Testimony before the

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

regarding

Credit Card Practices: Fees, Interest Rates, and Grace Periods

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Mr. Chairman, Senator Coleman, and Members of the Subcommittee, thank you very much for inviting me here to talk about the practices of the credit card industry. I am testifying today on behalf of the low income clients of the National Consumer Law Center,[1] as well as Consumer Action,[2] Demos,[3] National Association of Consumer Advocates,[4] and U.S. Public Interest Research Group[5]. We also thank Chairman Levin for commissioning the landmark Government Accountability Office report on credit cards.[6] This GAO Credit Card Report documents the numerous credit card practices that have been unfair and sometimes abusive toward consumers, confirming the experiences of consumers and their advocates.

I. Credit Card Abuses Squeeze the Vulnerable

We have a debt crisis in America and its source is the practices of the credit card industry. This debt crisis causes consumers to file bankruptcy more often, to reduce their savings to a historic low point, to spend the equity in their homes to pay off credit card debt by refinancing and putting homes at risk of foreclosure – all precipitated by unaffordable credit card debt. It is not generally the *amount borrowed* by these consumers that causes the swelling of unaffordable debt leading to these personal catastrophes for millions of families. It is the practices of the credit card industry that cause the most trouble. The exorbitant interest rates and multiple fees charged to already overburdened consumers are breaking the proverbial backs of American families. Make no mistake - the tremendous profits of credit card companies come off the backs of the most vulnerable, financially distressed consumers.

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[1] The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states who represent low-income and elderly individuals on consumer issues. As a result of our daily contact with these advocates, we have seen many examples of credit card abuses. It is from this vantage point –years of observing the oppressive credit card practices against the less sophisticated and less powerful in our communities – that we supply these comments. This testimony was written by Alys Cohen and Chi Chi Wu, both attorneys with the National Consumer Law Center.

[2] Consumer Action (www.consumer-action.org), founded in 1971, is a national nonprofit consumer education and advocacy organization based in San Francisco, CA, with offices in Los Angeles and Washington, DC. Consumer Action's advocacy work centers on credit, banking and housing issues. The organization's free multilingual educational materials and pricing surveys are distributed online and through its network of 8,500 community-based organizations across the country.

[3] Demos is a non-partisan, national public policy organization based in New York. Our work centers on expanding economic opportunity and creating a more robust democracy.

[4] The National Association of Consumer Advocates (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

[5] The U.S. Public Interest Research Group is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

[6] Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, GAO-06-929, September 2006. [Hereinafter "GAO Credit Card Report."]

A. An Incomplete List of Abuses

The abusive practices by credit card lenders are well documented, including by the GAO Credit Card Report. We discuss some of the most burdensome and egregious. This is by no means a complete list of credit card abuses-- the possibility of a new abusive practice is only limited by the human imagination.

Junk Fees. A significant contributor to snowballing credit card debt is the enormous increase in both the number and amount of "junk" fees, such as fees for cash advance, balance transfer, wire transfer, currency conversion, and more. Most prominent among these fees are late payment and over-limit fees.

Credit card lenders have made these fees higher in amount, imposed them more quickly, and assessed them more often. Banks now impose these fees not as a way to curb undesirable behavior from consumers – which used to be the primary justification for imposing high penalties – but as a significant source of revenue for the bank. According to the GAO Credit Card Report, over one third of credit card consumers were assessed a late fee in 2005.[7]

Penalty Rates. A penalty rate is an increase in a credit card's APR triggered by the occurrence of a specific event, such as the consumer's making a late payment or exceeding the credit limit. Penalty APRs average 27.3% according to the GAO Credit Card Report, and can be as high as 30% to 40%.[8] The new terms apply to the old balance – leaving consumers stuck to pay often high balances at interest rates far higher than was originally agreed, with devastating consequences.

Raising an APR from the mid-teens to 27% or higher, simply on the basis of a single transgression, itself is unjustified and unfair. After all, the card issuer has already collected a one-time charge for that late payment or over-limit transaction, which probably more than covers its costs. This practice is especially outrageous when applied retroactively. There is simply no legal or economic justification for assessing a penalty interest rate to an existing balance; the terms of a loan are being changed *after* the loan has already been made.

Universal Default. Even worse is universal default, in which credit card lenders impose penalty rates -- not for late payments or any behavior with respect to the consumer's account with that particular issuer -- but for late payments to any of the consumer's other creditors. In some cases, lenders will impose penalties simply if the card holder's credit score drops below a certain number, whether or not the drop was due to a late payment or another factor. Consumer Action's 2005 survey of credit card lenders found that 45% of banks surveyed had a universal default policy.[9] According to Consumer Action's survey

[7] *See* GAO Credit Card Report at 13.
[8] *Id.* at 24-25.
[9] Linda Sherry, *2005 Credit Card Survey*, Consumer Action (Summer 2005), *available at*: www.consumer-action.org/archives/English/CANews/2005_Credit_Card_Survey/index.php.

of credit card customer representatives, the following circumstances could trigger a penalty rate hike: credit score drops (90%); late payment to any creditor (86%); going over limit (57%); bouncing a payment check (52%); too much debt (43%); too much available credit (33%); getting a new credit card (33%); inquiring about car loan or mortgage (24%).[10] Among other concerns, using credit reports to trigger penalty rates is connected to the enormous problem of inaccuracies in credit scoring and credit reporting.

