



THE US CONSUMER CREDIT MARKET

TRENDS AND PERSPECTIVES

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Contents

	<u>Page</u>
<u>SECTION 1 - EXECUTIVE SUMMARY</u>	3
<u>SECTION 2 - BACKGROUND</u>	5
<u>SECTION 3 – RESEARCH OBJECTIVES & APPROACH</u>	6
<u>SECTION 4 – KEY FINDINGS</u>	7
<u>APPENDIX 1 – KEY SOURCES & REFERENCES</u>	27

Section 1 - Executive Summary

1. This document outlines the principal trends and developments in the non-mortgage consumer credit industry in the US.
2. In the last decade credit card debt has grown to become the main source of revolving unsecured debt in the US. Extensive competition in the credit card industry and the emergence of specialist monoline card issuers as well as new entrants have all fuelled the growth in marketing activity in the sector.
3. In recent years, pressure on card company profitability has led the cards industry to focus on pricing adjustments as well as innovative marketing practices. Many of these practices have met with opposition from Consumer groups who argue that they are not in the interests of the cardholder. Further regulation at national as well as at state level is a likely consequence.
4. Credit providers have also expressed concern as debt to income ratios have risen, economic activity has softened and as more risky sub-prime segments have been targeted.
5. The most significant developments have been:
 - a) A growth in risk-based pricing, leading to confusion or lack of specificity in APR quotations and the targeting of low income sub-prime segments such as students.
 - b) Extension of the practice of minimum APRs that benefit the issuer and penalize cardholders as prime rates fall.
 - c) Multiple APRs applying to a single card agreement.
 - d) A huge growth in the imposition of penalty fees and rates, not all of which are clearly advised to the cardholder.
 - e) The reduction in minimum repayment requirements, thereby extending the burden of debt for the cardholder.
 - f) The reduction or even elimination of grace periods.
 - g) Growth in other fees such as inactivity fees and currency conversion fees.
 - h) Aggressive and arguably manipulative marketing techniques to lure customers into high cost credit cards, insurance protection and buying clubs.
 - i) Claims by consumer groups that, by card issuers especially, key terms and conditions of the credit products are not adequately disclosed.

- j) A significant growth in payday and title loans that have been comparatively unregulated and have added to the debt burden of those least able to repay.

Section 2 - Background

The Consumer Credit Act (CCA) was introduced in 1974 and, in view of sundry developments in the credit market, is now subject to review. The review includes changes to the licensing regime, extortionate credit, over-indebtedness, changes to the CCA financial limit, online credit agreements, exempt agreements and amendments to early settlement regulations and advertising regulations.

As many aspects of the consumer credit industry in the UK follow trends in the US, it is considered important that any revision to the Act covers, as far as practical and possible, developments in the US that could well be exported to the UK in the next few years but which may require regulation under the Act. In the circumstances the Department of Trade and Industry (DTI) is undertaking a checkpoint analysis of the consumer credit trends in the US, so that, if possible and appropriate, some 'future-proofing' of the Act can be undertaken.

This report summarizes the findings of the research undertaken by Edgar, Dunn and Company (EDC).

Section 3 – Research Objectives & Approach

The purpose of the research is to identify and consider the main trends in the non-mortgage consumer credit industry in the US and the extent to which emerging creditor practices are, or may, impact adversely the consumer.

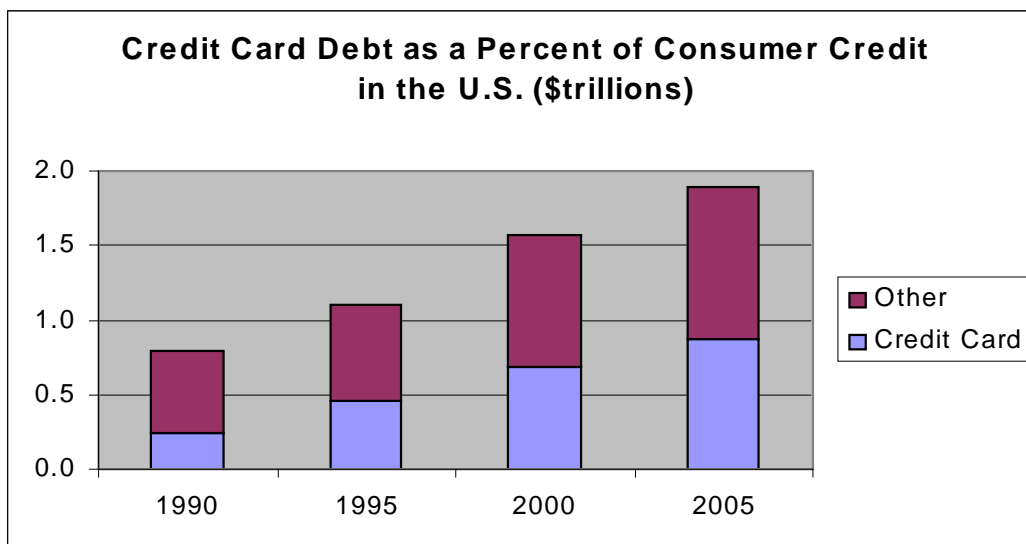
Most of the information obtained has been derived from secondary sources or EDC analyses. Details of principal sources are attached in the Appendix. The main areas covered by the research are:

- The promotion and marketing of credit facilities
- Developments in borrowing terms and conditions
- Issues as perceived by both consumer groups and lenders in the US market
- The impact of new channel usage
- Emerging credit product types and issues arising

