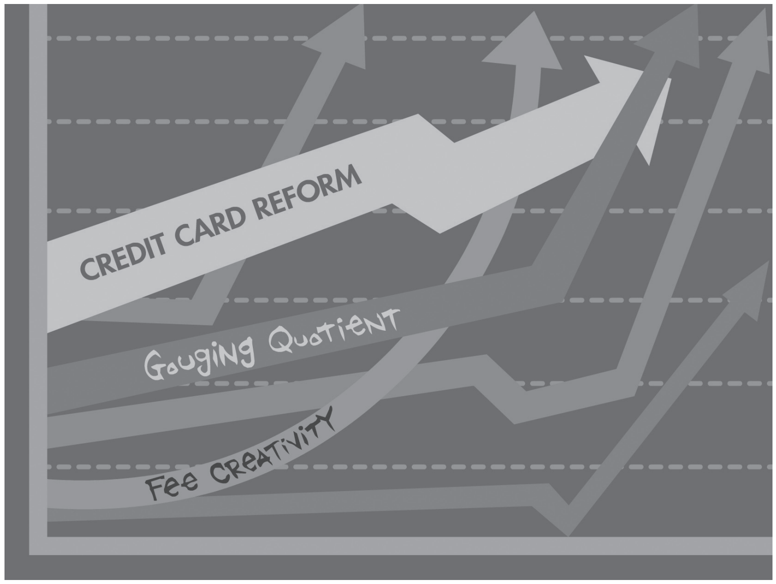

Dodging Reform:

As Some Credit Card Abuses Are Outlawed, New Ones Proliferate

Executive Summary

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December 10, 2009

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EXECUTIVE SUMMARY

Faced with pending and proposed reforms designed to protect consumers from a series of unfair charges, credit card issuers have established or expanded the use of at least eight hidden charges across more than four hundred million accounts.

The May 2009 Credit CARD Act addressed the hidden and deceptive pricing strategies that had been the most costly to credit card users. However, some issuers appear to be working to compensate for part of this lost revenue by instituting or accelerating new practices that increase hidden costs on consumers. Some of the tactics discussed here are not well known, while others are known but have not been explored in the context of larger trends and impact on credit card borrowers.

The pricing strategies discussed in this report all appear to be primarily designed to take advantage of inattention, lack of knowledge, and documented behavioral biases exhibited by consumers. In addition, they exploit areas that are not covered by recent policy changes—none are prevented by recent Federal legislation or Federal Reserve rules. All have been growing in frequency, with at least some top issuers changing their account terms recently to adopt or expand a particular practice. All are also either hidden or obscure and complex enough that most consumers are unlikely to notice these strategies or to fully appreciate their cost implications. Finally, most, if not all, are inefficient pricing strategies in that they fail to align prices with risk or other issuer costs. The eight pricing strategies discussed in this paper are detailed in Table 1. Several involve the gaming of interest rates using multiple tactics, one involves the deceptive structure of penalty fees, while others involve the padding of miscellaneous fees.

