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Beyond the Credit CARD Act: Features of a Safer Credit Card

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Introduction and Summary

Credit cards have long been a source of confusion for consumers and a tool of manipulation for many card issuers. The Credit Card Accountability, Responsibility and Disclosure Act of 2009 (Credit CARD Act) created long needed protections for cardholders. But the Act did not eliminate all dangerous aspects of credit cards or every unfair or abusive practice. Credit cards remain a risky product, especially for less affluent consumers.

Consumers should have access to a safe credit card—one with no surprises, reasonable terms, and features that won't trap cardholders with unaffordable debt. As credit card issuers refine their products and develop new ones, as organizations consider what credit cards should carry their brand, and as policymakers and advocates consider how credit cards should still be improved for vulnerable consumers, here is an updated set of goals:

1. A single, reasonable interest rate for all balances with no penalty rate increases.
2. Few and modest fees that cover relevant costs but are not hidden profit centers.
3. Hard credit limits that cannot be exceeded.
4. Stable, convenient payments that more quickly reduce debt.
5. Simple grace period and payment rules.
6. Lending based on ability to repay.
7. No dangerous deferred interest plans.
8. No co-signer surprises.
9. Agreements that change only with mutual consent.
10. Simple, clear terms that meet expectations.
11. Compliance with the law and access to justice.

These goals, described in detail below, build upon the protections that the Credit CARD Act has achieved and address the improvements that remain. Some of these recommendations are appropriate for every card. Some could be features of a safer card for more vulnerable consumers.

1. *A Single, Reasonable Interest Rate For All Balances With No Penalty Rate Increases*

Much of the anger that drove credit card reform stemmed from precipitous and arbitrary interest rate increases. Credit cards were nearly the only type of loan for which the lender could dramatically increase the interest rate, after the loan was taken out, for any reason at any time.

The Credit CARD Act of 2009 fixed part of this problem. For the most part, card issuers can no longer impose a retroactive interest rate increase on the balance that a cardholder has already incurred unless the consumer is at least 60 days late with a payment. Issuers cannot change rates for the first year of a card and must give 45 days notice of rate increases for future transactions.

But card issuers retain significant room to change rates for new purchases and to charge different rates for different balances, resulting in confusion and unfairness. For example, credit card issuers can still:

- Increase rates for new transactions for any reason in any amount.
- Use bait and switch tactics to lure consumers in with lower rates and hike up rates as soon as legally permitted.
- Charge different rates, buried in fine print, for cash advances.
- Impose large interest rate increases on the consumers least able to afford them: those who are 60 days late and are struggling with their finances. Consumers cannot avoid these increases even if they agree to close the account.
- Charge unaffordable rates up to 34% or higher.

Improvements needed*:* A safe credit card should have:

- A *single interest rate* for all types of balances.
- *No penalty rates*. Issuers should not make it more difficult for a struggling consumer to pay nor should they encourage a vulnerable consumer to take on more credit or exploit their vulnerability by charging unaffordable rates.
- *A reasonable rate*, well below the 29% to 34% range of penalty rates. The 18% rate that applies to federal credit unions is a good model. An 18% rate is already quite high considering the rate of inflation in past decades.
- *A clear rate,* either fixed or tied to a stable, neutral inflationary index, such as the Wall Street Journal prime rate plus 10%.

With a single rate that does not change precipitously, credit cards will be less risky for consumers and will avoid unfairness, bait and switch tactics, and confusion over different rates for different types of balances.

2. *Few and Modest Fees That Cover Relevant Costs But Are Not Hidden Profit Centers.*

For years, credit card issuers offered deceptively moderate interest rates while designing their cards so that consumers would incur a multitude of fees that significantly increased the cost of the card. Some of these fees even gave issuers an incentive to trick consumers into violating the card agreement or to seek out customers likely to run into trouble and to trigger fees.

The Credit CARD Act, and the regulations issued under it, took important steps to rein in the junk fees that plagued credit cards:

- Issuers may no longer charge over-limit fees when the issuer approves a transaction over the credit limit, unless the consumer has asked to have such transactions approved.

