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THE PLASTIC TRAP

Soaring Interest Compounds Credit Card Pain for Millions

By PATRICK McGEEHAN

This article was reported by Patrick McGeehan, Lowell Bergman, Robin Stein and Marlena Telvick and written by Mr. McGeehan.

When Ed Schwebel was whittling down his mound of credit card debt at an interest rate of 9.2 percent, the [MBNA Corporation](#) had a happy and profitable customer. But this summer, when MBNA suddenly doubled the rate on his account, Mr. Schwebel joined the growing ranks of irate cardholders stunned by lenders' harsh tactics.

Mr. Schwebel, 58, a semiretired software engineer in Gilbert, Ariz., was not pleased that his minimum monthly payment jumped from \$502 in June to \$895 in July. But what really made him angry, he said, was the sense that he was being punished despite having held up his end of the bargain with MBNA. "I paid the bills the minute the envelope hit the desk," said Mr. Schwebel, who had accumulated \$69,000 in debt over five years before the rate increase. "All of a sudden in July, they swapped it to 18 percent. No warning. No reason. It was like I was blindsided."

Mr. Schwebel had stumbled into the new era of consumer credit, in which thousands of Americans are paying millions of dollars each month in fees that they did not expect and that strike them as unreasonable. Invoking clauses tucked into the fine print of their contract agreements, lenders are doubling or tripling interest rates with little warning or explanation.

This year, credit card companies are changing the terms of their accounts at a historically high rate, said Michael Heller, an industry consultant. As those practices spread, they are creating a rift between the lenders and some of their more lucrative customers, according to cardholders, current and former bank consultants and regulators who were interviewed for a joint report by The [New York Times](#) and " [Frontline](#)," the PBS documentary program.

People like Mr. Schwebel, who carry balances from month to month and pay finance charges regularly, feel they should be the favored customers of the credit card business, which is now the most lucrative segment of banking. They make up the profitable majority of the 144 million Americans who have general-purpose credit cards. To a degree, they subsidize the 40 percent of credit card customers who pay in full each month without incurring any fees or charges.

But increasingly, they say, what should be a warm embrace has turned into a painful squeeze as lenders employ new tactics to extract more and bigger penalties for even the slightest financial transgressions. In the last few years, lenders have more frequently raised customers' rates because of slip-ups elsewhere, like late payment of a phone or utility bill, or simply because they felt a customer had taken on too much debt.

The practice, called universal default, started after a rash of bankruptcy filings in the mid-to-late 1990's and has increasingly become standard in the industry. While MBNA declined to comment on any specific customer's account, its general counsel, Louis J. Freeh, the former F.B.I. director, said in a statement that it was being prudent by raising rates when it had reason to think the risk of not being repaid had increased. Edward L. Yingling, executive vice president of the American Bankers Association, said bankers must have the flexibility to change terms on short notice. The bankruptcy filings of the 90's - many by customers who had been paying their bills on time - caught banks off-guard, he said.

Lenders decided they needed to watch for signs of trouble elsewhere, like missed car payments, he said. In those cases, he added, there are only two logical responses: "We're not going to let you have this credit card loan anymore and we're going to say, 'Pay it off,' or we can say, 'You're now more risky; we're going to raise your rate.' "

Still, some critics say the severity of the punishment does not match the risk of default. The suddenness and perceived unfairness of the penalties have left many consumers feeling burned by lenders who relentlessly courted them with promises of low rates. To some cardholders and consumer advocates, credit card companies are acting like modern-day loan sharks, strong-arming their customers to pay more - with no legal limit on how much they can charge.

In eight years, the major card companies have increased the fee charged to cardholders for being even an hour late with a payment to \$39, from \$10 or less.

Unleashing an Industry

Duncan MacDonald, who, as a lawyer for Citibank was involved in its successful case for deregulation of fees before the United States Supreme Court in 1996, now says he fears that he helped to unleash a monster. Until that ruling, most banks still charged an annual fee of about \$25 for the use of a card and a single fixed rate to all borrowers, usually around 18 percent. Applicants either qualified for the privilege of carrying a card or they did not.

