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Hearing on  
“Credit Card Practices: Current Consumer and Regulatory Issues”

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This testimony with all Figures and the academic articles referenced herein are available for download on my website at <http://mason.gmu.edu/~tzywick2/>.

TODD J. Zywicki is Professor of Law at George Mason University School of Law, Editor of the *Supreme Court Economic Review*, and Senior Fellow of the James Buchanan Center, Program on Politics, Philosophy, and Economics. From 2003-2004, Professor Zywicki served as the Director of the Office of Policy Planning at the Federal Trade Commission. He teaches in the area of Bankruptcy, Contracts, Commercial Law, Business Associations, Law & Economics, and Public Choice and the Law. He has also taught at Georgetown Law Center, Boston College Law School and Mississippi College School of Law and is a Fellow of the International Centre for Economic Research in Turin, Italy. He has lectured and consulted with government officials around the world, including Italy, Japan, and Guatemala. Professor Zywicki has testified several times before Congress on issues of consumer bankruptcy law and consumer credit. Professor Zywicki is a Member of the United States Department of Justice Study Group on "Identifying Fraud, Abuse and Errors in the United States Bankruptcy System." He is the author of the forthcoming books, *Bankruptcy and Personal Responsibility: Bankruptcy Law and Policy in the Twenty-First Century* (Yale University Press, Forthcoming 2007) and *Public Choice Concepts and Applications in Law* (West Publishing, Forthcoming 2008).

Professor Zywicki clerked for Judge Jerry E. Smith of the U.S. Court of Appeals for the Fifth Circuit and worked as an associate at Alston & Bird in Atlanta, Georgia, where he practiced bankruptcy and commercial law. He received his J.D. from the University of Virginia, where he was executive editor of the Virginia Tax Review and John M. Olin Scholar in Law and Economics. Professor Zywicki also received an M.A. in Economics from Clemson University and an A.B. cum Laude with high honors in his major from Dartmouth College.

Professor Zywicki is the author of more than 50 articles in leading law reviews and peer-reviewed economics journals. He is one of the Top 50 Most Downloaded Law Authors at the Social Science Research Network, both All Time and during the Past 12 Months. He served as the Editor of the *Supreme Court Economic Review* from 2001-02. He is a frequent commentator on legal issues in the print and broadcast media, including the *Wall Street Journal*, *New York Times*, *Nightline*, *The Newshour with Jim Lehrer*, CNN, CNBC, Bloomberg News, BBC, *The Diane Rehm Show*, and *The Laura Ingraham Show*. He is a contributor to the popular legal weblog The Volokh Conspiracy. He is currently the Chair of the Academic Advisory Council for the following organizations: The Bill of Rights Institute, the film "We the People in IMAX," and the McCormick-Tribune Foundation's "Freedom Museum" in Chicago, Illinois. He was elected an Alumni Trustee of the Dartmouth College Board of Trustees.

It is my pleasure to testify today on the subject of “Credit Card Practices: Current Consumer and Regulatory Issues.” The growth in the consumer use of credit cards over the past three decades has transformed the American economy, placing in consumers’ hands one of the most powerful financial innovations since the dawn of money itself. Credit cards have transformed the ways in which we shop, travel, and live. They have enabled the rise of the E-Commerce economy, delivering goods and services to consumers’ doorsteps and permitting consumers to shop when and where they like, unconstrained by traditional limits on competition and consumer choice. They have enabled consumers to travel the world without the inconvenience of travelers’ checks. And they have transformed the way in which we live, from such small improvements such as relieving us the inconvenience of checks and frequent visits to ATM machines to large improvements such as providing security against crime. Credit cards can be used as a transactional medium, a source of credit, or even as a short-term source of cash. Credit cards provide consumers with additional benefits, from cash back on purchases, frequent flier miles, car rental insurance, dispute resolution services with merchants, and 24 hour customer service. It has been aptly observed that that with a credit card you can buy a car; without a credit card you can’t even rent one. Many of these benefits, of course, have been most salient for lower-income, young, and other similar populations, and unsurprisingly, growth in credit card use has been rapid among those populations.

But the myriad uses of credit cards and the increasing heterogeneity of credit card owners has spawned increasing complexity in credit card terms and concerns about confusion that may reduce consumer welfare. American consumers encounter complexity every day in the goods and services they purchase, such as cars, computers,

and medical services, just to name a few. And the complexity of credit card terms is modest when compared to that of the Internal Revenue Code, as are the penalties (financial and otherwise) for failure to understand its terms. The relevant issue for regulation, therefore, is whether the complexity is warranted in light of its benefits.

In considering whether further legislation or regulation of credit card terms or disclosures is appropriate, two questions should be considered. First, what is the problem to be corrected through regulation? And second, will the benefits of the regulation justify the costs, including the unintended consequences of the regulation?

Based on what is known about consumer use of credit cards and credit card practices, it is doubtful that an analysis of these simple questions can justify further governmental intervention in the credit card industry. In fact, the increasing dynamism of the credit card industry suggests that regulators would be better served by revisiting, modernizing, or reconsidering certain extant regulations, rather than piling additional new regulations on top of old.

This is not to imply that certain credit card issuers or practices may not seem unfair or improper. But there are ample tools for courts and regulators to attack deceptive and fraudulent practices on a case-by-case basis when they arise. Unlike case-by-case common law adjudication, however, legislation or regulation addresses itself to *categorical* rulemaking, thus before categorical intervention is warranted it is necessary to examine whether categorical problems have arisen.

I have taught and written extensively on questions related to credit cards, consumer credit generally, and the relationship between consumer credit and consumer bankruptcies. Several years ago I published *The Economics of Credit Cards*, 3 CHAPMAN

L. REV. 79 (2000).<sup>1</sup> I have also published *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NORTHWESTERN L. REV. 1463 (2005),<sup>2</sup> as well as *Institutions, Incentives, and Consumer Bankruptcy Reform*, 62 WASHINGTON & LEE L. REV. 1071 (2005).<sup>3</sup> I am currently working on a book on consumer credit and consumer bankruptcy tentatively titled *Bankruptcy Law and Policy in the Twenty-First Century* to be published by the Yale University Press, from which portions of this testimony are drawn. I am honored to have the opportunity to share my research with you here today. From 2003-2004 I served as Director of the Office of Policy Planning of the Federal Trade Commission.

### **What is the problem to be corrected through regulation?**

Advocates of greater regulation have alleged three problems that are purported to justify additional regulation of the credit card market: (1) Consumer overindebtedness caused by access to credit cards, (2) Unjustifiably “high” interest rates on credit cards, and (3) A growing use of so-called “hidden” fees. Reviewing the empirical evidence available on these issues, however, there is no sound evidence that any of them present a meaningful problem for which greater regulation is appropriate.

