Forever in Debt

Anti-Competitive Credit Card Practices and their Impact on the Economy

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Executive Summary

Many blame the current housing foreclosure crisis on inadequate regulation and oversight of the mortgage, banking, and credit rating industries. Meanwhile, another financial crisis due to inadequate regulations is looming as families with burgeoning credit card debt struggle to cope with high interest rates and fees charged by credit card companies. The subprime and looming credit card crises share some common themes:

- innovations in financial instruments may have led to complex debt instruments that borrowers cannot fully understand;
- the securitization of both mortgage and credit card debt means that problems are not contained in these sectors, but rather have a broad impact on financial markets; and
- rising foreclosures and bankruptcies pose a significant threat to families and the economy.

Relaxed lending practices have led millions of Americans deeper into debt.[1] As with subprime lending practices, credit card issuers have been seeking to maximize their profits by lending to those who are economically vulnerable and then shifting their risk to investors by securitizing the debt.

The current economic downturn will make it difficult for families to pay their bills, so households will rely even more on their credit cards to make ends meet. Credit card company practices will compound households' financial distress and push them into bankruptcy. The effects of greater indebtedness will spill over into the broader economy, as families divert more of their income to servicing their debt, instead of boosting the economy with new purchases. As the bills come due, it is clear that consumer debt financing is not a sustainable way to grow the economy.

Credit card company practices—such as penalty interest rates, universal default provisions, "any time, any reason" changes in interest rates, and double-cycle billing—may actually increase personal bankruptcy rates.

The increased complexity and availability of financial instruments make it all the more important that consumers are protected from unfair practices by credit card companies. Broad pieces of legislation have been introduced by the Congress[2] and the federal government[3] to address these concerns. In addition, the Federal Reserve Chairman Ben Bernanke recently highlighted the need to reform unfair and deceptive credit card practices.[4]

These initiatives include calling for prohibitions on: 1) arbitrary interest rate increases to exorbitant or penalty levels on existing balances; 2) universal default; and 3) double-cycle billing. Regulations collectively proposed by the Federal Reserve Board of Governors, Office of Thrift Supervision, and National Credit Union Administration specifically ban these provisions as violations of the Federal Trade Commission Act prohibiting unfair acts or practices.[5]

If these practices by credit card companies are allowed to go unchecked, the debt crisis will have far reaching effects for families and the economy.

Weak Recovery Leaves Families Deeper in Debt

The economy is experiencing a period of stagnant growth and mounting job losses. Rising unemployment is occurring alongside rising prices and falling real wages. Adjusting for higher prices, wages are lower today than they were over a year and a half ago. The weak recovery has left families heading into the current downturn with income that is about $1,000 lower than it was in 2000. In addition, home values are falling, so families in many parts of the country will not be able to draw on their home equity to help make ends meet.

At the same time, personal savings rates of U.S. households have declined substantially—from 9.1 percent in the 1980s to 1.7 percent in this decade—so families will have very few financial resources to rely on during the downturn.[6] Recently, the Department of Commerce reported that personal saving as a percentage of disposable income, already low, declined to 0.4 in the first quarter of 2008.[7] Most Americans will not have savings to help them manage unemployment or stagnant wages during the downturn. To cope with weakening labor markets and rising economic insecurity, American families will more than likely take advantage of their last major financial resource—their credit cards.

"Consumer debt" consists of both revolving and non-revolving debt. This paper focuses on revolving consumer debt, which is almost entirely comprised of credit card debt. Non-revolving debt includes mortgages, loans for automobiles, education, vacations, etc. In the first quarter of 2008, total U.S. consumer debt was $2.56 trillion.[8]

Credit card debt is increasing and American consumers are increasingly "using their credit cards to stay afloat":[9]

- Revolving credit debt during the first quarter of 2008 was $956.6 billion.[10]
- About half (46.2 percent) of U.S. households held credit cards with balances, according to the 2004 Survey of Consumer Finances (SCF).[11]
- Among these households, the median revolving credit card balance was $2,200.
- A large share of disposable income goes to service overall debt—14.1 percent in the first quarter of 2008.[12]

Unfair and deceptive lending practices by credit card companies will compound households' financial distress and increase the likelihood of bankruptcy.

Securitization of Credit-Card Debt Has Added Stress to Already Weakened Financial Markets

As with subprime lending practices, credit card issuers have been seeking to maximize their profits by lending to those who are economically vulnerable and then shifting their risk by securitizing the debt. Securitization is a process whereby lenders and others create pools of loans and then sell investors securities that are backed by cash flows from these loan pools—thereby replenishing funds available for lending and reducing the lender's cost of capital.

