



GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Associate Professor of Law

Written Testimony of

Adam J. Levitin
Associate Professor of Law
Georgetown University Law Center

Before the
United States Senate
Committee on the Banking, Housing, and Urban Affairs

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

February 12, 2009

WITNESS STATEMENT

Adam J. Levitin is an Associate Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in payment systems, bankruptcy, and secured credit and directs the Georgetown-Hebrew University in Jerusalem Executive LLM Program in Business and Commercial Law. Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges LLP in New York. He also served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin's research focuses on financial institutions and their role in the consumer and business credit economy, including credit card and mortgage lending and servicing, identity theft, DIP financing, and bankruptcy claims trading. He is a regular commentator on *Credit Slips*, a blog devoted to credit and bankruptcy issues, and is the winner of the 2007 Editors' Prize of the *American Bankruptcy Law Journal* and the 2009 Article Prize of the American College of Consumer Financial Services Lawyers.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College, all with honors.

Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony. Professor Levitin does not represent any party in connection with any credit card regulatory issues.

Mr. Chairman, Ranking Member, Members of the Committee:

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 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 on-going 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) The risk premium is pool-based, rather than individually underwritten, so cross-subsidization concerns are 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.

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 <http://ssrn.com/abstract=1104327>. All source data for graphs in this testimony may be downloaded from <http://www.law.georgetown.edu/faculty/levitin/documents/ABADATA.xls/>.

² Comment Letter 177, Unfair or Deceptive Acts or Practices (2008-0004), from Oliver Ireland, Partner, Morrison & Foerster LLP, dated August 7, 2008, available at <http://files.ots.treas.gov/comments/bdc5cc5c-1e0b-8562-eb23-ff7159e49505.pdf>. The letter does not address on whose behalf Mr. Ireland is writing, but Mr. Ireland is a prominent credit card industry lobbyist.

I. CONSUMERS USE CREDIT CARDS INEFFICIENTLY AND IRRESPONSIBLY BECAUSE THE PRICE OF CREDIT CARDS IS NOT TRANSPARENT

It is a bedrock principle of economics, the price theory of demand, that demand is a function of price. When prices go up, demand goes down, and vice versa. This is what makes markets work. But in order for markets to work, prices must be transparent. Consumers must be able to accurately gauge the costs of a product in order to calibrate their demand. If consumers cannot accurately gauge the costs of a product, they will not use the product efficiently or responsibly. They will over-use it or under-use it. And if consumers cannot accurately gauge the costs of competing products, they might use the wrong product altogether. Inefficient use of products is a problem deserving regulatory intervention when it imposes costs on society in general.

The price of credit cards is not transparent to consumers. Credit cards are different from virtually every other consumer financial product in their complexity. Most consumer credit products, such as auto loans, mortgages, and student loans have only one or two price points. These price points do not vary except in relation to an objective index, such as the Federal Funds Rate or LIBOR. Unlike other common consumer credit products, however, credit cards have an astounding array of price points: annual fees, merchant fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default interest rates, late fees, overlimit fees, balance transfer fees, cash advance fees, international transaction fees, telephone payment fees, etc. These are all explicit price points, disclosed in Truth-in-Lending schedules.

The sheer number of explicit price points that make it difficult for consumers to accurately and easily gauge the total cost of using credit cards.³ Consumers are not capable of doing the on-the-spot calculations necessary to figure out whether or not to use any particular credit card for any particular transaction. There is too much information that the consumer must process, including information that the consumer cannot know at the time the card is used, such as when a payment will be credited. Even if the consumer had perfect information and could process it all, it simply would not be worthwhile to do for every transaction. The burden this would impose would negate all of the convenience benefits credit cards have for consumers.

Consumers' difficulty in determining the cost of credit cards is compounded by credit cards' hidden price points in the form of billing practices, such as universal cross-default, unilateral term changes, residual interest, two-cycle billing, unlimited overlimit fees, application of payments to the lowest interest rate balance, non-standard use of terms like "fixed rate" and "Prime rate," and unclear policies as to precisely when a payment is due. These billing practices make credit card pricing to vary based not only on objective indices, but also on the card issuers' subjective whim.

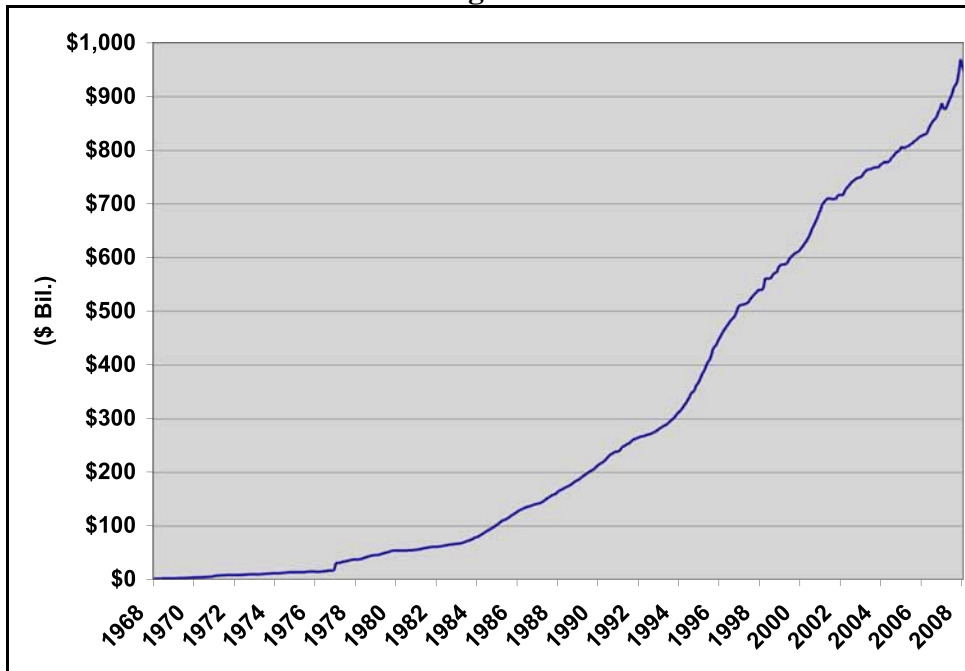
Credit card billing practices alter the application of the explicit price points and make the effective cost of using credit cards higher than disclosed. What is especially problematic about credit card billing practices is that they alter the cost of credit *after the consumer has already committed to using the card* and not in transparent, predictable

³ Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Fed. Res. Bank of Phila., Jan. 2003, at 19.

ways that the consumer could account for at the time the card is used. Credit card billing practices further obfuscate the true cost of using credit and make it virtually impossible for a consumer to make a fully informed decision about whether to use credit and, if so, which credit card product to use.

By concealing the true cost of using credit cards, these billing practices lead to inefficient and irresponsible credit card use. In particular, when consumers underestimate the costs of using credit cards, as occurs when consumers do not notice hidden price points, they will overuse credit cards. Accordingly, unfair and deceptive credit card billing practices have contributed to the soaring level of consumer card debt, which is rapidly approaching one trillion dollars (see Chart 1, below).

Chart 1. Growth of Revolving Credit in the United States



Source: Federal Reserve Bank Statistical Release G.19.⁴

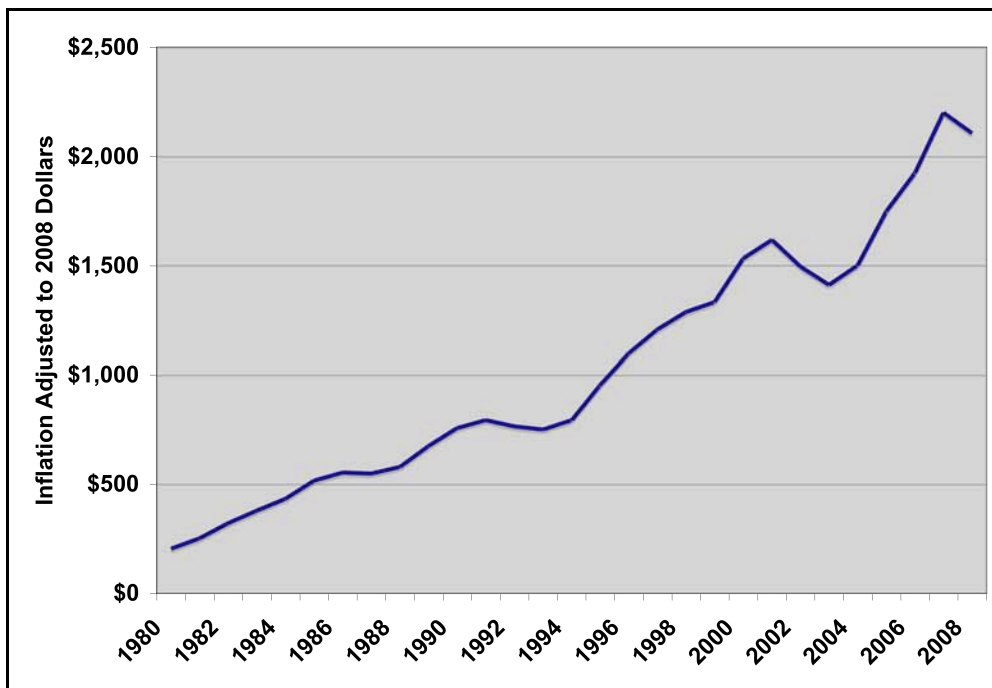
The overleveraging of consumers due to inefficient credit card usage caused by non-transparent pricing hurts the economy and society and is not sustainable. The higher levels of credit card debt service fostered by hidden price points in credit card billing practices come at the expense of other parts of the economy, as every dollar spent paying off credit card debt is a dollar that cannot be spent on new goods and services.⁵ As Chart 2 shows, even in inflation adjusted dollars, the amount of interest US households pay on revolving debt (almost all of which is credit card debt), has grown significantly and is

