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**Tom Brown**

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**Ron Mann**

Professor of Law, Columbia University, and author of *Charge It*

**Victoria Strayer**

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The full recorded webcast can be viewed at:

<http://www.finreg21.com/channel-21/interviews/cards-and-consequences-what-card-act-means-banks-and-consumers>

## FinReg21 Live: July 22, 2009

### CARDs and Consequences: What the CARD Act Means for Banks and Consumers

*The following is a transcript of the FinReg21 webcast, recorded July 22, 2009.\**

TRANSCRIPT BEGINS.

**David Evans:** Two months ago President Obama signed into law the Credit Card Accountability Responsibility & Disclosure Act, fortunately also known as the CARD Act of 2009. The first revisions of the Act kick in on August 20. There are reports that banks have already done a number of things, for better or worse, in anticipation of the Act. Today we have four of the leading experts on credit cards in the country to help us look at what the CARD Act means for card issuers and what the CARD Act means for cardholders, for consumers. They bring very different perspectives, so we're looking forward to a lively discussion.

*\* Any errors in the transcription of this webcast are the sole responsibility of FinReg21.*

Let me introduce you to the speakers. Oren Bar-Gill is an economist and a lawyer who teaches at New York University. He's written extensively on credit cards and has advocated greater consumer protection in this area. Tom Brown is a partner at O'Melveny & Myers and used to be in-house counsel at Visa. Tom wrote an article for FinReg21's *Lombard Street* which is fairly critical of the CARD Act. Ron Mann is a law professor at Columbia University and the author of *Charge It*, which is a highly regarded book on the credit card industry. He also had an article in *Lombard Street* on the CARD Act. He saw the new laws as having some pluses and some minuses. And we have Victoria Strayer – from TSYS, which is one of the largest payment card processing companies in the world. She's a senior executive there and has lots of practical experience with consumer protective regulations.

Let me turn to some questions and I'd like to start with you Oren. What's the problem that Congress wanted to fix with this legislation?

**Oren Bar-Gill:** Well I guess the first thing that everybody's been talking about -- and we see this in the press and in statements by Congress and the President -- are those tricks and traps -- and there are a variety of those and we'll probably get into them in some greater detail over this hour. There was a very strong sense, and it's almost a public outcry, about certain behaviors and practices of credit card issuers and I think that's the motivation for the CARD Act.

Now I think it's important to divide the problem into two dimensions, the ex-post dimension and the ex-ante dimension. I think that what was most salient is the ex-post problem and this is what happens to a cardholder after there is a rate hike from 10% interest to 30% interest, when fees start accumulating, etc., there is a financial hardship and these are all the

very personal stories that you read in the newspapers. And this is the ex-post problem, this is happening after the fact, after the rate hike has been imposed on these borrowers, they are in financial distress and their stories are the ones that touch the lawmakers and the administration.

From my perspective, however, the more important problem is the ex-ante problem and the ex-ante problem is that when borrowers--the cardholders--they sign on to their agreements, they get their credit cards, they are faced with a very complicated transaction relationship contract, a relationship that they don't understand very well. So from my perspective the biggest problem is not that there is a specific rate hike on a specific consumer -- this is the ex-post problem. The problem is that many consumers don't really understand the long-term costs of their credit card contracts and I think there's a big question which we will probably deal with as to what extent the CARD Act actually effectively addresses this ex-ante problem.

**David Evans:** And one of the things we're going to get to in a little bit, Oren as you know, is we're going to talk a little bit about the proposed Consumer Financial Protection Agency and how that interacts with the CARD Act. But for now let me just quickly turn to Ron and maybe Ron you could just tell us a little bit about -- just briefly -- what the key features of the CARD Act are.

**Ron Mann:** That's not an easy thing to say, the Act is a lot like one of these eastern divinities, it might appear in thousands of different avatars depending on who's looking at it and different people will have their views as to what the most important things are. But I think from my

perspective, I would divide up the things that are important into four categories. And the first category would be the provisions Oren's talking about right now, which are provisions that invalidate a specific detailed contractual provision and so these outlaw things like double cycle billing and small things like that in contracts. There's a long list of these kinds of provisions that are now made unlawful, many of which had been made at least tentatively illegal already by the UDAP regulations, published by the FTC and the Fed last year.

The second thing in the statute -- which I think is very different because it really affects the basic business model -- is the provision of the Act that makes it unlawful to have a contract under which the issuers can change the interest rate from time to time. So the basic idea is that if someone has a balance outstanding and based on the issuer's underwriting model something happens that makes the cardholder seem riskier than they were before, the issuer can't change the interest rates. After they sign up for what the interest rate's going to be, they can't really have the types of underwritten varying interest rates they've had in the past.