In 1996, $180.7 billion dollars of credit card debt was securitized, about 36 percent of the total outstanding revolving credit.[13] By the end of 2007, the amount had fallen from its peak in 2003, but the $347.8 billion dollars in securitized credit card debt still represents a substantial risk to the financial system. As credit card defaults rise, the fair market value of asset-backed securities based on credit card debt is also falling, requiring credit card issuers to add millions of dollars to their credit reserves and lowering earnings projections.[14]

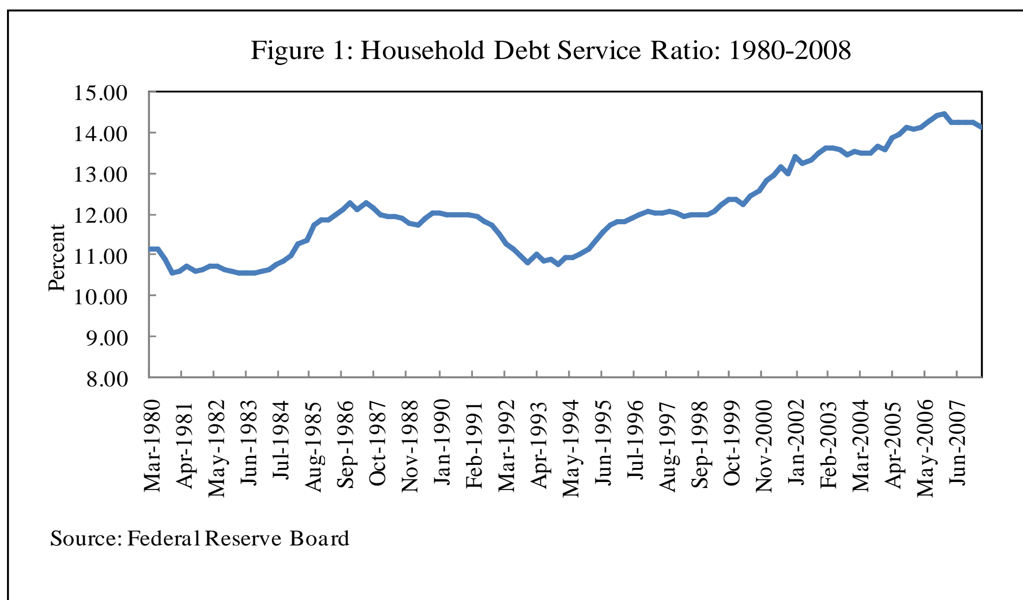
Securitization in the housing market provides useful lessons. As housing prices started to fall, defaults on subprime mortgages—and prime mortgages—increased. Because these mortgages were securitized and sold through mortgage-backed securities and collateralized debt obligations, the risk was spread throughout the financial system, rather than being borne solely by the banks that originally held the mortgages.[15]

Although securitization has increased the amount of credit available by reducing capital requirements, the increase in securitization raises the risk that credit card issuers are not adequately capitalized, especially in light of the increase in credit card defaults.[16] The degree to which securitization transfers risk from the issuing bank to others depends on the amount of "implicit recourse" retained by the issuing banks. Implicit recourse is the amount of responsibility that the issuing banks retain for the performance of the credit card receivables even after securitizing the debt. The issuing bank does not have the same capital requirements when the debt is securitized as when the debt is held by the issuing bank.[17]

The amount of outstanding credit card debt that is securitized has increased in recent years. As credit card defaults increase, the risks to the already weakened financial system will grow.

Debt-Financing from Credit Cards is Not a Sustainable Way to Grow the Economy

As the economy slows, households will be faced with more and more debt that they must service. The household debt service ratio (DSR) is an estimate of the ratio of debt payments to disposable personal income. These debt payments consist of the estimated required payments on outstanding mortgage and consumer debt. In the first quarter of 2008, the percentage of disposable income that went to service overall debt was 14.1 percent (Figure 1). [18]



A broader measure of debt, the financial obligations ratio (FOR), includes outstanding mortgages and consumer debt, as well as automobile lease payments, rental payments on tenant occupied property, homeowners insurance, and property tax payments.[19] For homeowners, the ratio of financial obligations to disposable income was 17.82 percent, while it was 25.98 percent for renters.[20]

The ability of individuals to service their debt is a function of two factors: 1) the level of the payments; and 2) the income and assets they have available to meet those payments. As families are faced with weakening housing and labor markets and anemic wage growth, their dwindling incomes and assets will make it more difficult to weather both an economic downturn and an increased debt burden. As long-term unemployment rises, it is predicted that households will rely more and more on their credit cards to make ends meet.

Some provisions imposed by credit card companies, such as universal default and penalty interest rates, will hurt the economy by forcing consumers to pay more on debt payments. The amount of credit card debt may affect the length and type of recovery, as more families cut back on spending to cope with the economic downturn.

Recent research suggests that with the current mortgage crisis individuals will now have additional debt to manage, and increased defaults could occur on both home mortgages and credit cards. As households become more financially strapped, they tend to carry ever-increasing balances on their credit cards.[21] Unlike in the past, these homeowners can no longer refinance their home mortgage to pay off their credit cards—they will now be faced with rising credit card debt and “upside down” mortgages.

