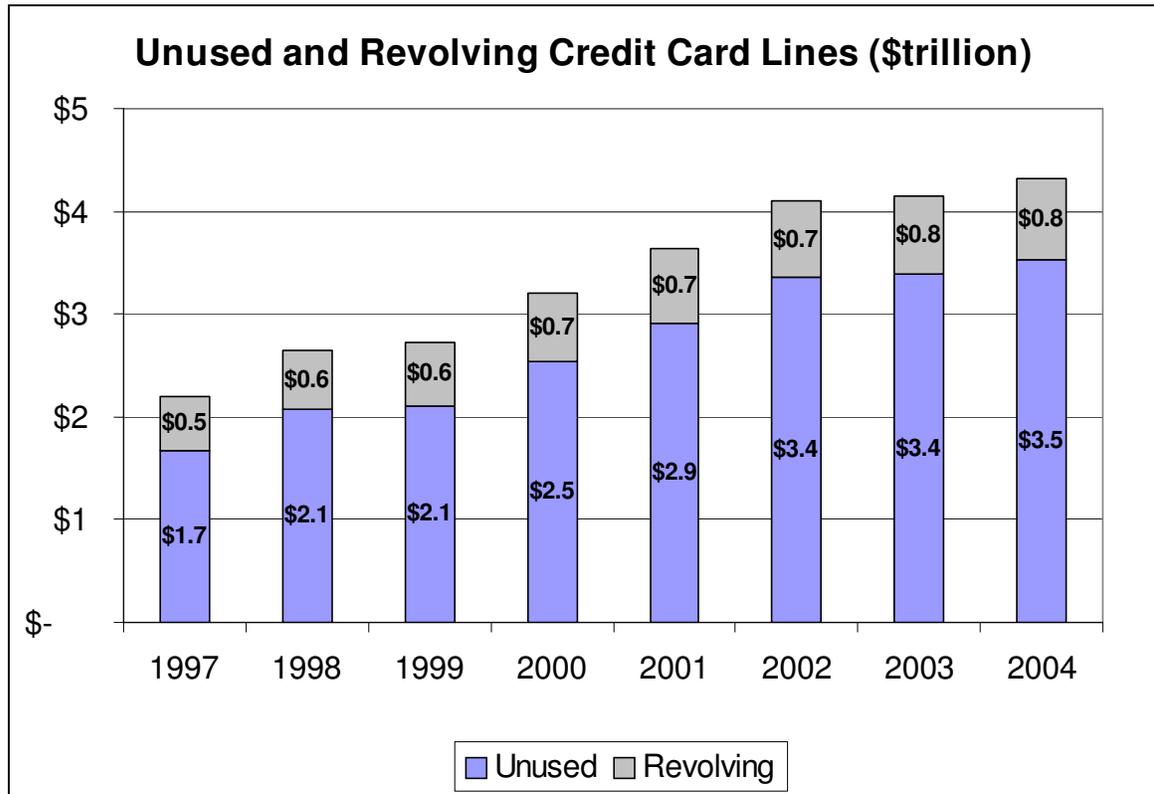
A. AS CONSUMERS EXERCISE MORE CAUTION IN TAKING ON NEW DEBT, ISSUERS CONTINUE TO EXPAND MARKETING AND AVAILABLE CREDIT

It is conventional wisdom that consumer demand has fueled the growth of revolving debt to just over \$801 billion.² 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

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 research, advocacy and education.

² Federal Reserve Board, Consumer Credit Outstanding. 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 \$688.4 billion and \$728.5 billion.

in pushing credit card debt to record levels. Since 1997, creditor marketing and credit extension has increased more than twice as fast as credit card debt taken on by consumers.³ Moreover, when consumers become more cautious in taking on new debt, as they have in recent years, issuers often sharply increase their marketing and credit in an attempt to entice reluctant consumers to exercise riskier behavior. That is why there is a growing credit “gap” between creditor supply and consumer demand.



The total amount of credit made available by issuers now exceeds an astonishing \$4.3 trillion dollars.⁴ The average amount of credit available per household is over \$38,700.⁵ Of that amount, only 18 percent has been taken on as debt by consumers. According to figures from Veribanc Inc., there were more than \$3.5 trillion in unused credit card lines in the fiscal quarter ending in December 2004. Between December 1999 and December 2004, revolving debt grew by 30.9 percent, but unused credit card lines made available by creditors grew by 67.0 percent – or twice as fast.⁶ As a result, revolving consumer credit has declined as a

³ Veribanc, Inc. and Federal Reserve Consumer Credit Outstanding. According to Federal Reserve figures, consumer revolving debt grew by 50.2 percent from \$530 billion in December 1997 to \$796 billion in 2004. According to Veribanc, unused lines of credit grew at more than double the rate consumers increased their use of credit card lines, growing from \$1.7 trillion in 1997 to \$3.5 trillion in 2004.

⁴ Veribanc, Inc. and Federal Reserve Consumer Credit Outstanding.

⁵ There are 111 million households in the U.S., U.S. Census Bureau, “America’s Families and Living Arrangements: 2003,” November 2004, at 2.

