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CONGRESSIONAL TESTIMONY

Credit Cards and Consumer Debt

Testimony before
Subcommittee on
Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

April 2, 2009

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Thank you for the opportunity to testify before you today on ways to best change certain credit card practices without damaging the ability of moderate to lower income consumers to get essential credit. My name is David John. I am Senior Research Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Let me make it clear from the start that my purpose today is not to defend in any way abusive credit practices. I find them as abhorrent as others who are testifying this afternoon. However, I also believe that there is a limit to what Congress should do as opposed to having the Federal Reserve and other regulators handle the issue. While detailed legislation on credit card practices may make legislators feel that they have resolved a tricky issue, the wrong approach is far more likely to make the situation for low and moderate income workers in need of credit even worse than it is now.

The credit card industry clearly needs reform. As other witnesses will discuss, a number of practices have developed which are clearly unfair to consumers. However, a legislative remedy for those practices could both be mistaken and detrimental to lower and moderate income borrowers, first time borrowers, and those seeking to repair their credit histories. In addition, the jurisdiction for such legislation lies with the House Financial Services Committee and the Senate Banking Committee. In the Senate, there is one bill, S. 257, the Consumer Credit Fairness Act, which does fall under the jurisdiction of that chamber's Judiciary Committee. However, as I will discuss below, that legislation is badly flawed, and could cause far more problems than it resolves.

The best approach to the problem of abusive credit card practices has already born results. On December 18, 2008, the Federal Reserve Board, Office of Thrift Supervision, and National Credit Union Administration released regulations that will ban most if not all of the abusive practices that will be discussed here. These regulations will greatly increase consumer protections, change the internal practices of issuers, and alter pricing. Violating the rules will carry a penalty that could reach $1 million a day. They were the result of four years of work that included extensive comments, consumer testing, and other work to ensure that the rules did affect the very practices before the subcommittee today.

Among the many changes imposed by the new regulations are:

- Comprehensive changes to credit card statements to ensure that consumers both have and can understand the terms of their cards, what their balance is and how much they need to pay each month, the consequences of late payment, and information about how long it will take the consumer to pay off the balance if he or she just pays the minimum each month. The regulations are very specific on the layout of the new statement, the language used, and the information provided.

- New consumer protections that include limitations on up front fees, a longer period between the time that statements are mailed and payments are due, and a 45 day notice period before higher rates can come into force. These protections and others were specifically targeted to respond to the complaints consumers made.

- Many abusive practices are banned. These include increasing interest rates on both current balances and certain future balances, paying off low interest rate credit first and higher credit rate purchase only after the earlier balances have been paid in full, and double cycle billing. Again, the regulations target the explicit practices that consumers most complain about.

As with all such changes, these regulations will have an effect on the availability of credit to customers with less than perfect credit histories. While credit cards will be cheaper for many customers, others will find it harder to get them. This is likely to force some customers to other types of lenders, and deny credit entirely to others.

Some have complained about the delay in implementating the new regulations. This impatience is understandable, for the practices being banned are often detestable. However, given that the affected companies will need to reprogram computers, completely redesign credit card statements, and retrain employees, the delay can be justified. Legislation is unlikely to speed the process to any appreciable extent.

In addition, legislation bears its own risks. The simple fact is that in situations like these, regulations are easier and faster to adapt t cover new abuses that may develop over time. Given that in any business it is likely that someone will seek additional profits by circumventing the rules, an alert regulator is likely to catch and deal with the situation long before legislation could be amended to catch it.

One approach that some legislation has taken is to attack high interest lenders under the belief that defining certain interest rates as abusive could have the perceived benefit of affecting both some credit card issuers and other types of lenders. The bill that I referred to in the Senate, S. 257, seeks to deny any high interest debt as defined in the bill the ability to receive any relief in a bankruptcy filing. Supporters of this approach believe that reducing the impact of high interest lenders cannot be anything but beneficial for their customers.

Unfortunately, economic literature on the economic effect that high interest lenders have on their customers is spotty, with many studies as interested in proving a point as in objective research. Activists take it for granted that there is a "debt trap" where customers of high interest lenders find themselves deeper and deeper in debt to the lender as interest rates and fees combine to make it impossible for them to repay their loans. Such a trap may well exist in both specific cases and in general. However, there is research from the New York Federal Reserve Bank[1] which suggests that the debt trap may not exist in all situations, and in fact some consumers may be better off with the presence of high interest lenders than they are without them. This paper looks at Georgia and North Carolina after payday lenders were banned, and found higher incidences of bounced checks, complaints about the collection methods of lenders and bankruptcy filings after the ban than before it. This suggests that high interest lenders meet a definite need, and raises questions whether a too stringent approach to credit card practices may end up causing more problems than it solves.

