Consumers Union

Publisher of Consumer Reports

Testimony of

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Legislative Counsel

Consumers Union

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

House Financial Services Committee

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Chairman Bachus, Congresswoman Waters, members of the Committee, I appreciate the opportunity to testify today on behalf of Consumers Union[1].

We commend the members of this committee and your staffs for continuing the work of Congress during this time. We appreciate all that you do for America. All of us have many friends who work in these buildings. We care deeply about your safety and our thoughts continue to be with you.

Consumers Union, along with many other consumer organizations, has long been concerned about the practices of credit card companies and we are grateful for your scheduling of this hearing. We strongly support legislation introduced by Congressman LaFalce and others to help the American public by addressing many of the concerns we will be discussing today. We concur with the testimony offered by the U.S. Public Research Group and also support the legislation cited in their remarks.

Credit card companies continue to trick and trap unsuspecting consumers, despite complaints by consumers and state Attorneys General, actions brought by the Federal Trade Commission and the Comptroller of the Currency at the Treasury Department, regulations passed by the Federal Reserve Board, and record-setting fines for deceptive behavior.

Now, more than ever, consumers need the help of Congress. Americans answered mightily when called upon to help in the aftermath of the tragic events of September 11. Hundreds of millions of dollars have been donated to the relief effort. Schoolchildren collected their pennies. American consumers are being asked to bolster the economy by getting on with life, by spending, by going out to movies and restaurants.

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[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 4.5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

And while Americans are answering that call, various industry groups have lined up in Congress for taxpayer bailouts. We saw it from the airlines. We are seeing it from the insurance industry and lenders. There may be some legitimate need to look at some of those proposals that are in direct response to the September 11 events or possible future acts of terrorism. The House of Representatives has already passed an economic stimulus package that is designed to help businesses through tax cuts and other forms of fiscal relief.

But what is Congress doing to help the American family? There are ways Congress can put money directly back into consumers' pockets. And it wouldn't cost Congress, the federal government, or other taxpayers a dime. Congress wouldn't have dip into the surplus. It wouldn't require Congress to pass another tax break. Simply make credit card companies pass along the Federal Reserve Board's cut in interest rates to their customers. Help consumers out by dealing with the unfair setting of fees and punitive penalty rates charged by credit card companies. Take away the means by which the credit card industry engages in deceptive practices.

We are not implying that the credit card industry shouldn't make a profit. But businesses should profit because they are offering consumers a good product, because they are competing in the marketplace, and because they are better than the other guy. Congress should not allow credit card companies to profit because they have figured out how to cheat consumers.

Credit card companies have become increasingly dependent on fee income to bolster their profits. From 1995 to 1999, fee income increased by 158%. In 2000, fee income represented 25% of credit card companies' total income. Credit card companies are making their profits through late fees and penalty interest rates.

As a result, many credit card issuers have now pushed late payment fees as high as $35 and punitive rates to 24.99 percent. Companies charging that much include Fleet and Citibank. Credit card companies have no incentive to bring down their fees, cut rates, or lower the penalty charges.

In fact, since January 3, the Federal Reserve Board has cut the federal funds rate by four points in an effort to stimulate the economy. Mortgage interest rates have dropped. Interest rates for auto loans appear to have been lowered. Not so with the credit card industry – where rates have been either slow to fall to only a fraction of the Fed's cuts or not fallen at all.[2]

[2] Some credit card issuers announced that they would waive late fees for cardholders affected by the September 11 events, according to CardTrack. Some companies, like Direct Merchants Credit Card Bank, announced it would waive fees for customers in directly affected areas that have payment due dates from September 11 to October 11. Bank One/First USA said they would sort through payments and determine who gets the fee waiver and who does not. Consumers should not face penalties for late payments caused by acts of terrorism.

Consumers with variable rate cards are hitting pre-set floors and therefore their interest rate no longer follows the Fed's rates to lower levels. Bankrate.com estimates that 25 percent of variable rate cards have floors. Many other consumers have fixed rate cards and will likely not benefit from the lowering of rates at all. It is estimated that about 45 percent of all bank credit cards carry fixed interest rates, which are unlikely to be cut.

Credit card rates have fallen by less than half the drop in general interest rates since January – meaning that many lenders are pocketing part or all of the difference as windfall profits. CardWeb, a research firm, estimates that the windfall for credit card companies amounts to at least $10 billion dollars. So while the Fed has made nine interest rate cuts this year to stimulate the economy, national credit card rates only dropped 1.59 percentage points below the December average interest rates. The bottom line is that the Fed's interest rate drops mean billions of dollars for credit card companies and little benefit for consumers trying to handle their credit card bills.