⁶ Veribanc, Inc. and Federal Reserve Consumer Credit Outstanding.

share of total outstanding credit lines from 22.3 percent of total credit lines to just above 18.0 percent of total credit lines.⁷

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.⁸

Issuers have increased the number of solicitations mailed more than five-fold since 1990, from 1.1 billion to a record 5.23 billion in 2004, or just over 47 per household. Wealthier families receive the highest number of credit card mailings, but low-income families are more likely to open the solicitations they receive.⁹ The table at right indicates that issuer interest in marketing credit cards has grown much faster than consumer interest in accepting new cards. The consumer response rate to mail solicitations has declined more than five-fold from 2.1 percent in 1990 to .4 percent in 2004. This means that for every 250 solicitations consumers receive, they reject 249. The tiny response rate demonstrates that the vast majority of consumers are being responsible when offered unsolicited credit.

	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%

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 2003.¹⁰ These figures are before the fourth largest credit card issuer, MBNA, started its first national advertising campaign during the 2005 Super Bowl.¹¹

⁷ CFA calculation based on Veribanc, Inc. and Federal Reserve Consumer Credit Outstanding.

⁸ Vertis Inc. press release, "Financial Direct Mail Readers Interested in Credit Card Offers," January 25, 2005; "Card Marketing 101," *CardTrack*, September 2002.

⁹ 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.

¹⁰ Nielsen Monitor, "U.S. Advertising Spending Rose 6.3 percent in 2004, Nielseon Monitor-Plus Reports," March 1, 2005.

¹¹ Sidel, Robin, "Card Issuer MBNA lets the Public Take a Peek at Its Hand," *Wall Street Journal*, January 20, 2005 at C1.

Issuers also promote and advertise their cards by establishing significant networks of co-branded affinity relationships, which offer credit cards with the logo and affiliation of a sports team, university, association or non-profit. Credit card companies gain access to mailing lists, marketing 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.¹²

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

The growth of revolving debt in this country to over \$800 billion¹³ has obviously not affected all Americans equally. The extraordinary expansion of the credit card industry in the 1990s was fueled by the marketing of credit cards to populations that had not had widespread access to mainstream credit, including lower and moderate income households, consumers with seriously blemished credit histories, college students, older Americans and minorities.

In a practice widely known as risk-based pricing, creditors charged riskier consumers more to cover potential losses, usually in the form of higher interest rates. To make the assumption of debt more attractive to these households – and to entice them into carrying debt for longer periods – creditors lowered minimum payment balances from around five percent of principal to just over two percent. As a result, an estimated eighty percent of all households now have at least one card.¹⁴ Moreover, vulnerable households shoulder a disproportionate share of the debt burden relative to their incomes. In other words, “democratization of credit” has had serious negative consequences for many Americans, putting them one unexpected financial emergency away from bankruptcy.

Lower Income and Minority Households

While the share of higher income families carrying credit card debt declined between 1998 and 2001, more lower and moderate income families were taking on debt.¹⁵ The share of homeowners with credit card debt declined (probably due to a large increase in “cash out” refinancings that were used to pay down credit card debt), but the number of renters with debt increased. While fewer white families accumulated credit card debt, more minority

¹² Sidel, Robin, “Card Issuer MBNA lets the Public Take a Peek at Its Hand,” *Wall Street Journal*, January 20, 2005 at C1.

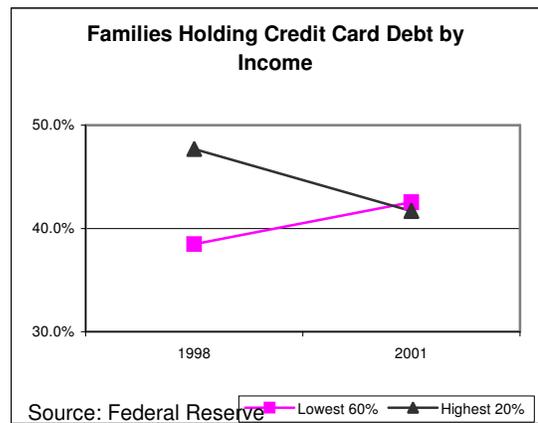
¹³ Federal Reserve Consumer Credit Outstanding.

¹⁴ Cardweb.com

¹⁵ Aizcorbe, Ana M., Arthur B. Kennickell and Kevin B. Moore, “Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances,” *Federal Reserve Bulletin*, January 2003 at 22-23 Table 11. The percentage of families earning the lowest 60 percent of income grew by 10.5 percent from 38.5 percent of these families in 1998 to 42.5 percent of the lowest earning families in 2001. The share of families with credit card balances earning the top 20 percent of incomes fell by 12.6 percent from 47.7 percent of top earning families in 1998 to 41.7 percent of these families in 2001.

households did.¹⁶ Moreover, although minority households are less likely to have credit cards than white families, they are more likely to have credit card debt.¹⁷ The amount of credit card debt held by minority households has also increased compared to white households.¹⁸

Credit card debt also consumes 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 \$100,000.¹⁹ The increase in credit card debt has contributed to alarmingly high overall levels of debt for many of these lower and moderate income families. More than one-quarter of the lowest income families spent over 40 percent of their income on debt repayment in 2001.²⁰ The proportion of lower income families falling behind on their debts is also increasing.²¹



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.²² Since Dr. Manning's report for CFA in 1999, this issue has been the subject of much public and media scrutiny. One of the

¹⁶ Aizcorbe, Kennickell and Moore, 2003 at 24.