[1] Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans", Federal Reserve Bank of New York Staff Report no. 309, November 2007 revised February 2008, at:

The first question is who would be the affected borrowers. While it is clear from many data sources that individuals from any and all socio-economic levels can be customers of high interest lenders due to either sudden income shocks or poor financial management skills, the largest proportion of customers fall into three groups. These are low-to-moderate income workers who have limited access to other credit sources either because of low income, poor credit histories, or the simple fact that few banks and other lenders have branches that are easily accessible to these consumers. Second are first time borrowers who may have high potential to become good credit consumers, but for now have no credit history and no one willing to co-sign their loan application. Finally, there are consumers who have poor credit histories or who may have just emerged from bankruptcy, and are seeking to rebuild their credit records.

Credit products are primarily priced by the risk of the customer. Thus, customers with either poor credit histories or none at all, can expect to pay significantly higher interest rates than those with better credit records. The high interest rates cover significantly higher chance of default along with much higher collection costs. However, these high rates are usually temporary. As new borrowers demonstrate their ability to responsibly handle credit, they qualify for lower and lower interest rates, often by switching lenders. The same is true for borrowers with poor credit records who are seeking to restore their reputations.

While it may seem that legislation such as S. 257 would encourage lenders to reduce their interest rates to these borrowers so that they will fall below the caps in this legislation, it will not. For responsible lenders who base their interest rates and fees on the risk that the borrower will either not repay the loan or that it will require extensive contact with him or her to get payments, a very costly process, the added risk that such products will not be recoverable in bankruptcy will simply result in their withdrawing from the market. The products will become too risky for reputable financial institutions to offer.

Certain other reputable lenders will continue to offer products to these borrowers, and may even lower their fees, but they will increase the requirements to qualify for such loans in a way that will reduce the number of potential customers. The combination of higher credit standards and fewer credit providers will leave high risk borrowers with either no credit available, or force them into the hands of less reputable lenders.

Some less reputable lenders will react to the inability to recover high interest loans in bankruptcy by raising their fees even higher so that they can make their profits faster. Their customers will not find any relief from the passage of this bill. Other even less reputable lenders, who never use the legal system for collections in the first place, will be delighted if the result of this legislation is a rise in the number of consumers forced to use their services.

The sad fact is that changing the interest rates charged for high risk loans is very unlikely to change the demand for them. This is especially true in hard economic times when record numbers of Americans are already losing jobs, having their hours of work reduced, or for other reasons finding it ever harder to meet their financial obligations. At the same time financial institutions are raising credit standards so that fewer and fewer customers qualify for their lowest rate products and raising both fees and interest rates for riskier customers and in many cases cancelling the credit lines of higher risk customers. All of these actions simply serve to increase the demand for higher cost credit products.

These tighter credit standards are likely to last for some time. In addition, recent massive increases in the money supply and federal spending may result in renewed inflationary pressures, which will further increase interest rates. This is where the specific language of bills like S. 257 could cause additional problems.

The bill's definition of "high cost credit consumer transactions" is too broad and could encompass transactions that no one regards as usurious, especially as regards "costs and fees". This would subject more lenders to having their loans disallowed when borrowers file for bankruptcy – perhaps, in some cases, to that lender's great surprise. The bill's definition specifically includes any credit transaction where the combination of interest rate and fees exceeds "at any time while the credit is outstanding" the sum of 15 percent plus the yield on 30-year Treasury bonds.

Under this definition, a traditional 30-year mortgage issued in October 1981 when mortgage interest rates peaked at an 18.45 percent annual percentage rate came under the bill's definition as a "high cost credit consumer transaction" in December of 2008, when the interest rate on 30-year Treasury bonds dropped to 2.87 percent. Depending on fees paid during closing, it may have come under the bill's definition well before then.

The bill's definition is even more stringent than that contained in the last Congress' H.R. 3915, the Mortgage Reform and Anti-Predatory Lending Act of 2007, which limited its reach to loans where the rate exceeded a spread over a Treasury bond rate on "the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor." S. 257's open ended liability places any fixed rate loans made during periods of high inflation at risk of being considered as high cost credit and being inexcusable under bankruptcy.

Other areas of the bill are also troubling. By granting a bankruptcy filer "who has any debts arising from a high cost consumer credit transaction" relief from requirements that those who have sufficient income to repay some of their debts must do so before receiving a discharge, this language invites gaming of the system. A prospective filer could take out a small, high-interest-rate loan for the express purpose of getting into Chapter 7 rather than Chapter 13 and thus avoiding any obligation to repay from future income. Such a loophole would provide hundreds of new customers for the very lenders that proponents claim to oppose, some of whom might be directed to the lenders by less reputable bankruptcy attorneys. This provision effectively guts the 2005 bankruptcy reforms.

In conclusion, legislation like S. 257 is unlikely to reduce high interest rate lending. Indeed, this is true of just about any legislative approach to this issue. All that it is likely to do is to either make it harder for certain populations to find credit at all, or to make it even more expensive for them to do so. The sad fact is that the customers of such lenders only utilize them because those customers have no other choice. The demand for those credit services will be there no matter what the cost. Any bill which is essentially a price cap or attempted prohibition is not likely to reduce that demand at all.

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