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STATEMENT OF

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on

THE CREDIT CARDHOLDERS' BILL OF RIGHTS: PROVIDING NEW PROTECTIONS FOR CONSUMERS

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

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Chair Maloney, Ranking Member Biggert and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding credit card practices and to provide comments regarding H.R. 5244, the Credit Cardholders' Bill of Rights Act of 2008.

Credit cards have become a vital component of everyday life, serving as an accessible form of credit that provides great convenience to consumers. However, as with all credit products, unless provided responsibly and used carefully, they hold the potential to cause significant harm.

At the Subcommittee's June 2007 hearing, FDIC Chairman Bair outlined credit card practices that have raised concerns at the FDIC. In my testimony today, I will discuss recent trends in credit card lending and borrowing, the current legal and regulatory context, and how H.R. 5244 addresses a number of abusive practices.

Trends in Credit Card Lending and Borrowing

Credit Card Usage and Growth

Credit card lending today is an integral part of the consumer finance marketplace, widely accessible to households spanning all demographic and socio-economic groups. By 2004, the most recent year for which aggregate consumer data are available, 75 percent of U.S. households had some type of credit card, and 46 percent carried a credit card balance.[1] A 2007 study found that U.S. consumers individually had an average of 4 credit cards, with approximately 51 percent holding at least 2 cards and approximately 14 percent having more than 10 cards.[2]

The Federal Reserve 2004 Survey of Consumer Finances documents that the median level of indebtedness for families with credit card debt was $2,200 in 2004, up from $1,300 in 1989 (in 2004 dollars). A significant number of families have much higher amounts of credit card debt, however. Thirty six percent of credit card users who carry balances owe more than $10,000, and 13 percent carry balances larger than $25,000.[3]

The use of credit card debt by lower income households has grown particularly quickly in recent decades. Nearly 30 percent of households in the lowest income quintile held credit card debt in 2004, up from 15 percent in 1989.[4] The increase in credit card usage has often been cited as a factor in the growing incidence of financial distress, especially for lower income households. Over one quarter of households in the lowest income quintile have debt to income ratios greater than 40 percent, and 16 percent report having had a debt payment 60 days or more past due.[5] Almost one-third of these lower income families report that they hardly ever pay their total balance in full.[6]

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[1] Federal Reserve 2004 Survey of Consumer Finances.
[2] Experian's National Score Index Study (2007).
[3] CardTrak.com, "Credit Card Debt – What Do Americans Really Owe?" May 31, 2007. www.cardtrak.com/press/2007.05.31
[4] Federal Reserve 2004 Survey of Consumer Finances.
[5] Federal Reserve 2004 Survey of Consumer Finances.
[6] Federal Reserve 2004 Survey of Consumer Finances.

Use of credit cards by young adults also has increased. The average credit card debt held by young adults ages 18 to 24 and 25 to 34 grew by 22 percent and 47 percent, respectively, between 1989 and 2004.[7] In 2004, more than three quarters of undergraduate students started the school year with a credit card, but only 21 percent of college students pay off their entire balance each month.[8]

As of fourth quarter 2007, consumer credit outstanding totaled $2.5 trillion; $941 billion of this was revolving credit, which is made up primarily of credit card debt.[9] Since 2006, increases in consumer credit outstanding have been largely driven by revolving credit growth. Revolving credit grew by $66 billion, or 7.5 percent, between fourth quarter 2006 and fourth quarter 2007. This was the fastest rate of credit card growth seen since second quarter 2001. At the same time, mortgage liabilities, while up 6.6 percent on a year over year basis in fourth quarter 2007, experienced the slowest growth since 1998[10] and unused commitments on home equity lines grew only 0.2 percent, the slowest growth since first quarter 2002.

It is expected that revolving credit demand will remain strong in the coming quarters, particularly if consumers are less able to obtain other sources of funding to finance consumption, such as drawing upon their mortgage equity. In contrast to other types of credit, credit card loans are still relatively easy to obtain. The January 2008 survey of financial institution Senior Loan Officers conducted by the Federal Reserve

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[7] "Generation Debt: Student Loans, Credit Cards, and Their Consequences," Demos, Winter 2007, at 3.
[8] "Undergraduate Students and Credit Cards in 2004: An Analysis of Usage Rates and Trends," Nellie Mae, May 2005, at 8.
[9] Federal Reserve Statistical Release G.19 Consumer Credit.
[10] Federal Reserve Flow of Funds.

