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Financial Institutions and Consumer Credit

The Honorable Spencer Bachus, Chairman

House Financial Services Committee

U.S. House of Representatives

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I would like to thank Chairman Spencer Bachus for providing this opportunity to share my views with the Committee on the increasingly important topic of credit card industry policies and the protection of consumer rights under the Fair Credit Reporting Act. I would also like to commend Ranking Member Bernard Sanders for his efforts in protecting consumers from deceptive marketing and contract disclosure practices of the credit card industry. The twin issues of rising consumer debt and shockingly low levels of financial literacy have grave implications to the continued economic well-being of the nation—especially as Americans cope with these increasing perlilous economic times. For these and many other reasons, I commend the Subcommittee for accepting the daunting task of examining the increasingly serious problem of protecting consumer rights in this period of the rapid deregulation of the financial services industry.

As an economic sociologist, I have spent the last 16 years studying the impact of U.S. industrial restructuring on the standard of living of various groups in American society. Over the last 11 years, I have been particularly interested in the role of consumer credit in shaping the consumption decisions of Americans as well as the role of retail banking in influencing the profound transformation of the U.S. financial services industry. In regard to the latter, I have studied the rise of the credit card industry in general and the emergence of financial services conglomerates such as Citigroup during the deregulation of the banking industry beginning in 1980. In terms of the former, my research includes in-depth interviews and lengthy survey questionnaires with over 800 respondents in the 1990s. The results of this research are summarized in my recent book, *CREDIT CARD NATION: America's Dangerous Addiction to Consumer Credit (Basic Books, 2001).* More recently, I have collected survey data from a case-study of a mid-sized public university based on a representative sample of nearly 800 college students in 2002. Some of the key findings of the study are reported in this testimony. In addition, I have become actively involved in the national movement to improve the financial literacy/education of our youth. My work with colleges, universities, and student loan organizations has inspired my own internet-based financial literacy/education program at www.creditcardnation.com. My next book, *GIVE YOURSELF CREDIT: The Power of Plastic in the Credit Card Nation*, includes my most recent work on several consumer protection cases regarding credit card industry policies as well as my recent surveys on college students.

Banking Deregulation:
From Community Banks to Financial Services Conglomerates

The recent revolution in consumer financial services dates to the 1970s with the increasingly successful assaults against Depression-era banking regulations. For example, the 1933 McFadden Act essentially limited national banks from crossing state boundaries and competing with state-chartered banks. These interstate branch banking restrictions protected the local community banking system and its conservative (asset secured), fixed term "installment" lending policies until the 1980s. Significantly, the best customers of these local banks were those with the lowest outstanding debts whom were most likely to repay their loans within an agreed upon period of time. This is significant today in terms of reviewing the profound changes in the credit screening process and risk assessment models of retail consumer services. That is, the best clients in the regulated, community banking system (pre-1980) were those with low debt-to-income ratios who most likely to repay their loans in-full within a specified period of time.

By the late 1970s, high inflation together with declining real wages encouraged American families to begin embracing consumer debt as a rational strategy for coping with intensifying financial pressures. State usury laws and interstate banking restrictions, however, limited the profitable growth of the universal or "all-purpose" national bank credit card until the 1978 U.S. Supreme Court decision, Marquette National Bank of Minneapolis v. First of Omaha Service Corporation. See Chart 1. For the first time, a nationally chartered bank was allowed to charge the highest interest rate permitted by its "home" state and essentially export these rates to its out-of-state credit card clients. By simply relocating its "bricks and mortar" office to states without consumer usury rate ceilings--Citibank immediately moved from New York to South Dakota--the universal credit card (led by Visa and MasterCard) was transformed into a high profit financial service product that could easily surmount banking barriers. Today, 29 states do not have any limits on the interest rates charged by in-state, credit card issuing banks (Lazarony, 2002).

The universal bank credit card played a major role in the de-regulation of the U.S. banking industry in the 1980s. National "money center" banks faced mounting losses on Third World, residential and commercial real estate loans following the 1981-82 recession as well as the loss of low-cost depositors funds with the end of Regulation Q's fixed passport savings rates. Although Citibank's credit card division lost over $500 between 1979 and 1981, this transitionary period belies the dramatic increase in its profitability following the 1981-82 recession. The sharp reduction in inflation and rapid advances in computer processing technologies underlie the dramatic increase in the profitability of "revolving" loans in the mid-1980s (Nocera, 1994; Manning, 2000). Over the next two decades, these trends precipitated the shift to consumer or "retail" financial services as increased competition through banking "de-regulation" produced higher cost "revolving" or credit card loans. Indeed, the decline in less profitable corporate loans (corporations raise capital directly by selling bonds via Wall Street) contrasts sharply with the rising demand for unsecured, consumer loans; an annual average of 1 million blue-collar workers lost their jobs in the 1980s.

The consumer services revolution shifted into high gear in the 1980s as soaring credit card profits (Asubel, 1991) fueled the unprecedented consolidation of the banking industry. In 1977, for example, the top 50 banks accounted for about one-half of the credit card market (Mandell, 1990). Today, the top 10 banks control over 80 percent of the credit card market (*Card Industry Directory*, 2002). See Table 1. In the process, "net" revolving credit card debt has climbed from about $51 billion in 1980 to over $610 billion in 2002. And, over one-half of outstanding credit card debt is resold in the secondary financial markets as securitarized bonds—at a typical premium of about 18%. This recent trend reduces the risk to credit card issuers (by complex corporate subsidiary structures and complicated insurance schemes) and increases the institutional demand for new "revolving" loans.