Table 1: Summary of Practices Examined

Practice	Description	Stopped by CARD Act?	Recent Trend	Consumer Knowledge	Economic Efficiency
Pick-a-Rate	Change in formula for calculating variable interest rates results in rates that average 0.3% higher.	No	Prevalence up from a year ago.	Buried in fine print, difficult to understand, hard to estimate cost.	Inefficient—causes revenue to become out of synch with cost of funds.
Variable Rate Floors	Variable rates cannot go down from the starting rate for the account, but they can move up.	No	Prevalence up from a year ago.	Buried in fine print, difficult to understand, hard to estimate cost.	Inefficient—causes revenue to become out of synch with cost of funds.
Minimum Finance Charges	Consumers with only a penny in finance charges, get charged a minimum amount up to two dollars.	No	Up from a year ago. Some raised since Credit CARD Act.	Probably receives little consumer attention, easily ignored or forgotten.	Inefficient—unrelated to costs (at higher levels in particular).
Compression of Balance Categories in Tiered Late Fees	Applying highest late fee amounts to smaller balances results in 9 in 10 consumers paying the highest fee.	Not Explicitly	Balance categories for late fees are closer together (more tier compression) than a year ago.	Designed to add complexity to terms, and brings focus on lowest fee which is least common.	Inefficient—causes penalty to be less proportional to violation.
Inactivity Fees	Issuers charge consumers for not using or closing their account, with fees as high as $36/year.	No	More common than a year ago. Some issuers added since Credit CARD Act.	Probably receives little consumer attention, easily ignored or forgotten.	Questionable efficiency—typically much larger than ongoing account management cost, but may reflect risk of loss.
International Transaction Fees: Level Growth and Expanded Definition	Issuers are increasing charges for transactions in a foreign currency, and expanding the definition of foreign transactions to include those in dollars.	No	Fee levels are up, and circumstances in which they apply are expanded since a year ago. Some growth since Credit CARD Act.	Probably receives little consumer attention, easily ignored or forgotten.	Inefficient—price does not reflect any cost. Expansion of fee is even harder to justify.
Balance Transfer/Cash Advance Fees	More issuers are charging a fee for these transactions, and the amount of the fee (as a percentage) is rising.	No	Higher than a year ago. Some issuers have raised since Credit CARD Act.	Consumers likely moderately aware of this, but may discount it when evaluating product cost.	Inefficient—high fees are unrelated to cost and risk is already accounted for through APR.
Balance Transfer/Cash Advance Fee Floors/Ceilings	Minimum cash advance and balance transfer fee amounts have increased, while maximum fee amounts have disappeared.	No	Some issuers have raised/added floors or removed ceilings since Credit CARD Act.	Adds a layer of complexity to fees, consumers likely often unaware of impact.	Inefficient—high floors reduce the correlation between revenues and costs.

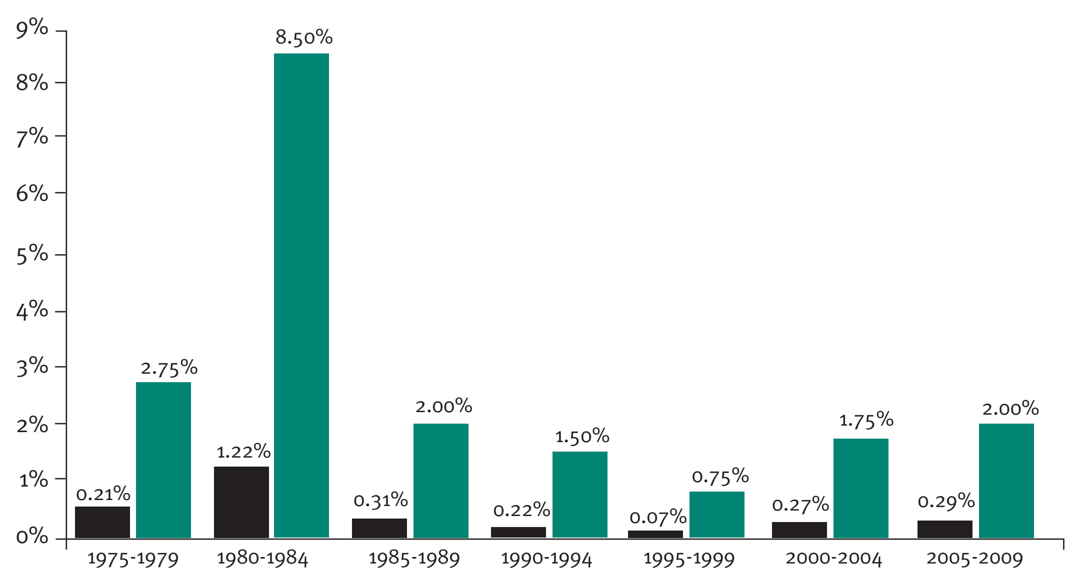
Finding 1: Issuers have adopted a number of schemes to game interest rates. An increasing number of issuers have adopted a practice we have identified as "pick-a-rate," with 117 million accounts currently affected.

- **Hidden "pick-a-rate" pricing charges consumers APRs 0.3 percentage points higher on average than traditional pricing.**
- **Pick-a-rate results in a total cost to consumers of $720 million per year and may reach $2.5 billion per year if the practice becomes the industry standard.**
- **Other rate-maximizing practices that increase costs for cardholders include minimum finance charges and variable rate floors.**

On a majority of credit card accounts, lenders calculate rates by adding a fixed amount to a previously identified index rate, typically a market-based rate that changes over time. Traditionally, issuers have specified the index rate on a certain date as the rate used for calculating that billing cycle's interest rate. A growing number of credit card issuers have begun to charge customers a higher interest rate by making a very minor and obscure change in the fine print of the agreement. More specifically, instead of stating that the index rate "will be the maximum prime rate reported on the last day of the billing cycle," many issuers now say the index rate "will be the maximum prime rate reported in the 90 *days preceding* the last day of the billing cycle."