#### **(1) Consumer Overindebtedness**

There is no doubt that consumer use of credit cards has increased over time, as has credit card debt. But available evidence reveals that this increase in credit card debt has not in fact resulted in an increased financial distress for American households. Instead, this increased use of credit cards has been a *substitution* from other types of

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<sup>1</sup> Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=229356](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229356).

<sup>2</sup> Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=587901](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587901).

<sup>3</sup> Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=681483](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=681483).

consumer credit to an increased use of credit cards.<sup>4</sup> For instance, when consumers in earlier generations purchased furniture, new appliances, or consumer goods, they typically purchased those items “on time” by opening an installment loan and repaying the loan in monthly payments or through a layaway plan. A consumer who needed unrestricted funds to pay for a vacation or finance a car repair would typically get a loan from a personal finance company or a pawn shop. Today, many of these purchases and short-term loans would be financed by a credit card, which provides ready access to a line of credit when needed, without being required to provide a purchase-money security interest, dealing with the up-front expense and delay of a personal finance loan, or pawning goods.<sup>5</sup> Credit cards are far more flexible and typically less-expensive than these alternative forms of consumer credit, thereby explaining their rapid growth in consumer popularity over time. Federal Reserve economist Tom Durkin observes that credit cards “have largely replaced the installment-purchase plans that were important to the sales volume at many retail stores in earlier decades,” especially for the purchase of appliances, furniture, and other durable goods.<sup>6</sup> Former Federal Reserve Chairman Alan Greenspan similarly observed, “[T]he rise in credit card debt in the latter half of the 1990s is mirrored by a fall in unsecured personal loans.”<sup>7</sup>

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<sup>4</sup> See Zywicki, *Bankruptcy Law and Policy*, Chapter 3.

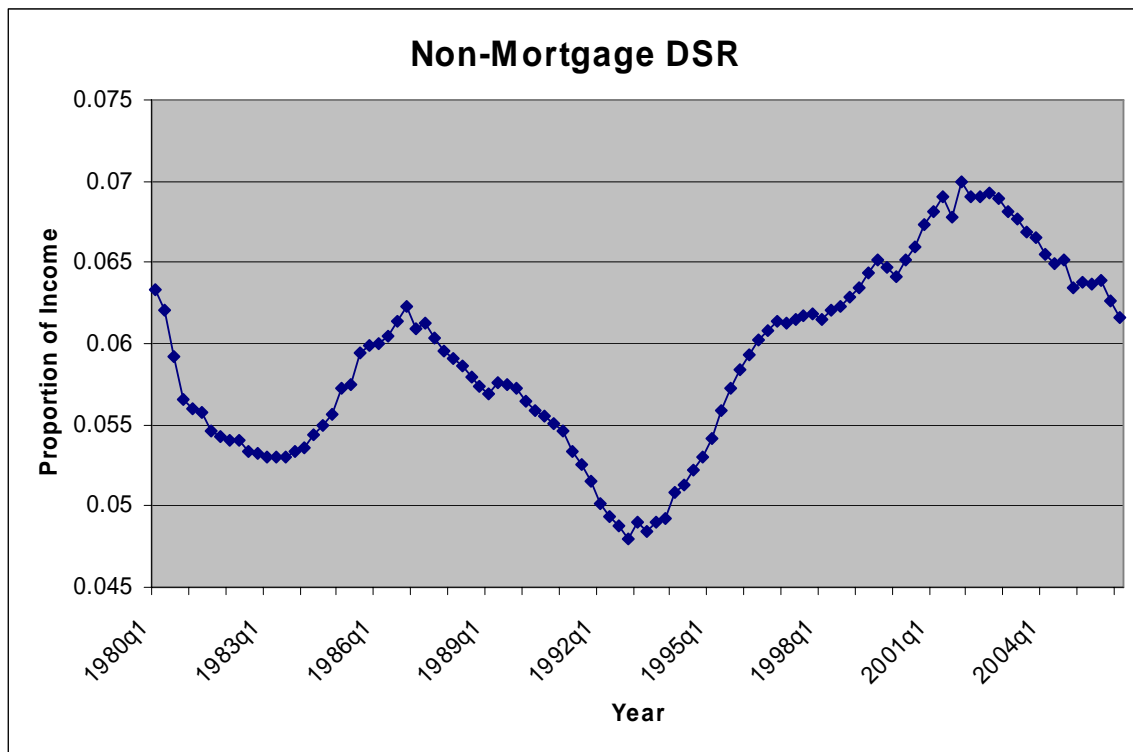
<sup>5</sup> Wal-Mart recently announced, for instance, that it was terminating its once-popular layaway program. Like other major department stores, Wal-Mart acknowledged that this form of credit had become irrelevant because of widespread access to credit cards. Unlike layaway, purchasing goods using a credit card permits the consumer to use the goods while paying them off, whereas under layaway the store keeps the goods until they are paid for.

<sup>6</sup> See Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970–2000*, 86 FED. RES. BULL. 623 (2000).

<sup>7</sup> Alan Greenspan, *Understanding Household Debt Obligations*, Remarks Given at the Credit Union National Association 2004 Governmental Affairs Conference (Feb. 23, 2004), available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040223/default.htm>.

In fact, the evidence suggests that the growth in credit cards as a source of consumer credit is explained almost completely by this substitution effect. Thus, even as credit card use has risen rapidly over time, it does not appear that this has contributed to any increase in consumer financial distress.<sup>8</sup>

Since 1980, the Federal Reserve has calculated on a quarterly basis the “debt service ratio,” which measures the proportion of a household’s income dedicated each month to payment of its debts.