Allocation of Payments. Many credit card companies heavily advertise low APRs in their solicitations that are only applicable to one category of transactions. They then allocate payments first to the balances with lower APRs. The disclosure of payment allocation order has been very minimal,[11] or nonexistent.[12] As shown by our example below, payment allocation abuses are a form of bait & switch, depriving consumers of the benefit of the credit card lenders' highly promoted "0% APR" or other teaser rates for balance transfers. Consumers find all of their payments applied to their 0% balance, eliminating that amount quickly, while purchases at higher APRs accrue significant finance charges since they are not being paid down.

Late Payment Triggers. Not only are late fees higher, credit card lenders have been quicker to impose them, often using hair trigger tactics. Previously, credit card lenders gave consumers a leniency period of a few days before imposing late fees.[13] Now, card lenders will impose late fees if the consumer is even one day over the due date. Some lenders impose late fees for payments received on the payment due date but after a certain cut-off time, such as 1 P.M. And until consumer advocates and lawyers began to complaint and file lawsuits, these lenders set ridiculously early times like 9 or 10 A.M. deliberately to result in the imposition of late-payment fees -- well before the U.S. Postal Service delivers the mail. Furthermore, when due dates sometimes fell on a weekend or holiday, lenders considered the payment late if not received on the prior business day.

Unilateral Change-in-Terms. The nature of credit cards is that the borrower signs an agreement at one point in time, but continues to draw upon the credit line thereafter. Creditors likely need some flexibility to respond to changes in consumer circumstances. The problem is that they are allowed to change any term of a credit card virtually at will with only a 15 day notice under the Truth in Lending Act.

There are two problems with these unilateral changes-in-terms. First, they deprive consumers of any "benefit of the bargain," making a mockery of both federal disclosure laws and contract law, because the terms of the contract are illusory. A savvy consumer can select a credit card after reviewing Truth in Lending disclosures, comparing terms, reading articles about picking a credit card – in other words, be a smart shopper – then be

[10] *Id.*

[11] Broder v. MBNA Corp., 722 N.Y.S.2d 524 (N.Y. Sup. Ct. 2001) (promotional material ambiguously disclosed in small print footnote that card issuer "may" allocate payments to promotional balances first).

[12] *See* Johnson v. Chase Manhattan Bank USA, 784 N.Y.S.2d 921 (N.Y. Sup. Ct. 2004).

[13] The *Role of FCRA in the Credit Granting Process*: *Hearing before the subcommittee on Financial Institutions and Consumer Credit*, at 7 (June 12, 2003) (statement of Dr. Robert D. Manning, Caroline Werner Gannett Professor of Humanities, Rochester Institute of Technology), *available at* http://www.creditcardnation.com/pdfs/061203rm.pdf.

faced with a change-in-terms notice that totally changes the APR and other terms of the credit card. One court has described change-in-terms provisions as "an Orwellian nightmare, trapped in agreements that can be amended unilaterally in ways they never envisioned."[14] Second, the vast majority of consumers probably do not read or understand change-in-terms notices. Credit card lenders have admitted that very few consumers opt out of changes.[15] Evidence uncovered from a case involving similar change in terms notices (albeit from cell phone contracts) found that very few customers actually read these notices.[16]

In any case, consumers have few options to switch to other companies even if they do figure out that the terms of their card are changing. In addition, when creditors change terms, they apply the new terms to previously incurred charges. In fact, the GAO Credit Card Report documented that creditors are now using change-in-terms notices to achieve universal default repricing.[17] In some ways, this is even worse, since it means the lenders don't need to disclose their penalty rate practices in the initial Truth in Lending disclosures.

Subprime credit cards. There are a number of credit card products targeted at the "subprime market," which generally means consumers with lower credit scores and/or impaired credit histories. The limited number of consumer protection actions taken by the federal banking regulators have primarily focused on subprime credit cards and have targeted practices such as:

- "Downselling" consumers by prominently marketing one package of credit card terms, but then approving consumers only for accounts with less favorable terms.
- Issuing credit cards with low credit limits, then adding mandatory fees or "security deposits" resulting in little or no available credit when the consumer receives the card.
- Deceptively marketing credit "protection" products.

While these cases shed light on the particular abuses in the subprime industry, they are in some ways an extension of the harsh practices of "mainstream" credit card lenders. A "prime" credit card can quickly become "subprime" with a change-in-terms notice, the imposition of a penalty rate, or one of the other abusive practices discussed above. A single late payment on a "prime" credit card account may result in the imposition of a $35 fee and an increase in the APR from a reasonable 10% to a sky-high 28%. This account now bears the hallmarks of a subprime credit card --- high rates and high fees.

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[14] Perry v. FleetBoston Financial Corp., 2004 WL 1508518 at *4 n.5 (E.D. Pa. Jul. 6, 2004). This court went on to say that it was "reminded of George Orwell's 1946 work, Animal Farm, in which the pigs assume power and change the terms of the animals' social contract, reducing the original Seven Commandments, which included 'All animals are equal,' to one—'All animals are equal, but some animals are more equal than others.'"

