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"Credit Card Practices: Current Consumer and Regulatory Issues"

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Chairwoman Maloney, Ranking Member Gillmor, and Members of the Subcommittee, thank you for inviting me to testify today. My name is Cindy Zeldin, and I am here representing Dēmos, a nonprofit, nonpartisan research and public policy organization working on issues related to economic security. As part of our ongoing work on these issues, Dēmos has conducted extensive research on consumer debt, particularly credit card debt, at the household level.

We approach our work on credit card debt and lending industry practices through the lens of rising insecurity among low- and middle-income households in a rapidly changing economy. Against an economic backdrop simultaneously characterized by stagnant incomes at the median and the rapidly rising costs of big-ticket necessities like housing, health care, and education, our nation has witnessed tremendous growth in credit card debt over the past two decades. Credit card debt has roughly tripled since 1989, with Americans owing more than $800 billion in credit card debt today.[1]

At the same time as our economy has undergone major changes, the banking and financial industry has been steadily deregulated. While deregulation has expanded access to credit for many people who had been denied or excluded from mainstream financial services in the past, this credit has come at a high cost. It is low- and moderate-income households whose levels of credit card debt have increased the most in recent years, and our research indicates that these households are increasingly turning to credit cards to manage economic shocks like job loss or a major medical expense or to fill in the gap between the cost of basic living expenses and stagnant incomes.

The democratization of credit has, in many ways, become our modern day safety net, albeit one that comes with high interest rates and an endless array of penalty fees that are unleashed upon borrowers in response to just the slightest slip-up. With debt service taking a big bite of the household budget, there is less left over to build savings and assets, quickly trapping families in a cycle of debt. Once in debt, the capricious and abusive practices of the lending industry make it exceedingly difficult to climb out. Indeed, the business model of the credit card industry is predicated upon, in the words of Harvard Professor Elizabeth Warren, hidden "tricks and traps" designed to maximize income from interest rates and penalty fees. When a cardholder falters, even just a little, they are placed in what Professor Ronald Mann calls a "sweat box" designed to extract as much in interest and fees as the card issuer possibly can.[2]

The credit card market is a broken market. When consumers initially shop for a credit card, the key element of their comparison shopping is generally the interest rate on the card. Yet this comparison shopping does not represent a well-functioning, competitive marketplace because the card issuer reserves the right to change the terms of the card agreement at any time, for any reason with a 15-day notice. Card issuers make no determination of the ability of a cardholder to repay at the time when they extend the credit card, but rather increase the interest rate retroactively once a consumer is late with a payment, exceeds their credit limit, or even has a change in credit score. Penalty interest rates can be as high as 30 or even 40 percent, with the average penalty APR around 27 percent.[3] Late fees and over-the-limit fees now are in the $29 to $39 range.

Trends in Credit Card Debt

Credit card debt has roughly tripled since 1989, with Americans owing more than $800 billion in credit card debt today.[4] Our national savings rate has steadily declined, and the number of people filing for bankruptcy since 1990 has more than doubled to just over 2 million in 2005.[5] To better understand what these trends mean for low- and middle-income households in today's economy, Dēmos has researched credit card debt trends by analyzing Survey of Consumer Finances data, research which has found that certain demographic subgroups have experienced particularly rapid increases in credit card debt since 1989. These groups are low- and moderate-income households, senior citizens, and young adults under age 34.

The average amount of credit card debt among all households with credit card debt grew 89 percent between 1989 and 2004. The average self-reported balance of indebted households was $5,219 in 2004. It is important to note that the SCF data are based on self-reported amounts of debt by respondents, and there is evidence that consumers tend to underestimate their credit card debt. Table 1 displays average credit card debt, and the percent change in that debt from 1989 to 2004, by income group.