While some Americans may be able to take a loan from their 401(k) pensions, such loans take away from future retirement income.[22] Moreover, given the current downturn in the labor and financial markets, the balances from which workers have to borrow are smaller. As all the bills come due, it is clear that consumer debt financing is not a sustainable way to grow the economy.

A high debt burden, or financial distress, occurs when families have unusually large total debt payments relative to their incomes, usually 40 percent. The most recent SCF reports that 12.2 percent of American families held high debt burdens.[23] These debt burdens are not always being repaid. According to a recent report by the American Bankers Association, consumers fell behind on credit card, home equity, and auto loans at the fastest pace in 15 years during the fourth quarter of 2007.[24]

High debt burdens differ by several factors including income, age, and homeownership. According to SCF data, 45.6 percent of households in the lowest two income groups have high debt burdens, compared to 4.2 percent of those in the highest two income groups.[25] Thus, families with lower incomes have the greatest need to borrow on their credit cards, and are the most vulnerable during periods of economic downturn.[26] Additionally, a study by the Center for American Progress revealed that the ratio of credit card debt to income rose fastest from 1989 to 2004 for low-income families and actually declined for high-income families.[27]

Anti-competitive Credit Card Practices and their Impact on Consumers

As credit card use and debt have grown, policymakers and consumer advocates have questioned the extent to which credit cardholders understand their credit card terms and conditions.[28] These conditions include applying fees or relatively high penalty interest rates if cardholders pay late or exceed credit limits—some as high as 30 percent annualized percentage rate in interest.[29]

Some credit card issuers also raise a cardholder's interest rates for actions the consumer takes with other creditors. For example, under "universal default," issuers increase rates if a cardholder fails to make timely payments to another creditor, including other credit cards, utility companies, or mortgage lenders. Additionally, some credit card contracts are particularly one-sided, allowing issuers to increase their interest rates at "any time, for any reason," which may leave the credit cardholder scrambling to find another credit card to transfer the balance on the credit card that just increased its rates. Finally, "double-cycle" or "two-cycle" billing used by some credit cards charges interest not only on the current balance due, but also on the previous month's charges. This occurs even when the previous month's balance has been paid off; it may be viewed as inherently deceptive and it creates a large burden on consumers whose balances fluctuate from month to month.

Although card issuers have argued that these practices are appropriate because they compensate for the greater risks posed by cardholders who make late payments or exhibit other risky behaviors,[30] consumer groups say that the fees and practices are harmful to the financial condition of many cardholders and that card issuers use them to generate profits.[31] These practices also make it more difficult for credit cardholders to switch to lower interest credit cards.

Penalty Interest Rates

Credit card companies have the incentive to include provisions such as penalty interest rates because the debt held by credit cardholders is not secured by any underlying assets. Professors Lawrence Ausubel and Amanda Dawsey argue in a recent paper that if the credit card company feels the cardholder may not be able to make payments on all of their outstanding debt in the future, the credit card company has the incentive to raise the interest rate paid by the credit cardholder immediately for two reasons: 1) increasing the interest rate will increase a cardholder's incentive to pay the higher cost debt first; and 2) if the cardholder becomes financially insolvent, the higher interest rate on the outstanding balance will increase the outstanding balance of the cardholder to that credit card, thus increasing the credit card company's share of the cardholder's assets in the case of bankruptcy.[32] These incentives are known as the "common pool" problem.[33]

The Common Pool Problem

Attempts by one credit card company to collect payment out of the credit cardholder's common pool of assets increases the probability that other credit card companies (or other unsecured debt holders) will not be able to collect and will also increase the probability that the credit cardholder will default on his or her outstanding debt. The credit card company has every incentive to engage in this behavior because the benefits of increasing the credit cardholder's in-

terest rate accrue to the credit card company, while the cost of doing so—the increased probability of bankruptcy—is spread over all of the credit cardholder's lenders.

The common pool problem has long been recognized in the economics literature as "the tragedy of the commons" where an individual's actions taken to maximize the individual's self interest end up having detrimental effects on everyone.[34] Using fishing as an example, the first economics paper on this topic showed that in the absence of property rights, each fisherman has the incentive to overfish the seas.[35] Thus, even a renewable resource like fish would be depleted. Each fisherman has the incentive to catch too many fish since the gains from catching an additional fish goes to the individual fisherman, while the costs of overfishing—resource depletion—are borne by the entire industry.

Because of the fear that either the assets of the cardholder that could be divided among creditors are less than the value of the total outstanding debt or that the ability of the cardholder to earn money to make debt payments will be less than the debt payments on all outstanding debt, credit card companies have the incentive to apply penalty interest rates, invoke universal default, and "any time, any reason" repricing.

