Sustaining Welfare for Consumers in the Credit Card Industry Reactions to the Credit CARD Act of 2009

Christina B. Lee
University of Puget Sound

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Reactions to the Credit CARD Act of 2009

By: Christina B. Lee

Dr. Ross Singleton, Advisor

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Abstract

Congress passed several laws to give consumers a more informed choice about their credit card decisions, the most recent being the Credit Card Accountability, Responsibility and Disclosure (CARD) Act of 2009. However, numerous fees and fee calculations implemented by opportunistic credit card issuers over recent years illustrate the depth of the asymmetric information problem in the industry, resulting in a market failure not fully corrected by the CARD Act. This paper will provide a critique of the CARD Act and argue that in order to sustain consumer welfare, the Consumer Financial Protection Bureau (CFPB) created by Title X of the 2010 Dodd-Frank Act must supervise and react to developments in the industry. I recommend creating a specific credit card division, requiring consent for intended fee implementations, enforcing more credit education for consumers, and evaluating the use of consumer credit scores as important steps for this goal.

I. Introduction

The growth of the credit card industry over the past few decades has been phenomenal. Improvements in technology and media outlets have made it easier to advertise credit card offers[1], revealing credit card issuers' eagerness to solicit new customers. As a result, these solicitations have spurred responses from many consumers. According to Census data, in 2000 there were 159 million credit cardholders in the United States, 173 million in 2006, and the number is projected to grow to 181 million Americans by 2010 (Woolsey & Shultz, 2010). This means that more than half of the US population has a credit card.[2] Clearly there is something beneficial about becoming a cardholder. Advantages such as building one's credit for the future, convenience of simply swiping a card and immediately going home with the purchase instead of dealing with the hassle of getting enough cash, and not feeling the sting of using income, account for the consumer appreciation of credit cards. Yet amidst the growth of the industry, issues regarding consumer protection have unraveled. Durkin (2000) noted that increased usage have corresponded with more negative consumer attitudes towards credit cards. This negativity reflects consumers' wariness of issuer practices, especially with regard to credit card fees. In fact, the growth of the credit card industry was accompanied by significant developments in credit card pricing strategies, many of which were not effectively disclosed to consumers (Furletti, 2003).

Several laws and amendment were passed to protect consumers and keep them informed about the terms of credit card usage. The first law of this type was the Truth in Lending Act (TILA) of 1968, or more commonly referred to as Regulation Z, the regulations which implemented the consumer credit protection statutes. These regulations required that "significant" fees be disclosed to

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1 Advertising activities currently range from television and Internet ads to mail-in and email offers.
2 Census information estimated that the US population in 2009 was around 307,006,550.

all credit borrowers at specific periods during the credit application process. Emphasis was placed on the Annual Percentage Rate (APR)[3], especially for purchases, because it was thought to be the most important and accurate description of credit costs. However these requirements were not effective enough to keep consumers informed as issuers eagerly applied new fees and calculations to the contracts. Congress responded by passing the Fair Credit and Charge Card Disclosure Act of 1988. It amended the TILA by adding requirements for issuers to display significant fees in an easy to read "Schumer box"[4] along with detailed explanations of those fee calculations before an agreement was made in hopes of giving consumers a more informed choice. Unfortunately, explanations of calculations such as double-cycle billing[5] and average daily balance were too confusing for the average consumer.

Grievances made by both consumers and regulators were addressed by the recent passage of the Credit Card Accountability, Responsibility and Disclosure (CARD) Act of 2009. There are several provisions of this law that will help consumers, such as the elimination of double-cycle billing and required consent for over-limit fees, but they should be worried about what is not included in the act. Market failures in the industry have the potential to harm social welfare and limit access to credit. Other financial reforms in response to the demand for greater consumer protection resulted in the Dodd-Frank Act of 2010. Title X creates a Consumer Financial Protection Bureau (CFPB), "which shall regulate the offering and provision of consumer financial products or services under the Federal

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[3] The APR is a percentage rate used to calculate how much one may expect in interest on loans annually. For credit cards, these loans typically refer to outstanding balances and cash advances. One may think that dividing the APR by 12 can provide the interest charges per month, but computational practices discussed later in the paper make this assumption invalid.

[4] This is a chart incorporated in all card agreements that discloses significant fees. It was named after Charles Shumer, a legislator who was prominent in the passage of the 1988 act.

[5] This is a finance charge calculation method where interest fees are added based on the balance of the current *and* previous billing cycle when a card balance moves from a nonrevolving to a revolving state (i.e. moving from no balance to some balance).

consumer financial laws" (H.R. 1473, 2010). Consumer protection now has significantly more regulatory support, but how these recent reforms will affect the credit card industry has yet to be determined.

I will argue in this paper that to mitigate the welfare loss in the credit card industry not adequately addressed by the CARD Act of 2009, the CFPB will need to resist influences from the industry in order to develop and enforce strict guidelines regarding the opportunistic issuers' innovative pricing strategies. This argument will be based on the critique of the CARD act, an analysis of credit card issuers' opportunistic behavior, and a discussion on how the CFPB will improve social welfare in response to the market failures of asymmetric information and adverse selection. I recommend that the bureau should create a specific credit card division, require consent for intended fee implementations, provide more credit education for consumers, and evaluate how well issuers use consumer credit scores to make pricing decisions.