⁴ Federal Reserve Statistical Release G.19 measures revolving credit, which is primarily, but not exclusively credit card debt. Mark Furletti & Christopher Ody, *Measuring U.S. Credit Card Borrowing: An Analysis of the G.19's Estimate of Consumer Revolving Credit*, Fed. Res. Bank of Phila. Discussion Paper, April 2006, at 24. There is no governmental statistic measuring just credit card debt, much less credit card debt accruing interest, a serious shortcoming in the Federal Reserve's statistical collection.

⁵ Adam J. Levitin, *Priceless? The Social Costs of Credit Cards*, 45 HARV. J. ON LEGIS. 1, 46 (2008).

now at over \$2,000/year. These high levels of credit card debt also discourage savings for future contingencies and retirement.

Chart 2. Interest Paid on Revolving Debt Per Household



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Products Accounts, Table. 2.1.1, Line 29.

For the average American family, the impact of these billing practices on household finance is staggering. The Pew Charitable Trusts calculates that a single credit card penalty repricing on a balance of \$3,500 is re-priced, the additional interest can consume one-quarter of an average household's discretionary income during a year.⁶ As Pew notes "Though positioned [by the card industry] as necessary to encourage responsible payment behavior, penalty re-pricing practices today can have severe and sometimes devastating effects upon household finances."⁷ The card industry itself estimates that just a handful of billing practices accounted for \$12 billion dollars in additional revenue.⁸ Eliminating these hidden price points will help the economy overall by putting more than \$12 billion dollars back in the pocket of consumers, which can be used for productive consumer spending.

Disguised credit card price points also contribute to bankruptcy filings. Concealed pricing encourages higher credit card use than would otherwise occur, which leads, inexorably, to more credit card debt. Dollar for dollar, a consumer with credit card

⁶ Letter from R. Dwane Krumme, General Manager, Credit Card Standards Project, The Pew Charitable Trusts, to Mr. Leonard Chanin, Assistant Director, Division of Consumer & Community Affairs, Board of Governors of the Federal Reserve System Re: Docket No. R-1314, dated Oct. 3, 2008.

⁷ *Id.*

⁸ Ireland, *supra* note 2.

debt is more likely to file for bankruptcy than a consumer with any other type of debt.⁹ Debt is of course a *sine qua non* of bankruptcy, but credit card debt has a particular and peculiar relationship with bankruptcy filings that other types of debt do not have. Banning unfair credit card billing practices may help limit bankruptcy filings, the costs of which are borne by all creditors, including the government, and thus by all taxpayers.

Because of the serious social costs of credit card billing practices and the inherent unfairness of many of them, Congress should act to make the credit card market more efficient and to encourage greater consumer responsibility by banning credit card billing practices that function as covert price points and mask the true cost of credit. Banning these billing practices would bring much needed transparency to the credit card market.

By banning billing practices that function as covert price points, Congress can promote greater competition in the card industry, help consumers exercise control of their finances responsibly, encourage productive consumer spending, and help decrease bankruptcy filings. Currently credit card issuers do not compete with each other on the net price of cards (benefits minus costs). Instead, they compete on selectively highlighted price points, such as teaser interest rates or bundled benefits, like frequent flier miles.¹⁰

Any card issuer that attempted to advertise its total price would suffer in the market because its total price advertisements would line up against the zero percent teaser rates and triple bonus miles offered by other issuers. It is easier for issuers' to push price points away from easily comparable, up-front costs, like annual fees, toward delayed back-end price points like penalty interest rates, late fees, and overlimit fees. Competition within the card market leads to obfuscated pricing with price points hidden away in fine print billing practices. Eliminating hidden price points encourages card issuers to compete on the basis of *total* price, which will make the credit card market more efficient.

Banning abusive billing practices will also empower consumers to exercise control of their financial affairs responsibly, both by making the price of credit more easily understandable and by permitting cardholders to opt-out of certain rate increases and opt-out of the ability to exceed their charge limit

Eliminating hidden credit card prices points will make credit card markets more efficient and will help consumers and the economy.

II. 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 2007,¹¹ which was over

⁹ RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD NETWORKS AROUND THE WORLD 66 (2006).

¹⁰ Adam J. Levitin, *Priceless? The Competitive Costs of Credit Card Merchant Restraints*, 55 UCLA L. REV 1321 (2008).

¹¹ Ireland, *supra* note 2.

30% of the industry's pre-tax profits.¹²

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.¹³ Card issuers will collect about \$48 billion in interchange fees this year.¹⁴

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, 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.

III. 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

¹² CardData.com (subscription data source).

¹³ 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* note 10.

¹⁴ Merchants Payments Coalition.

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,¹⁵ or the FTC, as proposed by Professor Heidi Schooner,¹⁶ with the power to license card issuers and regulate their practices.

IV. THE MYTH OF RISK-BASED CREDIT CARD PRICING

An important argument put forth by the credit card industry against any form of regulation is that it would negate the benefits of risk-based pricing.¹⁷ Risk-based pricing means that credit cards are priced according to individual consumers' creditworthiness. Credit card issuers contend that since the early 1990s they have engaged in risk-based pricing. Card issuers claim that risk-based pricing has benefited creditworthy consumers in the form of lower costs of credit and subprime consumers in the form of greater availability of credit. Card issuers contend that any regulation, including of their billing practices, would negate the benefits of risk-based pricing.

I wish to highlight four problems with the card industry's risk-based pricing story: (1) the risk component of credit card pricing is trivial, (2) credit card pricing does not reflect individual consumer risk, (3) risk-based pricing does not explain unfair and deceptive billing practices, and (4) neither creditworthy consumers nor subprime consumers have not benefited from putative risk-based pricing.

A. The Risk Component of Credit Card Pricing Is Trivial

Credit card pricing has four components: cost of funds, cost of operations, risk premium, and opportunity premium. These are not equal components. The cost of funds accounts for approximately 25% of the total cost of credit cards.¹⁸ Operating costs—overhead, solicitations, customer service, advertising, etc.—account for around 60% of the total cost of cards.¹⁹ The remaining 15% is a combination of a risk-premium and whatever opportunity-premium that the card issuer can extract. Thus, the risk premium

¹⁵ Elizabeth Warren & Oren Bar-Gill, *Making Credit Safer*, 157 U. PA. L. REV. (2008).

¹⁶ Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit*, 18 LOYOLA CONSUMER L. REV. 43 (2005).

¹⁷ E.g., Jonathan M. Orszag & Susan H. Manning, *An Economic Assessment of Regulating Credit Card Fees and Interest Rates*, Commissioned by the American Bankers Association, October, 2007.

¹⁸ FDIC Quarterly Banking Profile, Sept. 2008, at <http://www2.fdic.gov/qbp/2008sep/qbp.pdf>. According to the FDIC, the average yield on credit cards in 2008 was 11.99%, and the average cost of funding was 3.05%. This means that approximately 25% of the price of credit cards is attributable just to the cost of funds.

¹⁹ Glenn B. Canner & Charles A. Luckett, *Developments in the Pricing of Credit Card Services*, 78 FED. RES. BULL. 652, 655 n.8 (1992)

accounts for at most 15% of the cost of credit cards. That means for the average credit card assessed interest in November 2008, no more than 200 basis points of the 13.6% APR was attributable to a risk premium.²⁰

As it turns out, however, almost all of this 15% is opportunity pricing. The relative importance of opportunity pricing and irrelevance of risk premiums can be seen from a quick perusal of my own credit cards demonstrates that the pricing has little to do with risk. I have four general purpose credit cards in my name, three from JPMorgan Chase and one from Citibank. Although I am the exact same borrower, with the exact same risk profile, there are four different APRs on the cards, as shown below.

Card	Interest Rate	Credit Limit
Chase 1	0.00% (1-year teaser)	\$12,500
Chase 2	9.24%	\$40,000
Chase 3	13.24%	\$6,500
Citibank	16.99%	\$13,600

Even leaving aside the 0.0% APR teaser rate, Citi is charging a rate that is 83% higher than Chase's lowest rate, and there is a 42% difference in the rates charged by Chase. This shows is that almost one third of the interest rate on my 13.24% APR Chase card and nearly half of the interest rate on my 16.99% APR Citi card have *nothing* to do with risk and are pure opportunity pricing. Between cost of funds, costs of operations, and opportunity pricing, there is almost no room left for risk-based pricing.

