



# Safety Sells

The Case for an Incentive-Based  
Credit Card Disclosure System

Derek R.B. Douglas



# **SAFETY SELLS**

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CREDIT CARD DISCLOSURE SYSTEM

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## Executive Summary

It is difficult to think of a product as commonplace in terms of use, yet so lightly regulated, as the credit card. Today, regulation of the credit card industry is primarily in the area of disclosures. These regulations typically mandate credit card companies to provide certain important information to consumers so that they can use this information to compare credit card products. Usually, regulators mandate the disclosure of information that they feel consumers “deserve to know.” This “moral-based” system of disclosure, however, has failed to adequately inform consumers, and has had little effect on the behavior of credit card companies.

This report argues that to more effectively influence the behavior of credit card companies, an incentive-based system of disclosure—one that relies on the profit-seeking interest of companies to change their behavior—should be added to the current credit card disclosure regime. A good model for developing an incentive-based credit card disclosure system may already exist. At least, that appears to be the case with respect to the federal government’s New Car Assessment Program.

Congress called for the creation of NCAP in response to mounting concern raised in the 1960s and early 1970s about the safety of automobiles. At that time, injury and fatality rates related to automobile accidents were on the rise. Similarly, rising credit card indebtedness today threatens the financial and often personal well-being of millions of Americans and their families.

NCAP is just one component of a comprehensive regulatory regime that included specific regulations governing the manufacturer of automobiles as well as the establishment of several federal oversight bodies. But unlike the more traditional regulations that were designed to restrict the behavior of manufacturers, the purpose of NCAP was to “encourage manufacturers to make safety improvements to new vehicles and provide the public with information on the relative safety of vehicles.”<sup>1</sup> To this end, NCAP instituted a five-star rating system that created an incentive for companies to produce safer cars.

The results have been dramatic:

- From 1979 (the first year that NCAP performed its frontal impact test) to 2006, the number of five-star rated cars (for the driver’s side only) increased by 1,800 percent, jumping from just three percent of the cars tested in 1979 to 57 percent of cars tested in 2006. Over this same period, the number of one- and two-star rated cars plummeted, dropping from 47 percent of cars tested in 1979 to zero percent in 2006.
- From 1997 (the first year that NCAP performed side impact tests) to 2006, the number of five-star rated cars (driver side) increased by more than 1,200 percent, jumping from just four percent of the cars tested in 1997 to 54 percent of cars tested in 2006. The number of one- and two-star rated cars fell from 28 percent to one percent.



- The results for rollover resistance testing demonstrate that safety ratings can lead to changes in industry behavior in a short period of time. In just six years, from 2000 (the first year that NCAP performed rollover resistance tests) to 2006, the number of four- and five-star rated cars more than doubled, jumping from 32 percent of the cars tested in 2000 to 75 percent of cars tested in 2006. By comparison, the number of one- and two-star rated cars dropped from 23 percent to just one percent. The rollover results suggest that incentive-based disclosure systems have the most immediate impact in reducing the number of unsafe products. Also, given that behavioral changes occurred so suddenly, the results suggest that the ratings themselves are a key impetus for change as opposed to mere independent technological improvements.

These results show that an incentive-based safety disclosure system can have dramatic effects on the behavior of companies. This gives reason to believe that an “incentive-based” model would be a powerful tool for influencing the behavior of credit card companies as well. A system for credit cards could be modeled after the NCAP system, perhaps using a less detailed red-yellow-green formulation instead of the five-star crash rating system.

Specifically, like NCAP’s system, an incentive-based system for credit cards could:

- Empower the Federal Trade Commission to assess the safety of a credit card by testing for a limited set of credit card features that are deemed the most risky for consumers, among them: unilateral “at any time, for any reason” provisions for changing the rate of interest on credit cards; universal default provisions; the underwriting standards used to issue the card; the card’s interest rate spread between the introductory rate and the maximum rate allowed; and retroactive application of interest rate increases.
- Assign a red rating if the feature in question is below a pre-established basic standard of safety, a yellow rating if the card meets the basic standard of safety, and a green rating if the card exceeds the basic standard of safety.
- Require credit card companies to display the government safety rating on the card itself, as well as on credit card contract. The rating label on the contract should explain the basis for each of the cards safety ratings and the maximum available rating.
- Develop a public education component for the new rating system that explains the ratings to consumers in a clear and concise way, and provides consumers with a list of available government resources online and in print to help address any questions they have about the safety ratings system.



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As is the case with the NCAP ratings, not all credit cards will need to be tested to make the system effective, nor will credit card companies be *required* to produce cards that meet a green, or even a yellow, safety standard. The incentive to produce safer cards is entirely self-imposed, as companies (reasonably) might expect that consumers will be more inclined to sign up for a green-rated card rather than a red-rated card.

The above proposal is not intended to be the definitive word on what a safety assessment system for credit cards should look like. Considerable time and thought on the part of academics, consumer advocates, industry players, and the appropriate government bodies will be necessary to identify the limited set of features that should be tested, and to assign the “basic standard of safety” that should determine each rating.

The purpose of this paper is to make the case for adding an incentive-based disclosure system to the current disclosure regime. As fundamental economic theory suggests, this addition will make the credit card disclosure system more effective at influencing the behavior of credit card companies than a purely moral-based system. Moreover, an incentive-based system will have the added benefit of fostering a market for “safe” credit cards.



## Introduction

The credit card is quickly becoming the primary vehicle for conducting financial transactions in America. Once viewed as a luxury item for upper income families, it is hard to think of an item today that is more commonplace. There are nearly 1.5 billion credit cards in circulation—five for every American man, woman, and child, and they account for close to \$2 trillion in annual consumption. This statistic is all the more shocking when one considers that the credit card did not even exist until 1949. In fact, most of the growth in the industry has occurred in the last 10 to 20 years.

While credit card use has exploded recently, protection for consumers has not followed suit. The United States Supreme Court effectively deregulated the credit card industry in the late 1970s and mid-1990s.<sup>2</sup> Since then, very few meaningful regulations have seen the light of day.