¹⁷ Draut, Tamara, Director of the Economic Opportunity Program Demos, Testimony Before the House Banking Committee Subcommittee on Financial Institutions and Consumer Credit, September 15, 2004, at 6. Although African American and Latino families are less likely to have credit cards than white families (59 percent, 53 percent and 82 percent of these families have credit cards respectively), they are more likely to be carrying debt than white families. Just over half (51 percent) of white families reported having debt in 2001, compared to 84 percent of African American families and 75 percent of Latino families.

¹⁸ Aizcorbe, Kennickell and Moore, 2003 at 22, Table 11.

¹⁹ Gallup Poll News Service, "Average American Owes \$2,900 in Credit Card Debt," April 16, 2004.

²⁰ Aizcorbe, Kennickell and Moore 2003 at 29, Table 14. In 2001, more than one in four (27.0 percent) families in the lowest income quintile spent more than 40 percent of their income on debt payments, compared to less than one in six (16.0 percent) of families in the second lowest income quintile and one in nine (11.0 percent) of all families who spend 40 percent or more of their income on debt payments.

²¹ Aizcorbe, Kennickell and Moore 2003 at 29, Table 14. A larger share of lower-income families is behind on their debt in 2001 than a decade earlier. In 2001, about one in fifteen of all households (7.0 percent) were at least 60-days behind on at least one debt payment according to the Federal Reserve. In comparison, more than one in eight (13.4 percent) of households in the lowest income quintile and one in nine households (11.7 percent) in the second lowest income quintile were 60-days or more behind on a debt payment.

²² 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>

few Congressional oversight hearings of the credit card industry in recent years was conducted by this committee and focused on financial literacy among college students and the extension of credit cards on campus.²³

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 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

²³ Hearing of the Senate Committee on Banking, Housing and Urban Affairs on "The Importance of Financial Literacy Among College Students," September 5, 2002. Witness testimony and other hearing documents available at: http://banking.senate.gov/02_09hrg/090502/index.htm

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 percent) of Americans carry revolving balances compared to 71 percent of borrowers aged 25-34.

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

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.

74 years of age has risen steadily over the past decade,³² while about one in seven senior households paid more than 40 percent 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 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 Currently, 19 million credit card borrowers make only the minimum payments.³⁷

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. Current Acting Comptroller of the Currency Julie Williams 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.³⁸ CFA has concluded that reduced minimum payments were a significant cause of increasing bankruptcies in the last decade.³⁹

One way to alert consumers to the consequences of paying off credit card balances at the minimum rate is to offer each consumer a personalized notice on the billing statement about how long it would take to pay off the balance at the minimum rate, and what would be the total costs in interest and principal. That is what Senators Akaka, Durbin, Schumer and

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 percent from 9.8 percent in 1992 to 15.1 percent in 2001 and the debt services ratio for households 75 and older grew 169 percent from 2.6 percent to 7.0 percent in 2001.

³³ *Ibid.* 13.9 percent of households aged 65-74 and 14.3 percent 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 percent) of households over 65 years old have incomes below \$30,000, compared to 16 percent of those aged 30-49 and 18 percent 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 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.

³⁹ Consumer Federation of America, “Consumer Restraint Pressures Lenders to Reduce Credit Card Marketing and Credit Extension,” January 18, 2000.

Sarbanes have proposed in S. 393. Such a personalized disclosure is, unfortunately, not included in recently enacted bankruptcy legislation, which requires consumers to call a toll-free number to get information about how long it would take to pay off their balances.⁴⁰ 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 recent 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.⁴¹ These regulatory changes will not be fully phased in until the end of 2006.⁴² Many major credit cards began increasing their minimum payment requirements in 2005, including Bank of America, Citibank, Discover and JPMorganChase,⁴³ in some cases to as high as 4 percent.⁴⁴

It is essential that issuers phase in these higher minimum payments gradually to prevent households that have been reliably paying at such low rates from being pushed into delinquency or default. One effective way to phase in higher minimum payments would be for banking regulators to require issuers to provide consumers with prominent disclosure well before higher payments are required, and to then require that higher minimum payments be assessed only on new debts, not outstanding debts.

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.⁴⁵ Rising APRs and other increasing prices – such as energy costs – are leaving many consumers with less flexibility in their budgets. Even before the industry began to raise its minimum payments, consumers were increasingly worried about making their minimum credit card payments. Gallup found that the number of cardholders worried about being able to make their minimum payments had increased from 2002 to 2004.⁴⁶

⁴⁰ Section 1301, S. 256, Public Law 109-8.

⁴¹ 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.

⁴² Day, Kathleen and Caroline E. Mayer, “Credit Card Penalties, Fees Bury Debtors,” *Washington Post*, March 6, 2005.

⁴³ American Financial Services Association, “Credit Card Minimum Payments Going Up,” *Spotlight on Financial Services*, April 2005.

⁴⁴ 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 percent to 4 percent of the balance.