Section 4 – Key Findings

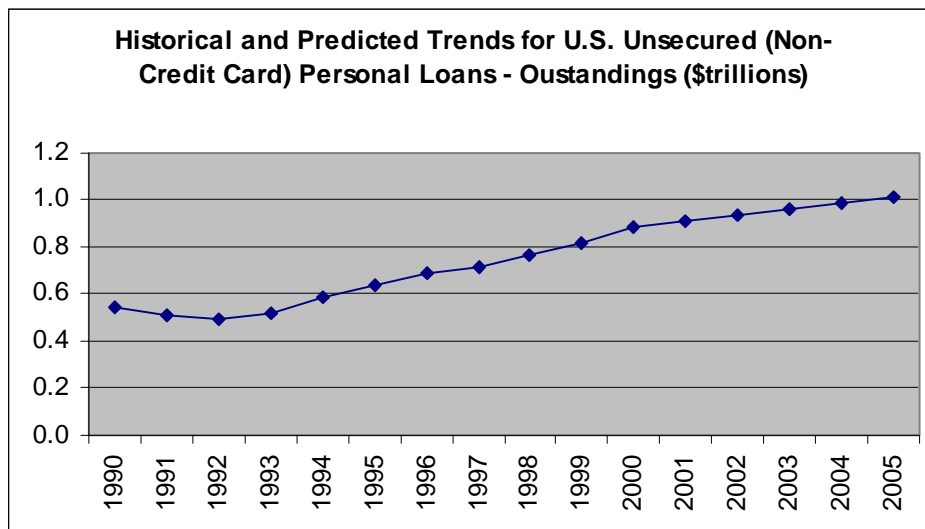
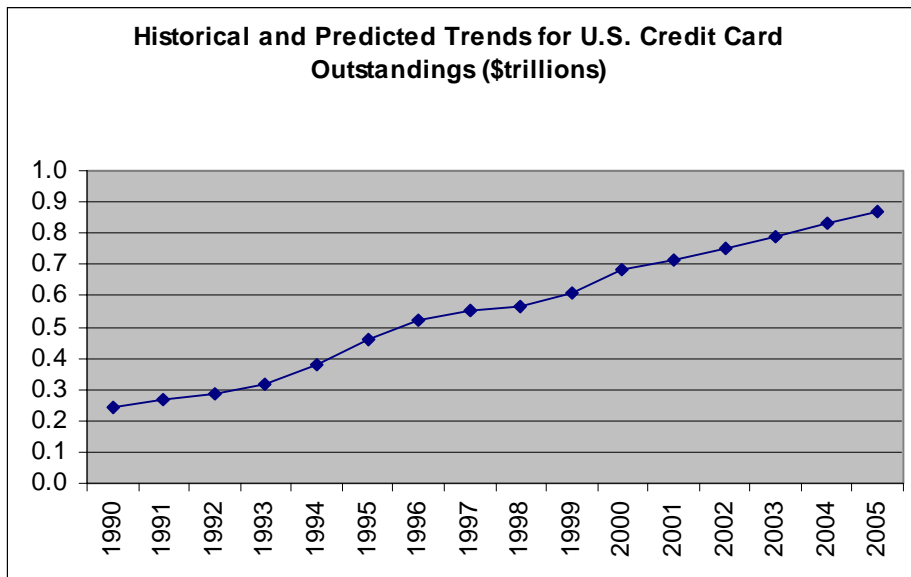
4.1 OVERVIEW OF UNSECURED CONSUMER CREDIT MARKET

Total consumer debt in the U.S. is about \$6.6 trillion, comprised of \$5 trillion in secured (includes mortgages) debt and \$1.56 trillion in unsecured (includes credit card and instalment loans) debt. As illustrated in the table below, credit card debt has become an increasingly larger portion of consumer credit in the U.S.



Credit card debt as a percent of consumer credit has jumped from 31% in 1990 to 44% year-end 2000. The Nilson Report estimates that credit card debt will represent 46% of consumer credit in 2005.

Approximately 75.8% of the U.S. nation's 209.4 million adults owned one or more credit cards in 2000 which totalled 1.44 billion cards. On average, each cardholder owned 9 cards. The total average debt per cardholder was \$4,302. The graphs below illustrate historical and predicted trends for U.S. credit card and unsecured (non credit card) personal loan outstandings.



Over the past few decades, there has been growth in the use of credit cards both as a means of payment and as a ready source of credit; recent estimates suggest that in 2000, consumers used about 1.4 billion credit cards (or roughly 9 cards per holder) to purchase nearly 1.5 trillion dollars in goods and services in more than 20 billion individual transactions.

According to the 1998 Survey of Consumer Finances, in 1998 the breakdown of consumer debt for all families was as follows: 43.1% of all families surveyed had home-secured debt; 43.7% had instalment loan debt; 2.3% had other lines of credit; 44.1% had credit card balances; 8.8% had other debt. Credit cards have become the primary source of unsecured open-end revolving credit in the US and they have replaced the instalment-purchase plans that were important to the sales volume at many retail stores 30 years ago.

Total (non-mortgage) consumer credit outstanding increased from \$119 billion at year-end 1968 to \$1.5 trillion at year end 2000. The revolving credit proportion grew from \$2 billion to approximately \$626 billion over the same time period.

Competition has led to shifts in market share among the US industry's largest credit card issuers. Most of the larger issuers have grown by acquisition of card portfolios or by mergers, but many of the more rapidly growing firms have attracted market share by offering comparatively low-rate cards and attractive balance transfer programs or through co-branding initiatives.

Recent trends in pricing practices in the credit card market have changed significantly. Interest-rate competition is playing a more substantial role now as opposed to the early 1990's when card issuers competed by waiving annual fees and providing credit card program enhancements. There has also been significant growth in risk-based and variable rate pricing. The decrease in the number of cards charging an annual fee has been offset by the increase in APR's and the introduction of new types of fees.

One consequence of the deregulation of interest rates, high credit card interest rates and high bank fees has been the rapid growth of the alternative financial services industry, which includes check cashing outlets, payday loan companies, rent-to-own stores, sub-prime auto lenders, traditional pawn shops and the growing business of auto title pawn companies. Auto title lending and payday lending, primarily catering for the sub-prime customer, are the fastest growing sectors in the fringe-bank financial services industry. Growth has been most prominent in those states that do not regulate or otherwise cap the fees these businesses are allowed to charge.