[15] GAO Credit Card Report at 26.

[16] Ting v. AT&T, 319 F.3d 1126 (9th Cir. 2003). An article by Bill Burt at Bankrate.com reports similar data, from a survey by Auriemma Consulting Group finding that only one-third of consumers who received change-in-terms notices were aware of the changed terms. Bill Burt, *Ignoring Credit Changes Can Cost You* (Jan. 30, 2004) *at* http://www.bankrate.com/brm/news/cc/20040129a1.asp.

[17] GAO Credit Card Report at 26.

Mandatory Arbitration Clauses. The use of arbitration provisions in credit card agreements has been a tremendous barrier for consumers seeking relief for credit card abuses. Consumers who complain about deceptive disclosures, late posting of payments, payment allocation abuses, and failure to follow federally required billing procedures have lost their day in court due to arbitration provisions (often added using change-in-terms notices).[18]

Card issuers are now using arbitration provisions offensively as well, as a lopsided method to obtain judgments against unsuspecting consumers. Some of these consumers include victims of unauthorized use and identity theft. A report issued by NCLC documents how credit card debt buyers use arbitration proceedings to obtain judgments for thousands of dollars against identity theft victims.[19]

B. Real World Examples of Abuses

The following are just a sampling of consumers who have been victimized by credit card abuses. Their cases are far from isolated, and each probably represents thousands of consumers with a similar story.

1. Low Balance Credit Cards

Our first example is a young Navy sailor who opened a credit card account with First Premier Bank on November 21, 2006. The credit card had a $250.00 credit limit and a 9.9% APR for purchases. The same day that the sailor opened the account, he was assessed two fees - a "Program Fee" of $95.00 and an "Account Set-Up" Fee of $29.00. The next day (November 22), he was assessed a Participation Fee of $6.00. Three days later (November 24), he was assessed an Annual Fee of $48.00. When this young sailor received his first month bill, which had a closing date of November 24, 2006, he had already accrued a balance of $178.00, *without making a single purchase*.

The next week, the young sailor used the credit card for four transactions totaling $84.85. On December 22, 2006, he was assessed a participation fee of $6.00. With all these fees, the young sailor was already over his credit limit, despite making less than $85 in purchases on a card with a $250 limit. He was assessed an over-limit fee of $25.00 and a late fee of $25.00, plus a finance charge of $1.96, on December 26. He now owed a balance of $320.81.

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[18] *See, e.g.,* Lawrence v. Household Bank, 343 F.Supp.2d 1101 (M.D. Ala. 2004) (compelling arbitration of Truth in Lending Act and Fair Credit Billing Act claims challenging a 9 A.M. cut-off for payment posting); Kurz v. Chase Manhattan Bank, 319 F. Supp.2d 457 (S.D.N.Y. 2004) (compelling arbitration of Fair Credit Billing Act claims as well as retaliation under the ECOA). *Cf.* Johnson v. Chase Manhattan Bank USA, 784 N.Y.S.2d 921, 2004 WL 413213 (N.Y. Sup. Ct. 2004) (compelling arbitration of state law claims challenging payment allocation abuse); Providian v. Screws, 2003 WL 22272861 (Ala. Oct. 3, 2003) (compelling arbitration of state law claims challenging bait & switch APRs, billing errors, and late fees).

[19] National Consumer Law Center & Trial Lawyers for Public Justice, *New Trap Door for Consumers: Card Issuers Use Rubber-Stamp Arbitration to Rush Debts Into Default Judgments* (Feb. 27, 2005), *available at* http://www.consumerlaw.org/initiatives/model/content/ArbitrationNAF.pdf.

In January 2007, the young sailor did not make any purchases with the credit card. He was again assessed a participation fee of $6.00, an overlimit fee of $25, a late fee of $25, and $2.64 in finance charges. As of January 25, 2007, the sailor owed a balance of $379.45 for $84.85 worth of purchases!

Another example for a low balance credit card comes from a summary by a consumer attorney defending a client against a Capital One collection lawsuit:

> Capital One is suing my client for over $3500 for a defaulted credit card. The client had just come out of bankruptcy and received a solicitation for a Capital One Mastercard with a $200 credit limit. He signed up for the credit card because he and his wife just had a baby and needed a crib. They charged a baby crib (total cost $158) on the credit card. The next week, the client received a call from Capital One trying to sell him a membership in a diner's club. He declined. The client then received his first monthly statement showing charges for the crib ($158), annual fee ($39), and the diner's club membership ($99). Capital One added a $25 over limit fee and finance charges. The client called Capital One and explained that he had declined the diner's club, and asked Capital One to please remove the charge for the diner's club and the overlimit charge. Capital One agreed to do so, but never did, despite follow up calls from the client. The account spiraled out of control with Cap One adding late fees, over limit fees, and finance charges each month. The client has paid over $700 to Capitol One, yet the company is suing him for over $3500. The only charge he ever made was for the baby crib.

