

## GAO Credit Card Study – Summary (November 2006)

On October 11, the Government Accountability Office (GAO) released a report entitled “Credit Cards – Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures.” The report addresses various issues relating to credit card fees and practices. These issues include the evolution of credit card interest rates and fees, the relationship between interest rates and fees and card issuer profitability, and the manner in which interest rates and fees are disclosed to consumers. Also discussed in the report is the relationship between credit card debt and consumer bankruptcy. Below is a brief summary highlighting the broader conclusions of the GAO report.

### *Disclosures to Consumers Can be Improved*

The sole recommendation made by the GAO in its report is a call for better disclosure standards so that consumers have a greater understanding of card usage. The card industry agrees with the GAO that consumers **need better, not more, disclosures.**

The report indicates that disclosures required by law, such as under the Truth in Lending Act and its attendant Regulation Z, are often written at an education level that is too high and sometimes contain design features that make them difficult to read. Disclosure documents failed to group relevant information, unnecessarily emphasized specific terms, used odd font sizes, and failed to use headings effectively.

Moreover, the GAO found many existing disclosure requirements to be less useful for the more complicated structures of today’s credit cards, and that issuers are further challenged to provide complete disclosure of account terms in a manner that complies with detailed and rigorous legal standards. As noted in the GAO report, the Federal Reserve Board (Fed) is currently undertaking a comprehensive review of credit card disclosure regulations.

The banking industry is fully supportive of modernized disclosure standards. Issuers have been very proactive in assisting the Fed in this effort and are supportive of the idea of testing new disclosures on consumers prior to making them permanent. In fact, the GAO recognized the efforts of many of the large issuers to improve their current disclosures by highlighting existing “effective” disclosures that are more consumer-friendly. The card industry will continue to work with the regulatory agencies, Congress, and other interested parties to improve consumer disclosures so that they are more clear and concise and not too long or more confusing.

### *Increased Industry Competition Has Led to Declining Interest Rates*

According to the GAO, increased competition among card issuers, along with a drop in the cost of funds to issuers, has resulted in a steady decline in interest rates. Up until about 1990, card issuers commonly charged a single fixed interest rate around 20 percent, with credit cards available only to a smaller subset of American

consumers. However, the GAO found that between 1990 and 2004 the average interest rate declined by 6 percent. For the 28 popular cards reviewed by the GAO, the average interest rate was just over 12 percent.

It is also worth noting that the GAO found that a large number of cardholders avoid paying any significant interest charges. According to the report, nearly half of all cardholders pay no interest charges because they pay their balance in full each month. Others avoid interest rates through low-interest, or even zero-interest, introductory periods offered by card issuers. The GAO report indicates these introductory rates have been necessary due to increased competition, and that roughly 25 percent of all purchases in 2005 were made with cards offering zero percent interest.

### *Consumers Have Control*

**Most Consumers Avoid Interest Charges.** The GAO found that a large number of cardholders – about 42% - avoid paying any significant interest charges. These “convenience” users pay-off their balance in full each month, and as a result, “availed themselves of the benefits of their cards without incurring any direct expenses.”

**Most Consumers do not Pay Penalty Fees.** The GAO also found that most of the cardholders of the largest six issuers do not pay penalty fees.

It is clear that consumers have a great deal of control over whether or not they pay finance charges, late payment, over-the-limit, and similar fees and can avoid them by simply paying on time and otherwise managing their credit wisely. Improved disclosures will amplify this control.

### *Competition Fuels Industry Growth and Consumers have Benefited*

Credit cards have become such an integral part of everyday life that the convenience, security, and financial mobility they provide is often taken for granted. The GAO report indicates that the number of credit cards currently in use has grown from less than 100 million in the mid-1980s, to over 690 million through 2005. Today, credit cards are accepted at more than 24 million locations in more than 150 countries and are responsible for more than \$2.5 trillion in transactions each year. Their continuing growth is directly attributable to the many benefits they provide.

