Testimony of John P. Carey

Before the House Financial Services

Subcommittee on Financial Institutions and Consumer Credit

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Introduction

Good morning Chairwoman Maloney, Ranking Member Biggert, and Members of the Subcommittee. My name is John Carey, and I am the Chief Administrative Officer of Citi Cards. I appreciate the opportunity to appear before you today to discuss our views on H.R. 5244 and its implications for credit card customers and issuers.

Citi Cards is one of the leading providers of credit cards, with roughly 45 million active bank card customer accounts in the United States, served by 33,000 employees in 20 states. This is a complex business—managing literally billions of individual financial transactions for our customers each month—and we strive to get it right. This is a highly competitive business, so we are continually analyzing our business practices and looking for ways to do a better job of meeting our customers' needs.

That's why last year we were one of the first issuers to stop two practices that were the focus of widespread customer concerns: repricing customers during the term of the card based on delinquent behavior with other creditors, often referred to as universal default, and so-called "any time any reason" repricing.

More broadly, we know customers are not satisfied with the status quo across the industry and, frankly, we are not satisfied either. We understand the concerns motivating legislative action. They are real. They are the same concerns that underlie the Federal Reserve Board's (Fed) proposed modification to the regulatory regime that governs credit cards. There is, in fact, a broad consensus—across the credit card industry and among consumers, advocacy groups, and academics—about the need for action. The question for robust discussion is what kind of action.

We have studied H.R. 5244 closely, and we welcome the opportunity to share our views. My testimony today will: (1) examine how the evolution of the credit card industry created the challenges we face today; (2) identify what we think are the best solutions to those challenges; and (3) offer our views about why H.R. 5244 is not the right approach.

Evolution of the Credit Card Industry: Roots of Today's Challenges

Background. To understand the roots of today's challenges in the credit card industry, it is important to appreciate how credit cards have evolved over the past half-century: they have transformed from an accommodation by local merchants for a few trusted customers to an integral part of the national economy and the principal form of credit for millions of Americans.

The industry's roots are found in small retail stores where customers charged purchases and paid the merchant back monthly; these arrangements were based on face-to-face relationships and the credit issuer's knowledge of the borrower's financial situation and ability to repay the loan. Even as recently as 25 years ago, credit cards were available only to a relatively small group of high-income individuals who had strong credit histories. But even those reliable customers had little choice and more onerous terms than what is available to most Americans today. Before 1990, nearly all credit cards carried an annual fee, ranging from $20 to $50, and most cards charged fixed interest rates of roughly 20%. Today, the situation is nearly reversed. By 2005, 75% of cards had no annual fee, and 80% of cardholders had interest rates lower than 20%.

Risk-Based Pricing. Before the late 1980s, two factors combined to create a one-size-fits-all credit card market, with fewer cards available and more restrictive terms: first, for lenders, credit card transactions are not secured by a lien on a tangible asset, which makes them a risky form of loan; and second, lenders at that time had no good way to evaluate and calibrate that credit risk for individual customers.

Because credit cards are now so familiar and ubiquitous, it is easy to lose sight of what they are. While most people may not think of it this way, the fact is that every time a person uses a credit card, that consumer is taking out an unsecured loan through a revolving line of credit. Although credit cards are treated interchangeably with cash, checks, or debit cards during a transaction, they operate quite differently. When a customer pays with cash, check, or debit card, she is simply choosing among different methods of transferring *her own funds* to a merchant. But a credit card is more than a method of payment; when a customer uses a credit card, she borrows funds from the issuer of the credit card and directs the issuer to transfer that *borrowed money* to the merchant at the same time.

And because the loan a customer takes out when using a credit card is an unsecured revolving loan, it carries a lot of risk from a lender's perspective. Unlike other common consumer loans, such as car loans and mortgages, which are backed up by tangible security, a credit card loan is secured only by a customer's promise to repay. Moreover, it is an open line of credit, which the customer can access at any time from almost anywhere in the world. Finally, these loans typically are made not through personal interaction, but through the mail, by telephone, or over the Internet, to someone the lender in all likelihood has never met.

The unsecured, open-ended nature of credit card loans means that lenders need to take steps to protect themselves against unanticipated changes in credit risk. Twenty-five years ago, issuers did that by lending only to customers with the strongest credit histories and by imposing across-the-board 20% interest rates and charging annual fees. At that point, credit card companies simply did not have sufficiently developed technology or the analytical tools to permit the pricing of credit card loans based on a customer's risk profile.

