REFORM OF CONSUMER CREDIT PROTECTION: AN EXAMINATION OF THE CREDIT CARD ACCOUNTABILITY RESPONSIBILITY AND DISCLOSURE ACT OF 2009

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ABSTRACT

Signed into law by President Barack Obama on May 22, 2009, the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009 ushered in a new era of reform to the credit card industry. Essentially the first major overhaul of the credit industry since the Truth in Lending Act of 1968, the CARD Act implemented several reforms considered to be significant in nature. These reforms include limiting interest rate increases, enhancement of required disclosures, curbing marketing and credit approval for young consumers, modification of how payments must be applied to outstanding debt, and addressing fees and related penalties. This paper examines the history of credit and credit cards in the United States, the passage of the CARD Act and its major changes, unintended consequences that have resulted from the passage of the CARD Act, and future implications of this federal legislation to the credit card industry.

INTRODUCTION

Credit cards are an integral part of the financial system in the United States and have become firmly embedded in American culture. Almost 80 percent of all U.S. families have at least one credit card and 44 percent carry a balance on their credit cards. For many Americans, the use of credit cards creates a greater quality of life in addition to a level of convenience. The accumulation of credit card debt by Americans is definitely on the rise, as illustrated by the $18.4 billion in outstanding debt added in the second quarter alone in 2011. To provide perspective, this increase in outstanding credit card debt is 66 percent more than the same quarter of 2010 and a staggering 368 percent more than was added in the same time period from 2009. As of July, 2011, total outstanding debt in the U.S. stood at $792 billion (Ellis, 2011).

Generally speaking, credit card companies seek to generate revenue streams in two distinct ways. First, they collect processing fees from merchants that are set up to accept credit cards from consumers (Danford, 2009). The amounts of these merchant fees, also commonly referred to as interchange fees, vary from bank to bank, but are typically in the one to five percent range of charged sales (Evans, 2010). Second, credit card issuers charge cardholders interest and other related fees for using the card (Barron, 2010). It is this second source of income that has attracted the most controversy, which led to new federal legislation to address this issue: the Credit Card Accountability Responsibility and Disclosure Act of 2009.

The Credit Card Accountability Responsibility and Disclosure Act of 2009, commonly referred to as the CARD Act of 2009 or the Credit Cardholders Bill of Rights, was signed into law by President Barack Obama on May 22, 2009. This act is a comprehensive credit card legislation that's purpose is ". . .to establish fair and transparent practices relating to the extension of credit under an open end consumer credit, and for other purposes." (United States Government Printing Office, 2009, p.1). As with any new legislation, the CARD Act of 2009 was designed to remedy certain problems. Examining the CARD Act and whether it has been successful in improving the consumer credit card industry in the past year since its full implementation on August 22, 2010, is the purpose of this paper.

HISTORY OF CREDIT CARDS AND ELECTRONIC PROCESSING

The inventor of the first bank issued credit card was John Biggins of the Flatbush National Bank in Brooklyn, NY. In 1946, Biggins invented the "Charge-It" program, which was a partnership program between bank customers and several local merchants. Merchants would deposit sales slips of retail transactions into the bank and the bank would subsequently bill the customer who used the card (Gerson & Woolsey, 2011). Similarly, in 1950 Diners Club launched a card specifically in the New York City area for the charging of meals at exclusive restaurants (Hardekopf, 2010).

In 1958, the first revolving-debt credit card was issued in California by the Bank of America. Known as the BankAmericard and marketed across the entire state, it was the first credit card to offer its users payment options. Cardholders could either pay the debt in full or they could make monthly payments, essentially invoking credit for the unpaid balance for which the bank charged interest (Simon, 2007). In 1965, Bank of America envisioned a potential for increased income and they began issuing licensing agreements to banks of all sizes nationwide. These agreements allowed other financial institutions to issue BankAmericards and to interchange transactions through issuing banks (Gerson & Woolsey, 2011).

Competition for Bank of America occurred in 1967 as four California Banks formed the Western States Bancard Association and introducing the MasterCharge program that would directly compete with the existing and popular BankAmericard. By 1969, almost all charge cards directly issued by individual financial institutions had been cannibalized and converted to either BankAmericard or MasterCharge cards. In 1977, to reflect the global mission of their marketing strategies, Bank of America instituted name a name change of their popular card to Visa. Shortly thereafter, in 1979, Mastercharge's name was changed to MasterCard (Gerson & Woolsey, 2011). Today, Visa International and Mastercard remain the industry leaders in the issuance of credit cards.