Only a very small component of the cost of credit cards has *anything* to do with risk. And, as it turns out, it has only a tenuous connection with the individual cardholder's risk.

B. Credit Card Pricing Has Little Relationship to Individual Cardholders' Risk

As sophisticated as the card industry is, it is incapable of doing individualized risk-based pricing. Its data sources and modeling capabilities are insufficient for individually-tailored risk-based pricing. Instead, consumers are priced by pools based on common characteristics, as in insurance underwriting. The statistical methods used by card issuers to place consumers in pools, known as "neural networks" are inherently limited in their predictive accuracy and cannot account for unusual economic shocks or any of the other unpredictable vagaries of consumer behavior and life. After cardholders are lumped into various risk buckets, the underwriting is done on the general characteristics of that bucket, not by the individual characteristics of the cardholder. While dividing consumers into multiple risk buckets is certainly superior to one-size-fits-all pricing, it is still quite imprecise.

The card industry's inability to price for individualized risk is reflected in the structure of credit card pricing. Only some components of credit card pricing could possibly relate to cardholder risk, and imprecisely so at that. Of the astounding array of explicit and covert credit card price points, only some interest rates and late fees are arguably risk-based. Most have no relation to risk.

²⁰ Fed. Res. Stat. Release G. 19.

There are two factors in determining cardholder repayment risk. First is the size of the cardholder's balance. The second is likelihood of the cardholder not repaying the balance (the "risk profile"). All else being equal, a cardholder with a large balance presents a greater risk to a card issuer than one with a smaller balance because in the event of a default, the card issuer's loss will be greater for the cardholder with the higher balance. It is important to remember that risk profiles, derived largely from credit reports and "on-us" payment history, are not the sole factor in determining risk to the card issuer; fully risk-based pricing should account for both the likelihood of default *and* the size of the issuer's exposure. Only some components of credit card pricing relate to either one or the other of these two risk components, and imprecisely so at that.

None of the many credit card interest rates vary depending on the size of a consumer's balance. On the fee side, only overlimit and late fees sometimes vary depending on the size of a consumer's balance, but even then it is within two or three tiers that do not permit for precise tailoring to risk. Likewise, some interest rates and late fees depend in part on issuers' perception of individual cardholders' default risk, but again are not narrowly tailored.

1. Interest Rates

Credit cards carry a variety of interest rates. Many cards have introductory teaser rates, often at 0%. They also typically have a base rate for purchases, a base rate for cash advances, a base rate for balance transfers, a base rate for overdraft advances, and a default or penalty interest rate. Introductory teaser rates, which typically last several months, are not risk-based; they are flat 0% rates for all borrowers, regardless of their risk.

Although the base interest rate for purchases is only one of many price terms that affect the total cost of revolving a balance on a credit card, it is often perceived as the most important price point; it is the first term listed in the Schumer Box and in larger font than any other term in the Schumer Box.²¹ Base interest rates are not particularly sensitive to individual consumers' evolving risk profiles.

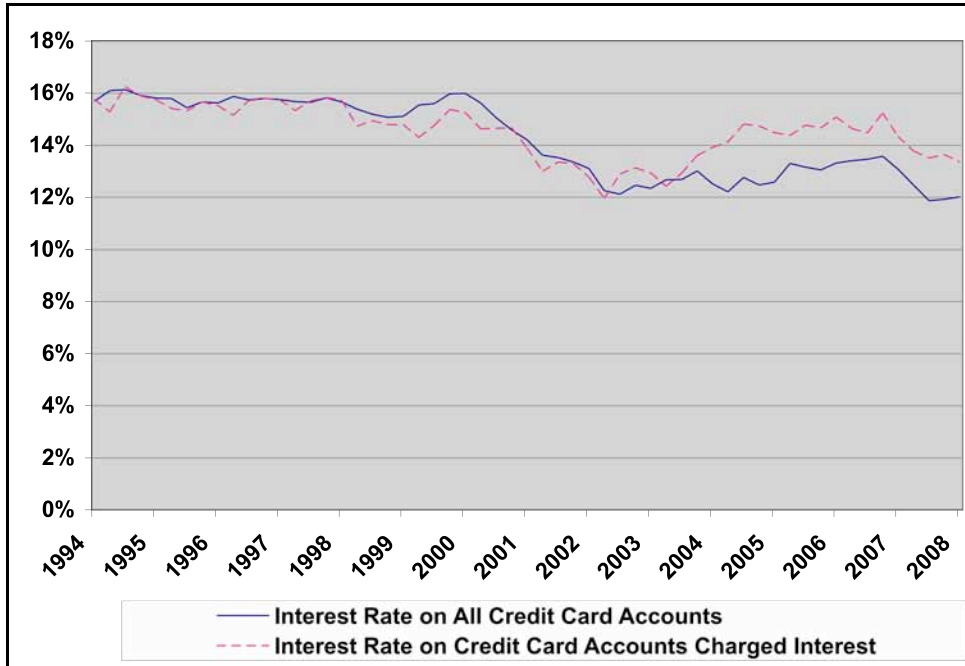
Most issuers offer only two or three pricing tiers for non-introductory base interest rates. Credit risk, however, does not come just in sizes small, medium, and large. These rates do not change with the percentage of the cardholder's credit limit that is used, even though there is a greater risk posed by identical cardholders, one of whom has a balance of \$200 and another with a balance of \$20,000. Base interest rates do change, however, with the cardholder's risk profile (excluding balances). When a consumer's risk profile changes, based either on "on-us" events, related to the cardholder's use of the card or other services from the issuer or on "off-us" events, related to the cardholder's other credit behavior, many card issuers apply default and penalty interest rates retroactively to existing balances.

Empirical data indicates that interest rates are, at best, marginally risk-based. The Federal Reserve tracks the average interest rates offered by commercial banks both on all credit card accounts and on accounts on which interest was charged. Accounts on which interest is charged are an inherently riskier subset of all credit card accounts.

²¹ 12 C.F.R. Pt. 226a5(b)(1); 12 C.F.R. Pt. 226, App. G-10(A)-(B).

If card interest rates were risk-based, then one would expect interest rates on accounts charged interest to be consistently higher than on cards in general. But as the Chart 3 shows, the interest rates on accounts charge interest have alternatively been higher and lower than card accounts in general. This flip-flopping indicates that, at least until 2004—fourteen years in the so-called risk-based pricing era—pricing was not risk-based. Only since 2004 has the expected for rate gap emerged, and it is quite small, in the nature of 1%.²² In other words, there is scant evidence that low-risk transactors are offered lower interest rates than higher-risk revolvers.

Chart 3. Terms of Credit Card Accounts at Commercial Banks



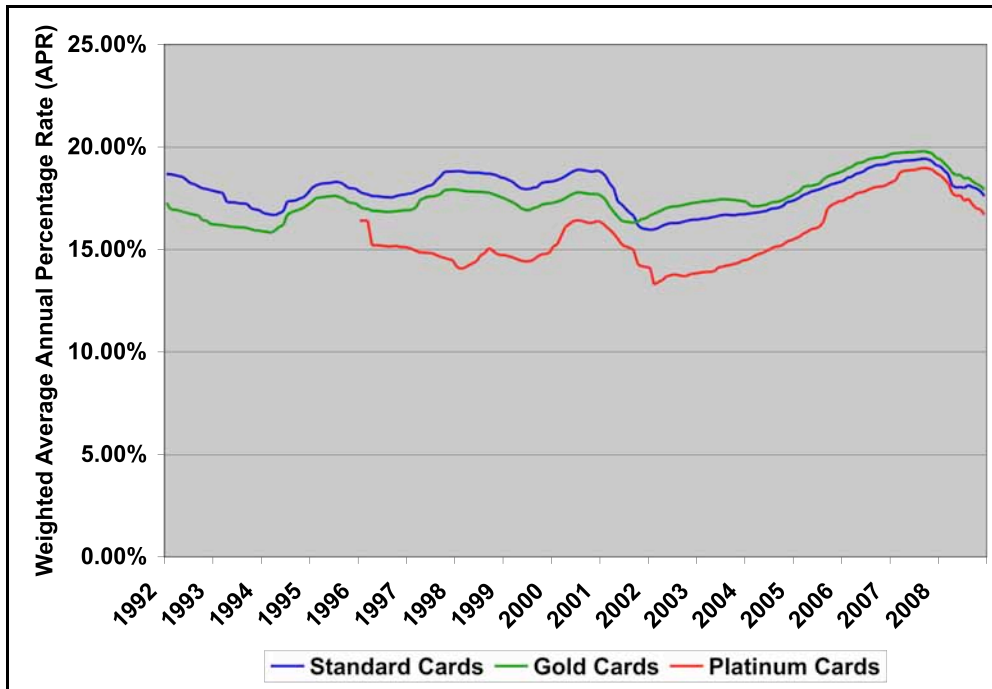
Source: Federal Reserve Statistical Release G.19.