Table 1. Average Credit Card Debt of Households with Credit Card Debt (2004 Dollars)			
Income	**Average Credit Card Debt in 1989**	**Average Credit Card Debt in 2004**	**Percentage Change, 1989-2004**
<$10,000	$622	$2,750	342.5%
$10,000 - 24,999	$1,528	$3,378	121.1%
$25,000 - 49,999	$2,468	$4,831	95.8%
$50,000-99,999	$2,854	$4,667	63.6%
$100,000 - >	$5,856	$7,691	31.3%

Source: Dēmos' Calculations using 1989. 1992, 1995, 1998, 2001 and 2004 Survey of Consumer Finances

Dēmos' report *Retiring in the Red* documented dramatic increases in the amount of credit card debt among older Americans. Roughly three out of every four Americans over 65 hold credit cards. Of these cardholders, slightly more than one in three (35 percent) carried debt in 2004, up from 29 percent in 1989. While the percentage of indebted cardholders increased only slightly, the amount of debt carried by older Americans grew precipitously. Average revolving balances among indebted seniors over 65 increased by 193 percent from 1989 to 2004, from $1,669 to $4,906 (in 2004 dollars).

In our issue brief *Generation Debt*, we examined trends in credit card debt among young Americans. The average credit card debt of Americans aged 25 to 34 years old increased by 51 percent between 1989 and 2004, to a self-reported household average of $4,358. According to the Survey of Consumer Finances, nearly 2 out of 3 young Americans aged 25 to 34 have one or more credit cards, a level basically unchanged since 1989. Compared to the population as a whole, however, young adult cardholders are much more likely to be in debt: 68 percent of young adult cardholders revolve their balances, compared to 58 percent of all cardholders.

The Plastic Safety Net: Findings from Dēmos' National Survey of Low- and Middle-Income Households

To better understand the factors contributing to household indebtedness, Dēmos and the Center for Responsible Lending commissioned a national household survey of households with credit card debt. The survey, conducted in March 2005 by ORC Macro, consisted of 1,150 phone interviews with low- and middle-income households whose incomes fell between 50 percent and 120 percent of local median income—roughly half of all households in the country. In order to participate, a household had to have credit card debt for three months or longer at the time of the survey.

The survey asked a series of questions about what types of expenses in the past year had contributed to the households' current level of credit card debt. Seven out of 10 low- and middle-income households reported using their credit cards as a safety net—relying on credit cards to pay for car repairs, basic living expenses, medical expenses or house repairs. Only 12 percent of households did not report any type of safety net usage, which may indicate a relatively low percentage of credit card debtors who use credit to "live beyond their means," purchasing items that are not critical or necessary.

Table 2: In the past year, please tell me if the following items have contributed to your current level of credit card debt, or not.		
	Yes %	**No %**
Car repairs	48	52
Home repairs	38	63
A major household appliance purchase	34	66
Basic living expenses such as rent, groceries, utilities	33	67
An illness or necessary medical expense	29	71
A layoff or the loss of a job	25	75
Tuition or expenses for college for a child, a spouse or partner, or yourself	21	79
Money given to other family members, or used to pay the debts of other family members	19	81
Tuition or other school-related expenses for a child who is of high school age or younger	12	88
Percent Who Answered Yes		
To none of these expenses:	12	
To one or more	88	
To two or more	71	
To three or more	48	
To four or more:	28	

In addition to asking about specific types of expenses, the survey also asked households whether they had used credit cards in the past year to pay for basic living expenses, such as rent, mortgage payments, groceries, utilities or insurance, because they did not have money in their checking or savings account. One out of three households reported using credit cards in this way—reporting that they relied on credit cards to cover basic living expenses on average four out of the last 12 months. Households that reported losing a job sometime in the last three years and being unemployed for at least two months, as well as households who had been without health insurance in the last three years, were almost twice as likely to use credit cards to pay for basic living expenses. Not surprisingly, households who needed to use credit for their basic living expenses had lower level of savings and higher credit card balances than households who did not use credit cards to pay for their basic expenses.

We also found that households in our survey that reported medical expenses as a factor in their credit card debt had higher levels of credit card debt than those who did not cite medical expenses as contributing to their credit card debt. Overall in the survey, 29 percent of indebted low- and middle-income households reported that medical expenses contributed to their current level of credit card debt. Within that group, 70 percent had a major medical expense in the previous three years. Overall, 20 percent of indebted low- and middle-income households reported both having a major medical expense in the previous three years and that medical expenses contributed to their current level of credit card debt. That subset of households had average credit card debt of $11,623.

