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Taking Charge (Spring 2010 Trust Magazine article)

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After U.S. Senator Claire McCaskill's father died, her mother stumbled into money problems and ran up a pile of credit card bills. By the time Sen. McCaskill and her sisters intervened, the card company had slapped their mother with late fees and penalty interest rates, which bloated her debt.

Even after her daughters paid off the charges, Betty Anne McCaskill kept receiving "convenience checks," encouraging her to spend more on credit. "It's like sending a six-pack of beer to somebody who is on their 30th day of sobriety and saying, 'Why don't you just have another drink?'" Sen. McCaskill said at a 2007 Senate hearing.

The same spring that Sen. McCaskill, who represents Missouri, railed against credit card issuers, The Pew Charitable Trusts began work to protect vulnerable folks like Betty Anne McCaskill and all Americans from the cards' most perilous provisions. That effort culminated in May of 2009 with the passage and presidential signature of the first major credit-card reform ever. The new law bans a variety of controversial practices and limits companies' ability to raise interest rates on existing balances.

"The problem is that credit cards can be dangerous," says Nick Bourke, manager of the Pew Health Group's Safe Credit Cards Project. "We view them through the lens of consumer product safety—they can be harmful to families' financial health."

The root of Pew's concerns was that card companies gave themselves the right to change the fine print of their agreements at any time for any reason. A card issuer could even raise a customer's interest rate if she defaulted on her debt to another creditor. This practice, called universal default, stemmed from the premise that any late payment showed that a borrower's finances had gotten shakier and that he or she had thus become a greater risk.

"Millions of people were entering into these contracts with teaser interest rates and other attractions," Bourke says. "What underpinned the card companies' ability to make those offers was the ability to change the contract later. Credit cards have lots of legal language around them, but they were one-sided agreements. We wanted to restore the sanctity of the contract so that people could make informed decisions."

Some card provisions seemed almost designed to drag people deeper into debt. Pew, in a report released in March 2009, found that all of the 400 cards it surveyed included provisions that the U.S. Federal Reserve, the nation's central bank, had classified as "unfair or deceptive."

As card use grew, these questionable practices were touching more and more Americans. The U.S. Census Bureau has predicted that, by 2010, 181 million Americans will have credit cards, up from 159 million in 2000. About half of families with cards carry balances, with the average balance reaching $7,300 in 2007, according to the Federal Reserve.

Critics have said that the new reform law will hurt consumers by restricting the availability of credit. Without the ability to quickly change rates and terms, the reasoning goes, card issuers won't lend to riskier borrowers. Some people thus won't qualify for cards, and others may see their credit limits lowered. Banks might also get stingier with rewards programs as they strive to protect their profits.

Minor changes are likely, says Travis B. Plunkett, legislative director for the Consumer Federation of America, but nothing in the new law should prompt the wholesale abandonment of a business that will still yield healthy margins. Pew, Plunkett's group and a coalition of consumer advocates aimed to end a handful of harmful practices, not kill credit cards.

"The credit card is a valuable tool for many Americans," he says. "Transactors like me—people who pay off their balance each month—get a good deal, and it's a convenience that I depend on. We were never involved in this debate for any reason other than believing consumers needed to be treated more fairly."

Jeffrey Wigand—portrayed by Russell Crowe in the film *The Insider*—famously blew the whistle on cigarette makers. His testimony that they knew they were addicting customers to a deadly product doomed them, not only because Wigand was a scientist with inside information but also because he'd once been a believer.

Pew's campaign to improve credit cards has a Wigand of its own, and his name is R. Dwane Krumme. Like Wigand, Krumme is a former executive who concluded that his industry had erred. Unlike him, Krumme couldn't be portrayed as a malcontent bent on revenge, as the tobacco industry had done to Wigand.

Krumme has had a distinguished career. Starting in the 1970s, he ran the credit card division for a California bank called First Interstate, which was acquired by Wells Fargo. At First Interstate, he pioneered the use of credit scores in granting cards. Later, he oversaw the North American credit-card operation for a Japanese company called JCB International Credit Card Co. Since his retirement, he has continued to observe U.S. card companies' practices. What he'd begun to see over the last few years gnawed at him.