The issuer selects the highest rate in this practice we call "Pick-a-Rate." This seemingly innocuous change is virtually invisible to cardholders but is extremely costly for borrowers in the aggregate. Using data since 2000, we find the practice raises APRs on average by 0.3 percentage points.

Average and Maximum Interest Rate Increase from Pick-a-Rate Pricing (using 5-year increments)



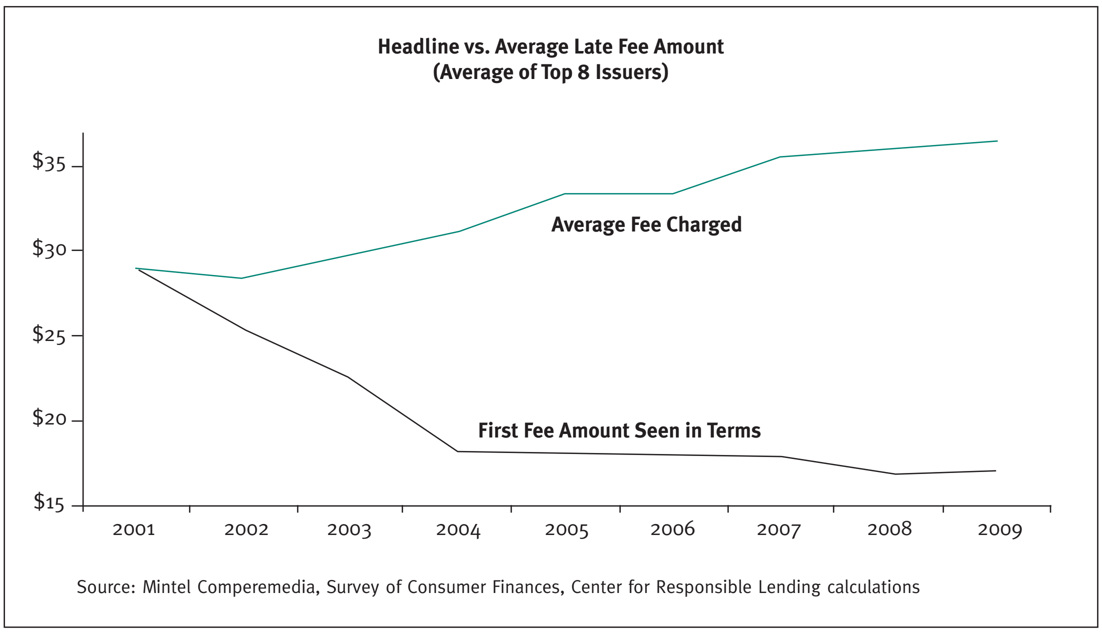
Source: HSH Associates and CRL estimates

Finding 2: Issuers have manipulated penalty fee structures to charge almost everyone (87 percent) the highest penalty fee possible, while projecting the appearance of charging lower fees.

In 2002, the top issuers started to introduce tiered late fees, varying based on the consumer's balance. This practice spread rapidly so that by the beginning of 2005, all of the top 8 issuers—who hold 86% of all balances—used tiered late fees. However, the ranges for balances used in tiered late fees have become compressed over the past five years so that an increasing number of people fall in the highest category.

For example, many top issuers used three balance categories five years ago with the highest range routinely being $1,000 and above. Today there normally are still three ranges, but the highest category is typically $250 and above. Rather than making fees proportional to the violation, tiered late fees seem designed to appear low while in reality a high fee is assessed.

Trend in Average Late Fee Charged vs. First Fee Consumers See



Finding 3: Issuers are padding their other miscellaneous fees since the announcement of new Federal Reserve rules and passage of the Credit CARD Act and have disguised many of these charges. Fee changes include:

- **adding inactivity fees**
- **expanding the definition of an international transaction, and**
- **raising consumer costs by changing cash advance/balance transfer floors, ceilings, and related charges.**

Issuers have increased costs to consumers through other mechanisms that borrowers are unlikely to notice. While these practices vary in nature and impact, they all share some traits. They were not regulated by the Credit CARD Act of May 2009, nor by rules announced in December 2008 by the Federal Reserve. Issuers have expanded the circumstances in which they apply or the amounts charged recently. All the practices are either hidden or at least obscure enough that they are easily missed by consumers. Most, if not all, are economically inefficient in that they create fees that have little correlation with issuer costs or the value of the benefits received.