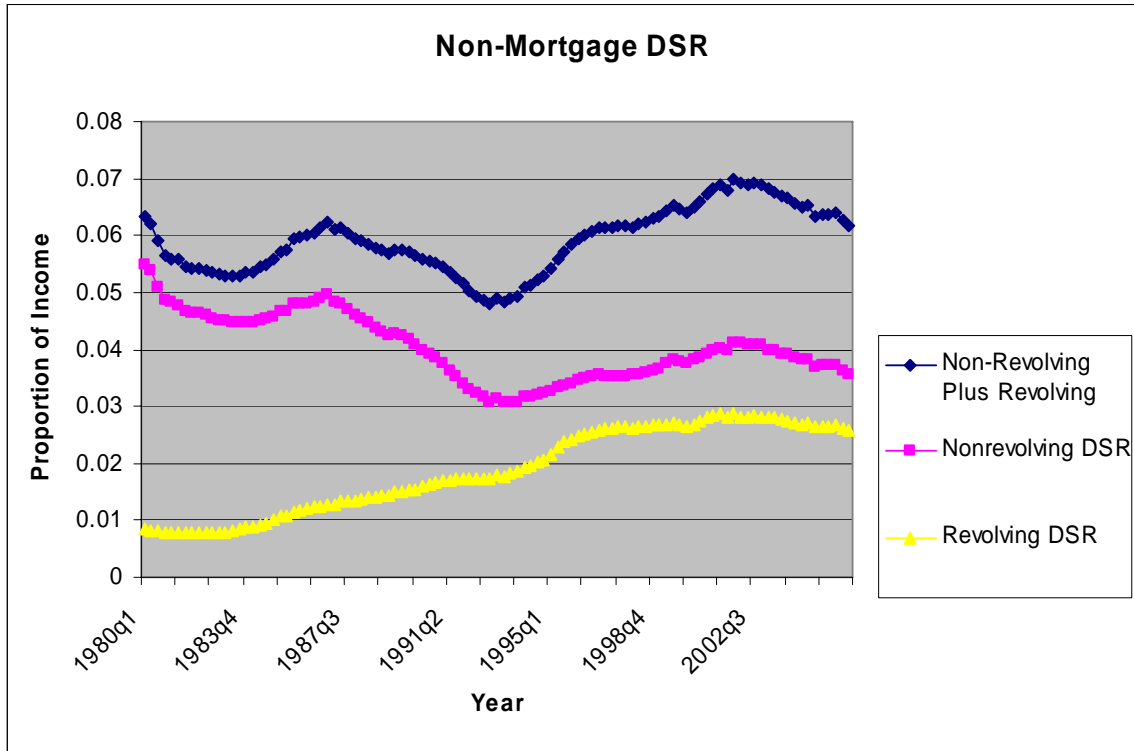


As this figure illustrates, the overall debt service ratio for non-mortgage debt (consumer revolving plus nonrevolving debt) has fluctuated in a fairly narrow band during the period 1980 to 2006. In fact, the non-mortgage debt service ratio was actually

<sup>8</sup>Accord BOARD OF GOVERNORS OF THE FEDERAL RESERVE, REPORT TO CONGRESS ON PRACTICES OF THE CONSUMER CREDIT INDUSTRY IN SOLICITING AND EXTENDING CREDIT AND THEIR EFFECTS ON CONSUMER DEBT AND INSOLVENCY 5 (June 2006) (hereinafter FEDERAL RESERVE REPORT).

slightly higher at the beginning of the data series in 1980 (0.0633) than at the end in the first quarter of 2006 (0.0616) with local peaks and troughs throughout.

Further isolating non-mortgage consumer debt into revolving and nonrevolving components illustrates the substitution effect:



As can be readily observed, from 1980 there has been a gradual downward trend in the debt service burden of nonrevolving installment credit, such as car loans, retail store credit (such as for appliances or other consumer goods) and unsecured loans from personal finance companies, that mirrors the upward trend for the credit card debt service burden over this same period, leaving the overall consumer credit debt service ratio unchanged. Moreover, according to the Survey of Consumer Finances, the percentage of



households in financial distress (as measured by a total debt service ratio, including mortgage credit, of greater than 40%) has fluctuated within a narrow band since 1989.<sup>9</sup>

This substitution effect of credit card for other types of consumer credit has been most pronounced for lower-income debtors, primarily because this group historically has faced the most limited credit options; thus, credit cards are likely to seem especially attractive to them. As a report of the Chicago Federal Reserve Bank concluded, “The increase in the credit card debt burden for the lowest income group appears to be offset by a drop in the installment debt burden. This suggests that there has not been a substantial increase in high-interest debt for low-income households, but these households have merely substituted one type of high-interest debt for another.”<sup>10</sup> As with the overall population, the percentage of lowest-quintile households in financial distress has been largely constant since 1989, and in fact, the percentage of lowest-income households in financial distress is actually at its lowest level since 1989.

In fact, it is likely that this data actually tends to *overestimate* the contribution of revolving debt to the debt service ratio, because of peculiarities in the way in which the debt service ratio is measured. First, there has been a dramatic increase in household wealth holdings over the past decade or so, first because of the roaring stock market of the late-1990s, and then the rapid appreciation in housing values into the 2000s. Because consumers rationally borrow against and consume some percentage their accumulated

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<sup>9</sup> FEDERAL RESERVE REPORT at 13.

<sup>10</sup> Wendy M. Edelberg & Jonas D. M. Fisher, *Household Debt*, CHI. FED. LETTER, Nov. 1997, at 1, 3 (1997); *see also id.* at 4 (“[I]ncreases in credit card debt service of lower-income households have been offset to a large extent by reductions in the servicing of installment debt.”); Arthur B. Kennickell et al., *Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 17 (1997) (noting that the share of families using installment borrowing fell between 1989 and 1995 as a result of increased use of mortgages, credit cards, and automobile leasing); Glenn B. Canner & James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 FED. RES. BULL. 1, 4 (1987) (noting that rise in credit card use may have been the result of “a substitution of credit card borrowing for other types of installment credit that do not provide flexible repayment terms”).

wealth, during periods of rapidly increasing household wealth (such as during the 1990s) consumers would be expected to increase their consumption and consumer debt in order to liquidate some of this accumulated wealth. The ratio of consumer credit to household net worth has been about 4% of household wealth for at least the past 50 years, thus as consumer wealth rises consumers will tend to increase their debt holdings even though their measured income does not increase.<sup>11</sup>

Second, the data used here to measure revolving credit likely tends to overestimate the true amount of revolving credit because of a rise in transactional use over time, an overestimation that tends to grow over time. Revolving credit is measured by the credit card balance *outstanding* at the end of a given month, regardless of whether it is actually revolved or paid off at the end of the billing cycle. As a result, the data also report as part of outstanding revolving credit balances on transactional accounts that will be paid at the close of the billing cycle, but happen to be outstanding at the time of reporting. Because some of this transactional debt is still outstanding at the end of the month, it is recorded as an outstanding debt balance and thus an increase in transactional credit card use will artificially increase the measured amount of revolving credit and overstate revolving credit as a percentage of income.

Transactional or “convenience” use of credit cards as a purchasing rather credit medium has been rising over time, both in terms of number of credit card transactions as well as dollar values. During the past 15 years, convenience use grew by approximately 15% per year, whereas the amount borrowed on credit cards as revolving credit grew

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<sup>11</sup> See Thomas A. Durkin, Comment, *in* THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT 36, 40 (Thomas A. Durkin and Michael E. Staten eds., 2002).

only about 6 ½% per year.<sup>12</sup> In part, the increase in transactional use of credit cards has been driven by the spread of rewards cards, such as cash-back programs or frequent flyer miles.