"I certainly didn't imagine that someday we might've ended up creating a Frankenstein," said Mr. MacDonald, who predicted that the penalty fees could rise to \$50 in another year. "I look at that and I say to myself, 'Is \$50 a fair fee, plus a 25 percent interest rate and all these other fees that are thrown on, for folks who are probably not that risky? Is that fair?'"

Mr. MacDonald said federal bank regulators should investigate the fairness of universal default and some of the banks' harsh penalties. But regulators and lawmakers have been reluctant to crack down on a popular consumer product that fuels America's economic engine. Consumer spending pulled the country through the last economic downturn, powered largely by purchases financed with debt, to the tune of \$2 trillion.

Few consumer products today are as cherished or reviled as credit cards. The typical household has eight cards with \$7,500 on them. People like Mr. Schwebel are known as "revolvers" in the industry because they roll balances over from month to month, never paying in full. Without the 85 million Americans who revolve, card issuers would be struggling to please their investors. But with them and the hefty finance charges they accrue from the moment cashiers swipe their cards, the industry is reaping record gains. Last year, card issuers made \$2.5 billion a month in profit before taxes.

"I think it is generally understood that those that use the revolving part of the credit card are kind of the sweet spot," said Mr. Yingling of the bankers' association, who spoke on behalf of several of the biggest issuers, including [Citigroup](#), [J. P. Morgan Chase](#) and MBNA, all of which declined to make executives available for interviews.

But the lenders' aggressive tactics have prompted a surge in complaints and lawsuits and even a warning from the primary regulator of national banks in September. In an advisory letter, the Office of the Comptroller of the Currency said banks should not raise card rates without having fully and prominently disclosed the circumstances that might cause an increase.

Changing the Terms

The case that opened up the industry came in 1978 when the Supreme Court decided that a bank could charge its cardholders any rate allowed in the bank's home state. Major banks swiftly moved their credit card operations to places like South Dakota and Delaware that had removed caps on interest rates. There is no federal limit on consumer credit rates.

After that ruling on interest rates, credit cards, which until then had generally been an uncertain business, started to look potentially lucrative. Banks began to innovate and compete. They cut the required minimum monthly payment to 2 percent of the balance, from 5 percent, to encourage customers to borrow more and stretch out the repayment. They dropped annual fees and dangled offers of low interest, or none at all, to lure new customers.

At the same time, legal teams crafted contracts of 12 or more single-spaced pages that gave the banks the leeway to change their terms whenever they wanted. A typical term sheet for a Visa card issued by [Bank One](#), which was acquired this year by J. P. Morgan Chase, includes: "We reserve the right to change the terms at any time for any reason."

John Gould has worked in and around the credit card business for 25 years, but he said he was shocked when his wife tried to make a last-minute payment over the phone and was charged an extra \$15.

"What a rip," he said. "That does get me mad."

Fees like that are accounting for a greater share of the revenue that card companies garner from their customers. Last year, they collected \$11.7 billion in penalty fees, more than half of the total \$21.5 billion in fees they collected from cardholders, according to CardWeb, a research firm.

Mr. Gould, a former executive of MasterCard International who conducts research for TowerGroup, a company owned by MasterCard, said he did not think that card companies were trying to trap people into financial distress. But he said it was "absurd" that 44 percent of them tell their customers that they might be penalized for one or two late payments with maximum rates that now exceed 28 percent.

This practice has gone on while the short-term interest rates set by the Federal Reserve Board have been unusually low, now at 2 percent, he noted, but the rates have been rising in recent months. "What are they going to do if we have a spike in interest rates?" Mr. Gould said. "What are they going to start charging people, 35 percent, 38 percent? If it comes to that, you might as well go to the loan sharks."

But Andrew Kahr, a financial services consultant who devised some widely used consumer-lending strategies, including the zero-percent teaser rates, said consumers should be able to recognize that the business is a "game of chance." Interest rates shooting past 25 percent may seem scandalous to some, Mr. Kahr said, but they are "no less realistic" than the low introductory rates many cardholders receive.

