WebMemo

Published by The Heritage Foundation

No. 2435
May 12, 2009

Senate Credit Card Bill Would Restrict Credit for Those Who Need It Most

David C. John

This week, the Senate is considering its version of legislation designed to best change certain abusive credit card practices without damaging the ability of moderate- to lower-income consumers to get essential credit.

Certain credit card companies deserve no defense for their abusive practices; however, there is a limit to what Congress should do as opposed to having the Federal Reserve and other regulators handle the issue. While detailed legislation on credit card practices may make legislators feel that they have resolved a tricky issue, the wrong approach is far more likely to make the situation for low- and moderate-income workers in need of credit even worse than it is now.

Unfortunately, even the latest version of the Senate language contains bad policy and unrealistic requirements and would end up hurting the very people it is designed to help by denying them credit opportunities.

Regulatory Reforms Already in Process. The best approach to the problem of abusive credit card practices has already borne results. On December 18, 2008, the Federal Reserve Board, Office of Thrift Supervision, and National Credit Union Administration released regulations that will ban most if not all of the abusive practices that certain credit card companies use. They were the result of four years of work that included extensive comments, consumer testing, and other work to ensure that the rules did affect the very practices that the Senate believes it is addressing.

What is equally important is that the regulations are realistic and can be implemented on schedule. While it is usually wise to be very cautious about a regulatory approach, this is one instance where years of study have produced a satisfactory result on an emotionally charged issue. These regulations will greatly increase consumer protections, change the internal practices of issuers, and alter pricing. Violating the rules will carry a penalty that could reach $1 million a day.

Among the many changes imposed by the new regulations are:

- Comprehensive changes to credit card statements to ensure that consumers both have and can understand the terms of their cards, what their balance is and how much they need to pay each month, the consequences of late payment, and information about how long it will take the consumer to pay off the balance if he or she just pays the minimum each month. The regulations are very specific on the layout of the new statement, the language used, and the information provided.
- New consumer protections that include limitations on up-front fees, a longer period between the time that statements are mailed and the time

This paper, in its entirety, can be found at:
www.heritage.org/Research/Regulation/wm2435.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

that payments are due, and a 45-day notice period before higher rates can come into force.

- Bans on increasing interest rates on both current balances and certain future balances, paying off low-interest-rate credit first, and double-cycle billing.

As with all such changes, these regulations will have an effect on the availability of credit to some customers with less than perfect credit histories. While credit cards will be cheaper for many customers, others will find it harder to get them. This is likely to force some customers to other types of lenders and deny credit entirely to others. However, the effect of these regulations is likely to be less drastic than that of the proposed Senate legislation.

Pitfalls of the Senate Legislation. While the latest version of the Senate credit card bill is a major improvement over the version that passed the Senate Banking Committee by a one-vote margin, it is still significantly flawed. Although the detailed requirements of how credit card rates should be set, under what circumstances they can be changed, and even how fast payments should be credited seem to superficially solve a host of problems, the language will raise many others.

For instance, the bill would require that consumers must agree in advance before a credit card company can approve transactions that go over an individual's credit limit (and thus incur a stiff fee). This provision may sound good, but it is likely to have the effect of reducing an individual's credit limit. As the individual approaches his or her credit limit, the credit card company is likely to refuse to approve new transactions until it is certain that there are none in the pipeline that could push the customer over the limit. This is only one of many detailed requirements that sound better in theory than they will be in practice.

Other provisions limit the ability to increase interest rates even in instances where a consumer's financial situation has changed or where the consumer has made a late payment. While these provisions sound fair to legislators, the net result is likely to be accounts that are closed at the slightest sign of trouble.

In addition, both the Senate legislation and its House counterpart bear their own risks. The simple fact is that in situations like these, regulations are easier and faster to adapt to cover new abuses that may develop over time. Given that in any business it is likely that someone will seek additional profits by circumventing the rules, an alert regulator is likely to notice and deal with the situation long before legislation could be amended to catch it.