The mismeasurement of transactional credit card use as credit card borrowing tends to overstate credit card debt by approximately ten percent, a figure that has doubled in the past decade as a result of the rapid rise of credit card convenience use.<sup>13</sup> The percentage of credit card transactions that are paid off at the end of each month relative to those that end up revolving has risen over time, indicating a growth in convenience use. In addition, the median monthly charge amount for convenience users has risen over four times more rapidly for convenience users than for revolvers. The median monthly charge for convenience users has increased by about \$130 (from \$233 in 1991 to \$363 in 2001), whereas the average charge of revolvers is substantially smaller and has increased more slowly, rising only \$30 during that same time period (from \$117 to \$147). Again, much of this growth in the median size of transactional purchases probably results from a rise in cash-back and cobranding benefits. In addition, because convenience users do not have to pay for their purchases until the end of the billing period *plus* the grace period after receiving their bill, they have the opportunity to take advantage of interest rate “float” during the time between their purchase and payment of the obligation, which may be as long as 45-60 days. During that period, a transactional user essentially receives a free loan from the credit card issuer at zero percent interest<sup>14</sup> during which time those same funds can be invested in assets that generate a positive return, even if only a money

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<sup>12</sup> Kathleen W. Johnson, *Convenience or Necessity? Understanding the Recent Rise in Credit Card Debt*, Finance and Economics Discussion Series, Federal Reserve Board, 2004-47.

<sup>13</sup> See Johnson, *Convenience or Necessity?*

<sup>14</sup> Technically the interest rate is slightly negative because of the time value of money.

market account or similar safe, short-term investment. In fact, empirical evidence tends to suggest that consumers do exactly this—convenience users tend to carry smaller precautionary balances in their checking accounts than revolvers, suggesting that they are taking advantage of this float. In addition, revolvers are more likely to make use of debit cards than are nonrevolvers, which can be explained by the fact that revolvers do not receive the benefit of interest-rate float because they are required to pay the full interest on the account.<sup>15</sup>

Overall, therefore, there is no evidence that increased use of credit cards has caused consumers as a whole to become overindebted. In fact, the rise in credit card use is the result of a substitution away from other less-attractive forms of credit (because of cost, flexibility, or other drawbacks such as the need to pawn personal goods) to credit cards.

## **(2) “High” Credit Card Interest Rates**

Many commentators insist that the growth in credit card use as a source of revolving credit is irrational in light of the “high” interest rates charged on credit cards.<sup>16</sup> But credit card interest rates have fallen substantially over the past fifteen years:

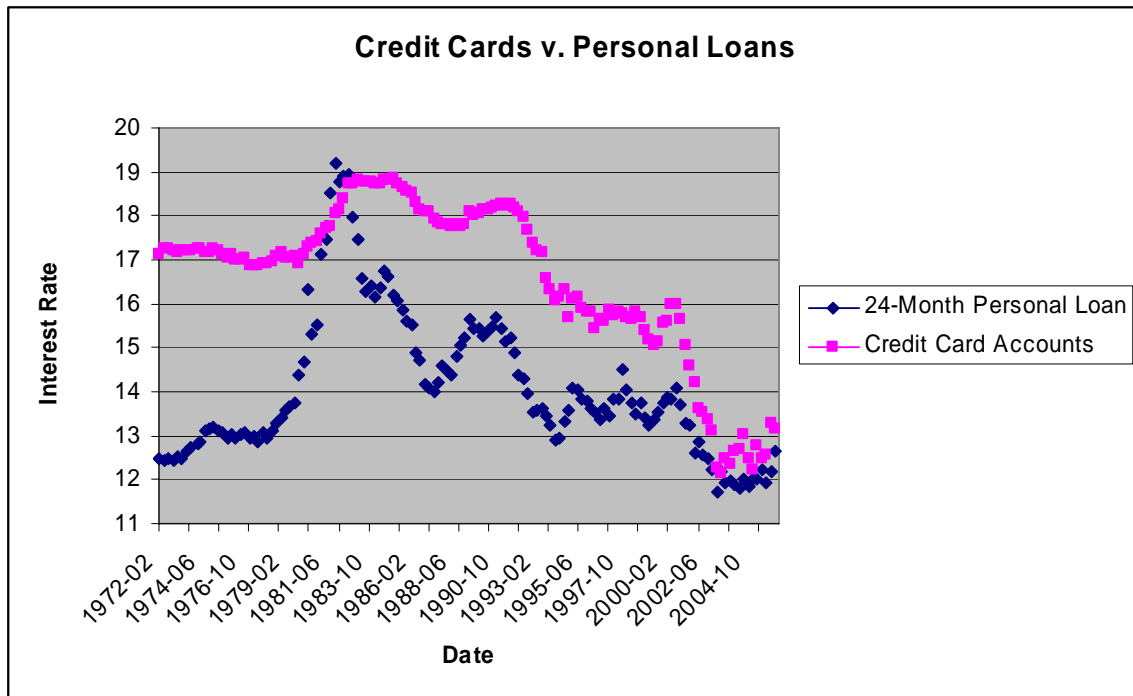
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<sup>15</sup> Jonathan Zinman, *Why Use Debit Instead of Credit? Consumer Choice in a Trillion Dollar Market*. Brown and Plache find that 62 percent of revolvers who acquired a general purpose debit card actually used that card whereas only 37 percent of nonrevolvers used their debit card. See Tom Brown & Lacy Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHICAGO L. REV. 63, 84 (2006).

<sup>16</sup> Note that if the interest rates really were higher on credit cards than on the types of credit that they supplant, then one would expect this to be reflected in a higher debt-service ratio, which as we have just seen, it is not.



finance company. The following Figure displays interest rates on 24-month unsecured installment loans versus credit card interest rates for the past thirty years:



As can be readily observed, the difference between interest rates on short-term personal installment loans and credit card accounts has narrowed over time. Indeed, in recent years the interest rate on credit card accounts has frequently fallen below that of short-term personal loans. A recent survey of consumer banking rates in the Washington, D.C., area found the prevailing interest rate on credit cards was 8.16%, whereas the prevailing rate for personal loans was 10.45%.<sup>18</sup> Moreover, once up-front initiation fees on personal loans are taken into consideration the overall cost of personal loans is almost certainly higher overall.<sup>19</sup> And this doesn't even consider the time, inconvenience, and

<sup>18</sup> The *Washington Times* reports area consumer banking rates each Friday. Data is drawn from those published reports.

