

Modernizing Consumer Protection in the Financial Regulatory System: Strengthening Credit Card Protections

Two ABI Members Testify before U.S. Senate Banking, Housing and Urban Affairs Committee

On Feb. 12, 2009, the U.S. Senate Committee on Banking, Housing and Urban Affairs held a hearing on “Modernizing Consumer Protection in the Financial Regulatory System: Strengthening Credit Card Protections.” The witnesses were: Travis B. Plunkett, the legislative director of the Consumer Federation of America; James C. Sturdevant, of The Sturdevant Law Firm; Kenneth J. Clayton, the senior vice president and general counsel for the Card Policy Council of the American Bankers Association; Lawrence M. Ausubel, a professor of economics at the University of Maryland; **Todd Zywicki**, a professor at George Mason University School of Law; and **Adam J. Levitin**, an associate professor at Georgetown University Law Center and ABI’s Fall 2009 Robert M. Zinman Resident Scholar. This Legislative Update column features excerpts from the written testimony of Professors Zywicki and Levitin, both of whom are ABI members. For their full testimony and for the testimony of the non-ABI member witnesses, please go to banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=d8561426-8765-479e-9f0d-00c069cb3544. ABI is a nonpartisan organization dedicated to research and education on matters related to insolvency. The statements of these ABI members reflect their views and/or positions, not those of ABI.

Testimony of Adam Levitin
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I am pleased to testify in support of the Credit Card Accountability, Responsibility and Disclosure Act and other legislation that would create a more efficient and fair credit card market and encourage greater consumer responsibility in the use of credit.¹ There are four major points I wish to make in my written testimony:

(1) Consumers cannot use credit cards efficiently and responsibly because the price of cards is not transparent, due to the unnecessary and deliberate complexity of credit card price structures and billing practices. Lack of transparent pricing

cost American consumers over \$12 billion in unnecessary interest and fees in 2007.²

(2) Opaque pricing, including billing tricks and traps, are an essential part of the card industry’s fee-based business model that encourages unsafe lending practices. Eliminating billing tricks and traps is an important step to ensuring sound underwriting in the credit card market and reducing systemic risk.

(3) The current regulatory regime for credit cards is inadequate and incapable of keeping pace with card industry innovation. The agencies with jurisdiction over credit cards lack regulatory motivation and have conflicting missions, and those with motivation lack jurisdiction. Congressional action is necessary, not

weak. Instead, the pool-based underwriting of credit cards calls for the adoption of key features of insurance regulation: standardized contracts, term prohibitions and requirements, and on-going licensing.

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Billing Tricks and Traps Are an Integral Part of a Credit Card Business Model that Encourages Unsafe and Unsound Lending

The complexity of credit card billing is not accidental. Instead, it is a key component of the card industry’s business model. These tricks and traps directly generated over \$12 billion in revenue for the card industry in 2007,³ which was over 30 percent of the industry’s pre-tax profits.⁴

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only to address the current problems in the card industry, but also to create a federal regulatory agency with authority and motivation to regulate the card industry on an ongoing basis. (4) “Risk-based Pricing” is not a valid reason to refrain from regulation of the credit card industry. The card industry does not engage in meaningful risk-based pricing.

(a) The risk premium is only a minor component of credit card pricing, and the card industry’s ability to refine risk premiums has had only a marginal impact on the total cost of credit or its availability. Total costs of credit have remained essentially static, while the growth of credit availability is due to the shift to a fee-based business model, as issuers are happy to lend when someone else holds the credit risk, just like in the mortgage market.

(c) [sic] The risk premium is pool-based, rather than individually underwritten, so cross-subsidization concerns are



Adam Levitin

Historically, the credit card industry was about lending money and making a profit based on interest rates. The card industry has changed, however. Increasingly, the card industry’s business model is fee-based, not interest based.

Unfortunately, just as with subprime mortgages, the fee-based business model creates a perverse incentive to lend indiscriminately and ignore delinquencies.

Card issuers make money on every credit card transaction, regardless of whether the consumer ultimately pays a finance charge. The issuer receives around two percent of every transaction in a fee paid by the merchant (and passed on to all consumers in the form of higher prices), called the interchange fee.⁵

³ Ireland, *supra* fn. 2.

⁴ CardData.com (subscription data source).

⁵ Technically, the interchange fee is the fee paid by the merchant’s bank to the issuer, but this fee is simply passed along to the merchant as is the bulk of the “merchant discount fee.” See Levitin, *supra* fn. 10 in full testimony, available at banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=d8561426-8765-479e-9f0d-00c069cb3544.