Some credit card companies play deceptive games with consumers who are merely trying to figure out how much the credit card will cost, what fees will be imposed, and what the penalties are. Credit card companies don't seem to want to tell consumers how much credit costs on their bill statements. Terms are buried in the fine print -- literally the fine print (at least until the Federal Reserve Board imposed a rule that increased the print size for a few key terms).

For example – how is a consumer supposed to act responsibly and make decisions when what a credit card company says isn't always what they mean? A spokesperson for Fleet explained how it works to *Consumer Reports* when she said that a fixed interest rate "doesn't mean it's fixed forever." In some cases, you don't even get all the fine print until you received the card. A case against Fleet concerned a "no annual fee" card that within months carried a $35 annual fee. Another case focused on a card promising a "fixed" annual percentage rate of 7.99 percent that soon rose to 10.5 percent. This is worse than Alice in Wonderland. At least there you had an idea that things were a little strange.

It is important to note that Fleet's changing the terms of the card didn't violate the Truth in Lending Act because the credit card agreement, like most, stated that the card companies could change the terms at any time. Finally, but perhaps coming as no real surprise, the Fleet customers who decided to cancel their cards found that the interest rate on the unpaid balance was a whopping 25 percent. That was in the cardholder agreement too.

Here's another example where consumers got duped. In May, the Office of the Comptroller of the Currency ordered Direct Merchants Credit Card Bank to pay restitution to 62,000 consumers. Direct Merchants was downsizing consumers by prominently marketing one package of credit card terms to consumers but then approving them for accounts with less favorable terms.

According to the OCC's consent decree, the solicitation package promised the consumer guaranteed approval with no processing fee. A disclosure made in the fine print on a separate insert stated that the consumer could be downsold to a card that required the consumer pay a $79 processing fee. If a consumer was downsold the consumer was told that he had been "upgraded" to a Titanium card and provided further information about the desirability of the Titanium card. The consumer would not be aware that he had to pay a processing fee until getting the periodic statement after the consumer had decided to accept the card.

Many lenders encourage minimum payments that do not pay down the loan. Currently, credit card statements, unlike mortgage loans and car loans, do not disclose the amortization rates or the total interest that will be paid if the cardholder makes only the minimum monthly payment. Using a typical minimum monthly payment rate on a credit card, it would take 34 years to pay off a $2,500 loan, and total payments would exceed 300 percent of the original principle. People don't understand how it works and the credit industry knows it. California recently passed a law that would require that credit card statement include how much a consumer actually owes in terms of principle and interest and how long it would take to pay off the debt if only the minimum payment was made.

Some in Congress and in the credit card industry say the answer lies in educating consumers. Even Chairman Greenspan says that financial education is important. And it is. But how much will financial literacy help consumers avoid these classic "bait and switch" scams?

If the practices of the credit card companies weren't enough for consumers to bear, the Federal Trade Commission estimates that consumer lose more than $40 billion a year to fraudulent telemarketers who make offers of worthless credit card protection services, guaranteed loans, and so-called protection from identity theft related to credit card use.

Usually, it is expected that a competitive marketplace would resolve some of these problems. The problem may be that the market is not competitive. The U.S. District Court in New York recently determined that practices of Visa and Mastercard are anticompetitive.

How does the lack of competition harm consumers? The court found that consumers may be denied the ability to choose from a variety of products that a financial institution could offer, may loose the benefit of increased innovation, and may not get the lower costs generally associated with a competitive marketplace.

Another way consumers may be impacted by the way the current credit card system operates is where merchants are forced to accept debit cards if they want to continue to accept credit cards. This requirement is the focus of a lawsuit filed by several major retailers. Those retailers say that the costs of taking the debit cards, which can be substantially higher than a card tied to a regional ATM network, get passed onto consumers.   This provides a strong indication of the power gatekeepers to payment systems can wield in the marketplace.

Is there competition simply because consumers' mailboxes are routinely stuffed with credit card offers? The fact is that the sheer volume of offers alone cannot compensate for a lack of meaningful choice among credit card products and services available through a consumer's primary bank.

Besides, the actual interest rate a consumer may end up paying may have little to do with competitive pricing.   The Federal Reserve Board reports that the pricing of interest rates is based on one of two factors, the cost of funds (typically tied directly to indexes that move with market rates), or borrower risk. Is the consumer really able to choose a card based on these pocketbook issues? And we’ve already seen how the rate isn’t necessarily dependent of the cost of funds.

If credit card interest rates depend almost entirely on the credit risk and credit worthiness of the borrower, then there is another issue that Congress must address – the accuracy of credit reports and credit scores. Freddie Mac and Fannie Mae have determined that many consumers are paying more for their loans because their credit score is inaccurate. Despite the harsh ramifications if a consumer’s credit score is inaccurate – higher fees, interest rates the inability to get a loan -- consumer advocates had to fight to get more details from the credit scoring companies about how that number is calculated. Until recently, a consumer couldn’t even see his or her score.