<sup>19</sup> Brito and Hartley reported, for instance, "A senior bank officer told us that the costs to the bank of processing a loan are so high that they cannot afford to make a loan of less than \$3,000 for one year except at interest rates *above* those charged on credit cards." They also note, "inquiries in Houston in February 1992 revealed rates ranging from 17 percent and a \$100 fixed fee for a collateralized 1-year loan at a

more limited usefulness of a personal finance loan, or the more flexible repayment option of credit cards. According to one survey conducted by the Federal Reserve, 73% of consumers report that the option to revolve balances on their credit cards makes it “easier” to manage their finances versus only 10% who said this made it “more difficult.”<sup>20</sup>

This decline in credit card interest rates has resulted from robust competition in the credit card market and savvy shopping by consumers. Survey evidence indicates that consumers who revolve credit card balances are extremely likely to be aware of the interest rate on their credit cards and to comparison shop among cards on that basis, and those who carry larger balances are even more likely to be aware of and comparison shop on this term than those who revolve smaller balances.<sup>21</sup> By contrast, those who do not revolve balances tend to focus on other aspects of credit card contracts, such as whether there is an annual fee, the grace period for payment, or benefits such as frequent flier miles. In fact, consistent with the observation of more aggressive interest rate shopping by revolvers, those who revolve balances are charged *lower* interest rates on average than those who do not.<sup>22</sup>

Empirical evidence indicates that credit card interest rates also generally reflect changes in the riskiness of credit card lending. Thus, when credit card chargeoffs

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branch of a major national finance company to over 50 percent for small loans (\$300 maximum) at a local finance company.” In short, bank loans of similar size and duration “either do not exist or are available only at terms more onerous than those offered by credit card issuers.” By contrast, credit cards generally require no application fee and no minimum loan size. See Dagobert L. Brito & Peter R. Hartley, *Consumer Rationality and Credit Cards*, 103 J. POL. ECON. 400, 402 (1995).

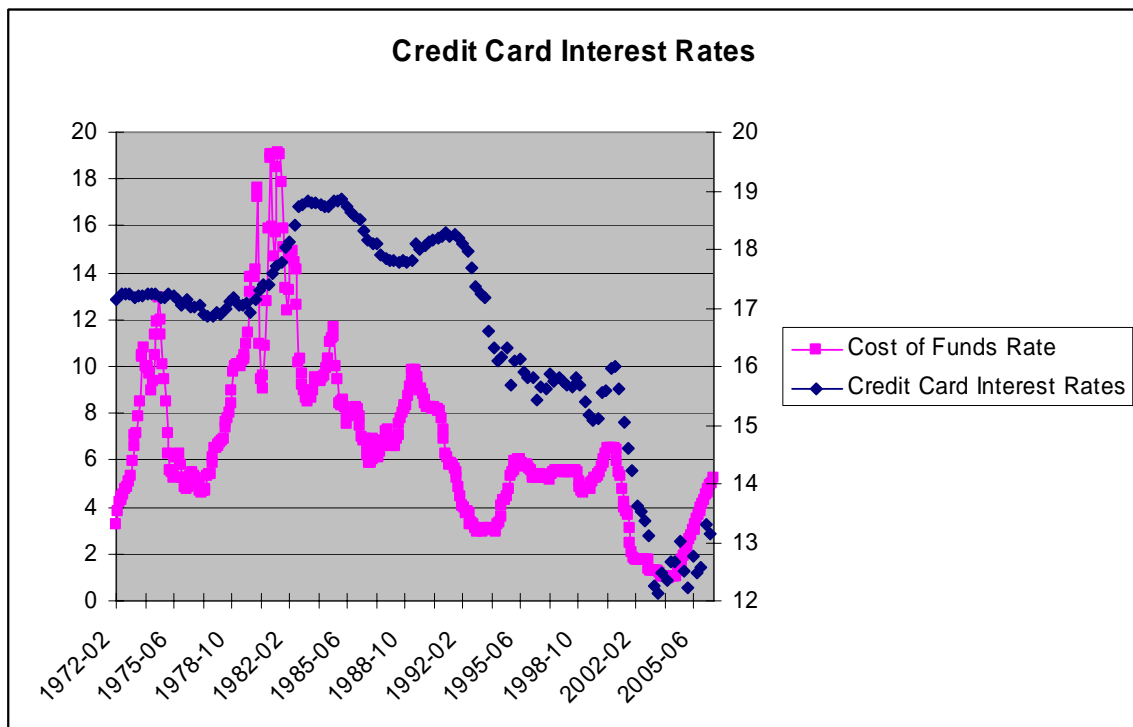
<sup>20</sup> Durkin, *Credit Cards: Use and Consumer Attitudes* at 623.

<sup>21</sup> See Thomas A. Durkin, *Credit Card Disclosures, Solicitations, and Privacy Notices: Survey Results of Consumer Knowledge and Behavior*, FEDERAL RESERVE BULLETIN p. A 109 (2006).

<sup>22</sup> Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHICAGO L. REV. 63 (2006).

increase, the spread charged between the underlying cost of funds and the interest rate rises.<sup>23</sup>

Furthermore, credit card interest rates have become less “sticky” over time, indicating that technological and risk-scoring innovations as well as more flexible risk-based pricing (as detailed below) has made credit cards even more responsive to competitive pressures. According to the General Accounting Office 93% of the cards they examined in 2005 had variable interest rates—a rise of 9 percentage points in just two years.<sup>24</sup> As a result, interest rates on credit cards have become more closely tied to overall interest rates in the economy, as illustrated in the following Figure.



<sup>23</sup> See Adam B. Ashcraft, Astrid A. Dick, and Donald P. Morgan, *The Bankruptcy Abuse Prevention and Consumer Protection Act: Means-Testing or Mean Spirited?* Working Paper, Federal Reserve Bank New York (Dec. 19, 2006).

<sup>24</sup> GENERAL ACCOUNTING OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES TO CONSUMERS 15 (Sept. 2006).



As can be seen, interest rates on credit cards historically were relatively “sticky,” when compared to other types of interest.<sup>25</sup> But note in particular that interest rates on credit cards were *equally sticky* throughout the *entire period* of 1972-1989. The era of the 1970s, of course, was an era of dramatically *increasing* interest rates – essentially the mirror opposite of the falling interest rates of the 1980s. During the period 1972-1982, the federal funds rate rose from a monthly low of 3.29% in February 1972 to a high of 19.10% in June 1981. Annual averages ranged from 4.43% in 1972, steadily increasing to 16.38% in 1982, before they started falling again. Thus, credit card interest rates were *also* sticky during the 1970s and early-1980s despite a *rising* cost of funds rate. Regardless of whether the cost of funds rate is rising or falling, for a period of 20 years the interest rate on credit cards has remained relatively constant, until the decline in interest rates in recent years. If credit card issuers were reaping large profits off the “spread” between the cost of funds and interest rates in the 1980s, they by definition were suffering equally large losses during the 1970s and the early 1980s. In fact, during this period, the average return on credit card operations was lower than for other sectors of banking activity. So, in general, whether the cost of funds rate has been rising or falling, interest rates on credit cards have been much less responsive to changes in the cost of funds than have other forms of consumer credit.