At the same time, these provisions increase costs to the credit cardholder while the credit cardholder is searching for a lower interest credit card. Currently, credit card companies can announce an increase in interest rates on outstanding balances held by the borrower, which can sometimes take effect immediately. It takes time for the credit cardholder to find a new credit card with a lower interest rate that is willing to extend credit and transfer the outstanding balance of the higher interest rate card. During the time that the credit cardholder is searching for a lower interest rate credit card, he or she has to pay the higher interest rate. The increased interest payments lower the ability of credit cardholders to switch to a credit card offering a lower interest rate, since the borrower will need to transfer a larger balance to the new card. Further, difficulty in deciphering disclosure statements, especially those of credit cards with these more complicated pricing provisions, increases the costs to credit cardholders of searching for a new credit card with a lower interest rate.

High Search and Switch Costs Due to Penalty Rates and Double-cycle Billing

High costs of searching for a lower priced card increase the ability of credit card companies to either charge high interest rates or use penalty interest rates.[36] Since consumers face costs in locating the lower interest cards, higher interest cards are able to stay in business and able to hold onto some of their customers.[37] As noted in the Federal Reserve Board of Governors, Office of Thrift Supervision, and National Credit Union Administration Proposed Rules (henceforth referred to as the "Proposed Rules"), few consumers are likely to make the effort to search for credit cards without these repricing provisions since the majority of creditors include such clauses.[38] Further, to the extent that credit card companies offer low initial rates to encourage customers to switch cards, the fact that credit card companies can (and do) increase those initial interest rates, lowers the incentives for consumers to switch to a new card because of the fear that the low rate will immediately be replaced by a higher interest rate.

With a higher interest rate in effect, the outstanding balance held by the credit cardholder is likely to increase, since any money used to pay the penalty interest rate could not be used by the credit cardholder to reduce the outstanding principal. As the outstanding balance increases, it is likely that the credit rating of the cardholder will also fall since credit scores are inversely correlated with the ratio of outstanding debt to credit limit. A cardholder's credit score is also likely to go down after switching to a new card, even if the debt to credit limit doesn't increase, because credit ratings are positively correlated with the length of time that cardholders have held the same bank's card.[39] The potential decline in credit score lowers the cardholder's incentives to look for a new, lower interest card.

Penalty interest rate increases are substantial—interest rates can increase from an initial range of 10 to 16 percent to 24 to 30 percent.[40] They can also cause zero percent introductory rates to be terminated early. The corresponding increase in the outstanding balance due to the increased interest charges can affect the cardholders' ability to find a lower interest credit card since the credit cardholder's increased indebtedness increases the credit card company's perception that the credit cardholder is a credit risk.[41]

As discussed above, although legislation that requires all issuers to disclose their interest rates, fees, and grace periods has been in place for two decades, these disclosure requirements are not easily understood by half of the adult population. As the complexity of repricing provisions increases, so do the costs to credit cardholders of searching for a lower interest credit card.

In its Proposed Amendments to Regulation Z, which implements the Truth in Lending Act, the Proposed Rules expressed concern that the "imposition of penalty pricing can come as a costly surprise to consumers who are not aware of, or do not understand, what behavior is considered a 'default' under their agreement."[42] Consumer testing indicated that some consumers do not understand what factors can trigger penalty pricing, "that penalty rates can apply to all of their balances, including existing balances, and they did not understand how long such penalty rates could stay in effect."[43] The analysis reported in the Proposed Rules stated that 45 days advance notice of an interest rate increase was insufficient to enable consumers to avoid the injury caused by an increase in the rate on an existing balance.[44]

The Proposed Rules indicated that institutions may increase interest rates for reasons either unrelated to the cardholder, for reasons that the cardholder may have been unaware of or unable to control, or for cardholder behavior that does not violate the account terms (e.g. increasing interest rates for people who are close to, but not over, their credit limit). Thus, the Proposed Rules would prohibit institutions from increasing the annual percentage rate applicable to the outstanding balance. This is based on the Proposed Rules findings that this practice causes substantial monetary injury by increasing interest charges which are not reasonably avoided and the injury in not outweighed by countervailing benefits.[45]

Finally, the Proposed Rules concluded that the elimination of repricing provisions on existing balances may enhance competition "because institutions that offer annual percentage rates that realistically reflect risk and market conditions will no longer be forced to compete with institutions offering artificially reduced rates."[46]

Double-cycle Billing

Double-cycle billing also has the effect of increasing credit cardholders' costs of switching to another credit card. If the credit card holder switches the outstanding balance to a new card at the end of the first billing cycle, he or she will still be liable for interest to the old credit card company at the end of the next billing cycle. In addition to the interest charge owed to the old credit card company, the cardholder will be responsible for the interest charge from the new card. Because the cardholder will owe interest to the old credit card company even after he or she switches to a lower interest rate card, the costs of switching cards are higher, further depressing the incentives and ability of a cardholder to switch to a lower interest credit card. And, as discussed above, an increase in borrowers' cost of switching to another credit card can increase interest rate charged by credit card companies. Further, since few, if any, consumers understand what double cycle billing is, they are unlikely to take it into account when shopping for credit cards, making it unlikely that competition among credit cards will compete away this provision.[47]

Conclusion

The current economic downturn poses a significant threat to the well-being of American families, who are likely to rely more heavily on their credit cards to make end meet. As credit card indebtedness rises and families find themselves under increasing financial difficulty, practices by credit card companies could add to household's financial distress.

