



Lombard Street

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The collapse of the world's financial markets has resulted in intense examination of how to restructure and reform regulation for banking, securities, insurance, and other parts of the financial services industry. Various regulatory proposals are already being circulated in academic and public policy circles. Governments around the world are considering reforms. The conversation and decisions surrounding these proposals will fundamentally impact how financial services is structured and conducted across the globe throughout the 21st century.

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From the Editor: The CARD Act

The Obama Plan for financial services will shape the debate over regulatory reform in Congress for at least the rest of this year. And it will shape much of the focus of Lombard Street as well.

The Consumer Financial Protection Agency proposed by the Obama Administration would regulate credit cards, among other financial products, which is one reason why credit cards are the subject of this issue.

Credit cards have been under increased scrutiny following the financial crisis which led to the passage of the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009, signed into law on May 22nd. The CARD Act imposes new rules and regulations on sellers of credit cards—ones that presumably the proposed consumer protection agency would build upon.

Three more of less skeptical authors take a look at the CARD Act in this issue. Lawyer Thomas Brown and economist Lacey Plache, both of whom have worked on behalf of Visa, argue that the enactment of its provisions will actually harm consumers and possibly even push up the interest rate that consumers pay.

Law professor Ronald Mann has his doubts as well. He contends that Congress missed an opportunity to deal effectively with “shrouded terms” on credit cards which lure consumers into taking new cards that they wouldn’t take if they understand long-run costs. At the same time he criticizes the bill for making it hard for issuers to charge for taking on risk.

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The good, the bad and the doubtful in credit card reform

By Ronald J. Mann, Professor of Law, Columbia Law School

You can't get a good understanding of the true impact of the cards legislation without a broader look at the historical context. What we have seen in the industry for the last two decades is a steadily increasing ability of card issuers to design products that are profitable on a stand-alone basis. Generally, this involves segmenting the population into ever smaller groups at which more specific products are directed. Thus, instead of "revolvers" paying interest that subsidizes the cards issued to "transactors" who pay their bills each month, we now have distinct types of cards with different fee structures.

The cards held by people who tend not to pay interest often have annual fees or affinity programs that generate revenues that are a substitute for annual fees. And the issuers that are best at marketing those products are very good at ensuring that most of their cards get used frequently, so that most of the cards generate enough revenues from interchange to offset the fixed costs of having an account.

Similarly, card issuers that specialize in products that result in high levels of borrowing are skilled at offering products that use features like teaser rates and low balance-transfer fees to attract customers for whom borrowing is highly likely. It surely is the case that there are more and less profitable customers within each of those product classes, but the groups within which the cross-subsidization occurs are much smaller than they used to be.

So, in the light of the new Credit Card Accountability, Responsibility and Disclosure (CARD) Act of 2009 signed into law by President Obama last month, the most important question is how the bill will affect the fees and products that issuers are going to offer.

The most obvious outcome – one that is happening right now -- is that card issuers are responding to the likelihood that the options they currently use to design specialized products will be truncated in important ways. Here, I would distinguish two groups of changes in the bill: changes that enhance the transparency of pricing and changes that limit the ability to price risk.

Change One: Shrouded Product Design

The first set of changes in the bill outlawed a set of product attributes that (at least to the academic outsider) seem to draw their attractiveness largely from their complexity. These are the "shrouded" attributes like double-cycle billing and minimum finance charges. Over the life of an account those charges can produce a substantial amount of income for the issuer, but because they are not apparent at the front end the customer does not account for them in estimating the price of the card when it is acquired and used. I would also put in that category "sharp" practices like procedures for receiving payments that enhance the likelihood that payments will be treated as late even when customers in fact place them in the mail before the date on which they are due.

On the surface, there is a lot to be said for banning those practices. If they make the product more profitable to the issuer only because customers systematically misunderstand the cost, the market produces a race to the bottom, in which those issuers seeking profit most zealously will have a strong incentive to maximize their use of those attributes. To be sure, the market does produce countervailing incentives. Cardholders may learn over time to avoid aggressive issuers, and the reputation of issuers whose products have too great a balance of back-end costs may suffer. We have seen in advertising for years how important it is for issuers to develop a reputation for having benign products. But how sure can we be that the reputation for benign products reflects (or depends on) anything more than careful advertising and marketing?

In any event, the forces of publicity and reputation already had persuaded most of the largest issuers to abjure many if not most of the practices banned by the legislation. And given the increasing concentration of credit card lending (the top six lenders now have about 90% of the credit card debt), practices abandoned by the largest issuers have relatively little market significance. To that extent, the major impact of the legislation will be to alter the practices of the smaller issuers who are least likely to be affected by publicity. To the extent the smaller issuers are issuing cards to people who have severely constrained credit options, the bans can substantially improve the transparency of the most expensive products.

The Problem with Banning “Harvester” Cards

The provisions banning “harvester” cards are illustrative. Those cards often trumpet amazingly low interest rates in the range of 15-20% for people with very bad credit; they recover the costs by charging to the card up-front fees that limit the available credit to a small share of the amount allegedly available on the card. Thus, in fact, the effective interest rates on those cards are more commensurate with those of payday lenders than those of conventional lending products. Banning those cards will have no effect at all on the practices of the JPMorgan Chases and Capitol Ones of the world, but it will change the marketing and pricing of the cards on the cutting edge of risk.

The most troubling thing about the strategy of banning these kinds of practices is the likely futility of the statute. As noted above, to the extent the bill identifies practices that ever have been in the portfolio of mainstream lenders, it bans things that for the most part those lenders already have abandoned. But nothing in the legislation alters the motivations of issuers to rely on the kinds of “shrouded” terms that legislators found objectionable in the statute. And so the legislation makes sense only if the problem of shrouded terms is a static problem of a few specific bad practices into which some issuers have drifted. But that ignores the behavioral aspects of the problem. The most important difficulty that issuers face in garnering revenues based on shrouded terms is that consumers that use the product have a financial incentive to learn about the terms over time – they are, after all, costly to the consumer that does not understand them. What this means is that over time the revenues from any particular shrouded term will decline as consumers learning of the term alter their behavior to avoid the conduct that results in higher charges.