In recent years, however, credit card interest rates became much more responsive to changes in the cost of funds rate during this period. Beginning with the final quarter of 1994 to the present, the interest rates on credit cards became tied much more closely to the cost of funds rate rose, and for credit card accounts actually assessed interest, the fit is

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<sup>25</sup> An extended discussion of the explanation for the traditional stickiness of credit card interest rates is provided in Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79 (2000).

even tighter, again likely reflecting the higher emphasis placed on this term by revolvers when shopping for cards.<sup>26</sup>

On the whole, therefore, there appears to be no evidence of any market failure with respect to interest rates on credit cards. Competition and increasingly sophisticated consumer choice have brought about lower and more responsive interest rates over time. Alternative types of consumer credit offer similar interest rates, but often higher fees and more inconvenience than do credit cards.

### **(3) Fees and Other Price Terms**

Interest rates on credit cards have fallen and become more flexible during the past decade, but during that same time period late fees, overdraft fees, and other fees have risen in frequency and amount. These fees remain only a relatively small percentage of issuers' revenues, however, only amounting to about 10% of issuers' revenues, whereas interest payments still amount to about 70% of revenues.<sup>27</sup> The remainder of revenue is generated by merchant discount fees and the like. Moreover, although the GAO was able to find some isolated instances where assessment of these fees imposed an undue hardship on particular consumers, it was unable to find any systematic evidence of categorical abuse or misuse of these fees.

This increased use of penalty fees arose during the same time period that credit card interest rates both became lower and more flexible. This does not appear to be a coincidence. Evidence indicates that, in general, these fees are risk-based fees triggered

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<sup>26</sup> See Kathleen Johnson, *recent Developments in the Credit Card Market and the Financial Obligations Ratio*, FED. RES. BULLETIN 473, 477 (Autumn 2005) (noting that correlation between credit card interest rates and the prime rate was only 0.09 during the 1980s and early 1990s but has risen to 0.90 from mid-1990s to present).

<sup>27</sup> GAO REPORT at 70-72.

by actual borrowing behavior and when used in combination with interest rates provides issuers with greater flexibility in pricing credit terms than relying on interest rates alone. Interest rates are generally an *ex ante* before the fact estimate of a given borrower's likelihood of default. Late fees, over-limit fees, and other similar fees, by contrast, are more tightly tied to the borrower's exhibited risky behavior. The only systematic empirical study of these fees of which I am aware concludes that these fees are risk-based and complement interest rates for efficient risk pricing.<sup>28</sup> Massoud, Saunders, and Scholnick find, for example, that a one standard deviation in bankruptcy per capita leads to an increase in penalty fees of \$0.62 to \$1.31. Similarly, a one standard deviation change in the chargeoff ratio was found to change late fees in a range of \$4.35 to \$7.57. In addition, they find that a 1 basis point reduction in card interest rates will result in an increase in penalty fees of between 0.88 and 4.11 cents. Thus, in their study, a one standard deviation in credit card interest rates (273 basis points) was estimated to change late fees by \$2.40. Moreover, they found no evidence that assessed penalties were larger for low-income borrowers.

The increased use of risk-based fees has occurred at the same time as increased variable-rate pricing on credit cards, as the combination of these two pricing mechanisms is evidently more efficient than interest rates alone. In addition, it appears that consumers who pay these fees are not surprised by their existence, but are aware of them before they enter into the transaction that triggers the fee.<sup>29</sup>

In addition, if credit card penalty fees were actually some sort of new form of consumer abuse, rather than simply a more accurate pricing scheme, then this tradeoff

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<sup>28</sup> See Nadia Massoud, Anthony Saunders, and Barry Scholnick, *The Cost of Being Late: The Case of Credit Card Penalty Fees*, working paper (January 2006).

<sup>29</sup> See Durkin, *Credit Card Disclosures* at p. A114.

between higher risk-based fees and lower interest rates would result in larger economic rents or “economic profits” to the banking industry. In fact, return on assets has been largely constant for credit card banks over the past two decades, even though there has been a steady rise in the returns of other commercial banks.<sup>30</sup> Thus, during the early days of credit cards, issuers relied heavily on annual fees that were assessed on all cardholders, regardless of risk. During the 1990s, issuers phased out widely-disliked annual fees and moved toward greater emphasis on interest rates that were more closely tied to borrower risk. The gradual increase in the use of risk-based fees to supplement interest rates has made credit pricing reflect risk still further. This suggests that the transition to more risk-based pricing has come about through market competition, resulting in more efficient pricing of credit terms to consumers. First, there was a general phasing out of annual fees and greater emphasis on interest rates, then recent years has seen a gradual increase in the use of penalty fees to further more closely tailor price to cardholder risk.

### **Cost-Benefit Analysis and Unintended Consequences**

Available evidence indicates that the credit card market is competitive and responsive to consumer choice. Understanding the economics of the credit card market therefore raises serious challenges for any proposals to heighten regulation of the credit card market. In fact, misguided regulation can have serious unintended consequences that will end up reducing consumer welfare; thus, any proposal for additional regulation should be studied carefully to ensure that the benefits of any such regulation exceed the costs, including any unintended consequences that such regulation is likely to spawn. In

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<sup>30</sup> See GAO REPORT at 76. For a discussion of the special difficulties in inferring credit card “profits” from the standard analysis of “return on assets” used in the banking industry, see Zywicki, *The Economics of Credit Cards*.

addition, it would be wise to examine the continuing relevance and utility of existing regulations before proposing new regulations.

There are three basic manners in which credit can be regulated: substantive regulation, disclosure regulation, or market and common law “regulation.” Each has costs and benefits.

### **Substantive Regulation**

The oldest and hoariest type of regulation of consumer credit is substantive regulation of credit terms, such as usury restrictions that cap the rate that can be charged on interest rates. Substantive regulation of terms is generally frowned upon today, as thousands of years of economic history has generally demonstrated that the costs of substantive regulation generally exceed any benefits that it would generate.

In particular, there are three predictable unintended consequences that result from substantive regulation of consumer credit terms: (1) term substitution and repricing, (2) product substitution, and (3) rationing. Each of these three would likely manifest themselves in response to efforts to place new regulations on credit cards.