4.2 CREDIT PROVIDERS – KEY ISSUES

Main issues perceived by established lenders in the US market:

- Bankruptcies – card issuers fear that the recent surge in bankruptcies will get worse because consumers lack liquidity and their card debt is high
- Debt to income ratios have been rising-key drivers are credit card marketing, education costs and increased debt servicing costs
- Lenders are concerned that the soft economy will result in increased debt problems, with the consumer credit counselling system overwhelmed by volume
- Average credit card quality is low
- Risk management based lending may be being monitored with inadequate and insufficient data
- Problems for small businesses could lead to more personal bankruptcies

4.3 DEVELOPING CREDIT CARD PRACTICES

4.3.1 The Promotion and Marketing of Credit Card Facilities

Risk-Based or Tiered Pricing

The trend in risk-based pricing is growing rapidly and this has led to confusion or lack of specificity in the provision of information on APRs.

The latest Consumer Action (CA) survey has revealed an increase from 14% to 37% in issuers not advising applicants of the actual APR that will be operable before they apply for their card. Credit card companies are increasingly quoting a range of possible APRs instead of giving a firm and specific quote to an applicant. Once the company receives an application, they assess the applicant's credit history and score and then assign the APR- applicants with higher credit scores get the lower rates, while applicants with lower credit scores get higher rates. From the issuer perspective this enables terms and conditions to be more closely related to the predicted risk of the cardholder.

However, as applicants do not know in advance what APR will apply, it is argued that they are denied the right to compare offers in the marketplace before applying for a credit card. Also, if they decide to cancel the card when they receive the APR information, this will impact negatively on their credit rating which includes in the calculation the number of credit accounts that the applicant has ever had.

With the growth in internet marketing, in particular, the trend is towards only providing a firm APR quotation to direct-mailed, pre-approved applicants.

Fixed Rate Offers

Although variable rate products have become more prevalent, fixed rate offers are still common. However, the term fixed rate refers to a specific type of APR, not that the rate is actually fixed for all time. Credit card companies can raise fixed rates with only 15 days notice to cardholders. However, the marketing literature does not explain this technical meaning of 'fixed', which consumers believe means everlasting.

Bait and Switch

Credit card issuers are also accused of using more aggressive and manipulative marketing techniques to lure consumers into high cost credit cards. One technique is known as bait and switch where mail solicitations advertise high-grade cards (such as Gold or Platinum) which generally have lower APRs and lower fees. Consumers often apply for the high-grade card assuming that is the only card they are applying for. However, most credit card companies reserve the right to send the consumer a lower-grade card with higher APRs and fees.

One ‘deceptive’ practice addressed by the Office of the Comptroller of the Currency related to a solicitation package from Direct Merchants Credit Card Bank promising the applicant guaranteed approval with no processing fee. However, a disclosure made in a separate insert stated the consumer could be downsold to a card that required the payment of a \$79 processing fee. If the consumer was downsold he was told he had actually been upgraded to a ‘titanium’ card. Once he had accepted the card, he was not aware of the processing fee until the periodic statement was sent.

Disguised Credit Card Offers

Card issuers are also starting to disguise direct-mail credit card offers to look like everything from IRS forms to rebate checks. This technique is because companies realize that they have saturated consumers with direct mail offers, and that an increasing number are refusing to open the offers they receive.

Student Targeting

Card issuers are aggressively marketing their products to get more cards in circulation by targeting consumers with little or no income, such as college students. There are lower income-eligibility standards for students than for other potential customers; thus, 3 out of 4 college students have at least one credit card, according to a survey by student loan agency Nellie Mae. The average balance on cards carried by the typical undergraduate student totalled \$2,748, the study found. The practice of automatically obtaining a co-signature to the card has effectively disappeared.

A US Public Interest Research Group (PIRG) report has also expressed concerns about campus credit marketing. Nearly half (48%) of all students surveyed with one or more cards have paid a late fee. It is argued they are being led into a credit card trap, induced by free offers as a result of applying for a card. Nellie Mae has reported that credit card marketing to students has led to onerous debt and many students giving up their studies.

Sub-Prime Targeting

The increasing focus on the sub-prime account has been based on growth in use of risk profiling tools and applications. Some credit card companies now offer “secured” credit cards to consumers with bad credit ratings. The secured credit card is linked to the bank account held by the cardholder. The cardholder makes a deposit into their account, and the credit line of the card is equivalent to, or sometimes a little higher than the amount of the deposit.

Negative Option Marketing

Practices in this area of marketing have attracted increased attention from the Federal Trade Commission (FTC), the US government’s primary consumer protection agency. Specific developments have been:

- In October 2001, the FTC agreed damages against a group of buying clubs including Triad Discount Buying Service Inc. that had misled consumers into accepting trial buying club memberships and obtained consumers' credit card numbers without the consumers' knowledge or authorization from telemarketers. Consumers were then enrolled in the clubs and charged up to \$96 p.a. in membership fees. Other instances of buying club marketers were referenced in the case
- According to one lawsuit against American Savings Discount Club (ASDC), ASDC telemarketers would telephone consumers and tell them that, in exchange for an advance-fee of \$100, an enrolment fee of \$40 and first and last months' payments of \$30 each, consumers will receive a loan or other extension of credit. Some consumers who pay the advance fees receive materials describing a plan under which they qualify for rebates on various purchases and might qualify for a loan if they remain in good standing with ASDC after 90 days. In reality the fees only bought membership in the ASDC buying club
- Negative option marketing has also been common in the provision of website and Internet services, which have led to unwanted/unauthorized charges on credit card accounts

Telemarketing

The FTC has also identified and taken action on a growing number of deceptive practices relating to credit and credit card services. These include:

- The telemarketing by American Consumer Membership Services Inc. of pre-approved, guaranteed credit cards for a \$69 fee to consumers with credit problems. The consumers received vouchers, coupons and credit card application forms instead of the cards (applying for these credit cards required additional bank fees of as much as \$150)
- Telemarketing of credit card protection services where companies misadvise consumers that when credit cards are lost or stolen, they are at risk for unlimited charges
- Partnerships with telemarketers making deceptive pitches for over-priced credit life insurance, roadside assistance and other unnecessary card add-ons
- The Federal Trade Commission estimates that consumers 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

4.3.2 Developments in Borrowing Terms and Conditions Adversely Impacting the Consumer

Extension of the Practice of Minimum APR's

Extension of the practice of minimum APR's has generated increased interest revenues for card issuers at a time when prime rates have been falling.

