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The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers: Hearings Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services, 110th Cong., Mar. 13, 2008 (Statement of Professor Adam Levitin, Geo. U. L. Center)

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Hearing: Credit Card Industry Practices

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U.S. House Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

Madam Chairwoman, Members of the Subcommittee:

I am pleased to testify in support of H.R. 5244, the Credit Cardholders' Bill of Rights, legislation that would end many unfair and abusive billing practices within the credit card industry.

There are four major points I wish to make in my written testimony. First, I want to underscore for the Subcommittee the unusual and confusing nature of credit card pricing and how deceptive and manipulative billing practices exacerbate the situation. Credit card billing practices function as hidden price points that increase the effective cost of credit to consumers, warp competition within the card industry, obstruct consumers' attempts to exercise responsible control of their finances, negatively impact the consumer goods and services economy, and contribute to bankruptcy filings. By banning various unfair and deceptive billing practices, H.R. 5244 would help improve the fairness and the efficiency of the consumer credit economy. Second, I want to emphasize the inadequate state of the current regulatory regime for credit cards, and explain why it is important that Congress act to fill the regulatory void. Third, I wish to address a central argument put forth by the credit card industry against any form of regulation, namely that it would dissipate the benefits of risk-based pricing. This argument against regulation is inconsistent with the evidence on credit card pricing and is ultimately inapplicable to H.R.5244's very moderate provisions. And finally, I would like to suggest that H.R. 5244 be expanded to prohibit an additional trio of unfair and abusive billing practices.

I. THE COMPLEXITY OF CREDIT CARD PRICING AND THE INADEQUACY OF THE CURRENT REGULATORY REGIME

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 prices points, disclosed in Truth-in- Lending schedules. The sheer number of explicit prices points that make it difficult for consumers to accurately and easily gauge the total cost of using credit cards.

This difficulty is compounded by credit cards' hidden price points in the form of billing practices such as universal cross- default, unilateral term changes, 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. These 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 encourage higher levels of credit card debt than would occur if there were clear and transparent pricing. A fundamental economic theory, the price theory of demand, tells us that consumer demand for credit products is shaped by the price of credit. When consumers cannot accurately gauge the net price of credit, however, they will use inefficient amounts of it. 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).

By banning billing practices that function as covert price points, H.R. 5244 will 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. Any 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 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.

H.R. 5244 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. Additionally, H.R. 5244 will help the economy by promoting productive consumer spending. 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. High levels of credit card debt also discourage savings for future contingencies and retirement. Eliminating these hidden price points will foster productive consumer spending and help the economy overall.

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 debt is more likely to file for bankruptcy than a consumer with any other type of debt. 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. H.R. 5244 may help limit bankruptcy filings, the costs of which are borne by all creditors, including the government, and thus by all taxpayers. By eliminating hidden credit card prices points, H.R. 5244 will make credit card markets more efficient and will help consumers and the economy.

II. H.R. 5244 FILLS A MAJOR REGULATORY VOID

H.R. 5244 is an important step in establishing fundamental fairness and efficiency in the credit card market and fills a major regulatory void. Credit cards are among the most ubiquitous consumer financial products. Credit cards' share of consumer payment volume is higher than cash, checks, or debit cards. More than one of every four dollars of consumer transactions in 2006 was done using a credit card. By 2011, the number is expected to be closer to one in three. In 2006 there were over $1.871 trillion dollars in credit card transactions in the United States, a number projected to rise to $2.8 trillion by 2011.

Yet the credit card industry is only minimally regulated and is among the least transparent in the financial services sector. State usury laws, the historical bulwark of consumer credit regulation, were gutted by the Supreme Court on federalism grounds. Binding mandatory arbitration has closed off the courts to consumers and has largely precluded the judiciary from ensuring even basic modicum of fairness in the card industry. State legislatures and banking regulators who have sought to curb abusive credit card billing practices have found themselves running up against preemption by federal banking law.

Federal law provides for little beyond barebones disclosure regulation, cardholder liability limits, and a minimum interest free grace period. Moreover, federal banking regulators have shown a remarkable indifference to consumer protection, which is fundamentally at tension with their primary safety-and-soundness mission. This indifference manifests itself both in terms of lax enforcement of existing regulations, and resistance to enacting of anything other than disclosure regulations. As a result, there is today no effective mechanism for regulating a leading consumer financial services product. It is important that Congress take the lead in filling this regulatory void in order to ensure fair and efficient consumer credit markets.

