



Priceless or Just Expensive?

The Use of Penalty Rates in the Credit Card Industry

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About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

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EXECUTIVE SUMMARY

With roughly a trillion dollars in credit card debt, Americans have come to rely on their credit cards as both a form of payment for purchases and a flexible way to borrow cash. Credit cards are also a key source of income for financial institutions, with a rate of return that tends to be much higher than most other consumer loan products.

While credit card companies compete to offer the lowest “headline” rates in solicitations, they also depend on less obvious tactics to boost their financial returns. Credit card issuers at one time charged a single fixed interest rate to all customers and now charge several varying interest rates at once. Some of these interest rates expire after a short time period, and some suddenly change to “penalty rates” under certain conditions. The number and importance of fees charged to consumers has also grown, with penalty fees up 69% between 2003 and 2007 according to the credit card industry consulting firm R.K. Hammer. Repricing customers based on penalty triggers is a common revenue-boosting strategy.

This study shows that penalty repricing leads people to underestimate the interest they are paying and that credit card issuers try to keep it that way. Furthermore, it shows that penalty repricing is increasingly common and there is a growing disparity between the size of the penalty and what consumers expect to pay.

More specifically, this study finds:

- **Almost 11% of all balances borrowed on credit cards carry penalty pricing, and the majority of borrowers being charged penalty rates do not realize it.** This lack of knowledge is not surprising given that credit card issuers do not give borrowers explicit notification when invoking penalty pricing, and routinely reprice accounts when borrowers make payments just one day late.
- **While penalty rates have been climbing, “penalty shock” (defined as the increase over the regular rate) has increased even more sharply, with penalty shock more than doubling between 2001 and 2007.** In 2008, the average penalty annual percentage rate (APR) was 16.9 percentage points **higher** than the average non-teaser purchase APR.
 - For a household with the average amount of \$10,678 in credit card debt, being penalty repriced on all their balances would result in an additional \$1,800 in interest costs per year.
- **The prevalence of penalty rates in credit card terms has been rising, with a penalty rate in the terms of 94% of new credit card solicitations issued in 2008.** This is compared to 82% in 2003.

Policy Recommendations

As this study goes to press, federal regulators are considering proposed regulations that would define some common practices relating to penalty rates to be unfair or deceptive. If adopted as proposed, they would ameliorate some of the worst abuses, but more should be done.

Transparent, Upfront Pricing

Genuine competition in the market and informed choice is best served by upfront, transparent pricing. Luring consumers into a particular card, then using arbitrary and opaque criteria to raise their rates later is not a mark of a competitive market. Penalty rates should not be permitted.

Limitations on Penalty Rates

Lenders argue that changes in pricing are necessary for credit cards because people make ongoing charges, and borrower risk levels can change. The proper response to the risk exposure presented by an open-ended loan is to allow lenders to raise the rates on future ongoing charges (after proper notification), not on past charges.

Federal regulatory agencies are currently considering proposals to place some limitations on penalty rates, by defining them as unfair or deceptive acts or practices. Those proposals would make progress on two of the necessary reforms. The proposal being considered by the federal agencies includes requiring that cardholders be given 45-days advance notice before the penalty rate becomes effective. The proposed rule would also prohibit retroactive application of most rate increases, including penalty rates, unless a card holder is more than 30 days late with a minimum payment.

These two improvements are important, but more could be done. Specifically, two other areas in need of reform were not addressed in the proposals:

- *Penalty rates should be reasonable:* If permitted at all, there should be a reasonable limit on the penalty rate. Some congressional proposals recognize this and would limit a penalty rate increase to 7% over the account's current rate.
- *Triggers should be reasonable, and related to the account:* Events that trigger the application of a penalty rate should be restricted to material breaches of the credit card contract. Triggers should be limited to actual performance on the account, as some congressional proposals would require.

Borrower Recommendations

Don't assume that events triggering a penalty could never happen to you

Making a late payment just once (even if it is not your fault) can trigger a penalty. In addition, conduct that does not in any way breach your credit card contract can trigger a penalty rate. For example, increasing balances on other accounts or even just changes in the way your loans get reported to the credit bureaus could trigger a penalty.

Avoid credit cards that include penalty rate options

Try to avoid card offers that include penalty rates. Although over 90% of solicitations have a penalty rate, it is still possible to find a credit card that does not have one. The card issuer can amend terms to add a penalty rate later, but they have to notify you if they do.

Watch your statement closely

If you have a card that includes a penalty rate, take a look at your APR every time you get your monthly statement to make sure your account has not been repriced. If it has, try to move that balance elsewhere. If you cannot transfer the balance, try to pay down the balance as soon as possible, and do not charge anything further on that card.