



# Putting Credit Card Debt on Notice

Using electronic reminders to give consumers the right information at the right time

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# Introduction and summary

The United States is in the midst of its worst recession in decades; jobs and wealth are falling at a rapid pace, driving more families into foreclosure and bankruptcy. December's unemployment rate reached the highest level since 1993, and incomes have been stagnant throughout the past decade. Many families have turned to debt to make up for the income they haven't been receiving and to finance their every day necessities. But because of the mortgage market contraction, fewer Americans have been able to access debt through their home equity, and they have instead turned to credit cards.

It is often difficult for consumers to find information about when payments are due and to understand what actions will lead to a penalty. In fact, credit card companies dole out \$18.1 billion in penalties to their customers each year. Moreover, many credit card penalties, such as late payments, come with the additional burden of an increase in the consumer's annual percent rate, or APR, to the penalty rate. This penalty rate can reach as high as 25 to 29 percent. The average penalty rate in 2008 was 16.9 percentage points higher than the average purchase APR, or standard APR. For a household that carries the average amount of \$10,678 in credit card debt, being repriced to the penalty rate would result in an additional \$1,800 in interest costs per year.

One simple technological solution could help level the playing field between cardholders and credit card companies and put money back into families' budgets. Text messages—or a similarly rapid electronic method—could allow a financial institution to transfer information to cardholders at the “teachable moment” when they need it the most. If the typical credit cardholder agreement were dissected into useful pieces, made clearer, and sent to the cardholder in real time, it would decrease the likelihood that cardholders would incur a fee. For example, a bank could automatically send a text message five days before a bill's due date warning the cardholder that a late payment will result in a late fee and an increase in the APR. The message would include both the event—in this case the due date—and the consequence: both a fee and an increase to the penalty rate.

Washington is awash in proposals for revamping banking regulation—and credit card fees are only one element that needs to be examined. But lawmakers should consider how technology can make everyday financial products such as credit cards easier to use and understand. A text message system should not, however, be a substitute for better

protection from the worst abuses in credit cards. A text-messaging program should be implemented in tandem with legislation that makes credit cards fairer by eliminating the worst credit card practices. The Credit Cardholders' Bill of Rights Act, discussed later in this report, would do just that.

Most Americans with credit cards likely have cell phones: 84 percent of the U.S. population uses a cell phone. But cardholders who don't have access to text messaging—and might also be those most in need of clear information—could instead receive messages by email, automatic telephoning, or paper mail in an envelope separate from the monthly billing statement. Electronic messages are very efficient and cost credit card issuers virtually nothing. In fact, many already offer text messages and have sophisticated call centers in place, which indicates that implementation may not be difficult.

Consider that:

- **Credit cards are convenient, but difficult to use responsibly.** Credit cardholder agreements are written in language that is above the level at which about 50 percent of U.S. adults read, and information within them is poorly organized. Moreover, issuers appear to “price” the cost of using credit cards by taking advantage of cardholders’ behavior biases. For example, credit card issuers take advantage of the fact that cardholders underestimate the probability of paying late or going over the credit limit, and punish this behavior with fees and increases in the penalty rate.
- **The right information at the right moment can help cardholders make better decisions.** A text-messaging system by itself would not prevent issuers from continuing to price credit cards however they like, but it would orient cardholders toward the best outcomes, such as paying on time and not going over their credit limit. This approach recognizes that most individuals don’t behave like *homo economicus*—the “economic man” of economic textbooks who maximizes every financial decision and has perfect information to do so. Most cardholders could benefit from a “nudge” toward a more beneficial choice.
- **Americans currently hold a record high amount of debt and are defaulting at alarming rates.** Americans held a record high amount of \$946.1 billion in credit card debt (in 2007 dollars) as of November 2008, the last month for which data is available. Partly as a result of the downturning economy, the credit card charge-off rate—the amount of loans a lender removes from its books and charges against its loss reserves when the loans are deemed delinquent—increased 79.5 percent from the first quarter of 2006 to the third quarter of 2008—to 5.62 percent from 3.13 percent. Data from 2005 and earlier are not comparable because of a change to the bankruptcy code.

Congress should pass legislation that requires issuers to reach out to a customer through a text message or similarly rapid method the first time he or she encounters each “teachable moment”; only then should the issuer be allowed to charge the customer with a penalty fee or rate increase. After the cardholder is notified through this system, the cardholder would then be responsible for making choices—not the bank.

The right information at the right time has the potential to let families keep their hard-earned money rather than turn it over to banks and avoid accumulating more debt in the future—money that could be kept in families’ budgets and used to help weather today’s economic storm.