"I felt that the industry was becoming greedy," he says. "In my mind, some of the leading banks should've drawn some lines. But nobody did. I have no problem with a profit motive. I have a big problem with exploitation and greed.

"The biggest issue for me was the changing of interest rates on existing balances. Someone could be an hour late with a payment, and an issuer would pop a penalty rate on them." Once card companies applied those higher penalty rates to accounts, they rarely relaxed them.

Michael Roster, former general counsel of Golden West Financial and an adviser to the Sandler Foundation, introduced Krumme to the staff at Pew. Roster knew that Pew sought someone with Krumme's expertise to lead its credit-card reform effort because the Sandler Foundation was an early partner in the work, initially helping to fund it. Roster also introduced Bourke, a former consultant with Visa, to Pew and Krumme. The Sandler Foundation brought not only contacts and money but also expertise: Its founders, Herbert M. and Marion O. Sandler, built Golden West into one of the country's largest savings and loans before selling their bank to Wachovia.

Initially, the Safe Credit Cards Project's goal was to persuade at least one of the biggest card issuers—10 banks control about 90 percent of the market—to issue a pro-consumer card—that is, one certified not to have any of the penalty rates and punishing provisions that can lead to a spiral of indebtedness.

The idea was that having a major issuer like, say, Capital One or Citigroup offer a certified card would change the dynamics of the industry, forcing other banks to follow.

Krumme and Bourke, with the help of a consulting firm and a clutch of advisers, including Elizabeth Warren, a leading advocate for credit card reform and a professor at Harvard Law School, laid out what they believed were reasonable parameters for such a card. They understood that companies had to be able to make healthy profits and protect themselves from borrower defaults. They thus spent 18 months talking with the banks and refining their guidelines in response to the concerns that they heard.

“We had many conversations talking through the tradeoffs. If we were inflexible, then nobody would have adopted the card,” Krumme says.

Krumme, Bourke and their advisers didn’t just confer with lenders. They had to create something that key consumer groups would support. If consumer advocates attacked the card and the media aired their complaints, Pew and its partners would look as though they had been co-opted by the industry.

Linda Sherry, director of national priorities for Consumer Action, says that she welcomed Pew joining the push for fairer cards. The institution brought credibility and resources to an issue that her group had pushed, with little success, for nearly two decades. “Pew has instant name recognition,” she says. Plus, its reputation for reasonableness gave it access to industry executives who might’ve been reluctant to meet with consumer groups.

Krumme and Bourke poured a year and a half into dialogue with the big banks but couldn’t persuade anyone to issue the certified card. One financial executive isn’t convinced that a certified card would’ve made much difference, even if a big bank had embraced it.

Jim Blaine runs the State Employees Credit Union in North Carolina, the second-largest credit union in the country. Blaine has long been recognized as an innovator in his industry, and he acted as an informal adviser to Krumme and Bourke. Brainy and outspoken, he also loves to evangelize about the benefits of credit unions over banks. For years, he and the chair of the North Carolina Bankers Association sniped at each other in a public, but mostly good-natured, feud about whether credit unions, because they’re tax-exempt, represent unfair competition to banks.

Yet when talk turns to credit cards, Blaine can sound much like a banker. He says that credit cards’ prodigious fees and quicksand policies arose not because banks are greedy but because consumers pay attention to only two things when shopping for a card: the advertised initial interest rate and the rewards. They fail to read, or heed, the fine print.

Blaine concluded this because State Employees Credit Union has conducted, in effect, a large multi-year experiment. It offers a card resembling Pew’s proposed certified one. The card has no annual or over-the-limit fees. Its late charge is $5. Its interest rate varies according to a published schedule, so cardholders don’t face surprise increases. And the credit union doesn’t increase credit limits unless customers ask and show they can manage higher ones; people thus aren’t lured into spending beyond their means.

But Blaine’s members haven’t scooped up this good-guy card. Despite being the second-largest credit union in the country, SECU ranks only 20th among credit-union card issuers. In other words, many of its members are going elsewhere for their plastic.