- Late fees will normally not exceed $25 or the amount of the late payment, whichever is less, for the first late payment and $35 if the consumer is late again in the next six months. Similar limitations apply to other penalty fees.
- Consumers must have 21 days to pay from the date the statement is mailed.
- Due dates must be extended to the next business day if the issuer does not accept mail on a Sunday or holiday.
- Inactivity fees and declined transaction fees are banned.
- Non-penalty fees during the first year for subprime “fee harvester cards” cannot exceed 25% of the credit limit.

But credit card issuers continue to find ways to increase their fee revenue. Even when fees are disclosed, they obscure the true interest rate that the consumer is paying, are hard to anticipate or quantify, and make it more difficult to comparison shop. Fee practices that remain problematic for consumers include:

- Hair trigger late fees, including fees charged when an electronic payment is delayed because it is not processed on a weekend or holiday.
- Non-penalty fees that are rising and have no constraints, such as cash advance fees of 7% of the advance.
- Application fees of $95 on some subprime cards, on top of other large fees, designed to evade the rule capping first year fees at 25% of the credit limit. Fees are also unlimited in subsequent years.
- Late fees that exceed the past due amount if the consumer makes a partial payment, such as a $25 late fee if the consumer is accidentally short by $1.
- High $35 late fees if the consumer is late even one day a second time in six months, and possibly higher than that if the issuer attempts to justify a higher amount.

Improvements needed: The price of – and profit center for – a safe credit card should be contained solely in the interest rate and a single annual fee. Those two items together should inform the consumer of the cost of the card and enable comparison shopping. Any fees beyond the annual fee should be tied closely to the cost of the relevant service and should not be used as a vehicle for padding profits or deceptive pricing.

- *No penalty fees beyond modest late fees.* A safe credit card will not have any penalty fees beyond a modest late fee, capped at the lesser of the past due amount or $20. Late fees should serve as an incentive for timely payments but not as a profit center (creating incentives for tricks and traps) or as a further impediment for struggling consumers or those with irregular income.
- *Courtesy period.* Late fees should be triggered only after a 3-day courtesy period. At a minimum, consumers should not incur late fees if the due date falls on a Sunday or holiday and payment is received the next day.

- *Fees beyond the annual fee limited to costs.* Other fees should be eliminated or limited to amounts to cover the cost of services beyond ordinary use of the card. Cash advance fees would be limited to the lost interchange fee not received on a cash transaction. A fee for expedited replacement of a lost card would cover the cost of express mail. Fees like foreign transaction fees, which have no basis in actual costs, should be eliminated.

3. *Hard Credit Limits That Cannot Be Exceeded*

For years, credit card companies gouged consumers by setting purported credit limits but then routinely approving transactions over those limits and imposing $34 or higher over-the-limit fees. The Credit CARD Act prohibited over-the-limit fees unless the consumer opts in to having those transactions approved. But problems with credit limits remain:

- Issuers do not seek the consumer's approval or opt-in before approving over-the-limit transactions that, to the consumer's surprise, must be paid in full on the next statement to avoid late fees.
- Consumers are induced to incur higher levels of debt as the issuer can raise or ignore the credit limit at will.
- Over-the-limit fees may return if issuers find deceptive ways to induce consumers to opt in to over-the-limit coverage.

Improvements needed:

- *Hard credit limits as a general rule.* A safe credit card should come with a "hard" credit limit that cannot be exceeded except for a de minimis amount (without any fee). A hard limit helps to control spending and debt and avoids surprise hikes in minimum payments.
- *No over-the-limit consequences if the limit is soft*. Higher income, credit worthy consumers can handle a soft credit limit that allows the issuer to approve transactions over the limit. But when it does so, the credit limit should float up, with no requirement to pay off the excess that month or other adverse consequences. Only the highest income consumers should, on an opt-in basis, be given cards that lack pre-set spending limits but do limit the balance that can be carried month to month.
- *Affirmative consent, by all co-signers, for credit limit increases*. Credit limits should not be raised unless the consumer and all co-signers affirmatively consent and the consumer can afford to pay the high limit (see below).