# Credit cards are convenient, but difficult to use responsibly

Financial services are a critical part of Americans' economic stability; they allow families to conduct basic transactions, save for future expenses and emergencies, and borrow in times of need. Credit cards provide a particular convenience; they have revolutionized how payments are made, and have replaced checks and cash for typical everyday transactions at the supermarket, gas station, pharmacy, and on the Internet.

Yet Americans who want to use their credit cards responsibly are often unable to do so because credit cards are not designed with the ease of cardholders' best outcomes in mind. Credit cards, like many financial services, are remarkably complex. A 2006 Government Accountability Office report found that credit card disclosures are written well above the eighth grade level at which about 50 percent of U.S. adults read.<sup>1</sup> And interviews with cardholders conducted as part of the report revealed that the pages of small print disclosures may obscure, rather than clarify, what actions cause credit card lenders to raise their rates.

The need for clear credit card terms is greater than ever amid the economic downturn, as families may accelerate their borrowing to weather job loss or unexpected medical emergencies. And Americans may turn increasingly to credit cards as lenders tighten standards for other types of loans, restricting families' access to less expensive forms of credit, such as borrowing against home equity.

A study conducted in July 2008 as the mortgage market was contracting found that credit card debt surged between March 2006 and May 2008 as the home equity cashout market dwindled from nearly \$137 billion per quarter (in 2007 dollars) to nearly nothing. This shows that families have responded to tighter home equity lending standards by turning to credit cards, which come at a higher price when considering higher rates and the multitude of fees.<sup>2</sup>

Credit card lenders appear to "price" the cost of using credit cards by relying on the cardholder's behavioral biases. Lenders charge consumers very high penalties for being late and for going over the credit limit rather than requiring them to pay an upfront annual fee, and count on the cardholder to underestimate the probability of these events.<sup>3</sup> They compete on the grounds of how individuals will respond to the terms that are most prominently displayed rather than by providing transparent information about the most consequential terms.<sup>4</sup> And indeed, issuers collected a record \$18.1 billion in credit card penalty fees in 2007.<sup>5</sup>

What's more, hair-trigger penalties such as being late or going over the limit are often accompanied by an increase in the penalty rate. The difference between the penalty APR and the standard APR—or purchase APR, in credit card parlance—can equal hundreds or thousands of dollars more in finance charges over the course of a year for a family with a balance on their card. Research by the Center for Responsible Lending has found that credit card penalty rates are on average 16.9 percentage points higher than the average purchase APR. Almost 11 percent of all balances borrowed on credit cards are at penalty rates—often without the cardholder realizing it. According to CRL's research, a U.S. household with the average amount of \$10,678 in credit card debt that is paying the penalty rate rather than the standard rate would have to pay an additional \$1,800 in interest costs a year<sup>6</sup>—a tremendous portion of their disposable income.

The complexity of penalty rates and cardholder agreements causes many cardholders to slide deeper and deeper into debt. Families held a record high \$946.1 billion in credit card debt in November 2008 (in 2007 dollars), the last month for which data is available. The credit card charge-off rate, which is the value of loans that a lender removes from its books and charges against its loss reserves once these loans are deemed delinquent, also increased 79.5 percent from 3.13 percent in the first quarter of 2006 to 5.62 percent in the third quarter of 2008—partly as a result of the souring economy. Data from 2005 and earlier are not comparable because of a change to the bankruptcy code.

This is where technology can enable a cardholder to make the choice that's most beneficial to them. It's hard to hide complicated terms in the 160-character limit of a typical text message. Cardholders are free to choose options that could both help or harm them, but a text message could “nudge” a cardholder toward making a better choice. Text messages would not force cardholders into making a choice, but they could present the cardholder with straightforward information about their terms of service and the most beneficial option.

Richard Thaler and Cass Sunstein explain in the book “Nudge” that “choice architecture” can orient individuals toward making choices beneficial to them, without blocking off less beneficial choices.<sup>7</sup> Many economists are committed to the idea of *homo economicus*—the idea that every household maximizes every financial decision to benefit its well being and has perfect information to be able to do so—but others believe that households are susceptible to mistakes, such as forgetting a due date or having trouble with long division.<sup>8</sup>

Just as a cook at a elementary school cafeteria can orient kids toward making healthy lunch choices by putting healthier options at eye level and within closer reach, so too can credit card issuers orient cardholders toward paying on time and not going over their credit limit by providing good information at the proper time. Choices are not eliminated—irresponsible cardholders can still incur the highest penalties available—but cardholders are led away from the least beneficial options.

# The right information at the right moment can help cardholders make better decisions

Cardholders would be less likely to incur a fee or have their APR driven to the penalty rate if credit card companies sent clear reminders to the cardholder in real time at the “teachable moment,” when the cardholder needs it the most. Cardholders would receive the information via text message or a similarly rapid method such as email, automated phone call, or on receipts for purchases and at ATMs. The message should include the event as well as the consequence, whether it is a fee, an increase to the penalty rate, or both.