Significantly, the re-sale value of unsecured credit card debt has continued to rise during the current recession even though the credit card industry has argued that consumer account default and delinquency rates are hurting its profitability. According to *Business Week*, thirty-seven major credit card portfolios (totaling about $37 billion) were sold at an average premium of 18.4% in 2002 and twenty deals ($4.1 billion) have averaged 18.99% in 2003. The reporter noted that this impressive premium for unsecured consumer debt was rising "despite high delinquency rates, rising unemployment, and escalating bankruptcies that heighten their risks" (Weber, 2003:70). . The result is the industry has intensified marketing campaigns to recruit new customers and encourage higher household debt levels. In the process, these industry pressures have profoundly changed the credit card industry's "pre-screening" policies and preferred client characteristics.

The industry's effort to increase its "revolving" debt portfolio is illustrated by the enormous increase in credit card solicitations and extended "lines" of revolving credit. For example, BAI Global reports that between 1997 and 2001, the number of mailed credit card solicitations rose 66.7 percent: 1997 (3.0 billion), 1998 (3.4 billion), 1999 (2.9 billion), 2000 (3.5 billion), and 2001 (5.0 billion). During this period, however, consumer response rates to these mass mailing declined from 1.3% in 1997 (3.9 million applications) to 0.6% in 2001 (3.0 million applications). Significantly, the reduction in the annual growth rate of the credit card industry's client base has fueled issuers' efforts to increase the debt "capacity" of their accountholders by raising available lines of credit. For instance, credit card debt (gross) rose 31.8% between 1997 and 2001 (from $554 billion to $730 billion) whereas total revolving lines of credit card jumped 75.0 percent from $1.667 billion to $2.917 trillion. The enormous increase in extended credit belies consumer demand as utilization of the revolving lines of credit dropped from 33.2 percent in 1997 to 25.0 percent in 2001. This trend continues today as consumer credit card debt declined during the first quarter of 2002 and yet aggregate revolving credit rose $262 billion (US Federal Reserve Board, 2002 and Veribanc Inc, 2002 as cited in CFA, 2002).

Not surprisingly, the credit industry began aggressively marketing previously neglected, economically marginal consumers in the 1990s. Significantly, the screening process essentially turns on its head the screening criteria for marketing to traditionally neglected groups such as college students and the working poor. That is, these potential clients were screened based on their underutilized "debt capacity" and the industry's assessment that they would be unlikely to payoff their debts in the near future. For example, the longitudinal Survey of Consumer Finance (conducted by the University of Michigan) shows that the largest increase in consumer credit card debt is among households with a reported annual income of less than $10,000. Between 1989 and 1998, the average credit card debt among households that revolve their credit card balances increased a moderate 66.3 percent versus 310.8 percent for the poorest households—from $598 in 1989 to $2,440 in 1998. Similarly, households headed by seniors (over 64 years old) experienced a dramatic increase of 140.9 percent, from $1,497 in 1989 to $3,607 in 1998 (reported in Draut, 2003; Manning, 2003b). See Table 2.

The aggressively marketing of college students has been reported elsewhere (PIRG, 1998; 2000; Manning, 1999; Manning, 2000:Ch. 6; 2002) with growing attention to the poor financial literacy of America's youth (Mandell, 1998; 2000; 2002; Manning, 2002). What is striking is the acknowledgement of the credit card industry is that college students are a desirable market because of their ignorance of personal finance and their lack of consumer debt. As shown in Table 3, the marketing of credit cards has shifted rapidly over the last five years from college upperclassmen to college freshmen and high school seniors. More significantly is the recognition that student consumption has a large debt component that is increasingly financed by family loans, federally subsidized student loans, summer earnings and part-time employment during the academic year, and even with other credit cards. As shown in Table 3, three out of five students with credit cards in our survey had already maxed them out during their freshmen year and, 3 out of 5 freshmen with multiple credit cards were already using bank cards to pay for other revolving credit accounts. Furthermore, this survey reveals that nearly three-fourths of students use their student loans to pay for their credit cards. Not incidentally, recent studies indicate that this indiscriminate marketing to college students has led to high incidences of fraud and identity theft among this young adult population.

Assessing the Deregulation of Consumer Financial Services: Soaring Profits and Spiraling Costs

Not surprisingly, the credit card industry has reported record profits this year. According to the most recent FDIC report (June 2003) on bank profits, [First Quarter 2003] "is the largest quarterly earnings total ever reported by the [banking] industry… [and] the largest improvement in profitability was registered by credit card lenders [with] their average Return-On-Assets (ROA) rising to 3.66 percent from 3.22 percent a year earlier." The extraordinary profitability of consumer credit cards is illustrated by comparing the ROA of credit card issuers with the overall banking industry. According to the FDIC, the increase in the ROA for the banking industry rose from 1.19% in 1998 to 1.40% in 2003 (First Quarter) or 17.6%. According to the U.S. Federal Reserve

Board, ROA for the credit card industry was 2.13% in 1997 and has risen impressively to 2.87% in 1998, 3.34% in 1999, 3.14% in 2000, 3.24% in 2001, 3.5% in 2002, and 3.66% in 2003 (First Quarter). This is largely due to lower cost of borrowing funds (widening "spread" on consumer loans), decline in net charge-offs ($911 million or 18.5 percent lower in 2003 than 2002), decline in delinquent accounts ($919 million or 14.3 percent lower in 2003 than 2002), cross-marketing of low-cost insurance and other financial services, and dramatic increase in penalty and user fees.

The most striking feature of the deregulation of the U.S. banking industry is the sharp increase in the cost of unsecured "revolving" credit. For instance, the 'real' cost of borrowing on bank credit cards has more than doubled due to widening interest rate "spreads" (doubled from 1983 to 1992) and escalating penalty and user fees (cf. Manning, 2000:Ch. 1). The latter is attributed to the 1996 U.S. Supreme Court decision, <u>Smiley v Citibank,</u> which ruled that credit card fees are part of the cost of borrowing and thus invalidated state imposed fee limits. Overall, penalty fee revenue has climbed from $1.7 billion in 1996 to $7.3 billion in 2001. The average late fee has jumped from $13 in 1996 to $30 in 2002. Incredibly, combined penalty ($7.3 billion) and cash advance ($3.8 billion) fees equaled the after-tax profits of the entire credit card industry ($11.13 billion) in 2001. See Table 4.

