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Sub-Committee on Financial Institutions and Consumer Credit
Of the Committee on Financial Services
of the United States House of Representatives

Hearing: The Credit Cardholders' Bill of Rights:
New Protections for Consumers

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Credit Card Practices that Undermine Consumer Safety

Thank you for the opportunity to join this discussion about H.R. 5244 and credit cards.[1]

We are here today to consider modest changes to the rules governing credit cards. Ironically, we are here to discuss banning practices that many responsible lenders have already renounced. As a result, much of this discussion is about ensuring that banks that claim to embrace clean practices are, in fact, following their own promises. It is also about ensuring that the most shameless creditors do not engage in practices that both borrowers and lenders have agreed are unfair.

We are not here to regulate credit cards. This is not a hearing to discuss interest rate caps, fee regulation or any restraint on free and competitive markets.

Instead, this is a hearing about the kinds of tricks and traps that undermine a competitive market. Markets in which customers are bound to terms to which they did not agree, are not free and competitive. Markets in which the terms of an agreement are not revealed until after the customer signs on, are not free and competitive. Markets that permit traps concealed in unreadable jargon, are not free and competitive.

For too long, the most aggressive credit card issuers have had a free rein to craft new terms to ensnare unsuspecting customers. In the absence of baseline rules such as those proposed in H.R. 5244, some credit card issuers have boosted profits by developing new terms that are unfair, often devious, and sometimes legally deceptive. This is a hearing about banning those practices to ensure real freedom and competition in the credit card market.

The events of recent months remind us that we are all in credit markets together. Customers and lenders of all stripes are affected by the lending and borrowing habits of everyone else. Without careful regulation to support prudent lending, the risk increases that a credit card bubble will further destabilize both families and the larger economy.

The Proposals

Billing Practices

To prepare for the hearing this morning, I read an entire credit card agreement in full before coming here. I could not find any clear information about billing practices, other than the due date and a promise of a grace period. There was certainly no mention in the agreement of universal default, double-cycle billing, or other such practice. But those billing practices can produce substantial revenues for some aggressive lenders. H.R. 5244 stops the scams. The bill

- bans due date tricks
- bans double-cycle billing
- bans imposition of repeated fees for a single over-limit violation
- requires pro-rata allocation of payments when customers have loans at different interest rates

These are modest changes that end practices that, quite frankly, serve no purpose except to mislead customers. Practices that would be banned, such as requiring payment before noon or using fine print to shorten the due date for long-time customers, are deceptions, not legitimate business practices. They should not be permitted. The same is true about double-cycle billing, which is used to collect interest on money that the customer has already repaid.

Creditors are hard-pressed to defend these practices. In fact, several major credit card issuers have announced that they will drop practices such as double-cycle billing and unlimited penalties for over-limit violations. These issuers are on record stating that their customers should not be treated this way. They should be commended. They also show us that the changes proposed here should not be controversial.

Violations of Basic Contract Law

Other amendments are designed to curb violations of the basic principles of contract law, principles that we have taught at Harvard Law School and other law schools around the country for decades. They include:

- Eliminating universal default and any-time, any-reason re-pricing
- Requiring advance notice of rate increases
- Giving consumers a chance to read the card terms before the card is issued
- Making sure that terms such as “fixed rate” and “prime rate” carry their ordinary, plain English meaning
- Limiting the issuer’s ability to change the credit limits without the consent of the customer

Contract law is based on the consent of *both* parties. When one party attempts to reserve to itself the right to change prices or terms unilaterally—without the consent of the other party—the contract is deemed illusory and neither party can enforce it. No party can meaningfully consent to terms that did not exist when the contract was formed or to terms that were not revealed until later. Yet some credit card issuers routinely use written agreements that violate these foundational principles of contract law.

Once again, credit card issuers are hard-pressed to defend these practices. Some won’t even try. When card issuers take advantage of contract terms they inserted in order to bind consumers, but refuse to bind themselves to the same agreement, they engage in the kind of heads-I-win-tails-you-lose game that contract law has banned for more than two centuries. Restoring the basic principles of contract law to credit card transactions is an important step toward restoring integrity and competition to the credit card market.

Encouraging Customers to Meet their Obligations

Finally, one of the proposals involves a practice that aims toward helping more customers meet their financial obligations and avoid default. This proposal benefits both consumers and the credit industry. It involves giving consumers a clear path to financial rehabilitation

This is an important measure to strengthen both the credit card industry and our national economy. When consumers fall behind on their credit card payments, the result is an increase in their fees and interest rates, but their mounting debt also affects the consumer's family, other creditors who are doing business with the consumer, merchants who hope to sell to the consumer, and the employer who needs the consumer to concentrate on work matters. A weakened consumer has trouble meeting all of these obligations.