Downward trends in the prime rate (now at its lowest level in almost 30 years) have not been universally reflected in the APRs of cards. In the CA 2002 survey, variable rate cards accounted for 67% of the cards surveyed and lower prime rates have resulted in APR reductions for the majority of them. However, almost 30% of the variable rate cards have not reflected the full drop in prime because of minimum APR terms (pre-set floors). The CA survey found that, of the top 10 US credit card issuers, only Capital One did not impose minimum APR pricing. At the same time about 45% of all bank credit cards carry fixed interest rates, which tend not to be cut as overall rates fall. As the Fed steadily cut interest rates over the last 12 months, so it is argued little benefit has been passed on to the consumer, whilst credit card issuers have enjoyed 'windfall' revenue.

Cash Advance APR's

Most cards now have a higher APR on cash advances, in addition to a fee for the advance. 85% of card issuers surveyed charge cash advance fees of 3-3.5% of the amount advanced, 24 issuers charge 2-2.5% and 13 charge 4%. 62% (60% in 2001) have higher interest rates for cash advances- cash advances begin accruing interest immediately and so does the higher interest rate (even cardholders who pay in full each month will get hit with interest). Cash advance APRs ranged from 12.95% to 26.49%. The average cash advance APR is 19.27%, compared to the 11.73% on average purchases. The APR for cash advances has often been buried in the fine print of a credit card agreement. Also, issuers have tended to use a different method to calculate interest on cash advances than for purchases and grace periods tend not to apply. Additionally, most card issuers apply minimum cash advance transaction fees.

APR Ranges

As competition intensifies, a wide range of APRs are being offered to consumers. According to the Consumer Action Credit Card Survey 2000-2001, the lowest rate card offered was 7.92% with a \$50 annual fee, while the highest rate was at 26.49%. However, it is not clear that consumers fully understand the terms and conditions of each offer and are caught out after they have accepted and use the card. For example, many card issuers introduce low introductory rates and then charge the non-introductory APR after receiving even one late payment.

Many issuers now offer initially lower "teaser" APRs to new cardholders ranging from zero-interest up to 9.99%-the average introductory rate on purchases was 3.63% and the average for balance transfers was 3.95%. Most offers stay in effect for 6 months, but some have one-year introductory rates.

Balance transfers are offered by about half of card issuers in the US, but as their popularity has grown, so have specific pricing aspects been introduced. The balance transfer APR is often different from the APR for purchases and is occasionally variable depending on the size of the transfer, interest may accrue immediately and there are usually transaction fees as well.

Multiple APRs may apply to a card agreement, increasing the complexity for the cardholder - e.g. a temporary introductory rate that applies to purchase and balance transfers, a fixed or variable rate that applies after the temporary introductory period, a separate rate for cash advances, and one or more 'penalty rates' that apply if the cardholder makes late payments.

On-Line Applicants

On-line card applicants are sometimes disadvantaged. Some banks charge a higher APR if a consumer applies online because they consider risk is greater. One bank in the CA Survey, for example, applies a variable APR of Prime + 6.9% to online applications, compared with an APR of Prime + 2.9% for standard written or phone applications.

Variable APR Adjustments

As the issuance of variable rate cards grows, so different terms have emerged with regard to APR adjustments. Most cards with variable APR's adjust monthly. However, at the extremes, there are examples of immediate adjustment and adjustment every six months. These adjustments can be disadvantageous to the cardholder, e.g. US Bank's World Perks card, which adjusts monthly when interest rates increase and quarterly when rates fall.

Penalty Fees and Rates

The principal reasons for raising an APR to a penalty or default rate are:

- The minimum payment is at least one day past due
- Any two consecutive payments are missed
- The account balance is over the limit
- Payment is not honoured by the cardholder's bank
- There is an adverse change in the cardholder's circumstances, e.g. job loss or divorce
- The cardholder is delinquent with another creditor
- Any two payments are late in any rolling 6 month period
- Any one payment is past due for two billing cycles

With the stated objective of enforcing timely payment, many credit card issuers are now imposing big penalties for missed payments or surpassed credit limits. Penalties include raising the APR or imposing late payment fees. However, consumer lobbyists suggest the real motive is to generate additional revenues and profits for the issuers. There is evidence that credit card issuers are becoming increasingly dependent on fee income to generate profits. By 2000, fee income accounted for 25% of card issuers' total income.

Late payment fees are now commonplace and have been rising sharply. This is because issuers have decreased the amount of time between when a bill is posted and payment is due and because most issuers have eliminated leniency periods before a late fee is assessed. Late fees range from \$10 to \$35 at many issuers according to the CA 2002 survey. The majority of issuers charge \$29 in late fees, but the average of all late fees is \$27.82 (a 7% jump from the 2000-2001 average late fee). 72% of the issuers surveyed said they would hit cardholders with a late fee if their payment was not received by the due date. The remaining issuers allow delays ranging from one to 10 days.

At least 74% (69% in 2001) of cards surveyed feature penalty rates for customers who make one or more late payments. Penalty rates ranged from 12% to 29.49%. Penalty interest rates are sometimes applied because of a late payment to an unrelated creditor. Card issuers are required by federal law to divulge penalty rates.