Business Week recently documented how Capitol One offers *multiple* low-limit credit cards to overextended borrowers in order to maximize over-limit and other fees.[20]

2. Allocation of Payments[21]

Similar problems occur with the application of payments by credit card lenders. Another consumer client, Mr. W, applied for a Capital One credit card advertising a 1.9% APR for balance transfers. Upon transferring over $7,000 to the new account, Mr. W was assessed a balance transfer fee of about $250. The balance transfer fee was recorded as a "purchase," and the standard APR of 18.9% for purchases was then applied to that fee. After Mr. W had made several payments, he noticed that the outstanding balance on the transfer fee was actually above $250. Apparently, only a tiny fraction of his monthly payment was being applied to the balance transfer fee, so the balance on that charge was actually increasing under the 18.9% APR while the balance on the transferred amount at the much lower APR was declining. Mr. W determined that if he had continued paying the amounts he was paying on the card, the Purchases balance would not have been paid off for over three years, and he could have paid nearly $250 in

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[20] Robert Berner, *Cap One's Credit Trap*, Business Week, November 6, 2006.

Note that the Minnesota Attorney General's sued Capital One in 2004 over abusive practices. Some of the allegations in that lawsuit included: (1) deceptive practices in heavily promoting low "fixed" rates, then engaging in aggressive penalty rate repricing or even raising rates for no reason at all; and (2) lowering a consumer's credit limit without notice, then charging an over-limit fee and imposing a penalty rate. Complaint, State of Minnesota v. Capital One Bank, *available at* http://www.ag.state.mn.us/consumer/PDF/PR/CapitalOneComplaint.pdf.

[21] Taken from Testimony of Michael D. Donovan Before the Senate Committee on Banking, Housing, and Urban Affairs, January 25, 2007.

additional interest on the transfer fee of $250. The true cost of the balance transfer was far different from the 1.9% advertised by Capital One. The true cost of credit was about 7.9%, which was not all that different from the APR on the card from which he had transferred the balance. Even worse, after about ten months, Capital One sent a notice to Mr. W that it was increasing the APRs on all of its accounts and that Mr. W had to reject the proposed increase within 15 days. Mr. W missed the deadline for rejecting the change in terms because he was away on vacation and had assumed, incorrectly, that the envelope was just another one of the many solicitations he continued to receive for a Capital One credit card.

3. Consumers Overwhelmed by Fees and Penalty Rates

The leading example of abusive credit card practices has been the case of *Discover Bank v. Ruth Owens* which the GAO Credit Card Report cites.[22] In that case, an Ohio court found that Ms. Owens, an elderly woman who depended on a monthly Social Security Disability check, had paid $3,492 on $2,000 principal that she had borrowed on a Discover credit card. The court rejected Discover's attempt to collect an additional $5,000 in late fees, penalty interest and credit protection costs, because those charges were, in the court's view, unconscionable.

Another classic example is the bankruptcy case of Josephine McCarthy.[23] On one account, Ms. McCarthy had made $3,058 in payments over a two year period during which her balance on the account increased from $4,888 to $5,357. She had made only $218.16 (net of store credit) in purchases during this time. On the other card, she made $2,008 in payments over the same period and the account balance increased from $2,020.90 to $2,607.66. This time she made all of $203.06 in purchases.

II. A Broken Market

A. Cross Subsidies in the Credit Card Marketplace.

Credit cards work well for some consumers. Credit cards are a tremendous convenience for consumers who are well off and can pay their balances every month, those known as "convenience users." Those consumers, as the GAO Credit Card Report notes, enjoy lower APRs and fewer annual fees. Convenience users collect airline miles, reward points, or even cash back, plus they enjoy an interest-free one month loan from the credit card lenders and the protections of federal law against theft or loss. The consumers who can pay off their balances every month generate such lower profitability for credit card lenders that they are sometimes referred to as "deadbeats" by the industry.[24]

Somebody, however, needs to pay for the deadbeat's great deal, and that person is the consumer who does not have the means to pay off a credit card balance every month - the

[22] Discover Bank v. Owens, 822 N.E.2d 869 (Ohio Mun. 2004).
[23] *In re* McCarthy, No. 04-10493-SSM (Bankr. E.D. Va. filed July 14, 2004).
[24] These users still represent a source of substantial income to the lenders, through the charging of "interchange" or the merchant fees.

"revolver." The revolvers make up most of the profits for the credit card industry, about 80%.[25] The revolver who makes the tiniest misstep – a day late on a minimum payment, a few dollars over the limit – becomes a profitable borrower. The revolver will be socked with penalty rates averaging 27% APR and fees averaging over $30. Even if the revolver merely pays late to another creditor or the credit score drops, the effect will be exorbitant penalty rates on the credit card.

Why do credit card lenders stick so many consumers who make the smallest misstep (or even no misstep) with rates averaging 27% APR, sometimes even after the lenders have collected $25 or $30 for their troubles? The reason is that card companies have figured out how to make money by lending to people without any determination of their ability to repay. There is no real evaluation of the consumer's ability to take on new debt – an evaluation that would involve not just obtaining a credit score but also determining whether the consumer can afford the credit given her income and other debts. Instead, credit card lenders engage in "back end" underwriting. *After* the consumer has received the credit card and run up a debt, and after facing trouble making the payments on the debt, the credit card lender hikes up the interest rate for the consumer and justifies the increase in rate based on the "newly discovered" high risk of non-payment.