⁴⁵ Der Hovanesian, Mara “Tough Love for Debtors,” *Business Week*, April 25, 2005.

⁴⁶ Gallup Poll News Service, “Average American Owes \$2,900 in Credit Card Debt,” April 16, 2004.

Targeting Consumers in Financial Distress

Nothing illustrates the perverse incentives of the credit card market better than the marketing of cards to consumers on the brink of bankruptcy, or to those just discharged from it. Several major issuers market high-cost, “subprime” cards to those with blemished credit histories. This population of cardholders can be profitable for the industry. Credit card industry consultant Andrew Kahr estimates that average subprime consumers will make two or three late payments a year, that the industry can generate fees from each of those tardy payments, and that these fees that can greatly exceed the interest payments on the small lines of credit themselves.⁴⁷

Subprime consumers haven’t just encountered high-cost offers of credit, but deceptive marketing practices as well. In 2000, Provident was required to pay more than \$300 million in restitution to its subprime cardholders for unfair and deceptive practices.⁴⁸ More recently, Cross Country Bank, the subprime and secured credit card issuer that has been investigated by state and federal regulators for misleading consumers about the terms of its subprime credit card accounts and engaging in abusive collection practices, advertised on late night and daytime television when more unemployed potential subprime customers are most likely to be watching television.⁴⁹

Consumers exiting bankruptcy are often swamped with offers at prime terms – low interest rates and without annual fees.⁵⁰ 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.⁵¹

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

Although credit card obligations, late payments and delinquencies have declined in the past two or three years, they are still higher than they were before the marketing expansion accelerated. Credit card charge-offs, the percentage of the value of credit card loans removed from the books (net of recoveries), or “written off,” have been persistently high for the past decade. Since the end of 1995, credit card charge-offs have only been below 4 percent for one quarter, and during the most recent economic downturn charge-offs reached a two-decade high.⁵² However, charge-off rates have also moderated recently and were below 5.1 percent for the entirety of 2004, and below 5.0 percent for first two quarters of 2005.

⁴⁷ Interview with Andrew Kahr, credit card industry consultant, “The Secret History of the Credit Card,” *Frontline*, November 2004.

⁴⁸ OCC, Statement of Comptroller of the Currency John D. Hawke J., June 28, 2000.

⁴⁹ Pacelle, Mitchell, “Pushing Plastic,” *Wall Street Journal*, November 5, 2004.

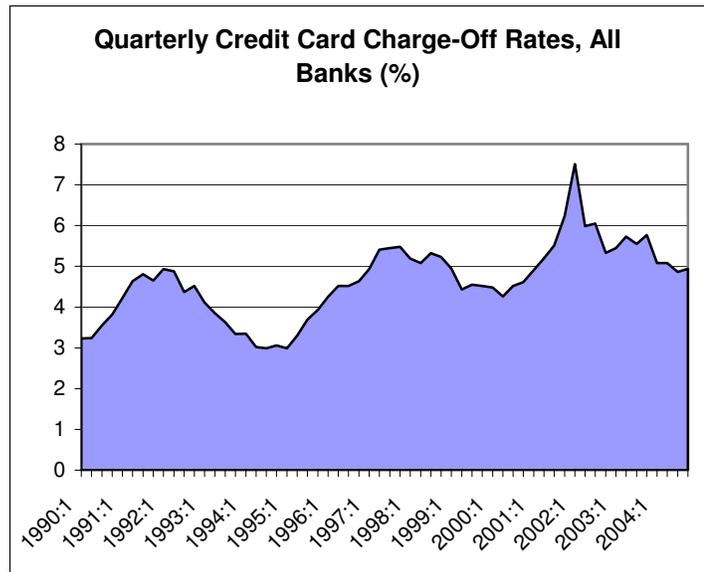
⁵⁰ Mayer, Caroline E., “Bankrupt and Swamped with Credit Offers,” *Washington Post*, April 15, 2005.

⁵¹ *Ibid.*

⁵² Federal Reserve Board, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, available at <http://www.federalreserve.gov/releases/chargeoff/>.

Despite these losses, the credit card industry is typically the most profitable in the banking sector, earning a return on assets since 1995 that is three times greater than that for commercial banks overall.⁵³ The return on assets for credit card companies has grown every year since 1988, by a total of 80 percent.⁵⁴ In 2004, the credit card industry had its most profitable year since 1988.⁵⁵ The industry earned \$30.2 billion in profits, up from \$20.5 billion in 2000.⁵⁶

According to credit card industry consultant Andrew Kahr, the basic profitability of the credit card industry is tied to those who carry revolving debt. Borrowers who pay off their balances in full and on time each month do not earn profits for the industry.⁵⁷ With revolving debt nearly quadrupling since 1990, credit card companies' profitability should remain strong. About 90 million Americans do not pay off their cards each month,⁵⁸ and of those about 19 million usually make only the minimum payment.⁵⁹ Currently, less than one fifth of credit card debt is repaid every month. In December 2004, the payment rate for cardholders was 17.4 percent of total outstanding debt according to Moody's and the fourth quarter 2004 repayment rate was 16.7 percent, up from 15.5 percent in the fourth quarter of 2003.⁶⁰



Second, credit card issuers earn a significant piece of their revenues from penalty fees alone. In 2004, issuers collected \$14.8 billion in penalty fees, or 10.9 percent of revenue, up

⁵³ “Card Profits 04,” *CardTrak*, January 24, 2005; “Banner Year,” *CardTrak*, February 2004; FDIC, *FDIC Quarterly Banking Profile*, Fourth Quarter 2004 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, about one third as large as the credit card industry average return on assets of 3.58 percent over the same period.