The history of late and over limit fees provides a good example of this phenomenon. Issuers in the early 1990's identified these fees as a good source for enhanced revenues. The fees are particularly attractive as part of the revenue structure for relatively risky low-balance cardholders for whom even a \$25-\$30 fee is a major return on the outstanding balance. Thus, the total revenues from those fees doubled during the 1990's (from about 70 basis points to 140 basis points, as a share of outstanding receivables). But as consumers learned to adapt their behavior to those charges, issuers were no longer able to increase revenues from those fees. Thus, despite frequent press reports about continuing increases in the fees charged for late payments or over limit transactions, the revenues from those charges have been stagnant for this whole decade. In 2008 -- not the best year for consumers -- issuers received only 120 basis points in revenues from those fees, according to estimates calculated from the annual Cards Profitability Survey of Cards and Payments.

The key regulatory problem is that issuers designing their contracts do not face a fixed set of onerous terms from which they make selections based on the predilections of their customers. On the contrary, they are constantly developing new strategies so that they can rely on new terms with which customers have not yet been familiar. This is most obvious from the steady progression through double-cycle billing, the poster-child for aggressive card issuers of five years ago, to minimum finance charges, first introduced a few years ago.

I see little reason to think that provisions of that sort contributed to the efficiency of card products, and so find nothing wrong in Congress's decision to ban several of them. But one thing we can be sure of is that the issuers that were motivated to develop those provisions will soon develop newer provisions. Now that the legislative moment has passed, those provisions will be developed in a world in which the prospects for renewed legislation are substantially diminished.

A more sensible response would look to one of the few things the mortgage industry has done well: standardized the "boilerplate" terms of the transaction and letting issuers compete only on the product attributes that are important to attracting customers: interest rates, annual fees, credit limit, rewards programs, and the like. A standard credit card contract like the Fannie Mae home mortgage would go a long way to facilitating a general understanding by consumers of the basics of how credit card contracts work -- because they would all work the same way. This is not to say that I think Congress took a wrong turn in banning many of these terms. It is more akin to regretting a missed opportunity to move the industry forward, an opportunity that is unlikely to repeat itself in an economy that presents Congress with so many burning issues for attention.

Change Two: Pricing Risk

Conversely, the most dubious change in the legislation is the limitation on the right of the issuers to alter interest rates from time to time to reflect changes in the risk profile of their customers. The issuers in this instance did a poor job of making a case to Congress to explain the business role of these provisions. The dominant public view, incorporated in most press reports, was that the law bars "arbitrary" interest rate hikes. There is, of course, nothing arbitrary about the interest rate hikes; they rest on determinations by the issuer that the customers facing those hikes are riskier or less desirable in some way than they previously were. The quality of those determinations surely differs from issuer to issuer and from time to

time, but I doubt that many of them in recent months have been arbitrary in any meaningful sense. Rather, they reflect the need of issuers to both contract the size of their portfolios and increase the revenues available to them to match the rising losses from delinquencies that they are facing.

That change will be particularly important to those that issue cards with large credit limits, for which interest revenues are the main way to cover the cost of funds and charge offs. For those issuers, the inability to shift interest rates over time based on the apparent riskiness of the cardholders at any given time necessarily will be replaced by some combination of lower credit limits (something we've seen already) and higher up-front fee structure that generate up-front revenues sufficient to cover the expected costs of bad events in the future.

Those kinds of fees have led to the common charge that issuers are making good customers pay fees to cover the misdeeds of the bad. But it is not as if the issuers are charging the fees only to the "good" customers and not to the "bad"; they are charging them to everybody because they don't know which people will generate the losses that make the fee prudent. The fee is not really any different from the annual fees charged on many cards already. The problem is that the issuers are being forced into a fee structure where they have to guess farther in advance (when they set the initial interest rate) whether the customer will turn out to be good or bad. An obvious response to that legislation will be to charge a greater number of fixed fees up front, if only because those fees have the virtue of making sure that cardholders that take cards will use them frequently. (Why pay an annual fee for your credit limit if you are not planning to use the credit?)

Looking Ahead

If anything is safe to predict, it is that we have not yet seen the pricing structures and products that these changes ultimately will motivate. Issuers have relatively little knowledge right now about how their customers will respond to the product changes the new legislation will motivate. I think many issuers were surprised, for example, at the first response of so many of their prime cardholders to economic turmoil: paying down their balances instead of lowering their monthly payments. The products surely will change as issuers develop a more accurate understanding of how cardholders will respond to the rapidly changing product environment.

More importantly, issuers as yet know very little about the extent to which the crisis will effect a long-term shift in borrowing and spending habits. The rapidly accelerating shift to debit card use in the last 24 months, for example, suggests a shift away from borrowing-based consumption, a shift that would have a much greater effect on the credit card product than anything Congress is contemplating. This is particularly true if that trend is truly age-based – so that it becomes ever harder to identify young and middle-aged households that will use cards as a routine transaction and borrowing vehicle.

In the end, the most likely outcome is that these changes in consumer behavior will increase even more the advantage of the technologically sophisticated issuers (like Capitol One and JP Morgan Chase) and disadvantage the relatively unsophisticated issuers (like Bank of America and CitiBank). The more sophisticated issuers will do a better job of underwriting products that will be both attractive to the

customers and profitable to the issuers, and as they do that their portfolios will steadily grow while those of their less capable competitors will shrink. As the number of issuers steadily shrinks, concerns about the level of competition will become even more serious than they have been in the past. The biggest question, though, is whether the issuers will ever witness the routinized credit card use on which they built their industry for the last decade.

I have my doubts.