Credit Card Industry Practices

The widespread availability of credit cards can help individuals and families weather difficult financial times or manage large, unexpected costs like a major car or home repair. However, the practices of the credit card industry make it exceedingly difficult to pay down this debt.

Deregulation of the industry began with a Supreme Court ruling in 1978. In *Marquette National Bank of Minneapolis v. First Omaha Service Corp*, the Court ruled that Section 85 of the National Banking Act of 1864 allowed a national bank to charge its credit card customers the highest interest rate permitted in the bank's home state—as opposed to the rate in the state where the customer resides.[6] As a result, regional and national banks moved their operations to more lender-friendly states, such as South Dakota and Delaware, where there were no usury ceilings on credit card interest rates. In domino-like fashion, states began loosening their own usury laws. Today, 29 states have no limit on credit card interest rates.[7]

As a result of *Marquette*, credit card companies that are located in states without usury laws and without interest rate caps—all the major issuers—can charge any interest rate they wish, as long as they comply with consumer disclosure rules. The *Marquette* decision allowed banks to nationalize credit card lending and take full advantage of the ease of centralized processing provided by the Visa and MasterCard systems. As a result, credit cards, which were once the province of the wealthy and elite business class, quickly became part of mainstream American culture. Riskier borrowers—often those on the lower end of the income distribution—were brought into the market, and lenders were able to charge higher interest rates to compensate for the increased risk.[8]

In the mid-1990s, further deregulation of the credit card industry again contributed to the increasing costs of credit for consumers. In 1996, the Supreme Court ruled in *Smiley vs. Citibank* that fees could be defined as "interest" for the purposes of regulation. As such, under the rules established by *Marquette*, the laws regulating fees were now to be determined by the state laws in which the bank was located. Prior to the ruling, the card companies were bound by the state laws of the customers' residence. Post-Smiley, credit card companies steadily raised the amount they charged in fees.

On average, interest rates on credit cards have declined over the past 30 years, and well-off consumers who pay their balance in full each month benefit from the convenience and often the rewards programs that credit card companies offer. This group of cardholders has been known to be referred to as "deadbeats" by card issuers, however, because they are not bringing in interest and penalty fee revenue. Of course, credit card companies take in revenue from interchange fees, which all transactions bring in. While interchange fees accounted for $20.62 billion in revenue in 2005, interest brought in $71.13 billion and penalty fees brought in $7.88 billion.[9] The majority of cardholders may not be in the penalty zone, but those consumers who are generate very high profits for the industry. While consumers shopping for a new credit card may not expect that they will ever be subject to penalty interest rates and fees, card issuers routinely invoke these penalty pricing tactics for relatively minor transgressions, turning customers who may have diligently researched and signed up for the credit card with the best rates and terms they could find into retroactively "repriced" default interest rate payers if they are simply tardy with a payment.

Several industry practices are worthy of scrutiny, and I will describe some examples. The first is penalty pricing, or interest rate hikes and fees for an array of infractions, many of which are quite minor and are not necessarily reflective of a cardholder's risk profile. When a payment is late, all the major card issuers typically increase the interest rate on the card to a penalty, or "default," rate (according to the GAO, these rates average 27.3%). Due dates are often listed down to the hour, for example at 1pm on a particular date, and payments received after that time are processed the following day. With payment grace periods no longer in place, cardholders who submit payments that are nominally late are routinely hit with interest rate increases that can drastically increase the cost of credit. It is also important to note that these penalty interest rates are applied retroactively to the entire existing card balance, not simply prospectively to future purchases. Cardholders who are late are also slapped with a late fee. According to a report by the GAO, late fees have steadily increased from the $5 to $10 range in 1990 to an average of $33.64 in 2005.[10] Penalty pricing is also typically invoked when a cardholder exceeds the credit limit on their card. Rather than denying the purchase, it is now routine practice to allow the transaction to go through, but to then increase the cardholder's interest rate retroactively and to apply an over-the-limit fee. According to the GAO, over-the-limit fees averaged $30.81 in 2005.