Most cardholders have access to text messages; 84 percent of the U.S. population uses cell phones,<sup>9</sup> and these users likely coincide with the 74.9 percent of families that have credit cards.<sup>10</sup> In fact, 77 percent of U.S. consumers believe it’s important to have real-time information regarding their bank and credit card accounts, and 80 percent say they want to use mobile devices to pay bills and receive notifications when they are due, according to a CardLine report.<sup>11</sup> But cardholders who don’t have electronic access may also be those most in need of clear information, and the credit card issuer should send those customers messages through email, automatic telephoning, or by paper mail in an envelope separate from the monthly billing statement if text messaging is not available.

For such a system to work, it would have to notify consumers when any fee has been triggered. There are two times when it would be particularly appropriate to send such a message:

- **Before late payments.** A bank could, for example, issue a text message five business days before the due date. The message would state that the late payment would result both in a late fee and an increase to the penalty rate (if applicable). The message should include both the event—in this case the due date—and the consequence: both a fee and a rate increase. Many banks now offer cardholders the option to change their due date, and making this ability known could help the cardholder make sure that the due date is a few days after payday or during a week when no other large bills are due to ensure a steady flow of cash.
- **After any fee has been triggered that moves up a cardholder’s APR to the penalty rate.** When an issuer increases the interest rate on a card to the penalty rate, it should send a monthly notice to the cardholder until he or she has made three consecutive payments, or until the penalty rate is removed—whichever is later. If the issuer sends the notice electronically, it should be sent at least 10 days before a payment is due, and

if it is sent by mail, it must be sent 20 days before a payment is due. To be effective, the reminder should say: “A penalty rate of \_\_\_ is being imposed on your account. To end the penalty rate and return to the standard rate of \_\_\_, you must [insert applicable provision, such as] make \_\_\_ consecutive payments on time.”

The infrastructure needed to enact a text-messaging system is largely already in place and may require only minimal costs on the part of the issuers. A number of banks already offer text message alerts, showing that the existing messages could be easily adapted into the system proposed here. Four of the five largest banks, which include Citigroup Inc., Bank of America Corp., JPMorgan Chase & Co., Wachovia Corp., and Wells Fargo & Co., had text message alerts of some kind for their credit cards as of October 2008, and all five offered text alerts for checking accounts.

Three of five banks issue text reminders when payment is due; only two of five issue text reminders when the credit balance reaches a specified level; and only one of five issue a reminder if payment is past due. It is unclear if issuers warn their customers of the penalties in the text messages.

Who would use text messaging from banks? The snap answer is tech-savvy young adults. Coincidentally, this is the same age cohort that is earning the nickname “the Debt Generation” because of the lack of good job opportunities available to them, as well as the loads of student loan and credit card debt they are forced to accumulate while in college. In 2004, 66 percent of 18-24 year old cardholders had credit card debt, as did 69 percent of 25-34 year olds.<sup>12</sup>

But this program holds an even greater potential for heads of households of all ages who are trying to get by in an increasingly difficult economy. In 2004, 46.2 percent of all families carried credit card balances—the highest level ever recorded.<sup>13</sup>

U.S. banks could also learn from studying developing countries, where mobile banking and mobile payments are helping to confront an entirely different set of challenges: very few poor people have access to financial services. Branchless banking using mobile phones has allowed people without a bank account to make peer-to-peer transactions by cell phone.

For example, one of the popular services in Kenya is M-PESA, which is offered by the largest telecommunications company in that country. Only 10 percent of Kenyans have traditional bank accounts. M-PESA allows unbanked Kenyans to make simple peer-to-peer transactions, giving them the ability to transact with more people—governments, businesses, and other individuals. It reduces the costs for banks to reach people, and lower-income users who use their cell phones along with the service can find cheaper prices for goods than if they had no services at all. Three million users have registered since the service was introduced in March 2007, and this number is expected to grow to 5 million by the end of 2008.<sup>14</sup>

# Conclusion and policy recommendations

The central challenge for policymakers seeking to implement this approach will be to provide the right policy to mandate electronic reminders, since it is not in the banks' interest in many cases to fully inform the cardholder of the card's terms and conditions.