H.R. 5244 will not resolve all of the problems of the credit card industry; it does not address deep-seeded problems of price structure, rewards programs, antitrust, merchant fees, or identity theft prevention, among other issues. The card industry might well find new ways to impose hidden price points. Nonetheless, H.R. 5244 is an important first step to reining in an industry that has run wild in a regulatory no-man's land of outdated and threadbare federal laws, preempted state laws, and somnolent consumer protection by federal banking regulators. The Credit Cardholders' Bill of Rights is an important piece of consumer protection legislation that will help shield consumers from the worst abuses of the card industry and that will make credit markets fairer and ultimately more efficient.

III. 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. 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) credit card pricing is not actually risk- based, (2) risk-based pricing does not explain unfair and deceptive billing practices, (3) neither creditworthy consumers nor subprime consumers have not benefited from putative risk- based pricing; and (4) H.R. 5244 does not interfere with card issuers' ability to price for risk.

A. Credit Card Pricing Is Not Risk-Based

Overall, credit card pricing is not risk-based. Only some components of credit card pricing relate to individual 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.

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. 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.

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 2 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%. In other words, there is scant evidence that low-risk transactors are offered lower interest rates than higher-risk revolvers.

Likewise, as Chart 3 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 .41% in February 2008. 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.

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, has the same late fee for consumers regardless of their credit profile. Capital One's late fee is tiered based solely on the account balance at the time the fees are applied.

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 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. 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 Issuer's Ability to Accurately 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 riskbased 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.

There is no requirement that creditors file reports with credit reporting agencies, 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. Often they will file only negative information or omit key elements of data, such as credit limits. And some creditors are reluctant to file information about certain types of consumers, out of competition concerns.

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 that they ware ceasing to use credit bureau information to adjust credit card interest rates. 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.

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: 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. Two-Cycle Billing

Two-cycle billing means that when a cardholder revolves a balance, interest accrues not just on the actual balance being revolved, but also on the entire balance from the previous billing cycle, even if it has already been paid off. 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).

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.

2. 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 Subcommittee a recent study by Professor Lawrence Ausubel that estimates the average cost of switching cards at $150. 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 rentextraction devices than risk-based pricing terms.

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. 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.

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 anytime/ any-reason term changes are devices to squeeze additional payments out of cardholders rather than to deter moral hazard.

3. 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 and insurance, but the core economics is the same--a gamble on whether a risk materializes. Doing cost- based or cost-plusrent- 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.

4. 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 Act 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.

5. 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.

6. 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.

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.

For 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. Traditionally, issuers permitted a significantly longer period, often 30-days. As Chart 4 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.

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 riskbased 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 riskbased 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. Nevertheless, empirical data strongly indicates that the decline in base interest rates is largely attributable to card issuers' lowered cost of funds. 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 5. 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.

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 6 shows, late fees and over-limit fees are up an average of 160% and 115%, respectively, from 1990 to 2005. As Professor Ronald Mann has noted, the aggregate amount of late an 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." 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. Moreover, minimum finance charges have increased, and the definition of certain transactions, such as cash advances have been broadened to apply to more transactions.

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.

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). 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.

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). 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. 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 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. 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. 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 the Senate Banking Committee "Children, dogs, cats and moose are getting credit cards." It is hard to reconcile credit cards issued to toddlers and pets with risk-based pricing.

Securitization of credit card receivables was introduced in 1987 and has soared since 1989, when the Federal Reserve began compiling data on it, as shown by Chart 7. As Chart 8 shows, in recent years the volume of outstanding securitized revolving debt has matched or exceeded that of non-securitized revolving debt. Around 60% of all credit card debt is currently held in securitized pools. Chart 7 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 nonexistent "risk-based" pricing.

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. 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 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.

For example, the First Bank of Delaware's Continental Finance Classic MasterCard comes with a $300 credit limit. But there is a $99 Account Set-Up Fee, an $89 Participation Fee, a $49 Annual Fee, and a $10 monthly Account Maintenance Fee. 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 overlimit fees, the effective APR is for this $53 of available credit is 819%!