Moreover, as the GAO report notes, the benefits credit cards offer consumers today are far greater than they were in the past. Indeed, not only were interest rates high before 1990, but only the most creditworthy borrowers had credit cards before that time.

According to the GAO, 75 percent of families now hold at least one credit card, meaning that more and more people are able to take advantage of the many benefits and conveniences offered by credit cards. They are used to make purchases large and small and now permit access to bank accounts, Internet shopping, and cash from automatic teller machines 24-hours a day year round. Furthermore, rewards programs such as cash-back and airline travel, and other benefits such as rental insurance or lost luggage protection have become standard.

Finally, technological innovations continue to provide enhanced protection, and cardholders are typically not responsible for loss, theft, fraud, or misuse of their credit cards by unauthorized persons.

### ***There is No Direct Link between Penalty Fees and Interest and Consumer Bankruptcy***

The GAO report notes that the number of consumers filing for bankruptcy has risen more than six-fold over the past 25 years. However, it found no direct link between credit card penalty fees and interest and the increase in bankruptcy filings.

Indeed, in June 2006 the Fed submitted a study to Congress addressing whether credit card debt is contributing to the rise in consumer bankruptcy filings. The Fed concluded that the card industry does not extend credit indiscriminately and does not solicit customers or extend credit to them without assessing their ability to repay debt. The Fed also concluded that while more people are using credit cards for more purposes, the debt burden on households has remained nearly the same. Finally, the Fed found no direct link between increased use of credit cards and the rise in consumer bankruptcy filings, noting that the reasons for filing bankruptcy are complex and tend to be driven by unforeseen events such as job loss, divorce, and uninsured illness.

The GAO report relies on the same data utilized by the Fed and concludes that a link between increased penalty fees and interest and rising consumer bankruptcy filings cannot be established. Like the Fed study, the GAO report indicates that increased costs associated with major life events, or a decline in the stigma associated with bankruptcy, may explain the recent rise in consumer bankruptcy filings.

#### **The GAO also noted:**

- Only a very small portion - 1% - of all the issuers' active credit card accounts was charged off for bankruptcy between 2003 and 2004.
- According to the Fed, credit card debt is actually declining as a total of household debt - - it represented 3.9% of total household debt in 1995 and 3.0% in 2004.
- "Unpaid interest and fees represented a small portion of amounts owed by cardholders who filed for bankruptcy."

### ***Credit Card Bank Profitability Has Remained Steady***

The GAO report notes that while interest rates have declined in recent years, credit cards today include higher and more complex fees for things such as late and returned payments, and exceeding credit limits. But the GAO also concluded that the profits of credit card issuing banks have been stable over the last 7 years. In fact, aside from some wide fluctuations in the mid-1990s, profits remained relatively stable between 1986 and 2004, with an average return on assets ratio of 3.12 percent. Furthermore, the GAO found that the vast majority of card issuer revenue stems from interest rate income, not fees. Indeed, the GAO concluded that interest revenues comprise between 69 and 71 percent of total card issuer revenues.

It is also interesting to note that while late payment and over-the-limit fees have increased, credit card annual fees have become almost non-existent. According to the GAO report, up until about 1990, card issuers charged annual fees ranging between \$20 and \$50, and much smaller amounts for penalty fees. By 2005, roughly 75 percent of credit cards no longer carried an annual fee. Significantly, the GAO found that the total of annual fees and penalty fees was roughly the same in 2004 as it was in 1990 – at a combined approximate of \$1.85 per every \$100 in outstanding credit card balances.

Hence, the notion that higher penalty fees are being charged by card issuers to increase their profit margins is largely without merit. It is more likely the case that, as the GAO found, these fees help to offset the increased operating costs associated with offering things such as rewards programs and because card issuers serve a very large number of relatively small accounts. Such fees may also offset the risk of loss posed by some cardholders who make late payment or engage in irresponsible card usage.