This dramatic increase in credit card fees following the 1996 <u>Smiley</u> decision is illuminated by information grudgingly released during ongoing litigation with a major credit card issuer concerning alleged abuse of a consumer's rights under the FCRA. As shown in Table 5, this regional bank's total, <u>nonfinance</u>-related revenues jumped from $28.98 million in 1994 to $31.57 million in 1996 (new fee structure imposed in second half of the year) and then to $73.03 million in 1997 and then to $76.03 million in 1998 when its acquired by FirstUSA credit card company (Bank One). During this period, late fee revenues nearly tripled from $10.49 to $29.20 million, overlimit penalty fees jumped from $4.93 (1996) to $15.22 million, returned check fees climbed from $0.20 to $2.85 million, and new credit life insurance soared to over $7 million. It is the outrageous imposition of costly credit card fees and the aggressive solicitation of new clients (especially college students, working poor, and seniors) that underlies the "plant, squeeze, and sell" strategy of regional banks whose primary goal is to increase their credit card revenues in order to maximize the eventual sale price of their credit card division to a top ten issuer (Manning, 2004).

Today, the ascension of the Credit Card Nation features the shift from installment to revolving loans where the best bank customers will never repay their high interest credit card balances. Unlike the installment lending system, the most economically disadvantaged (debtors) essentially subsidize the low cost of credit to the most economically advantaged (convenience users). It is this "Moral Divide" that leads banks to refer to 'deadbeats' as those clients whom pay off their charges in-full each month. These largely unprofitable accounts (depending on monthly charge volume and rebate/reward programs) increased substantially in the last decade, from 29 percent in1991 to 37 percent in 1996 and then peaking at 43 percent in 1999 (Manning, 2000). In 2003, less than 40 percent of credit card household pay off their balances in-full. As shown in Table 6, these accounts can be quite costly to banks that are not successfully cross-marketing other financial services products to these customers. For example, based on 2001 account expenses and revenues, a typical grocery store affinity cardholder (average charges of $700 per month) with a 1% cash reward program cost First USA about $51 for the year plus average cost of charge-offs per account in 2001 of $95. A disturbing trend in this period of credit card industry consolidation is the rise of "cherry picking" of profitable accounts. That is, even with the rising proportion of profitable "revolvers," many banks are seeking to screen out financially responsible "deadbeats" by not renewing their accounts or charging membership fees.

The escalating profits of the credit card industry underlie the increasing dependence of corporate retailers on finance revenues due to shrinking margins on consumer sales. In 2001, for instance, Sears and Circuit City reported that over one-half of their corporate profits were due to finance-related revenues. For instance, most consumers are not aware that "12 months interest free, same as cash" promotions feature a surprise at the beginning of the 13th month—all finances charges are retroactive if the account is not paid in full. See "Ann's" experiences with Home Depot's private issue credit card which is provided by Citibank in Appendix B. This is not surprising since credit cards are the most profitable product of the financial services industry. Even during the current recession, pre-tax profits of the credit card industry (measured by

Return on Assets) jumped 20% from 2000 to 2001. As reported in Table 2 below, the nearly $18 billion in pre-tax profits is an industry record. Not incidentally, the growing burden of high-cost credit card debt is disproportionately borne by middle-income and working poor families. Among the three out of five "revolver" households in the United States, their average credit card debt is staggering, rising from over $10,000 in 1998 to over $12,000 in 2002. These figures do not include the $1 trillion in outstanding, nonmortgage consumer installment debt, lease contracts (automobiles), and loans from the "Second Tier" financial sector including pawnshops, "payday lenders, and rent-to-own stores.

The Deregulation of Financial Services:

The Future of Consumer Rights

The current recession, which has elicited President Bush's patriotic exhortations to spend more time and money in the malls, has highlighted the critical role of consumer spending to the vitality of the U.S. economy. Although government policy-makers have encouraged household spending by reducing interest rates (Federal Funds rate was cut from 6.5% in 2000 to 1.75% at end of 2001), the sharp decline in the cost of borrowing by banks has not been passed on to consumers. For the major credit card companies, the Federal Reserve's low-interest rate policy has produced a financial windfall since "sticky" credit card rates declined only modestly--from an average of 18% in 2000 to about 16% in 2001 and nearly 15% in 2002. This trend was the focus of this Subcommittee's hearing "Abusive Credit Card Industry Practices" that was held on November 1, 2001

As shown in Table 2, interest revenues barely dipped from $64.6 billion in 2000 to $64.2 billion in 2001 (with an 8% increase in outstanding debt) whereas bank borrowing costs dropped steeply from $28.6 to $20.5 billion—more than compensating for the $5.2 billion increase in credit card debt charge-offs. And, as illustrated by ongoing litigation, Wells et al v. Chevy Chase F.S.B., any state regulation of credit card interest rate ceilings and fees will be aggressively resisted as well as the requirement of "meaningful notice procedure" for contract amendments. In this case, Maryland-based Chevy Chase Bank promised its credit card clients not to raise the top interest rate above 24%. In 1996, it moved its credit card headquarters to Virginia and raised its interest rate to a high of 28.8%. It also amended the terms of its contract to include higher late fees, a new overlimit fee, and a more costly "daily" calculation of finance charges without proper notification for clients to reject these unfavorable amendments to their existing contracts.

The credit card industry is so determined to protect the high profits derived from its most indebted clients that, in Lockyer et al v. American Banking Association et al (under appeal), it sued to prevent the enactment of a state disclosure statute. The 2002 California law simply requires banks to inform those clients that remit only the minimum credit card payment of the number of years necessary to pay off their outstanding balance (assuming no additional charges) in a notation on their monthly account statement. The goal of the legislation is to educate consumers about the long-term cost of their revolving credit accounts and thus encourage a shorter and less expensive repayment period.