The one area that has received some attention from federal regulators is credit card disclosures. Regulators have turned to The Truth in Lending Act of 1968 and Regulation Z (promulgated by the Federal Reserve) to mandate certain disclosures with the purported goal of informing consumers of the true cost of credit. According to the Government Accountability Office, the investigative arm of the U.S. Congress, the reason for focusing on disclosure is straightforward: In the wake of the Supreme Court's decisions, "the primary means that U.S. banking regulators have for influencing the level of [interest rates and fees] is by facilitating competition among issuers, which, in turn, is highly dependent on informed consumers."<sup>3</sup> The theory is that mandated disclosures "foster price competition among card issuers by enabling consumers to discern differences among cards while shopping for credit . . . [and] assure that the consumer will be able to compare more readily the various credit terms available to him or her and avoid the uninformed use of credit."<sup>4</sup>

Unfortunately, the current disclosure system has not been very successful at accomplishing these goals. Recent studies have shown that people still experience great difficulty in trying to understand the terms and conditions of credit cards.<sup>5</sup> Moreover, the current disclosure system appears to have done little to reduce the risks to consumers, as we have seen consumer debt skyrocket, bankruptcy rates increase, and the number of people carrying balances and paying penalty rates and fees approach all-time highs.<sup>6</sup> Indeed, the GAO's recent report on credit cards identifies a number of problems with the current disclosure system and makes various recommendations for improving on this system.

These regulations also have almost completely failed to change the behavior of credit card companies in a positive way. Indeed, it is arguable that they have caused companies to look for new ways to hide fees and costs and to pile on numerous disclaimers, thereby making the current disclosures almost incomprehensible.



It is hardly surprising that credit card companies are doing this—after all, the more fees and interest payments that consumers stumble into, the more profits the companies can make. Thus, one of the reasons why the current disclosure system does not seem to have much positive influence on the behavior of companies may be the “moral” basis on which it is grounded—namely, the notion that mandating disclosure is the “right” thing to do for them because consumers deserve to know the terms and costs of a particular credit card so they can make comparisons and make an informed decisions.

But companies are not inherently “moral”; they are profit-seeking. Therefore, a disclosure system that has this as its sole basis will achieve limited behavioral results.

This is not to say that “moral-based” disclosure has no role. Quite the contrary. Customers certainly “deserve to know” the terms that will apply to them and the true cost of credit that an issuer might offer. To influence company behavior, however, this moral-based disclosure system needs to be supplemented with an incentive-based system, one in which it is in the profit-seeking interest of companies to change their behavior.

One of the fundamental principles of economic policy is that market incentives can influence individual and firm’s behavior. Indeed, our tax system is filled with incentives to encourage behavior—among them the earned income tax credit, charitable contributions, and the home mortgage interest rate deduction. Fortunately, we also have a regulatory disclosure regime that provides the perfect model for this dual-track system of disclosure—the automobile industry.

This report builds on the idea first raised in *The Washington Monthly* article authored by Robert Gordon and Derek Douglas, entitled *Taking Charge*, on the need for supplementing the current credit card disclosure regime with an incentive-based credit card safety rating system.<sup>7</sup> To help make the case, this report relies on the automobile industry analogy—specifically, the five-star government sponsored crash safety rating system administered by the New Car Assessment Program, an outgrowth of the National Highway Traffic Safety Administration.<sup>8</sup>

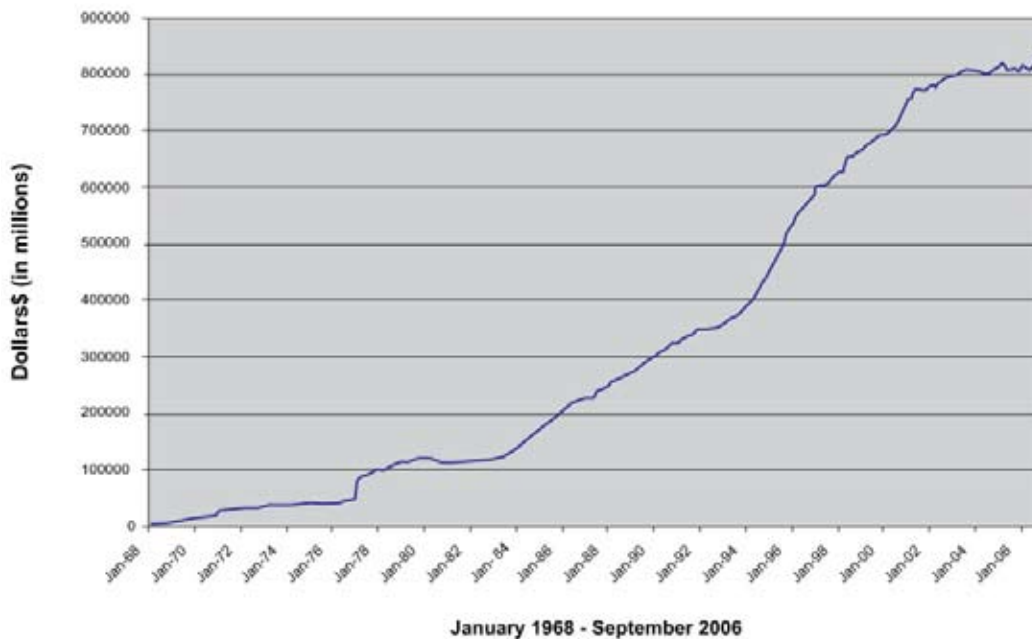
## The Dangers Of Credit Cards

The pervasiveness of credit card use in America has been well documented. There are 1.5 million credit cards in circulation today—five for every man, woman, and child. More than 6,000 companies issue credit cards today, with the 10 largest credit card companies controlling 90 percent of the market.<sup>9</sup> As of 2004, the average credit card balance in America was \$8,000,<sup>10</sup> and the median balance was \$2,200.<sup>11</sup> All told, 145 million people in America (about half the population) own credit cards.<sup>12</sup>

The rampant use of credit cards in the United States is an anomaly when compared to other industrialized countries. As Professor Ronald Mann reports in his recently released book, *Charging Ahead: The Growth and Regulation of Payment Card Markets*, in 2001 there were 74 credit card transactions per capita per annum in the United States, compared to just 39 in Australia, 25 in the UK, and 19 in Japan.

Figure 1 illustrates the dramatic growth in credit card debt in the United States since 1968 (the first year that data are available). The data in Figure 1 represent the inflation-adjusted (2005 dollars) revolving consumer credit in the United States as reported by the Federal Reserve.

**Figure 1—Real Growth in Credit Card Debt**



Notes: Author's calculations based on Table G.19 Consumer Credit – Revolving Credit, from Board of Governors, Federal Reserve System.