As the complexity and availability of financial instruments have increased, new consumer protections have become increasingly important—not just for families, but also for the economy. As credit card defaults increase, the risks to the already weakened financial system will grow. Moreover, unfair practices by card issuers will cause families to spend more to service their debt, instead of making new purchases that would boost our sagging economy. The unchecked practices by credit card issuers will only exacerbate the current financial crisis.

Appendix:

Broad pieces of legislation have been introduced by members of Congress and the federal government to address a number of practices by credit card issuers. These initiatives include calling for regulations on: 1) arbitrary interest rate and fee hikes; 2) arbitrary manipulation of due dates; 3) universal default, and 4) making credit cards available to students. Below is a list and brief description of current proposals.

Congressional Legislation and Federal Regulations on Credit Card Practices			
Bill Number	**Title**	**Sponsor**	**Brief Description**
HR. 5244	Credit Cardholders' Bill of Rights Act of 2008	Representative Carolyn Maloney (155 co-sponsors)	Prohibits retroactive interest rate increases except for variable or promotional rate accounts, or where the cardholder is more than 30 days late making the minimum payment. Allows acceleration of existing balances after a rate increases subject to limits. Requires 45 day notice of rate increases. Requires 25 days between statement date and payment due date. Eliminates double cycle billing. Requires prorata allocation of payments on balances. Allows cardholders to set a credit limit which cannot be exceeded.
S. 2411	Credit Card Safety Star Act of 2007	Senator Wyden and Senator Barack Obama	Establishes a rating system about the safety/transparency of credit card agreements, with 5 stars representing the most safe/ transparent and 1 star representing the least transparent.
S. 1176	Credit Card Minimum Payment Warning Act of 2007	Senators Akaka, Durbin, Leahy, and Schumer	Requires that companies warn consumers that making only the minimum payment will increase the amount of interest, amount, and the time it will take to repay outstanding balance.

S. 2542	Credit Card Minimum Payment Notification Act of 2008	Senator Feinstein	Requires that companies warn consumers that making only the minimum payment will increase the amount of interest, amount, and the time it will take to repay outstanding balance. These requirements would not apply if the minimum payment is at least 10% of the debt on the card, or in any billing cycle in which no finance charges are imposed on the account, or if the balance on the card is less than $500.
12 CFR Part 227 (Federal Reserve System) 12 CFR Part 535 (Dept. of the Treasury) 12 CFR Part 706 (National Credit Union Administration)	Unfair or Deceptive Acts or Practices; Proposed Rule Federal Register, Vol. 73, No. 97, May 19, 2008	Federal Reserve, System; Department of the Treasury: Office of Thrift Supervision; and National Credit Union Administration	Eliminates repricing provisions for existing balances except under limited circumstances (although it does allow for introductory promotional rates); provides for advance notice of account rate increases on new purchases; and eliminates double-cycle billing.

Source: JEC summary of selected legislative proposals.
This list does not include all proposed credit card practices/consumer-protection legislation.

End Notes

[1] This level of indebtedness has been quantified as average household credit debt of $8,565. See Gretchen Morgenson, *Given a Shovel, Digging Deeper Into Debt,* New York Times, July 20, 2008, www.nytimes.com. However, according to the 2004 *Survey of Consumer Finances*, the median credit-card debt for households that carry a balance was $2,200. The median value is more representative because household credit card balances are heterogeneous—with a large number of cardholder holding zero balances and a few holding very large balances.

[2]A list of selected proposed Congressional legislation is included in the Appendix.

[3]Federal Register Vol. 73 No. 97, *Truth in Lending, Proposed Rules*, 12 CFR part 226, May 19, 2008 and Federal Register, May 19, 2008, Vol. 73, No. 97, *Unfair or Deceptive Acts or Practices; Proposed Rules,* 12 CFR Part 227, et al. May 19, 2008.

[4]Statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, before the House Financial Services Committee, July 16, 2008, www.house.gov/apps/list/hearing/financialsvcs_dem/testimony_-_ch._bernanke071608.pdf . During the question and answer period following his statement to members of the House Financial Services Committee, the Chairman acknowledged that providing consumers with financial education alone is not the answer and that regulation may also play a part. He stated that three things are needed: 1) education on the consumer's part; 2) good, effective, consumer-tested disclosures; and, as a last resort, 3) the ability to ban certain practices.

[5]Federal Register, May 19, 2008, Vol. 73, No. 97, *Unfair or Deceptive Acts or Practices; Proposed Rules,* 12 CFR Part 227, et al. May 19, 2008.

[6]Karen E. Dynan and Donald L. Kohn, August 2007, "The Rise in U.S. Household Indebtedness: Causes and Consequences," Federal Reserve.

