AN ECONOMIC ASSESSMENT OF REGULATING CREDIT CARD FEES AND INTEREST RATES

JONATHAN M. ORSZAG
SUSAN H. MANNING

COMMISSIONED BY THE AMERICAN BANKERS ASSOCIATION
OCTOBER 2007

ABOUT THIS STUDY

This study was commissioned by the American Bankers Association as an independent economic assessment of regulating credit card fees and interest rates in the United States. The views and opinions expressed in this study are solely those of the authors and do not necessarily reflect the views and opinions of the American Bankers Association or any of the organizations with which the authors are or have previously been associated.

Jonathan Orszag (jorszag@competitionpolicy.com) is a Senior Managing Director of Competition Policy Associates, Inc. (COMPASS), an economic consulting firm. Mr. Orszag is also a Fellow at the University of Southern California's Center for Communication Law & Policy. Previously, Mr. Orszag served on President Clinton's National Economic Council and as the Assistant to the Secretary of Commerce and Director of the Office of Policy and Strategic Planning.

Susan Manning (smanning@competitionpolicy.com) is a Managing Director of COMPASS. Dr. Manning has more than 20 years of economic consulting experience, including extensive expertise in competition and regulatory policy analyses.

The authors thank Jeff Rudnicki, Anna Birkenbach, Katrina Calvert, Andrew Card, and Jeff Raileanu for research assistance, and Jason Bordoff for insightful and helpful comments.

TABLE OF CONTENTS

EXECUTIVE SUMMARY

During the past 25 years, credit card use in the United States has increased dramatically; evolving from a limited-use product primarily for high-income individuals to a financial tool relied upon daily by the vast majority of American families. The result has been a dramatic expansion in access to credit, lower costs, a more secure payment system, and greater choice and convenience for users, all of which in turn have contributed to overall economic growth.

This report provides an economic assessment of credit card pricing and the likely economic consequences of various proposals to regulate the interest rates and fees that credit card issuers can charge their customers. The report contains three primary findings:

1. Innovation and deregulation have allowed credit card prices to reflect borrower risk more precisely, which has benefited the vast majority of borrowers.

2. Proposals for price controls on credit cards may help a small minority of borrowers, but only at the cost of harming the vast majority of borrowers.

3. Effective alternatives exist to protect consumers from unfair or deceptive credit card practices without raising costs or limiting credit access for other borrowers.

Innovation and deregulation have allowed credit card prices to reflect borrower risk more precisely, which has benefited the vast majority of borrowers.

- Credit card pricing is a function of two key inputs: the cost of funds available to the lender and the credit risk of the borrower. Evidence shows that credit card interest rates have become tied much more closely to the cost of funds in the past two decades. Moreover, technological changes in credit scoring and other risk analysis techniques have enabled card issuers to assess borrower risk more precisely.

- The ability to set a cardholder's rates and fees based on that cardholder's individual risk profile benefits all consumers.

- Lower risk cardholders pay lower rates because each cardholder now receives pricing that reflects the risk of their individual account. Whereas most cards prior to 1990 charged fixed interest rates of roughly 20 percent, 80 percent of cardholders paid interest rates lower than 20 percent in 2005. And whereas nearly all cards used to charge an annual fee, in 2005 a very small percentage of cards charged an annual fee (except as part of a rewards program). The availability of cards for no annual fee has helped drive the growth of "convenience use" of credit cards; nearly half of card users pay their balance in full each month.

- Empirical evidence also shows that risk-based pricing has dramatically expanded access to credit for lower income and higher risk cardholders. While some cardholders may find themselves with levels of debt that they find difficult to manage, the vast majority of borrowers have benefited from the ability to get cheaper forms of financing; handle short-term bumps in income; smooth consumption over time; manage unexpected emergencies; build a credit history; and enjoy the convenience and security of credit cards. Moreover, the percentage of households with excessively high levels of debt was relatively stable between 1995 and 2004. Absent access to credit cards, many individuals who face unexpected emergencies or short-term income disruptions might have to turn to more costly forms of lending, such as payday loans or rent-to-own programs.

Proposals for price controls on credit cards may help a small minority of borrowers, but only at the cost of harming the vast majority of borrowers.

- In response to the increased use of risk-based pricing and service fees and the significant levels of credit card debt borne by some consumers, proposals have been advanced to regulate the service fees and/or interest rates charged by card issuers. There is little or no economic justification for such proposals, and most would do significantly more harm than good.

- Over the past century, economists have identified situations where price regulations may be warranted. However, the credit card sector bears none of the indicators of an industry in which price controls may be economically appropriate. For example, if competition is lacking, such as with natural monopolies, regulation may be economically efficient. But competition today is intense in the credit card market. If price regulations are imposed in situations where such controls are unwarranted, overall economic performance is necessarily harmed, which may have a particularly significant effect on economic growth since the U.S. economy has become highly dependent on consumer spending.

- The ostensible purpose of such proposed restrictions is to protect certain groups of borrowers, particularly higher risk and lower income borrowers. Yet the specific proposals that have been advanced – restrictions on the interest rates and fees that credit card firms can charge, and how and when they charge interest – will yield more harm than benefits.

- The most common proposals to regulate the credit card industry by imposing caps or other constraints on the fees and interest rates that issuers can charge would have the unintended consequences of raising costs and limiting access to credit for the vast majority of consumers – a concern borne out by historical and international experience – even if they may help a small minority of borrowers with unmanageable levels of debt.

- For example, after the Reserve Bank of Australia reduced interchange fees by almost half, bank issuers increased the fixed price of cards, leading to higher annual fees and lower rewards for cardholders offered by issuers.
- Similarly, in the United Kingdom, after regulators ordered credit card issuers to halve penalty fees, a range of other fees and charges "notably increased," according to a recent consumer group report.

- Such regulatory interventions are particularly unwarranted before the effects are known of the Federal Reserve Board's recent proposals to improve the effectiveness of credit card disclosures. The proposed changes were the result of exhaustive and comprehensive analysis and, more importantly, the result of consumer testing and focus groups to determine readability and clarity of disclosures.

Effective alternatives exist to protect consumers from unfair or deceptive credit card practices without raising costs or limiting credit access for other borrowers.

- **Improved disclosure of credit card rates and fee structures.** Efforts to increase transparency and disclosure have increased consumer awareness about credit card terms and enhanced competition. As credit card products have become more complex, however, further efforts are needed to make disclosures more concise, readable and understandable. The Federal Reserve's proposed amendments to Regulation Z seek to increase transparency, which will benefit consumers.

- **Increased consumer financial literacy.** Evidence suggests that programs targeted at improving financial literacy can be effective, but this remains a daunting challenge. Financial literacy education should be a priority for government, non-profit organizations, and financial institutions.

- **Consolidated regulatory oversight for unfair or deceptive practices.** Currently, regulation of the credit card industry is badly fractured among various state and federal agencies, leading to inconsistent and sometimes conflicting regulations. Providing appropriate tools within a more consolidated regulatory framework to both quickly and consistently address unfair or deceptive practices would enhance consumer protections.

I. THE DRIVERS AND BENEFITS OF CREDIT CARD PRICING

Over the past 25 years, credit card use in the United States has increased dramatically, evolving from a limited-use product primarily for high-income individuals to a financial tool relied upon daily by the vast majority of American families. The result has been a dramatic expansion in access to credit, lower costs, a more secure payment system, and greater choice and convenience for users, which in turn has contributed to overall economic growth.

From the perspective of an issuing bank, credit card lending is a risky practice. When a bank issues a credit card, it is extending a line of credit to a borrower. Unlike a mortgage or a car loan, credit card loans can be used for any purpose a cardholder desires and are unsecured; thus, the bank suffers a greater loss if the loan is not repaid because there is no collateral. Furthermore, it is in the borrower's interest to pay all secured loans first so as not to put the collateral, such as their house or car, at risk. Credit card lenders are thus among the lowest priorities for borrower repayment. Finally, credits cards are a revolving credit product, which means that the borrower has access to the funds over a longer period of time even as the borrower's financial circumstances and risk profile change.

Although the pricing of credit cards, like the pricing of other forms of credit, has become more reflective of varying risks exhibited by different consumers, price is a function of two key inputs: the cost of funds available to the lender and the credit risk of the borrower.

A. Cost of Funds

The cost of funds reflects the issuer's cost of obtaining capital to finance providing credit to the cardholder; it is a fundamental aspect of credit card price-setting. Credit card issuers use the capital markets as the primary source of lending capital. The cost of funds is thus driven by the prevailing interest rate environment in the global capital marketplace. Current benchmark interest rates (such as the U.S. Treasury Bill rate), as well as the issuer's portfolio and past performance and the structure of the financing are all factors that influence the interest rate obtained. The cost of funds fluctuates over time and is difficult to forecast.

As capital market interest rates increase, the cost of funds also increases. For credit card accounts with variable interest rates, such an increase in the cost of funds is matched by an increase in the rates borrowers pay. On the other hand, in a fixed or capped interest rate environment, or one in which the flexibility to respond promptly to changes in the cost of funds is restricted, the card issuer must bear any risk of interest rate fluctuations: the risk that the cost of funds will increase.[1]

Over time, credit card interest rates have become tied much more closely to the cost of funds

Because banks must source their capital from markets that operate without rate controls, the cost of funding fixed rate loans (or loans with limitations on the amount of increases or the timing of increases in interest rates) is necessarily higher than that of funding adjustable rate loans. A fixed annual rate would likely cause credit card issuers to adjust upwards their base interest rates as a hedge against potential interest rate increases.[2]

Over time, credit card interest rates have become tied much more closely to the cost of funds. Credit card interest rates were relatively "sticky" compared to other types of interest during the 1970s and 1980s, meaning that they were less responsive to changes in the cost of funds than other forms of credit.[3] Since 1994, however, credit card interest rates have been much more responsive to the cost of funds, and have thus dropped markedly. As one Federal Reserve economist noted, the correlation between credit card

---

[1] Banks can hedge against this risk by securing options on capital funds at a predictable rate. However, these options are themselves expensive, which raises the issuers' cost structure. Furthermore, these options have time limits, and when the options run out, the banks are still faced with obtaining funds at the market rate, again exposing the issuer to interest rate risk.

[2] This is analogous to 30-year fixed rate mortgages typically being priced above variable rate mortgages. The fixed rate mortgage removes the risk of potentially increasing rates, but for that assurance, borrowers must pay a higher rate. The higher rate, in essence, compensates the lender for assuming the risk of interest rate fluctuations.

[3] Todd J. Zywicki, "The Economics of Credit Cards." (2000), 3 CHAPMAN L. REV. 79 and Kathleen Johnson, "Recent Developments in the Credit Card Market and the Financial Obligations Ratio." (Autumn 2005), FED. RES. BULLETIN, 473, 477.

interest rates and the prime rate was only 0.09 during the 1980s and early 1990s, but has risen to 0.90 from the mid-1990s to the present.[4]

B. Risk-Based Pricing

Prior to 1990, when a credit card issuer decided to offer a credit card to a borrower, it did so with little variation in the credit terms, despite significant variation in borrowers' creditworthiness. Credit cards were effectively available only to high-income individuals with good credit histories and at fixed interest rates of around 20 percent.[5]

Since then, however, innovation and deregulation have allowed for more efficient risk-based pricing and management of individual cardholder risk. Changes in technology, such as credit scoring, automatic access to consumer reports, and response modeling and other risk analysis techniques, have enabled credit card issuers to better track and assess changes in an individual's risk profile. As issuers became better able to assess borrower risk, they could then offer a broader variety of credit products to borrowers with more diverse rates and fees.