Likewise, as Chart 4 shows, the spread in the effective interest rate charged between Platinum cards (issued to the most creditworthy cardholders), Gold cards (issued to less creditworthy cardholders), and standard cards (issued to even less creditworthy cardholders) is negligible. The effective rate charge includes penalty rates, but excludes promotional teasers. The difference in effective interest rates charged on Platinum Cards and Standard Cards, weighted for market share, was .91% in February 2008.²³ Even for base interests, arguably the most risk-sensitive and important component of credit card pricing, it is hard to discern anything more than a negligible risk-based pricing spread among high risk and low risk pools. Most of credit card price has nothing to do with risk.

²² Federal Reserve Statistical Release G.19.

²³ CardData, www.carddata.com (subscription data source).

Chart 4. Base Interest Rate APR by Card Type (Weighted by Market Share of Outstandings)



Source: CardData (subscription data source).

2. Late Fees and Overlimit Fees

Late fees and overlimit fees are also only marginally risk-based. Many issuers have up to three tiers of late fees, depending on the size of the late balance, but these tiers are much less exact at reflecting risk than if the fee were a simple percentage of late balance. Nor do late fees account for important risk factors like how late a payment is—the fee is the same whether it is received one hour or one month late. Nor are late fees based on the cardholder’s individual risk profile. For example, Capital One, fourth largest card issuer in terms of total cards,²⁴ has the same late fee for consumers regardless of their credit profile.²⁵ Capital One’s late fee is tiered based solely on the account balance at the time the fees are applied.²⁶

Likewise, overlimit fees bear no connection with the risk posed to the card issuer. Overlimit fees are typically flat fee amounts that do not vary by credit profile. A consumer who goes one penny over the limit pays the same amount as a consumer who goes \$200 over the limit. Some issuers vary overlimit fees by the amount of consumers’ credit limits, which are a function of credit risk profiles, among other factors, but even then it is within a limited number of tiers.

For example, some of Capital One’s cards do not have overlimit fees at all. For other cards, Capital One has three tiers of late fees, one for consumers with credit limits

²⁴ Nilson Report #896 (Feb. 2008), at 9.

²⁵ See Capital One Card Lab, at <http://www.capitalonecardlab.com/> (disclosure statements by credit profile on file with the author).

²⁶ *Id.*

under \$500, another for those with credit limits of at least \$500, but less than \$1,000, and a third for consumers with credit limits over \$1,000. A cursory perusal of consumer bankruptcy filings and claims shows that even consumers who are serious credit risks often end up with credit limits well over \$1,000.²⁷ Tiered overlimit fees based on credit limits are only vaguely risk-based, and when considered with the absence of overlimit fees on some cards, it is hard to see overlimit fees as being a risk-based pricing mechanism. If card issuers were truly concerned about the risk from overlimit transactions, they would either not permit overlimit transactions or make overlimit fees a percentage of the amount overlimit. Most issuers' overlimit fees are penalties, not risk-compensation.

The structure of late and overlimit fees makes it impossible for them to relate to individual consumer risk profiles. Similarly, other credit card price points, such as annual fees, merchant fees, transaction fees, and other back-end fees have no relation whatsoever to consumers' credit risk. To the extent that some credit card price points are risk-based, they are incredibly blunt instruments. Overall, credit card pricing is only marginally sensitive to consumer credit risk.

3. *Flawed Credit Scores Constrain Card Issuers' Ability to Price for Risk*

When one considers the data from which credit risk is assessed—consumer credit reports—it is apparent why the credit card industry has no real interest in implementing true risk-based pricing. Consumer credit reports are seriously flawed as data sources.

Credit reports contain only certain reported (not actual) debts and lines of credit. They are both over- and under-inclusive in their listing consumers' debts, often fail to include positive payment information, contain no information whatsoever on consumers' assets and income, and may not be updated to reflect changes in risk profile in a timely manner. 70% are riddled with errors, including false delinquencies and mismatched accounts.²⁸

There is no requirement that creditors file reports with credit reporting agencies,²⁹ so credit reporting may not show the full picture of a consumer's financial activity. This means credit reports can make consumers look either riskier or less risky than they actually are as borrowers. Moreover, most creditors are not required to file any particular information with reporting agencies when they do file.³⁰ Often they will file only negative information or omit key elements of data, such as credit limits.³¹ And some creditors are reluctant to file information about certain types of consumers, out of competition concerns.³²

It would be irresponsible for a card issuer to rely on such a flawed source for determining its prices. Indeed, both Citibank and JPMorgan Chase Bank have announced

²⁷ 2007 Riverside-San Bernardino Bankruptcy Project data (on file with the author).

²⁸ U.S. Public Interest Research Group, *Mistakes Do Happen: Credit Study Errors Mean Consumers Lose*, March 1998.

²⁹ Federal Trade Commission and Board of Governors of the Federal Reserve System, *Report to Congress on the Fair Credit Reporting Act Dispute Process*, August 2006, at 8.

³⁰ *Id.*

³¹ *Id.* at 9.

³² *Id.*

that they were ceasing to use credit bureau information to adjust credit card interest rates.³³ If two of the largest and most sophisticated card issuers in the country have determined that credit bureau information is a poor source of consumer risk data, we should be chary of other card issuers' reliance upon such data.

The credit card industry is not capable of doing individualized risk-based pricing. Instead, it prices consumers in pools based on certain general risk characteristics. Accordingly, there is inevitably cross-subsidization going on among consumers.

B. RISK-BASED PRICING DOES NOT EXPLAIN ABUSIVE BILLING PRACTICES

The total cost of credit card usage for cardholders is shaped not just by explicit price points, but also by covertly through billing practices. Even if the credit card industry were truly engaged in risk-based pricing, risk-based pricing does not explain abusive and exploitative billing practices, such as: residual interest, two-cycle billing; any-time, any-reason changes in terms; retroactive changes in interest rates; multiple applications of overlimit fees in a single billing-cycle; allocation of payments to the lowest interest rate debt; and universal cross-default. When one looks at the entirety of credit card pricing to consumers, not just the base interest rate, it is clear that card pricing is not risk-based overall. Instead, card pricing and billing structures are designed to exploit card issuers' market power in order to extract rents from locked-in and often unaware card users.

1. Residual or Trailing Interest

Card issuers apply finance charges to the average daily balance outstanding during a billing cycle. A new billing cycle starts, however, before the old billing cycle's bill has been sent out and payment has been received. If payment on the preceding cycle is received in full and on time, then it is not included in the average daily balance. But if even a penny of it is late or not paid, then the previous cycle's balance is treated as outstanding for the days that would otherwise be in the grace period.

To illustrate how residual interest works: if a cardholder charges \$5,000 in cycle 1 which ends on September 30, the cardholder does not get a bill until, say, October 7, after the start of the October billing cycle. The cardholder then pays \$4,500, which the issuer receives on October 12 (on time). Then on October 16, the cardholder charges another \$2,000. The cardholder's total daily balance for the October billing cycle (closing on October 31st), is calculated thus:

Oct. 1-Oct. 12 (12 days @ \$5000)=\$60,000
 Oct. 13-Oct. 15 (3 days @ \$500)=\$1,500
 Oct. 16-Oct. 31 (16 days @\$2500)=\$40,000

³³ Press Release, Citigroup, *Citi Announces Industry Leading Changes to its Credit Card Practices*, March 1, 2007, at <http://www.citigroup.com/citigroup/press/2007/070301b.htm>; Press Release, Chase Card Services, *Chase Announces Clearer, Simpler Credit Card Pricing Approach: Chase Will No Longer Increase Rates Based on Credit-Bureau Information*, Nov. 19, 2007, at <http://biz.yahoo.com/bw/071119/20071119006007.html?v=1>.

Total Daily Balance: \$101,500

This is then divided by the number of days in the cycle (31), yielding an average daily balance of \$3,274.20, to which the finance charge is applied. 14.49% compounded daily for 31 days on \$3,274.20 is \$41.10.

Not that the cardholder repaid \$4,500 back on time, but are still assessed interest on it. But for residual interest, the average daily balance would computed as:

Oct. 1-Oct. 15 (15 days @ \$500)=\$7,500
 Oct. 16-Oct. 31 (16 days @ \$2,500) = \$40,000

Total Daily Balance: \$47,500

This would yield an average daily balance of \$1532.30, so interest would be applied to a balance that is 53% lower. At 14.49% APR interest, compounded daily, the finance charge, without residual interest would be \$19.24.

Residual interest thus cost this hypothetical cardholder \$21.86 (\$41.10 minus \$19.24) in a single month. Annualized, that is \$262.32 in residual interest—interest accrued on funds that were repaid on time. For a household making less than \$50,000 per year, this extra \$262.32 in interest represents 13% of their annual discretionary income. Even for wealthier households, earning \$50,000-\$99,999 per year, it is over 2% of discretionary income.