The third thing that I think is important -- although it's not the mainstream sector of the industry, or the rapidly growing sector -- are the provisions that bar what I would call harvester cards, and these are named that because they're cards that harvest large amount of fees, and the typical product for those of you who haven't seen one of these is a product that might have a \$500 nominal credit limit, but when the card is issued they charge the customer \$200-\$300 in fees, which they extend on the card. And so when the card gets to the person they may only have \$150-\$200 left of credit and they already owe \$300 and owe a substantial payment the

first month before they've ever even gotten the card. And the effective interest rates on those cards could end up being very high.

And the fourth thing -- which I guess most people regard as fairly minor, but I think is a pretty important part of the statute -- are some provisions that make it relatively difficult to market cards to college students and to minors, and that's been a rapidly growing sector of the industry and the statute has made that considerably more difficult. So I would say those are the four most important categories.

**David Evans:** And Victoria is this going to have a big, moderate, or small impact on the credit card business, in your view?

**Victoria Strayer:** Well as you listen to what's already been covered here I don't think it's any surprise that the belief is that these changes will certainly have significant impacts to the card business at large. We frequently read that these changes are the most significant updates in 30-plus years. If you couple that with the multiple and compressed implementation timeframes, as well as the excessive expense to implement, we're now faced with a flurry of decisions and delivery work streams that are in place that have really basically put most other issuer initiatives on hold. Not to mention the impact that they have on their supporting providers.

You know, let's think back when the industry was very young; no one could've predicted the journey that we've been on up to this point. We had open-ended credit with fixed interest rates, great to have. Consumers willingly accepted annual fees at a cost for a good product. Then we have competition, we have rate wars -- varying rates, floating rates, break points -- annual fees now disappeared. Over time an endless array of new products emerged with co-

branding and a countless variety of features. Many of these came about in response to customer wish lists, demands -- much of what we've already heard about up to this point -- coupled with the issuer's desire to increase revenue and build customer loyalty, certainly an ever-changing path. I think the challenge we now face as an industry is how are we going to react to these changes that are not necessarily self evolving, but externally mandated, you know where is really that next leg of the journey going to be and I think we all agree for certain it's going to be about change.

**David Evans:** And we're going to get to some of those changes in just a second, but before we get to that, one of the striking things about the CARD Act is just the tremendous bipartisan support it had. Talk about Democrats and Republicans reaching across the aisle and holding hands. Tom what did the credit card industry do to get the two parties to agree so much on what needed to be done?

**Tom Brown:** David, like many summer blockbusters it's a slight retelling of an old tale. In this case it's a remake of the movie *Being There*. So you might remember Peter Sellers was a very sympathetic and charming gardener who became an advisor to the President simply because he was in the right place at the right time. In this case the industry was an incredibly unsympathetic target at exactly the right moment in time and so everybody could agree that something needed to be done and this is what was done.

**Ron Mann:** I think a lot of it also has to do with the sense that the card industry overreached in the legislative debate about the Bankruptcy Act. Because I think most people, looking back on the Bankruptcy Act, we recognize that the statute was very poorly done and the card industry

pressed really, really hard for that and I think a lot of legislators, particularly Democrats felt like they really got burned. I think that that undermined a lot of the efforts of the card industry to get their case made to legislators this time about the provisions and the statutes that are problematic and since there was such a good beachhead of the kinds of things Oren was talking about, of things that would play very well across all ages and demographics and political parties that needed to be changed, it was very hard for the card industry to limit that beachhead. So I think they just had relatively limited credibility after the things that they said at the time of the Bankruptcy legislation a few years earlier.

**Victoria Strayer:** Yes, that was a great point. I think Congress also saw an opportunity to win with consumers and win with the new administration, which is not always the case.

**David Evans:** Well with that let's shift over to sort of a practical topic, which is what the CARD Act means for card issuers, which are primarily the banks. Now as you mentioned Victoria the CARD Act is on kind of a fast track and the first part of the provisions, as I understand it, go into effect on August 20. What's kicking in then and what has that meant for your card issuers?

**Victoria Strayer:** Yes, fast track is certainly an understatement. So there are three main components effective in August. First, creditors must provide a written notice to consumers, a minimum 45 days before increasing an annual percentage rate or making other significant changes to their terms.

Second creditors must inform consumers in that same notice of their right to cancel the account: if they choose not to participate in that increase they have the ability to say "no, thank you. I will cancel that." So at this point issuers are analyzing their pricing models, they need to

understand where they have behavior-based auto-increased APRs and now they have to figure out how they assert technically and operationally this 45--day advanced notice. They're actually establishing right-to-cancel policies and then having to train their customer care staff on those new policies. And then just on these two points they're stepping back and saying "OK, what are those revenue implications going to be to my portfolio?"