Although banks emphasize the availability of low-interest balance transfers, the most indebted rarely qualify for these promotional programs ('bait and switch' offers) or benefit for only a short period of time (two to six months). Furthermore, credit card companies have adopted a stringent policy of imposing punitive financial penalties on promotional interest rates for minor payment infractions or simply due to high outstanding balances on other consumer loan accounts.

In Houston, Texas, for example, Doug received an enticing six month, 1.9% balance transfer offer from Chase MasterCard and shifted $5,000 from his MBNA credit card account. Unfortunately, Doug's wife mistakenly sent $80 instead of the required $97 for the first month's minimum payment. Even though it was received two weeks before the due date, his next statement reported $17 past-due plus a $35 late fee. More striking was the increase in the interest rate, from 1.9% to 22.99%, even though he had not had a late payment in over two years. In an attempt to negotiate a lower finance rate, Doug was informed by a Chase customer service representative that he would have to document six consecutive months of on-time payments before his request could be considered. This followed an earlier "bait and switch" from Chase where the 4.9% promotional rate was raised without warning simply because the bank had decided that the cumulative balances on his other credit cards was "too high." How high is too high is an answer that the banks will not explain.

Some sophisticated "reward" programs lure customers with attractive rebates that are much less generous than implied in the marketing brochures. For example, the Student Visa card issued by Associates National Bank of Delaware (recently acquired by Citibank) proclaims, "Get Up to 3% Cash Back on Purchases." Rosa, a law student at William and Mary University in Virginia, considered it a potentially prudent choice since she usually pays off her account balance each month. Upon reading the fine print, which qualified the terms of the agreement, she realized the true cost of Citibank's benevolence: "For the times when you carry a balance from statement to statement, we'll help you by giving you up to 3% cash back on the amount of the net purchase." Hence, Rosa would rarely qualify for the cash back rebate. And, when she did, Rosa would have to pay an annual finance charge that ranged from 14.74% to 24.74%.

In Orlando, Florida, Jolynn was offered a $10 discount coupon at the Costco Wholesale Club for applying for a co-branded American Express card. The card featured a 0% interest rate on purchases for the first 3 months (1.99% balance transfer for six months) and 12.74% thereafter plus "up to 2% cash back." The latter was most appealing until she read the tiered structure of the reward program: less than $2,000 annual charges, 0.75% cash back (0.25% without balance), $2,000 to $5,000 annual charges, 1.00% cash back (0.50% without balance), and over $5,000, 2.00% cash back (1.50% without balance). Unless Jolynn carried a monthly balance or charged over $5,000 per year, she would not receive even a 1.0% cash rebate.

An especially egregious policy is the unilateral increase of a consumer's credit card interest rate because of cumlative balances on other accounts, even when the contract specifies "fixed interest rates for the life of the loan." For example, Wally, who has an MBA degree and lost his six figure job in the financial services industry in the aftermath of the destruction of 9/11, has three credit cards with a cumulative balance of $17,000. All three cards were obtained through zero "balance transfer offers." Today, with a $55,000 annual salary and $73,000 in student loans, Wally considers himself an indentured servant with an average annual interest rate of over 23 percent. Even though he has not been late with a credit card payment in over 1 ½ years, the banks (Chase, Citibank, Discover) refuse to lower his interest rates. In fact, they told him to make an appointment with a consumer counseling agency or file for bankruptcy if he does not want to pay these high finance rates.

The most costly credit cards are marketed to the working poor. In its direct mail solicitation, United Credit National Bank Visa declares, "ACE VISA GUARANTEED ISSUE or we'll send you $100.00! (See inside for details.)" For John, a 55 year-old African American who lives on public assistance in suburban Maryland near Washington, D.C., the terms of this contract are outrageous,

> "Initial credit line will be at least $400.00. By accepting this offer, you agree to subscribe to the American Credit Educator Financial and Credit Education Program. The ACE program costs $289.00 plus $11.95 for shipping and handling plus $19.00 Processing Fee a small price to pay compared to the high cost of bad credit! The Annual Card Fee [is] $49.00... For your convenience, we will charge these costs to your new ACE Affinity VISA card. [They] are considered Finance charges for Truth-In-Lending Act purposes."

For unsuspecting applicants like John, this credit card will cost $369 for a net credit line of only $31 at 19.8 APR. It is no wonder that those households whom are most desperate for consumer credit often give up on the financial services sector after they realize the exploitative terms of these contracts.

The passage of the Financial Services Modernization Act of 1999, which consecrated the Citibank and Traveler's Group merger, marks the end of Depression-era regulation of retail banking as separate from commercial banking/insurance services. It is the emergence of financial services conglomerates such as Citigroup that was the catalyst for the plethora of recent Wall Street financial scandals. Moreover, the ability to acquire companies across financial services sectors and share client information with corporate subsidiaries underlies the rise of "cross-selling" financial products such as investment services to credit card clients. This explains Citibank's 1997 purchase of AT&T's unprofitable credit card company (8th largest), at a substantial premium, with its large number of high income customers. For Citigroup, this corporate synergy produces multiple revenue flows by originating high interest loans through its credit card

(Citibank) and subprime lending (First Capital Associates was acquired in 2000) subsidiaries which are then resold through its investment division of Solomon Smith Barney (cf. Hudson, 2003; Manning 2003a).

Not incidentally, access to personal consumer credit information enables predatory lenders to identify highly indebted households that are susceptible to duplicitous debt consolidation solicitations. In <u>Acorn v Household Finance Corporation</u>, a California suit filed in 2002, lists of prospective clients were obtained from affiliated retailers including Best Buy, Wickes Furniture, K-Mart, Costco, and Home Base. Homeowners with high credit card and other consumer debts were identified from these lists and contacted by account executives at nearby branches. Potential customers were promised that their debt consolidation loans would save them money after the refinancing of their credit card, consumer loan, and mortgage debts. In the process, the objective of this 'target practice' was to deliberately 'upsell' loans in amounts so high in relation to the value of the borrowers' homes that it would be nearly impossible to sell or refinance them in the future. By misrepresenting the total cost of these debt consolidation loans (origination fees, mandatory insurance, high interest rates), Household Finance Corporation generates high profits from the initiation of these loans as well as from their resale in secondary mortgage and securitarized bond markets.