Blaine believes that they're flocking to the same teaser rates and rewards that seduce everyone else. "If we play it straight with our card—and I think we do—with what's going on in the market, we always lose," Blaine says. "Our members go ahead and take those crazy cards because of the rewards or the zero interest rate for the first 90 seconds."

From Blaine's point of view, better laws will help consumers more than a certified card could have done. Laws give consumers tools they need to protect themselves: By banning the most egregious practices, they restore the fairness of contracts and let people make informed decisions.

When confronted with pushes for reform, business people often argue that the market will solve the problem. Once consumers start to complain, they say, an entrepreneur will figure out a way to capitalize on that dissatisfaction by dreaming up something better. Irate consumers, in other words, provide an incentive for someone. Thus when airline fares got too high and ticket policies too restrictive, Southwest Airlines and other discount carriers emerged, and travelers scurried to them. And when people got sick of late fees on video rentals at Blockbuster, Netflix offered an alternative.

The lack of results after Krumme's and Bourke's months of diplomacy, however, suggested that the same process wouldn't play out in the credit card industry, at least not quickly. Even when offered an enticing inducement—the positive publicity that would've come with public endorsements by Pew and leading consumer groups—the biggest credit-card issuers wouldn't change.

By 2008, the economy had sputtered into recession, and the subprime mortgage crisis had begun to spread beyond a handful of Sun Belt states and niche mortgage lenders. Some bankers told Bourke and Krumme privately that they knew their industry had to evolve. But none of them was willing to go first for fear of losing customers and profits to competitors—for fear, in other words, of finding themselves in Jim Blaine's situation.

"One executive at a large bank told us our Safe Credit Card Standards were just where the industry needed to go, but that it would never happen unless Congress established a level playing field," Bourke recalls. "That's when we started doing more policy-oriented research and reaching out to regulators and legislators in Washington."

As Krumme and Bourke continued to make their case and consumers continued to rack up debts, troublesome credit cards did begin to garner greater attention in Washington. Lawmakers began to threaten to increase regulation of the industry.

The certified-card effort became a resource to help propel the later legislative campaign. The project had achieved a lot—developing its Safe Credit Card Standards, documenting industry practices and building a bridge between the companies and consumer groups. The months of discussion also gave credibility to the argument that card issuers wouldn't change voluntarily.

Several legislators introduced bills to ban some of the most controversial practices. Then in May 2008, the Federal Reserve surprised reform advocates by proposing tight new rules, which included restrictions on "hair-trigger penalty rates" and some of the other practices targeted in Pew's standards, Bourke says. The proposal ended up generating about 56,000 public comment letters, an unusually large number.

Just as important, it represented a turnabout for the Fed—which had previously taken a mostly laissez-faire approach to consumer protection—and a signal of changing attitudes in Washington. Previously, banks had easily beaten back proposals for significant new credit-card regulation. But the Fed, the most respected and powerful of the country's bank regulators, couldn't be dismissed as some dreamy agitator.

Pew and its allies welcomed the Fed's proposal but believed that it wasn't enough. "Congress needed to get involved because Fed rules apply only as long as the Fed enforces them," Bourke says. "And we wanted to see a law with more consumer protections—something that more resembled our standards."

As he and others made this argument in Washington, events were moving in their favor. By the fall of 2008, the financial crisis was raging, and bank stock prices were beginning their long burn down to charred stubs. Some banks were flirting with insolvency, and Lehman Brothers had begun its market-rattling slide into bankruptcy. The U.S. Government was waging its effort to shore up the biggest financial firms and restore investor and consumer confidence. As the government geared up to pump hundreds of billions of dollars into the sector, people began to ask why, if taxpayers were bailing out the banks, banks weren't offering relief to their strapped customers.

On top of all of this, in September the House of Representatives passed a reform bill introduced by Representative Carolyn B. Maloney of New York. "The facts about abusive credit-card practices were out there," says Gail Hillebrand, manager of the financial services campaign for Consumers Union, publisher of *Consumer Reports*. "But in Washington, you have to win on the facts *and* the politics, and the politics changed."