The third point is about statements: creditors must mail or deliver periodic statements at least 21 days before the payment is due or before the loss of any grace period for which finance charges would not be assessed if the payment were received. So now issuers are diligently working to understand what are their options and again they have a very, very limited period of time to do that. You know, what is the process around their statement delivery? And in a very finite mode the timeline associated with that entire process, including the QA cycle. Do they have service level considerations? Are there potential contract amendments? And then again, understanding not just the revenue implications, but expense implications.

So kind of in summary they're having to review their payment due date calculation options, late fee triggers, grace period timing, change in terms triggers. They have to look at all of their collateral, their statement messages, how they're messaging that right to cancel, and impacts on some of the other fees that don't necessarily initially come to mind, but such as closed and cancelled account fees. So they've definitely got their hands full.

Let me touch on one other important point around what is being effective in August. On July 15 the Federal Reserve Board published the interim final rules for Reg. Z. So this provides guidance on implementation of this portion -- this August portion -- of the CARD Act. There's a

60 day comment period, so here's kind of another interesting chapter. The rules were published seven days ago, legislation's effective in about 30 days, we have a 60 day comment period -- and any comment submitted will be considered in the next round of the rules, but that presents a bit of a risk, that I as an issuer could make a decision that feasibly I may have to change based on what those future rules would be. That could be expensive, it could be confusing for the consumer, so we have to migrate through this process very, very carefully. Don't misunderstand, we welcome the comment period, I'm just illustrating how difficult this timeline is and the Fed certainly acknowledges this and quite frankly I think they're doing the very best job that they can for all parties given the constraints that these timelines that came out of CARD placed on the issuers.

**David Evans:** Thank you very much Victoria. Ron I wonder if you could just give us a preview of what's going into effect next February, what's layered on top of the August 20 deadlines?

**Ron Mann:** Yes, in a way, Victoria's discussion of this shows what I mean about trying to say what the important parts of the Act are because she mentioned a lot of things that will require people to expend large sums of money, and retrain personnel, and redrafting forms, and none of those include anything in the four categories I mentioned as what I regard as the most important substantive changes in the Act. So all four of the categories of things I mentioned in the beginning are things that don't go into implementation until next year.

And there are still other categories that go into implementation even after February because they depend on regulations that are as yet unwritten by the Fed. For example, there are rules that certain types of penalty fees have to be reasonable and proportional and the Fed

is obligated to write some regulations that will explain what that means and those regulations are not required until nine months after the Act and so they're supposed to go into effect in August of next year. There's a lot of stuff going into effect in August, but in a way I think the things that go into effect in August are the things that require the most rapid bureaucratic shifting and then a lot of the major substantive things go into effect next year.

**David Evans:** Thanks very much Ron. What I'd like to turn to now is a free for all discussion on how if at all the CARD Act is really going to change the issuing business. We're going to turn to consumers in a little bit, but for now I'd like maybe Oren, for you to start out and giving your thoughts on how the issuing business is going to change as a result of the Act.

**Oren Bar-Gill:** Well as has already been mentioned here there are some profit centers that are being curtailed or limited by the Act. Now, you know reading Tom and Lacey's piece in *Lombard Street* -- it's not clear to me, and I think Tom you will of course will correct me if I'm wrong, there's at least an argument that the profits that are going to be lost are not that great. I'm not sure how big the effect is going to be on that dimension and the need to replace profits from say more frequent rate hikes. As Victoria mentioned, one thing that's going to happen now is various adjustments to new information about the riskiness of borrowers will have to be made based on less information. They will have to be made earlier than they would otherwise, and this is going to change the business model somewhat.

But I think in looking at this globally, I believe that perhaps the bigger change in the business model here is actually not going to be from the CARD Act itself, but from changes in consumer behavior. Now we are going to get to the consumer side later, but I wanted to flag

this point that if we are going to see lasting change in borrowing behavior of consumers being less borrowing on credit cards, this is going to lead to big changes in issuers' business models, more than the CARD Act itself.

**Tom Brown:** Yes, so picking up on Oren's point. I think he makes two good ones, maybe even more than two, but the first is that the effect of the CARD Act on the issuing business is somewhat hard to predict particularly as we're still -- as both Ron and Victoria have laid out -- working through exactly what it is that the CARD Act changes about how issuers make credit available to consumers and how you operationalize the requirements of the Act. If we focus on specific mandates associated with the Card Act, like, for example, the ban on double cycle billing, or the implications of the changes associated with what I think of as risk-based pricing, the effects point in lots of different directions. Let's take for example risk-based pricing. We live in a world in which issuers have been able to hold open limits for individual consumers and then respond to how consumers use cards and respond by other changes in a given consumer's credit profile and then make changes in the terms of the card and respond to whatever information is collected. And the ability to do that has been driven by -- David as you know -- changes in technology and sophistication with respect to sort of real time credit scoring. I mean the CARD Act essentially says we don't like that anymore and we want to go back to a world in which we require issuers to make better predictions at the moment the credit is extended. Now I can think of lots of ways in which issuers might respond to that, right? Maybe they'll increase rates, maybe they'll increase fees, maybe they'll decrease limits, but I'm not sure exactly which of those -- which specific strategy will be the best, or which combination of strategies will prove

to be the most effective. I think that it's very difficult to say.