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).

The recent housing bubble burst shows how many (not just subprime) 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.

D. The Impact of H.R. 5244 on Risk-Based Pricing

H.R. 5244 proposed only modest and moderate regulation on the card industry. It leaves card issuers free to charge whatever interest rates they want and to price fees at whatever level they wish. Issuers can also continue to account for risk in their lending in five ways under H.R. 5244:

-- First, card issuers can control for risk by controlling the credit line. If issuers become concerned about the increasing financial risk of a cardholder, they can freeze or reduce the amount of credit that is offered.

-- Second, card issuers can engage in more careful initial underwriting. Issuers could make more careful decisions upon issuance of a card, regarding whether to grant the card, how much credit to grant and at what rate.

-- Third, issuers would still be able to increase rates prospectively for "off-us" behavior. If issuers became concerned that a cardholder were becoming a greater financial risk because of activity or behavior involving other creditors, or because of a decline in the cardholder's credit score, they could raise rates prospectively.

-- Fourth, issuers could continue to increase rates retroactively for "on-us" violations of the cardholder agreement. If a cardholder is late or exceeds the credit limit, issuers could raise interest rates retroactively. Nothing in H.R. 5244 prevents retroactive rate increases for "on-us" behavior.

-- Finally, issuers can always develop a workout plan with the cardholder in order to ensure ultimate repayment. As always, the issuer can develop a workout plan, as long as it meets the applicable banking regulator's guidelines, to lower interest rates, reduce principal, elongate payments, etc.

In short, card issuers do not need the deceptive billing practices targeted by H.R. 5244 to account for risk; H.R. 5244 leaves them with multiple effective methods of controlling cardholder risk.

IV. WAYS IN WHICH H.R. 5244 COULD BE IMPROVED

H.R. 5244 could be improved by banning a trio of additional unfair billing practices.

A. Banning the Accrual of Interest on Balances Before the Posting Date of Transactions

First, the bill could be improved by banning the accrual of interest on balances before the transaction is posted. Some issuers apply finance charges from the date of transactions, rather than the posting date of the purchase. Issuers do not advance credit, however, until the posting date. Issuers should not be able to earn interest before they have paid merchants for the transaction. Until the posting date, it is the merchant, not the issuer, extending credit to the cardholder, so for the issuer to collect finance charges in this period is unjust enrichment. The issuer is charging money for a period for which it has incurred no risk or cost. Moreover, by applying finance charges from the transaction date, rather than the posting date, issuers are charging a higher effective APR than disclosed in Truth-in- Lending disclosures. This practice should be banned.

B. Banning the Accrual of Interest on Fees Applied Within a Billing Cycle

Second, the bill could be improved by banning the accrual of interest on fees applied within a 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 increasing 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. The cardholder has not borrowed the overlimit fee amount from the issuer, so it is unfair for the cardholder to pay interest on the fee.

C. Banning the Application of Residual Interest

Third, H.R. 5244 could be improved by banning the application of residual interest. Residual interest is interest that accrues in the period between when a billing statement is generated and when the payment is received. 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 5cents, 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. H.R. 5244 could be improved by forbidding issuers to assess finances charges on for the period between a billing statement date and the timely receipt of a payment of the statement balance in full.

V. 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 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.

Even if credit card pricing were truly risk-based and even if it had the benefits claimed by the card industry, nothing in H.R. 5244, the Credit Cardholders' Bill of Rights, implicates the risk-based pricing model. The Credit Cardholders' Bill of Rights is about banning abusive and manipulative tricks from credit card billing, nothing more and nothing less. It does not regulate interest rates or fee amounts. Instead, all it does it ban or limit certain unfair and exploitative billing practices that have no relationship whatsoever to consumer risk. Because these practices are, at best, incidental to issuers' profitability, H.R. 5244 will not result in higher costs of credit or lower availability of credit. Instead, this legislation will help clarify credit card pricing, which is a prerequisite for an efficient, competitive market. H.R. 5244 will help consumers and will make for a fairer and more efficient credit economy, and I strongly urge this Congress to pass it.