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Statement of

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Madam Chair Maloney, Ranking Member Gillmor, members of the Subcommittee, I appreciate the opportunity to discuss the Federal Reserve Board's May 23, 2007, proposal to revise the credit card disclosures required by current Truth in Lending Act (TILA) regulations. The Board's proposed revisions to Regulation Z, which implements TILA, also apply to other revolving credit accounts not secured by a residence. However, I will focus my remarks on credit cards, the subject of this hearing and by far the most common form of open-end accounts that are not home-secured.

Many more households have obtained credit cards since the Board last reviewed TILA regulations comprehensively in 1981. In the early 1980s, less than half of American families had at least one general purpose credit card (43 percent in 1983), and now close to three quarters have at least one (71 percent in 2004). The increase was sharpest among lower-income families. From 1983 to 2004, the share of families in the lowest income quintile that hold a credit card jumped from 11 percent to 37 percent. Not only are more consumers holding credit cards, consumers are using their cards more. Total charges on credit cards increased by about four times from 1991 to 2004 alone.[1]

Growth in credit card use is explained in part by consumers switching from other forms of credit such as installment loans. Growth has also been enhanced by changes in consumer preferences related to the convenience and security of using card forms of payment rather than cash. Another substantial contributor has been the development of credit scoring and risk-based pricing, which has increased use of credit cards by consumers who traditionally lacked access because of poor or limited credit histories.

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[1] Board of Governors of the Federal Reserve System (2006), Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency (Washington: Board of Governors of the Federal Reserve System), tables 3 and 6.

As credit cards have become more commonplace, they also have become more complicated. Even a relatively simple credit card account is more complex than the fixed-payment installment loan it may have replaced. Moreover, most credit cards can no longer be described as relatively simple. Once, a card may have allowed the user to make purchases or obtain cash advances and applied a single annual percentage rate, or APR, to each feature. Fees were limited to a fee for cash advances, an annual fee on the account, and perhaps a fee if the consumer paid late. Today, a card may also offer balance transfers and treat different classes of purchases and cash advances as different features, each with its own APR. These APRs adjust much more frequently to respond to changes in the market or to changes in a borrower's credit risk profile. The typical card no longer has an annual fee, but it has many other fees tied to a variety of features, or to requirements of the credit agreement, or to a growing number of optional services.

All of these developments have joined to produce the seeming paradox that credit cards are both widely used and widely criticized. The Board is keenly aware of concerns over the fairness and transparency of card marketing and account terms. There is, for example, a concern that issuers advertise low introductory rates while downplaying that these rates can increase sharply. Observers worry that the varied reasons that rates can increase, sometimes by a factor of two or three, are not made clear when the consumer applies for the card, starts to use it, or builds up a substantial balance. Further, there are concerns that issuers' methods of calculating interest, such as the ways they choose to allocate customers' payments to different balances, are confusing or not clearly disclosed. More broadly, the presence in the market of terms seemingly unfavorable to consumers appears to some to indicate that the market is not fully competitive.

The Board's Goals and Process

The goals of our proposed revisions to credit card disclosures are to aid consumer decisionmaking and improve competition. More effective disclosures make information about terms and pricing easier for consumers to obtain and understand. When that happens, individual consumers are less likely to fall into "traps for the unwary" and are more able to choose products that offer the best combination of features and pricing to meet their personal financial needs. Better dissemination of information about credit card terms and pricing also enhances competition among credit card issuers, which, in turn, helps generate products that consumers want.

To achieve these goals, the Board's proposal seeks to ensure that consumers receive key information about the costs of credit card transactions in ways they can understand, in formats they can use, and at times when it is most helpful. To help us craft a proposal to meet these specific objectives, we considered the traditional sources: public input we received in over 250 comment letters, available sources of data and information, and our own long experience implementing TILA. We also considered what consumers, themselves, had to say. As part of extensive consumer testing, we interviewed consumers individually about their use and understanding of different disclosures. Consumers told us what information they find useful when making credit decisions and what information they ignore. We learned which words and formats for presenting information promote understanding and which do not. These lessons are reflected in a myriad of preliminary judgments we have made about appropriate disclosure content, format, and timing.

The judgments required were not always clear-cut. Frankly, it is sometimes difficult to determine which transaction terms are most important because consumers use credit cards in many different ways. It is also difficult to determine how much information about those terms is enough; what information should be highlighted, and what should be disclosed less prominently; what information should be disclosed early on in the transaction, and what can be reserved for later. The Board also must balance a rule's specificity, which makes disclosures more consistent and reduces the risk of non-compliance, with its flexibility, which reduces operational burdens and ensures that disclosures can be adapted to changes in credit products and practices. In addition, the Board tried to ensure that creditor compliance and operational burdens are justified by the expected benefits to consumers and competition, and to reduce existing burdens if they are not warranted.

Developing effective credit card disclosures is particularly challenging because of the complicated and dynamic nature of the product. First, explaining the effective cost of credit before the consumer uses the card is difficult because key elements affecting the cost, such as whether the consumer will pay off balances regularly or carry balances that incur finance charges, are unknown. So TILA requires disclosures that provide consumers several terms that, together, determine the effective cost of credit: the periodic rate and nominal APR, other charges such as fixed and minimum fees, the grace period, and the balance calculation method. Clearly and simply explaining what these terms mean and how collectively they determine the cost of credit is difficult. Second, effectively disclosing credit card pricing becomes more difficult as credit card pricing grows more complex with the spread of risk-based pricing and penalty pricing and the "unbundling" of the price of a credit card into many different types of rates and fees. Clearly explaining costs contingent on future events that might seem remote when disclosures are made and promoting awareness of the total cost--not just component costs--pose additional challenges. Third, credit card pricing and features will continue to change, which means that we must try to craft disclosure requirements that work today and as products change.