**David Evans:** Victoria did you want to comment on that?

**Victoria Strayer:** Yes, I was just going to say I certainly agree with all the points that have been made. I think as we watch what is going to happen with consumer behavior that is going to really teach us a lot about what we can think about in the future. I think that some of what we've heard is, profits are probably going to shrink in the channels we're used to seeing them from today. So what does that mean? A successful business isn't going to just rest on "well here's the new baseline and I guess I've got to live with it." We're going to see some creativity get shaken up in our industry and it's not going to be apparent tomorrow. Right now everybody's got their eye on trying to get through August and February and some of the other things shortly thereafter, but new products, new services, new ways of doing business with these consumers will come from the challenges that we're facing with CARD and Z.

**Ron Mann:** I think that's exactly right. I could flush out a couple of those points a little bit. On the consumer behavior point I think there are two effects that are going together, one is a general shift from credit cards to debit cards that really predates the economic downturn -- and that's, you know, partially age related in the sense that the group of people that uses credit cards as the routine transaction vehicle is getting progressively older, and the group of people that uses debits cards as a routine transaction vehicle is a lot younger. So if it's a generation that used credit cards more and that generation is getting older, the market for credit card use is going to steadily shrink and look more like other countries and that has nothing to do with the economic downturn. But I think the economic downturn accelerates that shift by putting

people in this position where the generation that has lived through this is like the generation that has lived through the Great Depression and you see signs of people having this attitude that our grandparents had: that it's really risky to borrow money and you shouldn't borrow money except when it's really, really important, as opposed to the attitude our generation had, which is we're supposed to borrow money because that is an economically effective way to shift consumption to the lifecycle. And so people just want to borrow less. It's going to be much more difficult for the credit card industry to get the kind of profits that it has had for the last 10-15 years.

And the second thing which I think is related to that and it builds really on what Tom said, that I think it's very hard to know what the credit card products will look like in three to five years -- I think the thing that's easiest to see is that the people that succeed in designing the products are going to be the people that are best at managing the information technology. Because what the statute has done is made it much harder to do a good job of pricing risk, because the statute doesn't say that you can't have risk-based pricing, it just says you can't do it the relatively easy way of observing people's behavior and pricing after the fact. You're going to have to figure out how risky people are before they started using your product and only the most sophisticated people are going to be successful at that. So I think what that's likely to lead to is further concentration in an industry that's already rapidly concentrating, if you're looking at the people that hold the outstanding loans. So I think you'll see a lot more people getting out of the business and a relatively smaller group of people that are smart enough to price this kind of risk effectively.

**David Evans:** One of the members of our audience asked whether as a result of the industry becoming unprofitable for the existing players, whether that might also lead to the opportunity for new entry. Any thoughts?

**Ron Mann:** I think that idea goes back to the argument you make in your book, David. You can look at this from two sides. One, you can say the industry is ridiculously more profitable than anything else banks do, if you only look at the people that are really, really good at it. Or you can say the industry is not unusually profitable if you look at all the people who are in this industry who are bad at it. I think there are people that can profit at this and there are people that can't. I think the hurdle's going to get a lot higher. I think the place for entry is going to be for people that want to try and design a payment product where you're not trying to charge fees to subsidize credit, but a payment product that's just supposed to be cheap and those products haven't been that successful yet largely because of the difficulties of getting over the hurdles of building a large payment network.

**David Evans:** Oren do you have anything to add to this topic before I move on to something slightly related?

**Oren Bar-Gill:** Yes, just one thought about how risk-based pricing is going to look and I agree with Ron, I think that Tom said a similar thing. We're going to see much more emphasis on ex-ante risk-based pricing. The issuers will have to predict risk ex-ante and credit reporting is again going to be affected by this. What issuers were doing, and now it's more difficult for them to do, is to adjust rates as they go along. But payments history and how people paid their debts and credit cards in the past at least is something that is available on credit reports. So at least

for people who have had a credit card for a significant period of time, there is substantial information that can be gleaned and used from the credit reports and those will be updated. Just another point -- there is still a possibility to adjust rates, it's just a little bit more difficult. So if there is a 60 day delinquency, that still allows an increase in the interest rates..