All card issuers charge over the limit fees when a cardholder exceeds a credit limit. These fees are typically over \$20, even if the limit has been breached by as little as \$1. On exceeding a limit, the card issuer will often also increase the APR for that customer.

Minimum Repayments

43% of surveyed cards require cardholders to pay only 2% of their outstanding balance each month as the minimum payment whilst a further 25% of cards require minimum payments of 2-2.5%. Whilst the industry standard was 4% for many years none of the cards covered in the survey now require 4% minimum monthly payments. This trend has undoubtedly resulted in longer periods of debt for many consumers and higher finance charges overall. The situation is exacerbated by the lack of information made available to the cardholder. Credit card statements, unlike mortgage and car loans, do not generally disclose the amortization rates or the total interest that will be paid if the cardholder makes only the minimum monthly payment. A recent law passed in California requires credit card statements to show how much a cardholder actually owes in terms of principal plus interest and how long it would take to pay off the debt if only the minimum payment was made.

Grace Periods

The grace period is the time after any new transactions are made during which interest does not accrue on these transactions. The due date of the minimum payment is generally the end of the grace period. Grace periods average between 20-25 days but now some are shorter and some card issuers offer no grace period at all. Grace periods are rapidly decreasing in length as credit card companies realize that shorter grace periods bring in

more profit. In addition, a grace period usually does not apply if a balance is carried from month to month.

Even if a grace period does apply, many banks now backdate interest charges. Once the grace period ends, the amount of interest assessed is calculated from the date of purchase rather than the posting date. So, if a consumer carries a balance of \$2000 from month to month on a card with a 15.04% APR, and interest charges are backdated an average of five days each month, the consumer will pay nearly \$50 per year in extra interest.

Currency Conversion Fees

There has been a growth in the number of issuers charging currency conversion fees on purchases made in other countries. MasterCard and Visa networks take a 1% commission for purchases or cash advances abroad but more issuers are now adding an additional conversion fee, so that the total fee for the consumer can now be as much as 4%. The conversion fee is not always transparent as the common practice has been to roll it into the exchange rate.

Inactivity Fees

A number of card issuers have introduced fees on cardholders who do not use their cards at all during a specified period, or where purchases are less than a certain dollar amount.

Application of Payments

Most credit card issuers have now introduced terms regarding application of payments that are geared to the consumer paying as much interest as possible. When the cardholder makes a payment of less than the full balance, it is now usual for the card issuer to apply the payment to the balance carrying the lowest APR-this invariably means that cash advance balances, which attract higher interest and for a longer period than purchase transactions, are repaid last.

Terms and Conditions Amendment

There is some evidence of changes in the terms and conditions of a card which, whilst not breaching the Truth in Lending Act, conflict with the spirit of the Act. This is because many credit card agreements state that the terms of the agreement can be changed at any time. If a cardholder, advised of a change, decides to cancel the card, the agreement sometimes allows the issuer to charge a penal interest rate on the unpaid balance. Other payment terms often changed are due dates and grace periods.

Many cardholder agreements have been amended to impose mandatory and binding arbitration in the event of dispute. These clauses are buried in the fine print of credit card agreements. The organization Trial Lawyers for Public Justice found that not one person of 136 interviewed knew their cards had mandatory arbitration clauses. Mandatory arbitration eliminates the possibility of class-action suits being filed against a credit card company.

One scenario which has led to an increase in a customer's APR is the corporate merger which de facto changes the cardholder agreement. When bank mergers take place, cardholders may find interest rates increasing.

4.3.3 Key Consumer Perspectives

In September 2000, the Federal Reserve published the results of several surveys on consumer attitudes to credit cards. There were a divergence of views but 91% of consumers with bank issued cards were generally satisfied with their card issuer. Nevertheless, complaints have steadily risen over the last few years. Complaint data analyses show that about 60% of the complaints relate to disputes about billing errors, penalty charges and other fees, disputes concerning the reporting of consumer's payment history and application rejections due to inaccurate credit reports.

Consumer groups and advocates continue to highlight a range of issues relating to the consumer credit sector, especially with regard to credit cards. The most prominent issues are:

- Credit card costs have been increasing steadily and have added to the debt load for the average consumer. A variety of practices designed to boost credit card company profitability are seen to be irresponsible
- Increasingly, card companies have quoted a range of APRs in offers rather than a specific APR, as a consequence of a risk-based pricing strategy. The result can be widespread confusion for the cardholder. There has also been a variety of APR formulae used when introductory rates have been applied. In most instances the APR has not applied to all of the services provided by the card; sometimes the APR applies only to balance transfers not to purchases; sometimes the APR applies only if a balance transfer is made
- Increased use of unfair penalty interest rates ranging as high as 30% APR for consumers who supposedly miss one payment to any creditor, not just one credit card company. Consumer bodies argue that such practices make it difficult for consumers to escape the high cost debt trap. They have demanded a prohibition on raising a credit card interest rate or taking other negative action based on information unrelated to the consumer's account
- The reduction in minimum payment has led cardholders to accrue more interest charges and remain in debt longer
- The average late payment fee has more than doubled in 10 years at a time when card issuers have decreased the amount of time between when they mail a bill and when payment is due. Research by PIRG shows nearly 2/3rds of card issuers have eliminated leniency periods and have begun to impose late fees immediately. Issuers are imposing higher late payment fees, even when consumers mail payments 10-14 days in advance. Several private class action lawsuits have been settled against large banks for abusive practices, such as charging consumers late fees, even when they pay on time. Even the introduction of automatic payment programs has not fully safeguarded the consumer from late payment fees. First USA Bank still charges late fees to

cardholders enrolled in its automatic payment program if the program withdraws payments late. The PIRG has lobbied for a minimum 30 days to pay credit card bills and that late payments should be based on postmark dates