The lenders offer tantalizingly low initial rates because that is what it takes to lure customers from competitors, said Mr. Kahr, who was a founder and chief executive, until 1986, of the San Francisco lending company now known as Providian. After he left, Providian ran afoul of state and federal regulators for some of its credit card practices, and agreed to a \$300 million settlement.

But, he said that banks cannot earn an adequate return by lending for less than it costs them to borrow, so they look for ways to recoup losses on the low-rate chasers. "They do better when they apply these price increases selectively to customers who statistically have become more risky, or to those who have violated the rules of the account," Mr. Kahr said.

Still, some cardholders complain that they did not know the rules until after they were punished for breaking them. Linda Sherry, editorial director for Consumer Action, an advocacy group, said "the consumer really has no rights to find out anything, to demand, 'Why is this being done to me?'"

Last month, a consumer advocacy group in San Diego, the Utility Consumers' Action Network, filed suit against Discover Financial Services, the issuer of the Discover card, asserting that it had changed the rules late in the game. The group contends that a recent rewording of Discover's universal-default policy is unfair to consumers, especially those in difficult financial situations. The change, disclosed to cardholders in April, allowed Discover to raise the interest rate to 19.99 percent, from as low as zero, for a single late payment. But the infraction did not have to follow the revision, because Discover reserved the right to look back 11 months for a late payment that could justify the increase.

"It has gotten to the point where the fine print is becoming almost outright abusive of their customers," said Michael Shames, executive director for the consumer group. "The customers who are affected most by this practice are those who, for one reason or another, are having trouble making payments and have a large balance."

Jennifer Kang, a spokeswoman for Discover Financial, said she could not comment because of the pending litigation. Discover executives declined repeated requests for an interview. Mr. Heller of Argus Information & Advisory Services in White Plains, the industry analyst who has studied the rate of change in credit card terms, said that his research showed that in the first half of this year, MBNA - the card issuer that doubled the interest rate for Mr. Schwebel, the Arizona engineer - repriced a smaller share of its card accounts than the industry average.

But MBNA, in the statement from Mr. Freeh, said: "If we see indications that a customer is taking on too much debt, has missed or is late on payments to other creditors, or is otherwise mishandling their personal finances, it is not unreasonable to determine that this behavior is an increased risk. In the interest of all of our customers, we must protect the portfolio by adjusting a customer's rate to compensate for that increased risk."

The Credit Score

The interest rate on a credit card is theoretically correlated to the likelihood that a borrower will make good on his debts. Lenders typically measure those odds by a three-digit number known as a FICO score. Calculated by and short for the Fair Isaac Corporation, a company in Minneapolis, that score has become the most vital of statistics to many Americans.

Credit scores are used to determine everything from how much a person can borrow to how much he or she pays for life insurance to whether he or she can rent a home. A utility company in Texas even experimented last summer with using credit scores to set prices for electricity.

The number crunchers at Fair Isaac do not make lending decisions. They simply take information collected by the three largest credit-reporting agencies, Experian, [Equifax](#) and TransUnion, and apply mathematical formulas to boil it down to a single number on a scale that runs to 850.

"Lenders use that score, almost like a thermometer, to determine if they're going to grant credit or not," said Tom Quinn, a spokesman for Fair Isaac. He estimated that his company had calculated a credit score for about 75 percent of American adults. The average FICO score is 720, he said. A score below 620 lands a consumer in the riskiest category, known as subprime, and virtually ensures the highest borrowing rates, if the consumer can obtain any credit at all. Credit reports generally note only those payments made at least 30 days late.

Consumers with better-than-average scores are usually, but not always, eligible for the lowest rates. As Steve Strachan, a flower importer in York, Pa., learned, a relatively high credit score does not guarantee favorable terms. A thick credit report on Mr. Strachan from January showed a FICO score above 730, but by then he had already been through a battle with the issuer of a card that had once been his favorite method of payment.