**David Evans:** Why don't we turn to the Consumer Financial Protection Agency. This came out of the Obama Administration as part of the President's Regulatory Reform Plan that was proposed in mid-June. The U.S. Treasury Department just came out with 150-odd pages of proposed legislation which is the starting point in Congress.

**Oren Bar-Gill:** Well, I have to plead ignorance on the recent Treasury blueprint because I have not had a chance to look at it. I can say a little bit about the motivation and reason for establishing something like the Consumer Financial Protection Agency. I think the main reason for such an agency from my perspective is not that we need more regulation of credit cards, it's that we need better organized enforcement of this regulation. And this comes out of the problem that we have too many regulators on the one hand, so we have all these banking agencies with authorities on different issuers. We also have federal versus state, adding another layer of regulation. And the other problem is that the banking agencies who have the authority to regulate these products, they don't really view consumer protection as the number one thing in their mission. So safety and soundness is what they care about most, and while there is a connection -- and we can argue about how this connection should look between safety and soundness and consumer protection -- history shows us it's not always the case that these banking regulators -- the Fed, the Controller of the Currency -- necessarily care about

consumer protection front and center. So the main purpose of the agency as I see it is to establish a single, unitary federal regulator that would establish the standard for credit cards and other consumer financial products -- like mortgages -- and from my perspective this does not mean more regulation. In fact it could mean less regulation or in fact instead of facing different levels of regulation, there will be just one level of regulation. The caveat there is that the current proposal does not preempt states, so still we would have one federal regulator and then states that can go above and beyond that

**Tom Brown:** I think Oren makes some good points about what may be motivating the idea that we need a new consumer financial regulator in Washington. But among other things, the proposal completely changes the existing rules with respect to National Bank Act preemption of state consumer protection laws that apply to lending instruments like cards and mortgages. It guts the jurisdiction of the FTC by taking away the jurisdiction that the FTC currently has for non-bank providers of financial services and gives it to the new regulatory agency. The regulatory blueprint laid out by the Treasury doesn't actually explain how it is that the new principle of consumer protection is supposed to work in connection with safety and soundness concerns. And what it seems to hearken to is a return to the era of consumer protection via rule making that characterized the FTC in the late sixties and early seventies when of course the FTC was identified as the second most powerful legislature in Washington, DC, and that created all kinds of problems -- both for industries that were subject to the FTC's jurisdiction, but also frankly put it at odds with the most powerful legislature in Washington, DC, which was Congress. So I think in thinking about what the rules of the game are going to be down the line

for all aspects of the credit business -- credit cards, mortgages -- we do need to get some prediction about 1) whether this new agency is going to be created and then 2) how it's supposed to interact with the existing laws.

And I think the CARD Act has some aspect of this, too, and it's reflected to some extent in the article that Lacey and I put together... and the quip that I made about the movie *Being There* earlier is -- in many ways I think that the legislative response that we see in the CARD Act can be traced back to the financial crisis that erupted on the scene for many people last September and that dramatically affected the trajectory, the Presidential race, and the election in November and that we've all been sort of dealing with the consequences of. But I think a problem with all of the legislation that we've seen -- both in active and proposed -- is that it's a sentence first, trial after. I mean we've decided that these regulations and the CARD Act and the proposed Financial Product Safety Commission are a response to whatever problem it was that created the situation that erupted in the national consciousness in September and I think that there is at least some reason to wonder whether that is in fact true and it might be nice to understand in a rigorous way what actually precipitated those problems and to know whether the kind of intervention that you see in the CARD Act and that you see proposed in the CFPA is actually the kind of thing that would ward off the kinds of problems that we've experienced. I'm not saying that it's impossible to make that case, I'm just saying that no one's attempted to make it so far as I'm aware.

**Ron Mann:** It's pretty much impossible to make that case, I'll say that. I think it's fairly clear that the villain of the story is not that the credit card underwriters did such a terrible job of

underwriting their loans that, like the economy, went in disarray. I mean the mortgage underwriters are very primitive in their tools compared to the credit card underwriters. They are the people that are to blame. I don't think anybody takes seriously the idea that credit card lending was the cause of the financial problems. It was clearly the mortgage industry, but I'm not sure that Congress' interest in passing this relates so much to the crisis as it does to -- I mean it's like the perfect moment for consumer protective regulation. It's the first time in a generation that we have a Democratic President and Democratic control of Congress. This is the chance to do something like this and I think that's why there is a chance to have it done now.

**David Evans:** I wonder if it might be possible just to switch gears and talk a little bit on a practical side of what the CARD Act means for consumers. Victoria maybe if I could start with you, does the CARD Act encourage issuers to curtail the supply of credit significantly? Are we going to see a curtailment in the availability of credit or is it just going to be a change in the kind of consumers that get credit. Or is it going to be something else altogether?