[7]Bureau of Economic Analysis, National Income and Product Accounts, *Table 2.1 Personal Income and Its Disposition*, www.bea.gov.

[8]Federal Reserve, July 2008, *Consumer Credit*, Federal Reserve Statistical Release, Washington DC, www.federalreserve.gov/releases/G19.

[9]Kathy Chu, February 29, 2008, "More Americans Using Credit Cards to Stay Afloat," *USA Today*, www.usatoday.com

[10]Federal Reserve, July 2008, *Consumer Credit*, Federal Reserve Statistical Release, Washington D.C., www.federalreserve.gov/releases/G19.

[11]The Federal Reserve Board's Survey of Consumer Finances is a triennial survey of the balance sheet, pension, income, and other demographic characteristics of U.S. families. The survey also gathers information on the use of financial institutions. The most recent survey is 2004: *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances* www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

[12]Federal Reserve, July 2008, *Household Debt Service and Financial Obligations Ratios*, Federal Reserve Statistical Release, Washington D.C., http://www.federalreserve.gov/releases/housedebt/default.htm.

[13]Calculations of securitized credit card loans are from Dr. Joseph R. Mason, Louisiana State University based on data from Securities Industry and Financial Markets Association, 2008. Outstanding revolving debt data is from the Federal Reserve, July 2008, *Consumer Credit*, Federal Reserve Statistical Release, Washington D.C., www.federalreserve.gov/releases/G19.

[14]Diana B. Henriques, July 22, 2008, "Earnings Fall at American Express and Its Shares Suffer," *New York Times*, p. C3, www.nytimes.com.

[15]Although securitization of credit card debt may lower borrowing costs to credit card issuers, it may also be used by originating banks to avoid minimum capital requirements (Charles Calomiris and Joseph Mason, 2004, "Credit Card Securitization and Regulatory Arbitrage," *Journal of Financial Services Research,* 26:1, 5-27.)

There is also evidence that heavy reliance on securitization may be an important factor in determining the creditworthiness of the card issuer. See Richard Martin Cantor and Jian Hu, May 21, 2007, "Deal Sponsor and Credit Risk of Asset-Backed and Mortgage-Backed Securities." Available at SSRN: http://ssrn.com/abstract=996014.

[16]Securitization in the credit card market increased by double digits in the late 1990s and early 2000s. From 2004 to 2006, the level of outstanding securitized credit card debt declined, probably due to a corresponding growth in the mortgage-backed securities market. Asset-backed securities began to increase again beginning in 2007. On average from 2000 to 2007, credit card

securitization increased by 4.25 percent on an annual basis. Calculations of securitized credit card loans are from Dr. Joseph R. Mason, Louisiana State University based on data from Securities Industry and Financial Markets Association. Outstanding revolving debt is from the Federal Reserve, July 2008, *Consumer Credit*, Federal Reserve Statistical Release, Washington D.C., www.federalreserve.gov/releases/G19.

[17]For a discussion on the effect of implicit recourse in the credit card market, see Charles Calomiris and Joseph Mason, 2004, "Credit Card Securitization and Regulatory Arbitrage," *Journal of Financial Services Research,* 26:1, 5-27.

[18]Federal Reserve, July 2008, *Household Debt Service and Financial Obligations Ratios*, Federal Reserve Statistical Release, Washington D.C., http://www.federalreserve.gov/releases/housedebt/default.htm.

[19]Ibid.

[20]Ibid. However, this average FOR understates the debt burden faced by subprime borrowers, who sometimes face debt-to-income ratios of well over 50 percent. See Center for Responsible Lending, "Restoring Common Sense and Confidence to the California Mortgage Market" 2008 at n.7.

[21]Tim Westrich and Christian E. Weller, February 2008, "House of Cards: Consumers Turn to Credit Card Amid Mortgage Crisis, Delaying Inevitable Defaults" Center for American Progress, Washington D.C., www.americanprogress.org.

[22]Credit cards and debit cards for 401(k) accounts are the opposite of a pre-commitment device. Commitment devices have been found to be essential for boosting savings rates. See Angela Littwin, February 2008, "Beyond Usury: A Study of Credit Card Use and Preference Among Low-Income Consumers," *Texas Law Review*, Vol. 86, No. 3, p. 472. See also Littwin at p. 472, citing work by David Laibson that argues that the increasing ability to borrow against illiquid assets is responsible for our declining savings rate.

[23]Federal Reserve, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances, Table 14,* Washington D.C., www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

[24]Hugh Son, April 3, 2008, "Overdue Consumer Debts Highest Since 1992, ABA Says (Update 3)," *Bloomberg,* www.bloomberg.com.

[25]Federal Reserve, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances, Table 14,* Washington D.C., www.federalreserve.gov/pubs/oss/oss2/scfindex.html. Further, higher income families generally have greater access to credit through home equity lines of credit, which tend to have more straight forward terms and conditions, leaving less wealthy consumers with credit only through credit cards, which may have abusive practices.