About the author



Ronald Mann is a nationally recognized scholar and teacher in the fields of commercial law and electronic commerce. After clerkships on the Ninth Circuit and the Supreme Court (Lewis Powell), he worked in private practice for three years. He then worked a stint for the Justice Department as an Assistant for the Solicitor General of the United States, where he argued eight cases in the United States Supreme Court. Ronald Mann accepted a position on the Faculty of Columbia Law School in the Fall of 2007, following previous tenured positions at Texas, Michigan, and Washington University in St. Louis. He is a member of the National Bankruptcy Conference and the American Law Institute and recently served as the reporter for the amendments to Articles 3 and 4 of the Uniform Commercial Code. Mann's award-winning book on the global credit card industry, *Charging Ahead: The Growth and Regulation of Payment Card Markets Around the World*, was published in 2006.

Credit Where Credit Is Due

By Thomas P. Brown, partner, O'Melveny & Myers
& Lacey L. Plache, VP, COMPASS LEXECON

The credit card industry has few friends at the moment. The Credit Card Accountability Responsibility and Disclosure Act of 2009 recently signed into law by President Obama passed the House and Senate with broad bi-partisan support. The vote in the House on the final bill was 364-64. The tally in the Senate was an even more lopsided 90-5.

In the hearings and floor debate that preceded passage of the bill, few lawmakers could bring themselves to say anything nice about the industry. At a hearing in February, the ever quotable Rep. Maxine Waters excoriated the CEOs of the nation's largest financial institutions for simultaneously taking TARP funds and raising rates on credit cards, revealing that all of her life she has been "in disagreement with the banking industry." Even the industry's chief defender in the House, Rep. Jeb Hensarling, conceded that if the question being debated was whether the credit card industry uses unfair and deceptive practices, a resolution in favor "could pass . . . with unanimous consent."

Given the context, when the President stood before a podium in the Rose Garden on May 22nd to give some brief remarks before signing the bill into law, many in the small crowd probably expected him to offer a scathing critique of the industry. After all, as he and Mrs. Obama pointed out during their long campaign for the White House, the President knows what it is like to carry a revolving balance on a credit card. But he chose a different path. He offered a portrait of the industry that was remarkably free of the shrill complaints that had defined the legislative debate. In tone and detail, his remarks evoked his campaign promise to "cast off the worn-out ideas and politics of the past" and the test for governance that he articulated in his inaugural address: "[t]he question we ask today is not whether our government is too big or too small, but whether it works."

Unfortunately, the CARD Act will likely fail the test set by our Law Professor-in-Chief. It is unlikely to improve the lives of ordinary Americans. It will not help people who have fallen behind on their credit card bills catch-up with their payments. It is unlikely to prompt a fundamental revision of the compact between credit card issuers and their customers. With that said, the Act is historic. It breaks sharply with the market-driven approach to consumer protection that has prevailed in the credit industry since the enactment of the Truth-In-Lending Act in 1968. And it may even lead to the very thing that motivated at least some lawmakers, including Representative Waters, to support the legislation in the first place--further increases in the APRs that appear on card solicitations and statements.

President Obama Sets A High Bar

President Obama's brief survey of the risks and rewards of credit largely explains why the CARD Act seems destined to fail on the terms by which the President has asked his efforts to be measured. His discussion begins with a point that critics of the credit card industry generally ignore--most adults in the United States use credit cards every day without incident. As he puts it, "in the majority of cases, [a credit card] is a convenience or a temporary, occasional crutch, a means to make life a little easier, to make the rare, large or unexpected purchase that's paid off as quickly as possible."

In explaining his ambitions for the bill, the President limits his concerns to the "minority of customers" that have "an uneasy, unstable dependence" on credit cards. Even within this group, the President accepts as true a point that many strenuously resist--that the credit card industry is not to blame for everyone who ends up with more debt than they can repay. As the President points out, some credit card users "end up in trouble because of reckless spending or wishful thinking." And he offers no sympathy to people who fall victim to their own bad choices. "We don't," according to the President, "excuse irresponsibility." The President hails the Act as an important step forward for a slice of the minority: "people who relied on credit cards not because they were avoiding responsibilities, but because they wanted to meet their responsibilities." Even here, however, the President does not lay all of the blame on the industry. He admits that part of the problem lies with "the broader economy." But according to the President, the industry must accept some responsibility. In his view, credit card companies "write contracts not to inform but to confuse." They charge "mysterious fees," shift payment deadlines, and raise rates. And by doing so, they transform what should be a "lifeline" into an "anchor."

The President's pre-signing remarks about the card industry follow pretty directly from his personal experience with consumer credit industry. President Obama appears to be the first occupant of Oval Office to admit publicly that he once revolved a balance on a credit card. Both he and the First Lady publicly discussed their struggles with debt during the long campaign for the White House. At one stop in Pennsylvania, Mrs. Obama recalled the days when she used to worry about the calls and letters from debt collectors warning that "you've got a few more days before you're in trouble." But even as they criticized some of the industry's tactics, they acknowledged that access to credit was critical to their ultimate success. As the President explained during his campaign, neither he nor his wife came from "wealthy families," and both borrowed money to go to college and law school.

President Obama's nuanced survey of the industry captures the impossibility of the task ahead for the CARD Act. Revolving credit is a ubiquitous feature of our economy. Virtually every adult in the country carries a credit card. Although some people end up with more revolving debt than they can repay, the vast majority of Americans do not. And as the example of the President and First Lady vividly attests, access to

credit is one of the great levelers of our society. It enables a poor young man raised by his grandparents in Hawaii to attend world renowned (and very expensive) universities and launch a political career. In order to be judged a success on the terms laid down by the President, the CARD Act must preserve the benefits of credit to all while solving the problems that befall the few. Nothing in the legislative record suggests that the Act is likely to accomplish this feat.