No one is helped when consumers in financial trouble cannot recover their financial footing. Giving the customer a clear path to financial rehabilitation is good not only for the customer, but also for everyone who relies on the financial health of that customer.

Credit Card Reform in a Time of Economic Uncertainty

The crisis in the subprime mortgage market has served as a bitter reminder of what can happen when lending terms are not transparent. When lenders are careless in screening their customers and when customers are unable to evaluate fully the risks associated with borrowing, especially without meaningful government oversight, the result is a series of risky loans, raising the specter of mass defaults and economic upheaval.

Dramatic and sustained weakness in consumer confidence and consumer spending make it imperative that Congress act to build confidence in credit card products. Financial markets need to be reassured that the lending on which the U.S. economy is based have been made prudently and are likely to be repaid. In a time of national economic turbulence, the credit card market should be a pillar of stability, not a shell game based on tricking consumers into spending more than they had intended.

Tricks, Traps and Bank Profitability

Some credit card contracts have become a dangerous thicket of tricks and traps. Part of the problem is that disclosure has become a way to obfuscate rather than to inform. In the early 1980s, the typical credit card contract was a page long; by the early 2000s, that contract had grown to more than 30 pages of incomprehensible text.[2] The additional language was designed in large part to add unexpected—and unreadable—language that favors the card companies. In a recent memo aimed at bank executives, a Vice President of the consulting firm Booz Allen Hamilton observed that most bank products are "too complex for the average consumer to understand."[3] That is an impressive understatement.

For an example of a trick hidden in a credit card, I turned to a mailing from a prominent credit card company. To determine the interest rate the card would carry, the customer would have to wade through a discussion referencing unfamiliar terms such as "LIBOR" and "Cash Equivalent Transactions." But even the most diligent reader would labor in vain. After 47 lines of almost incomprehensible text about various rates, the fine print concludes, "We reserve the right to change the terms at any time for any reason."[4] Evidently, all that convoluted language was there only to obscure the bottom line: The

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company will charge whatever it wants. In effect, lenders won't be bound by any term or price that becomes inconvenient for them, but they will expect their customers to be bound by whatever terms the lenders want to enforce—and will count on the courts to back them up.

Bankcard issuers generated record-breaking revenues in 2006, the latest year for which data are available. All-purpose cards generated $115 billion in revenues in 2006, up from $110 billion the year before.[5] Profits were a handsome $18.4 billion, a 45% jump from the year before.[6]

The breakdown in card income shows that most money comes from those customers who cannot pay in full each month.[7]

Interest	$75.15MM
Interchange	22.18MM
Penalty fees	6.44MM
Cash advance fees	5.65MM
Annual fees	4.00MM
Enhancements	0.92MM

There is, of course, no breakdown in the interest and fee categories to explain how much of the industry revenue came from raising interest rates on customers who were making all their payments in full and on time or how much came from charges based on double-cycle billing for debt that had already been paid. But it is possible to gain some sense of the need for such tricks and traps by noting the number of highly profitable card issuers that have publicly renounced such practices.

- Bank of America has testified before this committee that it has never engaged in universal default. The company's credit card profits nonetheless continue to grow.
- Capital One has testified before this committee that it does not engage in universal default.[8] The company's credit card profits nonetheless continue to grow.
- Citibank has testified before this committee that it would ban universal default practices during the time a credit card was outstanding.[9] The company's credit card profits nonetheless continue to grow.
- J.P. Morgan Chase announced that it will stop all universal defaults.[10] The company's credit card profits nonetheless continue to grow.

This summer, Money Magazine observed: "Since last March, none of the five major issuers, which control 80% of the market, officially practiced universal default."[11]

With so many card issuers abandoning universal default, it is difficult to claim that such clauses are essential for profitability. But why is it necessary to ban the practice? This is a little like asking why it is necessary to ban toxic dumping if most companies don't do it. The simple answer is that banning the practice makes sure that a minority of card issuers do not burn consumers with these practices. Discover is perhaps the most prominent of several lenders that still refuse to abandon this exploitative practice, despite the fact that their competitors remain quite profitable without this source of revenue.

H.R. 5244 is also important because it puts the force of law behind the pledges of Bank of America, Capital One, Citibank, and Chase. As it stands, nothing prevents these companies from quietly changing their policies. Consumers deserve better protection than the occasional benevolence of America's largest lenders.