The Board's Proposal

Taking all of this into account, the Board has developed a comprehensive proposal to revise Regulation Z that includes the following specific elements:

- Advertisements of introductory rates would more clearly disclose the eventual higher rates and how soon they would be imposed;
- Advertisements of "fixed" rates would be restricted to rates that are truly not subject to change, either for a clearly disclosed period or for the life of the plan;
- The "Schumer box" required with credit card solicitations and applications would be updated to more effectively present information about rates and fees. As can be seen in the attached model form, the most critical rate and fee information would be presented in the box; rates and fees would be separated into two sections; and graphic techniques such as minimum font size, judicious bolding, and vertical alignment of key numbers would make it easier to read and use;
- Summary tables similar to the Schumer box would accompany the lengthy, complex credit agreements that consumers receive both when they first open an account and would also be provided, later, when account terms are amended. A model of this new disclosure is attached;
- The penalty rate and penalty fees would be highlighted in the Schumer box and the account-opening summary table; and a reminder of late payment penalties would appear on every periodic statement;
- A consumer would be sent notice forty-five days before a penalty rate was imposed or the rate was increased for other reasons;
- The cumulative cost of fees would be highlighted every month, as can be seen in the attached model of a periodic statement. Fees charged in the last cycle would be grouped

together on the statement in a prominent location and totaled for the cycle and year-to-date;

- The periodic statement's "effective APR," another way of disclosing the total cost of credit, is the subject of two alternative proposals. Under one, the effective APR could be revised to make it simpler for creditors to compute and potentially easier for consumers to understand. Under the other, if continued consumer testing, the public comments and the Board's analysis indicate that the effective APR does not have a meaningful benefit, then it could be eliminated, as the statute authorizes;
- Consumers would be warned on the periodic statement about the higher cost of making only minimum payments, and creditors would be provided incentives to give consumers a more precise estimate of the time to repay the balance and to place that estimate on the periodic statement rather than make it available by telephone; and
- Creditors would receive clearer guidance as to what charges must be disclosed, when, and how, along with increased flexibility to disclose charges at times and by methods more convenient to the creditor and consumer alike.

We are committed to providing the public a meaningful opportunity to evaluate and comment on these and other elements of the proposal, most of which are detailed in Appendix I. The Board has posted to its web site a lengthy report of its consumer testing, which forms the basis for major elements of the proposal, and has explained the reasons for the proposal in some detail in over 300 pages of "supplementary information." The public has four months to submit comment letters, which the Board expects will contain many useful responses and suggestions.

I want to say more about two elements of the proposal that we expect will elicit vigorous comment. The first is the proposed new notification requirement when rates are raised. With some exceptions, the current regulation requires that notice be mailed fifteen days before a rate increase takes effect. The Board is concerned that this notice can leave consumers too little time to react and possibly to shop for alternative sources of credit or pay off the existing credit card balance under existing terms. Further, one of the current exceptions to the fifteen-day notice requirement is for rate increases that are penalties (for example, for exceeding the credit limit). The Board believes that consumers will not necessarily anticipate penalty-based rate increases when the penalty was disclosed in credit agreements they received months, or even years, earlier. Thus, the Board has proposed to lengthen the notice period for a rate increase to forty-five days and require advance notification of penalty-based rate increases as well. In practice, consumers would have the benefit of more than a month to pursue their options, and creditors would forego collecting some interest revenue. The Board wants to receive comments addressing whether the costs are justified by the benefits.

The two alternative proposals concerning the effective APR on the periodic statement also are expected to elicit vigorous comment. The effective APR reflects the cost of interest and certain other finance charges imposed during the statement period. As an example, a cash advance carries an effective APR that reflects both interest assessed on the balance in the billing period and any fee charged by the creditor for the cash advance. The effective APR can be quite high, often much higher than the nominal APR, in part because it amortizes the cost of credit, including fees, over one month. Although consumer groups argue that the resulting “sticker shock” helps consumers make better credit shopping and account management decisions, creditors argue that it confuses consumers and misleads them to think the cost of credit is higher than it is.

Consumer testing conducted for the Board suggests that many consumers have a limited understanding, if any, of the effective APR, but it also suggests that clearer presentation of the disclosure can improve understanding. Thus, the proposal seeks to present the effective APR more clearly to consumers with more straightforward terminology and better formatting that promotes understanding. In addition, the proposal seeks to improve consumer understanding and reduce creditor uncertainty by specifying more clearly than the present regulation which fees are to be included in the effective APR. However, because of inherent limitations of the calculation--such as the need to assume the repayment period--and continued concern that adequate consumer understanding may be difficult to achieve, the Board is also seeking comment on an alternative proposal to eliminate the disclosure. When evaluating these two alternatives, and any others the public comments might suggest, the Board will consider the comments as well as the results of additional consumer testing.

Conclusion

Madam Chair, in closing, let me emphasize the Federal Reserve’s commitment to ensuring that consumers get key information about credit card terms in ways they can understand, in formats they can use, and at times when it is most helpful. We appreciate efforts in the Congress and among consumer groups and the credit card industry to ensure that disclosure practices are in line with the needs of consumers. As my testimony this morning indicates, more complex pricing and continuous change in the marketplace make the task of writing rules for effective disclosure challenging. Nevertheless, the combination of extensive review, substantial public input, and systematic consumer testing has enabled us to propose changes that we believe will further the original goals of the Truth in Lending Act to promote economic stability and competition through the informed use of credit. I look forward to our continuing efforts in this regard, and I am happy to address any questions you might have.