Putting The CARD Act In the Consumer Protection Context

Since Congress passed the Truth-In-Lending Act in 1968, consumer protection law regarding the extension of credit to consumers has been premised on the view that the market is the most effective and reliable protector of consumers. So long as firms accurately disclose the terms on which they provide services to consumers, consumers will select the terms and providers that best meet their interests. The CARD Act of 2009 signals a sharp break with this view.

The Act dictates the manner in which issuers must treat consumers, regardless of whether the issuers had been completely and accurately disclosing their practices. The list of proscribed practices is long. It begins with bans on double-cycle billing and "any time, any reason" rate increases. But it extends to seemingly minor points such as regulating the dates on which payments are due and the time of day by which a payment must be received in order to be considered timely.

The Act itself does not explain the basis for rejecting markets as the most reliable protector of the interests of consumers. The legislative record gives a glimpse of the progression. After Democrats gained control of the House and Senate following the mid-term elections in 2006, these Democrats and a host of consumer groups built the case that the revolving credit industry had failed its customers. This was an easy case to make, given issuers' image as predatory and the perceived failure of deregulation of mortgages and securities.

Much of the public record criticizing the revolving credit industry focuses on the supply-side. Sponsors and supporters of the CARD Act argue that there is insufficient competition among issuers of revolving credit to discipline bad behavior. They claim that "some consumers may not be able to find another card with a rate that is comparable to [a] pre-increase rate." Advocates also claim that some consumers will not look for a different card because all issuers generally reserve the right to unilaterally change terms.

Sponsors of the legislation offer little to support these claims that the industry is not a competitive. To support the idea that consumers will not be able to find other cards with lower rates, the Joint Economic Committee cites two theoretical papers on price discrimination and price dispersion. For empirical evidence, they rely on Larry Ausubel's 1991 study of interest rates on revolving credit balances in the mid-

1980s. But as the Government Accountability Office, the investigate arm of Congress, has elsewhere observed, the card industry appears to have become significantly more competitive in the early 1990s (after the period of Ausubel's study). And this more recent competition has, according to the Government Accountability Office, "likely caused ... reduction in credit card interest rates."

To some extent, these concerns appear to be a cover for the real basis for intervention--the feeling that on the whole, consumers cannot be trusted with revolving credit. Elected officials tend to shy away from proposals that obviously question the ability of constituents to figure out what is in their own self interest. But the academic supporters of intervention in the revolving credit business like Elizabeth Warren and Oren Bar-Gill freely make this claim (although these claims have been forcefully rebutted by anti-interventionists like Richard Epstein). Diluted versions of these claims appear in the public statements of public regulators. Just last month, Ben Bernanke, Chairman of the Federal Reserve, claimed that revolving credit contracts had become too complex for "even the most diligent consumers." According to Chairman Bernanke, this complexity "and leads consumers to make poor choices."

Taking the Problem by the Tail

Given the Act's premise, it is somewhat surprising that Congress did not use it to enact more dramatic restrictions on the industry. There was plenty of political and academic cover. Last year, in her run for the White House, then Senator and now Secretary of State Clinton called for a return to the era of usury laws. And none other than Judge Richard Posner recently urged policy makers to consider imposing limits on credit card debt and "resurrecting usury laws." Although the CARD Act is important as symbolic matter for those who would like to see greater regulatory control of the credit card industry, the Act's principle prohibitions are directed at practices that are rather obscure--double-cycle billing and "any time, any reason" rate increases.

Double-cycle billing is a method for calculating the interest due on a revolving balance. Most revolving credit lines calculate average daily balances on a single-cycle basis. The calculation is pretty straightforward: Sum the balances since the close of the last billing cycle and divide by the number of days since the end of the last billing cycle. When an issuer calculates interest on a double cycle basis, the calculation of the average daily balance looks back to the balance on the card for the prior billing cycle as well. To see the difference between the two balance calculations, assume that cardholder had a balance of \$500 in the prior month, paid off \$450, and did not use the card in current month. An issuer using a single-cycle balance calculation would calculate interest based on the \$50 dollar average balance in the current month. An issuer using a double-cycle calculation would calculate interest on the \$500 balance from the prior month as well as the \$50 in the current month.

Admittedly, calculating interest payments on a double-cycle is somewhat complicated. But it really only affects people when they pay off some or all of their revolving balance. Consumers apparently pay little attention to how issuers calculate interest rates. But there does not appear to be any evidence that double-cycle billing systematically increases risk or reduces return. And this may explain why the practice remains fairly uncommon. Discover popularized the practice when it introduced its card in the late 1980s. But most other issuers did not embrace the practice. Three of the largest issuers, American Express, Citibank and Capital One, apparently, never implemented it. The GAO reported in 2006 that only two of the largest six issuers were using multiple cycles to calculate interest charges.