Another common problem consumers face is that credit card issuers can change the terms of the deal at any time. And they have, finding new ways to generate fee income by raising fees and changing other payment terms such as due dates and grace periods. Another example occurred after a number of successful lawsuits initiated by consumers who were victims of fraudulent behavior by some credit card companies resulted in stiff penalties. The response from the industry wasn’t a push to correct deceptive practices, but to amend their customer agreements and impose mandatory and binding arbitration thereby cutting off their customers’ ability to take them to court.

Other credit industry practices include low introductory rates that turn out to be temporary. Consumers getting hit with permanent penalty interest rate increases because of a single late payment, or a late payment to another unrelated creditor. Grace periods that are shortened. Being late now may mean the payment center didn't get the consumer's check by ten o'clock in the morning the day it was due. The trend does not seem to be towards consumers getting a better product, just to more ways credit card companies have found to charge consumers more fees.

Another issue is the way that credit card companies target America’s youth. According to bank regulatory agencies, including the Federal Reserve Board and the Federal Deposit Insurance Corporation, making loans without any regard for the borrower's ability to repay was "unsafe and unsound" and criticized such lending practices as "imprudent." Yet, credit card companies are on college campuses across the country signing up America's youth. Credit card companies often don't check if a student has the ability to repay and they typically don't require anyone to co-sign for the card. They used to, but don't anymore. Wouldn't it appear that the credit card companies' failure to check that a student has the ability to repay a loan is an unsafe and unsound practice?

The student loan corporation, Nellie Mae, said in a recent report that the increase in the number of students having a credit card includes students that would not have been given credit cards in past year, certainly not without a co-signer. The report also pointed to the need for counseling students at the front end -- before the student obtains a credit card. Nellie Mae found that:

- Some students unwittingly accumulate credit card debt, not consciously planning ahead whether they can afford to borrow that sum, and not aware of the actual finance charges they will pay over time.
- Having a card doesn't necessarily indicate knowledge about the ramifications of borrowing in general; nor does it show that the student has evaluated the benefit and costs of borrowing with a credit card vs. other types of financing.
- Without assistance, these students may not have the know-how to borrow wisely on the front end.

Many students end up dropping out of school under the weight of such debt. It is outrageous that the credit card companies' attitude has been that it is the student's fault, implying that the card companies themselves share no blame in what is a becoming a growing crisis on college campuses.

We cannot discuss issues related to the credit card industry without raising their collective effort to pass an onerous and lopsided bankruptcy bill. Consumers Union, as well as groups representing women and children, lower income consumers, labor, the victims of crimes, and the civil rights community, are concerned about the impact the credit card companies' version of bankruptcy reform will have on hardworking Americans.

Despite recent reports that there may be an attempt to conference on this bill, it would seem that with all that has happened the appropriate response would be – not now.

Congress could help all Americans avoid getting into trouble in the first place. Even before September 11 many Americans were facing job loss or downsizing, medical expenses they cannot afford to pay, and mounting bills. According the Federal Reserve Board studies new borrowers who are often riskier and more profitable for the credit industry as they get charged higher rates. But they often owe substantially more relative to their income, so even small drops in income can cause financial distress. These borrowers are more likely to work in relatively unskilled jobs. Delinquencies are higher among such workers, the report found, because their income is more closely tied to the business cycle. Thus, a mild economic slowdown can trigger a rise in bad debt.

We may not be able to predict with certainty which borrowers will be able to make it, but imposing high fees and punitive penalty interest rates, tricking and trapping consumers into paying more for credit cards, and not passing on interest rate cuts, does not help. It seems disingenuous for creditors to complain about the high number of bankruptcies when their behavior may push even more families over the edge.

Consumers Union and other consumer and privacy advocates remain concerned about the ability of financial institutions, including credit card companies, to share sensitive financial information about their customers. The shortcomings of the privacy provisions of the Gramm Leach Bliley Act have been widely discussed. Many privacy notices sent out to customers are virtually unreadable. Many consumers likely gave up and tossed the notices out or didn't understand how to respond. In reality, the law didn't give consumers much of a choice anyway. Even if a consumer opted out, the financial institution could share that customer's data anyway. Privacy and security concerns about consumers' personal financial information will remain until Congress acts. Identity theft continues to grow according to recent estimates by the Federal Trade Commission. Oftentimes the fraud occurs when the criminal obtains a credit card in someone else's name.

Unfair business practices that have gone unchecked for so long amount to an unfair tax on consumers. With the rise in credit card profits and mounting evidence of deceptive practices and improper fees that unfairly take money out of people's pockets, Americans deserve their own bail-in package.

You could save every consumer perhaps thousands of dollars by addressing even a few of the practices of the credit card industry. That's real money for American consumers and a welcome stimulus to the economy.

We appreciate the Committee's willingness to hold hearings on this issue