The dramatic increase in credit card use has led to increased risk for consumers. Some 90 million people carry balances every month, compared to the 55 million who pay off their balances each month.<sup>13</sup> Thirty-five million people can only afford to make the minimum payment every month, which means it could take years for them to pay off their debt. Approximately 35 percent of active cardholders pay late and/or over-the limit fees (among the most costly charges associated with credit cards),<sup>14</sup> and the total amount in fees and interest Americans pay each year is about \$90 billion.<sup>15</sup>

Perhaps the most dangerous of all credit card features is the ability of most credit card issuers to change the terms of consumers' accounts "at any time, for any reason." In some ways this creates limitless risk for consumers; literally overnight, the terms to which they thought they agreed can unilaterally change. Unilateral practices like these can put people into debt traps, from which it is often extremely difficult to escape.

The damage that credit card debt and abusive practices can cause for American families has been widely reported by scholars,<sup>16</sup> advocates,<sup>17</sup> filmmakers,<sup>18</sup> and even Congressional committees.<sup>19</sup> Indeed, at its most extreme, excessive credit card debt can even be a life or death matter.<sup>20</sup>

## **The New Car Assessment Program – History, Structure, And Results**

Like the credit card of today, there was a time when the safety of automobiles raised serious concerns for the American public.<sup>21</sup> In response, Congress took dramatic steps to regulate the manufacture of cars, and to assess the safety of various makes and models and disclose that information to the public.<sup>22</sup>

NCAP is one component of Congress's safety assessment efforts, and its history and structure provide a useful model for developing a safety rating system for credit cards. Indeed, NCAP's incentive-based "five-star rating" disclosure system has become one of the most effective tools for influencing the behavior of automobile manufacturers. There is no reason to believe that the results would be any different if applied to the credit card industry.

To fully understand how the NCAP model could apply to the credit card industry, some historical background is required.



## History

NCAP traces its roots back to the passage of the National Highway Act of 1970, when Congress created what is now known as the National Highway Traffic Safety Administration, an agency within the Department of Transportation. NHTSA was borne out of the outrage in the mid-1960s over the dangers associated with automobiles and the lack of safety standards to protect consumers. After a series of highly publicized meetings, Congress responded by establishing two government agencies—The National Traffic Safety Agency and the National Highway Safety Agency—both of which were the predecessors to NHTSA. These agencies implemented a series of important safety regulations—the Federal Motor Vehicle Safety Standards—to govern the manufacture and sale of automobiles.<sup>23</sup>

Recognizing that more could be done to positively influence the behavior of automobile manufacturers, Congress also passed the Motor Vehicle Information and Cost Savings Act of 1972, which required NHTSA to provide consumers with some measure of comparison of the “crash-worthiness” of automobiles. In response to this charge, NHTSA formed NCAP in 1978. The goal of NCAP’s incentive-based disclosure system was to “encourage market forces that *prompt* vehicle manufacturers to make safety improvements to new vehicles and provide the public with objective information on the relative safety performance of vehicles.”<sup>24</sup>

NCAP limits its crash testing to new vehicles that are expected to have high sales volume, have had major structural changes, or have improved safety equipment.<sup>25</sup> Due to budgetary limitations—NCAP’s budget was \$7.6 million for 2006—NCAP has had to be selective with its points of comparison. As such, NCAP tests for only the most dangerous accidents, such as full-frontal impact crashes in 1978, side impact crash tests in 1997, and rollover resistance tests in 2001. To compare crash test results, NCAP uses a five-star crash rating scale, which awards three stars for cars that meet the basic standard of safety, four or five stars for those exceeding the basic standard of safety, and one or two stars for those falling below the basic standard of safety.

NCAP acquires the vehicles for testing by purchasing or leasing them directly from manufacturers around the country. This significantly raises the cost of the program, and limits the amount of testing it can do. The remainder of the budget is used for testing (test dummies, instrumentation, tool maintenance, quality control) of automobiles, child restraints, and the dissemination (including any necessary research to support ongoing activities and the website) of that test data. On average, it costs NCAP approximately \$125,000 to provide front, side, and rollover ratings on any one make and model.<sup>26</sup>

Given its budgetary constraints, NCAP was only able to test 56 new vehicles slated for release in 2006. Even with a small budget, however, NCAP is able to provide buyers with frontal impact crash ratings for 85 percent of new vehicles, side impact crash ratings for 70 percent of new vehicles, and rollover resistance ratings for just over 75 percent of new vehicles.<sup>27</sup>



The heart of NCAP’s incentive-based disclosure system is its five-star rating structure. This structure is intentionally simple, yet sufficiently nuanced to create a powerful incentive for manufacturers to make safer vehicles. The simplicity comes from testing for a limited set of safety characteristics. Rather than evaluating every safety aspect of a vehicle, the system only tests for those that are most dangerous to consumers. This allows for clear and discernable standards for manufacturers to try and meet.

The nuance comes from the way the ratings are used—namely, the rules that guide a manufacturer’s ability to advertise its rating. To date, disclosure under the system has been purely voluntary (both in terms of vehicle production and advertising). That is, there is nothing that requires a manufacturer to produce a five- or four- or even a three-star vehicle, or to disclose its rating even if it receives a one- or two-star rating.<sup>28</sup>

Instead, NCAP specifies that in order for a company to advertise itself as a “five-star vehicle”—the government’s highest rating—the vehicle must receive five stars in *all* three categories of testing. Thus, if a car receives a five-star frontal impact rating but only a four-star side impact rating, the company cannot advertise it as a five-star vehicle. The company could, however, advertise the vehicle as receiving a five-star “frontal impact rating” from the government, so long as the distinction between this and an overall five-star rating is made. History has shown that car companies are anxious to take advantage of this advertising incentive.<sup>29</sup>

In 2005, Congress took the next logical step by making the disclosure of NCAP ratings mandatory. Specifically, under the leadership of Republican Senator Mike DeWine of Ohio, Congress passed the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, or SAFETEA-LU for short, which requires manufacturers to disclose all NCAP ratings for new vehicles on the vehicles Monroney label (the price sticker that appears in the window of new cars) starting on September 1, 2007.<sup>30</sup>