In the 1990's, Mr. Strachan traveled frequently from his home on the West Coast to Amsterdam and other foreign cities to meet with suppliers of tulips and exotic flower varieties that he distributed to domestic florists and wholesalers. He obtained a WorldPerks Visa card that rewarded him with seat upgrades through Northwest Airline's frequent-flier program. "I used that card whenever I possibly could because of the travel benefits," he recalled, sitting in his living room before stacks of credit card bills, change-of-terms notices and other correspondence between him and several lenders. "Never paid a penny of interest."

He was such a valued customer then, he said, that US Bank, which issued the card, had extended him a high credit limit of \$54,000 even though the card rate was just one percentage point above the prime rate. When the economy wilted after the collapse of the stock market in early 2000, so did Mr. Strachan's business. He began using his credit lines on that Visa card and a few others to stay afloat, paying smaller portions of his growing balances.

Then, in May of last year, US Bank sent Mr. Strachan a letter telling him that it planned to raise the card's rate to 20.21 percent, nearly quadrupling the existing rate of 5.25 percent. "I wasn't late, and I didn't go over the credit limit, and I didn't write bad checks," Mr. Strachan said. A representative of US Bank told him he was using too much of his available credit, he said. A US Bank spokesman declined to comment on Mr. Strachan's account.

The monthly interest charge on his \$50,000 balance jumped from \$209 in June to \$756 in July and \$808 in August. He eventually persuaded the bank to restore the original rate, but the bank closed the account, shutting off a key source of credit. By then, Bank One, another creditor, had compounded Mr. Strachan's woes. He was carrying a balance of about \$70,000 on one account when the bank started raising his rates, first to 19.99 percent in April 2003, then to 22.99 percent the next month, then to 24.99 percent in June. By October of last year, he was incurring a monthly finance charge of about \$1,500 on a \$77,000 balance. "It was like they almost all had a little meeting in the back room and said, 'Let's get Strachan,'" he said of his creditors. "How does it serve them to treat people like that? Are they trying to force them into bankruptcy?"

Lawyers he consulted advised Mr. Strachan to take the easy - and increasingly popular - way out by filing for bankruptcy protection, but he refused. He is struggling to make good on his debts "because I have principles and ethics." But the battle to dig out of a deepening hole has taken a toll. Mr. Strachan said he had lost 30 pounds and described himself as a "broken man." Lately, he said, Bank One has periodically reduced his credit limit to a level just above his remaining balance, leaving him little margin for error. Some months, he said, if he were to pay only the minimum due, the ensuing finance charge would put his balance over the limit, triggering a penalty fee. By doing that, he said, "They create their own little monster."

The Regulators

Consumer complaints prompted the Office of the Comptroller of the Currency, which oversees the nationally chartered banks that constitute most of the major card issuers, to warn banks about giving fair notice of term changes and about sending out tempting offers to people who are unlikely to qualify for them. Julie Williams, the acting comptroller, said in an interview that as long as the lenders were not intentionally deceiving their customers, they were free to set whatever rates and fees their home states allow. If customers do not want to pay a particular rate, "they have choice," she said. "They can find another card."

But consumers clearly are unhappy with the choices they have. About 80,000 people lodged complaints with the comptroller's office last year. Ms. Williams said the largest single source of their ire was credit cards. Those complaints are routed to examiners who monitor the banks, she said, but the examiners' foremost concern is to make sure the banks are financially sound.

Ms. Williams described her agency as a "tough regulator," but critics contend that the comptroller's office has taken strong action against only one major issuer of credit cards in the last five years. In 2000, the O.C.C. joined in an investigation into Provident that had been started by the San Francisco district attorney's office. Provident customers complained that they had been hit with late fees for payments that had been sent in on time but not credited to their accounts for days or weeks. Some said the resultant penalties pushed them over their credit limits, leading to additional fees. Later, Ms. Williams said, the two agencies joined forces to extract \$300 million in a settlement with Provident.