Board showed that lending standards for credit cards have not become more stringent. Specifically, 90 percent of banks reported that lending standards for approving credit card loan applications remained basically unchanged over the prior three months, while standards on mortgage loans and consumer loans other than credit cards tightened considerably.[11]

Although credit card lending standards might not be changing, overall solicitations are slowing. In 2007 there were 5.2 billion credit card solicitations sent to U.S. households, down nearly 10 percent from 5.8 in 2006.[12] Yet, as recently as third quarter 2007, offers sent to households using more than 30 percent of their available credit, who represent greater credit risks than those who use less credit, grew 5 percent from the previous quarter. This indicates that issuers have not stopped pursuing higher-risk borrowers.[13]

Credit Card Performance

In recent months, some analysts have expressed concerns that losses and disruptions of the type being experienced in the mortgage market will extend to credit card markets and other areas of consumer credit. However, to the extent that credit card lines at FDIC-insured institutions have shown signs of weakness, losses are much less

[11] January 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices, Board of Governors of the Federal Reserve System, February 4, 2008.
[12] "US credit card mail volume declined in 4th quarter 2007 as troubled issuers push back," Synovate Mail Monitor, February 6, 2008,www.synovate.com/current/news/article/2008/02/us-credit-card-mail-volume-declined-in-4-sup-th-sup-quarter.
[13] "Mailed Card Offers Gain As Lack of Liquidity Bites," *American Banker*, December 5, 2007.

severe than those in the mortgage sector. Thus far, credit card credit quality has remained relatively strong. The net charge-off rate for credit card loans was 4.06 percent in fourth quarter 2007, and 2.22 percent of credit card loans were noncurrent. Credit card charge-offs grew 33 percent from fourth quarter 2006, compared to mortgage loan charge-offs and home equity line of credit charge-offs, which climbed by 144 percent and 378 percent, respectively. Nevertheless, the FDIC will continue to monitor credit card performance, especially given the current turmoil in mortgage markets.

Similarly, despite the financial market turmoil of the past months, credit card lending remains a generally profitable business. In fact, credit card lending has been the most profitable business line for some time. The 27 institutions the FDIC has identified as credit card specialty banks reported a return on assets (ROA) of 2.61 percent in fourth quarter 2007, while the banking industry overall had a ROA of 0.18 percent; these figures were down from 3.43 percent and 1.20 percent, respectively, in fourth quarter 2006. These 27 institutions account for more than three-quarters of all credit card loans (on-balance sheet plus receivables securitized and sold) extended by insured institutions at the end of 2007. During the past 10 years, the average ROA of insured credit card specialists has ranged from a low of 2.86 percent in 1998 to a high of 4.19 percent in 2006. For all insured institutions during this period, the average ROA ranged from a low of 0.86 percent in 2007 to a high of 1.38 percent in 2003.

The higher profitability of credit card lenders stems from high average yields on their asset portfolios, combined with high levels of noninterest revenue. In 2007, the average yield on credit card specialists' interest-earning assets was 13.2 percent, almost double the industry average of 6.8 percent. Also, noninterest income accounted for 61 percent of total net operating revenue at the 27 credit card specialists.[14] For the industry as a whole, noninterest income represented 40 percent of net operating revenue. Notably, 54 percent of the noninterest income reported by credit card specialists was income from securitization and servicing of securitized receivables. These robust revenues help offset the higher net charge-offs associated with unsecured consumer lending. At 4.23 percent, fourth quarter charge-offs at credit card lenders were notably higher than for the banking industry as a whole.

Whether or not credit card performance will weaken in the coming quarters in the wake of the ongoing challenges faced by the mortgage industry is unknown. Historically, consumers have chosen to protect their most valuable asset, their homes, by paying mortgage debt before credit card debt. However, a study conducted by the consumer credit bureau Experian found that subprime borrowers were delinquent on mortgage debt more often than bankcard debt.[15]

Given current economic and credit conditions, bankers and analysts are not expecting marked improvements in credit card performance in the near future. In fact, about 70 percent of senior loan officers reported in January that they expected

[14] Net operating revenue is the sum of net interest income and total noninterest income.
[15] "Experian analysis of subprime lending market uncovers surprising trends," Experian Media Alert, April 10, 2007.