The ability to set a cardholder's interest rate and fee structure based on the cardholder's own risk profile benefits all consumers. Each cardholder now receives pricing that reflects the risk of the cardholder's individual account, which has caused prices to come down for most customers. In addition, issuers are able to offer credit cards to low income, higher risk consumers who would have been denied access to credit cards under a "one-size-fits-all" approach to rate-setting. A Federal Reserve economist concluded in a recent analysis that "[r]isk-based pricing has increased the availability of credit cards for all households, but its effect has been the greatest among riskier households. In particular, the rate of cardholding among households in the lowest quintile of the income distribution rose about half, from 29 percent to 43 percent, between 1989 and 2001…

[4] Kathleen Johnson, "Recent Developments," 473, 477.
[5] Government Accountability Office, "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosure to Consumers." (September 2006), 15 [hereinafter "GAO Report"].

whereas the rate of cardholding rose only 10 percent in the general population, from 70 percent to 76 percent."[6]

> ***Federal Reserve study: "Risk-based pricing has increased the availability of credit cards for all households."***

The use of risk-based pricing and management of individual borrower risk in the credit card industry is no different from risk-based pricing in other areas. The primary method by which corporations (and governments) borrow money, for example, is through the issuance of bonds, and the rate the corporation offers lenders on those bonds is determined by the corporation's bond rating—an evaluation of the corporation's risk made by one of the credit-rating agencies, Standard and Poor's, Moody's or Fitch. These agencies assign ratings (*e.g.*, AAA, AA+, etc.) that help to determine the bond's interest rate. The higher the rating, the lower the risk of default and the lower interest rate the borrower can obtain – just as a consumer with a better credit risk will be able to obtain a lower credit card interest rate because the borrower poses less of a default risk to the issuing bank.[7]

C. Revenue Sources: Interest Rates and Fees

Credit card issuer revenue from cardholders comes from both interest and fees. Using information from credit bureaus, the issuing bank is able to determine a consumer's default risk and charge an appropriate risk-based price through interest charges and penalty fees for accepting that risk, whether initially or upon periodic review. Risk profile changes can be characterized by late payment, going over a credit limit, or accumulation of debt, among other factors. In addition to risk-based revenue from cardholders, issuers also receive revenue from merchants, which reduces the necessary revenue from cardholders. Convenience fees compensate issuers for the cost of providing particular consumer services (*e.g.*, the ability to pay by phone with a customer

---

[6] Kathleen Johnson, "Recent Developments," 475.

[7] A corporate bond with a Moody's rating of Aaa had a five-year cumulative default rate of 0.1 percent from 1970 through 1997; a corporate bond with a Moody's rating of Baa had a 1.9 percent default rate. *See* Moody's, "Understanding Moody's Corporate Bond Ratings and Rating Process." (May 2002).
That differential in default probabilities translates into a differential in interest rates required to compensate investors for the increased risk of default. According to data collected by the Federal Reserve, in 2006, a corporate bond with a rating of Aaa had an average interest rate of 5.59 percent, whereas the average interest rate for bonds with a rating of Baa was 6.48 percent. *See* United States Federal Reserve Board, "Federal Reserve Statistical Release: Selected Interest Rates." (2007), Washington, DC: Retrieved Sept. 10, 2007 - (http://www.federalreserve.gov/releases/h15/data.htm).

service representative, redeem rewards, or transfer a balance).[8] The Government Accountability Office (GAO) found that revenue from so-called penalty fees has risen, though it still comprises only 10 percent of issuer revenue. Interest payments account for roughly 70 percent of total card issuer revenues, and the remainder of revenue comes from other fees (*e.g.*, for merchant transactions and consumer services).[9]

Some critics have complained that penalty fees, as well as the interest rates charged to the riskiest borrowers, are excessive even considering the higher risk. But evidence suggests that credit card interest rates and fees accurately reflect changes in the riskiness of credit card lending and the risk profile of the borrower. As noted above, interest rates are responsive to the cost of funds and do not appear to reflect rent-seeking behavior on the part of issuers. Although late fees, over-the-limit fees, and other penalty fees have increased in recent years, these fees tend to reflect consumer default risk and the level of these fees is negatively correlated with interest rates (*i.e.*, these fees complement interest rates for more efficient risk-based pricing).[10] Moreover, if the increased assessment of penalty fees were part of some abusive pricing scheme to take advantage of customers, one would expect issuer profits to have risen accordingly. In fact, aside from some fluctuations in the mid-1990s, profits of credit issuing banks remained relatively stable between 1986 and 2004, with an average return on assets of 3.12 percent.[11]

Others have criticized the changes in interest rates that a borrower may face as circumstances change to increase the cost of funds or the borrower's default risk. Such risk-based pricing is consistent with economic theory, however, where the problem of so-called moral hazard can lead to inefficient pricing. Moral hazard problems exist where a particular policy changes people's motivation. The classic example is that an individual

[8] Though previously commonplace, only 25 percent of credit cards now charge an annual fee, but nearly all of those that do charge one do so to compensate for the cost of offering a rewards program to the cardholder. *See* GAO Report, 23. Indeed, in 2002 only two percent of customers not enrolled in a rewards program paid an annual fee. *See* Mark Furletti, "Credit Card Pricing Developments and Their Disclosure." Federal Reserve Bank of Philadelphia Discussion Paper, (January 2003), 10 [hereinafter "Furletti, 'Credit Card Pricing'"].
[9] GAO Report, 67.
[10] Nadia Massoud, Anthony Saunders, and Barry Scholnick, "The Cost of Being Late: The Case of Credit Card Penalty Fees." Working Paper, (October 2006) – (http://papers.ssrn.com/Sol3/papers.cfm?abstract_id=890826).
[11] GAO Report, 75.

with insurance against theft may be less motivated to lock his or her house than an individual who is not insured. In the case of credit cards, a person who knows that the cost of borrowing funds will not change if his or her credit risk increases may be less motivated to maintain good credit (*e.g.*, by paying bills on time and restricting debt to a manageable level) than an individual who knows that the credit card interest rate could change. The use of risk-based pricing by issuing banks thus helps to address the economic inefficiencies that can be created by the motivational problems associated with a non-risk-based pricing system. Moreover, unlike traditional bank loans, the fact that credit cards are a revolving form of credit means that borrowers continue to have access to that line of credit even as their risk profile changes, and issuers need the ability to adjust prices accordingly or else either restrict credit or raise rates across the board.

D. The Benefits of Risk-Based Pricing for Consumers

The ability to price credit cards to reflect more precisely the degree of borrower risk has had several benefits for consumers, including: (1) expanded access to credit; (2) lower cost credit; and (3) a more diverse range of credit products.

According to former Federal Reserve Chairman Alan Greenspan, "Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes. Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services."[12]

An examination of Survey of Consumer Finance data from 1989 to 2004 bears out this statement. The share of total consumer debt held by low- and middle-income families (defined as those in the bottom three income quintiles) increased from 1989 to 2004, while the share held by those in the top two income quintiles declined, suggesting that more families are qualifying for loans than in the past.[13]

---

[12] Alan Greenspan, "Consumer Finance." Remarks presented at the Federal Reserve System's Fourth Annual Community Affairs Research Conference, Washington, D.C.: (April 8, 2005).

[13] Andrew Kish, "Perspectives on Recent Trends in Consumer Debt." Federal Reserve Bank of Philadelphia Discussion Paper, (June 2006). To be sure, this higher share is not exclusively attributable to increased access to credit, since some is no doubt the result of households electing to take on additional debt, but evidence shows that increased lending to low and middle-income families had a significant impact. This conclusion is supported by an analysis showing that 25 years ago there were significant liquidity constraints

Expanded access to credit has had many benefits for consumers. It has allowed more borrowers to get cheaper forms of financing (compared to payday lending or even personal loans,[14] for example); handle short-term bumps in income; borrow against future income to smooth consumption over time;[15] or manage unexpected health costs, job loss, or other emergencies. Increased lending to consumers at lower incomes has also allowed millions of American families to take advantage of the benefits of credit, such as periods of interest-free "floating" and the use of credit as a revolving debt instrument. Furthermore, the expanding use of credit by lower income individuals has allowed such individuals to establish credit histories that signal creditworthiness, and ultimately has allowed access to other sources of credit for larger purchases, such as cars and homes, at lower financing costs. Building a credit history helps in other areas as well, such as applying for insurance, rental housing, and even some jobs. Consumer demand for credit cards has also increased for other reasons as cards: (i) are safer and more convenient than cash; (ii) are accepted at more places than checks, and (iii) are the ubiquitous form of payment on the Internet and over the phone.[16]

"Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes. Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services." – Former Federal Reserve Chairman Alan Greenspan

for many lower income families that wanted to take on greater debt, but were denied access to credit. Using data from the 1983 Survey of Consumer finances, researchers predicted that liquidity-constrained households would have held 75 percent more debt than they actually did in the absence of liquidity constraints. *See* Donald Cox and Tullio Jappelli, "The Effect of Borrowing Constrains on Consumer Liabilities." JOURNAL OF MONEY, CREDIT AND BANKING, 25 (1993), 197-213.

[14] As traditional installment loans were replaced with credit card borrowing, the interest on the two types of borrowing has gradually converged over the past 30 years. Indeed, in recent years the interest rate on credit card accounts has frequently fallen below that of short-term personal loans. *See* Todd J. Zywicki, Testimony Before the House Financial Services Committee Subcomittee on Financial Institutions and Consumer Credit. (April 26, 2007), 13-14 - [hereinafter "Zywicki Testimony"].

[15] Economists refer to this as the "life-cycle hypothesis"—the idea that a young person with high expected future earnings may rationally want to borrow from expected future earnings now, and more perfect credit markets should allow him or her to do so. Indeed, a recent NBER paper confirms just such a dynamic in the context of mortgage borrowing—that innovations in mortgage markets have let people make better, not more irresponsible, decisions to take out mortgages that reflect their long-term incomes. *See* Kristopher Gerardi, Harvey S. Rosen, and Paul Willen, "Do Households Benefit from Financial Deregulation and Innovation? The Case of the Mortgage Market." NBER Working Paper 12967, (March 2007).

[16] For certain individuals, credit cards are more convenient than cash or checks because they can be used almost anywhere in the world.

IMPACT OF INNOVATION AND DEREGULATION
ON CREDIT CARD PRICING

	BEFORE	AFTER
INTEREST RATES	Fixed interest rates of roughly 20 percent.	80 percent of cardholders pay rate less than 20 percent, with average interest rate of 12.3 percent.
FEES	Annual fees of between $20 and $50	Only 2 percent of customers not enrolled in rewards program pay annual fee, and only 25 percent overall.

In addition to expanding access to credit for lower-income and higher-risk consumers, innovation and deregulation, along with intense competition, have also driven prices down. Whereas most credit cards prior to 1990 offered a fixed interest rate of roughly 20 percent, a 2006 GAO study found that 80 percent of cardholders now paid interest rates lower than 20 percent. For the 28 popular cards reviewed by the GAO, the average interest rate assessed for purchases was 12.3 percent in 2005.[17] Moreover, borrowers now benefit from low introductory interest rates and no annual fees. Whereas nearly all credit cards used to carry annual fees before 1990, roughly 75 percent of cards in 2005 carried no annual fee.[18] (Moreover, nearly all those who do pay an annual fee do so in exchange for a rewards program like frequent-flyer miles; in 2002, only two percent of customers not enrolled in a rewards program paid an annual fee.[19]) The ability to carry credit cards with no annual fee has contributed to the rapid growth of credit cards as a convenience method of payment. Nearly half of current users carry no monthly balance, meaning they are enjoying the benefits of credits cards as methods of payment for little or no cost.[20]

---

[17] GAO Report, 15.
[18] GAO Report, 23.
[19] Furletti, "Credit Card Pricing," 10.
[20] GAO Report, 32.