CREDIT CARD REGULATION PRIOR TO PASSAGE OF CARD ACT OF 2009

Prior to the CARD Act of 2009, the Truth in Lending Act (TILA) was the primary federal law regulating the issuance of credit cards to consumers. Passed by Congress in 1968, TILA authorized the Federal Reserve Board to implement regulations, which became known as Regulation Z. Generally speaking, TILA requires credit card issuers to make certain disclosures so that consumers can make informed decisions based on terms and costs. However, as the use

of credit cards proliferated and consumer debt increased, it became apparent many cardholders did not understand the disclosed terms of their cards. Additionally, soon after the implementation of TILA card issuers began to engage in practices that increased the cost to consumers of using their card without their knowledge.

Pursuant to Regulation Z, the credit card issuer must disclose the annual percentage rate (simply known by the acronym APR) to the consumer. This required transparency of APR must have been disclosed in two places: the credit application and the contract itself. Historically, the APR on credit cards was a fixed amount, which would usually increase automatically to a higher rate in the case of default. However, nothing in Regulation Z expressly prohibited a variable interest rate and many cards subsequently gravitated to a floating rate which was usually based on some fixed amount above an index, usually referred to as "prime rate" (Rodriguez, 2009).

OVERVIEW OF CARD ACT OF 2009

As with almost any new federal regulation, the CARD Act of 2009 originated from a single bill proposal in one or both houses of Congress. In early January, similar bills emerged in the U.S. Senate (S. 235) and the U.S. House of Representatives (H.R. 627) that would lead to the CARD Act legislation. On May 12, 2009, the Senate Banking Committee merged the two bill proposals into a single bill (S. 414) that would be agreed to by both houses of Congress. President Barack Obama officially signed the CARD Act of 2009 into law on May 22, 2009 (Choo, 2009).

The implementation of the CARD Act occurred in two phases, with the first deadline occurring on February 22, 2010, approximately nine months after the bill was assigned into law. This date was agreed to in order to give financial institutions adequate preparation time to prepare and notify their customers of the changes under the CARD Act. Only certain provisions of the new legislation were implemented on this date, the most important being rules for new credit card accounts. The second, and final, phase of the CARD Act of 2009 was implemented on August 22, 2010. This final phase placed into effect all remaining provisions of the CARD Act and making these provisions mandatory going forward for all new and existing credit card accounts.

PRINCIPAL COMPONENTS OF CARD ACT OF 2009

The official document of the Credit Card Accountability Responsibility and Disclosure Act of 2009 totaled 33 pages and addressed reforms in five general sections or titles. These titles, in numerical order, are: (I) consumer protection, (II) consumer disclosures, (III) protection of young consumers, (IV) gift cards, and (V) miscellaneous provisions (United States Government Printing Office, 2009). While there are many provisions within each of the five sections of the CARD Act, eight of the most important components of this legislation are discussed in the following sections.

Notice of Interest Rate Increases

Under the Truth in Lending Act of 1968, credit card issuers were required to provide 15-days' notice to the consumer when an increase in interest rate occurs (Schorer, 2010). This policy is altered by the CARD Act, which requires a 45-day notice to implement any increase in APR.

This notice must contain a clause that outlines in a “clear and conspicuous manner” the cardholder’s right to cancel the holder’s account. Issuers are also prohibited from punitive responses to a cancellation by demanding immediate payment of the entire outstanding balance or charging fees for closing the account (Evans, 2010).

Also at issue among credit card companies’ more questionable practices were introductory or “teaser” interest rates. It was a common practice for credit card issuers to offer very low interest rates or even no interest as an enticement for consumers to open a new credit card or transfer existing balances from other cards. Shortly thereafter, these “teaser” rates were raised to a much higher interest rate. The CARD Act of 2009 prohibits card issuers from increasing interest rates in the first year after a credit card is opened. Additionally, low promotional rates must last at least six months before the issuer can increase them to the cardholder (Frank, 2011).

Abolishment of Double-Cycle Billing

Another controversial action reversed by the CARD Act of 2009 is double-cycle billing. Under double-cycle billing, a consumer who begins with no outstanding balance and pays off a majority of the purchases he or she makes in the first months will still be charged interest for the entire balance in the second month. The end result of the practice is that consumers ultimately pay interest on charges incurred, and paid off, in the interest-free period between the transaction date and the payment due date. In a 2007 report on credit card practices, the Government Accounting Office (GAO) determined that at least 40 percent of surveyed card issuers used double-cycle billing. GAO concluded in this report that the balance calculation methodology used in double-cycle billing “can substantially increase cardholder costs.” (Schorer, 2010).