deterioration in the quality of credit card loans.[16] Despite the possibility that some borrowers may choose to keep paying credit card bills even after becoming delinquent on home loans, the available evidence is mixed so it is not clear that new bill payment behaviors will favor credit cards. A recent survey found that credit cards were the most likely bill not to be repaid if the borrower did not have enough money. Nearly 35 percent said they would leave their credit card bill unpaid, versus less than 5 percent who said they would leave their mortgage unpaid.[17]

Legal Context and Developments

Truth in Lending Act/Regulation Z

The Truth in Lending Act (TILA), enacted in 1968, along with its implementing regulation (Regulation Z), are still the primary federal law applicable to credit card lending. TILA and Regulation Z focus primarily on disclosure of the cost and terms of credit. Included in the law, however, are some important consumer protections related to crediting of payments, treatment of credit balances, various protections to cardholders (such as limits on consumer liability for unauthorized or unlawful credit card use and the right of a cardholder to assert claims or defenses against a credit card issuer), and billing resolution procedures.

[16] January 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices, Board of Governors of the Federal Reserve System, February 4, 2008.
[17] "Payment Delinquencies Spanning All Industries: A Survey of US Consumers and the Companies They Pay," Online Resources, December 2007.

The Federal Reserve Board (FRB), which has exclusive authority to promulgate regulations to implement TILA,[18] proposed amendments[19] to Regulation Z in late May 2007 which would significantly improve credit card disclosures. The proposed amendments include changes to format, timing, and content requirements in solicitations, applications, account opening documents, change-in-term notices, and periodic billing statements. The proposal also incorporates an increase, from 15 to 45 days, in the required advance notice before a changed term could be imposed on consumers. While improved disclosures are important, it is doubtful whether even improved disclosures can mitigate the harmful effect of some of the most questionable practices. Action by Congress may expedite solutions to some of the most troubling practices.

Unfair and Deceptive Acts and Practices

Credit card issuers also are subject to the Federal Trade Commission (FTC) Act Section 5 prohibition against unfair and deceptive acts and practices (UDAP). The UDAP prohibition applies to all types of consumer lending, such as mortgages and credit cards, and to every stage and activity, including the development of products. The prohibition also applies to the marketing, servicing, collections, and the termination of the customer relationship.

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[18] While they lack rulemaking authority, other Federal banking agencies enforce compliance with TILA and Regulation Z by their supervised institutions and use their enforcement authority pursuant to section 8 of the Federal Deposit Insurance Act (FDI Act) to address violations. *See* section 108 of the Truth in Lending Act, 15 U.S.C. § 1607.

[19] *See* May 23, 2007 press release announcing issuance of proposed amendments to Regulation Z (Truth in Lending), http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070523/default.htm. The proposed amendments may be found at 72 Fed. Reg. 32948 (June 14, 2007).

The UDAP prohibition provides a powerful supervisory tool. However, its strength is limited by the need to make case-by-case determinations and then, depending on the problem being addressed, to decide appropriate corrective action. While this approach results in changes to practices at individual institutions, it does not necessarily result in changes industry-wide. Having rulemaking authority enables an agency to significantly limit, or even prohibit, practices deemed to be unfair or deceptive.

Current law limits FTC rulemaking authority with respect to banks, thrifts and credit unions to the FRB, Office of Thrift Supervision and National Credit Union Administration, and excludes the Office of the Comptroller of the Currency and the FDIC, who are the primary federal regulators of about 7,000 institutions.[20] Last year, the House of Representatives passed legislation, H.R. 3526, to amend the FTC Act to grant each federal banking agency the authority to prescribe regulations governing unfair or deceptive acts or practices with respect to the institutions each such agency supervises. The authority in H.R. 3526 would be a helpful addition to our present enforcement authority, and would enable us to improve our ability to address egregious and pervasive practices on an industry-wide basis. Including the perspectives of the supervisor of some of the nation's largest banks and the perspectives of the supervisor of the largest number of banks as well as the deposit insurer would provide valuable input and expertise to the rulemaking process.

[20] While it lacks rulemaking authority, the FDIC will take appropriate action pursuant to its authority under Section 8 of the FDI Act when unfair or deceptive trade practices are discovered at state-chartered banks under its supervision.

Comments on H.R. 5244

The FDIC views H.R. 5244, the Credit Cardholders Bill of Rights Act of 2008, as a balanced and constructive effort to address many of the most problematic credit card practices in an effective way.