Importantly, under this new system, production is still voluntary—a company is not required to produce a five-star, four-star, or even a three-star vehicle—but disclosure will now be mandatory. Thus, a company that produces a car with a 1-star rating, for example, will be required to disclose that on the price sticker. Under SAFETEA-LU, when disclosing the NCAP ratings for a vehicle on the Monroney label, the company must:

- Graphically depict in a “clearly differentiated fashion” the number of stars that the vehicle received for *each* of the three safety ratings
- Indicate the maximum possible safety rating
- Describe the nature and meaning of the reported crash test data and a reference to additional vehicle safety resources (including NHTSA’s toll-free customer hotline)



- Present the information in a “legible, visible, and prominent fashion” that covers at least 80 percent of the total area of the label or an area with a minimum length of 4 ½ inches and a minimum height of 3½ inches, whichever is *larger*
- Expressly state if one or more of the NCAP safety tests were not performed
- Provide the existence of safety concerns “identified during NCAP testing, but not reflected in the resulting NCAP ratings.”<sup>31</sup>

Public education is the final essential component of NCAP’s safety rating system. NHTSA considers public education to be critical because that is how consumers learn about the meaning of the ratings, which enables them to factor the ratings into their buying decisions. This, in turn, is what creates the incentive for manufacturers to make safer cars. NCAP ratings are available to the public on the internet at [www.safercar.gov](http://www.safercar.gov) and through the NHTSA *Buying a Safer Car* brochure. NCAP ratings are also distributed in vehicle safety ratings developed by non-governmental sources, such as *Consumer Reports* and *The Car Book*.

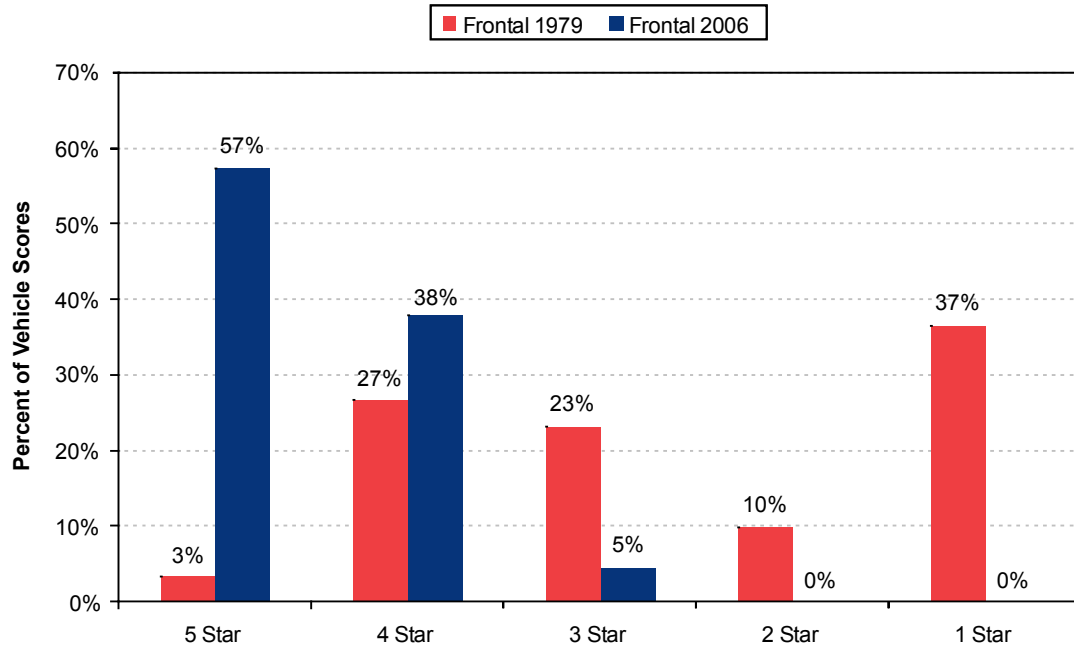
## Results

While some may try to argue that an incentive-based disclosure model only makes sense in theory, the results from the NCAP safety rating program confirm that it also makes sense in practice. Put simply, the results have been dramatic.

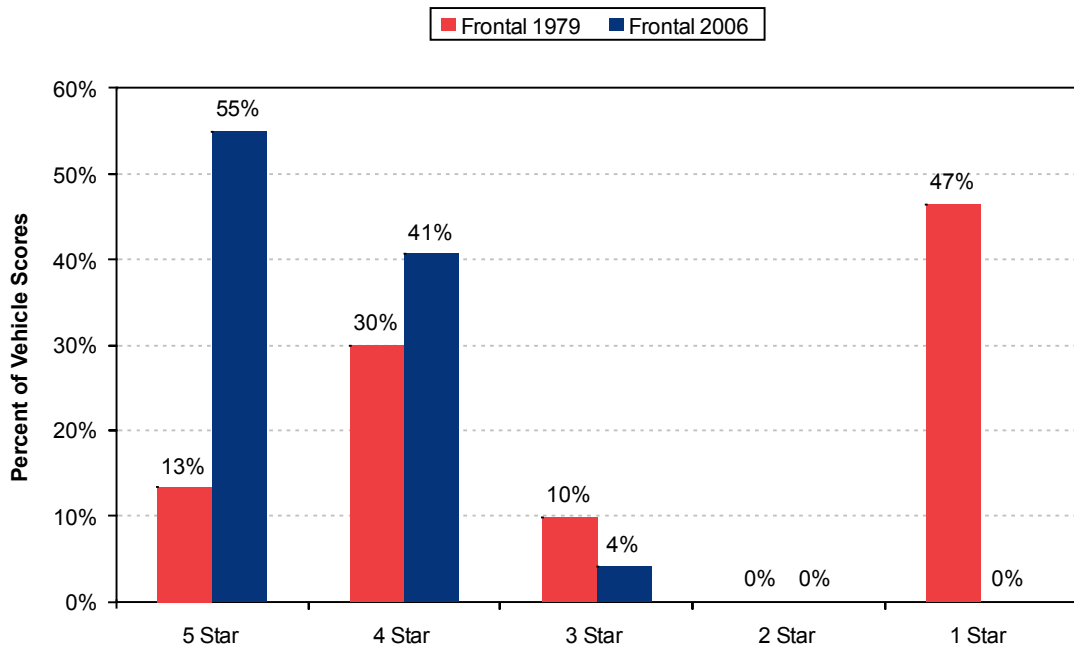
Figures 2 and 3 below provide comparative results for NCAP’s frontal impact safety ratings.<sup>32</sup> Figure 2 provides data on drivers, while Figure 3 provides data on passengers. These charts display the number of one-, two-, three-, four-, and five-star rated cars that were produced in 1979 (at the time that NCAP started its frontal impact safety rating program) compared to the number produced in 2006.