¹ This testimony derives from Adam J. Levitin, “A Critique of the American Bankers Association’s Study of Credit Card Regulation,” Georgetown Law and Economics Research Paper No. 1104327, at ssrn.com/abstract=1104327. All source data for graphs in this testimony may be downloaded from www.law.georgetown.edu/faculty/levitin/documents/ABADATA.xls.

² Comment Letter 177, Unfair or Deceptive Acts or Practices (2008-0004), from Oliver Ireland, a partner at Morrison & Foerster LLP, dated Aug. 7, 2008, available at files.dts.treas.gov/comments/bdc5cc5c-1e0b-8562-eb23-f7159e49505.pdf. The letter does not address on whose behalf Mr. Ireland is writing, but Mr. Ireland is a prominent credit card industry lobbyist.

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Card issuers will collect about \$48 billion in interchange fees this year.⁶

Because interchange is based on transaction volume, it creates an incentive for banks to issue as many cards as possible, regardless of the creditworthiness of the borrower. By creating a huge revenue stream unrelated to credit risk, interchange encourages card issuers to engage in reckless lending—and virtually every credit card loan is a “liar loan” with no income verification.

Banks have compounded this problem by shifting much of the loan risk to investors through securitization. When card issuers securitize credit card debt, they transform the credit card debt into a pool of assets used to pay off bonds. If the pool turns out not to be large enough, the bond investors take the loss. But if there’s a surplus, it goes to the card issuer.

While card issuers sell off most of the default risk, they keep any upside that comes from inflating their fees and rates. This is a heads I win, tails you lose situation and leads the banks to increase fees and interest rates on securitized debt. If the higher fees and rates cause more defaults, it is investors who bear the loss. If the higher fees result in more income, however, it is the card issuer, not the investors, who benefit.

The billing tricks and traps are used to ensnare consumers in these fees, [and] the card companies deploy numerous billing tricks and traps. When card issuers are able to keep the upside and avoid much of the downside risk on cards, it creates an inherently unsafe and unsound lending practice. Eliminating the billing tricks and traps are the first place to start to curb the systemic dangers of this reckless credit card lending.

Congress Must Create a Regulatory System Capable of Keeping Pace with Innovation in Consumer Financial Services

Banning these abusive and unfair billing practices is an important first step in restoring efficiency, fairness and responsibility to credit card markets and reducing systemic risk. But it is not enough for Congress to prohibit certain enumerated credit card practices. The card industry has shown itself to be remarkably resourceful in engineering its products around regulation. This means that regulatory initiatives aimed at specific practices inevitably devolve into a game of regulatory Whac-A-Mole: Every time

regulators put the kibosh on one practice, the card industry invents another to take its place. Congress will always be playing catch-up in this game of regulation and innovation. The only way to stop this negative innovation is to flip the regulatory model on its head. Currently, card issuers are allowed to do anything, except specific prohibited practices. The better regulatory structure would be to prohibit anything, except for specific permitted practices.

Congress is not well-suited for determining whether every innovation of the card industry should be permitted or not; the better solution would be to vest a federal regulatory agency, such as the Consumer Financial Product Safety Commission proposed by Professors **Elizabeth Warren** and **Oren Bar-Gill**,⁷ or the FTC, as proposed by Prof. Heidi Schooner,⁸ with the power to license card issuers and regulate their practices.

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Conclusion

“Risk-based” pricing’s “benefits” are not a reason for Congress to shrink from regulating the credit card industry’s abusive pricing and billing practices. If anything, the pool-based nature of credit card underwriting urges a regulatory regime similar to that for insurance—an ongoing system of licensing and regulatory supervision, as well as standardized contracts, prohibitions on certain terms and requirements of certain other terms and restrictions on types of fees.

Transparent pricing is a prerequisite for an efficient, competitive market and responsible consumer behavior. If the card industry were required to price its products in a straightforward manner, and it were less costly for consumers to switch cards, deceptive practices would be harder to maintain, Truth-in-Lending disclosures would be more effective, as consumers would be able to easily compare cards and make informed decisions about card usage, and competitive pressures would push down total card prices, forcing the card industry to operate more efficiently, benefiting all consumers.

I strongly urge Congress to pass legislation that creates transparency in credit card pricing and that creates an ongoing regulatory system that is capable of quickly evaluating and responding to innovations in the consumer financial products market place.