BENEFITS OF EXPANDED ACCESS TO CREDIT CARD USE:

- ☑ Get access to cheaper forms of financing
- ☑ Handle short-term bumps in income
- ☑ Borrow against future earnings to smooth consumption over time
- ☑ Manage unexpected health costs, job loss or other emergencies
- ☑ Take advantage of period of interest-free “floating”
- ☑ Establish credit history
- ☑ Safety and convenience
- ☑ Ability to purchase over the internet and by phone
- ☑ Greater acceptance than checks

Finally, innovation and competition have dramatically expanded the range of products and options available to consumers. Credit card programs now offer myriad reward programs (from airline miles to cash back), varied interest rate and fee structures, and low-interest checks or balance transfer services, among others. Additionally, credit cards also provide consumers with other valuable services, such as more convenient record-keeping, the ability to pay for online purchases (for which credit cards are the dominant form of payment),[21] and increased protection against fraud (which is a particular concern with internet purchases).[22]

[21] “2005/2006 Study of Consumer Payment Preferences.” Conducted by the American Bankers Association and Dove Consulting, (Oct. 2005), 8.
[22] Id., 9.

E. Concerns About Rising Levels of Consumer Debt

The expansion in credit access helped drive the spectacular growth of the credit card market, from $69 billion in 1980 to more than $1.8 trillion in 2005. Some commentators view the expansion of access to credit and concomitant growth of the credit card market as saddling borrowers, particularly those with low incomes, with unmanageable levels of debt. Yet according to the Survey of Consumer Finances, the proportion of households that could be considered to be in financial distress – those that report debt service ratios exceeding 40 percent – was relatively stable between 1995 and 2004.[23]

Part of the explanation for this is that total outstanding credit card debt overstates the amount of new debt that families have taken on for two reasons.

First, if a borrower charges $1,000 to his credit card and pays the balance in full at the end of the month, that $1,000 still counts in data on total credit card debt. Thus, the increased use of credit cards and higher levels of debt in part reflects the fact that consumers are now much more likely to use credit cards as a convenience method of payment. During the past 15 years, convenience use grew by approximately 15 percent per year, whereas the amount borrowed on credit cards as revolving credit grew only about 6.5 percent per year.[24]

The increased use of credit cards has resulted in an increase in revolving credit card debt, but there has been a corresponding decrease in non-revolving forms of consumer credit.

Second, while the increased use of credit cards has resulted in an increase in revolving credit card debt, there has been a corresponding decrease in non-revolving forms of consumer credit. In other words, whereas people used to

[23] The percentage was 11.7 in 1995, rose to 13.8 in 1998, declined to 11.8 in 2001, and rose slightly to 12.2 in 2004. *See* United States Federal Reserve Board, "The Federal Reserve Board: Survey of Consumer Finances." (2004), Washington, D.C.: Retrieved Sept. 10, 2007 – (http://132.200.33.130/pubs/oss/oss2/2007/scf2007home.html).
[24] Kathleen W. Johnson, "Convenience or Necessity? Understanding the Recent Rise in Credit Card Debt." Finance and Economics Discussion Series, (2004), Federal Reserve Board, 47.

make large purchases like furniture or appliances through installment loans or layaway plans, consumers today just charge such items to credit cards.[25] This substitution can be seen in data from the Federal Reserve, which calculates the "debt service ratio" to measure the proportion of a household's income dedicated each month to payment of its debts. A Federal Reserve study concluded that:

> "Over the past fifteen years, households appear to have substituted some forms of credit for others. In the early part of this period, the rise in the share of household debt associated with credit card loans mirrored a decline in so-called 'personal loans' and loans tied specifically to the purchase of durable goods other than vehicles. Trends in more recent years suggest that households may have been using mortgage loans as an alternative to credit card debt."[26]

The figures below illustrate this point. The overall debt service ratio for non-mortgage debt has fluctuated within a fairly narrow band from 1980 to 2006. However, when that debt service ratio is broken down into revolving and non-revolving debt, one can see that there has been a gradual decline in the non-revolving debt service burden that roughly mirrors the gradual increase in the credit card debt service burden.[27]

To be sure, expanded access to credit means that some consumers will find themselves with high levels of debt, whether due to excessive consumption, unexpected income shocks, or emergency expenses. And such risks are no doubt higher for lower income individuals who have the least financial resources to cushion such economic blows. For the vast majority of consumers, however, particularly low-income individuals who previously had more limited access to credit, the democratization of credit has allowed for more productive borrowing. And even for those who find themselves with high levels of debt, the alternatives – inability to pay emergency bills, higher cost forms of

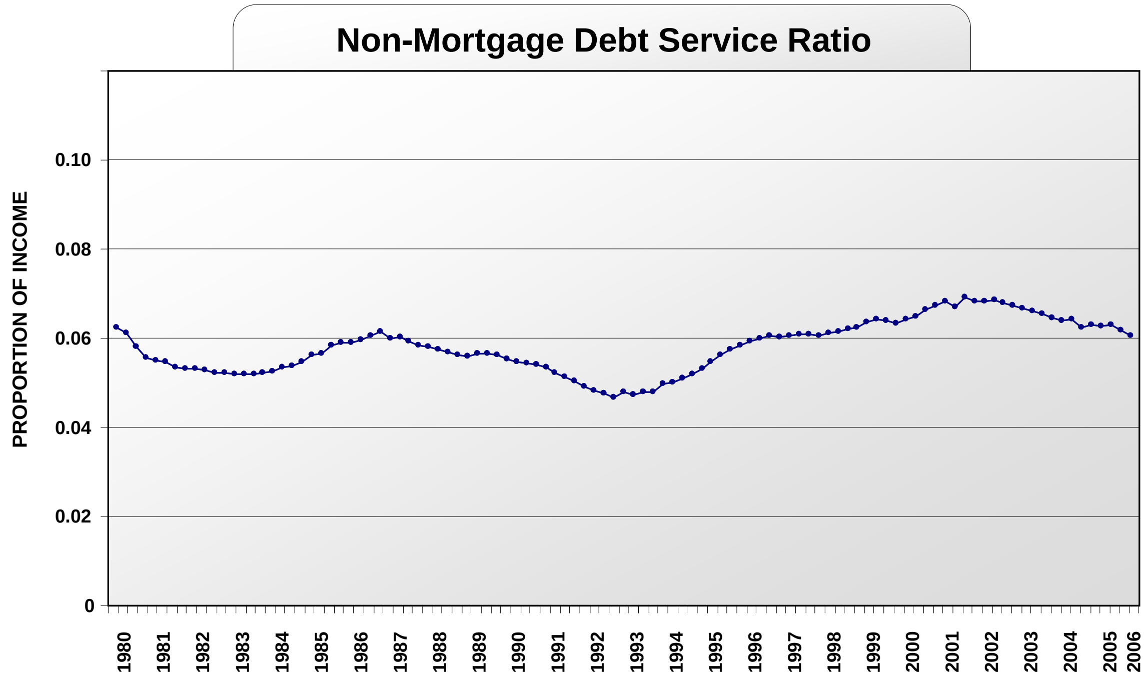
---

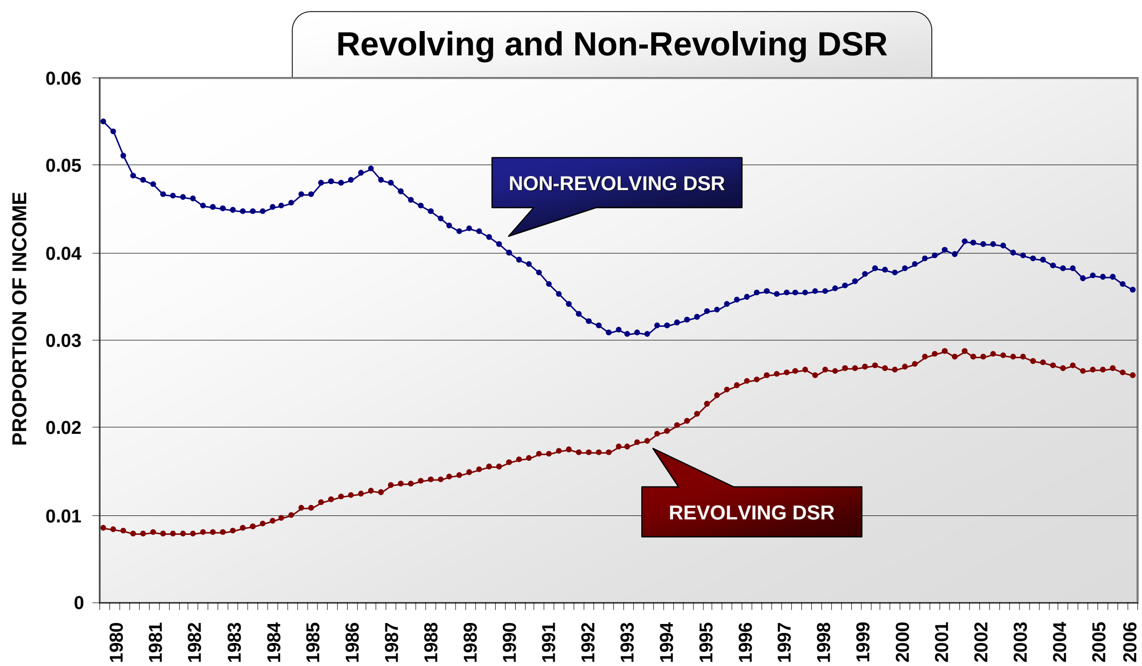
[25] Federal Reserve economist Tom Durkin has observed that credit cards "have largely replaced the installment-purchase plans that were important to the sales volume at many retail stores in earlier decades." *See* Thomas A. Durkin, "Credit Cards: Use and Consumer Attitudes, 1970-2000." (2000), 86 FED. RES. BULLETIN 623. 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." Alan Greenpan, "Understanding Household Debt Obligations." Remarks Given at the Credit Union National Association 2004 Governmental Affairs Conference, (Feb. 23, 2004).

[26] Kathleen Johnson, "Recent Developments," 482.

[27] See Zywicki Testimony, 7-8.

borrowing, or even bankruptcy – are often worse than the consequences of taking on too much credit card debt.[28]





[28] *See*, for example, Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, "Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings." (2006), 59 STAN. L. REV., 213.

Even so, many commentators have expressed concern that unwary borrowers may sometimes take on more debt than they can manage because they may not understand the terms of ever more complex and diverse lending products. In response to that concern, in May 2007, the Federal Reserve Board issued for public comment proposed amendments to Regulation Z of the Truth in Lending Act aimed at enhancing the effectiveness of required credit card disclosures. In particular, the proposed changes are intended to improve and simplify the format, timing, and content requirements of the five types of open-end credit disclosures regulated by the TILA: (1) applications and solicitations; (2) account-opening disclosures; (3) periodic statement disclosures; (4) changes in consumer's interest rate and other account terms; and (5) advertising provisions.[29] The proposed changes were the result of exhaustive and comprehensive analysis and, more importantly, the result of consumer testing and focus groups to determine readability and clarity for consumers.