The discussion is organized as follows. Section II to IV will begin with a review of relevant literature. A more comprehensive discussion of the adverse selection and asymmetric information market failures will be presented in section II, followed by a critique of the CARD Act in section III, and further comments on the structure and role of the CFPB in section IV. Section V provides the limitations of this paper and section VI offers concluding remarks.

II. Market Failure

Scholars have analyzed issues in the credit card industry for many years. Ausubel (1999, p.3) was one of the first to take on the task of empirically proving the existence of adverse selection using results from a series of market experiments in the 1990's with "randomized trials on pre-approved credit card solicitations" by a certain credit card issuer. He discovered that with the vast amount of solicitation available, high credit risk consumers are more likely to respond. He also found that those who accept inferior offers (i.e. higher interest rates) are more likely to default. In effect, the credit card issuers face the problem of attracting many high-risk consumers. His results then provide an answer to an even more complex question of why credit card rates seem to have remained relatively "sticky" over the years. With the threat of adverse selection, card issuers would be hesitant to lower their rates and attract those high-risk customers. Zywicki (2000) adds to the argument that credit card loans are more risky because of its unsecured nature, and because issuers do not have perfect information about the borrower's intentions, they will have to assume the worst and charge high interest rates to all borrowers. These conclusions highlight the idea that credit card issuers should be wary of the consumers. Although this may seem contradictory to the purposes of this paper, I will use their results to illustrate the adverse selection problem and stress why consumers should be cautious about issuer practices and associated welfare losses.

Furletti (2003) further discussed the growth of innovative pricing strategies of card issuers and their ineffective disclosure based on analysis of public data, proprietary data, and data he collected of card member contracts from 15 of the largest issuers over a five-year period. He noted that as the credit rating systems improved and competition for new consumers increased, so did the complexity of the fees. APR's evolved from being a flat rate to one based on a consumer's credit risk, and other fees were created to account for consumer's behavior in order to hike up revenues. Several examples of newly adopted fees include the late fee, over limit fee, foreign currency fee, and phone payment convenience fee. To further complicate matters, issuers also administered new computational techniques that allowed them to increase their revenues without violating the disclosure laws.

Examples include compounded interest, double-cycle interest, and allocations of payments.[6] In addition, issuers were also raising fees. Yet as these changes occurred, Furletti found that disclosure laws were ineffective despite several regulatory reforms that were passed to curb deceptive practices. The statutes mandated that issuers disclose the fees to consumers, but the fee calculation explanation methods were presented in a way that confused the consumers, or not presented at all[7], and some were "hidden" among the fine print of contracts. This provides strong evidence that consumers are unaware of the true costs of credit. However, while Furletti's results offer strong evidence for information asymmetry, he does not specifically address the important matter of welfare concerns.

Consumer behavior is also an important topic that should be addressed since credit card usage has substantially changed the spending decisions of consumers who now rely on credit rather than their own disposable income. This is partly due to the value that consumers receive from the ease of using credit cards. Credit cards provide significant benefits to society by being the most easily accessible and lowest cost form of credit for issuers, consumers, and merchants (Mann, 2006). Unfortunately, consumers may underestimate or irrationally accumulate credit costs. In a survey of studies relating consumer behavior and credit cards, Bar-Gill & Warren (2008) highlighted the situation where consumers failed to escape incurring additional charges because of mistakes, which include failure to switch to new cards with lower rates, impatience, inconsistent time preferences[8], making purchases with cards that would incur significant fees, and carelessness to pay bills on time even with sufficient funds available. Ausubel (1991, p.50) further attributed the underestimation bias to consumers' failure of anticipating "the very high probability that they will pay interest on their

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[6] See Furletti (2003)for a more extensive list of new fees and computation techniques.

[7] Disclosure laws did not require fee calculations to be presented to consumers.

[8] The authors refer to the method of hyperbolic discounting, where consumers are more likely prefer smaller payoffs near the present time rather than wait for large payoffs in the future. Therefore decisions made in the present do not agree with the decisions that would be made in the future.

outstanding balances." These behaviors further support the claim that consumers do not truly understand the costs of using their credit cards. Consumers are essentially borrowing more for current consumption than they would under rational thought.

Reliance on credit and underestimation of costs also bring to light debt issues. Durkin (2000) analyzed survey responses from cardholders and shared many findings relating to consumer debt, attitudes, and reactions to disclosure. He found that those who held a revolving balance rose from 37 percent in 1970 to 55 percent in 1980, revealing consumers' preference for credit cards. Mann (2006) complements the argument by offering support about the relationship between overall consumer debt and its relation to credit card debt and credit card spending. He used an econometric approach with time series data from five countries (Australia, Canada, Japan, the UK and the US) normalized to US 2002 dollar values and found that both credit card debt and credit card spending are positively correlated with consumer debt. In fact, "each dollar per capita increase in credit card spending is associated with an increase in consumer debt per capita of about $1.15" (Mann, 2006, p.53). The relationship between credit card debt and bankruptcy was also explored, showing that an increase in $100 per capita in credit card debt would increase bankruptcy filings by about 200 filings per million" (Mann, 2006, p.67). These results provide substantive evidence for welfare concerns, although neither Durkin nor Mann elaborated on the issue.