[26]Additionally, research has found that workers who do not have adequate health insurance are incurring higher levels of credit card debt to pay for medical expenses. See Demos, January 2007, *Borrowing to Stay Healthy: How Credit Card Debt is Related to Medical Expenses*, www.demos.org/pubs/healthy_web.pdf.

[27]Christian E. Weller, 2004, "Pushing the Limit: Credit Card Debt Burdens American Families" Center for American Progress, Washington D.C., www.americanprogress.org.

[28]Government Accountability Office, September 2006, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, GAO-06-929, Washington, D.C., pp. 6, 36-50. This GAO study found that the majority of disclosure forms were too complex and were written at the tenth or twelfth grade reading level, while approximately half of the adult population can only read at the eighth grade level or below (p. 37).

See also Littwin, February 2008, p. 455-6 (stating that low-income borrowers are particularly vulnerable to accumulating balances because scarcity conditions may inhibit financial skills). Littwin found that 87 percent of the participants in her study described themselves as "not understanding how their credit cards worked before using them" (p. 496).

[29]Lawrence M. Ausubel and Amanda E. Dawsey, March 12, 2008, p 1, *Penalty Interest Rates, Universal Default, and the Common Pool Problem of Credit Card Debt*. Penalty interest rates can be triggered by late payments to the credit card company or, in the case of universal default provisions, late payments to other creditors. With "any time, any reason" provisions, a penalty interest rate can be triggered by the credit card company's perception that the riskiness of the credit cardholder has increased—such as the consumer carrying a larger outstanding balance—even if the cardholder is current on all payments.

[30]Some have argued that if penalty interest rates are not allowed, especially penalty interest rates attached with universal default provisions, borrowers may be less motivated to maintain a good credit rating (Jonathan M. Orszag and Susan H. Manning, October 2007, "An Economic Assessment of Regulating Credit Card Fees and Interest Rates," Commissioned by the American Bankers Association, p. 11-12). Further, they argue that limiting penalty interest rates on existing balances will reduce access

to credit for some borrowers and raise interest rates for all cardholders (Orszag and Manning, p. 38). However, the Federal Reserve Board of Governors, Office of Thrift Supervision, and National Credit Union Administration's Proposed Rules find that the practice of increasing the annual percentage rate applicable to the outstanding balance "appears to meet the test for unfairness under 15 U.S.C. 45(n) and the standards articulated by the FTC" (Federal Register, *Unfair or Deceptive Acts or Practices; Proposed Rules,* 28917). The Proposed Rules specifically find that although the proposal to eliminate increasing interest rates on existing balances "could ultimately result in higher upfront costs and less available credit for some consumers, it appears that consumers and competition may benefit as a whole" (Ibid, 28919).

A recent Congressional Research Service paper argues that double-cycle billing is similar to repricing strategies in that it responds to riskier borrowers by charging them more (Darryl E. Getter, June 12, 2008, "The Credit Card Market: Recent Trends and Regulatory Proposals," Congressional Research Service.) In actuality, this practice eliminates the interest-free grace period and has the same effect as increasing the interest rate charged to the borrower. However, other analysts have pointed out that double-cycle billing cannot be described as risk-based pricing since it based on balances that have already been paid off. See Adam J. Levitin, March 9, 2008 revision, "A Critique of the American Bankers Association's Study of Credit Card Regulation" Working Paper, Georgetown University Law Center, p. 8.

Economists have argued that credit card use puts households in an unstable financial position, making them unable to weather a catastrophic event that they might otherwise be able to withstand (Ronald J. Mann, 2006, *Charging Ahead: The Growth and Regulation of Payment Card Markets*, New York: Cambridge University Press. See p. 64, which cites work by Elizabeth Warren and Amelia Tyagic). Thus, penalty interest rates may be a cause of financial distress.

Further, Mann states that "In the modern information-based lending world, however, it makes less sense to view the borrowers as operating in full control, to the detriment of hapless and incapable lenders . . .the modern lender (at least in the United States) has access to pervasive and frequently updated information about the credit behavior of its customers" (p. 200). And the card issuer can always terminate the borrower's use of funds by withdrawing the remaining credit line.

[31]In 2004, the breakdown of U.S. card issuer revenues was as follows: net interest (65 percent), merchant fees (interchange fees) (18 percent), penalty fees (9 percent), cash advance fees (5 percent), annual fees (3 percent) (Mann, p. 23). Further, full service issuers, who offer a broad portfolio of banking products including credit cards, may be able to charge higher fees for all of their services because the cost to the borrower of switching all accounts may be high (Ibid, p. 22).

Although GAO (September 2006) was unable to find comprehensive data to determine the extent to which fees and penalty interest rates contributed to consumer bankruptcy, they found anecdotal evidence in some bankruptcy cases that involved substantial penalty charges and fees. Further, the credit card companies were unable to provide GAO with evidence regarding the size of penalty fees or interest charges for customers who were unable to make their payments. Additionally, GAO estimated that about 70 percent of credit card company revenues in recent years come from interest charges and that the share of those revenues that are associated with penalty interest rates is growing (p. 8).