II. THE ECONOMICS OF PRICE CONTROLS

A. Economic Justification for Price Controls Based on an Absence of Competition

Over the past century, economists have identified situations where government regulation of business practices may be warranted. Such direct market interventions may include price regulations, such as those proposed by certain parties for the credit card sector. The credit card sector bears none of the indicators of an industry in which price controls may be economically appropriate. The potential rationales for government regulations include:[30]

1. Failure of competition. In the absence of effective competition, the potential gains from private production may not be realized. Those potential gains include lower prices and higher productivity. As the President's Council of Economic Advisers has argued, "Industries in which companies compete vigorously tend to

[29] United States Federal Reserve Board, "Federal Register: Federal Reserve System Part II: 12 CFR Part 266, Truth in Lending; Proposed Rule." (June 14, 2007), Washington D.C.: Retrieved Sept. 10, 2007 - (http://edocket.access.gpo.gov/2007/pdf/07-2656.pdf).

[30] For further discussion of these rationales for government regulation, *see* Joseph E. Stiglitz, "Economics of the Public Sector."(1998), W.W. Norton: New York, 71-83.

be more productive. Conventional economic logic argues that companies operate efficiently and innovate whenever there is the chance of a profit payoff. In practice, however, companies can become complacent and keep doing things the old way even when new, more profitable methods are available. The pressures of competition encourage change and force companies to adopt the more productive methods."[31] In the absence of effective competition, these benefits are lost. In such cases, the government can help to ensure effective competition in private markets.

2. Public goods. Public goods have two critical properties: First, no additional costs are involved in providing the good to an additional person (formally, the good has zero marginal costs and is referred to as being "nonrivalrous"). Second, it is impossible to exclude individuals from benefiting from the good (formally, the good is "nonexcludable"). A classic example of a public good is national defense: Defending 300 million people does not necessarily cost more than defending 290 million people, and it is generally not possible to exclude anyone from the benefit of national defense. In general, private markets will not supply public goods – or not supply them in sufficient quantities – and therefore the government has a role to play in providing them.

3. Externalities. An externality arises when the actions of one firm or individual affect the well-being of another, but in which the first entity does not compensate (or receive compensation from) the second entity. For example, a negative externality arises when one individual imposes additional costs on another individual, without having to pay the second individual for those additional costs. The classic example of a negative externality is pollution. An example of a positive externality is technology. In general, the government has a role to play in correcting negative externalities or promoting positive externalities. Without

[31] Council of Economic Advisers, "Economic Report of the President 2000." op. cit., 30.

government involvement, private markets will typically under-produce goods with positive externalities and over-produce goods with negative externalities.[32]

4. Incomplete markets. A fourth possible justification for government activity is incomplete markets. For example, imperfections in capital and insurance markets – such as the absence of insurance coverage for certain types of risks – may warrant government involvement. A classic example of an imperfect capital market is the inability to borrow against higher future earnings, which justifies a government role in providing loans or loan guarantees for post-secondary education expenses. In addition, certain types of goods or services may require large-scale coordination, which may be possible but difficult to achieve without governmental assistance.

5. Information failures. Government activity may be justified by imperfect information in private markets. For example, the Truth-in-Lending legislation requires lenders to provide clear information about the true cost of loans, and the recent proposed changes by the Federal Reserve Board to Regulation Z are aimed at making complex credit card terms easier to understand.

6. Macroeconomic fluctuations. The government has a role to play in correcting macroeconomic imbalances, such as those that lead to periodic problems with high unemployment, inflation, or recession.[33]

7. Redistribution. Even if private markets produce goods and services efficiently, society may not prefer the distribution of income that results. The government may therefore have a role in redistributing income – for example, through a progressive tax system – to produce a more equal distribution of income.

---

[32] The Coase theorem shows that under very restrictive conditions, the externality can be corrected by voluntary private actions even if the role of government is limited to enforcing property rights.

[33] Some economists view the macroeconomic justification for government action as a result of interactions among the other market failures listed.

8. Merit goods. Finally, there may be cases in which individuals would make "bad" decisions if left to their own devices, and in which government paternalism is therefore warranted. The government may sometimes be justified in compelling individuals to consume "merit goods" (such as attending school or wearing a seatbelt) when there would be widespread failure to do so otherwise. In cases where most people make responsible decisions on their own, even if a few do not, the case for the government's dictating private behavior is far weaker.

None of these eight potential rationales for government intervention provide a sound justification for regulating interest rates or fees in the credit card sector. For example, there is not a failure of competition in the issuance of credit cards; credit cards are not a public good; and there are no negative externalities associated with credit card use.

It is important to emphasize that these factors offer only the *potential* for social gain from governmental activity. They do not automatically justify a governmental role, nor do they define precisely how the government should intervene. In particular, in addition to the potential shortcomings in private markets delineated above, the government itself may suffer from so-called governmental failure – basically, inefficiency in its activities or its regulation of private markets. Only if the government can succeed in effectively correcting a shortcoming in private markets should it undertake the activity.

B. Unintended Consequences of Price Controls

If price controls are not justified by one of the rationales noted in the previous section, price regulations can harm the public interest by unnecessarily interfering in private markets. Such unwarranted interference can lead to a restriction in supply: for example, a ceiling on the price of credit (*i.e.*, credit card interest rates) will inevitably cause issuing banks to restrict access to higher-risk cardholders and increase prices on lower risk borrowers to cross-subsidize higher risk ones.

Regulating rates or fees that issuers can charge would have the unintended consequence of harming borrowers

The historical experience is consistent with economic theory. Before 1978, issuers were forced to comply with state usury laws that capped the interest rate issuers could charge.[34]

The result was the denial of credit to large segments of higher risk and lower income consumers. Moreover, issuers made up for the lost revenue from their inability to price according to borrower risk by readjusting other credit card terms. For example, issuers imposed annual fees, which not only were an inefficient pricing mechanism because they failed to reflect borrower risk, but which also forced convenience users to subsidize high-risk revolvers who were borrowing at artificially low interest rates. Following *Marquette*, advances in information technology and the concomitant ability to estimate default risk meant that issuing banks could better charge an appropriate interest rate to reflect the default risk of the cardholder. The ability to tailor interest rates and fees to reflect default risk opened up access to credit to greater numbers of cardholders and reduced the cost of credit for most cardholders. International experience also lends support to these concerns. As discussed further below, in 2003 the Reserve Bank of Australia reduced interchange fees by almost half, causing bank issuers to increase annual fees and other fixed prices to make up the lost revenue.

After Australia capped interchange fees, bank issuers increased annual fees and lowered rewards for cardholders.

The ostensible purpose of proposed price controls on credit cards is to protect certain groups of borrowers, particularly higher risk and lower income borrowers. Yet capping the rates or fees that issuers could charge would have the unintended consequence of harming those very borrowers. Issuing banks would be forced to pass along increased costs to consumers and limit access to credit not only to higher-risk cardholders, but also possibly to lower-income cardholders. Acting rationally, issuing banks must recover their risk-adjusted costs by some means.[35] If risk-based pricing is prohibited through price controls on fees or interest rates, these banks will re-optimize their pricing strategies and fee

[34] In 1978, the Supreme Court ruled that the credit card interest rates a bank could charge were determined by the laws of the state in which the bank resided, not the state in which its customer resided. *See Marquette Nat. Bank v. First Of Omaha Corp.*, 439 U.S. 299 (1978).

[35] As already noted, empirical evidence indicates that credit card prices are generally reflective of risk. Higher penalty fees, for example, are explained by borrower risk and are offset by lower interest rates.

structures to ensure that they can recover their costs of providing credit given these new constraints. Regulatory caps on the prices credit card issuers could charge would thus likely increase prices for lower-risk borrowers, forcing them to subsidize higher risk borrowers, and reduce the availability of credit for many higher-risk and lower-income borrowers. Those borrowers with reduced access to credit would find it harder to smooth consumption and deal with emergencies and might have to resort to higher-cost forms of borrowing.

A simple hypothetical demonstrates the unintended consequences of price controls on credit cards. Suppose a group of 100 cardholders currently each has a credit card. Roughly 50 of these cardholders are convenience users and pay their bills in full each month. Another, say, 40 cardholders pay their bills on time each month, but do not pay their bills in full and thus face interest charges; for this hypothetical example, any proposed fee or rate regulations would not be a constraint on this group (*e.g.*, their current risk-based interest rate is below the regulated level). The last group of 10 cardholders have difficulty paying their credit card bills and each face the prospect of paying penalty interest rates and/or fees as a result (and any regulation would have a direct effect on the rates and fees charged to these consumers).[36]

Limiting credit card interest rate hikes or late and over-the-limit fees may or may not help the group of 10 cardholders with high debt. These individuals would clearly benefit from the fact that payments owed on their outstanding balances would grow at a slower rate, thus making it easier for them to pay off their debts. However, one must also consider the dynamic effects of such a policy change. As a result of not being able to charge a risk-based price to those 10 cardholders, the credit card issuers may decide: (1) to deny their application, in the case of prospective borrowers or (2) close their account, in the case of current customers whose risk profile deteriorates. If they lose access to credit, the alternative options for those individuals may be far more severe than their current interest

[36] These numbers are hypothetical, given the limited data available. As a relevant benchmark, however, recall that roughly half of cardholders pay their balance in full each month and, further, that of those consumers who have debt, 12.2 percent had a debt service ratio that exceeded 40 percent of household income (a figure that has been relatively stable over the past two decades). *See* “Survey of Consumer Finances,” 33.

rate charges. For example, if denied credit from credit card lenders, many of these consumers might need to turn to payday lenders or other lenders that charge even higher interest rates. A recent *New York Times* profile, for example, explained how a non-profit organization helped a woman, who took a payday loan as a stopgap measure after losing her job, bring her debt payments to a manageable level by converting her payday debts, which charged the equivalent of more than 500 percent annual interest, to a one-year loan at 18.9 percent—a rate much closer to that of credit cards. (Although credit card interest rates may be higher for borrowers with poor credit histories, bear in mind this 18.9 percent rate was the rate required for the non-profit to just cover costs).[37] Thus, it is ambiguous whether these individuals would, in fact, be better off with fee or rate regulations.

But the effect of the regulations on the other two groups of consumers is unambiguous. For the 50 convenience users and 40 consumers who pay interest charges or fees (but would not be directly affected by the regulations), the likely effect would be either that issuers (i) raise their interest rates slightly (which would have no direct effect on the 50 convenience users since they pay their balance in full and a direct effect on the 40 other users) or (ii) impose annual or other fees, which would affect them all. Card issuers would need to implement the higher interest rates or fees in order to cross-subsidize the riskier borrowers who are paying artificially low rates (the customers who were approved for loans but whose risk profile deteriorated). Imposing rate or fee regulations is the functional equivalent of squeezing a balloon: the air (read: interest rates or fees) is just shifted to the other side of the balloon (read: these two groups of consumers). Rate or fee regulation would have no benefit to either of these groups (since they already pay fees or interest rates below the regulated level) – and would almost certainly harm them.

Price controls on credit card interest rates and fees *may* reduce the cost of credit card borrowing for the 10 cardholders, but only at the much greater costs of: (1) reducing their

[37] John Leland, "Nonprofit Payday Loans? Yes, to Mixed Reviews," *New York Times*, (August 18, 2007), A1.

access to credit (2) and raising costs for the remaining 90 who have benefited from innovation and deregulation in the credit card market.