While universal default has attracted the most attention, there are other practices that do not grab headlines, but that slice into customers' pocketbooks. Even here, major issuers have already abandoned some of the worst practices.

- Bank of America has testified before this committee that it has never engaged in double-cycle billing. It also limits the number of consecutive over-limit fees to three.
- Senator Coleman announced in hearings last year that Chase had agreed to "eliminate the odious practice known as double-cycle billing."[12] The Senator also said that Chase would not impose more than three over-limit fees per event.
- Capital One has testified before this committee that it does not engage in double-cycle billing, and that it has eliminated billing practices that would impose high interest rates when a customer is only a day late in paying.[13]

These companies may have abandoned other sharp practices as well, and they are to be commended. Their competitors may also have renounced double-cycle billing or repeat over-limit fees, but such information is not readily available. We know about these practices only because Congressional committees, led by Congresswoman Maloney and others, have asked. Otherwise, customers remain in the dark about such practices. So long as that is so, the market will not work. The only hope for restoring a competitive market that provides transparency to consumers is to send a clear signal that these disreputable stratagems have no place in the American financial system. Passing H.R. 5244 is an obvious way to end some of the most obvious forms of exploitation of consumers while maintaining the vibrancy of the American credit industry.

Economic Stimulus and Credit Cards

Money siphoned off in devious billing practices and hidden fees is money not spent on goods and services in this economy. Credit card debt now consumes a sizeable portion of a family's income, leaving families with less to spend elsewhere. Current data show an average of 9.2% of families' disposable income is taken up by credit card debt, money that is not used to purchase goods and services that can bolster the U.S. economy.[14]

It is ironic that Congress would pass a huge stimulus package, committing billions of dollars of taxpayer money to families in the hope that they will spend it on goods and services to give the economy a much-needed lift. If, instead, that money goes to paying interest on outstanding debts, the stimulus will fall flat. But Congress has other tools at its disposal beyond spending taxpayer dollars. Families would have more to spend if they did not lose money to credit card issues through traps.

For a more detailed explanation of this phenomenon, I commend your attention to the work of my co-panelist, Professor Adam Levitin. He explains the larger economic impact of even small dollar differences that are multiplied by millions and millions of transactions.[15] H.R. 5244 gives Congress a chance to help strengthen the economy by strengthening family budgets.

Regulation and Credit Bubbles

As experience in the subprime market has taught us, so painfully, when lenders can increase their profits by promoting tricky products, they will make more loans with less regard for the customers' ability to repay them. At the margins, some loans will be made that should never have been approved. For a short time, this reckless lending looks like good news to the borrower who got money that he would not have otherwise obtained and to the lender that generates an extra profit on the loan and packages the debt for re-sale.

But the good news is always followed by bad news. Inflating lending through tricks and traps is classic bubble activity—artificially driving up the number and dollar amount of loans. Over time, a large fraction of the people who receive these loans will default on them. When they do, the bubble bursts.

Credit card activity is no longer funded exclusively by bank deposits and capital reserves. Instead, like mortgage loans, credit card receivables are passed along into securitized pools. Currently about 60% of all credit card debt is held in securitized pools, such as special purpose entities (SPEs in the parlance of the trade).[16] These debts are then moved off the card issuers' balance sheets so that they no long require capital reserves—and so that they are no longer so visible either to regulators or investors, let alone to consumers.

As the mortgage crisis has also taught us, the consequences of an exploding credit bubble are not confined exclusively to those who engaged in imprudent lending and borrowing. Instead, when a consumer fails financially, all of the people who do business with that person are also in jeopardy. Other, more prudent credit card issuers are not paid. Doctors' bills and dentists' bills go unpaid. Car loans break down. There is less money to pay rents and mortgages. Defaults and bankruptcies will not discriminate between prudent and imprudent lenders, and so thousands of responsible loans will become collateral damage of the easy money epidemic.

There are no publicly-available data documenting the magnitude of each of the particular practices identified in H.R. 5244. If they are rarely used, then the current markets are secure. Of course, if they are rarely used, then there will be little impact on the industry if they are eliminated entirely. H.R. 5244 will serve the valuable purpose of ending these pernicious practices before they spread.

If, however, the practices identified in H.R. 5244 are widespread, then it is imperative they be eliminated before they precipitate a financial crisis. Families cannot bear the strain of losing money to credit card tricks, and responsible lenders should not be forced to compete with those who are willing to boost their profits by taking advantage of customers. Given the current vulnerabilities of the national economy, a second credit crisis would almost certainly plunge us into a deeper and even more severe recession.