Cardholders should not be paying interest on funds that they have repaid on time. Eliminating residual interest would have the effect of significantly increasing American families' discretionary spending capacity and would foster real economic growth. Billing tricks and traps like residual interest drain away spending power from American consumers.³⁴

³⁴ The existence of residual interest means that if a revolving cardholder submits a payment for the entire balance indicated on the billing statement, there will still be a remaining residual interest balance to pay the next month. Residual interest can actually create a financial Zeno's paradox, in which the cardholder can never eliminate the balance, except by overpaying the issuer or closing the account.

To illustrate, suppose a cardholder had an interest rate of 10%, compounded daily, and a revolving balance of \$1000. The customer mails in a payment for \$1000, which is received by the issuer 25 days after the statement was generated. The cardholder would then receive a bill the next month for \$6.87, that is 25 days worth of interest. The cardholder then sends in \$6.87, say another 25 days later and thinks that the bill is paid off in full finally. But the next month, the cardholder receives a bill for \$1.00. Interest has accrued on the residual balance of \$6.85 for 25 days, which should be 5¢, but because the card issuer has a minimum finance charge of \$1.00, the cardholder is billed for \$1.00. At this point, assuming that there are no further charges made and no double-cycle billing, the cycle repeats itself again and again. The cardholder pays \$1.00, but and less than a penny of interest accrues, but the cardholder is charged \$1.00.

Theoretically this can go on forever; the only way the cardholder can pay off the balance is to overpay by a sufficient amount to cover the residual interest in a month or to close the account. Cardholders should not find themselves in the Groundhog's Day of residual interest and have to either overpay or close their account in order to eliminate all balances.

2. *Two-Cycle Billing*

Residual interest is closely related to two-cycle or double-cycle billing. Two-cycle billing calculates an average daily balance based on the current and past billing cycle.³⁵ To illustrate, in month one a cardholder charge \$500 and pays off \$450 off at the end of the month. In month two, the cardholder charges \$500 and pay off \$400. Interest accrues as if on a balance of \$600, even though the cardholder only owes \$150 (\$50 balance from month one plus \$100 balance from month two).

What both residual interest and two-cycle billing share is that they calculate the average daily balance to which the finance charge is applied by including amounts that have been timely repaid. And as with residual interest, the result is that the cardholder pays a far higher effective interest rate than is disclosed under Truth-in-Lending provisions. In this example, the cardholder would be paying an effective interest rate four times higher than that disclosed in the cardholder agreement. Two-cycle billing is neither risk-based nor even cost-based, as it computes interest based on balances that have already been paid off, where there is no risk whatsoever. Instead, two-cycle billing merely exploits card issuers' market power to squeeze more dollars out of unwitting cardholders.

3. *Unilateral Term Changes*

Many cardholder agreements permit the issuer to change the terms of the agreement, including the interest rate, unilaterally, at any time, for any reason. Applied purely prospectively, this is could be a risk-based provision that allows card issuers to adjust future pricing based on changed risk-profiles. In practice, however, these terms are often applied in ways that have no relation to changes in risk. For example, opening of a new low-limit charge account is often an act that can trigger an increase in interest rates, such as the application of a default interest rate that can easily be twice as large as the base rate. Surely, though, the cardholder's likelihood of default has not doubled merely by opening an additional line of credit. There is nothing that restricts unilateral any-time/any-reason terms to being risk-based repricing.

Even if unilateral any-time/any-reason terms were applied sensibly in relation to risk they are still problematic because of the significant lock-in effect for card users. I commend to the Committee a recent study by Professor Lawrence Ausubel that estimates the average cost of switching cards at \$150.³⁶ Not only does it take a week or so to get a new card, during which the consumer's cash management might be severely constricted, but switching cards hurts a consumer's credit rating, and affects not only the price at which the consumer can get further cards, but also the price at which the consumer can get any form of credit. Given the lock-in effect of credit card borrowing, unilateral any-time any-reason terms are more like rent-extraction devices than risk-based pricing terms.

³⁵ Double-cycle billing can be combined with residual interest, so that charges from a third billing cycle that are paid off during the grace period still are figured into the balance calculation.

³⁶ Haiyan Shui & Lawrence M. Ausubel, *Time Inconsistency in the Credit Card Market*, 14th Annual Utah Winter Finance Conference, at <http://ssrn.com/abstract=586622>. See also Paul S. Calem *et al.*, *Switching Costs and Adverse Selection in the Market for Credit Cards: New Evidence*, 30 J. BANKING & FIN. 1653 (2006) ("information based barriers to switching have remained relevant in the credit card market despite the many changes seen in the market over the past decade.").

The card industry contends that risk-based repricing is necessary to negate the moral hazard that would exist if consumers did not incur costs for becoming riskier borrowers.³⁷ When someone does not bear the full costs of his actions, he is likely to engage in riskier behavior than he would otherwise. This situation is moral hazard. Moral hazard could exist in the credit card context because a person who knows that the cost of borrowing funds will not change if his credit risk increases may be less motivated to maintain good credit.³⁸

The moral hazard argument is flawed, however, because issuers often determine credit risk by factors that are out of the control of the individual, and that may well be inaccurate. A consumer simply cannot know whether opening up an additional line of credit will result in a higher interest rate or not under unilateral term change provisions. Likewise, a *bona fide* dispute with a landlord might be viewed as risky. The consumer cannot know whether pursuing her rights against the landlord, such as withholding rent, will result in higher interest rates on credit cards. Because of the lack of clarity of what constitutes risky behavior and the lack of consumer control over many risk factors, it is unlikely that risk-based repricing will effectively dissuade risky credit behavior.

If card issuers were truly concerned about moral hazard they would make the trigger events to term changes very clear and apply them scrupulously. They do not. Unilateral any-time/any-reason term changes are devices to squeeze additional payments out of cardholders rather than to deter moral hazard.

4. *Retroactive Application of Interest Rate Increases*

Many card issuers apply increases in interest rates retroactively to existing balances. Combined with two-cycle billing, this can even be applied retroactively to balances that have been paid off. This is not risk-based pricing. Risk-based pricing means that the pricing has to be fixed *before* the risk materializes. The whole idea of risk-based pricing is that it is supposed to be prospective risk-based pricing. Risk is a prospective concept; after-the-fact pricing is at the very least cost-based, and can easily be used to milk cardholders by pricing at a level far above cost. After-the-fact pricing is not risk-based.

The classic financial services example of risk-based pricing is insurance. Insurers offer premiums based on the individual risk-profile of the insured. An insurer cannot decide to change the premium required for past coverage after the coverage event occurs; there would be no risk-involved. It would be unconscionable for an insurer to base coverage for a past event on the payment of higher premiums, retroactively applied; the whole reason people purchase insurance is so they do not have to pay the full costs of the event they are insuring against.

Insurance is just lending upside down. Lenders and insurers both gamble on risk. The insurer is paid premiums up front and pays out *after* the risk materializes. The lender pays out up front, but receives its payments later *if the risk of default does not materialize*. The timing of payments and the risk contingency differs between lending

³⁷ ABA Study, *supra* note 17, at 12.

³⁸ *Id.*

and insurance, but the core economics is the same—a gamble on whether a risk materializes. Doing cost-based or cost-plus-rent-extraction-based pricing defeats the benefits of true risk-based pricing for consumers.

Retroactive application of interest rates means that instead of paying according to risk, which would limit moral hazard, cardholders who revolve pay whatever the issuer decides, regardless of their risk profile. Again, retroactive application of interest rates provides an example of card issuers' exploiting their market power over cardholders, not risk-based pricing.

5. *Universal Cross-Default*

Many cardholder agreements contain universal cross-default clauses that provide that the cardholder's account is default if the cardholder is declared in default (accurately or not and with notice or not) by any other creditor, even if the cardholder has been making payments on time to the card issuer. Cross-default clauses are common in the corporate lending world, although the default triggers are usually limited to defaults on bonds or other lines of credit, not any possible contract dispute.

Universal cross-default appears at first blush to be a risk-based pricing mechanism. But there is no obligation for issuers to verify the fact of a default. The typical source of issuers' knowledge of a default are credit reports, but credit report entries are made without consumers' knowledge and hence ability to contest. The Fair Credit Reporting Act³⁹ does not require any notification of the consumer of the entry of negative information in a credit report. Thus, as a measure of real risk, universal default is problematic.

6. *Multiple Applications of Overlimit Fees in One Billing Cycle*

Some card issuers will charge a cardholder an overlimit fee for every overlimit transaction in a single billing cycle. This practice is not risk-based because it has no relation to the total amount of overlimit spending. A single \$200 overlimit transaction will produce only one overlimit fee, whereas three \$20 overlimit transactions (or \$60 total overlimit) will produce five overlimit fees. This system can often result in pricing that is actually *inverse* to risk.