ILLUSTRATIVE UNINTENDED CONSEQUENCES ON 100 CARDHOLDERS OF RESTRICTING RISK-BASED PRICING

	BENEFITS	HARMS
50 CONVENIENCE USERS (carry no balance)	None	Potentially face new or higher fees, such as annual fees.
40 REVOLVERS (carry balance but face no penalty fees)	None	Potentially face higher interest rates on revolving balance. Potentially face new or higher fees, such as annual fees.
10 DISTRESSED REVOLVERS (having difficulty paying on time and face possible fees)	Interest payments owed might grow at slower rate. Amount owed in fees might be lower.	Some may lose access to credit and be left with costlier borrowing options (e.g., payday lending).

Obviously, this is a highly stylized example, but historical evidence bears out the hypothetical, as more restricted credit and higher prices were the norm prior to roughly 1990. Moreover, a just-released report from the Federal Reserve Board of Governors reiterates the benefits of risk-based pricing to expand access to credit, price more efficiently, and lower costs for lower risk customers:

> Credit scoring increases the efficiency of consumer credit markets by helping creditors establish prices that are more consistent with the risks and costs inherent in extending credit. Risk-based pricing reduces cross-subsidization among borrowers posing different credit risks and sends a more accurate price signal to each consumer. Reducing cross-subsidization can discourage excessive borrowing by risky customers while helping to ensure that less-risky customers are not discouraged from borrowing as much as their circumstances warrant. Finally, risk-based pricing expands access to credit for previously credit-constrained populations, as creditors are better able to evaluate credit risk and, by pricing it appropriately, offer credit to higher-risk individuals.[38]

[38] Board of Governors of the Federal Reserve System, "Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit." (August 2007).

Furthermore, not only those high-risk borrowers, but the economy more broadly would be harmed as a result of consumers' reduced inability to maintain consumption through periods of income disruptions or borrow against future earnings. Such "automatic stabilization" helps to promote more balanced economic growth – in downtimes, an individual can borrow on his or her credit card and not change spending levels as dramatically, and in boom times, that individual can pay back the debt, thereby reducing funds available for consumption. A reduction in credit may have a particularly significant effect today, since U.S. economic growth has become highly dependent on consumer spending.

C. Two-Sided Markets Complicate Regulation of Credit Card Rates/Fees

As noted above, even if there were a market failure, one would need to determine whether the benefits of government regulation exceeded the costs of such regulations. The nature of the credit card market makes any potential regulation relatively more costly and inefficient.

Two-sided markets are those where one or more "platforms" (*e.g.*, malls, television channels or video game systems) permit the mutually beneficial interactions of two groups of economic actors (*e.g.*, shoppers and stores, advertisers and viewers, or game players and writers). In two-sided markets, the volume of transactions can be affected by charging more to one side of the market and charging the other side a lower price. The platform must allocate the total price charged between the two sides in such a manner so as to attract users to both sides of the market. This is sometimes referred to as the positive externalities of participation. The price structure as well as price level matters in two-sided markets. The allocation of the total price will depend on several factors, including the relative elasticity of demand between the two sides, the nature and intensity of the indirect network effects between the two sides, and the marginal costs resulting from changing the output of each side.

Credit cards are an example of a two-sided market. Cardholders and card issuers (banks or proprietary network issuers) make up one side of the market and merchants and acquiring banks (or intermediary) are on the other side. Networks act as the intermediary platform facilitating transactions and determining price allocations between the two sides to induce transaction volume.[39]

In a two-sided market, regulations can create a vicious cycle of reductions in credit card usage throughout the economy

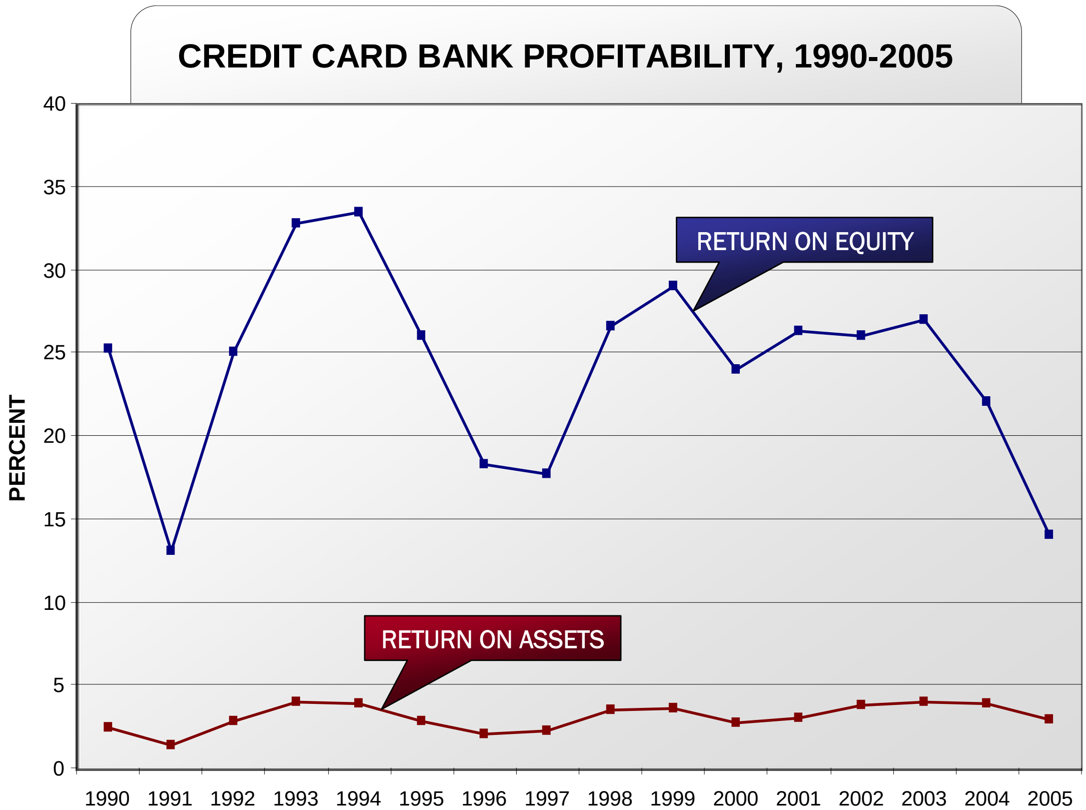
Price regulations in two-sided markets may have greater negative consequences than in traditional markets, because of the externalities associated with a two-sided market. Limiting issuing banks' ability to set prices at efficient rates to reflect risks and encourage transactions volume may shift this role more to the merchant side of the market. The increasing use of credit cards at grocery stores, quick serve restaurants, and other low spend, but high transaction volume settings may be adversely impacted by the reduction in card volume. Lower volumes may lead to reductions in card acceptance, which reduces demand for credit cards, which in turn lowers merchant acceptance. The regulations can thus create a vicious cycle of reductions in credit card usage throughout the economy.

D. The Profitability of Credit Card Issuers

Some commentators have observed high profits of firms in the industry. They suggest that such high profit levels are evidence that the market is failing and serve as a motivation for regulation. This argument fails for two reasons. First, there is no evidence that profitability of credit card issuers and networks can be deemed to be extraordinary. The chart below is based on survey data compiled by the Federal Reserve. It shows return on equity and return on assets at credit card banks, defined as those banks having credit card assets greater than 40 percent of their total assets and ranked among the 1,000 largest in total assets. In 2005, the annual return on assets for credit card banks was 2.89

[39] *See*, for example, Carl Shapiro and Hal Varian, "Information Rules." (1999), Harvard Business School Press: Boston.

percent.[40] By comparison, the return on assets for the motor vehicles and motor vehicle parts industry was 3.5 percent and food and drug stores was 3.6 percent.[41]



Source: Profits and Balance Sheet Developments at U.S. Commercial Banks in 2005, Federal Reserve Bulletin 2006

The second reason the argument fails is that the economics literature has considered, and rejected, using measures of profits to determine the extent of competition in a market.[42] The economics literature has shown that high and persistent profits, as well as varying profits among firms, are consistent with competitive markets that perform optimally for consumers and social welfare. Firms may earn economic profits simply because they are more efficient, innovative, and entrepreneurial than their competitors. They may have accumulated valuable intangible assets that lower their costs of production or enhance demand for their products. Some firms may be particularly adept at recognizing and

[40] United States Federal Reserve Board, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 2005." (2006), FED. RES. BULLETIN.
[41] Analysis of data from CNNMoney.com
[42] *See*, for example, FM Fisher and JJ McGowan, "On the Misuse of Accounting Rates of Return to Infer Monopoly Profits." (March 1983), AMERICAN ECONOMIC REVIEW, vol. 73, no. 1, 82-97.

taking advantage of unexplored market opportunities. Some firms may earn high economic profits as a result of taking on a substantial amount of risk. And some firms may earn high and persistent economic profits from luck – that is, some firms may be or have been in the "right place at the right time."

One of the reasons economists have rejected using profits as a measure of competition in the market is that economic profits are a theoretical construct that may not be easily applied to real-world economic situations. In fact, measuring economic profits accurately in real-world markets may be impossible, especially in cases where one is attempting to measure the economic profits of a single business division that shares the use of tangible and intangible assets with other significant portions of the firm as a whole.

III. HARMFUL CONSEQUENCES OF PROPOSED REGULATIONS ON CREDIT CARD INTEREST RATES AND FEES

The growth in credit card issuance and spending has drawn critics who label certain practices "predatory" or "overly aggressive". This section will address the various proposals, and discuss the likely economic effects of such proposals. The proposals can be broadly grouped into these categories:

A. Penalty Fee and Interest Limits
B. Service Fee Limits
C. Timing Issues

A. Penalty Fee and Interest Limits

Proposals to limit penalty fees and interest involve restrictions on late fees, over-the-limit fees, and penalty interest rate increases.

1. Late Fees

Currently the onus to make a payment on-time to the issuer falls on the cardholder. As mentioned, issuers tend to provide customers at least 20 days following their statement closing date to make an on-time payment, and by law, issuers post payment as of the date of receipt. Issuers also instruct customers using first-class mail to allow sufficient time for their payment to reach issuers' payment processing centers. In addition, all lenders surveyed by the GAO for their 2006 report offer on-line and express payment alternatives, like online bill pay and Western Union. The percentage of recurring bills paid electronically is growing rapidly, up from 22 percent in 2001 to 45 percent in 2006.[43] Pay-by-phone is accepted typically with a fee, and overnight mail is accepted at all payment processing centers. Also, credit card companies offer email alerts and electronic bills that allow individuals to receive their bills even more quickly. Consumers can also arrange for automatic or manual pay online.

Certain limits on late fees may seem reasonable at first, such as requiring a grace period beyond the payment due date before imposing late fees so that a person is not assessed a $39 fee (and possibly a higher penalty interest rate) for paying a bill one day late.[44] But it is important to remember that credit card issuers *already* lend money *interest free* until the payment due date to convenience users who pay their bills in full each month—which accounts for roughly half of cardholders. That is, such a cardholder borrows from the issuer every month without paying *any interest*. Moreover, Regulation Z requires that a cardholder receive a credit card bill 14 days before the payment due date. The fact that a cardholder decides not to pay until near the end of the interest-free window is the cardholder's decision. If the cardholder paid his or her bill right when it was received or paid online it would be unlikely that there could be any issues associated with late payments.