Who Get Hurts When Credit Card Markets Don't Work?

Credit cards are everywhere. As of 2004, the Survey of Consumer Finance documented that three-fourths (74.9%) of all households held at least one credit card, and 58% of those with credit cards carried balances.[17] In other words, about 43.5% of all households in the US carry a balance on their credit cards. For those who carry debt, the average debt per household in 2006 was reported as an astonishing $8,467.[18] Since then, debt has continued to grow. A household earning the median income would have to turn over every paycheck for nearly three months to pay that bill.[19] Of course, they would have to find a way to stop eating, stop paying rent, stop driving to work, stop making car payments, and, most importantly, stop the interest from continuing to accumulate on their debt loads.

The publicly-available data are aggregated, which means that it is not possible to identify particular lenders or particular practices. Many subtle and not-so-subtle ways of taking advantage of vulnerable groups can be covered up by combining data from multiple sources. Even so, the aggregated data reveal some deeply troubling trends.[20]

- Single women are nearly twice as likely to be paying penalty rates of interest as single men.
- African-American and Latino card holders who carry balances are more likely to be paying interest rates above 20% than are their white counterparts.
- Families with incomes in the bottom 40% are twice as likely to be paying penalty interest rates as families in the top 40%.

The cumulative effects of lower earnings and fewer accumulated assets leave many Americans vulnerable to the exploitative practices of credit card companies. Unlike those with more resources, they cannot always shrug off late fees or higher interest rates, paying them with no real effect on their financial security.

Nearly half of all credit-card holders missed payments in 2006 (the latest year for which data are available).[21] This makes them obvious targets for the most aggressive and unfair tactics. Sending in a payment that arrives one day late costs a family an average of $28, even though the cost to the company of a late payment can be measured in pennies.[22] More importantly, a single late payment can trigger a rise in interest rates on that card and on other outstanding cards that will make it far more difficult for the family to get any of its debts paid.

Anxiety has become a constant companion for Americans struggling with debt. Today about one in every seven families is dealing with a debt collector.[23] Forty percent of families worry whether they can make all their payments every month.[24] An additional 2.1 million families missed at least one mortgage payment.[25] In 2006, a then-record 1.3 million families received foreclosure notices, followed by another 2.2 million families who were in foreclosure in 2007.[26] One in five Americans is losing hope, saying that even when they don't count their mortgages, they expect to die still owing money to their creditors.[27]

What will happen to these families? Since 2000, families have filed nearly 10 million petitions for bankruptcy. In 2005, the National Opinion Research Council asked families about negative life events: the death of a child and being forced to live on the street or in a shelter topped the list, but filing for bankruptcy ranked close behind, more serious than the death of a close friend or separating from a spouse.[28] Of those who file for bankruptcy, 85 percent struggle to hide the fact from families, friends, or neighbors.[29]

Some Americans believe that their neighbors are drowning in debt because they spend and borrow recklessly—and there can be no doubt that some portion of the credit crisis is the result of foolishness and profligacy. But that is not the whole story. Lenders have deliberately built tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debt. With H.R. 5244, Congress has an opportunity to eliminate some of the most harmful practices.

Making Markets Work

Americans are justifiably angry about how they are treated by their credit card issuers. In 2007, 11,427 people filed complaints with the Office of the Comptroller of the Currency, which oversees only the subset of credit cards that are issued by federally chartered banks. Last summer, when the Federal Reserve opened its website for public comments on its proposal that lenders give 45-day notice before increasing interest rates, more than 2,500 consumers wrote in to support the rule change.

Lenders employ thousands of lawyers, lobbyists, marketing ad agencies, statisticians, and business strategists to help them increase profits. In a rapidly changing market, customers need some basic protection to be certain that the products they buy meet minimum safety standards. Personal responsibility will always play a critical role in dealing with credit cards, but no family should be brought low by tricks and traps designed to prey on the unwary.

Creating safer marketplaces begins with making certain that the financial instruments on which we depend are fair to consumers and sustainable over the long term. Terms hidden in the fine print or obscured with incomprehensible language, reservation of all power to the seller with nothing left for the buyer, and similar legally-sanctioned confidence games have no place in a well-functioning market.

Congresswoman Maloney and Chairman Frank have taken an important first step toward ending the practices that put families and markets at risk. They deserve our support and our thanks.

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[1] In preparing this testimony, I received excellent research help from Adam Lebovitz, Harvard Class of 2010.