**Victoria Strayer:** It's probably going to be a little bit of everything above. Right, so how these are impacting each issuer varies based upon the makeup of the portfolio. I don't think it is the intention of the CARD Act to decrease credit; however some of these unintended consequences that we will learn about as we get into the actual implementation of this Act, some of those things will come to play. It's difficult, you know, the CARD Act is the poster child for everything right now. But as we've all been talking, it's not just about the CARD Act, it's about the economic indicators, it's about the behavior of the consumers and the population of consumers

changing, the increased use of debit cards. There's so much that's playing into why issuers are making decisions.

Now is CARD certainly playing a heavy impact into that and into perhaps the very most short term? Perhaps. As we look at how this plays out longer term, issuers are having to tighten up their risk assessments, not just because of CARD, but for lots of other reasons. So our thought is probably it's a short term, but we have to kind of wait and see. But you can just go check your mail, see how many solicitations that we're all getting as opposed to what we were getting six months ago. It's certainly dramatically different, I think, for most folks.

**David Evans:** There are two different things going on right? I mean there's a curtailment of credit availability now as a result of the financial crisis. So that's been going on, but then in addition we have whatever effect the CARD Act is going to have.

**Victoria Strayer:** Right, and the offset of that expense that is being introduced -- so we have the risk factors and we have the expense factors and the issuer has to determine, how am I going to balance all of this out.

**Tom Brown:** David, I think we can make some reasonably good predictions about impacts on certain segments of the consumer population. I think from everything that Victoria and Ron and Oren have said, if you're young and you don't have much credit history you can expect that it's going to be much harder for you and much more expensive for you to obtain credit. And I think that that is -- that was a very much intended consequence of the Act. I don't think we can identify that as an unintended consequence; I think that the Act is deliberately targeted to make it more difficult for young consumers to obtain credit. I think that the argument is that

people between the ages of 18 and 21, although they can vote and do many other things, can't be trusted to take on revolving credit loans.

**David Evans:** I guess my impression, Oren, was that some of the concerns that led to the passage of the CARD Act, and sort of the undercurrent, what was really a general concern was that consumers overall were taking on too much credit. Not just younger people, but that consumers were just being enticed to take on more credit than we like them to be doing. Is that right?

**Oren Bar-Gill:** I think it is right. There is a general sense that at least before the crisis hit that we've been borrowing too much and savings rates at the macro level have gone down, gone negative actually, and this was a concern in the background of all of this. Now again I think it's very difficult to say more credit, less credit, is good or bad. These are individual decisions that have to be made by individuals based on their circumstances. There are many very good reasons to take on debt, to use credit, and this has been recognized by the President in his statements, etc. I think that the real concern is not about credit or debt, in itself, it's about -- and this goes back to the ex-ante problem I mentioned in the beginning -- is people taking on credit without fully understanding the long term cost of credit and this I think is the core of the problem.

Now I'm not sure to what extent the CARD Act actually targets or addresses this problem -- in some sense it might. So if we're saying when people take on a credit card they don't really fully understand the likelihood that something's going to happen which will increase their interest rate or increase the fees that they pay, and now the CARD Act as well,

now we're putting restrictions on how rates and fees can go up. In some sense this is helping or reducing the implications or the cost for those people who underestimate long term cost, but I think it's important to view the main problem -- to understand that the main problem is not credit. It is the problem that we believe, or some people believe, that borrowers are taking on credit without fully understanding the long-term costs.

**Victoria Strayer:** And I think that is certainly one component addressed in CARD as it relates to the revolvers and kind of the transparency, the cost of repayment, right? So now we're saying that on the statement there needs to be something that says: here's what you would need to do to repay this amount that you owe within a 36 month period of time. To try to put some reality around this "I'm out there spending money." You know, providing some of the toll free phone numbers and debt management assistants. I don't know consumer behavior; we'll see if that really helps to have that so accessible. But trying to put that repayment time into better terms hopefully will help the consumers to be more educated about those buying decisions.

**Oren Bar-Gill:** And that's just another example of a disclosure requirement. Now you have to be a little more specific in the statements about what costs exactly have been incurred in the past few months, over the past year, how many fees you've paid, etc. So now people might have better information that will perhaps correct some of the optimism or the underestimation of future costs.

**Ron Mann:** Yes, I think on the flipside, that part of the reason the statute got passed is in fact that Congress didn't really believe it would curtail the supply of credit, because I think that Congress is -- particularly at this time of the economic cycle -- preoccupied with not doing

anything it believes would slow the supply of credit or slow consumption, because they want to get the economy going. And I think the difference between this statute and a lot of other things that have been proposed, is Congress didn't really believe at the core that taking away the so-called tricks and traps from credit card issuers would slow the supply of credit. They really didn't believe that when the credit card issuers tried to say that, and that's why the statute was passed. I think if Congress really believed that this would substantially slow the supply of credit to people who want to buy things, they would not have passed the statute. I think in general they didn't really believe that at a macro level it was going to affect credit supply, or I think Congress couldn't have been persuaded to pass it.