- Credit card statements have not, unlike mortgage and car loans, disclosed the amortization rates or total interest that will be paid if the cardholder makes only the minimum payment. They have also not indicated clearly the impact on the duration of the borrowing
- There is confusion as to how card issuers compute purchase balances and the method of computation can significantly affect how much consumers pay for credit. Typically, the method of computation is not explained in offer literature. The three most common forms of computation are:
 - Average Daily Balance, whereby the outstanding balances for each day in the billing cycle are added, and this total is divided by the number of days in the billing cycle. New purchases may or may not be added, depending on the terms of the card
 - Adjusted Balance, whereby payments or credits that are received during the current billing period are subtracted from the balance at the beginning of the billing cycle
 - Two-Cycle Balance, whereby the average daily balances for the current and previous billing cycles are added together. The average daily balances for the current billing period may or may not include new purchases. This computation method is least favourable to the borrower
- Consumers have received checks from several major lenders in the post for as much as \$5,000. Cardholders do not necessarily understand that cashing these checks can lead to acceptance of high rate credit terms. Also, consumer groups have argued that providing pre-approved credit through cashed checks eliminates the cooling off period which more common credit application processes provide
- Consumer groups have also complained of deceptive and irresponsible marketing and failure to adequately disclose key terms and conditions; terms and conditions are considered to be worsening. The Consumer program director for U.S. PIRG (Public Interest Research Group), Ed Mierzwinski has stated “Credit card marketing has become reckless and deceptive, and sometimes violates consumer protection laws. These deceptive tactics are used by some of the country’s largest card issuers and affect millions of consumers each year.” Concern has been raised about deceptive telephone and direct mail solicitation to existing credit card customers – ranging from misleading teaser rates to add-ons such as “freeze protection” (a form of credit life insurance). A recent Federal Reserve survey found that about 60% of respondents found solicitations offering a low introductory rate to be confusing

- Aggressive marketing to new customer segments, such as college students, senior citizens and subprime borrowers is causing concern. Several colleges and universities have banned or strictly regulated the marketing of credit cards on campuses, to address widespread complaints about unsatisfactory practices. 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. Nellie Mae (student loan corporation) 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 the past year, especially without a co-signer
- At the same time the amount of debt owed by senior citizens (65 years or older) has increased significantly in recent years. In 1992, retirees owed an average of \$8,000. By 2000, that number nearly tripled to \$23,000. Today's retirees owe on houses, cars and credit cards
- There has been considerable criticism of the use of free trial offers to encourage consumers to incur greater debt. Some card companies have automatically signed up cardholders for free trial offers. For example, Direct Merchants' Bank has signed up cardholders for an extra product warranty called PurchaseShield. If a cardholder fails to cancel the service before the trial offer ends, then there is a charge for continuation of the service. This practice has been legal as long as the terms and conditions of the trial offer are stated in the card application, but usually these terms are buried and unclear in the documentation. A growing number of card issuers have signed up their cardholders for free trial services such as magazine subscriptions and credit protection, sometimes arguably through deceptive marketing practices to obtain consent
- In the online marketing environment, potential customers are not being provided with a firm APR quotation-this is argued to be against the spirit of the Credit Card Disclosure Act
- Some research has suggested that many consumers are paying more for their loans owing to inaccurate credit scores
- The Consumer Federation of America has called credit insurance "the nation's worst insurance rip-off" as consumers who enrol in credit protection plans pay interest on the cost of their insurance. Most card issuers promote credit insurance known as 'payment protection plans' and it is estimated that it accounts for up to 40% of fee income. The marketing of this insurance has been heavily criticized. It is stated that, while credit insurance is optional under the Truth in Lending Act, credit card offers lead consumers to believe that insurance enrolment is mandatory
- Another product that is being marketed is the debt suspension plan. Debt suspension, sold like credit insurance, freezes an enrollee's debts on illness or unemployment until the enrollee is able to pay or the deferral period ends. As these are not insurance plans, debt suspension plans are not bound by cost and marketing regulation
- There have been calls to ban pre-dispute mandatory arbitration in consumer contracts, including credit cards

- There is concern that credit card companies have reduced their support for and participation in non-profit debt counselling and debt reduction plans. Issuers are starting to refuse to lower interest rates for consumers who have enrolled in debt management programs, and some of the largest card issuers, e.g. MBNA, have actually raised interest rates for consumers that have programs. PIRG calculated that the MBNA increase would add over \$1000 over 3 years to a cardholder that is \$10,000 in debt. At the same time, credit card companies have significantly reduced their financial contribution to the counselling agencies

Lawsuits have been filed over the last year against several card issuers. Class action suits have been filed against Provident for deceptive marketing and sales procedures – the practices include sales of optional products, such as coupons and credit protection, which were marketed deceptively or just added to cardholder’s accounts without permission. Provident agreed to pay \$105 million to cardholders. Provident also violated the Federal Trade Commissions Act when it said a card had no annual fees, even though mandatory monthly fees on the card totalled \$156/year. The bank settled the charges and had to pay consumer restitution of \$300 million. Suits have also been filed against First USA which stated that First USA charged cardholders with unfair late fees. Complaints were filed by cardholders who said that they had sent their payments in on time, yet were still being charged late fees. First USA’s card member agreement stated that payments must arrive by 10 a.m. on the due date to be considered on-time; however, many cardholders ended up with late fees even when their payments were processed before 6 a.m. on the due date.

Proposed bankruptcy legislation has met with criticism that it is too harsh on consumers. The proposed new bankruptcy legislation would establish a "means test" to determine whether people should be allowed to file for protection under Chapter 7 of the federal Bankruptcy Code, which discharges filers from credit card and other unsecured debts. It would make more debtors file under Chapter 13, which requires debtors to pay off most or all their debts. Also, the bankruptcy reform would make it mandatory for consumers to go through credit counselling before filing bankruptcy – a credit counselling agent would have to give approval before a consumer can file for bankruptcy. Travis Plunkett, Consumer Federation of America’s legislative director has said “Credit card issuers are brazenly lobbying for new bankruptcy restrictions at the same time their aggressive marketing and lending practices are pushing many families closer to the financial brink. While the issuers urge Congress to deny families access to bankruptcy relief, their profits are soaring.”