[2] Mitchell Pacelle, Putting Pinch on Credit Card Users, Wall Street Journal (July 12, 2004) (citing industry consultant Duncan MacDonald, formerly a lawyer for the credit-card division of Citigroup Inc.).

[3] Booz Allen Hamilton, Inc., *Innovating Customer Service: Retail Banking's New Frontier*, Strategy + Business, Knowledge@Wharton (December 22, 2006) (quoting Alex Kandybin, Vice President, Booz Allen Hamilton, Inc.).

[4] First BankCard offer. Copy on file.

[5] Jeffrey Green, Bankcard Profitability 2007, Cards & Payments at 27 (May 2007) www.cardsandpayments.net

[6] Id.

[7] Id.

[8] Testimony of John G. Finneran, Capital One, House Subcommittee Hearings, at 3-5 (June 7, 2007); Testimony of Ryan Schneider, Capital One, Permanent Subcommittee on Investigations (Levin), at 8-9 (December 4, 2007).

[9] Testimony of John P. Carey, Chief Administrative Officer, Citibank, House Subcommittee Hearings, at 9-10 (June 7, 2007).

[10] Reported in Sarah Mangla Ismat, "One Less Sneaky Credit-Card Policy," *Money*, Vol. 37, Issue 2 (February 2008); Jessica Silver-Greenberg, "Credit Cards: Battle in Congress," *Business Week Online*, December 5, 2007.

[11] Id.

[12] Senator Coleman, Opening Statement at Credit Card Hearing, at 3 (March 7th, 2007).

[13] Testimony of John G. Finneran, Capital One, House Subcommittee Hearings, at 3-5 (June 7, 2007); Testimony of Ryan Schneider, Capital One, Permanent Subcommittee on Investigations (Levin), at 8-9 (December 4, 2007).

[14] Calculations from Federal Reserve Bank, Flow of Funds Accounts (March 2008).

[15] Adam J. Levitin, Priceless? The Social Costs of Credit Card Merchant Restraints, 45 HARV. J. ON LEGIS. 1, 46 (2008).

[16] Darryl E. Getter, The Credit Card Market: Recent Trends, Funding Cost Issues, and Repricing Practices, Congressional Research Service CRS 4-5 (February 27, 2008).

[17] Other estimates place those with balances even higher. CardData reports that in 2006 the percentage of cardholders who *consistently* revolve a balance was 61.3%. www.carddata.com (2006).

[18] *Bank Credit Card Annual Revolving Balances Per Carded Households*," CardData.com (2006) (data are calculated excluding "balances paid-off before interest accrues; also excludes commercial cards, debit cards and private label credit cards").

[19] Median household income in the U.S. in 2007 was $48,201. http://www.census.gov/prod/2007pubs/p60-233.pdf at 4.

[20] Jennifer Wheary and Tamara Draut, "Who Pays? The Winners and Losers of Credit Card Deregulation," Demos Foundation 1-2 (2008).

[21] Walechia Konrad, *How Americans Really Feel About Credit Card Debt*, Bankrate.com (Survey 2006).

[22] Id. at 7.

[23] Tom W. Smith, Troubles in America: A Study of Negative Life Events, National Opinion Research Council (December 2005); Lucy Lazarony, Denying Our Debt, Bankrate.com (July 2006 (11% in collection on credit cards).

[24] Consumer Federation of America, Rising Energy Costs Dampen Holiday Spending Plans (November 19, 2007).

[25] Sandra Block, *Foreclosure Hurts Long after Home's Gone, So Cut a Deal While You Can*, USA Today quoting Mortgage Bankers Assn (March 23, 2007).

[26] Nationwide Foreclosures Jumped 75% in 2007, Credit & Collections World (February 8, 2008). http://www.creditcollectionsworld.com/article.html?id=20080129S4FTCWQT&from=creditandcollectionnews

[27] Smart Borrow Survey, Marketwise, prepared with support from Lending Tree, at 145 (April 2007).

28. TOM W. SMITH, NAT'L OPINION RES. CTR., TROUBLES IN AMERICA: A STUDY OF NEGATIVE LIFE EVENTS ACROSS TIME AND SUBGROUPS 10 (2005), *available at* http://www-news.uchicago.edu/releases/05/051228.troubles.pdf.

29. ELIZABETH WARREN & AMELIA TYAGI, THE TWO INCOME TRAP: WHY MIDDLE CLASS MOTHERS AND FATHERS ARE GOING BROKE, at 213 n.13, 74-75.