

## Five myths about America's credit card debt

By Robert D. Manning Sunday, January 31, 2010

*They're yuppie food stamps. They give new meaning to the question "paper or plastic?" And they're in everyone's wallet. Americans have nearly 700 million all-purpose bank credit cards, plus nearly 500 million retail store cards -- and they have transformed how we live and consume. Today, Americans are more dependent on credit than savings, a radical departure from the last major economic crisis, in the 1930s. Congress's effort to change that, the Credit Card Accountability, Responsibility and Disclosure (CARD) Act signed by President Obama last spring, will go into effect in a few weeks. But it won't fix everything. Or maybe not much of anything. Here are the myths that muddle our understanding of how we've racked up so much credit card debt.*

### **Middle-class American families have long depended on bank credit cards to manage their budgets.**

1. Not true. Consumer credit originated with local merchants that offered "open book" credit to cement customer loyalty and increase sales. As major retail chains and malls replaced small shopkeepers in the 1950s and '60s, stores such as Sears and Montgomery Ward issued credit cards for the same reasons. But if you didn't like what Sears had to offer, you couldn't use its credit card anywhere else.

Universal or bank cards such as Visa or MasterCard were reserved for high- and upper-middle-income households. They were offered to reward the banks' best customers (after all, how many toasters could they use?) and served as loss leaders, as most cardholders paid off their monthly balances. Until the early 1980s, bank credit cards were a symbol of high social status, used mainly for convenience rather than because of need. This was the inspiration for the color-coded cards that emerged in the 1980s and 1990s: Fiscally responsible "convenience" users wanted to be distinguished from less credit-worthy consumers with a platinum card.

### **More people have credit cards because companies got better at managing risk and began marketing to lower-income customers.**

2. Mostly no. Credit card use expanded dramatically during the golden age of the industry -- beginning in the early 1980s -- because deregulation suddenly allowed high interest rates and penalty fees, and credit cards became a major engine of bank profits. In 1978, a Supreme Court decision effectively ended consumer interest-rate limits and the federal usury law. After the 1981-82 recession, industrial restructuring shifted demand for bank loans from manufacturing companies to individual households, and national banks aggressively pushed for more deregulatory policies, in line with the '78 decision. A 1996 Supreme Court ruling that ended state-regulated limits on credit card fees furthered that cause. Today, only nonprofit credit unions, as mandated by Congress, must abide by an interest rate ceiling of 15 percent.

As more and more people were preapproved for credit cards in the '80s and '90s, the "free" credit used by the most affluent households was subsidized by the high interest rates and penalty fees paid by the most financially distressed. A carefully guarded secret of the industry is that about a quarter of cardholders have accounted for almost two-thirds of interest and penalty-fee revenues. Nearly half of all credit card accounts do not generate finance and fee revenues.

### **Responsible cardholders will have to pay more to make up for the defaults of irresponsible consumers.**

3. False. Although credit card companies are experiencing record default rates, irresponsible consumer borrowing is not the main culprit behind soaring interest rates and fees. Banks have suffered far more from mortgage foreclosures and home-equity loan defaults. Major banks encouraged their credit card divisions to relax their standards at the end of the financial bubble; more customers went deeper into credit card debt. Those customers were encouraged to refinance their mortgages, generating high fees for the banks. Banks then sold securities backed by credit card debt to institutional investors around the world. When the [bubble burst](#) in September 2008, banks could not sell these low-quality securities. They were stuck with poorly performing credit card portfolios.

For cardholders, the central problem is that the credit card industry's business model is fundamentally flawed; bankers want consumers to foot the bill for its reengineering through higher interest rates and fees. As deregulation gave rise to conglomerate financial institutions, credit cards continued to serve as marketing loss leaders for attracting higher-income cardholders (who typically paid off their monthly charges) by bundling them with other financial products such as loans, brokerage fees and insurance. With the recession, these other bank revenues have declined sharply, raising pressure on credit card companies to boost profits.

### **The credit card industry is so competitive that regulation is unnecessary.**

4. Rather than a self-regulating and intensely competitive market of more than 5,000 issuers, the credit card industry is one of the most concentrated in the nation (and is increasingly being hit with allegations of monopoly practices). The top three issuers -- Bank of America, Citibank and Chase -- control more than 60 percent of outstanding credit card debt. Consumer choice has declined over the past 20 years as economies of scale for marketing, administration and customer service have led thousands of card issuers to cash out to the largest banks. And self-regulation has failed when it comes to weeding out the worst card issuers; Visa and MasterCard have dismal track records in disciplining their members.

### **The CARD Act finally protects consumers against the credit card industry's most abusive practices.**

5. Yes and no. Although touted by the Obama administration as a major consumer achievement, the long-awaited CARD Act, which goes into effect Feb. 22, offers a mix of overdue protections and surprising omissions.

Some of the worst industry practices are prohibited, including billing systems that generate finance charges on paid-off balances, some retroactive interest-rate increases and unrestricted marketing to consumers under the age of 21 who don't have an independent source of income.

On the negative side, Congress stipulated a nine-month phase-in period for these regulations. For millions of Americans, especially those suffering from employment and income interruptions, this is too late. If you're in debt today, this bill doesn't help you. Companies already have jacked up interest rates, sharply reduced lines of credit, increased service fees and diluted the value of loyalty reward programs. These trends have brought consumer credit scores down, triggering higher borrowing costs and greater difficulty finding work.

But there is a silver lining to falling credit scores and fewer preapprovals for cards: More people are learning that when it comes to plastic, you can leave home without it.

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