In 1979, most of the cars produced by manufacturers received a one-star rating (37 percent for the driver frontal impact test and 47 percent for the passenger frontal impact test), and just a few received a five-star ratings (three percent for drivers and 13 percent for passengers). By 2006, the situation was completely reversed. In 2006, the vast majority of cars received a five-star frontal impact rating (57 percent for drivers, 55 percent for passengers), and none (zero percent) received a one- or two- star rating. Thus, in less than 30 years, NCAP’s incentive-based disclosure system led to dramatic behavioral changes within the industry.

**Figure 2**  
**Frontal NCAP Trends Compared: 1979 v. 2006 Drivers**

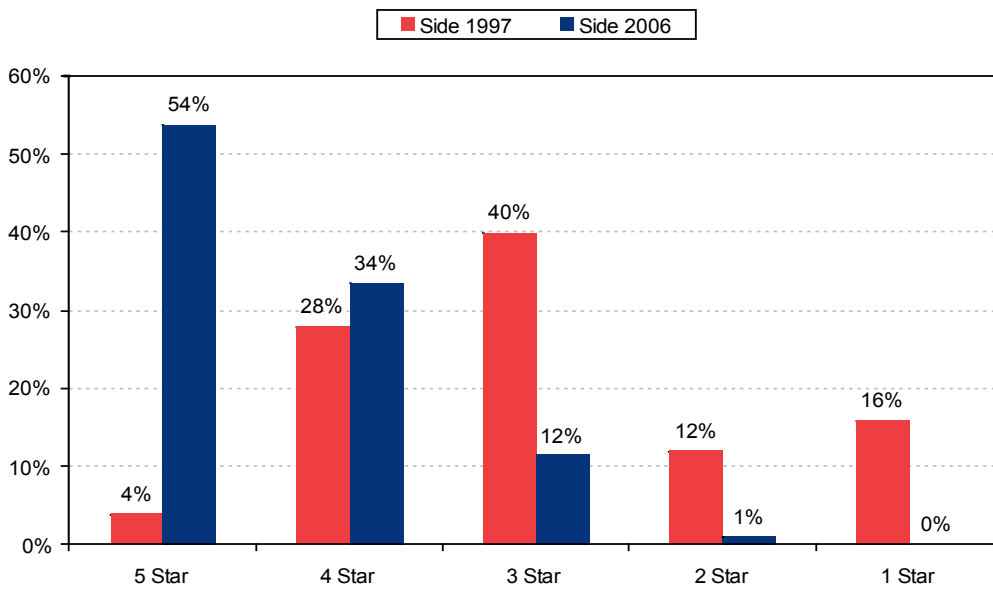


**Figure 3**  
**Frontal NCAP Trends Compared: 1979 v. 2006 Passengers**

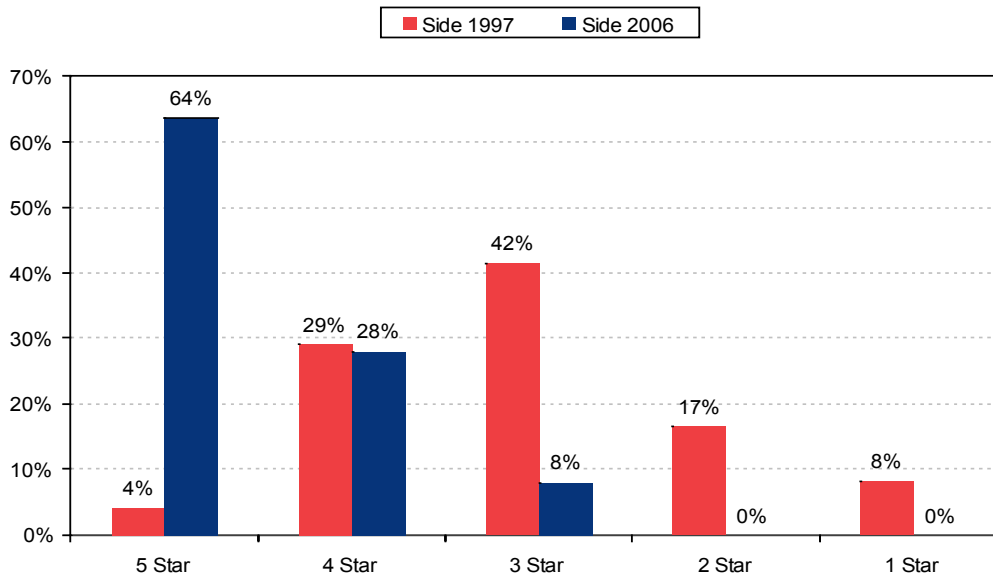


The side impact results demonstrate that it does not take 30 years to observe a change in industry behavior. Figures 4 and 5 below provide data on NCAP’s side impact safety ratings for 1997 (the year the test began) and 2006. Again, the results are significant. In 1997, only four percent of cars tested received a five-star side impact rating for either drivers or passengers, whereas 28 percent (drivers) and 25 percent (passengers) of cars received a one- or two-star rating. Nine years later, 54 percent of cars received a five-star rating for driver tests and 64 percent received a five-star rating for passenger tests. Only one percent received a one- or two-star rating for driver tests and none (zero percent) received a one- or two-star for passenger tests.