In the last 15 years, new technology and more sophisticated risk management analytics and practices have made it possible for issuers to evaluate an individual customer's risk profile more effectively at account opening and throughout the relationship, and to base credit card loan pricing on those evaluations. Thus, while issuers still have to contend with the inherently riskier nature of an unsecured, revolving loan, these technological and analytical advances have given issuers more precise and effective tools to mitigate that risk. This is risk-based pricing, and it has revolutionized the credit card market, with many benefits for consumers.

Benefits to Consumers. Issuers now can set prices and credit limits at the time a credit card application is approved that will better correspond to an individual customer's credit risk profile, and they also can react in "real-time" to changes in risk over the life of a customer's account.

This risk-based pricing is good for consumers in two ways. First, by allocating the cost of risk to individual customers, issuers can reward customers who have solid credit histories with more competitive pricing, while the customer who poses a higher risk appropriately absorbs the cost of that risk himself.

Second, risk-based pricing actually grows the pie, providing more people with access to regulated credit, including consumers who were previously underserved or had no access to unsecured, revolving credit. With the ability to adjust pricing so that it has a nexus to risk, issuers can expand access to credit, giving a broader range of consumers across the economic spectrum the opportunity to establish a credit history, better manage their cash flow, and deal with costs associated with unexpected life events such as job loss or health emergencies. These benefits are particularly important for Americans who may not have been able to build up a cash nest egg and otherwise would have to dip into retirement savings or seek credit from payday lenders or others in the unregulated market.

These improvements derived from risk-based pricing also have led to increased competition in the industry, which, in turn, has created both more choices for consumers and overall lower prices. Issuers offer affinity, co-branded, and special feature credit cards, including cards with rewards programs tied to airlines or retail stores, with special pricing for higher payments, or that provide contributions to an associated 529 college savings plan. In addition, credit card interest rates have declined since mid-1991, largely through greater competition and reduced cost of funds. As a result, in 1991 only 11% of cardholders reported interest rates below 16%, while 71% did so in January 2007. According to the 2006 report by the Government Accountability Office (GAO), the average interest rate on cards declined by almost six percentage points as compared to 1990.[1]

Taking Action: Solving the Challenges

There is widespread agreement on the need for comprehensive changes—beyond individual companies' actions—to improve the credit card marketplace. As the credit card market has evolved and the products have become more numerous and complex, it is all the more important for consumers to have complete, clear, consistently-presented information to make informed choices. Unfortunately, federal disclosure requirements have not kept pace with market innovation. Nor has the industry been able on its own to develop a uniform set of rules that would effectively inform consumers about the credit card products they choose and use every day. This lack of transparency prevents consumers from being able to make fully informed decisions and distorts the marketplace.

Citi's Experience as an Innovator. I can tell you from our own experience that the lack of complete, understandable information about credit card practices undermines the incentive to make consumer-friendly changes. Last year, we led the industry in responding to consumers and policymakers who criticized two practices that, while rational from a purely credit risk-pricing perspective, were viewed as heavy-handed. First, we eliminated the practice—known as universal default—of adjusting our customers' interest rates during the term of their card based on their delinquent behavior with other creditors, even though a customer's credit behavior with another creditor has proven to be predictive of that customer's behavior with us. Some issuers continue to

[1] *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, GAO at 15, Sept. 2006.

assert that they have eliminated universal default simply because they give customers *notice* before they reprice on the basis of behavior with another issuer. But we mean more than that: we have eliminated not just "automatic" repricing (*i.e.*, without notice) based on such behavior, but *any* repricing.

Second, we also gave up the ability—commonly known as "any time any reason repricing"—to increase rates or fees during the term of the card (typically two years) for reasons such as changes in economic conditions, including our own cost of funds, which obviously affect our business.

We hoped and expected that these two points of differentiation would lead customers to vote with their feet. These changes were widely applauded, both by consumer advocates and by many of you. But we have been disappointed with the results we have seen so far. So, what happened? The problem is that customers cannot recognize the differences between us and our competitors; disclosures across the industry are not providing sufficient, straightforward information that allow a layperson to use a side-by-side comparison to select the best value.