**(1) Term Substitution and repricing:** Credit card contracts are complicated, multiple-term contracts. Term substitution refers to the phenomenon that regulation of some terms of this multiple-term contract will cause issuers to adjust other terms in order to reach the market clearing “price.” Even in the relatively short history of credit cards, history is littered with examples.<sup>31</sup> Prior to the Supreme Court’s decision in *Marquette National Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978), most consumer credit card contracts were governed by usury restrictions that capped the interest rate that could be

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<sup>31</sup> See Zywicki, *Economics of Credit Cards* for an extended discussion.

charged on credit cards. As interest rates generally rose during the 1970s, this rate ceiling meant that card issuers could not charge a market rate of interest on their consumer loans. The era witnessed a number of offsetting term repricing adjustments by credit card issuers, all of which almost certainly made consumers worse off. First, issuers imposed annual fees on all cards to make up for the shortfall from the inability to charge a market rate of interest. Not only was this an inefficient pricing mechanism because it wasn't calibrated to borrower risk, it also forced transactional users of credit cards to subsidize revolvers who were able to borrow at the sub-market interest rate. Similarly, retailers would bury their credit losses by marking up the price of the goods they sold on credit; for instance, states with stricter usury ceilings also had higher retail prices for appliances. Usury restrictions also had a number of other unfortunate negative impacts on consumers. Customer benefits were lower in states with stricter usury ceilings, such as shorter banking hours and the elimination of other services such as free Christmas gift wrapping at department stores. Moreover, this term substitution also had the effect of making credit more heterogeneous in nature, making it more difficult and expensive for consumers to compare prices and shop. Most notably, annual fees made it more expensive for cardholders to carry more than one card, thereby making it difficult to switch from one card to another that presented a better deal.

The immediate aftermath of *Marquette* was the opportunity for credit card issuers to charge a market rate of interest for their products. In turn, this led to the rapid elimination of annual fees, which were no longer necessary to offset regulatory caps on interest rates. In turn, this enabled greater competition and consumer choice, which eventually resulted in a fall in a proliferation of card variety, lower interest rates, and

heightened competition. According to a study by Thomas Durkin of the Federal Reserve, 90% of consumers report that they are “Very” or “Somewhat Satisfied” with their credit cards.<sup>32</sup> Given the ease of comparison shopping and the wide variety of cards in the marketplace, it should not be surprising that most consumers have found products and issuers with which they are largely satisfied.

Empirical evidence strongly suggests that efforts to place substantive limits on credit card pricing today would likely generate similar offsetting term substitution. As noted, empirical evidence indicates that penalty fees imposed by credit card issuers are generally tied to consumer risk and as a result have an offsetting effect on interest rates. Any regulatory efforts to cap or otherwise regulate late fees, overlimit fees, and the like, would therefore almost certainly lead to increased interest rates for all consumers, or other offsetting adjustments in credit contract terms. It is not readily apparent why regulators would seek to impose a regulatory scheme that forces responsible and less-risky borrowers to pay higher interest rates to subsidize irresponsible and risky borrowers who pay their bills late or exceed their credit limits. This cross-subsidization is especially unfair to low-income but responsible borrowers who would otherwise be lumped into the same interest rate category as these other borrowers. In fact, the GAO Report indicates that at least one credit card issuer is experimenting with a credit card that would eliminate all penalty fees—but in exchange would impose a much higher interest rate (above 30 percent) if the cardholder pays late or otherwise defaults on the terms of the card.<sup>33</sup> Thus, while there appears to be some isolated instances of penalty

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<sup>32</sup> Thomas Durkin, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, FEDERAL RESERVE BULLETIN (April 2002).

<sup>33</sup> GAO REPORT at 24.

fees run amuck, blanket regulatory limitations on these fees will likely make credit card pricing less efficient and harm overall consumer welfare.

**(2) Product Substitution:** Notwithstanding the ability of credit card issuers to readjust uncontrolled terms of the credit card contract to try to price credit efficiently, in some situations the inability to charge efficient risk-based prices will make it impossible to extend credit card credit to some borrowers. Nonetheless, Americans need access to credit to deal with life's surprises, such as the need for unexpected car repairs, medical bills, to furnish a new apartment, or simply for a student to buy an interviewing suit to seek a job. If these individuals are unable to get access to credit cards, experience and empirical evidence indicates that they will turn elsewhere for credit, such as pawn shops, payday lenders, rent-to-own, or even loan sharks.<sup>34</sup> As noted above, there is no evidence that more widespread access to credit cards has worsened household financial condition because this growth in credit has been a substitution from other types of consumer credit.

It is hard to see how a college student or any young American is made better off by being denied a credit card and thus forced to furnish her apartment through a rent-to-own company. Nor is it readily apparent to me how a lower-income family who needs schoolbooks or a clarinet for their child is made better off by being forced to borrow from a payday lender or pawn shop to make ends meet. The young and the poor already have

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<sup>34</sup> See Susan Lorde Martin & Nancy White Huckins, *Consumer Advocates v. The Rent-to-Own Industry: Reaching a Reasonable Accommodation*, 34 AM. BUS. L.J. 385 (1997); Signe-Mary McKernan et al., *Empirical Evidence on the Determinants of Rent-to-Own Use and Purchase Behavior*, 17 ECON. DEV. Q. 33, 51 (2003); James P. Nehf, *Effective Regulation of Rent-to-Own Contracts*, 52 OHIO ST. L.J. 751, 752 (1991); Eligio Pimentel, *Renting-To-Own: Exploitation or Market Efficiency?*, 13 LAW & INEQ. J. 369, 394 (1995); LENDOL CALDER, FINANCING THE AMERICAN DREAM; JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR 37-67 (1994); RICHARD L. PETERSON & GREGORY A. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE (Credit Research Ctr., Working Paper No. 40, 1981); see also Robert W. Johnson & Dixie P. Johnson, *Pawnbroking in the U.S.: A Profile of Customers* 47 (Credit Research Ctr., Monograph No. 34, 1998)



fewer and less-attractive credit options than middle class families—restricting their credit options still further by making it even more difficult for them to get access to attractive credit on competitive terms does not seem to be a plausible way of making their lives better.

**(3) Rationing:** Finally, if issuers are unable to reprice terms so as to reach a market-clearing price for all consumers, and those consumers are unable to get needed credit from pawn shops, loan sharks, and other less-attractive lenders, the eventual result will be that some Americans will lack access to much-needed credit. This is the well-established finding of thousands of years of economic history, going back at least to Ancient Greece. What of the person who needs access to credit to repair a broken transmission so that he can get to work? In the end, at least some consumers are going to be forced to survive without credit that will allow them to repair their car, buy braces for their children, or Christmas presents for their relatives. Simply wishing that he could have access to credit on terms favored by regulators will not make it so and it is not clear what policy benefit is gained by pretending otherwise.