[32]Additionally, research shows that the 2005 bankruptcy reforms, which made it harder for consumers to default on their credit card debt, simply increased credit card companies' profits without making credit card holders better off. After the 2005 bankruptcy reform, credit cardholders have seen increased interest rates and higher fees, in spite of the lower risk to card issuers that cardholders will default (Michael Simkovic, July 8, 2008, "The Effect of the 2005 Bankruptcy Reforms on Credit Card Industry Profits and Prices," pp. 16-17. Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1157158).

[33]See Thomas H. Jackson, January 14, 1985, "Translating Assets and Liabilities to the Bankruptcy Forum," *Journal of Legal Studies*; Susan Block-Lieb, 1993, "Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case," *American University Law Review,* Vol. 42, 337-431; and Ausubel and Dawsey, "Penalty Interest Rates, Universal Default, and the Common Pool Problem of Credit Card Debt."

[34]The term "tragedy of the commons" comes from a later article. See Garrett Hardin, 1968, "The Tragedy of the Commons," *Science* 162:1243, available at http://www.garretthardinsociety.org/articles/art_tragedy_of_the_commons.html.

[35]H. Scott Gordon, 1954, "The Economic Theory of a Common-Property Resource: The Fishery," *Journal of Political Economy,* Vol. 62:2, 124-142.

The concept of the tragedy of the commons was first described by Aristotle (Elinor Ostrom, 1990, *Governing the Commons: The Evolution of Institutions for Collective Action,* New York: Cambridge University Press, p. 2.) Ostrom also points out that the commons problem has been used to describe everything from famine to the inability of the U.S. Congress to limit its capacity to overspend.

[36]The ability of firms to charge higher prices when consumers face search and switching costs is well documented in economic literature. See Steven Salop, 1977, "The Noisy Monopolist: Imperfect Information, Price Dispersion and Price Discrimination," *The Review of Economic Studies*, 44:3, 393-406 p. 393; Michael R. Baye, John Morgan and Patrick Scholten, 2006, "Information, Search, and Price Dispersion," *Handbook on Economics and Information Systems,* Terrence Hendershott, ed.; and Lawrence M. Ausubel, March 1991, "The Failure of Competition in the Credit Card Market," *The American Economic Review*, Vol. 8:1, 50-81. Ausubel cites five reasons that search and switch costs may be high in general for credit cards: 1) high information costs of discovering low interest rate cards; 2) costs of filling out applications and fear of rejection; 3) annual fees billing once a year; 4) perception of acquiring a better credit rating or higher credit limit by holding the same bank's card for a long period of time; and 5) time lag between applying for and receiving the new card (1991, p. 69). See also Simkovic stating that the credit card industry is not competitive due to complex, misleading pricing structures (p. 18).

However, researchers have argued that adverse selection—the propensity for higher risk borrowers to respond to credit card solicitations of lower interest rates—is the reason that credit card interest rates do not appear to decline when the underlying cost of funds declines (Ausubel, p. 70).

[37]Salop, p. 393.

[38]Federal Register, May 19, 2008, Vol. 73, No. 97, *Unfair or Deceptive Acts or Practices; Proposed Rules,* 28915, n. 43 (referring to FTC Credit Practices Rule, 48 FR at 7746).

[39]Credit rating agencies do assume that new credit cards will have a higher default rate than seasoned credit cards (Calomiris and Mason, p. 12). See also Todd J. Zywicki, "The Economics of Credit Cards," George Mason University School of Law, Law and Economics Working Paper Number 00-22, p. 87, stating that "It may be the case that when an individual switches to a new card in the short run he suffers some reduction in his credit limit."

[40]Ausubel and Dawsey, p. 1.

[41]Mann states that as "borrowers spiral deeper into financial distress, their switching costs increase, which makes it easier for the card issuer to charge them higher rates and fees. . .it will be difficult for the cardholder to find a new lender who will make an attractive offer" (p. 201).

[42]Federal Register, *Unfair or Deceptive Acts or Practices; Proposed Rules,* 28917.

[43]Ibid, 28917.

[44]Ibid, 28918.

[45]The limited circumstances under which the Proposed Rules would allow an increase in interest rates on existing balances are: 1) when the variable rates are used that reflect the operation of an index that is not under the institution's control, such as the prime rate; 2) When the promotional rate expires or is lost for a reason specified in the account agreement, such as a late payment; 3) if the minimum payment has not been received within 30 days after the due date. Under 2), the rate cannot increase to a penalty rate, but must increase only from the promotional rate to the standard rate. Federal Register, *Unfair or Deceptive Acts or Practices; Proposed Rules*, 28917-20.

[46]Federal Register, *Unfair or Deceptive Acts or Practices; Proposed Rules*, 28919.

[47]None of the participants in Littwin's study understood the more complex features of credit card billing such as double-cycle billing and minimum-finance charges (Littwin, p. 497).