In contrast, Bar-Gill & Warren (2008) formally discussed the social welfare impact of consumer irrationality and debt. Through an extensive analysis of the problems in the credit industry that resulted from financial products, they noted that the costs to society are best represented by negative externalities. For instance, the financial distress indebted individuals face has a large effect on their families, especially those who cannot afford to support their children and/or elderly dependents.

Also, when choosing between a bank loan and credit card, as more consumers miscalculate the costs and find credit cards more attractive, demand will shift from bank loans to credit cards and cause a distortion in the prices of the two products, ultimately affecting the financing decisions of everyone in society. An allocative inefficiency would follow as the economy shifts resources to satisfy the inflated consumer demand for credit cards caused by the misperceptions of borrowing costs (Bar-Gill & Warren, 2008). Based on these findings, social welfare concerns resulting from credit card use should be a priority when creating new laws.

2.1 Adverse Selection

This subsection will expand on the adverse selection issue, the process by which less desirable trading partners volunteer to exchange (Frank, 2008). For the purposes of the following discussion, this refers to a situation where high credit risk consumers (those most likely to default on payments) are eager to enter into a credit card contract. Most consumers use the APR to determine credit costs because of its emphasis in Regulation Z and credit card advertisements. Thus in the market, it acts as a price signal to make a contract with a certain issuer because consumers see it as the price for gaining access to credit. This is of particular concern to credit card issuers who face the potential of attracting high-risk customers.

Figure 1 (a) depicts a static representation of the dynamics related to this issue. The "price" of credit is expressed as a rate, *r*, equal to the total percentage of fixed fees, such as the annual fee, and other adjustable fees, such as the purchase APR, based on the outstanding balance. For example, consider a simple scenario where consumers have \$1000 balance with a \$50 annual fee and a 15% APR. The rate for these consumers would be 20%.[9] Of course, this rate would increase as the number and type of fees consumers incur grows. In the credit market, initially the demand for credit consists

[9] This total resulted from adding the 15% APR plus the annual fee as a percentage of the balance, 50/1000 = 5%.

of a wide range of both low and high credit risk consumers. Issuers then maintain a pool of revenues from every customer to account for the high costs that may occur if high-risk customers default on

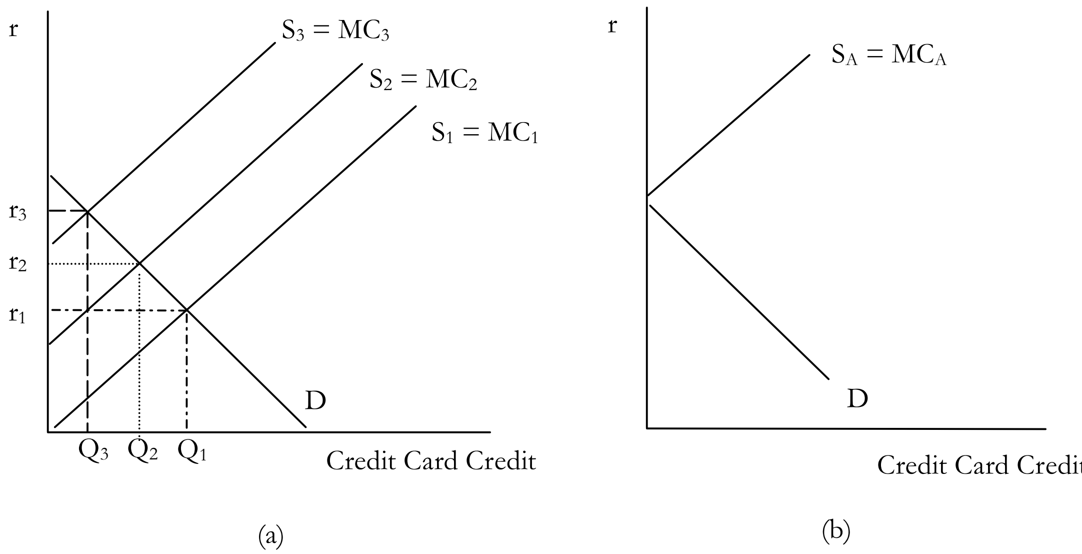

Figure 1: Adverse Selection

payments. This market seems relatively stable until high-credit risk customers find APR's attractive, that is they believe the rate at which they will have to pay in interest relative to the amount they intend to borrow is fairly cheap. These customers will then be more than willing to sign into a credit card contract and start to represent a high proportion of the demand for credit cards. To account for the more risky behavior of these new customers, issuers will respond to this change in the composition of demand by applying APRs based on the consumer's credit history in addition to incorporating more risk adjusted fees when the opportunity arises. Yet for the issuer to remain profitable and maintain their pool of revenues, they will also have to adjust the cost of credit to reflect the average level of risk of their consumers. Since the consumer pool now comprises more high-risk customers, the average level of risk will increase, resulting in a higher cost of credit. This increase in the marginal cost of credit causes a decrease in the supply from S_1 to S_2. This shift then results in a lower credit usage of Q_2

at a higher rate of r_2. The low risk customers, recognizing that the cost of credit have increased, no longer find it worthwhile to stay in the market, and leave to look for cheaper substitutes for credit. This means that the demand composition changes to reflect a higher proportion of high credit risk consumers, and prompts issuers to again adjust the cost of credit upward. As a result, the supply of credit decreases again to S_3, followed by a reduction in credit to Q_3 at an even higher rate of r_3. Then the process repeats itself with lower risk customers dropping out of the market and prices changing to reflect the high-risk demanders. As this cycle continues, the supply of credit could decrease until the market enters into a "death spiral"[10] situation depicted in Figure 1 (b) where access to credit card credit is lost because the costs become too expensive.