Today, high credit card interest rates are no longer sufficient to satisfy the voracious appetite of the financial services industry. Penalty and transaction fees continue to rise while new fees are imposed such as overdraft transactions, foreign currency conversion, and "double billing" cycles which reduce the payment "grace" period. In addition, banks have begun aggressively marketing financial-related services that offer little practical benefits for their clients including credit protection programs ($9.99 per month from Citibank) that can not prevent identity fraud, unemployment and injury insurance (typically 0.5% of outstanding monthly balance) that provide minimum credit card payments that rarely can exceed premium payments, and other forms of low-value term-life and health insurance. The proliferation of these credit information and insurance products yield very high profits for the banks and only modest benefits for consumers.

As for future statutory regulation and other consumer protections, local and state attempts have been aggressively thwarted through the creative use of Federal Preemption. That is, the U.S. Constitution specifies that public efforts to regulate the operation of a national banking system can only be legislated by the U.S. Congress to the exclusion of local and state jurisdictions. The tremendous political influence of the banking industry on both the Executive Branch (MBNA was the largest contributor to George Bush's Presidential campaign) and the U.S. Congress (especially Senate Banking and House Financial Services Committees) ensures that there will not be any significant pro-consumer bills enacted in the next couple of years. In addition, the credit card industry's recent imposition of binding arbitration is designed to drastically curtail class action lawsuits. The legality of mandatory arbitration and thus the future of consumer litigation against unfair lending policies by the credit card industry is being challenged with varying degrees of success by several ongoing lawsuits.

Lastly, with the twin threat of statutory regulation and class action litigation greatly diminished, the current focus of the credit card industry is the enactment of the Bankruptcy Reform Act. Vetoed by President Clinton at the end of 2000, versions of this aggressively lobbied pro-banking bill were passed by the U.S. House and Senate during the last Congress. The objective of the bill is to increase the amount of unsecured consumer loans (especially credit card debts) that must be repaid before the approval of a bankruptcy petition. If this bill is enacted into law, it will expand the U.S. government's role as a *de facto* debt collector and increase the costs assumed by the public in extending consumer credit to the most risky credit card clients. Hence, it will provide a <u>dis</u>incentive for the banks to curtail the marketing of high-cost credit to its most marginal clients. For an industry whose motto is "Greed is Good," this legislative distortion of the free market system constitutes the final piece of the puzzle for sustaining its record profits and spiraling executive bonuses. As shown in Table 7, this compensation mix is incredibly lucrative for credit card industry executives whose total mean compensation in 2002 averaged $20.23 million, led by Alfred Lerner of MBNA at $195.00 million (Punch, 2003).

Chart 1

Federal Regulation of the Credit Card Industry

1978 **Marquette National Bank of Minneapolis v. First National Bank of Omaha**: U.S. Supreme Court decision permits national banks to move their headquarters to states with high interest rate ceilings and thus evade federal interstate banking restrictions and state usury laws. By essentially "exporting" high finance rates to states with strong pro-consumer rate protections, a national market for bank credit cards is created. Citibank immediately moves its headquarters from New York City to Sioux Falls, South Dakota. Today, 29 states do not have interest rate caps on credit cards.

1996 **Smiley v. Citibank**: U.S. Supreme Court voids state regulations on credit card related fees such as late and overlimit penalty fees. The ruling specifies that fees are part of the cost of financing consumer credit and can only be regulated by U.S. Congress. Between 1996 and 2001, credit card penalty fees soar from $1.7 to $7.3 billion.

1999 **College Student Credit Card Protection Act**: First introduced in 1999, the legislation proposes restrictions on marketing credit cards to college students under 21 years old and to impose low credit limits on students under 21 years old without demonstrable sources of income and whose parents will not co-sign the credit card contract. Bill is denounced by banking industry and is defeated in the U.S. House of Representatives.

1999 **Wells et al v. Chevy Chase Bank, FSB** (under appeal): Regional Credit Card Company blatantly disregards existing contract with card accountholders by moving its headquarters to Virginia in 1996 and raising interest rates (high of 28.8%), imposing new fees, higher daily interest rate calculation, mandatory arbitration, and purposively fails to provide meaning notice procedure for disclosure of new contract terms. Bank argues that federal preemption denies plaintiffs' the legal right to seek relief.

1999 **Financial Services Modernization Act:** Essentially ends Depression-era regulation of U.S. banking industry by permitting Citibank to merge with Traveler's Insurance Group into a single conglomerate, Citigroup. The Act rescinds most interstate branch banking restrictions as well as "firewall" protections between retail (consumer services) and wholesale (investment) banking activities. The goal is to facilitate "one-stop" banking and pursue "cross-marketing" strategies. Citibank purchases AT&T credit card company in 1998 and Citigroup acquires First Capital Associates in 2001.

2000 **Deaton v. Chevy Chase Bank, FSB** (under appeal): Plaintiff is billed five-fold for purchases incurred on a business trip in 1994 even though the merchants verify consumer's claim. Under FCRA, plaintiff's demands corrections to her credit report which are ignored. In 1997, plaintiff's account file is lost" during sale of credit card company to First USA and additional late fees and legal expenses are billed by First USA. The case raises serious questions regarding how banks respond to FCRA obligations and how illegally obtained "other" revenues are deposited and classified for accounting purposes.

2002 **Lockyer et. al. v. American Banking Association et. al.** (under appeal): Credit Card industry files injunction against enactment of a bill passed by the California state legislature that requires credit card companies to clearly state how many years it will take for a consumer to pay off the outstanding balance if only the minimum payment is submitted. Litigation demonstrates the credit card industry's intent to resist legislative efforts to inform consumers about nonfinance related issues such as disclosure of specific contract terms and payment information.