Is There a "Debt Trap"? In addition to addressing specific practices, developers of the Senate bill appear to believe that reducing the impact of high-interest lenders cannot be anything but beneficial for their customers. Unfortunately, economic literature on the effect that high-interest lenders have on their customers is spotty, with many studies as interested in proving a point as in objective research. Activists take it for granted that there is a "debt trap," where customers of high-interest lenders find themselves deeper and deeper in debt to the lender as interest rates and fees combine to make it impossible for them to repay their loans. Such a trap may well exist in both specific cases and in general.

However, there is research from the New York Federal Reserve Bank[1] that suggests that the debt trap may not exist in all situations, and in fact some consumers may be better off with the presence of high-interest lenders than they are without them. This paper looks at Georgia and North Carolina after payday lenders were banned. It found higher incidences of bounced checks, complaints about the collection methods of lenders, and bankruptcy filings after the ban than before it. This suggests that high-interest lenders meet a definite need, and it raises questions whether a too-stringent approach to credit card practices may end up causing more problems than it solves.

Effects on Borrowers. The first question is: Who would be the affected borrowers? While it is clear from many data sources that individuals from any and all socio-economic levels can be customers of

1. Donald P. Morgan and Michael R. Strain, "Payday Holiday: How Households Fare after Payday Credit Bans," Federal Reserve Bank of New York Staff Report No. 309, November 2007 (revised February 2008), at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1032621* (May 12, 2009).

The Heritage Foundation
LEADERSHIP FOR AMERICA

high-interest credit card issuers due to either sudden income shocks or poor financial management skills, the largest proportion of customers fall into three groups:

1. Low- to moderate-income workers who have limited access to other credit sources either because of low income, poor credit histories, or the simple fact that few banks and other lenders have branches that are easily accessible to these consumers;
2. First-time borrowers who may have high potential to become good credit consumers but for now have no credit history and no one willing to co-sign their loan applications; and
3. Consumers who have poor credit histories or who may have just emerged from bankruptcy and are seeking to rebuild their credit records.

Credit cards and similar products are primarily priced by the risk of the customer. Thus, customers with either poor credit histories or none at all can expect to pay significantly higher interest rates than those with better credit records. However, these high rates are usually temporary. As new borrowers demonstrate their ability to responsibly handle credit, they qualify for lower and lower interest rates, often by switching lenders. The same is true for borrowers with poor credit records who are seeking to restore their reputations.

While it may seem that legislation would encourage lenders to reduce their interest rates to these borrowers, this is unlikely to happen. For responsible lenders who base their interest rates and fees on the risk that the borrower will either not repay the loan or that it will require extensive contact with him or her to get payments—a very costly process—the added burden imposed by this legislation will simply result in their withdrawing from the market and focusing on more creditworthy customers.

Certain other reputable lenders will continue to offer products to these borrowers and may even lower their fees, but they will increase the requirements to qualify in a way that will reduce the number of potential customers. The combination of higher credit standards and fewer credit providers will either leave high-risk borrowers with no credit available or force them into the hands of less reputable lenders.

As it becomes harder for moderate- to lower-income customers to get credit cards, many of these consumers are likely to be forced into the arms of less reputable lenders who charge ever higher rates for products such as payday loans, car title loans, and other similar products. Their customers will not find any relief from the passage of this Senate credit card bill. Instead, less reputable lenders will be delighted if the result of this legislation is a rise in the number of consumers forced to use their services.

Ineffective and Counterproductive. While well intentioned, the Senate credit card bill is likely to either make it harder for certain people to find credit cards at all or make it even more expensive for them to do so. Although the explicit language of most of the legislation's provisions appears to address specific problems, sponsors fail to realize that the legislation will hurt the very people who need credit the most.

—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation. This paper was adapted from his testimony before the House Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, on April 2, 2009.