Simple, clear disclosures stimulate innovations that benefit consumers, encourage firms to adopt policies and practices that are distinctive and attractive to consumers, and help to prevent potentially unfair practices by shining a light on them. If properly designed, disclosures provide a clear understanding of credit card policies and practices; help consumers in selecting the card best suited to their needs; help consumers avoid being surprised by unexpected fees; provide sufficient notice of potential changes in practices; and promote greater competition within the industry.

We have invested significant time and effort in making sure our own disclosures communicate effectively. While we are, of course, always looking for ways to improve, our disclosures were the only ones singled out by the GAO in its September 2006 industry-wide report on credit cards as effective and simpler to read. We also have introduced an enhanced "*Facts About Rates and Fees*" table in our cardmember agreements, summarizing all rates and fees in clear, easier to read language; adopted a more consumer-friendly notice to better inform each customer of a change in terms and the right each customer may have to opt out of that change; and enhanced our "responsible lender" disclosures by adding a simple paragraph to the front page of all solicitation letters making clear, among other things, any balance transfer fee, the circumstances under which a customer may lose a promotional rate, and the balances to which the promotional rate does and does not apply.

We recognize, however, that our own efforts, and those of a number of other issuers, are not enough. The industry cannot solve this problem itself because there is no incentive for companies with poor practices to have clear disclosures. In fact, quite the opposite is true. That is why we applaud the Fed's efforts to modernize and improve the disclosure regime for the entire industry for the first time in 30 years.

Regulatory Action by the Fed. When we last appeared before this Subcommittee in June 2007, the Fed had just announced its proposed changes to Regulation (Reg) Z, which implements the Truth in Lending Act (TILA). Our initial reaction was quite positive, and now, having had the opportunity to study the Fed's detailed proposal carefully, we fully support this approach to reform.

The nuanced and extensively reviewed proposal aims to improve the clarity and consistency of disclosures at every important point in the customer's relationship with her bank, and to enhance the customer's understanding of key credit card terms and conditions. The proposal is rooted in the belief, as expressed by Congress in TILA, that economic stability and competition among consumer credit providers are strengthened when consumers make informed judgments about the cost of credit. The Fed would, for example, require a standardized presentation of information in easy-to-read tables that show key rate and fee information, including penalty fees.

In essence, the proposed Reg Z changes seek to move credit card disclosures toward the successful model of food labeling, where consumers can get all the information they need in simple, uniform terms that allow them to readily compare one product to another. Consumers should be able to do the same thing in the world of credit cards, relying on the consistent, easily-understandable presentation of important information in table-form when applying for credit, when opening an account, when receiving their statement, or when the terms of the account change. We also want consumers to have ample opportunity to exercise their leverage and negotiate with the issuer or seek out a new credit card provider if they are not satisfied with a change in terms proposed by their current issuer. And because meaningful disclosure and financial literacy go hand-in-hand, we also support a broader, sustained investment in financial literacy on a national basis, in conjunction with improved disclosures.

While all of these changes certainly would benefit consumers, they also would ensure that financial services providers compete on a level playing field. At Citi, we want consumers to be able to compare us to our competitors on an apples-to-apples basis.

In fact, we relish that comparison. We want disclosures that will highlight our best practices and enable us to compete effectively in the marketplace against issuers whose practices may be less consumer-friendly.

We agree that industry-wide change is necessary to address the real challenges in the system, but, in our view, the regulatory changes underway at the Fed offer a better path to reform than H.R. 5244.

H.R. 5244: Not the Right Approach

We understand the impetus for this bill. We have heard the dissatisfaction of consumers and policymakers loud and clear. But we urge Congress to tread cautiously here in order to avoid unintended consequences—particularly at a fragile time for the economy.

Premature. First, passing legislation—which itself would result in months of rulemaking to develop implementing regulations—would slow down the regulatory train, which is already nearing its destination. The Fed's thorough revision of Reg Z—which reflects extensive consumer testing and review—will be finalized before the end of the year. We are confident that, if given the chance to work, the Fed's revamped disclosure requirements will largely address the problems H.R. 5244 is intended to address. Uniform disclosure that enables customer understanding is the best way to address practices that are not consumer friendly; in a fully effective marketplace, consumers will be the judge, and issuers who adopt the best practices will enjoy a competitive advantage. We think that the Fed's approach should be given an opportunity to take effect before Congress makes a determination as to whether legislative action is necessary.