4. *Stable, Convenient Payments That More Quickly Reduce Debt*

One of the most seductively dangerous aspects of credit cards is their long repayment period. It can take a consumer 20 years or longer to pay off credit card debt if the minimum payment is made each month. Regular payments do little to chip away at the debt. Most of the payments go to cover interest, so that in the end the consumer will have paid vastly more in interest than the original debt.

The Credit CARD Act now requires credit card statements to tell consumers how long it will take to pay off a debt with only the minimum payments as well as the amount needed to pay the debt in only three years. But the lowest minimum payment will always be seductive to a cash-strapped consumer, just as the ability to make interest-only mortgage payments lured homeowners into saving a few dollars in the short term with serious long term consequences.

The Credit CARD Act includes measures that prevent issuers from demanding payment in full or making precipitous increases in the minimum payment. But the protections are not air tight and leave room for issuer manipulation, especially if a higher minimum payment or full payment is demanded independent of a rate increase.

The Credit CARD Act also prohibits changes in the payment due date. But that date might still fall at a bad time for the consumer, such as a few days before pay day.

Improvements needed:

- *5 year repayment schedule.* A safe credit card should have minimum payments that result in the debt being repaid in no more than five years. That is the period that banking regulators have long used for credit card workout programs. Consumers should also be offered the choice of cards with shorter repayment periods, such as one or three years.
- *No changes in minimum payment rules.* A safe credit card will have a repayment formula that does not change for old balances so that consumers can plan their budget without worrying about sudden increases.
- *Self-select due date*. Consumers should also be able to select their payment date.

5. *Simple Grace Period and Payment Rules*

Most consumers understand that if you pay your credit card balance in full each month, you do not owe any interest. The Credit Card Act stopped certain confusing practices that deprived consumers of grace periods. Issuers can no longer charge consumers interest on the portion of a balance that they pay within a grace period, and they cannot take away a grace period by reaching back to charge interest from a prior billing period ("double cycle billing").

But some new practices by credit card issuers, and some old ones, can still deprive consumers of their grace periods or subject them to unexpected interest charges when they pay in full. For example:

- Consumers who take out cash advances on their credit cards, or use their cards for other cash-like transactions, may be surprised to learn that those advances accrue interest immediately, with no grace period.

- Some department store credit cards now begin charging interest on the day of the purchase, with no grace period, but have a complicated method for refunding the interest if the balance is paid in full.
- Some card issuers are exploring ways to trick consumers into losing their grace period, and incurring interest from the date of purchase, even if they paid their previous bill in full. For example, the consumer could unexpectedly lose the grace period if she takes out a cash advance.
- If a consumer who has been carrying a balance then pays it in full, most credit cards will surprise the consumer with "trailing interest" on the next statement (covering the time between the statement date and the payment date) after the consumer thinks the slate is wiped clean. In some cases, new interest charges will continue for months even after repeated attempts to pay the balance in full.

Improvements needed: A safe credit card will have simple, consistent grace periods and rules for when interest accrues that do not lead to unexpected interest charges.

- *No differing grace periods.* A safe credit card will have the same grace period rules for all types of transactions.
- *No complicated rules for obtaining or losing grace periods.* Grace periods should not be granted or eliminated unexpectedly – either you have one or you do not.
- *No trailing interest the next month.* Once the consumer pays the balance in full, there should be no further interest charges the next month.

6. *Lending Based On Ability to Repay*

Millions of Americans are in deep financial trouble due to ballooning credit card debt. Though many undoubtedly took on more than they should have, credit card issuers bear a large portion of the fault for their reckless lending. Issuers besieged consumers with offers of credit cards, often targeting those who had recently emerged from bankruptcy or had blemished credit, and mailed millions of bait-and-switch "preapproved" offers. Credit cards were granted, and credit limits increased, with little regard for the consumer's ability to handle the debt.