⁵⁴ “Card Profits 04,” *CardTrak*, January 24, 2005. The industry’s return on assets grew from 2.5 percent in 1998 to 4.5 percent in 2004.

⁵⁵ “Card Profits 04,” *CardTrak*, January 24, 2005.

⁵⁶ “Banner Year,” *CardTrak*, February 2004.

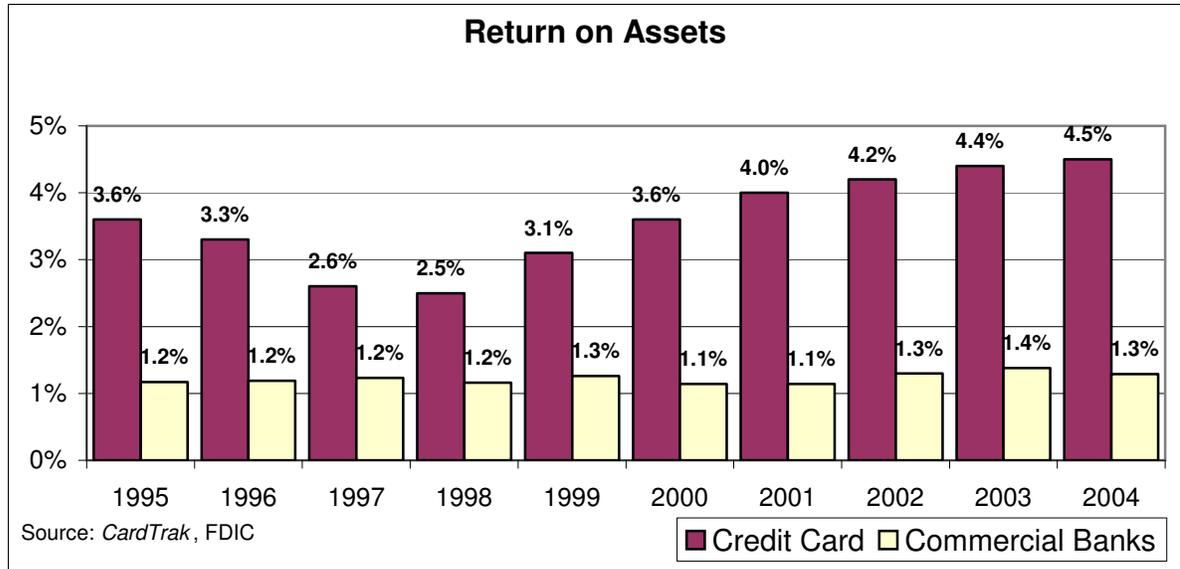
⁵⁷ Interview with Andrew Kahr, credit card industry consultant, “The Secret History of the Credit Card,” *Frontline*, November 2004.

⁵⁸ Gallup 2004; McGeehan, Patrick, “The Plastic Trap,” *New York Times*, November 21, 2004. CFA calculation based on Gallup 2004 poll results and number of cardholding Americans.

⁵⁹ Der Hovanesian, Mara “Tough Love for Debtors,” *Business Week*, April 25, 2005.

⁶⁰ American Financial Services Association, “Across-the-Boards Decline in Delinquencies,” *Spotlight on Financial Services*, April 2005.

from \$10.7 billion and 9 percent of revenue in 2002.⁶¹ Credit card analyst R.K. Hammer Investment Bankers predict that card issuers will focus on “re-pricing” their products in 2005, especially increasing late fees, over-limit fees, and utilizing universal default provisions to trigger higher penalty interest rates to increase income for the issuers.⁶²



The new bankruptcy legislation recently enacted by Congress 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.⁶³

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

In recent years, credit card companies have become far more aggressive in implementing questionable fees and interest rate practices. The upshot of these practices is that penalty interest rates, high and accumulating fees and interest on fees can push consumers with high debts over the financial brink into bankruptcy.⁶⁴ In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges as in principal. Consumers also have to worry that an older industry practice – “sticky” interest rates that shoot up fast but decline much more slowly – will threaten their financial stability as interest rates increase.

⁶¹ Day, Kathleen and Caroline E. Mayer, “Credit Card Penalties, Fees Bury Debtors,” *Washington Post*, March 6, 2005.

⁶² “Card Profits 04,” *CardTrak*, January 24, 2005.

⁶³ Heller, Michelle, “Gauging the Bottom-Line Effects of Bankruptcy Bill,” *American Banker*, April 15, 2005.

⁶⁴ Day, Kathleen and Caroline E. Mayer, “Credit Card Penalties, Fees Bury Debtors,” *Washington Post*, March 6, 2005.