4.4 OTHER CONSUMER CREDIT DEVELOPMENTS

4.4.1 Payday Loans

Payday loans are, in essence, cash advances based on personal checks held for future deposit (or electronic access to a consumer's bank account). Typically, the borrower writes a personal check to the lender for the amount of the loan plus a fee. The lender holds the check until the borrower's next payday (usually one week to one month later); only then is it cashed. Loans typically range from \$100 to about \$500. Payday loan customers must have an open bank account and acceptable account status to qualify for cash advances based on check holding. However, a credit report is not usually obtained.

The loans are provided by stand-alone companies, check-cashing outlets and pawn shops, through faxed applications to loan servicers, online and via toll-free telephone numbers. Major providers of these loans are:

Stand-Alone Companies	Check Cashing Outlets
<ul style="list-style-type: none"> ■ Advance America ■ Check N'Go ■ Check into Cash ■ United Credit Services 	<ul style="list-style-type: none"> ■ ACE Cash Express ■ Dollar Financial ■ QC Financial

There has been significant growth in payday lending in recent years, and increasing concerns amongst consumer bodies that the structure and marketing of these loans are leading to over-indebtedness and inability to repay.

Market analysts have estimated there are 12,000 to 14,000 payday loan stores, each making about 100 plus loans per month, in addition to about 8-10,000 small volume operators. About 65 million transactions to over 8 million households is estimated to have generated \$2.4 billion in fee revenue.

In the absence of comprehensive official data on this area of the credit market, late in 2001, the CFA and PIRG issued a report outlining the findings from a survey of 235 payday lenders in 20 states. The key findings were:

- Lenders charge an average APR of 470% and an average fee of \$18.28 to borrow \$100 for 2 weeks. APR's ranged from 182% to 910% and fees ranged from \$10-\$35 per \$100 borrowed
- The most common APR was 390% imposed by 30% of all stores
- A third of all stores imposed APRs greater than 500%

- 15% of payday lenders in states that cap fees quoted rates higher than allowed by law in that state and an additional 38% of payday lenders quoted rates exactly at the allowable APR
- Even in states where usury and small loan rate caps prohibit high interest rates, payday loans are being made through out of state banks or other practices
- 83% of lender stores allow the 'rollover' of an unpaid payday loan. Of these over half allow 3 or more rollovers
- Almost half of surveyed stores impose bounced check or insufficient fund fees

The consumer issues surrounding the expansion of payday loans are described below.

1. Consumers Union's regional offices have urged state lawmakers to better regulate payday loans; in part, due to the fact that some payday lenders were getting around state laws by forming alliances with national banks, in an attempt to avoid state usury laws and other regulations. Several states are now taking action to enforce local regulation.
2. Payday lenders are accused of targeting the most vulnerable customers-those on welfare, low income households and military personnel.
3. Payday loans are very expensive, with penal APR's and, in many states, lenders exceeding maximum allowable interest rates or loan caps. This is achieved through a range of tactics:
 - One is the marketing of deals as sale-leaseback arrangements, where borrowers 'sell' a household item, then lease it back. The borrower leaves a post-dated check for the amount of the 'sale' proceeds plus the 'lease' fee to repay the loan on the next payday
 - Rent-a-bank arrangements also operate. For example, in California lenders that partner with banks make larger loans than the Californian law permits
4. The design of payday loans leads to customers becoming trapped in debt. This is because those on lower incomes cannot afford to repay the average check in one lump sum. The result is either bounced check fees (from both payday lender and bank) and/or debt rollover making the situation worse. There are also examples of lenders taking legal action under laws relating to bad checks.
5. Payday lenders have a strong financial interest in encouraging and enabling borrowers to roll over their loans-a study in North Carolina has shown that payday lenders had made 90% of their revenue from borrowers making multiple transactions a year. This factor has led some states to try to regulate the provision of debt by limiting the number of rollovers or establishing waiting periods between paying off one loan and taking out another. One practice to avoid regulation on rollovers is when consumers redeem checks for cash, then immediately write a new check to borrow money ('touch and go' loans).

6. Most lenders do not disclose the cost of payday loans, either accurate APRs or finance charges.

4.4.2 Title Loans

Title loans are small consumer loans that leverage the equity value of a car as collateral. The car title must be free of any encumbrance. Loan terms are often for 30 days, and failure to repay the loan or make interest payments to extend the loan allows the lender to take possession of the car. Consumer groups argue that such loans – given the high fees and short terms – are rarely paid off. Loans are repeatedly renewed and/or extended and the consumer ends up paying over 200% of the original balance. A state of Illinois study on short-term loans found that almost half of title loan customers were repeat customers, and the average duration of loans (including extensions) was about 4 months.

As with payday loans, regulation and control of this sector has been fraught with difficulty.

4.4.3 Auto Financing

The industry has been impacted by a variety of scams in recent years, of which the most prevalent has been spot deliveries. The scams identified by NACAA members in 2001 were as follows:

- Spot Deliveries. The consumer agrees financing terms with the dealer and takes home the car. The dealer then calls for the car to be returned as the consumer did not ‘qualify’ for the rate quoted. This leaves the consumer with problems in getting the trade in terms and with a higher interest rate to retain the new car
- Overpriced service contracts, with unnecessary extra items
- Failure to deliver title within the 30 day timeframe
- Problems in getting title after the final loan payment
- Alteration of financing documents
- Verbal promises about getting out of a deal that are subsequently denied
- Leases disguised as purchases
- Undisclosed balloon payments
- Failure of dealer to pass on extended warranty payments to the finance company

The auto industry has also made it hard for consumers to pay off auto loans early due to the “Rule of 78s” formula. The Rule of 78 is a mathematical formula that was devised in the days before modern calculators. It was used as a quick way for lenders to estimate payoff amounts when a customer paid ahead on an instalment loan. Some auto lenders still use the “Rule of 78s” formula to calculate a rebate of finance charges when a customer pays off a loan early. The rebate is actually an under-handed way of including a

prepayment penalty. According to some consumer groups, this method of calculation is another way of padding an instalment loan.