**Victoria Strayer:** Right, I think that's a strong indication that they really don't understand -- and you know, how would they without a good deal of education -- the complexities around this payments business. So we've got some responsibility to try to help with that, but that also says OK at the point and time where we do see what the kind of downstream implications and impacts have been from CARD, will there be something that comes up later to somewhat course correct some of these things? That will be interesting to watch.

**David Evans:** Tom here's a softball coming your way. You and Lacey recently wrote an article for *Lombard Street* at FinReg21.com where you talked a bit about the Obamas' use of credit cards. I thought this was very clever; you went back to President Obama's two autobiographies. Did you want to say a few words about how the CARD Act would've affected our first card users?

**Tom Brown:** I think -- and we used it as a rhetorical device in the piece, David, as you know -- I mean I think had the CARD Act been in place over the period of time in which President Obama

was making his way from Hawaii to Columbia to the south side of Chicago to Harvard back to Chicago and ultimately to the White House, one of the images that I have in mind -- and as you know I'm a big fan of the President -- is -- and I was at the University of Chicago Law School when he was a professor there -- and I have in my mind this image of him toiling away in his office on his autobiography, which was obviously critical to his political career. And working a long day, going home, and wanting to take Mrs. Obama out to a nice dinner and then needing some device to pay for it and trying to trade on what he expected would be their future household income and finding it harder to obtain because he didn't come from the kind of background that would've put him in a position to have a good credit report.

I mean I think people in the position that the Obamas were in, in the eighties and nineties, over the course of the next decade will find it harder to obtain credit than we have experienced the last several decades. And I agree with Professor Mann -- Congress apparently didn't think that that was the case or they wouldn't have been persuaded to enact the statute. But I also agree then with the point that Victoria made, which is, as somebody who has some experience with the card industry, I find it hard to understand how you could not understand that that would be the effect of this particular legislation, and then I have a hard time understanding how we can think that denying people access to credit can make them consistently better off. This is an issue that Oren and I have talked about and sort of exchanged views on in a series of articles going back five years, ironically to the University of Chicago. But this is a case that I find hard to make and I think ultimately it will put all of us in a worse position.

**Oren Bar-Gill:** I agree with Tom and Victoria, that it's very hard to predict what's going to happen, but I think that one of the things that people -- including in Congress -- thought might happen is that if you restrict the ability to price on the back end by increasing rates and fees, this will result in increased pricing on the front end, say higher interest rates to begin with, or perhaps annual fees. So the cost of credit need not go up, it's just a shifting of cost from the back end to the front end. But one implication of this shift is that the cost of credit becomes more salient to consumers. Now the result of this may well be that we're going to see less borrowing because the cost of credit is going to be more salient. It's not clear if this is a bad thing, again only to the extent that the reduced level of borrowing is the artifact only of now people understanding better what the cost of borrowing really is.

**Ron Mann:** Yes, but I think that you have to really distinguish between two sets of changes. That's true for things like double cycle billings, and patterns of receiving payments, people mail their bill three days before their due date and get charged a late fee, and all those kinds of things. I think that's one group of things you can say, yeah, consumers if they understood how much it was costing them, maybe they would think twice before they borrowed. I think that's very different to the response to changing the ability to use information technology to assess the riskiness of customers because that's necessarily causing people to price risk less accurately than they currently do and I think there's a lot to be said for the idea that it makes the pricing less efficient. And so the total cost -- the total -- the ability to price things more accurately has been taken away and that's very different. That's not doing anything except saying we would like you to do this in a less efficient way because we can't stomach the consequences of the

more efficient way.

**Oren Bar-Gill:** I understand, and I agree with Ron on this, by the way. And I definitely agree that there's going to be a cost when risk-based pricing is limited in the way the CARD Act limits it. Now the only point I was trying to make, and this goes, I think, beyond the double cycle billing and various questions about how you post payments, etc. This, I think, applies also to increases in the interest rates midstream. Now there are efficiencies to that, clearly, and I agree with Ron on that point, but I think it's also pretty clear that many consumers, when they take on the credit -- the credit cards -- they don't fully understand the implications of risk-based pricing in terms of their long term costs. So when we limit this, there is a countervailing benefit. I'm not saying that it will outweigh the inefficiencies of limiting risk-based pricing for those of us who perfectly understand the probabilities that this will affect us.