7. *Allocation of Payments to Lowest Interest Rate Balances*

If a cardholder has balances accruing interest at different rates, such as a purchase balance and a cash advance balance, many card issuers apply payments to the lowest interest rate balance. This is not risk-based pricing. The risk should be reflected in the interest rates, not in the payment allocation because the card issuer cannot know when lending how the balances will be paid—they could be paid off in full in one cycle, or it might take a while. This uncertainty does not relate to the cardholder's risk profile and cannot be accounted for in the payment allocation method. Any method other than pro rata is simply rent-extraction, not risk-based pricing.

³⁹ 15 U.S.C. § 1681 *et seq.*

8. *Accrual of Interest on Fees Within the Same Billing Cycle*

Some issuers apply overlimit fees on the date of the overlimit transaction, rather than at the end of the billing cycle. This means interest accrues on the overlimit fee for part of the billing cycle, which functionally increases the amount of the overlimit fee beyond what is disclosed; the cardholder pays not only the stated overlimit fee, but an overlimit fee that consists of the fee plus interest on it.

This practice is the quintessential “junk fee.” The cardholder has not borrowed the overlimit fee amount from the issuer; no cash has flowed out of the issuer’s pocket. There is only a notional credit given to the consumer in the form of the fee being levied. To apply interest to a junk fee, especially in the same billing period that the fee is levied, is an unfair windfall to the card issuer and jacks up the price of using a card beyond what the consumer can anticipate.

The total cost of credit card usage for cardholders is shaped not just by explicit price points, but by billing practices, many of which are not risk-based, but instead designed to exploit card issuers’ market power in order to extract additional payments from locked-in card users.

C. *The Ephemeral Benefits of “Risk-Based” Credit Card Pricing*

1. “Risk-Based” Pricing Has Dubious Benefits for Creditworthy Consumers

Even if the card industry’s pricing were meaningfully risk-based pricing, it is far from clear whether either creditworthy or subprime consumers benefit from it.

a. Card Benefits Have Declined for Transactors

There are two types of creditworthy cardholders. First, there are cardholders who never revolve a balance. They use credit cards merely to transact and enjoy the “float” during the interest-free grace period. Second, there are cardholders who revolve balances, but generally make at least the minimum payment on time.

Only a very small percentage of cardholders *never* revolve a balance. In 2007, 86% of cardholders revolved a balance at least once,⁴⁰ and over 60% consistently revolved a balance.⁴¹ If we were to look over a period of several years, those numbers would be much higher. There are very few pure transactors; instead, there is mainly a spectrum of revolvers.

For those handful of cardholders who never revolve balances, there are no direct costs of credit other than possibly annual fees. Annual fees are less common than they once were, but cardholders have never needed to pay annual fees, so for savvy transactors, there really has been no change in the direct cost of cards. What is relevant to transactors, however, is the length of the float or interest-free grace period before repayment.

Card issuers are required, by law, to have a 14-day interest-free repayment period.⁴² Traditionally, issuers permitted a significantly longer period, often 30-days. As

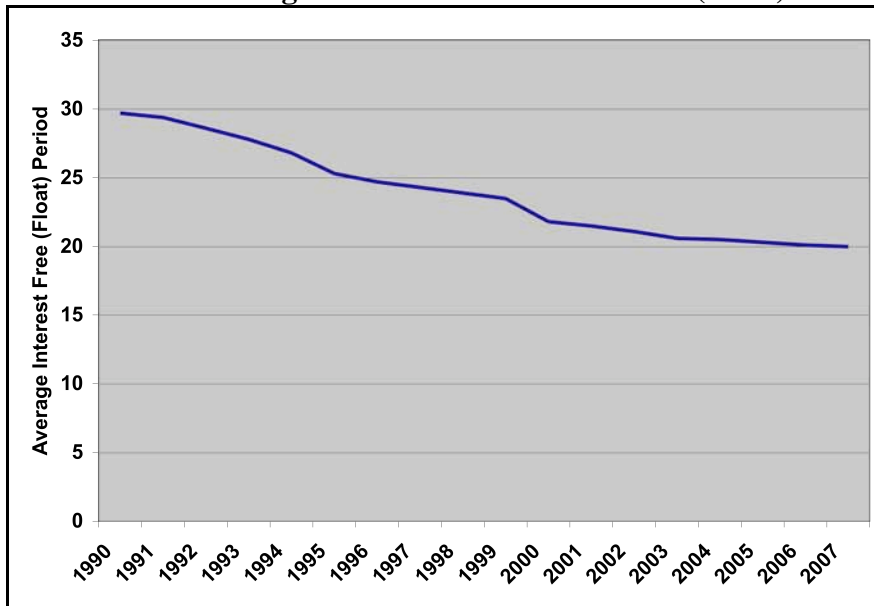
⁴⁰ Ireland, *supra* note 2.

⁴¹ CardData (subscription data source).

⁴² 12 C.F.R. Part 226.5(b)(ii).

Chart 5 shows, since the early 1990s the average float period has declined from around 30 days to 20 days. One-third of the major benefits of credit card usage to creditworthy non-revolving cardholders have disappeared since the onset of risk-based pricing. If pricing were truly risk-based, it is hard to understand why card issuers needed to cut their float exposure by a third. Rather than explicitly raising prices on creditworthy transactors, card issuers have done the economic equivalent by reducing the benefit given to them.

Chart 5. Average Interest Free Grace Period (Float)



Source: CardData (subscription data source).

Declining float also increases the potential likelihood that of a creditworthy consumer making a late payment and getting hit with late fees and penalty interest rates. And as soon as creditworthy consumers start paying interest and fees, their creditworthiness declines.

b. The Drop in Base Interest Rates Is Due to a Drop in Issuers' Cost of Funds

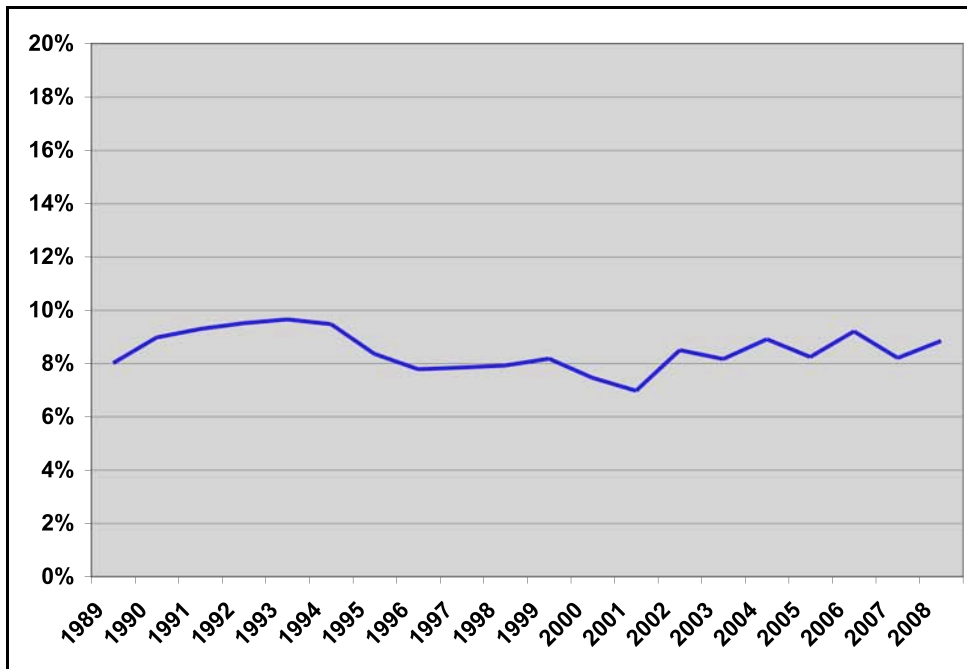
Creditworthy cardholders who revolve balances have supposedly benefited from risk-based pricing in the form of lower base interest rates. The decline in base interest rates, however, is attributable to a decline in card issuers' cost of funds and has been offset by higher backend fees. Because credit cards have multiple price points, one cannot gauge the cost of credit merely by looking at one price point. Credit card pricing is designed in such a way that it is near impossible to calculate the total cost of carrying balances on a card, but overall, it appears that the costs of revolving balances on credit cards might have gone up since the advent of risk-based pricing.

Since 1990, when risk-based pricing supposedly began, base interest rates on credit cards have dropped. There is some dispute over the amount of the drop, in part because of the inadequate nature of official credit card statistics.⁴³ Nevertheless, empirical data strongly indicates that the decline in base interest rates is largely

⁴³ See Levitin, *supra* note 1.

attributable to card issuers' lowered cost of funds.⁴⁴ The proof is that between 1990 and present, card issuers' net interest margin—the difference between the interest rate charged consumers and the cost of funds of card issuers—has remained static since before 1990, as shown below in Chart 6.⁴⁵ The multi-panel time series data showing static net interest margins proves that changes in base interest rates largely reflect changes in card issuers' cost of funds, not so-called “risk-based” pricing. Cost of funds, and not risk-based pricing explains virtually the entire decline in credit card interest rates since 1990.