Limitations on Universal Default Clauses

Historically, cardholder agreements have allowed card issuers almost unlimited flexibility to increase the annual percentage rate (APR) of interest charged to the card holder (Choo, 2010). Fairness would dictate that APR increases should occur when certain circumstances related to cardholder’s behavior, such as a history of late payments. However, many credit card agreements contained “universal default clauses.” Under a universal default clause, the issuer is allowed to increase the APR on charges under a card based on the holder’s default on any other debt (Schorer, 2010). For example, a credit card issuer could increase the APR on a credit card even if the consumer failed to make a car payment or a timely payment on a totally unrelated credit card from another issuer. Additionally, many card agreements contain “any time, any reason” clauses that allow the issuer to increase APR at any time entirely at the issuer’s discretion, without any legal recourse from the card holder. Prior to the CARD act of 2009, issuers only had to provide 15-days’ notice before implementing a rate increase (Frank, 2011).

Universal default and “any time, any reason” clauses have long been a point of contention for consumer advocates. The rationale was that, if the cardholder has performed under the cardholder agreement’s terms and conditions, it is unfair that the APR on new and existing purchases can be escalated based on unrelated actions. Even more egregious is the practice of raising interest rates on products and services that were purchased when the lower APR rate was in effect (Barron, 2010). Card issuers counter this argument by contending these clauses permit

adjustment of interest rates to account for risky cardholder behavior that can be a precursor to adequately service debt outstanding on a credit card. Card issuers also pointed out that these controversial clauses allow them to provide lower APR cards initially to the consumer as there is freedom to adjust rates on those customers not fulfilling the terms of the cardholder agreement (Frank, 2011).

Over the Limit Practices

Credit cards utilizing over the limit features have been a controversial policy. When credit cards contain an over the limit feature, a cardholder charge that places the total amount of outstanding credit above the limit is not automatically rejected. Instead, the card issuer agrees to approve the charge, albeit with a transaction charge for exceeding the limit (Schorer, 2010). Additionally, many credit card issuers will levy a fee for each individual purchase over the credit card's limit. Certain issuers have also gone as far as to impose additional charges each month that the account exceeds its limit, even for single purchases, until the excess purchase is repaid.

The CARD Act of 2009 limits this practice without implementing an outright ban. The issuer is required to set up its system to refuse credit charges that exceed the limit, effectively preventing the consumer from incurring an extra charge. If over-the-limit protection is desired, the credit card issuer must explain the features and the consumer must affirmatively request this capacity. Additionally, credit card customers who request over-the-limit protection can only be charged a fee once per billing cycle, even if there were multiple charges during the cycle that pushes the outstanding balance over the credit limit. Finally, the holder may only be charged for going over the limit for three consecutive cycles, even if the charge taking the holder over the limit remains outstanding for more than three cycles.

Payment Applications to Outstanding Debt

Prior to the passage of the CARD Act of 2009, card issuers were allowed to charge different interest rates for purchases, cash advances, and balance transfers. These practices frequently left the average cardholder with multiple interest rates on the same credit card. Credit card companies usually allocated payments to the outstanding debt associated with the lowest interest rate, forcing cardholders to pay off lower interest balances prior to applying payments to higher rates of interest. Obviously, the intent of prioritizing these payments to the lowest interest rates allowed balances on higher interest purchases to remain outstanding for longer periods of time, which accumulated more interest charges and extended the time it took to pay off the debt.
The CARD Act addresses this controversial practice by setting standards of how payments must be allocated. Credit card issuers are required to apply all amounts in excess of the minimum payment to the highest interest rate balances. This provision is more restrictive than the Final Rule, which provides card issuers the option of distributing the payment pro rata among the balances at various interest rates.

Enhanced Disclosure Rules

Another controversial practice used by credit cards is to provide disclosure documentation that is hard to comprehend, poorly organized, and unnecessarily detailed and long. Credit card

companies are required to provide information that assists cardholders to understand to understand the costs associated with their cards. While credit card disclosures fulfill the legal requirements, the spirit of the law is often undermined through the structure of the disclosures. In most cases, disclosure documents were very complicated, included more detail than necessary, and used complex terms when simpler ones would suffice (Choo, 2010).

The CARD Act requires contract terms associated with the credit card be written in a language that cardholders can easily understand to assist in avoiding unnecessary costs and fees. For example, the CARD Act requires that credit card issuers highlight fees cardholders may be charged along with the reason they may be charged those fees. Issuers must include a written statement, similar to the one suggested in the CARD Act: "Minimum Payment Warning: making only the minimum payment will increase the amount of interest you pay and the time it takes to repay your balance." Issuers must also provide a scenario that discloses a payment schedule a cardholder would have to follow to pay off the entire balance in three years. Finally, credit card issuers must provide a toll-free telephone number in a prominent location on the billing statement a cardholder can use to receive credit counseling and debt management services.