In addition, if a cardholder pays a bill late, that provides a signal to the issuer that the cardholder has become a riskier borrower. As noted above, late fees tend to reflect consumer default risk and the level of these fees is negatively correlated with interest rates.[45] As explained by Federal Reserve Bank of Philadelphia economist Mark Furletti:

[43] "2005/2006 Study of Consumer Payment Preferences." Conducted by the American Bankers Association and Dove Consulting, (Oct. 2005), 11.

[44] Presidential candidate John Edwards, for example, recently proposed requiring a 10-day grace period before imposing late fees and penalty rates. *See* "Building One America: Taking on Abusive Lenders and Helping Families Save." (2007), John Edwards '08, Retrieved Sept. 10, 2007 - (http://johnedwards.com/news/press-releases/building-one-america/).

[45] Nadia Massoud, Anthony Saunders, and Barry Scholnick, "The Cost of Being Late: The Case of Credit Card Penalty Fees." Working Paper, (October 2006) – (http://papers.ssrn.com/Sol3/papers.cfm?abstract_id=890826). In a recent paper, these authors find that "a significant portion of those who pay credit card penalty fees do so by mistake because of inattention."

"The industry's modeling and analysis efforts have shown that customers who are late or over their credit limit or who write bad checks are more likely to default. Risk-related fees help compensate for this increased risk."[46] Thus, any limits on late fees will harm the effectiveness of risk-based pricing and result in higher prices for all cardholders, as explained above.

Another proposal related to late payment calls for prohibiting service fees, such as for cash advances, as long as customers pay their bills on time. Yet the proposed reform is unrelated to the purported problem – excessively high service fees. Service fee proposals are discussed further below, but the basic point is that the service fees banks charge reflect the costs of providing particular services to the consumer—for example, reward redemption fees partly offset the cost to the issuer of carrying unredeemed rewards points as a liability on their books and compensating partners, like airlines, for the rewards. Similarly, fees for telephone payment that involve a live customer service representative reflect the higher cost to the issuer of accepting payment in this fashion, rather than via mail or the Internet.[47] Moreover, to prohibit issuers from recouping the cost of providing such services to customers who pay their balances on time would unfairly result in issuers' shifting more of those costs to those who pay late—even though both timely and untimely borrowers are using the same exact services. Not only would such a pricing structure be economically inefficient, but it would also shift more costs to precisely those borrowers who have difficulty managing their debt burdens, and who are precisely the types of consumers that reform advocates are most concerned with protecting.

They argue that default risk thus may not be the explanation for rising penalty fees. In the first instance, further study is required to understand the relationship between the reasons for incurring fees and default risk (*i.e.*, what is the relationship between inattention and default risk). Regardless, given that the paper shows that a majority of penalty fee payments are *not* mistakes and thus very likely tied to default risk, the appropriate policy response to consumer inattention is not rate regulation, but increased financial literacy (as proposed below). While the authors dismiss financial literacy as a solution, they fail to consider, as discussed below, that financial literacy teaches cardholders that there are real costs to inattention and increases the likelihood that consumers pay their bills on time. See Nadia Massoud, Anthony Saunders, and Barry Scholnick, "Who Makes Credit Card Mistakes?" Working Paper, (August 2007) – (http://www.philadelphiafed.org/econ/conf/consumercreditandpayments2007/papers/Scholnick_Who_Makes_Credit_Card_Mistakes.pdf).

[46] Furletti, "Credit Card Pricing ," 10.

[47] Automated or Interactive Voice Response (IVR) systems may not be more costly on a marginal basis than alternative payment mechanisms, such as mail or the Internet, which suggests that payments via such mechanisms should not be as costly as payments via live customer service representatives.

2. Over-the-Limit Fees

There are a variety of proposals to cap over-the-limit penalty fees, which seek to restrict issuers' ability to charge penalty fees to cardholders exceeding their established line of credit. These range from banning over-the-limit fees on issuer-approved transactions to restricting over-the-limit fees by requiring advance written consent of the customer to allow over the limit transactions. For quantification, the total amount credit card issuers assessed in over-the-limit fees in 2005 was $293 million; this equated to $9.49 per active account among those issuers surveyed by the GAO. Among those issuers, 13 percent of active customers were assessed an over-the-limit fee in 2005.[48]

The proposal to ban over-the-limit fees is unwarranted and would likely drive up costs for other cardholders who do not exceed their limits, because exceeding or even using all of an established credit limit is highly correlated with borrower risk, such as potential default.[49] Since customers who max out their credit lines are much more likely to default, over-the-limit fees are imposed by issuers as a buffer against further risky behavior. Without fees imposed on users for exceeding their limit, credit issuers' only other means to prevent charges above the established credit limit would be flat-out denial of acceptance. Denial of acceptance, however, would likely cause more harm to borrowers than over-the-limit fees. Borrowers often go over the limit in times of emergency or other unforeseen events, for example, and would be harmed by not having access to emergency over-the-limit funds. These denials could leave borrowers stranded during travel or in an unexpected emergency situation. Finally, it is often not technically feasible to reject over-the-limit transactions because many credit purchases are not subject to approval by card issuers. Purchases like those made at gas stations, convenience stores and fast-food restaurants—which are a rapidly growing segment of card-accepting merchants—are not authorized in the same manner by issuers due to the enormous constraints they would put on the networks.

For the same reasons a flat-out ban on over-the-limit fees would harm consumers, so too would the proposal seeking to restrict over-the-limit fees by requiring advance written

[48] GAO Report, 5.
[49] *See, e.g.*, Furletti, "Credit Card Pricing," 10.

consent of the customer to allow over-the-limit transactions (and concomitant fees). There are sure to be many borrowers who ignore such consent forms and then find their card rejected in times of emergencies or at other times when the consumer would be willing to pay the fee for access to additional credit. Moreover, even for those who return the consent form, such a requirement is an onerous and costly way to make borrowers accept a term that the vast majority of borrowers prefer, and also ignores that borrower preferences regarding this term may change over time.

A less harmful variant of this proposal might give cardholders the option to opt-out of paying over-the-limit fees if they prefer that their card be rejected if they hit their credit limit. Setting the ability to go over the limit (for a fee) as the default, while giving consumers the ability to opt-out, is a less burdensome and costly way to expand consumer choice and increase consumer protection.

3. Interest Limits

Proposals to limit cardholder interest expenses include: prohibiting interest rate hikes on credit card accounts unless the cardholder agrees to them at the time of the increase; prohibiting interest rate increases unless it was disclosed in advance in connection with the expiration of an introductory rate or the application of a variable rate or penalty rate; limiting interest rate increases to seven percent of the current rate; prohibiting universal default (the practice of automatically adjusting a rate because of an adverse event related to another credit product that harms the borrower's credit score); permitting rate increases only for future credit card debt and not prior debt; and, finally, prohibiting charging interest on credit card transaction fees, such as late fees and over-the-limit fees.

As discussed, the majority of revenue – roughly 70 percent – earned by issuing banks is from interest charges. Managing risk and properly assessing interest rates based on cardholders' creditworthiness is the core competency of credit card issuers. Using interest rates to price for risk is economically efficient, pro-consumer welfare, and has helped to expand access to credit. As discussed above, interest rates have declined for the vast majority of consumers since the Supreme Court allowed issuers to charge prices that more accurately reflected borrower risk. Whereas prior to 1990 cards generally carried fixed interest rates of about 20 percent, the average rate in 2005 was 12.3 percent.

Compared to other forms of credit lending, risk-based pricing in credit cards is more difficult than in most industries because it is a revolving line of credit. Thus, the lender does not know when, and how much, borrowing will be done or for what purpose. In order to make the best prediction about a cardholder's credit card behavior, an issuer must take all legally available information into account. Adverse changes in a person's credit score signals to a lender that a borrower is a greater credit risk than when the line of credit was established and thus a higher interest rate may be warranted to reflect that risk.

Some proposals seeking to prohibit so-called "universal default" provisions preclude automatic interest rate hikes for any reasons other than the actions or omissions of the consumer that are directly related to his or her account. Yet, as indicated, credit card debt is unlike a fixed loan where the amount is amortized in predictable installments over time. Also, credit card debt is unsecured, meaning it is not guaranteed with any asset and thus the risk of repossession does not exist.[50] The unpredictable nature of credit card debt requires that issuers be adaptable to adverse behavior, or else risk the potential for partial or complete non-payment. The cardholder's credit score is one of the few tools credit card issuers have in assessing creditworthiness. (That is, in part, because the credit card has evolved from a limited financial add-on provided by banks to their customers to, in most cases, a line of credit to a borrower with which the lender has never had a financial relationship. The lender's best assessment of risk and creditworthiness can thus only be surmised from a limited number of sources, credit scores being the most comprehensive.)

New York Governor Eliot Spitzer recently echoed these concerns. When he vetoed a bill prohibiting credit card issuers from raising a cardholder's interest rate or imposing a fee

[50] Note that in cases of unsecured debt the lender can still take legal action to attempt recover the money owed, but that legal process is decidedly longer and more expensive than with secured loans.

based solely on the reported delinquency of the cardholder on another creditor's account, he said:

> [A] consumer's delinquency on a creditor's account is an indication that the consumer may be at risk of not paying other accounts. Typically, credit card issuers increase the interest rates or fees charged to consumers at a greater risk of nonpayment. By prohibiting that response, this bill would force credit card issuers to increase interest rates or fees charged to all of their credit cardholders – thereby shifting the financial burden from those who are in default on an account, to those who are not.[51]

Moreover, a regulatory prohibition of "universal default" seems unnecessary given that competitive market forces are pushing issuers to abandon the practice, which has proven especially unpopular with consumers. Issuers began the process of universal default in 2000. In 2004, the Office of the Comptroller of the Currency issued guidance to banks urging them to disclose this practice in promotional material. Since then, this practice has been among the most frequently attacked practices of the industry by consumer advocacy groups. As a result, by 2005, according to the GAO, only three of 28 issuers surveyed still had universal default clauses. A number of issuers have decided that the benefits of a universal default clause are smaller than the cost of lost customers.[52] For those issuers, on the other hand, who have determined that universal default clauses produce more efficient risk-based pricing, barring them from offering such a product will likely lead to either higher rates or less credit from these issuers. Barring universal default clauses will also distort competition among issuers. Currently, certain issuers have decided that the use of universal default clauses is the most efficient way to compete in the marketplace, while others have decided against the practice. Government regulation of which practices are appropriate (and which are not) can distort the competitive process to the detriment of competition and consumers. Some consumer groups define "universal default" even more broadly and urge that Congress prohibit

---

[51] Gov. Eliot Spitzer, "Veto Message No. 109 regarding Senate Bill Number 2969-B, entitled 'AN ACT to amend the general business law, in relation to prohibiting certain agreements between the issuers and the holders of credit cards and debit cards.'" New York, Retrieved Sept. 10, 2007 – (http://www.nyba.com/government/VetoMsgUniversaldefault.doc).

[52] As John Carey, the Chief Administrative Office of Citi Cards, recently explained to Congress, Citi initially gave consumers the right to opt out of universal default provisions and subsequently eliminated the practice altogether because "we recognized why customers, and others, would question the practice." John P. Carey, Testimony Before the Subcommittee on Financial Institutions and Consumer Credit. (June 7, 2007).

credit card issuers from making use of industry-standard credit scoring to adjust rates and fees, but the ability to make use of such information to price risk accurately has enormous benefits for consumers, as explained above.