Chart 6. Net Interest Margin of Credit Card Lenders



Source: FDIC Quarterly Banking Profiles, Net Interest Margin by Asset Concentration Group.

2. Three Credit Card Monte for Revolvers' Pricing

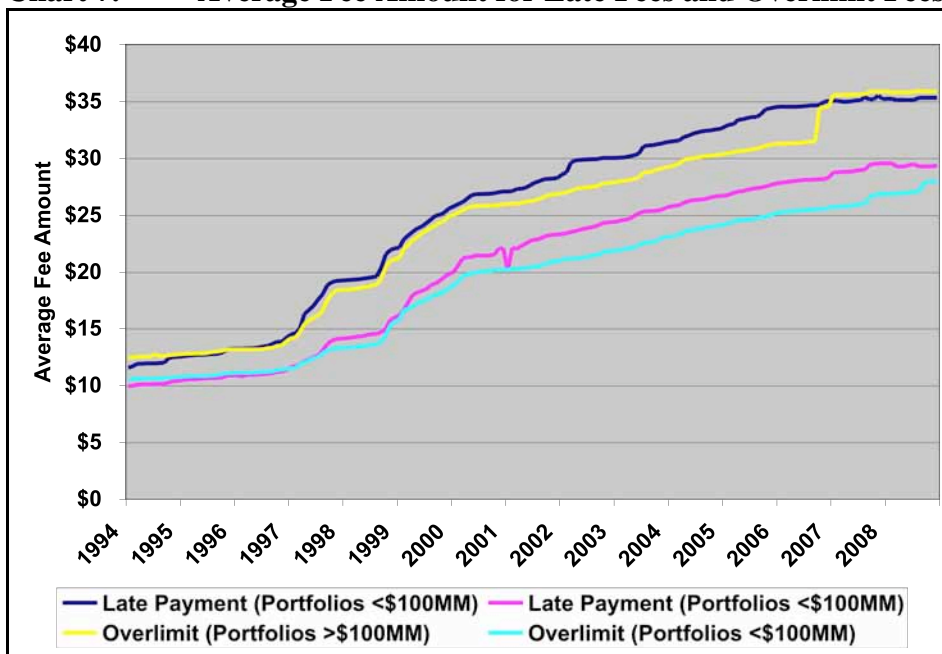
The decline in base interest rates since 1990 has been offset by increases in other credit card fees that do not distinguish between creditworthy and riskier cardholders, so there is no net benefit to creditworthy consumers. As Chart 7 shows, late fees and over-

⁴⁴ Board of Governors of the Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions*, (Washington, D.C.: June 2005). This decline in the cost of funds may be due, in part, to the ability of credit card lenders to tap international securities markets for funds by securitizing card receivables. Board of Governors of the Federal Reserve System, 11-12. A 2006 GAO Report considered possible causes for the decline in interest rates, but was unable to pinpoint a cause. United States Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, Study to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate (Sept. 2006), GAO-06-929, at 15, 17, 35-51 (*hereinafter*, “GAO”). The GAO Report mentioned, as possible factors, risk-based pricing, along with increased competition from the entry of monoline card issuers (Capital One and MBNA) to the market, greater consumer awareness of interest rates because of the implementation of the Schumer box, and a decline in the cost of funds.

⁴⁵ FDIC Quarterly Banking Profile, Net Interest Margin by Asset Concentration Group.

limit fees are up an average of 160% and 115%, respectively, from 1990 to 2005.⁴⁶ As Professor Ronald Mann has noted, the aggregate amount of late and overlimit fees “as a share of outstanding debt, has doubled since 1990, increasing from about 70 basis points per year in 1990 to 140 basis points per year in 2004.”⁴⁷ Additionally, credit cards now feature many charges and fees that did not exist in 1990, such as penalty interest rates, cash advance fees, balance transfer fees, telephone payment fees, stop payment fees, additional card fees, convenience check fees, money transfer fees, statement copy fees, and foreign transaction fees.⁴⁸ Moreover, minimum finance charges have increased, and the definition of certain transactions, such as cash advances have been broadened to apply to more transactions.⁴⁹

Chart 7. Average Fee Amount for Late Fees and Overlimit Fees



Source: CardData (subscription data source).

When one nets out lower base interest rates with increases in other fees, it becomes clear that creditworthy consumers who pay fees might actually be worse off. For example, on a \$500 balance, paid off over six months with 20% annual interest compounded daily and a \$10 late fee, the consumer would pay a total of \$562.85. By contrast, with 10% annual interest compounded daily and a \$45 late fee, the consumer would pay a total of \$572.54.

⁴⁶ United States Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, Study to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate (Sept. 2006), GAO-06-929, at 18.

⁴⁷ Ronald J. Mann, *Bankruptcy Reform and the “Sweatbox” of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 389 (2007).

⁴⁸ Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Fed. Res. Bank of Phila., Jan. 2003, at 26.

⁴⁹ *Id.*

This shows that base interest rates are not a useful metric for measuring the actual cost of credit cards. A better metric is weighted average interest rates, including penalty rates. When penalty rates are included in weighted average interest rates, there is only a 0.41% spread between standard cards (for those who are just above subprime) and platinum cards (for the far more creditworthy).⁵⁰ On a \$500 balance, this spread would amount to a savings for the Platinum cardholder of \$2.05, less than the cost of a gallon of gasoline or a cup of coffee. There is good cause to think that many creditworthy cardholders may not have benefited from changes in card pricing and some may have even been harmed by the shift away from upfront interest rates and toward backend fees and penalty interest rates.

3. *Subprime Consumers Have Not Benefited from Risk-Based Pricing*

In recent years there has been a dramatic growth in the availability of credit, including credit cards, to subprime consumers. This growth has been fueled by securitization, rather than risk-based pricing. Securitization is a financing method in which card issuers bundle large numbers of cardholder receivables and selling them to specially created trusts. These trusts pay for the accounts receivable by selling securities, which are secured by and paid off from the receivables' revenue stream. The card issuer typically serves as the servicer for the accounts receivables in the trust in exchange for a fee.⁵¹

Securitization allows card issuers to obtain cash now for debts that will take a while to collect. It also allows them to transfer credit risk to the trust (and ultimately the investors in the trust).⁵² Securitization also lets card issuers increase their lending capacity. Federal and state banking regulations require the banks and thrifts that issue credit cards to maintain certain reserves of capital as a provision against loan losses. The more loans a financial institution has outstanding, the more capital it has to keep on hand in liquid form earning little return. Securitization enables card issuers to underwrite more debt without maintaining higher reserve requirements.

Reserve requirements only apply to the receivables a card issuer carries on its books; once the receivables are sold to a securitization trust, the reserve requirements do not apply, and the card issuer's capital is available for underwriting additional loans. Likewise, securitization of risky debt helps credit card lenders avoid the even higher reserve requirements caused by 180-day delinquent revolving debts.⁵³ Securitization allows card issuers to move debt (and especially delinquent debt) off their books and avoid "charge-offs" and thus maintain lower reserve levels. Thus, securitization has by

⁵⁰ CardData, Monthly Pricing Averages, U.S. Standard Card Weighted and Platinum Card Weighted. There is no standard definition of subprime, but a rule of thumb is that consumers with FICO scores beneath 600 are subprime, and above 650 are not. Definition varies by lender between 600 and 650. See Dana Dratch, *Buyer Beware on Subprime Loans*, BankRate.com, at <http://www.bankrate.com/brm/news/debt/debtmanageguide/beware-subprime1.asp>. There is no data on average subprime card rates.

⁵¹ STEVEN L. SCHWARCZ *ET AL.*, SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 145 (2004).

⁵² *Id.*

⁵³ See 12 C.F.R. Pt. 3, App. C, Pt. 1 § 31(e) (national banks); 12 C.F.R. Pt. 567, App. C, Pt. 1 § 31(e) (federal savings associations); 12 C.F.R. Pt. 325, App. D, Pt. 1 § 31(e) (state member banks); 12 C.F.R. Pt. 208, App. F, Pt. 1 § 31(e) (insured state non-member banks).

itself dramatically increased banks lending capacity. Since banks can lend more, it is not surprising that they would be willing to extend more credit to more marginal consumers.

Securitization also shifts much of the repayment risk from the card issuer to the securitization trust.⁵⁴ This reduces the incentive for card issuers to have careful underwriting standards. Moreover, the master securitization trust structure (or more recently issuance trust structure) used for credit card securitization encourages lower underwriting standards. A master securitization trust continually acquires credit card receivables against which it issues securities.⁵⁵ This means that a master securitization trust will hold billions of dollars in credit card receivables, so that a higher initial default rate on any batch of millions of dollars of receivables it purchases from the issuer has little effect on the total return. Uncollected receivables reduce the excess spread that goes to the servicer-issuer, but it appears to be more profitable for issuers to screen out poor credit risk consumers *after* lending by looking at their payment history, than to screen them out *before* lending via underwriting diligence. Loans made to true deadbeats can be siphoned out by several months of seasoning more cheaply for the issuer than through careful upfront underwriting. Developments in the form of securitization have made it more profitable for some issuers to screen out the worst credit risks by payment history *after* issuing cards than by careful and diligent underwriting before issuing cards.