However, when they realize a consumer is a risk, the card issuers don't simply cut off these consumers who it turns out can't afford the credit handed to them. Instead, lenders raise the interest rates for these consumers to sky high levels and assess exorbitant fees on a monthly basis. The lenders use the extension of risky credit to justify the higher interest rates, but that simply exacerbates the riskiness (or likelihood of default) of those borrowers. Enough high risk customers pay these exorbitant amounts to subsidize any losses that actually result from customers who do not repay their debt.

Thus, the industry has found a way to use risky lending to their benefit. These tactics have proven to be immensely profitable. One of the most startling facts uncovered by the GAO Credit Card Report is that an enormous amount of credit card revenues come from financially vulnerable or distressed consumers.[26]

These abusive practices also permit credit card lenders to "hide the ball" on the real price of a credit card. Consumers will shop for credit cards based on sales pitches in the solicitation - points and rewards, and if pricing is something they focus on, APR and annual fee. Consumers never shop on "what is the penalty APR or late fee" because they never expect to be that consumer who is late, or loses a job and can't pay off the bill.

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[25] GAO Credit Card Report at 69-72 (approximately 70% of revenues from interest charges, with a growing portion attributable to penalty interest, and 10% from penalty fees).

[26] The GAO Credit Card Report noted that about 11% of credit card consumers are assessed an interest rate of 25% or more, which is probably a penalty rate. However, only about half of cardholders are revolvers. That means about a quarter of revolvers have a penalty rate. These penalty rate revolvers probably make up for more than 25% of profits from interest rates, since as the GAO noted they pay higher prices and also may carry larger balances. Interest makes up about 70% of credit card lenders profits, and penalty fees account for another 10%. GAO Credit Card Report at 67-72.

Once the consumer has racked up the debt, a consumer is beholden to the credit card lender, and has few choices in the marketplace. Consumers who are homeowners are often able to tap home equity, but if their credit score is poor, they now face the risk of abusive subprime home equity lending. Otherwise, the best that a distressed consumer might be able to do is file for bankruptcy, or try to walk away (stop paying). Therein also lies part of the reason credit card lenders use such draconian tactics when a consumer stumbles even a little - lenders often can squeeze enough out of distressed consumers to make the account profitable, even if ultimately the consumer files for bankruptcy or the debt is written off.

It is important to understand that the industry often does NOT lose money on borrowers who don't fully repay their credit card debt. Generally, before a borrower defaults, the creditor has already received multiple fees and payments of interest from that borrower – often equal to or in excess of the actual amount borrowed. Some examples of this tactic, which has been called the "sweat box" by Professor Ronald Mann,[27] are shown in our real world cases discussed above.

Altogether, the abusive practices, the back end underwriting, and the attempts to "sweat out" consumers have created a form of credit card economic Darwinism. As the GAO Credit Card Report documents, the credit card market has improved over the last several decades for the financially secure who do not carry a credit card balance or can manage not to stumble even a little – lower interest rates, reward programs, fewer annual fees, and convenience. For Americans who have a tougher time, the market has become much worse with high penalty rates and excessive penalty fees for strapped consumers who cannot escape by paying off their balance.[28] The financially vulnerable consumer is subsidizing the financially secure. Moreover, the increasing securitization of credit card debt[29] will only magnify this problem because a profitable business model sells on Wall Street whether or not working Americans benefit.

Even many of the borrowers who routinely pay off their balances are at risk of becoming forced "revolvers. Many households live paycheck to paycheck, with only small savings to buttress them against financial catastrophe. A recent study from Demos and the Access Project documents that medical bills are responsible in part for credit card debts for 29% of the families that are revolvers.[30] An earlier report by Demos and the Center for Responsible Lending found that credit card debtors often incur ongoing debt as a result of automobile repairs, medical bills

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[27] Ronald Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007.1 Ill. L. Rev. 375 (2007), *available at* http://works.bepress.com/ronald_mann/14.

[28] In the GAO's own words:

> the increased revenues gained from penalty interest and fees may be offsetting the generally lower amounts of interest that card issuers collect from the majority of their cardholders. These results appear to indicate that while most cardholders likely are better off, a smaller number of cardholders paying penalty interest and fees are accounting for more of issuer revenues than they did in the past.

GAO Credit Card Report at 79.

[29] The GAO noted that more than 50% of credit card debt is securitized. GAO Credit Card Report at 68.

[30] Cindy Zeldin and Mark Rukavina, *Borrowing to Stay Healthy: How Credit Card Debt Relates to Medical Expenses*, Demos and the Access Project (January 2007).

and just to buy groceries.[31] Professor Elizabeth Warren's research documents how consumers end up in unmanageable debt due to divorce, illness or other financial disasters.[32] It's not plasma screen televisions or luxury handbags - it's the medical bills, the groceries, the car repairs and the gas bill that pulls families into the quagmire of high credit card balances, higher interest rates and fees.