The proposal to limit interest rate hikes to a rigid and arbitrary limit of seven percent would similarly restrict issuers' ability to price their revolving credit product to reflect risk accurately and respond to changes in a borrower's risk profile. The result would likely be reduced access to credit for some high risk borrowers and higher prices for all other customers as low-risk customers subsidize higher risk ones. The same adverse consequences would likely result (though admittedly to a lesser degree) from the proposal to prohibit interest rate hikes on credit card accounts unless the cardholder agrees to them at the time of the increase or it was disclosed in advance (in connection with the expiration of an introductory rate or the application of a variable rate or penalty rate). By also limiting an issuer's ability to adjust to the unpredictable nature of credit card debt, this proposal would severely constrain the credit card market and prevent it from operating as efficiently.

The proposal recommending that rate increases only apply to future credit card debt and not prior debt also ignores the real risks of customer default in cases where penalty rates are triggered. According to at least one major issuer, only roughly two percent of cardholders will have their balances written off by the issuer because of default. Argus Information and Advisory Services conducted an analysis of industry data and found that 32 percent of accounts in default were likely to be written off within a two-year period.[53] As a result, increasing interest rates on prior, as well as future, debt after a penalty-triggering event is a loss mitigation strategy on the part of the issuer that reflects risk-based pricing.

Moreover, the proposal is also shortsighted. The most obvious scenario is that a cardholder could charge up to the account limit with knowledge that his or her credit

---

[53] Proprietary analysis conducted by Angus Information and Advisory Services, September 2007 based on the cumulative write-off of accounts who exhibited a 100 basis point change in price and either paid late, were delinquent, or over their credit limit in the prior cycle.

would soon deteriorate and then not be subject to re-pricing when that increased risk became apparent. As a result, credit card companies would likely stop offering such low interest rates in an effort to compensate for potential deteriorating credit across the entire portfolio to the detriment of the consumers who have historically benefited from low rates. In other words, instead of assuming that a customer's risk level will not increase and raising rates for those customers whose risk level does rise, issuers will charge everyone higher rates to account for the possibility that some cardholders' credit profiles may deteriorate.

TYPE OF LIMIT	LIKELY EFFECT OF LIMIT	REAL-WORLD EXPERIENCE WITH PROPOSED LIMIT
Penalty Fee Limits • Late Fees • Over-the-Limit Fees • Interest Rate Limits	• Higher prices for *all* cardholders (e.g., interest rates and annual fees) • Reduced access to credit for some high-risk borrowers • Fewer low introductory interest rate offers • Increased card denials, leaving customers stranded (e.g., during emergencies and travel)	• After penalty fees were recently halved in the UK, banks reintroduced annual fees and imposed various new fees. • Following deregulation in the U.S. that allowed issuers to charge risk-based prices, average interest rates declined from roughly 20% prior to 1990 to 12.3% in 2005.

Advocates of this proposal argue that raising interest rates on outstanding debt is particularly unfair to cardholders because a cardholder who may have been able to manage a given level of debt at a certain interest rate may find the payments unaffordable at a higher rate, yet has no option but to pay the higher rate or default. Thus, advocates of this proposal claim, there is nothing to prevent issuers from raising interest rates midstream and "trapping" consumers into making higher interest payments. But the credit card industry is highly competitive, and borrowers thus need not suffer from such a "lock-in" effect. If an issuer raises a borrower's rate higher than is justified by that borrower's risk profile, there is little to prevent that borrower from transferring their outstanding balance to another issuer at a lower price, as competition will lead other issuers to compete for that cardholder's business and drive interest rates down to the lowest profitable risk-based price.

B. Service Fee Limits

Proposals seeking to limit service fees include prohibiting charging fees on the method of payment (most prominently paying by phone with a customer service representative) and regulating the amount issuers can charge for currency exchange services. Yet such proposals fail to acknowledge the reasons for such fees. These services cost issuers money to implement and operate. Rather than allocate these fees across their entire portfolio of cardholders, including those that never use the services, or, even worse, eliminate the offered services altogether, the issuer recoups the cost of offering the services by charging only those cardholders who use them.

Barring service fees is similar to the federal government's barring toll roads because it is unfair for individuals who use the road to pay a fee for its use. If such a regulation were imposed, instead of tolls, all taxpayers would need to pay for the maintenance of the road – even those individuals who never use it. There is no economic rationale for shifting the costs of a service from those who use it to those who do not.

As discussed more thoroughly above, cardholders are given multiple methods to make timely payments including: standard mail, online bill pay, preauthorized debits, Western Union, and expedited mail services. Cardholders who choose to use more costly methods of payments, such as paying by phone, are charged more. For similar reasons, consumers who now buy plane tickets on the phone typically pay a fee to offset the higher cost to airlines of booking reservations in this manner. To the extent that the amount charged by issuers for pay-by-phone service still exceeds the marginal cost of providing such service, the reason is simply that the industry has not set up the infrastructure to accept such payments on a large scale and thus tries to discourage cardholders from paying through this channel. Card issuers typically disclose the costs of using such services to the consumer, which ensures that cardholders make an informed choice. And the Federal Reserve Board's proposed changes to Regulation Z would specifically require such disclosure so that there is liability under the Truth in Lending Act for failure to do so. (It should be noted that cardholders will often choose this service to avoid paying even higher late fees or potential negative credit reporting when the payment is verging on being more than 30 days late.)

C. Timing Issues

Several proposals seek to regulate timing issues with regard to how credit card issuers charge interest. The practices targeted by these proposals include trailing/residual interest and payment allocation.[54]

Proposals targeting trailing interest, sometimes called final or residual interest, are directed at the method of calculation whereby interest is charged up until the day of a full payment. Cardholders of banks that use this method receive a bill listing the balance owed and interest accrued, as well as the amount needed to pay off the bill in full. On the next statement they are billed a "final" amount of interest even if no purchases or cash advances have been debited since. The reason for this is that interest continues to accrue from the time of the close of the previous statement until the day the payment for that statement is actually received.[55]

In addition, one proposal targets payment allocation and attempts to force issuers to apply the balance with the highest interest rate first. The typical mechanism of payment allocation is that credit card companies apply monthly payments towards the part of the balance with the lowest interest rate. This can include any portion of the balance covered by a promotional period interest rate, like a zero-interest introductory offer. Card issuers disclose this payment allocation method to cardholders, and the proposed changes to Regulation Z aim to make these disclosures even more understandable. This method of payment allocation is clearly the most profitable for the issuer; however it is also logical in its application. Issuers and cardholders alike have benefited from low introductory promotional rate offers. The promotional rates allow cardholders to finance revolving credit purchases more cheaply, while issuers attract customers and volume to their

[54] An additional timing related proposal seeks to increase the minimum payment period to 30 days (from 20). As mentioned in the section on service fees, cardholders are given many different options. Extending the minimum payment period to 30 days gives cardholders 10 more days of interest-free financing.

[55] "Credit Card." (2007), Answers.com, Retrieved Sept. 10, 2007 – (http://www.answers.com/topic/charge-card?cat=biz-fin).

network with aspirations of earning customer loyalty and income down the line. Changing the way payments are allocated would have several adverse effects. Most obviously, issuers would curtail low introductory rate offers. But perhaps the most significant would be that average rates would rise for all customers, harming those who only occasionally use their credit card for borrowing and increasing the cost of using credit across the economy. Again, this is not unlike the balloon metaphor explained above. Imposing a particular "stacking order" for payments is the functional equivalent to squeezing a balloon: the air (read: interest rates or fees) is just shifted to the other side of the balloon (read: to other consumers).

D. International Experience

The predicted unintended consequences of price controls and other proposed regulations are not mere hypotheticals. International experience bears them out. In 2003, for example, the Reserve Bank of Australia reduced interchange fees by almost half in an attempt to align the prices of using various payment methods with their perceived social costs and thus reduce the use of credit cards, which the RBA viewed as socially less acceptable than other forms of payment. The short-term result has been straightforward: Bank issuers have increased the fixed prices for cards recovering between 30 and 40 percent of the loss of interchange fee revenue; credit card transaction volume has been unaffected; and there has been a significant transfer of profits to the Australian merchant sector with that burden being borne by bank issuers and cardholders.[56]

In addition to the issuing banks that have lost hundreds of millions of dollars in revenue, cardholders in Australia have been harmed. In a recent study of Australia's rate regulation, economists estimated that Australian cardholders had seen their annual fees and finance charges increase by between AU$148 million and AU$197 million, and the value of rewards to cardholders on credit cards has fallen by nearly 20 percent.[57] According to calculations by the Reserve Bank of Australia, between 2003 and 2006

[56] Howard Chang, David Evans, and Daniel Garcia-Swartz, "The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia," REVIEW OF NETWORK ECONOMICS, forthcoming.
[57] Timothy J. Muris, Counsel O'Melveny & Myers, "Credit Card Interchange Fees." Testimony Before House Judiciary Committee Subcommittee on Antitrust Task Force, (July 19, 2007).

average annual fees on no-frill cards increased from AU$0 to AU$38, average late payment fees increased from AU$23 to AU$31, and average over-the-limit fees increased from AU$25 to AU$30.[58] One large bank, National Australia Bank, capped rewards on its Visa rewards card.

Similarly, in the UK, the Office of Fair Trading (OFT) last year ordered credit card providers to halve penalty fees, by setting a maximum charge of 12 pounds. Since then, according to a recently released consumer group report, a range of other fees and charges levied on credit cards has "notably increased." Several companies have reintroduced annual fees, for example, the report found. Some banks have introduced fees for non-use of cards or for not notifying the issuer of a change of address or raised fees for such services as balance transfers.[59]

IV. ALTERNATIVES TO CREDIT CARD FEE/RATE REGULATION

In sum, the harmful unintended consequences of credit card fee and rate regulation would be to restrict the availability of credit to higher risk people who did not previously have access to it, forcing them to use more expensive forms of borrowing. Less risky cardholders, for whom the regulations were not intended, would see higher rates and fees, a decrease in the benefits of credit cards, such as decreased membership rewards, and a reemergence of annual membership fees and other costs. Finally, the reduced access to credit and less efficient market pricing would likely harm economic growth more broadly.

Rather than regulate credit card prices and other terms, there are several reform measures policy makers can take that will help consumers and curb potential abuses without the unintended consequences discussed above: (1) increased disclosure of rates/fee

---

[58] Reserve Bank of Australia, "Banking Fees in Australia." (May 2007), RESERVE BANK BULLETIN, Retrieved Sept. 10, 1007 –
(http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_may07/banking_fees_aus.html).

[59] Faith Archer, "Credit Card Firms Quick to Turn Fee Losses into New Charges." *Daily Telegraph*, (August 29, 2007) –
(http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2007/08/29/ncredit129.xml).

structures; (2) increased consumer education; and (3) increased regulatory oversight of unfair or deceptive practices. In addition, policy makers should focus on addressing the underlying causes of unmanageable credit card debt. Most families who take on too much debt and file for bankruptcy do so because of unexpected financial shocks, such as job loss or illness.[60] Policymakers should mitigate the likelihood that families will be forced into taking on excessive credit card debt by taking measures to enhance economic security, boost private savings,[61] and protect American families against economic risks.

A. Improved Disclosure of Credit Card Rates and Fee Structures

Many of the objectives of the proposed regulations above can be achieved through better disclosure to correct for possible information asymmetries. Asymmetric information is the term given when one side of a transaction has more or better information than the other party. Different levels of information can lead to inefficient outcomes and, in some instances, can cause a market to erode to the point of nonexistence.[62] Better information, ideally perfect information, often leads to more competitive outcomes. Assuming buyers and sellers are rational and have perfect information, they will choose the best products, and the market will reward those who make the best products with higher sales. In non-commodity markets, like credit cards, better information also allows for a better product match between buyers and sellers, which will lead to more efficient outcomes. In practice this improved information will allow cardholders to better select the card that's right for them, whether that be a card with no annual fees, low-interest rates, increased membership rewards, or, perhaps, no card at all.