**Figure 4**  
Side NCAP Trends Compared: 1997 v. 2006 Drivers

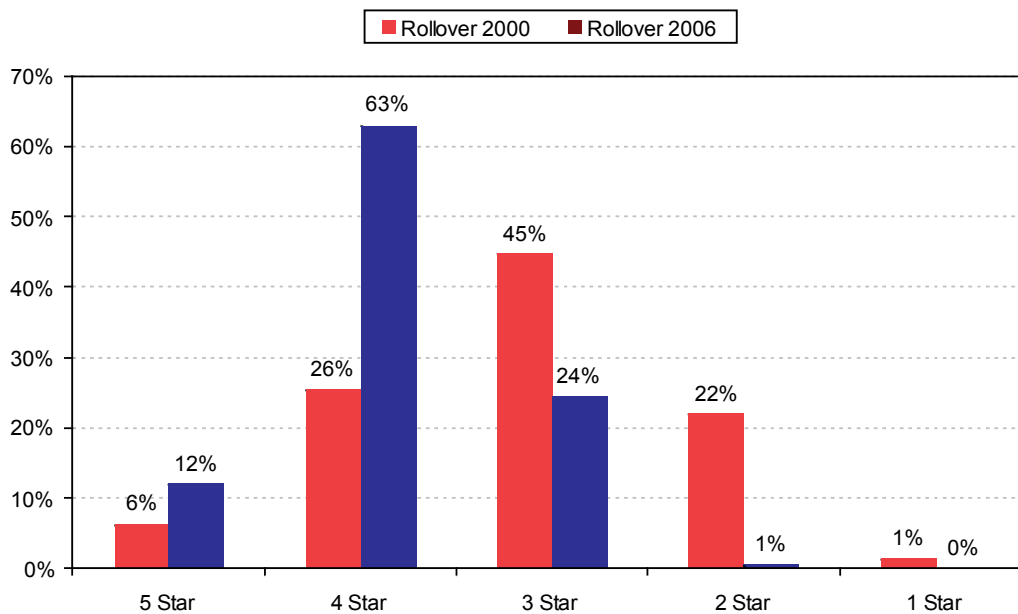


**Figure 5**  
Side NCAP Trends Compared: 1997 v. 2006 Passengers



Rollover results show similar patterns. Rollover testing began in 2000, so we only have six years of data (see Figure 6 below). Yet in just six years, the percentage of one- or two-star rated cars produced in a year decreased from 23 percent to one percent, and the number of five-star rated cars increased from six percent to 12 percent. The majority of cars produced in 2006 received a four-star rollover rating, as opposed to the five-star rating most cars received for frontal and side-impact tests. This data suggests that incentive-based disclosure systems have the most immediate impact in creating pressure on companies to stop producing unsafe products (one- or two-star rated cars), with movement to the most safe products (five-star rating cars) occurring a bit more slowly. In addition, given that behavioral changes occurred in just six year, these results suggest that the ratings themselves are a key impetus for change as opposed to mere independent technological improvements. In fact, an argument could be made that the ratings actually contribute to technological innovation, as manufacturers look for ways to achieve the highest rating.

**Figure 6**  
**Rollover NCAP Trends Compared: 2000 v. 2006\***



*\*2006 data only contains 2-wheel drive vehicle scores.*

Taken together, these results demonstrate that incentive-based disclosure systems are powerful tools for influencing company behavior. Indeed, NCAP has been so successful at encouraging manufacturers to build safer cars that last year GAO suggested that the program needs to be updated to maintain its relevance.<sup>33</sup>

NCAP is scheduled to hold a meeting in January 2007 to discuss ways for advancing and improving the current system. One likely area for expansion is to add a test for rear-end collisions, a leading source of automobile related injuries.

## Proposal For A National Credit Card Assessment Program

So how is all of this relevant to credit cards? It provides a blueprint for developing an incentive-based credit card disclosure system. As discussed above, such a system would have three components: testing, advertising and labeling, and public education.

Before getting into the details of this proposal, it is important to first explain what it is not. Above all, it is not intended to replace the various important regulations that have been advocated by others,<sup>34</sup> and in some instances, proposed by members of Congress.<sup>35</sup> Nor is it meant to be the definitive word on how to structure an incentive-based disclosure system for credit cards. Rather, this report offers some initial thoughts on how to structure such a system, and is intended to make the case for *adding* an incentive-based system to the current disclosure regime. Considerable time and thought on the part of academics, consumer advocates, industry players, and the appropriate government bodies will be necessary before settling on any particular system.

### Testing

The heart of any incentive-based disclosure system is its safety ratings structure. For cars, NCAP uses a five-star rating system to maximize differentiation. For credit cards, the need for differentiation is not as great, so something a bit simpler is appropriate. We propose a red-yellow-green formulation—with a red rating applying to tested features that rate below a pre-established basic standard of safety, a yellow rating applying to tested features that meet this basic standard of safety, and a green rating applying to tested features that rate above this basic standard of safety. The most likely candidate to administer a credit card safety assessment program is the Federal Trade Commission, which has jurisdiction over the labeling of consumer products. More specifically, the FTC's Bureau of Consumer Protection, which houses both the Division of Financial Practices and the Division of Advertising Practices, would likely be best suited to administer the program.

One of the most important lessons from NCAP's incentive-based disclosure model is that an effective rating system should be limited in scope. NCAP tested for only the most dangerous accidents. The rest are dealt with through the standard regulatory process. To test every aspect of a product that poses a risk would complicate the rating system to a point where it would likely be unworkable.

It also is worth noting that not all credit cards need to be tested. As with NCAP, various constraints make it difficult to test 100 percent of the market. NCAP chose to focus primarily on testing *new* vehicles expected to have high sales volume. Doing this still allows it to capture anywhere from 70 percent to 85 percent of the market, depending on the test. Although it is arguably easier to test credit cards given that testing would only require companies to submit contracts to the FTC for review, a more pragmatic approach may be to focus on the cards that are expected to have the "highest sales volume."





A good measure for this would be to limit testing to those cards issued by the ten largest companies and their subsidiaries in terms of credit card balances outstanding. According to the GAO, this would capture 90 percent of the total market. Using this definition, testing would be limited to the cards issued by the following companies: Citigroup, Inc.; Chase Card Services; MBNA America; Bank of America; Capital One Financial Corp.; Discover Financial Services, Inc.; American Express Centurion Bank; HSBC Credit Card Services; Provident Financial Corp.; and Wells Fargo.

One of the most difficult tasks in developing a credit card safety assessment system will be to identify the most dangerous aspects of credit cards that will be subject to testing. This is beyond the scope of this paper, and will require additional research. That said, it would be wise to include the specific areas for testing in the authorizing legislation for any credit card assessment program. However, the FTC, through the standard notice and comment promulgation process, should have some discretion to determine the standards that will apply for each test.

In thinking about the “most dangerous” aspects of credit cards, a few features come to mind. First, there are those features that allow credit card companies to unilaterally change the terms of the contract. The most obvious of these is the “at any time, for any reason” provision, which is included in many contracts.