Testimony of Todd J. Zywicki

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

But the myriad uses of credit cards and the increasing heterogeneity of credit card owners has spawned increasing complexity in credit card terms and concerns about confusion that may reduce consumer welfare. American consumers encounter complexity every day in the goods and services they purchase, such as cars, computers and medical services, just to name a few. And the complexity of credit card terms is modest when compared to that of the Internal Revenue Code, as are the penalties (financial and otherwise) for failure to understand its terms. The relevant issue for regulation, therefore, is whether the complexity is warranted in light of the benefits.

⁶ Merchants Payments Coalition.

⁷ Elizabeth Warren & Oren Bar-Gill, “Making Credit Safer,” 157 U. Pa. L. Rev. (2008).

⁸ Heidi Mandanis Schooner, “Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit,” 18 Loyola Consumer L. Rev. 43 (2005).

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

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

What Is the Problem to Be Corrected Through Regulation?

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

There is no doubt that consumer use of credit cards has increased over time, as has credit card debt. But available evidence reveals that this increase in credit card debt has not in fact resulted in an increased financial distress for American households. Instead, this increased use of credit cards has been a *substitution* from other types of consumer credit to an increased use of credit cards.¹ For instance, when consumers in earlier generations purchased furniture, new appliances or consumer goods, they typically purchased those items “on time” by opening an installment loan and repaying the loan in monthly payments or through a layaway plan. A consumer who needed unrestricted funds to pay for a vacation or finance a car repair would typically get a loan from a personal finance company or a pawn shop. Today, many of these purchases and short-term loans would be financed by a credit card, which provides ready access to a line of credit when needed, without being required to provide a purchase-money security

interest, dealing with the up-front expense and delay of a personal finance loan or pawning goods.² Credit cards are far more flexible and typically less expensive than these alternative forms of consumer credit, thereby explaining their rapid growth in consumer popularity over time. Federal Reserve economist Tom Durkin observes that credit cards “have largely replaced the installment-purchase plans that were important to the sales volume at many retail stores in earlier decades,” especially for the purchase of appliances, furniture and other durable goods.³ 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.”⁴

In fact, the evidence suggests that the growth in credit cards as a source of consumer credit is explained almost completely by this substitution effect. Thus, even as credit card use has risen rapidly over time, it does not appear that this has contributed to any increase in consumer financial distress.⁵

Cost-benefit Analysis and Unintended Consequences

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

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

Market Competition and Common Law as Regulation

It must also be kept in mind that market competition is a form of regulation as well. The credit card market is extremely competitive, with thousands of issuers constantly competing to woo consumers with better offers. Consumers routinely carry as many as four credit cards in their wallets, ready to switch immediately to the card that offers a more attractive package of benefits and terms. In such a market, it is unlikely that oppressive or unfriendly contract terms would last, and in fact this seems to be the case. The GAO Report found, for instance, that only three of the 28 cards that they examined had “universal default” clauses in 2005.⁶ The GAO Report also found that between 2003 and 2005, only a minority of credit card issuers used the so-called “double-cycle billing method” of calculating finance charges, and I understand that even those issuers have eliminated that scheme today.⁷ In addition, only 2 percent of cards charge annual fees and virtually all of them provide some rewards program in return. In fact, annual fees traditionally have been the cost of credit cards most despised by consumers—in fact, when annual fees were first implemented in the 1970s, consumers cancelled 8 percent of their credit cards immediately.⁸

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

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

¹ See Zywicki, *Bankruptcy Law and Policy*, Chapter 3.

² Wal-Mart recently announced, for instance, that it was terminating its once-popular layaway program. Like other major department stores, Wal-Mart acknowledged that this form of credit had become irrelevant because of widespread access to credit cards. Unlike layaway, purchasing goods using a credit card permits the consumer to use the goods while paying them off, whereas under layaway the store keeps the goods until they are paid for.

³ See Thomas A. Durkin, “Credit Cards: Use and Consumer Attitudes, 1970–2000,” 86 Fed. Res. Bull. 623 (2000).

⁴ Alan Greenspan, “Understanding Household Debt Obligations, Remarks Given at the Credit Union National Association 2004 Governmental Affairs Conference” (Feb. 23, 2004), available at www.federalreserve.gov/boarddocs/speeches/2004/20040223/default.htm.

⁵ Accord, “Board of Governors of the Federal Reserve, Report to Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and Their Effects on Consumer Debt and Insolvency 5,” June 2006.

⁶ GAO Report at 26.

⁷ GAO Report at 28.

⁸ See Zywicki, *Economics of Credit Cards*.