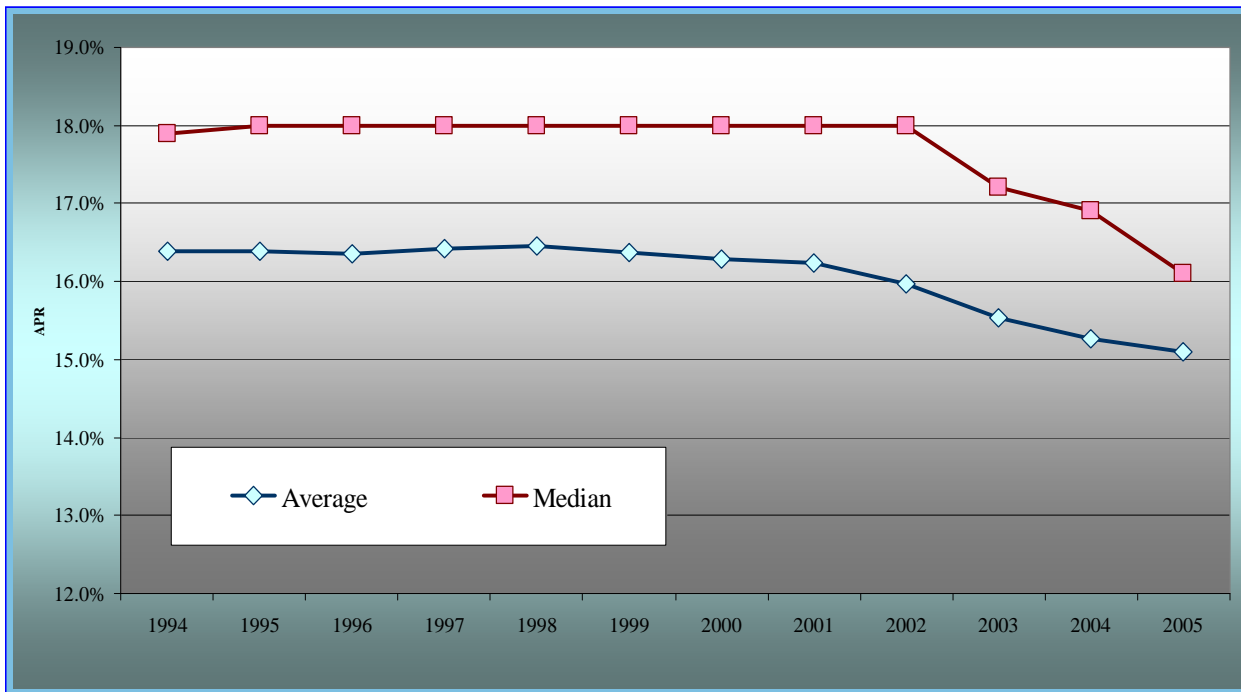
“Any time, any reason” rate increases have a somewhat different pedigree. The contract provision that allows an issuer to increase a cardholder’s rate for any reason is widespread in the industry. President Obama identified this practice as particularly unfair to consumers during his run for the White House. Although the presence of this language in credit card contracts has been well documented, there is very little information about how often the language is invoked, the extent to which cards with balances are targeted, or the nature of any ensuing rate changes. Using data drawn from the Payment System Panel Study (“PSPS”) commissioned by Visa USA, we have attempted to discern the answers to the following questions:

- o How frequently do APR changes occur and what is the nature of such changes?
- o Are cards with balances substantially more likely to see changes than cards without balances?

The PSPS contains information on the card APR, a continuous variable for which panelists are requested to report each quarter. Our sample consists of 1.2 million quarterly observations on general purpose credit cards, including Visa, MasterCard, American Express, Discover, and other cards.

Sixty-two percent of quarterly observations of card ownership details contain information on card APR in any two out of three consecutive quarters. For cards with APR information, the data show that the average APR is 16.1 percent and the median APR is 18 percent for the 1994-2005 period. In fact, nearly 90 percent of card observations containing a value for APR have APRs of 21 percent or less during the period. In addition, as shown below, average and median APRs are basically flat for most of the period, with declines occurring toward the end of the period.

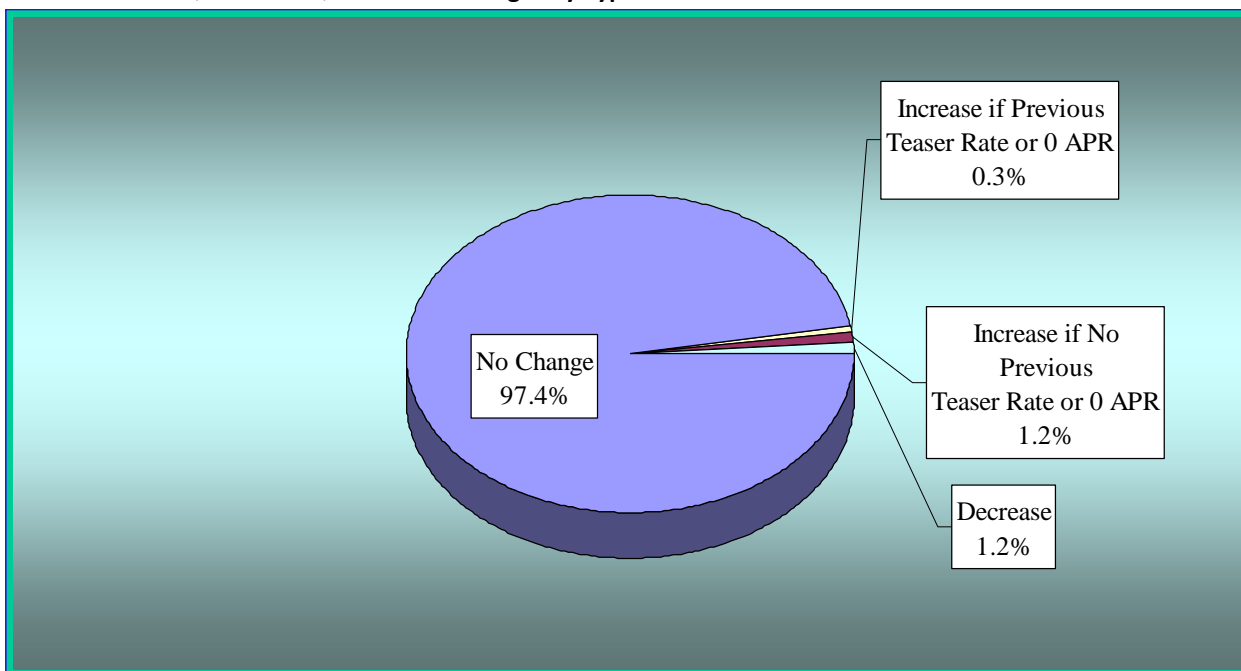
Figure 1: PSPS Average and Median APRs



Looking at changes on individual cards, the conclusions are even more striking:

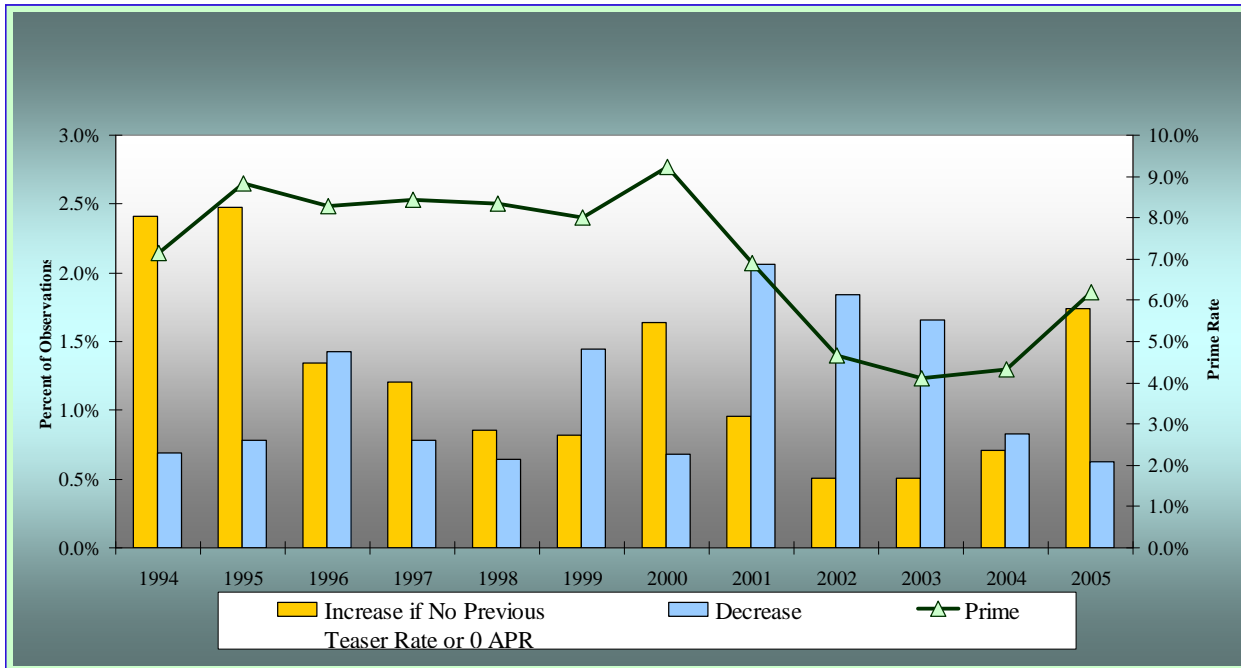
- Rates on 90 percent of the cards in the survey did not change during the survey period.
- For any given quarter, APRs are constant for 97.4 percent of cards on average. As shown below, APR increases and decreases are equally likely once “teaser” rate changes are excluded.

FIGURE 2: PSPS Quarter-to-Quarter APR Changes by Type



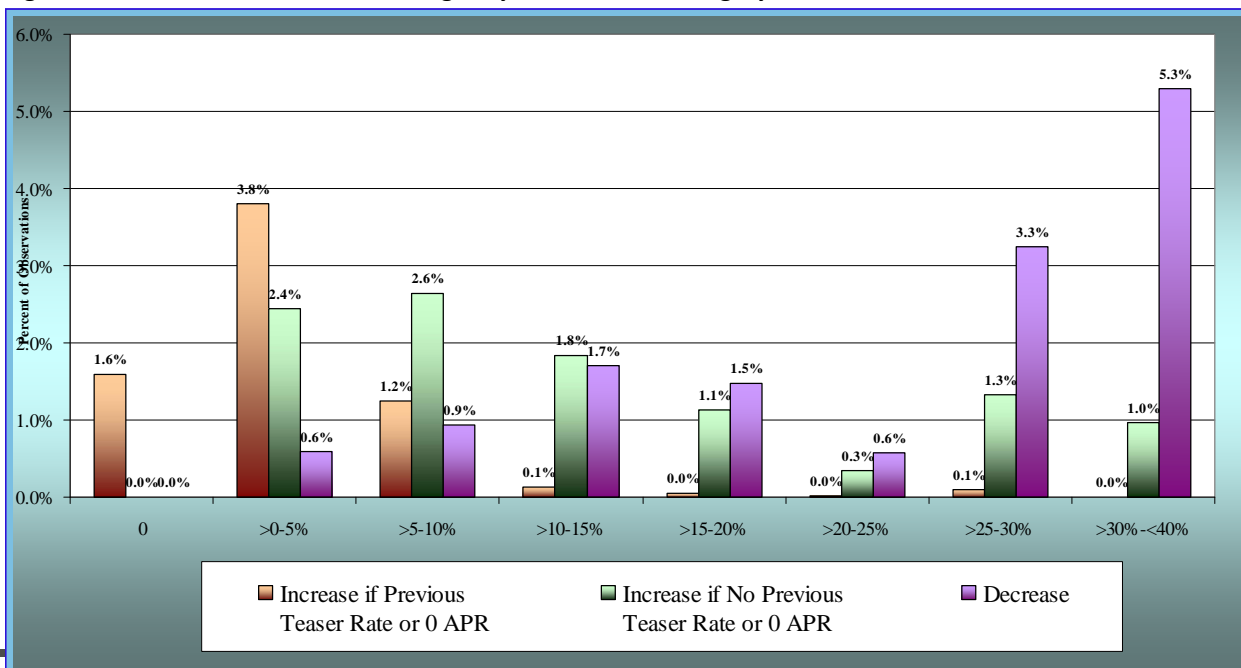
- APR changes tend to follow changes in the prime rate. APR increases on “non-teaser” cards tend to occur more frequently when the prime rate increases and less frequently when the prime rate decreases or remains stable. Similarly, decreases in APRs tend to occur more often when the prime rate decreases and less often when the prime rate increases or remains stable.