A close cousin to this is the universal default provision, which allows a credit card company to raise a customer’s interest rate based on the customer’s behavior with another creditor. In other words, for example, under universal default an MBNA customer who pays his or her bill on time every month could experience an increase in their MBNA card interest rate for being late on their Sears card.

A third feature that can be particularly dangerous for consumers is the underwriting standards that a credit card company uses in issuing the card. Countless stories have been written about the billions of credit card solicitations that go out each year. Often (perhaps students present the best example) the credit card company issues the card with little regard, if any, for the customer’s ability to pay. Yet we know a credit card in the wrong hands can lead to tragic results.<sup>36</sup>

A final set of features that are especially dangerous is one might term the “bait and switch” features of the card. Perhaps the best two examples of this are the spread between the introductory (sometimes called “teaser” rate) on the card and the maximum allowable rate. It has become commonplace for a customer to sign up for a card at 12 percent interest, only to find out eight months later that their rate was jacked up to 30 or even 35 percent (many times, without any prior notification).

The retroactive application of interest rate increases is another example of the “bait and switch” feature. Under this practice, a customer who bought a refrigerator on his card at 12 percent interest can find that he has to pay back the balance on interest at 30 percent if the credit card company finds cause to raise his rate.



Although others could certainly argue there are other features of credit cards that are more or less dangerous than the ones described above, the debate must start somewhere. As such, we recommend testing for the following five aspects of credit cards: provisions granting companies the right to unilaterally change the terms of the card “at any time, for any reason”; universal default provisions; the underwriting standards that companies use to issue the card; the spread between the original interest rate offered by the card and the maximum rate allowed; and the retroactive application of interest rate increases.<sup>37</sup> To keep the safety assessment program current, the FTC should periodically review the tested features to see if others features pose serious enough risks to merit adding or substituting them into the safety assessment program.

The second difficult task in developing a credit card safety assessment system will be deciding on the “basic standard of safety.” It would be premature to attempt to offer definitive basic standards of safety for each of the five features identified here. However, for example, one could conceive of the following red-yellow-green formulation for testing of the “at any time, for any reason” provision:

- Red rating—if the credit card contract contains the provision
- Yellow rating—if the credit card contract gives companies to right to change the terms, but only after receiving the written or oral consent of the customer
- Green rating—if the credit card contract does not contain the provision, meaning that the original terms of the contract cannot be changed.

Similarly, a reasonable standard for the interest rate spread test might be:

- Red rating—if the maximum interest rate is more than twice the original of the introductory rate (from, say, 12 percent to more than 24 percent)
- Yellow rating—if the maximum interest rate is between 50 percent and 100 percent of the original or introductory rate (from 12 percent to between 18 percent and 24 percent)
- Green rating—if the maximum interest rate is less than 50 percent of the original or introductory rate (from 12 percent to less than 18 percent).

With respect to the overall rating for a credit card, the following might make sense:

- Red rating—if the card earned a red rating for more than one of the five tests
- Yellow rating—if the card earned a green rating for less than four of the tests but also had no more than one red rating.
- Green rating—if the card earned a green rating for at least four out of five of the tests.



One advantage that a credit card rating system would have over NCAP's system is cost. To test a car, NCAP needs to purchase it. This takes up the lion's share of NCAP's budget. Credit cards, on the other hand, do not need to be purchased to be tested. Instead, the credit card companies merely need to send credit card contracts to the FTC. NCAP estimates that it costs \$125,000 to conduct frontal, side, and rollover ratings for one car. Testing credit cards should cost dramatically less.

## Advertising and Labeling

The second major component of any disclosure system is the process for advertising and labeling the safety testing results. Originally, NCAP used a voluntary model, which allowed manufacturers to advertise the safety ratings of their vehicles under certain conditions. With the passage of SAFETEA-LU, however, alongside the promulgation of the final rule by NHTSA, it is now mandatory for manufacturers to display the NCAP ratings of their vehicles on the Monroney label. It is important to keep in mind, manufactures still are not required to produce cars that meet any rating in particular.

For credit cards, we propose following the mandatory disclosure model established by the SAFETEA-LU. This would involve a two-part system: the label that appears on credit card itself with the overall safety rating (red, yellow, or green) of the card, and the graphic that appears on the credit card agreement.

With respect to the label on the credit card, a card would receive its overall rating pursuant to the structure outlined above.

As for the graphic on the credit card agreement, NHTSA's recently promulgated labeling requirements are a good guide. Thus, the label should:

- Graphically depict in a “clearly differentiated fashion” the rating the credit card received for *each* of the five safety tests (red-yellow-green)
- Indicate the maximum possible safety rating
- Describe the nature and meaning of the reported safety data and a reference to additional credit card safety resources (the FTC would have to produce these)
- Present the information in a “legible, visible, and prominent fashion” that covers at least 80 percent of the total area of the label or an area with a minimum length of 4 ½ inches and a minimum height of 3 ½ inches, whichever is *larger*
- Expressly state that if one or more of the safety tests were not performed (for example, if the credit card had no maximum balance, or requires payment of the balance in full each month, the underwriting test articulated above may not apply).



## Public Education

Of course, for this system to work the public must be aware of it. Thus, any credit card safety assessment program must include a system for informing the public of the existence and meaning of the safety tests and ratings. The creation of a website would be helpful in this regard (such as “www.safercards.gov”) as would the development of materials for publication and public dissemination. Like NCAP, the credit card ratings could be distributed by outside entities as well.

In addition to spreading the word, a public education campaign would have the added benefit of making it easier for consumers to compare credit card offers. Given that this is a stated purpose of the current disclosure regime, it is worthwhile to have an incentive-based safety assessment program that may be more effective at furthering this goal.

## Conclusion

The NCAP disclosure model proves that an incentive-based disclosure system can dramatically influence industry behavior in a positive way. Given the increased dangers of credit cards, this has become increasingly important. The “moral-based” disclosure model for the credit card industry has failed in this regard. As such, Congress should add an incentive-based disclosure system for credit cards



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**Derek Douglas** is the Associate Director for Economic Policy at the Center for American Progress. At the Center, he also directs the Economic Mobility Program, which focuses on issues that bear directly on the economic mobility and security of low- and middle-income families—such as banking, housing, and higher education. Prior to joining the Center, he was Counsel in the Strategic Counseling Practice Group at O’Melveny & Myers LLP, Assistant Counsel at the NAACP Legal Defense and Educational Fund, Inc. (LDF), and worked in the Economic Studies Program at The Brookings Institution as a Research Assistant to Dr. Charles Schultze. He has been a frequent guest on numerous television and radio programs. He graduated from the University of Michigan with Highest Honors in Economics, and from the Yale Law School. After graduating from Yale, he clerked for The Honorable Timothy K. Lewis on the United States Court of Appeals for the Third Circuit.