2003 **Acorn v. Household Finance Corporation** (pending): The predatory "trolling" for heavily indebted consumers by identifying households with high levels of credit card and other unsecured debt. These consumers are persuaded to consolidate their unsecured debts with existing home mortgages into a single high interest loan. By "upselling" loans above the value of their homes, the consumer is typically unable to seek more favorable refinancing with other banks and unable to sell their home in the future.

2003 **Consumer Bankruptcy Reform Act**: This bill, which was vetoed by President Clinton in 2000, is primarily promoted by the credit card industry. The goal is to prevent more petitioners from seeking relief through debt liquidation (Chapter 7) by pushing them into a repayment plan (Chapter 13). Debate is still unresolved over the Homestead Exemption provision (five states including Texas permit protection of all home equity) and consumer advocates are seeking to deny banks priority status over personal obligations such as child support and alimony. Higher cost of filing and administration will deny the most disadvantaged an option to file for bankruptcy. Also, it shifts some of the costs of debt collection to the public and thus limits the banks' financial risk of marketing to low income and highly indebted consumers. Credit card giant MBNA was the largest financial contributor to George W. Bush’s presidential campaign.

Table 1

Top Ten U.S. Credit Card Issuers:

Account Balances, Charge Volume, and Customer Accountsa

(December 31, 2001)

Rank	Name	Balances ($ billions)	Volume ($ billions)	Accountsb (millions)
1	Citibank	108.9	218.5	92.9
2	MBNA America	74.9	142.3	50.9
3	First USA/Bank One	68.2	140.4	39.4
4	Discover	49.3	93.3	50.3
5	Chase	40.9	70.9	24.0
6	Capitol One	38.4	50.6	38.9
7	American Express	32.0	224.6c	34.6c
8	Providian	32.9	30.5	19.1
9	Bank of America	27.2	48.9	14.5
10	Household Bank	16.1	34.9	17.9

aTotal of charges during year (January 1 – December 31, 2001).

bIncludes multiple accounts of same households.

cIncludes American Express charge and credit card (Optima) accounts.

SOURCE: CardWeb.com, Inc available at www.cardweb.com.

Table 2

AVERAGE FAMILY CREDIT CARD DEBT:

Revolving Debtor Households by Income and Age (1989 – 1998)*

(Reported in 1998 Dollars)

HOUSEHOLD INCOME	1989	1992	1995	1998	% Change (1989-98)
Less $10,000	$594	$1,318	$1,503	$2,440	310.8%
$10,000 - $24,999	$1,443	$1,923	$2,399	$2,745	90.2%
$25,000 - $49,999	$2,240	$2,658	$2,809	$3,976	77.5%
$50,000 - $99,999	$2,948	$3,306	$3,684	$4,628	57.0%
Over $99,999	$5,107	$5,723	$6,384	$7,335	43.6%
ALL FAMILIES	$2,482	$2,753	$3,153	$4,129	66.3%
Older Households					
Head (55-64 yrs)	$2,400	$2,557	$3,120	$4,931	105.5%
Head (Over 65 yrs)	$1,497	$1,973	$1,698	$3,607	140.9%

SOURCE: University of Michigan Survey of Consumer Finances (SCF), 1989, 1992, 1995, and 1998 as reported in Tamara Draut, *"Trying to Make Ends Meet: The Growth of Credit Card Debt,"* (New York: Demos Final Report, 2003).

*Data analysis excludes "convenience users" whom are defined as accountholders without any outstanding credit card balances.

Table 3

STUDENT LOANS, AGE OF FIRST CREDIT CARD, MAXED CREDIT CARD LIMIT, & USED CREDIT CARDS TO PAY FOR OTHER CREDIT CARDS BY CLASS STANDING

George Mason University (April 2002)

	FRESHMEN	**SOPHS**	**JUNIORS**	**SENIORS***
	(N=117)	(N=102)	(N=120)	(N=161)
AGE OF FIRST CREDIT CARD (77.4% undergraduates have bank credit cards)				
16 and under	12.3%	5.8%	5.7%	5.0%
17	17.7%	10.1%	10.4%	5.0%
18	56.2%	56.5%	38.7%	45.4%
19	11.0%	14.5%	20.7%	14.9%
20	0.0%	2.9%	13.2%	9.2%
21	0.0%	1.5%	2.8%	8.5%
22	1.4%	5.8%	1.9%	2.8%
23 and over	1.4%	2.9%	6.6%	9.2%
TOTALS	100.0%	100.0%	100.0%	100.0%
MAXED OUT CREDIT CARDS (73.4% undergraduates)				
Yes	59.7%	77.9%	71.2%	80.0%
No	40.3%	22.1%	28.8%	20.0%
TOTALS	100.0%	100.0%	100.0%	100.0%
USED CREDIT CARDS TO PAY OTHER CREDIT CARDS (66.0% undergraduates)				
Yes	58.1%	67.7%	64.2%	70.6%
No	41.9%	32.3%	35.8%	29.4%
TOTALS	100.0%	100.0%	100.0%	100.0%

*Includes students who have matriculated at least four or more years.

Table 3

	FRESHMEN	SOPHS	JUNIORS	SENIORS*
	(N=117)	(N=102)	(N=120)	(N=161)
STUDENT LOANS (45.0% received)				
Yes	33.6%	41.2%	40.0%	52.8%
No	66.4%	58.8%	60.0%	47.2%
TOTALS	100.0%	100.0%	100.0%	100.0%
CREDIT CARDS (77.4% undergraduates)				
Yes	62.4%	65.7%	87.5%	88.2%
No	37.6%	34.3%	12.5%	11.8%
TOTALS	100.0%	100.0%	100.0%	100.0%
USED STUDENT LOANS TO PAY DOWN CREDIT CARDS (68.3% or 112/164)				
Yes	73.3%	74.2%	70.5%	63.5%
No	26.7%	25.8%	29.5%	26.5%
TOTALS	100.0%	100.0%	100.0%	100.0%

*Includes students who have matriculated at least four or more years.