Since the cost of credit rises, the benefits consumers receive from goods/services bought on credit decreases. For this discussion it is important to analyze the effects finance charges that occur with credit purchases have on the marginal net user benefit. Here I use the relationship where Marginal Net User Benefit = Marginal User Benefit from purchases – Marginal Finance Charges. For example, consider a television that costs $1000. A consumer who buys the television with cash will receive the full user benefit of $1000. On the other hand, a consumer who uses a credit card with a rate of 15% to buy the television would pay an additional $150 in finance charges. This consumer could have received the full $1000 user benefit, but because he paid with a credit card instead receives $150 less, so his net user benefit is worth $850. Figure 2 depicts this effect in the market for televisions. When more and more high-risk customers enter the market, the marginal net user benefit of television purchases decrease from $MNUB_1$ to $MNUB_2$ to $MNUB_3$ and so on because finance charges increase as a result of credit rate increases. This corresponds with decreases to Q_2 and Q_3 in the

[10] The term "death spiral," typically used in insurance markets, is the extreme end result of adverse selection where costs become too high as more undesirable trading partners participate in the market and consumers no longer want to participate.

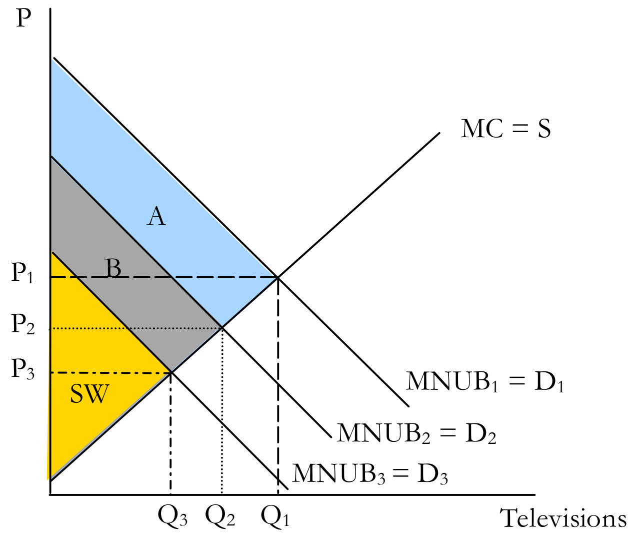

Figure 2: Social Welfare Effects from Adverse Selection

quantity of televisions purchased and social welfare reductions by areas *A* and *B*, respectively. This declines of the social welfare and quantity of televisions purchased will continue as credit card rates continue to rise with adverse selection until consumers find an adequate substitute for credit card credit. Otherwise they may choose to continue buying fewer goods/products than before, which could ultimately harm the economy.[11] From this analysis we can see the adverse selection issue must be kept in mind when making decisions to uphold social welfare.

<u>2.2 Asymmetric Information</u>

The issue of asymmetric information, the idea that one party has more information than the other when making an agreement, will be addressed further in this subsection. Recall that prior laws promoted the importance of disclosing the APR because it was believed to be the main price of credit card usage. However, we know from Furletti (2003) that developments over the years show that the cost of credit card credit includes not only the interest rate, but also the many new fees that have

[11] The effects in the market for televisions could also extend to markets for any goods/services since consumers can purchase many products with credit cards. Keep this in mind as later models also discuss the television market.

developed over the years. The problem is that the credit card issuers do not effectively disclose the information regarding these new fees in a way that consumers can easily understand. In other words, consumers do not have enough information to calculate the actual costs of credit when they make a card agreement. This situation is illustrated in Figure 3.