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

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.⁶⁵ 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.⁶⁶



Penalty Fees

Traditionally, penalty fees were designed to deter irresponsible cardholder behavior, but in recent years these fees have become primarily a revenue enhancer for credit card issuers. Late fees, for example, have been steadily rising over the past half-decade. In 1996, a Supreme Court decision prohibited states from setting limits on the fees credit card companies could charge their cardholders. Prior to this court ruling, credit card late fees were commonly around five to ten dollars, but have risen sharply since the decision.⁶⁷ According to figures from the Consumer Action Annual Credit Card Surveys, late fees have increased from an average of \$20.80 in 1999 to \$32.86 in 2004.⁶⁸ More than half of cardholders pay late fees at least once a year, according to *CardTrak*.⁶⁹ Late fee charges have gotten so high that they can easily exceed monthly payments for consumers paying low minimum balances.⁷⁰

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-

⁶⁵ *In re Blair*, No. 02-1140 (Bankr. W.D.N.C. filed Feb. 10, 2004)

⁶⁶ National Consumer Law Center, "Responsible Consumers Driven into Default," February 22, 2005.

⁶⁷ Bergman, Lowell and David Rummel, "Secret History of the Credit Card," *Frontline*, November 2004.

⁶⁸ CFA analysis of Consumer Action's Annual Credit Card Surveys 1999 – 2004.

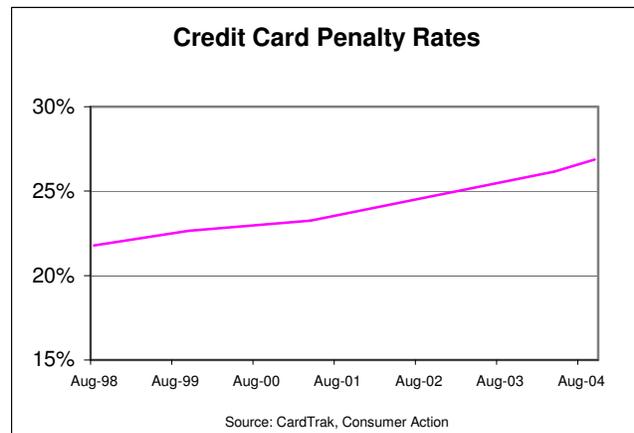
⁶⁹ "Late Fee Bug," *CardTrak*, May 17, 2002.

⁷⁰ "The Ugly Issuer," *Credit Card Management*, September 2004.

limit fee on cardholders who exceed their credit limits.⁷¹ 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.⁷² These monthly fees are charged every month a consumer carries a credit balance higher than their credit limit. Between 1994 and 2004, over-limit fees have more than doubled, from \$12.75 to \$30.35. This fee has increased an average of \$1.09 a year since 1999.⁷³ Critics of this practice argue that issuers should not assess a penalty fee when they can simply enforce the credit limit if they wish to prevent consumers from exceeding it.

Penalty Interest Rates

The majority of credit card issuers also increase interest rates for credit card account holders who pay their bills late, even by a few hours. In 2004, Consumer Action found that 85 percent of issuers charged penalty rates for late payments on their cards.⁷⁴ Between 1998 and 2004, penalty rates rose by nearly a fifth, from an average of 21.79 percent to 26.87 percent, according to figures from *CardTrak* and Consumer Action. Some consumers with low-rate cards could have their interest rates double over night for being late on one payment to their credit card.⁷⁵



Retroactive Application of Penalty Rates

Most issuers also apply penalty interest rates retroactively to prior purchases. This has the effect of increasing the price on purchases already made (but not paid off).⁷⁶ Some cards even apply penalty rates to debts that were already paid at a lower rate.⁷⁷ There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance. I know of 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.

⁷¹ *Ibid.*

⁷² Bergman, Lowell and David Rummel, “Secret History of the Credit Card,” *Frontline*, November 2004.

⁷³ “Over-Limit Fees,” *CardTrak*, February 2, 2005.

⁷⁴ Consumer Action, *Annual Credit Card Survey 2004*.

⁷⁵ Bergman, Lowell and David Rummel, “Secret History of the Credit Card,” *Frontline*, November 2004.

⁷⁶ 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.

⁷⁷ 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 percent 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.

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 score declines. The increases are triggered not just by late mortgage or credit card payment to other lenders but also to other creditors, like utilities or book clubs.⁷⁸

In 2004, the OCC sent an advisory letter to the institutions it oversees covering credit card marketing practices the OCC “regards as unacceptable,” including failing to disclose the conditions for imposing unilateral cost increases for cardholders. However, disclosure will not help consumers avoid a practice that many consumers find inequitable when most major issuers pursue this practice. It is fundamentally unfair to impose a penalty interest rate on a consumer who has not made a late payment or defaulted on an obligation, especially when this rate increase is applied retroactively. Another concern with using credit reports to trigger a penalty rate is the problems with inaccuracies in credit scoring and credit reporting that CFA and other organizations have documented.⁷⁹

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 of these punitive rate hikes seems to belie that contention. One late payment can result in significant increases in interest rates, although there is little to no evidence that a single late payment to one creditor increases the likelihood of default to all creditors. Moreover, the increase in fee burdens and punitive interest rate hikes may have similar or greater impacts on borrowers’ ability to repay than modest problems with another creditor.