Table 4

Bank Credit Card Profitability: 2000-2001
(Billions of US Dollars)

Revenues	2001	% Change From 2000	As % of Ave Outstandings	2000
Interest	**$64.2**	**-1.0%**	**12.7%**	**$64.6**
Interchange	**$14.1**	**7.0%**	**2.8%**	**$13.2**
Annual Fees	**$2.4**	**5.0%**	**0.5%**	**$2.3**
Penalty Fees	**$7.3**	**11.0%**	**1.5%**	**$6.6**
Cash Advance Fees	**$3.8**	**12.0%**	**0.8%**	**$3.4**
Enhancements*	**$0.6**	**5.0%**	**0.1%**	**$0.6**
TOTALS	**$92.5**	**2.0%**	**18.3%**	**$90.7**

Expenses	2001	% Change From 2000	As % of Ave Outstandings	2000
Cost of Funds	**$20.5**	**-28.0%**	**4.1%**	**$28.6**
Charge-offs	**$29.9**	**21.0%**	**5.9%**	**$24.7**
Operations/Mrkting	**$23.8**	**8.0%**	**4.7%**	**$22.1**
Fraud	**$0.7**	**8.0%**	**0.1%**	**$0.7**
TOTALS	**$74.8**	**-2.0%**	**14.8%**	**$76.0**
Pre-Tax Profit/ROA	**$17.7**	**20.0%**	**3.5%**	**$14.7**
Taxes**	**$6.54**			**$5.44**
After-Tax Profit/ROA	**$11.13**	**20.0%**	**2.2%**	**$9.26**
Ave Outstandings	**$505.34**	**7.7%**		**$469.10**

Sources: Card Industry Directory 2003 Edition (Thompson Publishers, June 2002) and James J. Daly, *"A Little Help From Uncle Sam, Government Intervention Never Looked Better Than It Did in 2001,"* Credit Card Management, March 2002, pp. 3-7

*Enhancements include marketing revenues from third party retailers, insurance premiums, and returned check fees.

Table 5

NonFinance Credit Card Revenues and Rebate Expenses:

East Coast Regional Bank (1994-1998)

(Millions of Dollars)

REVENUES (Fees)	**1994**	**1995**	**1996**	**1997**	**1998**
Membership	$5.19	$1.54	$3.70	$6.11	$7.19
Merchant	$10.63	$6.43	$1.21	$10.91	$11.41
Late Penalty	$10.49	$3.12	$15.28	$25.47	$29.20
Over Limit	---	---	$4.93	$13.39	$15.22
Cash Advance	$2.47	$1.23	$5.69	$6.20	$3.04
Returned Check	$0.20	$0.31	$0.76	$1.66	$2.85
Credit Life Insurance	---	---	---	$9.29	$7.12
TOTALS	**$28.98**	**$12.63**	**$31.57**	**$73.03**	**$76.03**
Rebate Expenses	$13.44	$5.52	$4.73	$6.25	$15.04
NET REVENUES	**$15.54**	**($7.11)**	**$26.84**	**$66.78**	**$60.99**

SOURCE: Discovery documents from defendant in ongoing FCRA civil suit (2003).

Table 6

Are You A Credit Card 'Deadbeat'?:

Typical *GIANT* Supermarket Affinity Account: 2001*

(First USA Bank)

($700 volume of charges per month)

INTERCHANGE FEES	$142.80	$142.80
BANK's COST OF FUNDS	-$28.35	-$28.35
1% CASH REBATE Program	-$84.00	**Without Rebate Program**
MARKETING/OPERATING EXPENSES	-$81.30	-$81.30
Subtotal	**-$50.85**	**$33.15**
AVE COST OF CHARGE-OFFS	-$95.15	-$95.15
Net Cost per Deadbeat Account	**-$146.00**	**-$62.00**

($1,000 volume of charges per month)

INTERCHANGE FEES	$204.00	$204.00
BANK's COST OF FUNDS	-$40.50	-$40.50
1% CASH REBATE Program	-$120.00	**Without Rebate Program**
MARKETING/ OPERATING EXPENSES	-$81.30	-$81.30
Subtotal	**-$37.80**	**$82.20**
AVE COST OF CHARGE-OFFS	-$95.15	-$95.15
Net Cost per Deadbeat Account	**-$132.95**	**-$12.95**

Sources: Card Industry Directory 2003 Edition (Thompson Publishers, June 2002) and James J. Daly, *"A Little Help From Uncle Sam, Government Intervention Never Looked Better Than It Did in 2001,"* Credit Card Management, March 2002, pp. 3-7

*Based on 2001 industry averages of 1.7% interchange fee, 4.05% cost of funds, 4.7% combined cost of marketing and operating expenses (as a percentage of managed receivables, and 2001 First USA charge-off rate of 5.5% of managed receivables.

Table 7

Highest Paid Card-Industry Executives: 2002

(Compensation includes Salary, Bonus, and Stock Options in millions)