For these reasons, federal regulation for decades has endeavored to facilitate competition in the credit card marketplace by increasing transparency and disclosure of information. The Truth in Lending Act of 1968 (TILA), which mandates certain disclosures aimed at

---

[60] *See*, for example, Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, "Less Stigma or More Financial Distress: An Empricial Analysis of the Extraordinary Increase in Bankruptcy Filings." (2006), 59 STAN. L. REV. 213.
[61] *See*, *e.g.*, Bill Gale, Mark Iwry, and Peter Orszag, "The Automatic 401(k): A Simply Way to Strengthen Retirement." (March 2005) TAX NOTES.
[62] George Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." (1970), QUARTERLY JOURNAL OF ECONOMICS, 84(3), 488-500.

informing consumers about the cost of credit, proved quite effective in this regard. Federal Reserve Board economist Thomas Durkin, for example, concluded that "it is clear that awareness of rates charged on outstanding balances . . . has risen sharply since implementation of the Truth in Lending Act."[63] Recognizing that the format and readability of disclosures can be as important as the content, since 1989 certain pricing terms must be disclosed and presented in tabular format on credit card applications or solicitations. The table, generally referred to as the "Schumer Box", must contain certain basic information, such as regarding rates and fees and how finance charges are calculated, and has proven effective at making credit card products more transparent to customers.

As credit card products have become more complex, the disclosures that accompany them have become longer and more complicated and continue to suffer from poor organization and formatting of information. According to the GAO report, "these disclosures have serious weaknesses that likely reduced consumers' ability to understand the costs of using credit cards."[64] Better disclosure standards are needed to provide consumers with a greater understanding of credit card products and prices. Such disclosures should be made more concise, readable, and understandable. For example, a revised and expanded "Schumer Box" should have more and improved information on rates, fees, interest calculations, which would allow consumers to better understand and compare the prices of competing credit cards. Information on penalty and service fees should be prominently and uniformly featured to enhance customer understanding.

In response to that concern, in May 2007, the Federal Reserve Board issued for public comment proposed amendments to Regulation Z of the Truth in Lending Act aimed at enhancing the effectiveness of required credit card disclosures. In particular, the proposed changes are intended to improve and simplify the format, timing, and content requirements of the five types of open-end credit disclosures regulated by the TILA: (1) applications and solicitations; (2) account-opening disclosures; (3) periodic statement

---

[63] Thomas A. Durkin, "Credit Cards: Use and Consumer Attitudes, 1970-2000." (Sept. 200), FED. RES. BULLETIN, 631.
[64] GAO Report, 6.

disclosures; (4) changes in consumer’s interest rate and other account terms; and (5) advertising provisions.[65] The proposed changes were the result of exhaustive and comprehensive analysis and, more importantly, the result of consumer testing and focus groups to determine readability and clarity for consumers.

In addition to improved Federal disclosure requirements, at least one credit card company has proposed a rating system for credit card products to signal clearly to consumers, who might not read or understand lengthy credit card contracts, which cards carry terms that could be considered unfair or deceptive. Such a rating might be provided by a third party and encourage best practices as issuers compete for customers by offering terms that would receive the organization’s seal of approval.

With better information, customers can force the market to respond by demanding cards without certain terms that they might find particularly objectionable, as seen in the way the market has responded to offer fewer cards with universal default provisions for example. Similarly, customers aware of service fees charged for over-the-limit transactions can decide whether to exceed their limit in an emergency situation. Better disclosure allows consumers with strong preferences against fees of this type to compare prices among cards available to them.

The importance and effectiveness of improved disclosures was acknowledged recently by the UK Competition Commission’s report on the practices of UK store card issuers. After an extensive review of the industry, rather than choose to regulate prices directly, the Commission sought to better inform consumers about their choices and the repercussions of their decisions when choosing a UK store card over another payment method.[66] The Commission’s remedies (described in the footnote below) are focused on

[65] United States Federal Reserve Board, “Federal Register: Federal Reserve System Part II: 12 CFR Part 266, Truth in Lending; Proposed Rule.” (June 14, 2007), Washington D.C.: Retrieved Sept. 10, 2007 - (http://edocket.access.gpo.gov/2007/pdf/07-2656.pdf)..

[66] Specifically, the Commission’s decision on remedies was:

a) Full information on statements: This requirement includes disclosing the current APR; an estimate of interest payable next month in the event that the cardholder only makes a minimum payment; a ‘wealth warning’ outlining the consequences of only making minimum payments; late payment or default charges and the policy for levying these charges; the basic assumptions used in calculating improving disclosure and providing more symmetric information. The Commission recognized that with better and clearer information, consumers will make more informed decisions. If the Commission's assertion is correct, and UK store card rates are above competitive levels, informed consumers will move away from using store cards in the UK to other forms of payment. This movement will put competitive pressure on UK store cards to lower their interest rates and late fees or else risk further revenue loss. The enhanced disclosure by UK store card issuers to borrowers should achieve the objectives of the Commission, or else prove their non-competitive market assertions false.

B. Increased Consumer Financial Literacy Education

Improved disclosure alone will be insufficient if consumers do not have the tools to understand the credit terms being offered and manage their credit products. Disclosure must thus go hand in hand with efforts to increase consumer financial literacy. As discussed above, the ability to price risk much more efficiently has led to more consumers being offered a wider variety of more complex, credit products. To navigate today's increasingly complex financial services marketplace, consumers must have the necessary financial knowledge.

Unfortunately, increasing financial literacy remains a daunting challenge. The Jump$start Coalition for Personal Financial Literacy reports that high-school student

---

the estimate of interest payable next month; and a 'how to pay' section and contact details for setting up or amending a direct debit, prominently displayed within the 'how to pay' section.

b) APR warning on store card statements: The warning applies to store card programs using a single APR for purchases in which the APR is 25% or more.

c) Provision and prominent display of facility to pay by direct debit: Store card providers must provide an option for all store cardholders to pay the account balance on their cards by direct debit.

d) Separate offer of payment, purchase and price protection insurance: Where store card providers offer insurance packages containing payment, price and purchase protection, they must also offer, as separate items, (a) payment protection cover alone and (b) a package of price and purchase protection.

"Store Cards Market Investigation." (March 7 2006), Competition Commission, Retrieved Sept. 10, 2007 – (http://www.competition-commission.org.uk/rep_pub/reports/2006/509storecards.htm).

performance on financial literacy tests has not improved during the past decade.[67] And there is a large gap between minority and non-minority students.

Evidence suggests, however, that programs targeted at improving financial literacy can be effective. One study, for example, found that after receiving on-line instruction in credit management, new or recently delinquent credit cardholders were more likely to pay on time and to have lower revolving balances.[68] In another study, researchers found that credit counseling reduced reported debt levels and delinquency rates, particularly for individuals with the lowest credit scores.[69]

Improved financial literacy would have broad benefits for consumers beyond just management of their credit card products, including a better understanding of how to save for retirement, buy a home or car, and manage personal day-to-day finances and cash flow.

Increasing consumer financial literacy should thus be a priority for government, for non-profit organizations, and for financial institutions. All major credit card issuers and networks already offer a broad range of consumer financial education programs and online tools. They do so not only to benefit consumers, but also because they recognize it is in their best interest to educate their customers. More informed consumers have lower rates of default and are more comfortable using their credit cards, which leads to more frequent use.

---

[67] "Executive Summary." (Aug. 11, 2006), 2006 Jump$tart Coalition Survey Results, Retrieved Sept. 10, 2007 – (http://www.jumpstart.org/fileindex.cfm).

[68] Kimberly Gartner and Richard Todd, "Effectiveness of Online 'Early Intervention' Financial Education for Credit Cardholders." (July 2005), Retrieved Sept. 10, 2007 – (http://www.chicagofed.org/cedric/files/2005_conf_paper_session3_todd.pdf).

[69] Gregory Elliehausen, E. Christopher Lundquist, Michael Staten, "The Impact of Credit Counseling on Subsequent Borrower Credit Usage and Payment Behavior." (January 2003), Retrieved Sept. 10, 2007 – (http://www.chicagofed.org/cedric/files/2003_conf_paper_session1_staten.pdf).

C. Consolidated Regulatory Oversight of Unfair and Deceptive Practices

Even with improved disclosure and more educated consumers, there is still a role for regulatory oversight to prevent fraud and abuse. Currently, however, the regulation of the credit card industry is badly fractured, leading to inconsistent and sometimes conflicting regulations regarding unfair and deceptive practices. The credit card industry is regulated by both federal and state regulators, depending on whether banks operate under a state or federal charter.[70]

Even at the federal level, however, credit card regulation is divided among numerous agencies, including the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC). The Federal Trade Commission (FTC) is also responsible for regulating consumer credit products, including preventing unfair and deceptive practices, but its reach does not extend to banks and other depository institutions.[71] Broadly speaking, the Federal Reserve Board is responsible for implementing part of the Truth in Lending Act through Regulation Z's disclosure requirements for state-chartered banks that are part of the Federal Reserve system. The OCC, part of the Treasury Department, oversees the activities of federally-chartered banks and has authority to regulate their lending products. The OTS, also part of the Treasury Department, supervises the practices of savings associations. And the FDIC, best known for insuring deposits up to $100,000, also examines and supervises more than half of the institutions in the banking system; in particular, it is the primary federal regulator of banks that are chartered by the states but do not join the Federal Reserve System.

[70] Mark Furletti, "The Debate Over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards." (2004), 77 TEMPLE L. REV. 425, 427.

[71] The Commission may "gather and compile information concerning, and * * * investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce, excepting banks, savings and loan institutions * * * Federal credit unions * * * and common carriers * * *." FTC Act Sec. 6(a), 15 U.S.C. Sec. 46(a). *See* United States of America Federal Trade Commission, "A Brief Overview of the Federal Trade Commission's Investigative and Law Enforcement Authority." (Sept. 2002), Washington D.C.: Retrieved Sept. 10, 2007 – (http://www.ftc.gov/ogc/brfovrvw.shtm). The FTC does regulate mandatory disclosures by non-federally insured depository institutions, as required by the FDIC Improvement Act of 1991. Federal Deposit Insurance Corporation Improvement Act of 1991 (Pub. L. No. 102-242), Section 151(a)(1) (codified in relevant part at 12 U.S.C. § 1831t).

The result of so many varied regulators of credit card issuers is that regulators may issue inconsistent and conflicting regulations regarding unfair or deceptive practices, and the large number of regulators limits the speed and consistency of implementation of such regulations. The result can be confusion for consumers, who may not know which regulations govern their credit product or what redress they have in the event of a dispute. Providing appropriate tools within a more consolidated regulatory framework would significantly enhance consumer protections regarding credit card products.

V. CONCLUSION

Innovation and deregulation have benefited cardholders by making credit available to many more Americans at much lower prices than a generation ago. Restrictions on the interest rates and fees that bank issuers can charge is likely to harm the vast majority of borrowers by leading to higher fees and reduced access to credit, even if such restrictions might be helpful to a small minority of borrowers with high levels of debt. A better approach would be to help the minority without harming the majority through improved disclosure, increased consumer financial literacy, and consolidated regulatory oversight for unfair or deceptive practices.