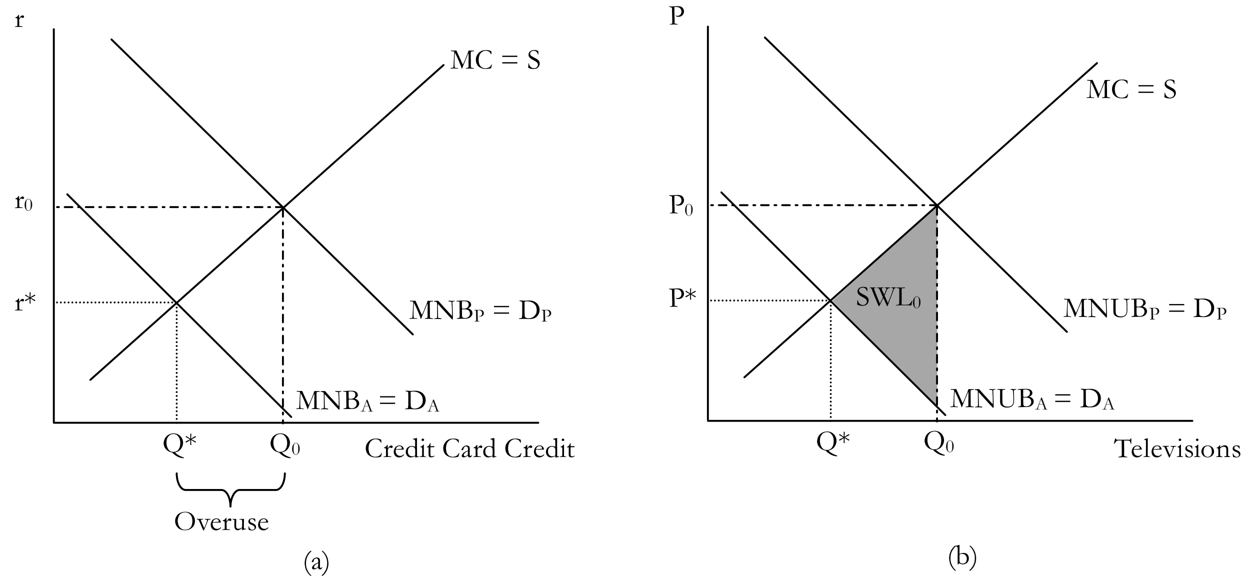

Figure 3: Credit Cards Information Asymmetry Effects

For this analysis I will focus on the marginal net benefit of consumers who have a credit card, where Marginal Net Benefit (MNB) = Marginal Benefit of credit – Marginal Associated Usage Costs of credit in the credit card credit market. Figure 3 (a) depicts the current market where consumers perceive that their marginal net benefit from using card credit is best represented by the MNB_P line. This results in a quantity Q_0 and an associated r_0 rate for using these credit cards. However because of the deceptive practices of the credit card issuers, consumers do not know how to accurately calculate the cost of credit. They believe that their usage costs are fairly low. Thus, the actual (higher) associated usage costs results in a lower and more accurate marginal net benefit, depicted by the MNB_A line. Due to this realization, we see that the optimal condition should be a lower Q^* quantity of credit card credit with a corresponding lower rate of r^*. From this we can see that there is an overuse of credit of $Q_0 - Q^*$, meaning that there is an over-allocation of resources to fund the activities of credit card credit usage.

To determine the effects on social welfare, we must look at the effects in the market for products and services since credit is used as a medium to exchange goods instead of providing actual welfare gains. This situation is shown in Figure 3 (b) with the market for televisions. Here I will also use the marginal net user benefit idea discussed previously. We know from the existing literature that irrationality and lack of information play a large role in the perception of purchase costs. In particular, the misunderstandings costs cause consumers to believe that their finance charges are lower than actual, so that the perceived marginal net user benefit ($MNUB_P$) from those goods to seem higher than actual ($MNUB_A$). With the overuse of credit cards, we see that consumers are buying Q_0 of televisions, which is much more than the social optimal quantity of Q^*. As a result, there is a social welfare loss depicted by the SWL_0 triangle. This makes sense because of the previously mentioned welfare concerns of debt that consumers face from irrational purchase decisions and misunderstandings of the costs. This result provides significant motivation to correct information asymmetry in the market.

III. The CARD Act

Credit card industry reform was needed as innovation in the industry increased over time. President Obama signed the CARD Act into law on May 22, 2009 in response to the concerns about deceptive industry practices. The act amends the TILA and implements additional regulations, which were enforced in three stages on February, July, and August 2010. Several key provisions of the new act include 45 day notification for any changes in the contract terms such as the APR, no increases in the APR during the first year of a new contract, elimination of double-cycle billing and fee hikes on remaining balances, required consent for over-limit fees, included calculations about the number of months it would take to pay off a balance at minimum payments on billing statements, receiving statements at least 21 days prior to the due date, and requirements for those under 21 to have a cosigner before applying for a credit card (H.R. 627, 2009). The asymmetric information problem in the industry could now be corrected with these enhanced disclosure requirements.

A new act was needed because regulators and consumers believed that the previous regulations were not enough to keep consumers informed. In fact, Durkin (2000) noted in his study that less than 50 percent of consumers felt like they received enough credit card information from their credit card companies. What were the issuers doing? Stango (2003) studied stock market data of bank issuers to test regulatory threat models and found that firms receive private benefits when faced with the threat of interest rate caps because rate cuts were followed by large positive returns, for the firm and their competitors. He also noted that this result does not occur absent of regulatory threat. Clearly the TILA and its amendments were not effective at influencing issuer decisions for the benefit of consumers. Shaffer (1999) conducted a structural empirical test to determine the efficacy of the Fair Credit and Charge Card Disclosure Act of 1988 by measuring its impact on the degree of competitive conduct among a nationwide sample of 44 credit card banks. She found a significant degree of market power among bank issuers, with the average bank pricing above marginal costs,[12] but the act with its improved disclosure requirements did not improve the degree of competition among issuers. This result is puzzling considering that more informed consumers should promote a more competitive market. While formal discussion on market power goes beyond the scope of this paper, Shaffer's results uncover the issue that legislators must be aware of how issuers and consumers react to disclosure requirements.

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12 In Shaffer's sample, the average price was 69% above marginal cost.