The Credit CARD Act now requires credit card issuers, before approving a card or increasing a credit limit, to consider a consumer's ability to make minimum payments based on the consumer's income, assets, and obligations and their debt-to-income ratio. The Act does not impose any particular formula for gauging affordability and requires minimal efforts to corroborate the information provided by the consumer. It remains unclear how closely credit card issuers will stick to the spirit of the Act's prohibition on reckless lending. But early signs are that, with the banking crisis and recession over even though Americans are still reeling, credit card issuers are once again flooding the mail and internet with credit card offers.

Improvements needed*:* A safe credit card will not burden the consumer with debt even if the full credit limit is used.

- *Consider income, assets and obligations.* Applications should require information about the consumer's income, assets, and other obligations. Issuers should establish clear rules on the debt-to-income or debt-to-assets ratio, or amount of free income after expenses, that a consumer must have to qualify for a card. No credit should be granted if the consumer cannot handle additional obligations.
- *Verify.* For higher limit cards, some documentation of income should be required, just as it would be for a bank signature loan. Though verification will impede instantaneous credit decisions, consumers should not take on significant debts lightly, and those who need or seek credit instantly may by their very nature warrant heightened validation of ability to repay.

7. *No Dangerous Deferred Interest Plans*

Consumers are often lured into opening up new credit cards by the promise of no interest for a period of time. Deferred interest offers can contain hidden tricks that can subject the consumer to sudden, large retroactive interest charges if the consumer fails to repay the entire amount by the end of the deferral period. Indeed, issuers count on consumers' failure to meet the stringent terms of a deferred interest offer in order to profit off of an otherwise free loan.

The Credit CARD Act contains only minimal protections against the risks of deferred interest plans. Interest that accrues silently and can be imposed retroactively cannot be described as "0% APR." Credit card statements also must contain warnings about the need to pay the balance in full by the deadline to avoid interest charges, and payments in the final two months must be allocated to that balance. In addition, bank regulators now insist that the consumer make regular minimum payments during the deferred interest period, but not enough to pay off the balance during that period. Nonetheless, if payments on a $5,000 purchase are only $100 or one day short of full repayment by the due date, the consumer can still be hit with an immediate retroactive interest charge on the entire $5,000.

***Improvements needed*:**

- *No deferred interest plans.* A safe credit card will not offer deferred interest that can be retroactively imposed. Interest should never be deferred and later revived. Deferred interest plans are much more dangerous than teaser rates, which can expire or be lost but do not revive dormant interest from previous months.

8. *No Co-Signer Surprises*

The Credit CARD Act requires consumers who are under 21 to have a co-signer who has the ability to make payments if the young consumer does not have independent income. But co-signers may not realize that they can be on the hook for the card indefinitely. Even twenty years later, after a parent has long forgotten about co-signing the card, the credit card issuer may come after the parent, or hurt the parent's credit report, if the son or daughter is delinquent. Moreover, though the Credit CARD Act requires co-signers to approve any credit limit increases until the cardholder is over 21, after that time the credit limit can be increased without co-signers' knowledge, increasing their potential liability.

Improvements needed:

- *Co-signer only until age 21.* A co-signer of a card issued to a consumer under 21 should remain responsible for the card only until the cardholder turns 21, or only for credit extended before that date. If the credit card issuer is unwilling to keep the account open after that point without a co-signer, then the co-signer should be required to reaffirm responsibility.
- *Co-signer approval of credit limit increases*. Co-signers should always be required to approve a credit limit increase regardless of the age of the primary cardholder.

9. *Agreements that Change Only with Mutual Consent*

Even consumers who do their homework and carefully compare different cards cannot protect themselves, because credit card issuers reserve the right to change terms with little notice. The Credit CARD Act imposes some limits on when and whether changes can be made, discussed above. Consumers also have the right, if they act promptly, to reject changes to fees, interest rate increases (unless the consumer is 60 days late) or other significant terms, and can repay the balance under the old terms (with limited minimum payment increases) if, as is likely, the issuer closes the account.