Competition and innovation in the credit card market has sometimes outstripped the ability of the regulatory process to expeditiously address practices that may be unfair to consumers. Further, the disclosures required by TILA, while useful, are not necessarily sufficient to fully inform consumers about the prices and terms of credit products or to protect them from abusive practices. H.R. 5244 addresses many of the concerns the FDIC and others have identified as questionable credit card practices. As we have seen repeatedly, loan products that trap consumers in debt they cannot repay raise significant concerns for safety and soundness, as well as consumer protection.

Key Provisions

H.R. 5244 addresses a number of the most troubling credit card practices, several of which raise supervisory and consumer protection concerns no matter how clearly they are disclosed. These practices include: universal default; double-cycle billing; payment allocation to the lowest rate portion of the balance; and inconsistent and punitive billing practices.

Universal Default: In utilizing universal default, an issuer increases rates when a cardholder fails to make payments to other creditors or has an overall decline in his or her credit score. The result is that a cardholder who repays on time still may be assessed a higher interest rate because the cardholder made a late payment to another creditor, or has incurred a significant amount of additional debt. Employing this practice may materially worsen a cardholder's financial condition, contributing to the cardholder's overall level of financial distress and reducing incentives to stay current. This has potentially serious implications for ultimate debt repayment, and raises risk management concerns.

H.R. 5244 would address universal default by prohibiting a creditor from increasing the annual percentage rate (APR) applicable to an outstanding account balance due to adverse information about a borrower in a credit report or as a result of a change in their credit score, other than borrower actions or omissions directly connected to the account in question. This provision is a reasonable approach that both reduces the likelihood that increasing payment amounts will undercut the ability of the borrower to repay, as well as preserving for the lender the flexibility to use risk-based pricing for amounts borrowed in the future.

Double-Cycle Billing: Under double cycle billing, when a cardholder fails to pay the entire balance of new purchases by the due date, the issuer, despite the cardholder's having no previous balance, computes interest on the original balance that had previously been subject to an interest-free period.[21] H.R. 5244 prohibits double-cycle billing, providing that creditors may not impose or collect an interest charge on the portion of credit that was repaid on time. The complex nature of double-cycle billing practices and calculations do not lend themselves to clear and concise disclosure that effectively communicates usable information to consumers.

Payment Allocations: In this practice, varying interest rates are tied to account usage, but the issuer applies payments first to the portion of the account with the lowest rate. As a result, balances on different tiers may shrink or grow disproportionately as payments are made by a customer. Allocating payments to the balance with the lowest interest rate effectively increases the overall interest payments for the customer. H.R. 5244 would end that practice by providing that if a credit card account accrues interest at two or more different APRs, each periodic payment must at least be allocated among the outstanding balances at each APR at the proportion each balance bears to the total balance.

Billing Practices: A variety of billing practices that have been used by the credit card industry generate confusion and complaints by consumers. H.R. 5244 addresses a number of these practices.

For example, the bill would address the so-called "any-time any-reason" clauses regarding changes in terms. Credit card agreements that reserve the right of issuers to

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[21] *See* GAO-06-929, Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers (GAO Report), "How the Double Cycle Billing Method Works," p. 28, Figure 6.

change their terms at any time or for any reason render illusory the value of those agreements as contracts or as a means for consumers to understand the potential cost of credit. While there are legitimate reasons for lenders to change the terms of a credit agreement over time, those reasons should be clearly described so that consumers understand the terms they are accepting and can set their expectations accordingly. Issuers should specify in their agreements the reasons they will change the terms of the agreement, at least for interest rates, fees, and the borrower's line of credit.

Under the terms of H.R. 5244, creditors would be prohibited from changing the terms of an agreement until renewal, except for specific material reasons articulated in the agreement at the time of account opening. This approach allows creditors to adjust the terms of accounts for changing risks while at the same time providing borrowers with important account information in a manner that allows them to appropriately manage their use of the credit.

Another difficulty cardholders face is that "any-time any-reason" changes to their credit agreement may be coupled with very short advance notices. The combined impact of these two practices force cardholders to either accept the change or immediately pay off any balance – which many cardholders cannot do. TILA/Regulation Z currently requires only that creditors mail or deliver a notice of change in terms 15 days prior to the effective date.[22] There is no requirement that borrowers be given the opportunity to pay off the account on its existing terms.

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[22] 12 C.F.R. §226.9(c).