Figure 3: PSPS Types of APR Changes & Changes in the Prime Rate 94- 05



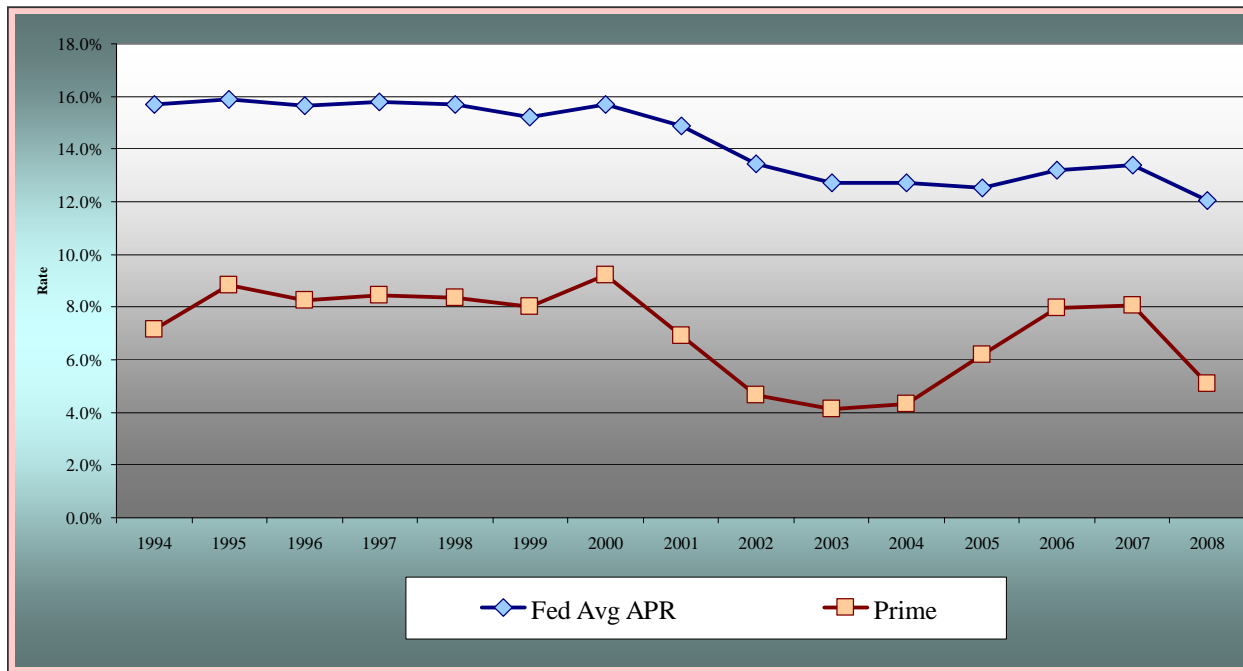
- As shown below, very few cards in each APR category experienced either APR increases or decreases in any given quarter. Cards with lower APRs in the previous quarter were more likely to experience increases in previous “teaser” rates, while cards with higher APRs were more likely to experience APR decreases.

Figure 4: Quarter-to-Quarter APR Changes by Previous APR Category



Although our data ends in 2005, average interest rates reported to the Federal Reserve continued to reflect movements in the prime rate through the end of 2008, as shown in Figure 5.

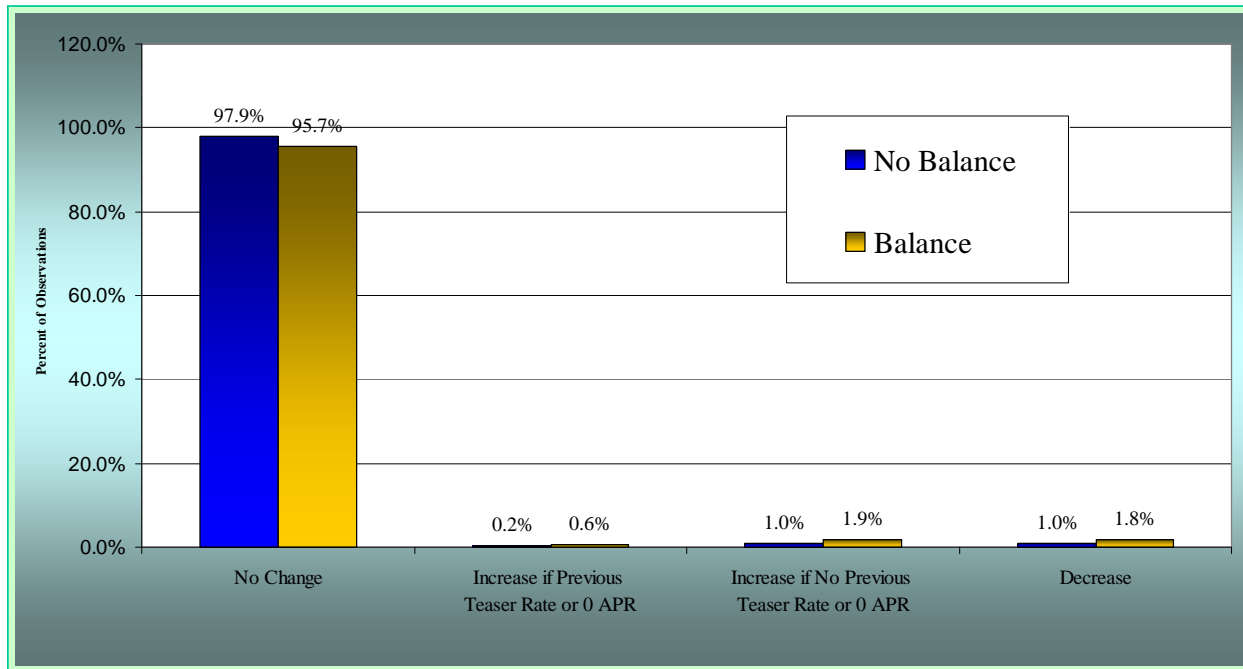
Figure 5: Credit Card APRs versus the Prime Rate



In addition, other studies have shown that issuers continued to follow practices consistent with those revealed by our analysis, failing to confirm a general perception held by lawmakers and others that APR changes have become epidemic in recent years. Oliver Ireland, former General Counsel to the Board of Governors of the Federal Reserve (“Board”) and now a partner at Morrison & Foerster, submitted an analysis prepared by Argus Information & Advisory Services to the banking agencies in connection with the proposed rules regarding Unfair and Deceptive Acts or Practices. Ireland and Argus pulled together a data set covering approximately 70% of outstanding balances for the period from April 2006 through February 2008. Using that data set, they were able to identify interest rate changes that were imposed as a result of default and a unilateral change in terms. They found that the incidence of these rate changes across all accounts varied by month from a low of 1.1% of all accounts to a high of 2% of all accounts.