Although U.S. Congress outlawed the use of the Rule of 78s formula in closed-end loans longer than 61 months, many states still allow lenders to apply the Rule of 78s method to instalment loans of five years or less. The auto loans that do still use the Rule of 78s method to calculate prepayments tend to be found in the sub-prime market.

4.4.4 Rent to Own

The rent-to-own industry aims its marketing efforts at low-income consumers by advertising in minority media, buses, and in public housing projects. Rent-to-own businesses are essentially appliance and furniture retailers which arrange lease agreements rather than typical instalment sales contracts for those customers who cannot purchase goods with cash or who are unsophisticated about money management. Consumer groups are increasingly concerned over the predatory practices of these businesses.

4.4.5 Auto Insurance

A recent trend is that Auto insurance providers are using consumer's credit scores (pulled from credit bureaus) to determine issuance of policies and predict claims as well as for pricing policies. Many state legislatures are looking at curbing the growing practice of using a customer's credit history to predict insurance claims.

More than nine out of 10 insurers now use credit information to underwrite auto or homeowners insurance according to a study released by Conning & Co., an industry management and research firm.

4.4.6 New Channel Usage

Online marketing is beginning to impact traditional direct mail campaigns, especially for cards. However, this type of marketing has brought its own set of issues.

- Consumers have few legal safeguards that limit what data gatherers on the Web can do. The Federal Trade Commission has provided better protection of children's privacy on the Web, however, it has been slow to recommend legislation to protect consumers from targeted online marketing
- Consumers are having more problems with new payment options for credit cards. New electronic payment options such as pay-by-phone services (using electronic checks) and online bill paying do not provide some important legal safeguards. Emerging payment mechanisms like Speedpass, a keyfob payment method, also lack consumer protection regulation, even though they may generate a debt situation. Current Truth in Lending laws are only written for credit cards and do not account for the different payment mechanisms that have emerged in the electronic and mobile commerce environment

- At the same time consumer organizations have stated that steps need to be taken to amend the Fair Credit Billing Act so that consumers are not taken advantage of in the online environment. The current Act is only applicable to credit cards, not other e-commerce payment mechanisms
- Consumer groups are actively working with Congress to address the provisions of the consumer consent provisions of the Electronic Signatures in Global and National Commerce Act (E-Sign). There is a need to protect consumers on special issues facing consumers in the electronic commerce world. The issues include: a) the necessity to protect consumers who are conducting real world transactions from unfair or fraudulent practices which may be facilitated by E-Sign or other laws designed to expedite e-commerce; b) the importance of protecting consumers who are conducting business on line using a public access computer; c) the risks that consumers face when relying on electronic transmission of important notices

4.4.7 Credit Information Availability

Consumers now have access to their credit scores – a three digit number based on a borrower's bill-paying history and debt profile that lenders use to determine what interest rate they'll charge for a loan. Consumers can pay to receive their credit report from any of the major credit bureaus (Equifax, TransUnion or Experian).

In a survey in 2000 conducted by the Federal Reserve Board that looked at consumers' knowledge of credit terms it was found that consumer awareness of APRs on bank-type credit cards has continued to rise and was measured by the survey at 85% of bank-type card holders. About two-thirds of consumers who had bank-type credit cards said that obtaining information on credit terms is easy; only 7% of holders of bank-type cards believed obtaining information about credit terms is very difficult.

Credit information availability and usage is emerging as a significant consumer issue in the US.

Prior to October 1999, banks and other financial firms were allowed to share confidential experience and transaction information about consumers with their affiliates and with telemarketers. The Gramm-Leach-Bliley Act of 1999 made it mandatory that banks and other financial institutions provide a notice of their information sharing policies to consumers and a limited right to opt-out to some sharing. Consumer groups are now concerned that the disappearing boundaries between financial services companies and their ability to link huge databases might be a source of potential harm to consumers. They have cautioned that banks and finance companies can disseminate sensitive information about their customers to third parties without their permission and that the privacy provisions of the Gramm-Leach-Bliley Act are inadequate. Some firms are routinely sharing both credit reports and detailed experience and transaction information with their affiliates and basing credit decisions off of this type of information. These unregulated databases do not always accurately reflect consumer credit history.

There is also growing concern about the accuracy of credit information reported on borrowers due to the increase in the amount of databases being used to generate credit scores/credit history for borrowers

Other issues include the numerous unregulated and under-regulated database marketers, such as Choicepoint (spin-off of Equifax) and Axciom, that sell credit report-like products and online marketing practices that obtain private information for targeted marketing purposes.

4.5 REGULATORY DEVELOPMENTS

The Truth in Lending Act is the primary federal law that governs credit cards. The Federal Reserve implemented new rules (effective October 2001) designed to help consumers compare credit terms and to protect consumers against unfair credit card practices. The new rules amend Regulation Z of the Truth in Lending Act. The new rules include: 1) It is mandatory that the permanent APR for purchases must be printed in 18 point type in credit agreements; 2) Credit card issuers must reveal not only the APR for purchases, but the rates for cash advances and balance transfers as well – these disclosures must be included in the interest rate table common in most credit card solicitations (must be in at least 12-point type); 3) Card issuers must disclose penalty rates for late payments (previously issuers would bump up rates without warning for cardholders who pay late); 4) For Internet sites that allow consumers to apply for credit cards online, the applicants must be shown a page with all the rate information and must click on an “Accept” button before being allowed to submit an application.

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