Securitization encourages card issuers to issue cards without regard to consumers' ability to repay because they do not bear the ultimate repayment risk from securitized accounts. Accordingly, card issuers are incentivized to lower underwriting standards and make credit cards available to subprime consumers who present serious credit risks. Indeed, the card solicitation and approval process appears to be so indiscriminate that as former Federal Reserve Board Chairman Alan Greenspan testified to this committee "Children, dogs, cats and moose are getting credit cards."⁵⁶ It is hard to reconcile credit cards issued to toddlers and pets with risk-based pricing.

⁵⁴ SCHWARCZ *ET AL.*, *supra* note 51.

⁵⁵ FDIC CREDIT CARD SECURITIZATION MANUAL, at http://www.fdic.gov/regulations/examinations/credit_card_securitization/.

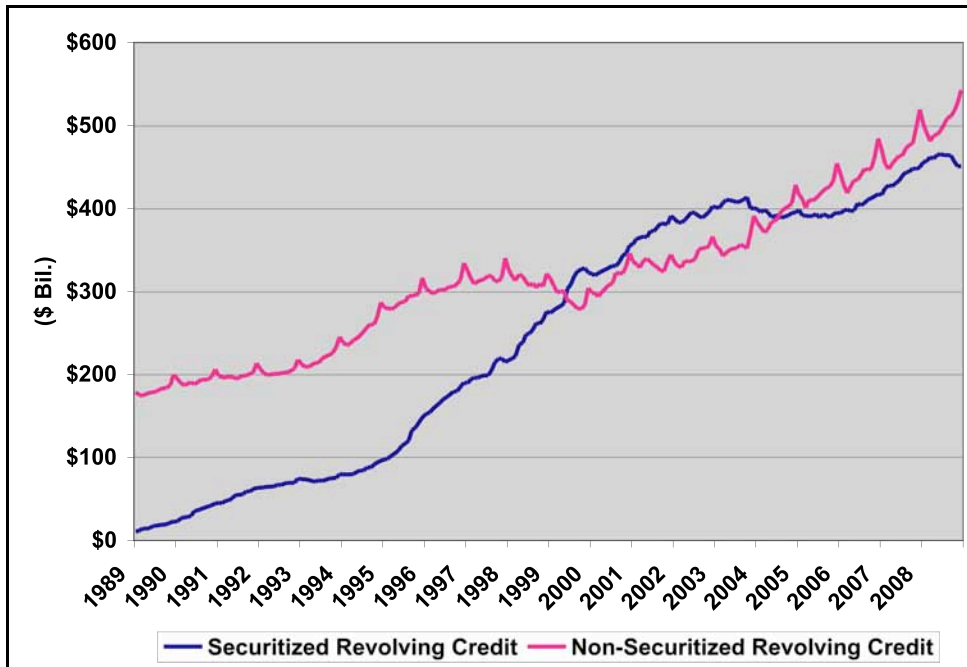
⁵⁶ *Credit Cards at 50: The Problem of Ubiquity*, N.Y. TIMES, Mar. 12, 2000, at C11. *See also*, e.g., *Dog Issued Credit Card*, NBC San Diego, Jan. 28, 2004, at <http://www.nbcsandiego.com/money/2800173/detail.html>; Jane Hughes, *Toddler Issued Platinum Card*, BBC News, Aug. 11, 1999, at <http://news.bbc.co.uk/2/hi/americas/417131.stm>.

Section 1229 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 directed the Federal Reserve to "conduct a study of (1) consumer credit industry practices of soliciting and extending credit—(A) indiscriminately; (B) without taking steps to ensure that consumers are capable of repaying the resulting debt; and (C) in a manner that encourages consumers to accumulate additional debt; and (2) the effects of such practices on consumer debt and insolvency." In 2006, the Federal Reserve published the required study. The study concluded that "as a matter of industry practice, market discipline, and banking supervision and enforcement, credit card issuers do not solicit customers or extend credit to them indiscriminately or without assessing their ability to repay." Board of Governors of the Federal Reserve System, *Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency* (June 2006), 5.

Unfortunately, the Federal Reserve's conclusion is based solely on two short paragraphs of analysis that contain neither citations nor statistics, *id.* at 22, and fly contrary to common sense and the statement of Chairman Greenspan. There is no evidence that card solicitation and extension of credit is in fact based on consumers' ability to repay.

Securitization of credit card receivables was introduced in 1987⁵⁷ and has soared since 1989, when the Federal Reserve began compiling data on it, as shown by Chart 8. As Chart 8 shows, in recent years the volume of outstanding securitized revolving debt has matched or exceeded that of non-securitized revolving debt.⁵⁸ Around 60% of all credit card debt is currently held in securitized pools.⁵⁹ Chart 8 does not prove a causal relationship between securitization growth and lowered standards for access to credit, but it provides at least as compelling an explanation of increased access to credit for subprime consumers as does non-existent “risk-based” pricing.

Chart 8. Growth of Securitized Credit Card Debt in the United States



Source: Federal Reserve Bank Statistical Release G.19.

3. *The Dubious Benefits of Predatory Credit to Consumers: Fee Harvester Cards*

It is also far from clear whether subprime consumers really end up better off from access to credit cards. Access to credit is valuable only if one has the ability to repay. Otherwise, it is a Trojan horse. It is worthwhile considering the terms found on so-called subprime “fee harvester” cards.⁶⁰ These cards have credit limits of \$200-\$300, but they come with substantial upfront fees when the consumer opens the card account. These fees are charged to the card and thus potentially accrue interest and late fees. The upfront fees also reduce the cardholders’ initial available credit to a mere \$50-\$100. The

⁵⁷ Mark Furletti, *An Overview of Credit Card Asset-Backed Securities*, Discussion Paper, Fed. Res. Bank of Phila., Dec. 2002, at 1.

⁵⁸ Revolving debt is largely, but not entirely credit card debt, but securitized revolving debt is almost entirely credit card debt. See note 4, *supra*.

⁵⁹ Darryl E. Getter, *The Credit Card Market: Recent Trends, Funding Cost Issues, and Repricing Practices*, Congressional Research Service CRS 4-5 (Feb. 27, 2008).

⁶⁰ See National Consumer Law Center, *Fee-Harvesters: Low-Credit High-Cost Cards Bleed Consumers*, Nov. 2007.

effective APRs on these subprime cards are often in the range of 300%-500%, rates that approach or exceed the cost of a payday loan.⁶¹

For example, the First Bank of Delaware's Continental Finance Classic MasterCard comes with a \$300 credit limit.⁶² But there is a \$99 Account Set-Up Fee, an \$89 Participation Fee, a \$49 Annual Fee, and a \$10 monthly Account Maintenance Fee.⁶³ The initial total useable credit on the card is \$53, and the opening balance is \$247, with a 19.92% APR, compounded daily. In other words, the cardholder has incurred \$247 dollars in debt simply for the opportunity to borrow an additional \$53 at 19.92%. Assuming there are no overlit fees, the effective APR is for this \$53 of available credit is 819%!⁶⁴

The terms of subprime cards speak for themselves; it is hard to imagine that anyone is better off borrowing at an 819% APR. Subprime lending invites predatory lending practices because of the presumed lower financial sophistication of subprime consumers. To the extent that anyone bothers to listen to what subprime consumers themselves say, it turns out that many don't think much of gaining access to credit cards. Sociological studies show that if the marginal subprime consumers did not have access to credit cards they would either borrow from friends and family or not borrow at all rather than turn to less desirable forms of credit (such as loan sharks).⁶⁵

The recent housing bubble burst shows how many households can be hurt when they are lured into lending arrangements that they cannot reasonable finance. It also shows how there are collateral costs ("externalities") to the entire financial system. Increased access to credit for subprime households beyond reasonable ability to repay is of dubious benefit to subprime consumers themselves and to society as a whole.

IV. 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 on-going 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

⁶¹ *National Consumer Law Center, supra* note 60, at 20.

⁶² First Bank of Delaware, Continental Finance Terms & Conditions, <https://www.cfcapply.com/gold1mc/fbd-terms.htm> (last viewed November 28, 2007).

⁶³ *Id.*

⁶⁴ This figure was arrived at by compounding daily 19.92% interest on an initial balance of \$300 over the course of 365 days, broken down into a regular calendar year with a \$10 monthly service fee added to the compounding balance on the first day of each month. Over the course of a 365-day year, the initial \$300 balance plus monthly service fees will accumulate to \$486.96. In other words, the consumer will have paid \$433.96 in interest and fees in order to borrow \$53.

⁶⁵ Angela K. Littwin, "Comparing Credit Cards: An Empirical Examination of Borrowing Preferences Among Low-Income Consumers," available at <http://ssrn.com/abstract=101446>.

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 on-going regulatory system that is capable of quickly evaluating and responding to innovations in the consumer financial products market place.