Regulatory Expertise and Flexibility. There are other practical reasons—in addition to timing—to favor the Fed's regulatory approach. As the regulator responsible for addressing consumer concerns with the credit card industry, the Fed has an unparalleled understanding of this complex and evolving business, so it makes sense to take advantage of this expertise in designing solutions to the challenges facing the industry. Regulations are also more flexible than legislation and can be modified more easily than statutes to take into account changes in market conditions or consumer demands.

Unintended Consequences. We have significant concerns that H.R. 5244 would fundamentally alter the credit card business in ways that would dramatically affect consumers and the broader economy. I will highlight a few of our key concerns below, and we would be happy to discuss our concerns in greater detail with the Committee.

First, H.R. 5244 would seriously impair issuers' ability to reflect consumer risk in credit card pricing. At bottom, the bill's restrictions amount to price controls—not because they impose specific numerical caps, but because they limit the amount of risk an issuer can incorporate into the price of the loan. For example, by prohibiting issuers from using credit bureau information to evaluate a customer's risk when her card is up for renewal, the bill (as we understand it) would have the perverse result of forcing the issuer to make a pricing decision based on anything *except* the customer's own risk profile.

The capacity to consider relevant information about risk when making credit available is a fundamental foundation of safe and sound lending practices. Without that ability to differentiate risk, less creditworthy consumers would have fewer means of accessing regulated credit, relatively risk-free consumers would face a higher cost of credit, and banks would have to re-think their lending models. The Congressional Research Service (CRS), for example, reports that legislation that limits the ability of issuers to reprice for risk could lead to increased minimum payments, reduced credit limits, and less access to credit cards.[2]

In short, if this bill is enacted, the financial burdens associated with the higher-risk customers will be spread across all customers, instead of being borne by the higher-risk customers themselves.

Second, the bill effectively bars a lender from charging interest on an outstanding loan. That result would fundamentally alter the credit card economic model. Under current industry practice, a cardholder qualifies for a grace period and can avoid paying interest on her loan when she pays the entire balance on time and in full. This is an extraordinary feature in the world of lending. It is good for issuers because it encourages customers to pay on time, and it is good for customers because it gives them an interest-free loan. In fact, 55% of our customers use it. But because it is so unusual, and so contrary to the basic business model of lending money for interest, this deal has set terms: a cardholder must pay off the *entire* balance by the due date. The bill would completely rewrite the terms of the deal to make the lender give an interest free loan for *any* amount paid by the due date, greatly expanding the grace period concept. If such a provision were enacted into law, card issuers would be forced to change their pricing models, and to consider eliminating the grace period altogether.

Third, by prohibiting any changes to the terms of the card agreement except for reasons that are specifically set out in the agreement at the time the account was opened,

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[2] Darryl E. Getter, *The Credit Card Market: Recent Trends, Funding Cost Issues, and Repricing Practices*, CRS REPORT TO CONGRESS at 11, Feb. 27, 2008.

H.R. 5244 undermines the push to simplify disclosures, as issuers will be forced to set forth every potential eventuality in the original agreement.

Fourth, by barring issuers from notifying credit reporting agencies about the existence of a new card until it is actually used, this bill will distort customers' credit risk profiles and could adversely affect their credit scores. Moreover, this bill will make it more difficult to prevent fraud and identity theft. Prohibiting this flow of information means that no one will be able to flag unusual and inappropriate patterns of card activity, which are key triggers to stopping fraud and identity theft before it happens.

Conclusion

I believe that this legislation is unnecessary in light of the targeted regulatory efforts underway to address these concerns, and that its unintended consequences would undermine the genuine benefits the risk-based model has brought to consumers and threaten to destabilize the credit markets.

Thank you for the opportunity to discuss these important issues with the Subcommittee. I look forward to answering any questions you may have.

United States House of Representatives
Committee on Financial Services
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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: John Carey	**2. Organization or organizations you are representing:** Citicorp Credit Services, Inc.
3. Business Address and telephone number: Citicorp Credit Services, Inc. One Court Square Long Island City, NY 11120	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2005 related to the subject on which you have been invited to testify? ☐ Yes ☒ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2005 related to the subject on which you have been invited to testify?** ☐ Yes ☒ No
6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
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