**David Evans:** Do you think there's a learning effect there?

**Ron Mann:** You have to remember, the segment where risk-based pricing is most important is where you have people that have \$10,000 and \$20,000 credit limits. The segment where the fees are most relevant is like Capital One, I mean the late charge is relevant for Capital One that has a \$500 credit limit and then they rely on getting three late charges a year. The risk-based pricing isn't that important to Capital One because they can't make it out of those people on interest rates. The interest rate pricing is really primarily important for customers that you know have \$10,000 and \$20,000, and \$30,000 and \$40,000 and \$50,000 that they're carrying on their credit cards -- like the John McCains of the world. I mean those are the people that we're protecting with that, it's the people that are high income, people that are borrowing lots

of money, and that's primarily the people that that particular provision effects, and that's a little hard for me to swallow as an important benefit.

**Victoria Strayer:** Yes, we're certainly talking about varying aspects of the consumer.

**Oren Bar-Gill:** I think that's absolutely right, but just in response to Ron's point about sophisticated consumers, I agree that people with high incomes generally will be less susceptible to the types of mistakes, underestimations, biases, etc. But there's a recent paper coming out in the American Economic Review, by Stango & Zinman, and they have a sample of credit card users that are rather sophisticated, you know, the type of card users that Ron is talking about. And they show that 60% -- that in this sample the median borrower could save 60% of the costs of credit cards and banking, they're just making mistakes. So I'm not saying that people are making less mistakes in that segment is true, but we have evidence that they still are making mistakes.

**Ron Mann:** But my argument is that those people understand that interest rates go up and down. I'm not sure that rich people are any more likely, they're probably less likely, to make sure they mail the payments on time than poor people, because they may care less about the \$35. But I think people that carry \$20,000 on their credit card are the kinds of people that understand that the interest rate can just change at any time, or from time to time, for any reason or for no reason and that's not a surprise to them.

**Oren Bar-Gill:** That's absolutely right, but they do not necessarily understand the probability that that will happen to them.

**Tom Brown:** But Oren I think we still have to identify if we have a population of people, even if

we assume that there are some people in the population who aren't good at it, we have to concede that there are at least some who are good at it.

**Oren Bar-Gill:** Absolutely.

**Tom Brown:** Why are we making it more difficult to identify those people based on how they reveal themselves, so that we effectively create a cross subsidy across the two populations.

Now I'm not even sure that the two populations exist, but the elimination of the ability to price based on that distinction is, I think, hard to understand, and is the piece of the bill that seems most likely to be most damaging to the availability of credit to the American consumer.

**David Evans:** We're going to have to close this off very soon. I'd like to conclude with just one question and I'd like to get short answers from each of you. And I think this is relevant as the CFPA goes through Congress over the next few months. Rightly or wrongly the card industry, it seems to me, got a lot of influential people very unhappy with it, and I think I tend to agree with Ron that it wasn't entirely the financial crisis. Does the evolution of this legislation provide any lessons to the card industry? And why don't we start with you Oren.

**Oren Bar-Gill:** I think there is a question of public relations that Tom mentioned at the beginning. It's sometimes hard and difficult to explain to Congress and to the public the advantages of risk-based pricing in a way that would hold us back. But I think that the main lesson is that when you start seeing too many kind of sob stories in the papers about the ex-post effect, in terms of a smart business model, this is not a good thing to have for the industry. And there are certain practices that perhaps issuers need to trade the profitability of those practices against the risk of a public outcry resulting from it.

**Tom Brown:** I think the lesson for the industry is that it needs to explain the value that it delivers to the American consumer. I think that every industry does things that under the harsh glare of the lights of Congress are going to look bad, but I think that fundamentally the financial services industry and the people who are in the business of extending credit need to help again make the case that they made very, very, very effectively at the beginning of the 20th century that making credit available to consumers makes all of us better off.

**Ron Mann:** I think the credit card industry overreached. You know, two to three too many really cute contractual provisions that were just not necessary, not worth the money they generated, and too outrageous in the light of the day, and if they hadn't overreached so much, none of this would've ever happened to them.

**Victoria Strayer:** I will say our opportunity to educate, educating Congress, the consumers, the press, how we're telling our story -- and it's not about whether we agree or we disagree, it's about how we as an industry are managing our risk, how we're dealing with implementation time frames, or the evolution. It's about being aware of perception, real, perceived, and perhaps self adjusting when that would be in the better interest.

**David Evans:** Oren, Tom, Victoria, Ron, I really appreciate all the time you've spent today. I've learned a lot from listening to all of you. This has been tremendous, so thanks again.

TRANSCRIPT ENDS.

The full recorded webcast can be viewed on FinReg21 at: <http://www.finreg21.com/channel-21/interviews/cards-and-consequences-what-card-act-means-banks-and-consumers>

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