Recommendations

This report uncovers a disturbing trend: a number of hidden pricing mechanisms have risen as reform has been debated and enacted. Credit card legislation has been successful in limiting some of the most costly consumer traps in existence right now, but reform has been hampered by the issuers dynamically adjusting their own behavior to identify new ways to increase fees and raise revenue. It is likely future credit card issuer practices will continue to circumvent the intent of Congress, making tracking and enforcement an ongoing challenge for regulators and for borrowers. The practices described in this report illustrate how seemingly minor—and largely unnoticed—changes in terms can cost consumers billions of dollars in the aggregate.

These issuer policies damage the economy by hurting not only consumers, but also small businesses that often rely on credit cards.

Policy Recommendation

None of the practices examined here were addressed by the Federal Reserve's 2008 rules, nor by the provisions of the Credit CARD Act of May 2009. In every case, the use of these practices has expanded while Congress and the Federal Reserve were occupied debating a legislative fix or the implementation of rules geared toward a completely different set of harmful practices. The need for a proactive consumer protection agency, a real-time monitor for the marketplace, is clearly demonstrated by industry's actions. As proposed, the Consumer Financial Protection Agency would have the capacity to quickly identify tactics adopted to evade existing rules, or otherwise undermine fair and transparent rules for a competitive market. It could then act to curb such abuses through enforcement, regulation, or education.

"You make the stupid laws, I'll comply, and I'll make money.... Tell me the rules, and then I'll outsmart you all."

Shailesh Mehta, Providian Ex-CEO,
describing industry mind-set
Frontline – November 24, 2009

The Credit CARD Act was landmark legislation that put in place important basic protections for credit card customers. However, like almost all legislation, it requires vigilant oversight by a regulator to make sure that new abuses and tricks do not replace the ones that were just stopped. This report has highlighted eight practices that banks have recently begun or expanded to add unfair fees and interest to families' credit card bills. In addition, there are other areas where credit card banks may game the rules in an attempt to evade the provisions of the Credit CARD Act.

For example, credit limits can be reduced and accounts can be closed without notice. Minimum payments can be sharply increased, and if the cardholder is unable to stay current with the new higher payment and falls 60 days behind, the existing balance can be raised to a penalty rate. Minimum payments also may be used as a bargaining tool to get cardholders to accept a higher interest rate on their balance. These are just a few of the tricks that are possible even with the protections that go into effect in February 2010. In some cases, issuers have already actively started using these tactics. Effective protection from unfair practices ultimately depends upon a new regulator that will make safeguarding American consumers its top priority. Enactment of the proposed Consumer Financial Protection Agency (CFPA) is the best way to stop credit card banks from creating new tricks and traps.

Effective protection from unfair practices ultimately depends upon a new regulator that will make safeguarding American consumers its top priority.

The rise of tiered late fees also has important implications for interpreting existing legislation. The Credit CARD Act requires penalty fees to be reasonable and proportional to the violation, with the exact limits on penalty fees determined by the Federal Reserve. The Federal Reserve should use its authority to hold issuers strictly accountable to this standard. Issuers may argue that they have already made late fees “proportional to the violation” by basing the fee on the balance, but the evidence here demonstrates the contrary. Late fee tiers have been moving in the opposite direction of proportionality. A top late fee tier typically starts for balances of $250 and up. Roughly 9 in 10 consumers fall into this top tier, showing that issuers are not trying to create true proportionality in their late fee system. Instead they are creating a system that suggests a low fee exists, while in reality charging almost everybody the highest fee.

Recommendation for Borrowers

Monitoring the number of hidden charges discussed here would be very challenging for consumers. These practices often can only be detected by scouring the detailed terms and conditions of the credit card contract. Unfortunately, even if one reads and successfully interprets the subtle differences in language that define, for example, how the variable rate is calculated, it still is almost impossible to comparison shop. It is difficult to compare because how your rate will be increased by this practice is unknown in any future period.

Consumers should review both the terms and conditions on their credit card, and the actual charges they receive on each statement. However, until a robust regulatory regime is in place to curb abusive practices, consumers will have a difficult time tracking all the possible “gotcha” tactics issuers continue to use.

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.

Visit our website at **www.responsiblelending.org.**

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