B. Deregulated Interest Rates Cause Extensions of Unaffordable Credit

The credit card industry has used the deregulation of interest rates as a justification to make these unaffordable extensions of credit to people who cannot afford to repay that debt. Rather than evaluate the borrower's ability to repay and then charge a rate of return based simply on the cost of extending that credit, plus a reasonable margin to cover profit and a small risk of loss from non-payment, the industry charges high margins of interest to cover *anticipated losses from borrowers whose ability to repay has never been determined.* The high rates of return are charged to whole classes of borrowers, regardless of whether they can afford to repay. These returns provide ample income to cover losses for those who default and to provide huge profit margins. The high interest rates thus facilitate lending to borrowers who cannot afford the credit, and whose lives are significantly damaged by their attempts to pay high cost credit which no underwriter would have anticipated they could repay. Moreover, the riskiness of the credit is used as the excuse for charging exorbitant rates of interest – thereby making the credit more unaffordable and more risky.

This approach is backwards. The market should not provide an incentive for making loans to consumers who can not repay. The industry should be evaluating a borrower's ability to repay and only extending credit to those who can afford the credit provided to them. If interest rates were limited, the industry's profits would come from paying borrowers (who would sometimes default due to life events). There would not be sufficient excess profit from those who could pay to allow for making predictably unaffordable loans to borrowers who were never in a reasonable position to repay the debt.

III. History of Credit Card Regulation: How Did We Get Here?

Credit card companies were not always so free to engage in reprehensible behavior. Credit card deregulation, and the concomitant spiraling credit card debt of Americans, began in 1978, with the Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*[33] This case gave national banks the green light to take the most favored lender status from their home state across state lines, and preempt the law of the borrower's home state. As a result, national banks and other depositories established their headquarters in

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[31] Tamara Draut, Ansel Brown, Lisa James, Kathleen Keest, Jabrina Robinson and Ellen Schloemer, *The Plastic Safety Net: The Reality Behind Debt in America,* Demos and Center for Responsible Lending) (Oct. 2005), *available at* www.demos.org/pubs/PSN_low.pdf.

[32] Warren, Elizabeth et al. "Illness and Injury as Contributors to Bankruptcy," *Health Affairs*, February 2, 2005; Elizabeth Warren, et al., *Illness and Injury as Contributors to Bankruptcy*, Health Affairs (Feb. 2, 2005); Elizabeth Warren, *Families Alone: The Changing Economics of Rearing Children*, 58 University of Oklahoma Law Review 551(2005); Elizabeth Warren & Amelia Warren Tyagi, *The Two-Income Trap* (Basic Books 2003).

[33] Marquette Nat'l Bank of Minn. v. First of Omaha Serv. Corp., 439 U.S. 299, 99 S. Ct. 540, 58 L. Ed. 2d 534 (1978).

states that eliminated or raised their usury limits, giving them free rein to charge whatever interest rate they wanted.[34] From 1978 to 1996, credit card debt grew from $50 billion to $378 billion, multiplying six-fold.[35]

In 1996, the Supreme Court paved the way for credit card banks to increase their income stream even more dramatically. In *Smiley v. Citibank (South Dakota), N.A.*, the court approved a definition of interest that included a number of credit card charges, such as late payment, over-limit, cash advance, returned check, annual, and membership fees.[36] As a result, national banks and other depositories can charge fees in any amount to their customers as long as their home-state laws permit the fees. Uncapping the amount of fees that credit card banks can charge nationwide has resulted in the rapid growth of and reliance on fee income by credit card lenders.

After *Smiley*, banks rushed to increase late charges, over-limit fees, and other charges. As the GAO noted, the average late payment fee has soared from $12.83 in 1995 to over $33 in 2005, an increase of 115% adjusted for inflation.[37] Over-limit fees have similarly jumped from $12.95 in 1995 to over $30 in 2005, an increase of 95% adjusted for inflation.[38] Since *Smiley*, penalty fee revenue has increased nearly nine-fold from $1.7 billion in 1996 to $14.8 billion in 2004.[39] The income from just three fees – penalty fees, cash advance fees and annual fees – reached $24.4 billion in 2004,[40] Concurrently, card issuer profits, though declining somewhat between 1995 to 1998, have steadily increased between 1999 and 2004. These profits rose from 3.1% in 1999 to 4.5% in 2004.[41]

It is this complete deregulation of interest rates, and the resulting escalation in interest rates and fees charged to many consumers, that has directly caused the industry's deliberate decision to extend credit to consumers in amounts far in excess of what they can afford to repay.

IV. Restoring a Fair and Functioning Credit Card Market

The industry's practice of deliberately making unaffordable loans, and then charging these borrowers an arm and a leg when they don't repay, must stop. This damages everyone, and is a contributing factor to the boom in risky mortgage refinancing, reduced savings and foreclosures.