### **Disclosure Regulation**

The drawbacks of substantive regulation of consumer credit terms are well-understood. As a result, it has become increasingly common to mandate certain disclosures, rather than to impose substantive regulations on consumer credit. Evidence suggests that some disclosures, like the requirement of disclosing the APR for credit card

loans, has tended to facilitate consumer awareness of competing credit offers and thus to shop for the best deal available.<sup>35</sup>

But as with substantive regulation, there is a trade-off to increased mandatory disclosures. Consumers have limited attention for reading disclosures and issuers have limited space and expense for making disclosures. Thus, mandating some disclosures necessarily makes it more difficult to disclose fully other card terms that some consumers may care more about or may make it more difficult for consumers to find the information that they care about.

For instance, approximately half of American consumers do not revolve a balance on their credit cards. For those consumers, the APR is a completely irrelevant term in shopping for and using a card. And the evidence suggest that in fact transactional users of credit cards pay much less attention to the APR and Finance Charge than do those who revolve balances (and the larger the balance the more attention is paid).<sup>36</sup> Transactors generally care more about other aspects of cards, such as grace periods, benefits (such as car rental insurance or purchase price protection), and any rewards they offer (such as frequent flier miles or cash back). Although requiring disclosure of information of interest rates is certainly useful for those who shop on that basis for the other half of card users who do not revolve balances it is simply unnecessary clutter that makes it more difficult for them to locate the information that they want from a card issuer.

Moreover, experience demonstrates that once disclosures are mandated, they become very difficult to update in light of changing circumstances. This can be a particular problem in rapidly-evolving markets such as the credit card market. For

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<sup>35</sup> See Durkin, *Credit Card Disclosures*.

<sup>36</sup> Durkin, *Credit Card Disclosures* at p. A 113.

instance, the “Schumer Box” requires disclosure of useless or trivial information such as the amount of the minimum finance charge, which according to the GAO Report, was typically about 50 cents. Other mandatory disclosures, such as the method for computing balances, may be too complicated or of little importance to most consumers in choosing among cards.<sup>37</sup> The GAO Report observes that the outdated structure of the Schumer Box, TILA, and Regulation Z make it difficult to accurately and effectively disclose many of the new terms on credit cards that have been described, rendering such disclosures less helpful than would otherwise be the case.

Nonetheless, trivial, outdated, or irrelevant disclosures are given the same importance as other more important terms, and newly important terms are difficult to disclose at all. For mandatory disclosures to be an effective tool for facilitating consumer choice, rather than a counterproductive distraction and threat of information overload, regulators must be committed to updating them swiftly and regularly in order to keep up with rapid changes in the market and consumer preferences.

Still another problem with the actual practice of disclosure regulation is the apparent effort to use disclosure regulation as a “back door” version of substantive regulation, to try to guide consumers in the “right” direction. Thus, although it is recognized that usury restrictions are counterproductive, it is implicitly assumed that forcing disclosure of the “high” rate of interest will shock consumers into moderating their credit use, along the lines of “If consumers *only knew* how much they were paying in interest, they would borrow less.” A related problem is mandating disclosures in order to advance some political or social goal, rather than to facilitate careful and responsible consumer borrowing. Thus, Congress recently mandated the disclosure of the amount of

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<sup>37</sup> GAO REPORT at 54.

time it would take to pay off a cardholders existing balance assuming that only the minimum payment were made. Federal Reserve economist Thomas Durkin estimates that this disclosure actually will be useful to only 4% of cardholders who state that they actually intend to stop adding new charges to the card and to repay their balance by making only the minimum payment.<sup>38</sup> Although this disclosure effects a very small number of consumers—who could otherwise get the same information simply by calling their credit card issuers—it will necessitate still further expense by cardholders and further increase the costs to consumers of locating the information that they actually care about. Properly implemented, standardized disclosure may facilitate autonomous consumer choice by making it easier for consumers to comparison shop among credit products. But efforts to use disclosure as a back door version of substantive regulation is likely to be ineffective at bringing about the desired substantive outcome, while simultaneously failing to provide the useful information to consumers that disclosure regulation should produce.

Finally, according to another study by Durkin, two-thirds of credit card owners find it “very easy” or “somewhat easy” to find out information about their credit card terms, and only six percent believed that obtaining this information was “very difficult.” Two-thirds of respondents also reported that credit card companies usually provide enough information to enable them to use credit cards wisely and 73% stated that the option to revolve balances on their credit card made it “easier” to manage their finances versus only 10% who said this made it “more difficult.” Finally, 90% of credit card owners were “Very” or “Somewhat Satisfied” with their credit cards, versus only 5%

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<sup>38</sup> Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, FED. RES. BULLETIN 623, 634 (Sept. 2000).

who were “Somewhat Dissatisfied” and only 1% percent—that’s 1 out of 100—who were “Very Dissatisfied.”

In short, consumers seem overwhelmingly satisfied with their credit cards, the information they receive from credit card issuers, and ease with which they can get information about their cards. Credit card issuers appear to have the incentives to provide timely and accurate information to consumers and by all accounts appear to be doing so.

### **Market Competition and Common Law as Regulation**

It must also be kept in mind that market competition is a form of regulation as well. The credit card market is extremely competitive, with thousands of issuers constantly competing to woo consumers with better offers. Consumers routinely carry as many as four credit cards in their wallets, ready to switch immediately to the card that offers a more attractive package of benefits and terms. In such a market, it is unlikely that oppressive or unfriendly contract terms would last, and in fact this seems to be the case. The GAO Report found, for instance, that only 3 of the 28 cards that they examined had “universal default” clauses in 2005.<sup>39</sup> The GAO Report also found that between 2003 and 2005 only a minority of credit card issuers used the so-called “double-cycle billing method” of calculating finance charges and I understand that even those issuers have eliminated that scheme today.<sup>40</sup> In addition, only 2% of cards charge annual fees, and virtually all of them provide some rewards program in return. In fact, annual fees traditionally have been the cost of credit cards most despised by consumers—in fact,

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<sup>39</sup> GAO REPORT at 26.

<sup>40</sup> GAO REPORT at 28.

when annual fees were first implemented in the 1970s, consumers cancelled 8% of their credit cards immediately.<sup>41</sup>

In addition, courts have used traditional common law rules and contract remedies to punish fraudulent or deceptive practices by card issuers. This has been quite efficacious in protecting consumers and raises further questions about the need for additional regulation.

Thus, although issuers may try to impose on consumers a variety of disagreeable terms, the ease with which consumers can shift from one card to another, and the heated competition among issuers for consumer loyalty, renders such a scenario relatively implausible. Whether annual fees, universal default clauses, or “double-cycle billing,” the market appears to be quite self-correcting in terms of delivering to consumers the credit card products that they desire—which explains the 90 percent positive satisfaction rate described above.

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<sup>41</sup> See Zywicki, *Economics of Credit Cards*.