Interest Rates Stay Higher than the Cost of Funds Would Indicate

Although interest rates have been at historical lows over the past six years, credit card issuers’ rates have not passed the cost savings completely through to their customers.⁸⁰ 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. According to Federal Reserve data, the prime rate fell by 4.5 percentage points from 8.75 percent in February 2000 to 4.25 percent in November 2002, but credit card interest rates fell by only 1.52 percentage points from 14.30 percent to 12.78 percent over the same period – about a third the decline of the prime rate.⁸¹ When prime rates began to rise, credit card rates rose faster than the prime rate increases. Between November 2002 and February 2005, the prime rate rose by 1.25 percent and credit card interest rates rose by 1.35 percent, even more than the increase in the prime rate. The spread

⁷⁸ Burt, Bill, “Pay One Bill Late, Get Punished by Many,” *Bankrate.com*, January 20, 2004.

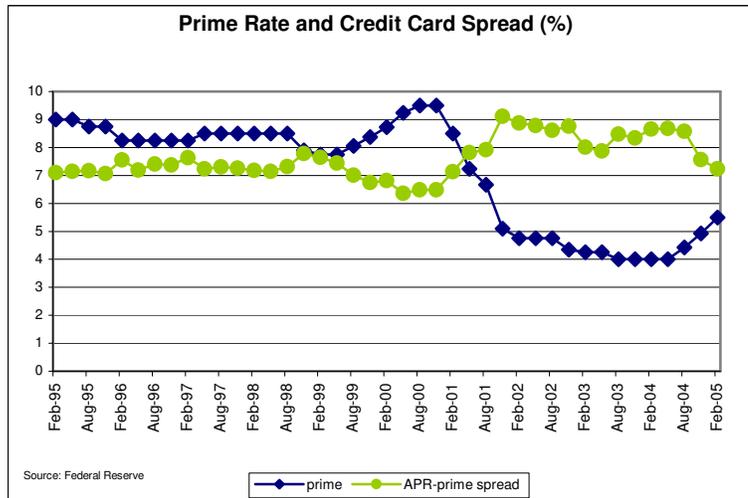
⁷⁹ Consumer Federation of America and National Credit Reporting Association, *Credit Score Accuracy and Implications for Consumers*, December 17, 2002. CFA and NCRA reviewed over 500,000 credit files and found that 29 percent of consumers have credit scores that differ by at least 50 points between the credit bureaus.

⁸⁰ “The Ugly Issuer,” *Credit Card Management*, September 2004.

⁸¹ Federal Reserve Bank Prime Loan Rate Changes: Historical Dates of Changes and Rates, H15 Selected Interest Rate Data Series, available at the St. Louis Federal Reserve <http://research.stlouisfed.org/fred2/series/PRIME/downloaddata>; Federal Reserve Consumer Credit Data, Terms of Credit, G19, available at http://www.federalreserve.gov/releases/g19/hist/cc_hist_tc.txt.

between credit card APRs and the prime rate rose when the prime rate declined. Between 1995 and 2000 the spread between credit card rates and the prime rate hovered around 7 percent, but after the prime rate began to fall the spread rose to over 9 percent and only fell below 8 percent once between November 2001 and August 2004.

The changing interest rate environment will primarily impact credit card debt carried on variable rate credit cards. Variable rate cards first appeared on the market in 1991.⁸² Over the past six years, it appears that the distribution of credit cards between variable and fixed rates is somewhat related to the interest rate picture. As interest rates increase, issuers tend to switch consumers over to variable rate cards. *CardTrak* reported in November 2004 that more than half (55 percent) of credit card debt was carried on variable interest rate cards, up from three years earlier when rates were declining and card issuers were shifting to fixed rate products.⁸³ By March 2005, *CardTrak* was reporting that 65 percent of credit card balances were carried on cards with variable rates.⁸⁴ This trend means that more consumers will be extremely vulnerable to rising interest rates.



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

Although industry-wide figures are not yet available for 2004, 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.⁸⁵ 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 2003.⁸⁶

Credit Card Issuers Reduce Assistance to Consumers Entering Credit Counseling

Credit card lenders have not only helped push many families into debt trouble in recent years with irresponsible and abusive lending, fee and interest policies; issuers have also reduced the assistance they offer to consumers in debt trouble who seek credit counseling as

⁸² "Card Rates," *CardTrak*, September 17, 2001.

⁸³ "5% Prime," *CardTrak*, November 10, 2004.

⁸⁴ "Prime Impact," *CardTrak*, March 23, 2005.

⁸⁵ Daly, James J., "Smooth Sailing," *Credit Card Management*, May 2004 at 31.

⁸⁶ CFA calculation from Daly, James J. 2004 and Census Bureau figures.

an alternative to bankruptcy. According to a study by the National Consumer Law Center and Consumer Federation of America, five of 13 major credit card issuers increased the interest rates they offered to consumers in credit counseling between 1999 and 2003.⁸⁷ Currently, only two major credit card issuers (Wells Fargo and American Express) completely waive all interest charges for consumers in credit counseling. The majority of other major credit card companies charge interest in credit counseling above 9 percent, with issuers like Capital One, General Electric and Discover charging rates of 15 percent or more. Additionally, all major issuers have sharply reduced “fair share” funding to legitimate credit counseling agencies in the last five years.