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[34] Other depository institutions obtained the same most favored lender status when Congress enacted § 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (codified at 12 U.S.C. § 1831d).
[35] *See* Fed. Res. Bull., *available at* http://www.federalreserve.gov/releases/g19/hist/cc_hist_mt.txt. Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and in the Personal Bankruptcy Rate*, FDIC--Division of Insurance, Bank Trends, 98-05 (Mar. 1998), *available at* http://www.fdic.gov/bank/analytical/bank/bt_9805.html.
[36] Smiley v. Citibank (S.D.), Nat'l Assn., 517 U.S. 735, 116 S. Ct. 1730, 135 L. Ed. 2d 25 (1996). The OCC definition of interest is found in 12 C.F.R. § 7.4001(a).
[37] GAO Credit Card Report at 20.
[38] *Id.* at 21.
[39] Cardweb.com, *Fee Party* (Jan. 13, 2005), *available at* http://www.cardweb.com/cardtrak/news/2005/january/13a.html.
[40] *Id.*
[41] Cardweb.com, *Card Profits 04*, (Jan. 24, 2005), *available at* http://www.cardweb.com/cardtrak/news/2005/january/24a.html.

Because of the deregulation of bank credit, virtually no state regulation on creditor conduct applies to the practices of the credit card industry. While there are some – very few – limits placed on the most outrageous abuses of consumers by banks by the federal banking regulators, the Truth in Lending Act (TILA) is the primary regulatory structure applicable to the relationship between credit card lenders and their customers. The TILA was intended to be – and remains – primarily a disclosure statute. It was never intended to stand on its own – to be the sole and primary means of regulating and limiting a powerful industry vis-à-vis the individual consumers who borrow money for personal, family or household purposes. Indeed, when the TILA passed in 1968, state usury and fee caps applied to credit card transactions.

Uniform and accurate disclosures *are* useful for consumers, but they cannot substitute for real regulation. The best proof of this is the unbalanced and dangerous situation that American consumers face today with the credit card industry. Disclosures alone are not sufficient because:

- Consumers lack equal access to information – most consumers will not have the knowledge to understand the legal consequences of the terms of credit.
- Consumers lack equal bargaining power – no consumer has the market power to call up a credit card company and negotiate either the basic terms or those in the adhesion contract.
- The credit card market does not provide real choices. With the increasing consolidation of credit card providers, the industry guarantees *less* meaningful competition. There is generally competition only on the surface, on a few prominently-advertised terms such as the periodic rate and annual fee. Consumers have little or no meaningful choices on the terms that create the bulk of the cost of credit card debt.
- Without some basic substantive regulation, there will continue to be competition between industry players only as to which can garner the most profit from the most consumers – regardless of the fairness, or the effects on consumers.

Furthermore, many consumers lack the ability to make effective use of even straightforward and uncomplicated disclosures. One example of this inability is the failure of many consumers to derive information from FDA food nutrition labels, considered by many to be the gold standard in disclosures. A recent study found that 40% of consumers could not answer the simple question of "how many carbohydrates were in half a bagel" when the label stated information about the amount of carbohydrates for a whole bagel.[42] What chance do these consumers have of figuring out credit card disclosures?

For the past two decades, substantive credit regulation has been steadily whittled away, with no discernable benefits for consumers. The twin justifications for this diminution in credit regulation have been that too much regulation limits access to credit, and that consumers can adequately protect themselves so long as they are armed with full information about the costs of the credit. The pendulum has swung too far – there is no lack of available credit; indeed for many families there is far too much dangerous credit available to them.

[42] Eric Nagourney, *Nutritional Information Leaves Many Uninformed*, New York Times, Sept. 26, 2006, at D6.

Real, substantive limits on the terms of credit, and the cost of the credit, including the interest rate and all fees and charges, must be re-imposed. We recommend substantive regulation along the following lines. Most of these reforms are also discussed in the Joint Recommendations of Consumer Groups on Credit Cards, attached.

- **Meaningful underwriting of the consumer's ability to pay.**

- **A cap on all other charges to an amount the card issuer can show is reasonably related to cost.** Penalty fees should be based on the lender's cost for a default; they should not be a profit center. This is the longstanding common law doctrine on penalties in contracts. It is also the principles-based standard reiterated for such fees by the Office of Fair Trading in the United Kingdom and Europe.[43]

- **No unilateral change-in-terms allowed** Credit card lenders should not be able to change the terms of a contract mid-stream. If a credit card lender wants to change the terms of a contract, they should be required to close the old account (and permit the balance to be repaid on the pre-existing terms) and offer the consumer a new deal with respect to future credit.

- **No retroactive interest rate increases allowed.**

- **No universal default.**

- **Penalties should not be allowed for behavior not directly linked to the specific card account at issue.**

- **No over limit fees allowed if issuer permits a credit limit to be exceeded.**

- **A cap on all periodic interest rates.**
  The time has come to consider reinstituting the historic prohibition against usury in this country. A new usury cap could be designed to "float" with the prime rate, so that lenders can still make a *reasonable* profit in a high interest rate environment. A cap on interest rates would have the important result of forcing the industry to limit their profits from too-risky loans.