H.R 5244 would increase the notice period for changes to the APR[23] to at least 45 days and consumers would be permitted to cancel the account without penalty and repay any balance due under the current terms. The consumer could exercise the right to cancel at any time during the period between when they receive the notice and when they receive the third periodic statement after the effective date of the increase. This provision of the bill allows creditors to adjust their terms while providing consumers a genuine opportunity to opt out. The Committee may wish to consider whether these same provisions also should apply to other fees, especially penalty fees. This is a particular issue with respect to subprime credit cards (as well other types of subprime credit), where the fees are often more onerous than the interest rate and the cards are structured in a way that makes it difficult to avoid incurring fees.

Subprime Cards: Practices in the subprime credit card area are often particularly egregious. These include inadequate or deceptive marketing and account disclosures, as well as credit products that have little or no credit availability left following the assessment of opening and other fees -- so-called "fee harvester" cards. Fees associated with the product, which in the case of subprime cards can be very sizable, may result in depletion of the available credit.[24] Practices also include card programs with features and requirements that produce frequent and excessive fees and penalties that result in a debt spiral, along with abusive collection practices.

[23] Except for introductory rates or changes to another interest rate to which the APR is indexed.
[24] *See* "Fee Harvesters: Low-Credit, High-Cost Cards Bleed Consumers," National Consumer Law Center, November 2007, www.consumerlaw.org.

H.R 5244 would prohibit creditors from issuing a credit card or reporting the account opening to a consumer reporting agency if the account requires the consumer to pay fees in an amount exceeding 25 percent of the authorized credit in the first year, until payment of such fees is made in full and the payment is not made from the available credit on the card. Based on our experience, the FDIC would also suggest consideration of other approaches, such as restricting use of such fees to reduce available credit, or capping the fees. We would be happy to work with the Subcommittee on a comprehensive restriction of these practices.

The agencies have, on occasion, taken action under Section 5 of the FTC Act against card issuers who effectively provide no credit as a result of the initial fees and the structure of certain subprime credit cards. However, rather than having to make a case-by-case determination of unfairness, it would be more effective to have a bright-line test such as the one embodied in the bill to apply to all offered cards. The Subcommittee also might consider whether, in addition to fees that are charged in conjunction with the account, the 25 percent test should include auxiliary products and services (such as travel programs, insurance, etc.) sold by the card issuer in conjunction with the account. These products often have limited utility and may consume all of the credit not used by the initial fees.[25]

[25] Ibid.

Additional Provisions in H.R. 5244

H.R. 5244 contains a number of other provisions to improve credit card practices. For example, the bill would require creditors to allow consumers to choose whether to prohibit the creditor from completing a transaction that would put the consumer over their credit limit ("over-limit transactions") if the credit plan has an over-limit fee provision for extensions over the limit. In addition, for consumers who opted to allow over-limit transactions, the bill would restrict over-limit fees to one per billing cycle, and would limit their imposition in later cycles.

These provisions would allow consumers to avoid unexpected "over-limit" fees or penalty interest rates, which often significantly increase the cost of credit, particularly for consumers with subprime credit cards that have very low credit limits. Very often such consumers have balances that reflect little use of credit for actual purchases, but instead consist of over-limit fees piling on each month, coupled with rapidly increasing interest charges. Even if consumers opt to allow over-limit transactions, the bill's provisions would reduce the disproportionate cost that some currently pay.

Other provisions also address questionable fee increases, such as the bill's prohibition on charging fees in connection with balances that consist only of accrued interest on previously repaid credit, and its prohibition on finding the failure to pay those amounts in a timely manner to be an event of default. These practices substantially increase the cost of credit for consumers.

Finally, the bill addresses consumer concerns about abbreviated due dates that make it difficult for consumers to make timely payments and avoid fees. The bill would require that periodic statements be sent to consumers at least 25 days before the due date. The bill also would require that periodic statements disclose a payment due date, and treat any payment received by 5:00 p.m. EST on that due date as timely. Further, if the borrower has proof of mailing at least seven days prior to the due date, the payment must be presumed timely. This is an improvement over current law. Consumers deserve a fair opportunity to pay their bills on time and avoid additional fees.

Conclusion

The credit card has been an important innovation in consumer finance, allowing consumers greater flexibility to access credit. This flexibility, in turn, has fueled economic growth by making it more convenient for consumers to purchase goods and services. Yet, like all credit, credit cards can create economic hardship if not properly managed or if consumers are confused or misled regarding the terms and conditions of their use. A proper balance needs to be struck. Legislative and regulatory changes, such as H.R. 5244, can help strike that appropriate balance.