It is important to note that credit card credit is more risky compared to other methods of providing credit since the issuer receives no collateral for purchases that the consumer may make over time. Therefore credit card issuers have a high incentive to cloud significant information to account for the risk. Williamson (1975) offered a perspective about the self-interest seeking nature of agents and its effects on transactions between people. He discussed bounded rationality, the idea that individuals' perceptions are limited by their ability to store and process information. This issue is especially important under conditions of complexity and impacted information, where a certain group or groups of people know relevant information about a transaction, but that same information may be costly to obtain for other groups. He further discussed the idea of opportunism in which agents pursue their self-interest with guile to strategically misrepresent their product. With all three of these issues apparent in the credit card industry, transactions costs increase, and there is serious cause for worry. For instance, in a recent study done by the Pew Charitable Trusts, the foundation reported that bank issuers took full advantage of the lag time between the passage of the CARD Act and its enforcement date by increasing penalty fees and interest rates on outstanding balances (Blake, 2009). The current analysis will incorporate these ideas into the credit card market and offer insights into whether or not the CARD Act alleviates market failure.

3.1 Critique

Consumers will benefit from the improved disclosure requirements. The provisions help consumers be aware of the actual usage costs of credit by improving the notifications of any fee changes. Recall from Figure 2 that the asymmetric information problem causes the marginal net benefit from using credit cards to be higher than it should be, resulting in an over usage of credit and a corresponding social welfare loss equal to the area SWL_0 in the television market.

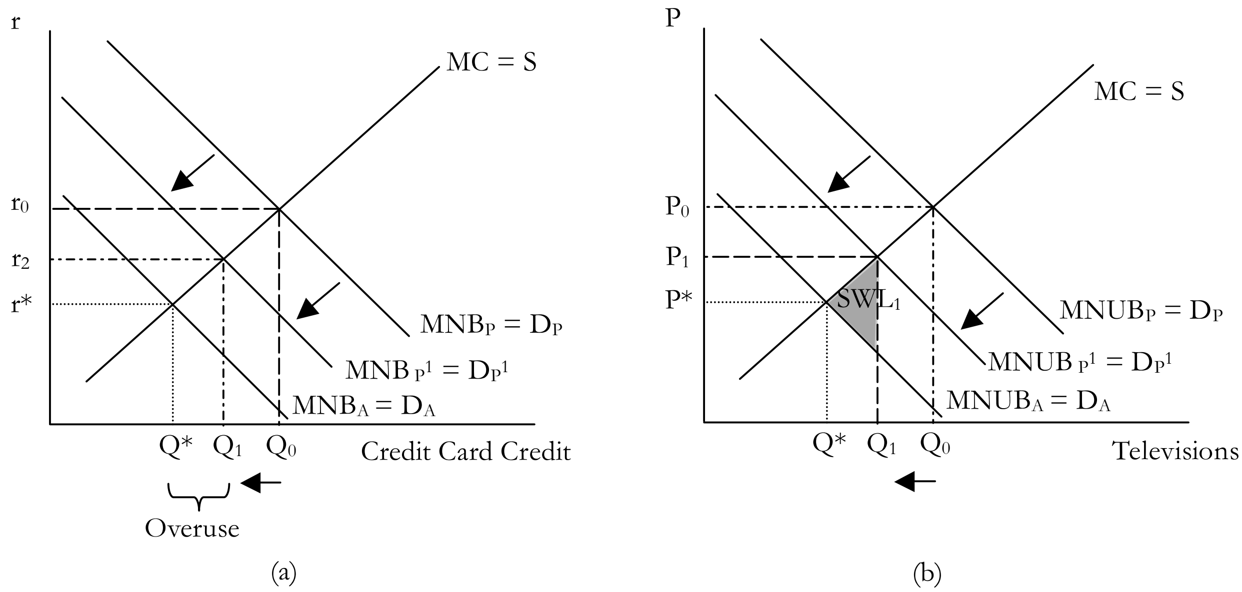

Figure 4: Effects after CARD Act

In Figure 4 (a), we see that with the passing of the CARD Act, consumers more accurately calculate the high costs of credit, so that the perceived marginal net benefit, MNB_P^1, lowers and becomes closer to the actual. As a result we see that credit card credit has decreased to Q_1, which also lowers the over usage of credit to $Q_1 - Q^*$. This decrease in credit usage means that consumers no longer want to buy as much products and services with credit cards compared to before. This situation is depicted in Figure 4 (b). Consumers who now understand the higher finance charges of card purchases can more accurately perceive their marginal net user benefit, $MNUB_P^1$, so that it lowers closer to the actual. Accordingly, consumers purchase Q_1 of televisions so that the quantity of television purchases also becomes closer to the social optimal. This is good because the social welfare loss also reduces to a smaller triangle, SWL_1. Therefore we see that the CARD Act can reduce the welfare loss in society.

One may wonder why there is still some welfare loss in the market. This is best explained by the nature of the credit card industry. Extending Williamson's analysis to the credit card industry, we can say that credit card issuers are profit-seeking agents who have a strong incentive to mislead consumers in order to acquire more profit. We have indeed seen this in the recent practices of the issuers. As Furletti (2003) explained, many new fees and calculation techniques have been introduced and implemented in the industry over the years. Credit card contracts are also full of fine print, and have grown significantly in page length over the past few decades. Furthermore the complicated language used in the contracts also makes it difficult for the average consumer to understand what is going on with their credit cards. Essentially, issuers make relevant term information too costly for consumers to obtain. These deceptive practices are most likely attributed to the issuers' enthusiasm to take advantage of the cardholder who has limited understanding of the available information. The opportunistic behaviors of credit card issuers are not adequately accounted for in the current regulation, and so consumers, who are subject to irrational behavior as noted before, are at a disadvantage of not knowing how much using credit card credit will cost them in the long run.