Protection of Young Consumers

In the past few years, young consumers (specifically those 21 years of age and under) have become a primary target in the marketing campaigns of credit card issuers. Although usually denied by issuers that their marketing campaigns specifically target these younger consumers, available data seems to indicate the otherwise. Between 1989 and 2004, the average credit card debt held by young adults age 18 to 24 increased by more than 22 percent. In 2006, more than three-quarters of undergraduate college students started the year with a credit card, but only 21 percent of college students paid off their entire outstanding balance each month (Schorer, 2010). Consumer advocates complained that young consumers, while lacking the financial resources needed to pay credit card charges, often are "seduced" into applying for credit cards by underwriting techniques that require less scrutiny than the standards used for older adults (Bannan, 2010).

The CARD Act of 2009 addressed the issue of unethically targeting younger adults for credit cards in three ways. First, it limits the underwriting process itself by prohibiting the issuance of credit cards to young consumers. However, two exceptions to this policy exist that allow credit cards to be issued to consumers in this younger age group:

- The consumer's parents or another co-signer over 21 agrees in writing to be liable for debts accumulated on the card; or
- The consumer demonstrates that he or she has the financial means of repaying any debts that arise from proposed extension of credit on the account (Rodriguez, 2010).

Second, marketing practices to college students were seriously curtailed by the CARD Act. Under the CARD Act, card issuers are now prohibited from offering "tangible items" as an inducement to prospective card applicants on or near the college campus or at any college-sponsored event. Examples of these "tangible items" include free clothing items such as t-shirts or hats, soft drinks, or gift cards (Bannan, 2010). Finally, the CARD Act of 2009 mandated additional disclosure, not only to the general public but also to the Federal Reserve Board,

regarding credit card marketing policies and underwriting practices. The bill's intent is that this additional disclosure to come from both the colleges and the issuers. It requires all colleges and universities to publicly disclose their contracts or "other agreements made with a card issuer or creditor for the purpose of marketing a credit card." These requirements include limiting the number of places on campus at which issuers can market their cards and to offer credit card debt education and counseling sessions as an integral component of their student orientation programs (Pry, 2010).

Additional Regulations for Gift Cards

The CARD Act regulation has also affected the gift card industry. For the 2010 U.S. holiday season, a total of $24.8 billion was spent on gift cards, with the average American spending almost $146 on gift cards (Knobbe, Cook, & Hanson, 2011). Retailers offering gift cards recently became saddled with compliance issues at the state level from more than 40 states that have consumer protection laws regulating the gift card industry. However, the CARD Act provides additional regulations at the federal level in addition to the regulations already in place from individual states (Fest, 2010).

Regulations from the CARD Act establish new minimum standards in several areas, including gift card disclosures, expiration dates, service fees, and dormancy charges. For example, these new regulations protect recipients of gift cards by requiring all gift cards to have a minimum life of five years. In addition, the practices of declining card balances over time are eliminated as are hidden fees for those cards not used within a reasonable period of time. These inactivity or "dormant" fees were often implemented by gift card issuers to encourage consumers to use the cards as quickly as possible. However, these fees were viewed as punitive and in many cases, unknowing to the consumer, these fees would exhaust all remaining balances of gift cards (Fest, 2010).

IMPACT OF CARD ACT OF 2009 ON CREDIT CARD ISSUERS

Credit card issuers' response to the CARD Act since 2010 assist in explaining their strategies to protect existing revenue streams and finding additional revenue sources. Many credit card issuers have sought to maintain company profit levels by raising interest rates. Specifically, many credit card companies decided to raise these interest rates on consumers just prior to the February 2010 implementation of certain aspects of the CARD Act. The logic behind the timing of these interest increases prior to February 2010 is that after this deadline, card issuers will have less flexibility in raising these rates. No longer are credit card companies allowed to automatically raise interest rates for consumers experiencing credit problems and the resulting lowered credit scores. These eleventh hour interest rate hikes were very controversial indeed, raising the ire of certain members of the U.S. Congress. Representative Betsy Markey, a co-sponsor of the CARD Act of 2009, asked credit card companies to avoid raising interest rates prior to this February 2010 deadline. She stated, ". . . the effective date of the original Credit CARD Act legislation was set for February 2010 to give credit card companies enough time to comply with these new regulations – not additional time to violate the spirit of the law by hiking interest rates on consumers." (Choo, 2010).