Congress should pass legislation mandating that banks must reach out to their customers through a text message (or similar method) if they want to assess any type of late fee or penalty that would increase a customers' rate to the penalty rate. The bank would be required to make the contact the first time one of the following occurs: 1) the customer has not paid their bill within five days of its due date, with a message that includes the due date and the consequence for being late; 2) after any fee has been triggered that

## The Credit Cardholders' Bill of Rights

The Credit Cardholders' Bill of Rights Act takes a balanced approach to banning several of the most abusive practices of credit card issuers and would create a more even playing field between credit card companies and their cardholders. It would require implementation within three months of passage, a significant improvement over a rule passed by the Federal Reserve Board that wouldn't take effect until 2010. Among its many provisions, the bill would:

**End arbitrary interest rate increases.** The bill prevents card companies from unfairly increasing interest rates on existing card balances; retroactive increases are permitted only if a cardholder is more than 30 days late, if a pre-agreed promotional rate expires, or if the rate adjusts as part of a variable rate. It would require card companies to give 45 days notice of all interest rate increases so consumers can pay off their balances and shop for a better deal.

**Allow consumers to set hard credit limits and stop excessive "over-the-limit" fees.** The bill requires companies to let consumers set their own

fixed credit limit. It also prevents companies from charging "over-the-limit" fees when a cardholder has set a limit or when a preauthorized credit "hold" pushes a consumer over their limit. It limits to three the number of over-the-limit fees companies can charge for the same transaction; some issuers currently charge virtually unlimited fees for a single limit violation.

**End unfair penalties for cardholders who pay on time.** The legislation ends unfair "double cycle" billing; card companies will no longer be allowed to charge interest on debt that consumers have already paid on time. If a cardholder pays on time and in full, the bill prevents card companies from piling additional fees on balances consisting solely of leftover interest.

**Require fair allocation of consumer payments.** Many companies credit payments to a cardholder's lowest interest rate balances first, making it impossible for the consumer to pay off high-rate debt. The bill bans this practice, generally requiring that payments be allocated proportionally to balances that have different rates.<sup>15</sup>

moves a cardholder to the penalty rate. A notice must be sent monthly until there have been three consecutive payments without the triggering event or until the penalty rate is removed, whichever is later. The reminder should say: “A penalty rate of \_\_\_ is being imposed on your account. To end the penalty rate and return to the standard rate of \_\_\_, you must [insert applicable provision, such as] make \_\_\_ consecutive payments on time.”

This policy should apply to all new credit card accounts opened after the legislation is enacted. And within one year of its enactment, all existing accounts should also receive text messages the first time the consumer encounters one of the two teachable moments.

This proposal is based on better disclosure, but disclosure alone is not a sufficient strategy to curb some of the worst credit card practices and reduce the Americans’ overall debt.<sup>16</sup> Congress should go further to mandate a higher level of fairness in credit card terms. Several bills proposed in the last Congress would do exactly that, most notably, the Credit Cardholders Bill of Rights Act, just introduced in the 111th Congress by Rep. Carolyn Maloney (D-NY) with the backing of House Financial Services Committee Chair Rep. Barney Frank (D-MA).

American families are currently mired in a record-high amount of debt and ought to have credit cards that orient them toward the most beneficial choices. Technology can be a key ingredient in getting clear and understandable information to cardholders.

# Endnotes

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- 12 Tamara Draut, "The Economic State of Young America" (Demos, 2008).
- 13 Christian E. Weller, "Pushing the Limit: Credit Card Debt Burdens American Families" (Center for American Progress, July 2006).
- 14 Thomas Kalil, "Harnessing the Mobile Revolution" (New Policy Institute, October 2008).
- 15 Text largely based on "Summary of the Credit Cardholders' Bill of Rights," Congresswoman Carolyn Maloney, 2008, available at [http://maloney.house.gov/documents/financial/creditcards/20090115\\_cc\\_Onepager.pdf](http://maloney.house.gov/documents/financial/creditcards/20090115_cc_Onepager.pdf).
- 16 For more on CAP's public policy proposals for credit cards, See Tim Westrich and Christian E. Weller, "House of Cards: Consumers Turn to Credit Cards Amid the Mortgage Crisis, Delaying Inevitable Defaults" (Center for American Progress, February 2008).

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## About the author

Tim Westrich is a Research Associate for Economic Policy at American Progress. His work focuses on Americans' experience with financial services and building assets. Prior to working at the Center, Westrich was a research analyst at the National Community Reinvestment Coalition, where he provided technical assistance to local housing organizations and helped to develop NCRC's policy positions on subprime mortgage lending. Tim has also worked at the Woodstock Institute, where he co-authored studies on improving consumer protections for credit cards and bank accounts. Tim is a frequent guest on radio shows and at conferences, and his work has been cited in major news outlets such as *NBC Nightly News*, *USA Today*, *The Washington Post*, *Chicago Tribune*, and others. He blogs about young Americans' personal finances at [qvisory.com](http://qvisory.com). Tim earned his master's degree in urban planning and policy from the University of Illinois at Chicago.

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