Strategies not specifically addressed in the act also reflect the opportunistic behavior of the issuers. For instance, restrictions on advertising are not included in the act. This is worrisome for consumers since profit-seeking issuers are likely to promote offers with impacted information to make credit seem cheaper. In addition, issuers are bound to incur revenue losses because of the elimination of several fees. To make up for these losses, they will yield to their profit seeking desires and look into what the act does not prohibit. In fact, there are several fees that are not specifically included in the act, such as the annual, cash advance, and balance transfer fees. Therefore, issuers have an incentive to increase these fees and find ways to make them applicable to their current customers to increase revenues. Furletti's (2003) discussion on developments in credit card pricing over the years also signifies that the creation of new fees is highly probable. Overall, the improved disclosure requirements will make it difficult for issuers to be secretive regarding their pricing strategies. However, issuers will still count on the bounded rationality of the consumers and hope that their limited understandings will cause them to disregard the high price of credit.

It is important to note how the APR is treated since many still refer to it as the main price of credit. While there are no restrictions on the rate in the CARD Act, society can count on the competitive pressures within the industry to provide reasonable rate for consumers. In addition, the adoption of risk-based pricing allows issuers to provide an appropriate rate to all customers. This will also help counter the death spiral effect of adverse selection in the market and allow consumers to continue reaping the benefits of credit card usage.

IV. The Bureau's Role

The current situation in the credit card industry emphasizes the need for further consumer protection. Warren (2008) argued that an entity for financial protection should be created because defective financial products, much like defective appliances, can have serious negative consequences on one's life. She also noted that current consumer financial protection has not been at the priority of any industry since enforcement is fractured among seven agencies.[13] Companies that issue credit products therefore have the ability to move from one regulatory body to another. For example, if a bank decided it did not like the rules it was being subjected to, it could stop taking deposits to become a non-bank institute and be subject to a new (more desirable) set of rules (Warren, 2010). This idea can help explain why credit card regulation may not have had as much effectiveness as it should have.

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[13] The seven agencies include the National Credit Union Administration, Federal Trade Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Department of Housing and Urban Development, Office of Thrift Supervision, and the Federal Reserve.

Legislators have responded to her idea with the establishment of the Consumer Financial Protection Bureau. It would consolidate all consumer protection power from the seven agencies and have the power of "implementing the Federal consumer financial laws through rules, orders, guidance, interpretations, statements of policy, examinations, and enforcement actions" (H.R. 1473, 2010). In addition, Warren's recent appointment as the "Assistant to the President and Special Advisor to the Secretary of the Treasury on the Consumer Financial Protection Bureau" will help to ensure that consumer protection will be the primary objective as the bureau undergoes its development (White House, 2010). In a recent statement, she stated that the bureau will focus on making sure all institutions that issue financial products have a standard set of rules to follow (Warren, 2010). By doing so, companies would no longer be able to move between industries, and regulations would be better enforced to create efficient markets for consumers.

In contrast, Tennyson (2009) offered a more objective view by outlining a debate of the pros and cons of the Bureau. She discussed concerns of over-regulation, insufficient funding, and lack of industry expertise as hindrances to its goals of consumer protection. On the other hand, she also noted that the consolidation of protection power in the Bureau would increase efficiencies in financial markets. She then suggested that fees from the regulated industries be used to fund the Bureau's activities and uphold its mission. While Tennyson does not take a firm stance on the Bureau, her discussion reveals issues that must be considered to ensure it will protect consumers.

4.1 Bureau Structure

The current set up of the board consists of a director who is appointed by the President with the approval of the senate and serves a five-year term or longer until a successor is named, along with a deputy director whom the director chooses. Neither may hold any office, position, or employment in any Federal reserve bank, Federal home loan bank, covered person, or service provider during the period of service (H.R. 4173, 2010). Requiring that the director be reappointed every few years is a good way to ensure that the bureau keeps pace with the changes in the industry. This is especially important for a bureau with so much regulatory power. However, note that in order to understand the complex details of credit card prices and create effective guidelines, there is a need to elicit help from individuals highly involved in the credit card industry. This makes regulatory capture, the idea where regulators meant to promote public interests are instead sympathetic to the firms being regulated and become more lenient in rule enforcement, a problematic issue. With card industry representatives considerably involved in the regulatory process, one may be skeptical of the regulations' effectiveness. The bureau may have to create a specific credit card research agency and employ investigators to accurately research and disclose pricing strategies of the issuers. This would help remove the issuers' information advantage so that knowledgeable credit industry personnel will not be as necessary anymore. The Bureau would then be less likely to accede to the interests of card issuers. In addition, any decisions made by this credit card division should be subjected to an approval process. This would help thwart "captured" decisions from going into effect.

4.2 Recommendations for the Bureau

There are several ways in which the bureau could inhibit opportunistic behavior to reduce the transaction costs of credit agreements and support consumer welfare. Based on the previously discussed analysis, it is difficult to predict what kinds of fees issuers may choose to charge consumers. Therefore, the Bureau must primarily play a supervisory role and react to the revenue enhancing strategies that issuers may implement. It should create a specific division dedicated to credit card industry supervision to make it easier to keep up with the changes in the industry. This division would be better equipped to implement appropriate rules, and observe how well those rules are followed by issuers. For instance, consider a situation where issuers decide to implement a risk adjusted annual fee. This could significantly raise the price of credit. As a reactionary measure, the bureau could then impose a cap on the annual fee charged to consumers.