Rank	Name	Title	Company	Total Pay
1	Alfred Lerner	Chairman & CEO	MBNA	$195.01
2	Charles M. Cawley	Pres & CEO	MBNA	$49.08
3	Charles T. Fote	Chairman & CEO	First Data	$39.22
4	John R. Cochran III	V. Chairman	MBNA	$36.16
5	Bruce L. Hammonds	V. Chairman	MBNA	$28.80
6	Kenneth I. Chenault	Chairman & CEO	American Ex	$18.30
7	Robert B. Willumstad	Pres, Global Consumer	Citigroup	$9.78
8	Pete J. Kight	Chairman & CEO	CheckFree	$7.89
9	James M. Cracchiolo	Pres, Global Fi Services	American Ex	$7.81
10	Ronald V. Congemi	SVP, Network Services	Concord EFS	$5.43
11	Alfred F. Kennedy	Group Pres, US Consumr	American Ex	$5.29
12	Thomas F. Chapman	Chairman & CEO	Equifax	$4.40
13	Gary L. Crittenton	EVP & CEO	American Ex	$3.43
14	Matthew J. Bannick	SVP, Global Online Pay	eBay	$2.90
15	Phillip G. Heasley	EVP	Bank One	$2.48
16	Joseph W. Saunders	Chairman, Pres, CEO	Providian	$2.41
17	Warren Wilcox	V. Chairman, Marketing	Providian	$2.37
18	Susan Gleason	V. Chairman, Ops & Sys	Providian	$2.33
19	Ronald N. Zebeck	Chairman & CEO	Metris	$2.23
20	Ellen Richey	V. Chairman, Risk Mgnt	Providian	$1.79
21	Paul J. Liska	EVP, Credit & Fin’l Prods	Sears	$1.52

Sources: Standard & Poor’s ExecuComp cited in Linda Punch, “Fading Pay,” Credit Card Management, June 2003, p. 42.

Appendix A

CREDIT CARD NATION: Historical Anomalies of Post-Industrial America

[1] More Profitable to <u>Finance</u> Consumption than to Produce/Sell Commodities such as *Circuit City* (electronics) and *GE Finance Corporations*.

[2] <u>The Most Desirable Clients of the Financial Services Industry Are Those Unable To Repay Their Loans</u>. Conversely, Customers That Pay-Off Their Credit Card Charges Each Month Are Least Desirable and called 'DEADBEATS.'

[3] The lowest Income and most financially Distressed "Revolver" Credit Card Users <u>Subsidize</u> the Most Affluent and Financially Advantaged "Convenience Users" (Moral Divide).

[4] Banks Prefer to Reject Loans to Small Businesses, the Primary Source of New Jobs, With the Expectation that They Use High Interest Credit Cards; Today, Credit Cards are the Number One Source of Start-Up Capital for Entrepreneurs.

[5] First Credit Card is More Likely to Be Received Before First Full-Time Job For Most College Students. Hence, Most College Students Perceive Credit Cards as an Entitlement Rather Than an Earned Privilege With Financial Responsibilities.

[6] Since 1980, the Deregulation of the Banking Industry has Produced High Cost "Financial Products" that Defy Traditional Definitions of Loans ('Cash Advances,' 'Lease Cash') at Interest Rates of Over 700% APR. Credit Card Finance Charges of 19.9% APR are a Bargain in Comparison to these Usurious Interest Rates.

[7] More Than One-Half of US Credit Card Debt is Re-Sold as "Securitarized" Bonds (NY, London, Tokyo). This Means Institutional Investors are <u>Purchasing Credit Card Debts to Help Finance Your Future Retirement.</u>

[8] A 1997 Marketing Campaign by the <u>US Department of Treasury encouraged the Purchase of "Savings Bonds" Over the Internet With Bank Credit Cards</u>; Credit Card Interest Rates Averaged About 18% versus 4.5% for Bonds.

[9] <u>Banks Routinely Reject Credit Card Applications From Senior Citizens While Inundating Their Grandchildren With Offers</u>--Before Their First Job--in College.

[10] Over Educated and Under Compensated Recent College Graduates Often Refer to Their Credit Cards as a Form of Social Class Entitlement: "<u>YUPPIE FOOD STAMPS.</u>"

Appendix B

Six Months of Financial Freedom: Can You Afford It?

Ann saw the promotional offer in the weekend edition of the *Orlando Sentinel* newspaper and thought that it sounded almost too good to be true. A Home Depot credit card with a promise of 10% off the first purchase (up to $2000) and zero percent financing and NO PAYMENTS for six months. She called the Home Depot credit approval office—toll free—and received a $1,000 line of instant credit, courtesy of the new “partnership” with Citibank’s private issue credit card subsidiary. Ann thought that with the backsliding of the economy, it was a great opportunity to finally replace the 20 year-old carpet in her home. Although Ann’s local Home Depot store in suburban Orlando, Florida refused to honor the discount coupon, the final sale price of $1,619 with free padding for wall-to-wall carpeting in her two-bedroom house was too good to pass-up.

After a call to the credit department, which was informed of Ann’s pending purchase by a sales agent, her Home Depot credit card limit was raised to a $10,000. Hard to believe considering that her current monthly income of about $1200 was dwarfed by the over $21,000 in outstanding credit card balances on her six other credit cards. Ann was surprised and relieved that the exaggerated income that she listed on the application was not checked (she reported $2500 per month).

To Ann, six months without payments seemed like an eternity and interest free, too. She couldn’t wait to feel the plush new carpet under her bare feet. When the first bill arrived, she did not realize that the free financing clock started ticking on the date of the sale contract NOT the day of installation. So instead of six months of no payments it was really only five months. When the second bill arrived, Ann did not understand why there was a monthly finance charge of $20.88 and simply reminded herself that it was interest free. Afterall, the Home Depot salesman assured her that there were no finance charges on the purchase. And, everyone was complimenting her on how nice the new carpet looked.

It was only after six months had passed that Ann understood the financial realities of the “promotional offer.” The accrued interest charges of $125 was now added to the $1,619 sale price at an annual percentage finance rate (APR) of 15.48 percent. With a minimum monthly payment of $25, it was manageable but will require 15 years to pay it off assuming no additional charges. And, the conveniently low minimum payment obscured the total cost of the carpet at the end of the 15 year period--$4,489. Needless to say, no one mentioned that increasing the monthly payment by only $10 would cut the payoff period in half to only 7 ½ years and thus reduce the final cost to “only” $2,811. Or, that lowering the APR by only 3 percentage points (12.48%) would reduce the payoff period to 10 ½ years and the total cost to $3,124.

Ann was interviewed for this article in March 2003 and requested that her last name not be identified.

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