But credit card issuers retain the ability to change the terms for new transactions at almost any time and almost any reason. Change in terms notices tend to come buried in fine print and are often not noticed by consumers. Merely continuing to use the card is deemed to be acceptance of the new terms, which goes against the traditional contract law principle that mutual agreement is needed to form a contract.

Improvements needed:

- *Changes no more frequently than once a year.* The terms of a credit card agreement should be set for a fixed period, such as one to three years. Only de minimis changes that do not affect the consumer's costs or use of the card should be permitted during that period.
- *More conspicuous notice of new terms.* After the terms expire, if the credit card issuer wishes to make changes, a safe credit card will give the consumer a clear and conspicuous summary of the terms, highlighting the changes, in a manner designed to ensure that the consumer will notice the terms and be able to use them for comparison shopping. For example, the phone number needed to activate a new card could be placed on the same page as a short, clear summary of the new terms and the changes.

- *Affirmative consent for changes.* If the terms have changed in any significant way, the consumer should be required to give affirmative consent before the card can be continued. Mere use of the card is not sufficient. Requiring conspicuous notice and active consent will encourage consumers to consider other options and will restrain issuers from slipping in arbitrary changes. The consumer's consent could be timed to coincide with activation of new cards – an event that already requires consumers to take action – and with the imposition of the next annual fee (if any).

10. *Simple Terms That Meet Expectations*

The elements described above should go long way to simplify credit cards and make them a safer, more understandable product. But there is no end to the ingenuity of credit card issuers to come up with new schemes that confuse and confound consumers.

***Improvements needed*:**

- *Understandable terms explainable in one page.* A safe credit card should operate no differently than a consumer would expect based on a clear, simple one-page disclosure. The terms must be simple enough and disclosed clearly enough that they are likely to be noticed and understood by the vast majority of cardholders.
- *No material terms that differ from expectations.* Credit card agreements should not have any terms that materially affect the costs of the card, or the consumer's ability to use it or to comply with the cardholder agreement, unless those terms meet consumers' normal expectations.
- *Better APR disclosures.* Consumers shop for credit cards based on the price tag: the APR (annual percentage rate). But the usefulness of the APR for comparison purposes has declined as some issuers undermine it by using hidden fees to pad their profits, making their APRs deceptively low and giving them an advantage over more honest issuers. Credit card solicitations should be required to provide a typical APR that reflects the full cost that the average consumer will pay for the card including all fees.

11. *Compliance with the Law and Access to Justice*

Credit card issuers have gotten away with so much for so long in large part because they built into the fine print of their agreements a requirement that consumers relinquish their right to access the court system if the agreement is unfair or otherwise violates the law. Instead, consumers have been pushed into a system of forced arbitration that is secretive, lawless, and biased. Though recent legal settlements have pushed many credit card companies into temporarily stopping arbitrations for a few years, they will undoubtedly return to that system once the limelight is gone.

Many credit card agreements also prohibit consumers from coming together to file class actions when the amount of their individual claims is not large enough to find an attorney. Class action bans are an effective means of preventing consumers from challenging and remedying practices that affect tens of thousands of people.

Improvements needed:

- *No forced arbitration or class action ban.* A simple credit card agreement should not include a forced arbitration clause or a ban on class actions.
- *No venue or other provisions limiting access to justice.* No provision should limit the consumer's access to justice, such as a venue requirement that puts the lawsuit outside the consumer's home state.
- *Reciprocal attorneys' fees.* Any provisions giving the credit card issuer the right to attorneys' fees in a collection lawsuit must be reciprocal.

Conclusion

The Credit CARD Act made important strides toward eliminating credit card tricks and traps, but a lot of room for improvement remains. Credit card rules should be tightened to make credit cards safer for everyone. Credit card issuers should also do more on their own to create products that help all consumers, but especially vulnerable ones, to manage their financial lives without becoming caught in a debt trap.