Since it will be difficult to anticipate what the issuers will try to do in the future, the Bureau should also take necessary proactive measures to protect consumers. For instance, it could enforce limits on advertising expenditures so that consumers are not misguided by attractive offers. The Bureau could also require that issuers gain approval for any new fee they may want to implement. This would curb deceptive practices and protect consumers who might otherwise unknowingly incur such fees. If the credit card issuers violate those rules, fines could be imposed. The revenue from fines could then help the bureau fund efforts for clearer disclosure practices and enhanced industry supervision. Ensuring that the Bureau has adequate funds available is important since the opportunistic behavior of the issuers creates higher enforcement costs. Stricter guidelines on the amount of fine print in card contracts should also be enforced. Furthermore, the most confusing part about the fees is the way they are calculated. Therefore, actual or hypothetical examples of fee calculations rather than detailed explanation should be included on contracts and billing statements to increase consumer understanding and give them the tools to calculate costs on their own.

Rigorous efforts by the bureau to educate consumers about using credit cards are also recommended.[14] If disclosure requirements were not enough to deter consumers from spending too much and potentially incurring more fee charges, then more education about how to use credit cards wisely would help increase consumer awareness. Online classes and production/distribution of

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[14] Both the CARD and Dodd-Frank Act implement provisions to further education programs to enhance consumer understanding of financial products.

informational videos could help this resolve. The bureau could also require consumers to take and pass a credit card knowledge test that it would administer while also offering preparatory classes for those tests. Issuers would then only be allowed to offer credit cards to those who show that they passed the test.

The bureau could also take efforts to evaluate how well issuers use consumer credit scores to provide appropriate credit rates for consumers. Consumers know that a higher credit score is better, but they do not receive information about how their credit scores are used.[15] This is worrisome because of issuers' have an incentive to place consumers in higher risk groups and charge additional fees. Since issuers have implemented many risk-based fees, ensuring that consumers are place in the correct risk group could improve efficiencies and welfare in the market.

V. Limitations

The results of this analysis are limited to the current conditions of the laws. The CFPB is currently under development, so the specific roles it will have in relation to the credit card industry have yet to be realized. Since the Bureau has the power to regulate all financial products, the attention it will pay specifically to the credit card industry is also difficult to determine. Further analysis after the bureau has been fully established regarding its specific powers and how it will affect consumer welfare would enhance the findings of this paper. Several political aspects regarding the appointment of the Bureau's director also were not fully explored. Further discussion on this matter would help enhance the understanding of how effective the bureau would be in its regulatory role to moderate market failure. In addition, empirical analysis of how the CARD Act has affected issuer revenues could help to further explain the impact the act has in the industry. However, the regulatory situation

[15] However, consumers can view their credit score for free, but this is usually limited to once a year, and requires a subscription to a credit monitoring service. Websites such as www.freecreditscore.com and www.creditreport.com are merely a couple of many agencies that offer such services.

would change drastically after the bureau begins its policy implementation process. Therefore analysis of the CARD impact would need to be done during the period between after the passage of the act and before enforcement of the Bureau. Furthermore, analysis of the nature of the credit card contracts (such as implementation of new and/or higher fees) during this period would also be of value, as an effort to quantify the opportunistic nature of these issuers. Analysis about the optimal level of credit card regulation would also be beneficial. It is highly unlikely that all credit card issuers will cease to be opportunistic. Discussing the appropriate amount of regulation would help us understand how to best maximize social welfare.

VI. Conclusion

The CARD Act of 2009 inadequately addressed the social welfare losses in the credit card industry, suggesting the importance of the CFPB role to uphold and enforce strict guidelines regarding innovative pricing strategies of issuers. An economic analysis of the asymmetric information and adverse selection in the industry were conducted to illustrate the concerns and motivate reasons to correct them. Issues of consumer irrationality and debt contributed to the over usage of credit and social welfare losses in the market for products and services. The CARD Act was passed as an attempt to alleviate market failure and associated welfare losses by enforcing more timely and accurate disclosure practices for the consumers. However, while the act can reduce welfare losses resulting from the market failure, further analysis of the Act revealed several weaknesses, primarily ones related to inadequate control of the opportunistic behavior of the card issuers. Arguments for how the new CFPB could address the shortcomings of the act were then explored. Recommendations were made to resist regulatory capture, create a specific credit card division, require approvals before new card fees go into effect, promote efforts to educate consumers about using credit wisely, and reevaluate credit score treatments in order to support consumer welfare in the industry.

The analysis was taken shortly after the acts were passed, and so the full effects were difficult to determine. This provides concerns about the completeness of the results. Further investigation into how the Dodd-Frank Act may alter the conduct of credit card issuers could offer insights into how the regulation address market failure. It would also be interesting to analyze whether or not newer provisions that the Bureau may implement replace the current provisions of the CARD Act. There are also significant opportunities for job creation if the Bureau intends to increase research efforts and improve its supervisory role, which could be researched to further characterize its benefits to society. A more detailed analysis of the Bureau would also provide insights into how much consumer protection will improve from its interventions in the market.

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