However, the Senate did not act on the bill, which expired without becoming law. It was not all bad news for reform advocates, who got something to cheer when the Federal Reserve finalized its consumer protection rules in December. But even then they were disappointed, especially because the rules would not take effect until mid-2010. "Much more needed to be done," said Bourke, "and more quickly."

In early 2009, Representative Maloney reintroduced a version of her bill that closely matched the Federal Reserve's rules but would speed up their implementation. This time, the Senate responded. Connecticut's Christopher J. Dodd, who chairs the Senate Banking Committee, offered up an even tougher measure. In arguing for it, Dodd cited research Pew published in March, pointing out that Pew's report found that, in one year, "card companies raised interest rates on nearly one out of every four accounts, nearly 70 million cardholders, who were charged $10 billion in extra interest rates."

His arguments met a receptive audience among his fellow senators. Last May, they passed the Credit Card Accountability Responsibility and Disclosure Act of 2009 by a vote of 90 to 5. House members, too, voted strongly for reform. President Obama—who'd called on the Congress to act on credit cards before Memorial Day—promptly signed the measure into law. "We don't begrudge [credit card companies] turning a profit," he said at the signing ceremony. "We just want to make sure that they do so while upholding basic standards of fairness, transparency and accountability."

The campaign to make credit cards safer for consumers isn't completed. The new law represents a real victory for the coalition of Pew and consumer groups and, more important, for Americans who use credit cards.

But some people who've already watched their debts swell because of hefty fees and penalty rates won't see immediate relief. The new law wasn't retroactive, and much of it has yet to take effect. Its first part took effect last August, and the rest will be phased in by August of this year.

Pew is continuing its research and advocacy to ensure that forthcoming regulations hew to Congress's intent to stamp out the most abusive practices. “The law says that penalty fees and charges must be ‘reasonable and proportional,’ so the Fed needs to hear from organizations that don’t represent the industry to help it identify what ‘reasonable and proportional’ means,” Bourke says. “The long-term benefits of the new law will depend significantly on what the Fed does next.”

Meanwhile, around the country millions of people (“a record high,” says Plunkett of the Consumer Federation of America) continue to struggle to catch up with their loans or avoid defaulting.

Lynn Acheson, in Elyria, Ohio, near Cleveland, is one person who found herself in financial straits. She lost her job at Barnes & Noble when the recession sapped her store’s sales. To cope, she slashed her spending and found two part-time jobs. Even so, she could make only the minimum payments on her credit cards. She managed to keep the accounts up to date, paying on time. She nonetheless saw the interest rates on two of her accounts rise.

“They didn’t give any reason,” she says. “I called Capital One, and they said it was nothing personal. They were doing it to everybody.”

Her only alternative to accepting the rate hike, the bank’s telephone operators told her, was canceling the card. But she feared trying to get along without plastic in a world where cash has become nearly as retro as roof-top TV antennas.

Situations like Lynn Acheson’s are far too typical, Pew’s ongoing research shows. According to a report released by the project last fall, advertised interest rates on 400 credit cards studied had risen 20 percent on average between December 2008 and July 2009, even as the federal funds rate, a key benchmark for bank lending rates, fell to near-zero percent. The report also revealed that 100 percent of credit cards offered online by the leading bank-card issuers indulge in practices that will become illegal once the Credit CARD Act fully takes effect.

Yet consumers like Acheson won’t have to tolerate these kinds of increases much longer. As Bourke points out, they can already close their accounts without fear, in most cases, of being cut off from credit. And because the credit card industry remains profitable and competitive, people will continue to have choices. At the same time, once the act totally kicks in, they’ll no longer have to worry about issuers unilaterally raising rates on money they already borrowed.

“Going forward, contracts will be real contracts,” Bourke says, summing up. “Over-the-limit fees will become much less common and less severe—they may even go away. Hair-trigger and permanent penalty interest-rate increases will be banned. And if the rate people pay on new purchases goes up because of a drop in their credit scores, they will have to come down later as the scores improve. Credit cards will be much safer and more transparent.”

Tim Gray, a freelance writer based in the Boston area, has won editorial-excellence awards for his articles on business and management practices.