A second method credit card companies are using to maintain profit levels under the new regulations of the CARD Act is by charging additional penalties and adding annual fees to certain products. These additional fees will unilaterally affect those consumers with excellent and poor credit alike. To illustrate an example, certain financial institutions now charging a "dormant account" penalty if a consumer does not use the card for twelve months (Choo, 2010). In a similar manner, several issuers have begun imposing an additional fee for international payments; essentially any product purchased outside of the United States would increase the final cost to the consumer. Credit card companies are also scaling back their customer loyalty or rewards programs by setting a higher threshold to redeem reward points (Rodriguez, 2010).

Lastly, in order to protect revenues and maintain profitability, card issuers have started switching many accounts from fixed-rate to variable-rate interest cards. Under the CARD Act of 2009, account holders with a fixed interest must be provided a forty-five day written notice before rates can be increased. However, this rule does not apply to variable-rate accounts. The Bank of America and JP Morgan Chase, two of the largest U.S.-based credit issuing banks, have now started switching from fixed to variable rates (Schorer, 2010). According to researcher BankRate.com, approximately 75 percent of all cards used in 2010 were variable-rate interest cards, up from 65 percent in 2009 (Bankrate.com, 2011).

UNINTENDED OUTCOMES OF CARD ACT OF 2009

When the CARD act of 2009 was signed into law, it was championed as legislation designed to protect consumers against unfair and deceptive practices by credit card issuers. While this intent is largely fulfilled and this law provides many helpful consumer benefits, many finer points of the CARD act are complex and confusing. Many loopholes in this legislation create unintended outcomes.

One of the primary facets of the CARD Act that is often misunderstood is that an upper limit to interest rates for all credit card customers now exists. However, this is not true. The lowest credit card interest rates are still marketed to consumers with excellent credit scores while those with poor credit histories are still somewhat at the mercy of credit card companies. Maximum credit card interest rates are still set by individual states, setting the tone for credit card companies to legally charge what the market will bear as long as it does not exceed the maximum rate set by state statute.

The CARD Act requires banks to give 45 days' notice before a rate increase. However, that requirement is very misleading and is perhaps one of the least understood aspects of the new law. The 45-day requirement actually refers to the payment due date, not the specific date of the rate increase. To provide an illustration, if a credit card company does increase the interest rate, the customer will have 45 days before a payment on the new, increased rate. But the CARD Act technically empowers credit card issuers the right to begin charging the higher interest rate on purchases as soon as fourteen days after they have mailed the notice to the customer.

Another important provision of the CARD Act is that raising interest rates in the first year is absolutely prohibited after issuance of a new credit card. While new rules do exist under the Card Act, there are several important exceptions to this rule. Many consumers believe their

individual interest rates cannot be raised at all in the first year but this only applies to credit cards with fixed interest rates. Interest rates of credit cards that carry variable interest rates can be increased and the vast majority of credit cards are variable-rate cards. Under the CARD Act for variable-rate credit cards, banks can include language in the credit card agreement that allows them to instantly increase interest rates if they are tied to a publicly reported rate such as the prime rate. Additionally, a customer's rate can be increased if he or she is 60 days late on a payment (Rodriguez, 2010).

Because card issuers will seemingly have less flexibility in raising interest rates on defaulting credit card holders, banks will most likely reduce the amount of available credit for all borrowers, low and high-risk holders alike. One recent study found that future credit lines could be reduced by $931 billion, which computes to an average reduction of $2,029 per account (Schorer, 2010). Additionally, lending standards most likely will be tightened which could have an effect of putting credit card approval out of reach for as many as 45 million consumers. The inability of credit card issuers to correlate their prices with potential risk levels may have a significant impact for both the "risky and non-risky."

CONCLUSION

The Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009 provided the first major overhaul of policies within the credit card industry since the passage of TILA in 1968. The CARD Act's primary focus was to address problems in the credit card industry that originated from allegations into credit card impropriety from consumer advocates. Perceived anti-consumer practices by credit card issuers in an effort to maintain market share and company profitability finally caused a public outcry that led to this federal legislation being passed.

The cost to financial institutions of implementing policies and procedures regarding the CARD Act is unclear at this time. One aspect that is very clear is that the CARD Act will affect almost every aspect of the industry's business model, including the determination of how credit is allocated and how credit cards are priced. All credit card companies will face costs due to operational changes that must be made to computer software, billing statements, advertisements, and cardholder agreements. Unfortunately, many of these associated costs were not included in short or long-term budget projections for most companies and these additional funds must be raised from some source. Although some unintended outcomes have definitely occurred in the one year interim since full implementation of the CARD Act of 2009, the long-term benefits to the credit card consumer as a result of this federal legislation should outweigh these shortfalls.

REFERENCES

Available from author upon request.