



# Putting Credit Card Debt on Notice

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

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Tim Westrich February 2009

# 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.

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