The comptroller's office has since angered state attorneys general by trying to limit their ability to regulate how national banks behave in their states. Eliot Spitzer, the attorney general of New York, said his office gets "thousands of complaints every year about credit card issues relating to the major banks, the major card issuers." But more often, he said, the banks' response has been that " 'we don't need to deal with you because the O.C.C. has told us - indeed, directed us - not to deal with state enforcement entities.' "

Elizabeth Warren, a professor at Harvard Law School who has been a vocal critic of consumer lenders, said the comptroller's office should do more than express discomfort with the practices of credit card companies, as it did in September.

The regulators did not say that "those are unfair practices, they are unsafe and unsound and don't do them," Ms. Warren said. "Instead, they said it's a problem. Look, if they think it's a problem, then tell the credit card companies to stop doing it."

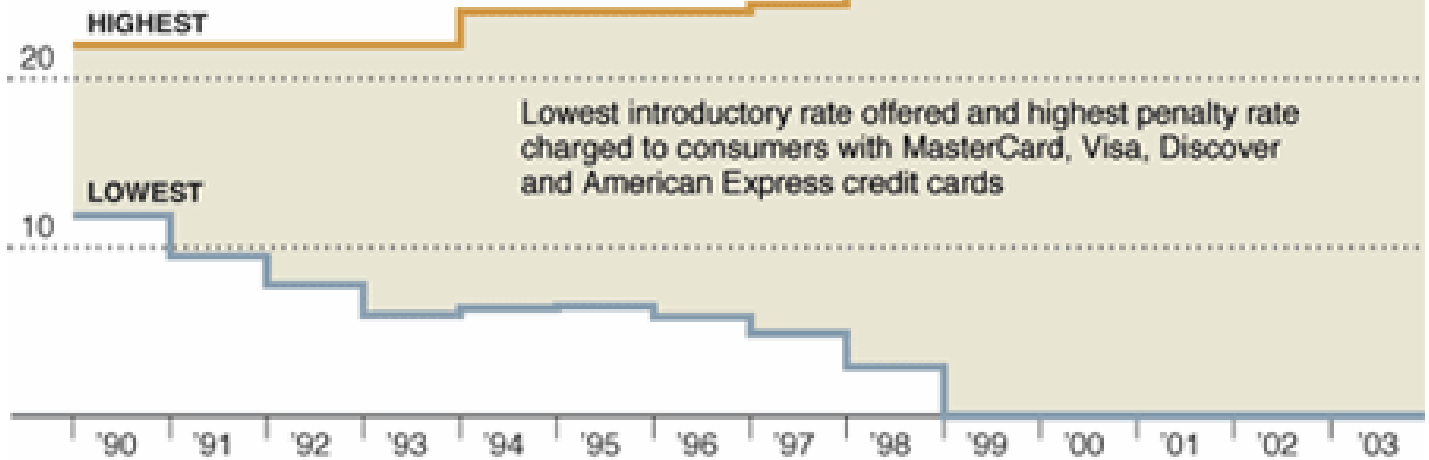
"Secret History of the Credit Card," produced in conjunction with this article, will be shown Tuesday on "Frontline" (PBS, 9 p.m. in most cities).

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A License to Charge

Credit card companies have placed the ability to carry a balance into the hands of millions more Americans, including those with relatively poor credit who pay the highest rates.

Range of credit card rates



In consumers' wallets ...

| | CARDHOLDERS In millions | CHARGE VOLUME In billions | AVG. REVOLVING BALANCE Of households that carry a balance |
|-------------|----------------------------|------------------------------|--------------------------------------------------------------|
| 1990 | 82 | \$ 338.4 | \$2,549 |
| 2003 | 144 | 1,524.6 | 7,519 |

... and on company balance sheets

| | FEE REVENUE In billions | PRETAX PROFIT In billions |
|-------------|----------------------------|------------------------------|
| 1990 | \$ 6.2 | \$ 6.4 |
| 2003 | 21.5 | 29.8 |