- **No mandatory arbitration, either for consumers' claims, or for collection actions against consumers.**

- **Meaningful penalties for violating any substantive or disclosure requirements that provide real incentives to obey the rules.**

- **A private right of action to enforce section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive practices by businesses, including banks.**

[43] *Calculating Fair Default Charges in Credit Card Contracts*, United Kingdom Office of Fair Trading, April 2006.

We need a standard of fairness on credit card companies when they deal with consumers. Fundamentally, the abuses of the credit card industry represent a simple breakdown of the concept "treat the consumer right." A fairness standard is also important, because a flexible standard is necessary to restrain the industry from responding to reforms by creating new and innovative techniques designed to squeeze consumers. Alternatively, credit card lenders should be subject to the old common law contract doctrine of good faith and fair dealing. This is another standard reiterated by the Office of Fair Trading in the United Kingdom.[44] Basic fairness is a baseline standard; it is something people have the right to expect.

The increasing mountain of debt held by American consumers coupled with the growing number of abusive practices by the credit card companies, illustrate amply that de-regulation has not worked. Since biblical times government has recognized that consumers need strong, enforceable limits placed on the power of lenders to exert their far greater bargaining power in the marketplace. The age-old protection of borrowers from over-reaching lenders needs to be reinstituted.

We look forward to working with Chairman Levin and other members of this committee on further examination of the credit card industry.

[44] *Calculating Fair Default Charges in Credit Card Contracts*, United Kingdom Office of Fair Trading, April 2006, at 10.

ACORN * Center for Consumer Finances * Consumer Action * Consumers Union Consumer Federation of America * Demos * National Association of Consumer Advocates * National Consumer Law Center • U.S. PIRG

Joint Recommendations of Consumer Groups on Credit Cards

Eliminate reckless and abusive lending by credit card companies

No unsound loans: Make issuers offer credit the old fashioned way, using sound underwriting principles based on the ability of consumers to pay and that ensure the cardholder is not overextending financially by taking on more debt.

Restrict lending to youth without conditions. Young people deserve credit, but only if they qualify. Yet right now, young people are the only group that can obtain a credit card without either a positive credit report, a job, or other evidence of ability to pay, or, barring any of these, a co-signer. No other adult can get a credit card without meeting at least one of these conditions. Young people should have the same safeguards.

No abuse of consumers in bankruptcy. Credit card issuers drive consumers into bankruptcy with abusive terms and collection practices. Stop issuers from collecting on these abusive loans in bankruptcy.

End deceptive and unjust terms, interest rates and fees

Ban retroactive rate increases. Stop issuers from changing the rules in the middle of the game by raising interest rates on past purchases.

No unilateral adverse changes in terms for no reason: Credit card company contracts currently claim the right to change terms for any reason, including no reason. Any change in terms during the course of the contract should require knowing affirmative consumer consent and reasonable notice.

Ban universal default in all its forms. Prohibit punitive "universal default" interest rates based on alleged missteps with another issuer but involving no missed payments to the credit card company itself. It is unfair to impose a penalty rate on a consumer who has not made a late payment to that creditor. Stop card companies from using a change in terms clause to impose penalty rates.

Stop late fees for payments mailed on time. Require credit card companies to follow the Internal Revenue Service (IRS) and accept the postmarked date as proof of on-time payments. This will also eliminate the tawdry practice of assessing late payment fees when payment is received on the due date, because it did not arrive by a specific time (such as 11 a.m.).

Relate fees to cost. Ensure that all fees and other charges closely match the true cost borne by the card issuer.

End roll-over or repeat late and over-limit fees. Ban fees that are charged in consecutive months based on a previous late or over the limit transaction, not on a new or additional transaction offense, even if the consumer remains over the previous limit.

No fees for creditor approved transactions. Don't let the credit card company charge a fee for a transaction it has approved. Ban over-limit fees when the issuer approves the over limit transaction.

Empower consumers with more detailed information.

Ban deceptive credit card offers. Solicitations and "invitation to apply" solicitations that do not make a truly firm offer of credit are deceptive because they lead consumers to believe that they are pre-approved for or have a good chance of getting certain interest rates. Most consumers instead receive cards at much less favorable interest rates and terms.

Simplify pricing. Reduce the number and types of fees so consumers can compare cards and understand the real cost of using the card.

Real minimum payment warning. Give each consumer a personalized warning on his or her monthly statement calculating the length of time—in months and years—and the total interest costs that will accrue, if the consumer makes only the requested minimum payment.

Ban unfair teasers. Stop issuers from downplaying permanent interest rates in advertisements and solicitations and from trumpeting temporary rates as "fixed rates."

Enhance 'Schumer Box' disclosures. Include a "Schumer box" disclosure table in all cardholder agreements containing personalized information about the terms of the card granted. The box should include the APR, 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.

Give consumers strong protections to deter illegal acts

Ban pre-dispute binding mandatory arbitration. No consumer should be forced to waive his or her right to a court trial as a condition of using a credit card. Prohibit binding mandatory arbitration for consumers' claims *and* for collection actions against consumers.

Toughen Truth In Lending Act (TILA) penalties. TILA penalties have stagnated since 1968.

Give aggrieved consumers a private right of action to enforce the Federal Trade Commission Act to challenge unfair or deceptive practices by businesses, including banks.