Of course, neither these findings nor the Ireland-Argus findings rule out the possibility that card issuers single out cardholders with revolving balances for rate increases. However, the PSPS data appear to contradict this hypothesis. APRs did not change in any given quarter for over 95 percent of cards regardless of whether cards had a previous balance. Cards with previous balances were slightly more likely to experience APR increases than cards without previous balances, as shown in Figure 6. Such cards were also likely to experience APR decreases than their no-balance counterparts.

Figure 6: PSPS APR Changes for Cards With and Without Previous Balances



Moreover, the amount of the balance did not appear to determine whether APR increases or decreases occurred. The difference in the average previous card balance for cards with non-teaser increases versus decreases was less than \$100.

A Lot of Work to Save Some Consumers \$7 per Month

Our analysis suggests that those hoping the CARD Act will transform the revolving credit industry in the United States are likely to be disappointed. Even if we were to suspend disbelief and assume that issuers will not change interest rates, annual fees or some other dimension of the card contract in response to the passage of the Act, the impact of the change on the relatively few consumers with balances that saw non-teaser rate increases would amount to \$7 a month on average, based on average increases and previous quarter balances for these consumers during 1994 to 2005.

But that, of course, misses the important point that President Obama made in the Rose Garden before signing this legislation into law. As the President explained, nearly everyone has a credit card, but only a small number of people find themselves heading down the “one-way street” of debt. And of those that do head down that street, some are there because they fail to use their heads.

Yet the CARD Act makes no distinction. It forbids an issuer from adjusting rates to reflect the experience with a customer. If the issuer started three customers at a given rate, all three customers must receive that rate even if they behave very differently. The issuer may not distinguish between the consumer who gets a card and runs up a debt but manages to stay current from the customer who misses the occasional payment or even the customer who defaults for a while but manages to make six consecutive payments before missing again.

And this, even apart from the Act's other prohibitions and mandates, seems likely to lead issuers to raise interest rates for all consumers. If issuers cannot adjust rates in response to the experience with the cardholder, they will almost surely build the risk into their underwriting models. They will likely raise rates, increase annual fees, and/or lower credit limits. And none of these responses seems even remotely likely to make all Americans better off. This is true even if the adjustments are slight because the interest income lost as a result of the Act is minimal.

But that's just the tip of the spear. The clamor for more extensive regulation of the card industry rests on the claim that consumers get the credit cards that they demand but not the ones that they need. Support for this conclusion, however, falls somewhere in the range of weak to non-existent. Most articles advocating for paternalistic intervention in the credit industry rely on the work of behavioral economists. And while behavioral economists have documented that people make decisions in ways that diverge from the rationality assumptions that support neo-classical economics, they have not yet shown that consumers fail to make rational decisions regarding their use of revolving credit.

Actual human beings are not fully informed, risk neutral automatons, and their lives are often messy. As President Obama noted, some consumers may make bad decisions that have unfortunate consequences. But for many people, as President Obama noted, credit cards provide a way to cover an unforeseen medical bill, a layoff, or a long weekend to forget about that medical bill or layoff. The decrease in available credit that is likely to result from the CARD Act will curb certain practices by card issuers, but it will also deprive consumers of some of their options for financing that unfortunately timed medical bill, layoff, or vacation. Limiting consumer choices may prevent some people from making a bad decision, but it does nothing to improve their alternatives.

And this observation takes the conversation full circle. In explaining why he opposed the CARD Act of 2009, Rep. Henslerling conceded a point for which there appears to be universal support: card agreements contain provisions that many people find surprising after the fact. And the Federal Reserve's exhaustive focus group research has established conclusively another apparent truth about the industry: even well-meaning consumers do not always succeed in deciphering their card agreements. But it does not follow that eliminating such practices by legal fiat makes people better off. Revolving a balance on a card that

calculates interest on a double-cycle may be a “poor choice,” but it could well be the best option available. And eliminating the choice likely will create all sorts of inefficiencies and hidden subsidies that may make everyone worse off, even those who previously steered clear of cards that featured double-cycle billing. Markets provide a much more effective cure for the sorts of problems at which the CARD Act seemingly is directed. This is an industry defined by standard agreements. As Richard Epstein has observed, standard agreements, whatever the objections that may be directed at them, reflect mutual gain. Although people surely make mistakes in choosing among different standard contracts or electing options within a given standard contract, they have every incentive to learn from and correct those mistakes. Standardization makes the process of learning and correcting easier. It decreases the transaction costs associated with sharing and comparing experiences, and it increases the gains to be had from new entry.

For those who think that this is purely a theoretical point, consider the movie rental business circa 1999. The entire industry had adopted a pricing model based on a small up-front payment for the rental and a significant penalty for the failure to return the movie in the allotted time. A new entrant came along and offered consumers an alternative--a set number of movies at a fixed price per month. The new entrant, Netflix, quickly displaced the dominant incumbent, Blockbuster. And their stock prices tell the story. Shares in Netflix have more than tripled since May 2002. Shares in Blockbuster have lost 97% of their value. Competition may not be perfect, but it is still the most effective protector of the consumer’s interest.

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