Card companies should be required to provide a reasonable late-payment grace period to protect responsible debtors from being unduly penalized by a run-of-the-mill tardy payment. Credit card companies should also be held accountable to the original contract with the cardholder for all purchases up to any initiated change in terms, and any change to the APR should be limited to future activity on the card.

The second practice I would like to highlight is universal default, a bait-and-switch practice whereby card issuers retroactively change a cardholder's interest rate not because of any change in behavior with that particular card, but because of a change in the cardholder's credit score or their payment behavior with another lender. While some card issuers have halted this policy, others still engage in it, and still others increase interest rates because of behavior with other creditors but institute these increases through a change-in-terms rather than automatically, which means that cardholders must be given at least 15 days notice under the Truth in Lending Act. According to the GAO, cardholders would have to be given the right to opt out of the change under the laws of the states in which four of the six largest issuers are chartered. However, 15 days may not be sufficient time for a cardholder to make other credit arrangements, and, if a cardholder is required to stop using the card or to pay off the entire balance in a short period of time, opting out may not be a feasible option.

Two other practices highlighted in the recent GAO report on credit cards also deserve attention: payment allocation methods and balance computation methods. Most major card issuers allocate payments first to the portion of the balance that is assessed the lowest rate of interest. In fact, the balance with the lowest interest rate would need to be fully paid before payments can be allocated to the portion of the bill with higher interest. An example of how this might work is when a cardholder transfers a balance from another credit card because a low interest rate was advertised for balance transfers. All payments would be applied to that balance transfer at the low rate, while the previously existing balance (from purchases made with the card) would continue to accrue interest at the higher rate. In the case of balance computation methods, the GAO report drew attention to a practice known as double-cycle billing, whereby cardholders who move from nonrevolving to revolving status are charged interest on their original balance that previously had been subject to an interest-free grace period.

To address these and other industry practices and to restore responsible credit practices and fair lending terms for borrowers, Demos supports legislative changes such as those incorporated in legislation introduced by Senator Menendez (S. 2655) in 2006.

Conclusion

In the absence of meaningful regulation, credit card companies are free to design credit card agreements that are not only confusing in their complexity, but that, once deciphered, are fundamentally unfair. Despite borrowing money under one set of terms and conditions, a borrower can be asked to pay back that money under an entirely different set of conditions for being a day or two late or for going just over their credit limit. Once in penalty territory, households are typically paying interest rates of 27 percent. For low- and moderate-income households, whose levels of credit card debt have increased the most in recent years, these penalty interest rates drain resources from already tight family budgets, inhibiting the ability of these households to pay down their debt, let alone save money to weather future economic shocks.

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[1] Federal Reserve Statistical Release, Consumer Credit, April 6, 2007, available at http://www.federalreserve.gov/releases/g19/Current/g19.htm

[2] See the testimony of Alys Cohen before the Senate Permanent Subcommittee on Investigations, March 7, 2007.

[3] GAO, "Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," September 2006.

[4] Federal Reserve Statistical Release, Consumer Credit, April 6, 2007, available at http://www.federalreserve.gov/releases/g19/Current/g19.htm

[5] American Bankruptcy Institute. "U.S. Bankruptcy Filings 1980-2005."

[6] Vincent D. Rougeau, "Rediscovering Usury: An Argument for Legal Controls on Credit Card Interest Rates," *University of Colorado Law Review*, Winter 1996.

[7] Lucy Lazarony. “States with Credit Card Caps.” Bankrate.com, March 20, 2002. <www.bankrate.com/brm/news/cc/20020320b.asp>

[8] David A. Moss and Johnson A. Gibbs, “The Rise of Consumer Bankruptcy: Evolution, Revolution or Both?,” 1999 National Conference of Bankruptcy Judges, p 13.

[9] Testimony of Elizabeth Warren before the Senate Banking Committee, January 25, 2007, data from CardWeb

[10] GAO, “Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers,” September 2006.