E. ISSUER “RISK-BASED” PRICING OFTEN LOOKS MORE LIKE PREDATORY PRICING

Credit card issuers often claim that their interest rate and fee policies are justifiable because they are necessary to compensate for the increased financial risk of lending to borrowers with blemished or limited credit histories. It is clearly true that borrowers who pay their balance every month are receiving a valuable service at no cost. It is quite possible, in fact, that riskier borrowers who revolve their debt and pay higher interest rates and fees are subsidizing the cost of services that these non-revolvers receive. However, the key question is whether interest rates and fees charged to riskier consumers are fair and can be legitimately related to the actual financial risk incurred by creditors. There is increasing evidence that the answer to this question is “no.” It is becoming ever more apparent 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 far 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. As stated above, 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 hitting 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.
- **A rational market would lead lenders to limit their risk by limiting credit available to consumers with riskier credit records or histories, instead of increasing this risk by charging consumers who may be in significant financial trouble significantly more money.** Allowing higher-risk profile 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, preventing balances from increasing and helping to keep the cardholder out of default. But credit card issuers are not cutting

⁸⁷ National Consumer Law Center, Consumer Federation of America, “Credit Counseling in Crisis,” April 2003.

off the credit, freezing the credit limit or closing the accounts of cardholders that the issuers deem increased risk. Instead they are allowing the borrowers to rack up more credit under more expensive terms,⁸⁸ making it more likely that the consumer might suffer serious financial consequences. This demonstrates that issuers are not particularly concerned about the financial consequences to the consumer of these higher costs since distressed customers are so lucrative and that profits from these consumers more than compensate for the financial risk involved.

- **If risk-based pricing truly reflects risk, it should decline or at least moderate as risk decreases.** For example, credit card delinquencies have been declining steadily in the last two years, demonstrating lower total risk to the issuers. During the recent economic slump, the highest credit card delinquency rate was 4.75 percent in the fourth quarter of 2002 (well below the more than 6 percent level delinquencies were at during the economic downturn of 1992), but delinquency rates have fallen steadily since then, to 3.91 percent in the fourth quarter of 2004.⁸⁹ The key risk that credit card issuers identify is the risk of default, but that has also been declining. Although charge-off rates were at a two-decade high in 2002, they have also moderated somewhat.⁹⁰ Given that issuers have stated so frequently that they are adhering to the doctrine of risk-based pricing, it is perfectly appropriate for consumers to ask why they do not see lower interest rates in response to a more positive credit environment.
- **The assessment of retroactive interest rates is another sign of abusive charges, not 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 at a time of increasing caution by consumers is also a red flag that pricing in the credit card industry is skewed.** As documented above, issuers continue to increase their marketing expenditures significantly, even as consumers respond less frequently to mail solicitations and show more caution in taking on new debt. A rational market response to these dynamics would be to pull back on marketing expenditures, unless other factors existed, such as windfall profits resulting from abusive pricing.

⁸⁸ Pacelle, Mitchell, "Growing Profit Source for Banks: Fees From Riskiest Card Holders," *Wall Street Journal*, July 6, 2004.

⁸⁹ Federal Financial Institutions Examination Council (FFIEC), Consolidated Reports of Condition and Income, FFIEC 031 & 041, available online at the Federal Reserve.

⁹⁰ Federal Reserve Board, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, available at <http://www.federalreserve.gov/releases/chargeoff/>.

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

F. LEGISLATIVE RECOMMENDATIONS

1. Eliminate abusive lending by credit card companies. A good starting point would be to enact S. 499, Senator Dodd's Credit Card Accountability Responsibility (Credit CARD) Act of 2005. This proposal would take many important steps to rein in abusive lending practices. For instance, it would mandate that issuers lend responsibly to young Americans, by either assessing an applicant's ability to pay or requiring a co-signor who could pay back the amount loaned. S. 499 would also prohibit credit card lenders from attempting to collect on high-interest loans in bankruptcy that exceed the federal prime rate by more than 20 points.

2. End unjust interest rates and fees. Once again, the Credit CARD Act has a number of important provisions. S. 499 would prohibit issuers from applying interest rates retroactively to past purchases. It would also require credit card companies to take the same approach as the Internal Revenue Service (IRS) in assessing whether a customer has paid on time. Issuers would be required to accept the postmarked date as proof of on-time payment. CFA also recommends that issuers be prohibited from unilaterally altering the terms and conditions of a credit card agreement until a card expires without the affirmative permission of a customer. We also urge Congress to consider legislation that would prohibit the imposition of “universal default” interest rates based on alleged missteps with another issuer. Congress should also ensure that all fees and other charges that are assessed closely match the true cost borne by issuers. Finally, Congress should ban particularly abusive fees, such as over-limit fees, where the issuer allows a customer to exceed the credit limit.

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

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

5. Increase penalties to deter illegal acts by credit card companies. In particular, fines under the federal Truth in Lending Act need to be increased. We also support the inclusion of a

“private right of action” to empower consumers to use the Federal Trade Commission Act to challenge unfair or deceptive practices by businesses, including banks.