## Endnotes:

- <sup>1</sup> GAO, “Vehicle Safety: Opportunities Exist to Enhance NHTSA’s New Car Assessment Program” (April 2005).
- <sup>2</sup> *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978) (finding that states cannot cap the interest rates on credit cards issued by national banks if the bank is not chartered in the state); *Smiley v. Citibank*, 517 U.S. 735 (1996) (finding that fees charged on credit cards issued by national banks are a form of interest).
- <sup>3</sup> GAO, “Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers” (September 2006).
- <sup>4</sup> GAO (September 2006) (citing TILA).
- <sup>5</sup> GAO (September 2006).
- <sup>6</sup> Christian Weller, “Pushing the Limit: Credit Card Debt Burdens American Families” (July 2006); Christian Weller, “Drowning in Debt: America’s Middle Class Falls Deeper in Debt as Income Growth Slows and Costs Climb” (May 2006)
- <sup>7</sup> Robert Gordon and Derek Douglas, “Taking Charge”, *The Washington Monthly* (December 2005).
- <sup>8</sup> Other examples of federal safety rating systems include the Food and Drug Administration’s food labeling program, and the Environmental Protection Agency’s Energy Star Program.
- <sup>9</sup> GAO (September 2006).
- <sup>10</sup> Frontline Series (2004), “Secret History of the Credit Card,” available at <http://www.pbs.org/cgi-registry/generic/trivia.cgi>.
- <sup>11</sup> US Federal Reserve, Survey of Consumer Finances, 2004, Table 11, pp A29.
- <sup>12</sup> LendingTree.com, “The Hidden Costs of Credit Cards,” available at <http://www.lendingtree.com/smartborrower/Credit-cards/The-hidden-costs-of-credit-cards.aspx>
- <sup>13</sup> Frontline Series (2004); compare Julia Lane, “Will Credit Card Holders Default Over Minimum Payment Hikes?” *Loyola Consumer Law Review*, 2006, pp. 1 (reporting that 115 million people carry balances); GAO (September 2006) (reporting that 58 percent of credit card customers carry balances).
- <sup>14</sup> GAO (September 2006).
- <sup>15</sup> Gordon and Douglas (2005).
- <sup>16</sup> Elizabeth Warren, “The Two Income Trap,” (2003); Robert Manning, “Credit Card Nation” (2000); Oren Bar-Gill, “Seduction by Plastic” (April 2004).
- <sup>17</sup> Testimony of Travis Plunkett, Legislative Director, Consumer Federation of America, before the Committee on Banking, Housing and Urban Affairs (May 2005).
- <sup>18</sup> *Maxed Out*, Directed by James Scurlock ([www.maxedoutmovie.com](http://www.maxedoutmovie.com)).
- <sup>19</sup> Various hearings of the U.S. Senate Committee on Banking, Housing and Urban Affairs available at <http://banking.senate.gov/index.cfm?FuseAction=Hearings.Archive>; and hearings of the U.S. House of Representatives Committee on Financial Services available at <http://financialservices.house.gov/hearings.asp>.
- <sup>20</sup> Testimony of Janne O’Donnell and Trisha Johnson, Consumer Federation of America, “Credit Card Debt Imposes Huge Costs on Many College Students” (June 1999); see also, Manning (2000).
- <sup>21</sup> Ralph Nader, “Unsafe at Any Speed” (1965); Gordon and Douglas (2005).
- <sup>22</sup> GAO (April 2005).
- <sup>23</sup> The Federal Motor Vehicle Safety Standards (FMVSS) are regulations to which manufacturers of motor vehicle and equipment items must conform and certify compliance. The first FMVSS became effective in 1967, and several standards have been added since. More information on FMVSS is available at: <http://www.nhtsa.dot.gov/cars/rules/import/FMVSS/index.html>.
- <sup>24</sup> GAO (April 2005) (emphasis added).
- <sup>25</sup> <http://www.safercar.gov/Info.htm#iq4>



<sup>26</sup> Interview of NCAP Division Chief Nat Beuse.

<sup>27</sup> NCAP uses a series of assumptions about vehicle performance that allows it to issue ratings for more cars than it actually tests. More specifically, according to Nat Beuse:

In selecting vehicles for NCAP testing we have made several assumptions about vehicle performance based on our prior test experience. The assumptions are as follows: (1) 2-door cars and 4-door cars perform the same in frontal impacts but differently in side impact and rollover resistance, (2) 2-wheel drive vehicles and 4-wheel drive vehicles perform the same in both frontal and side crash tests but differently for rollover, (3) a regular cab truck and an extended cab truck perform the same for frontal impact, side impact, and rollover resistance, (4) a vehicle with side air bags will perform differently than one without side air bags in a side impact (5) corporate twins (i.e. a Ford Escape and a Mazda Tribute) will have the same performance and (6) a vehicle equipped with ESC will perform differently than one without for rollover resistance testing. On occasion, based on our technical judgment or information provided by manufacturers, we may decide to deviate from one of these assumptions.

<sup>28</sup> For frontal impact and side impact testing, the FMVSS establishes a floor that all manufacturers must meet. The NCAP safety rating standards are above that floor for both of these tests. For rollover resistance, however, there is no FMVSS standard that underlies the test.

<sup>29</sup> See, e.g., Volkswagen Jetta commercial, available at [http://www.vw.com/jetta/photos\\_vids.html](http://www.vw.com/jetta/photos_vids.html).

<sup>30</sup> P.L. 109-59 (August 10, 2005); 119 Stat. 1144. SAFETEA-LU called on NHTSA to promulgate regulations to govern the mandatory disclosure of NCAP ratings. The final rule took effect on November 13, 2006. See 49 C.F.R. Part 575 [Docket No. NHTSA-2006-25772], “New Car Assessment Program (NCAP); Safety Labeling.”

<sup>31</sup> NHTSA Final Rule, See 49 C.F.R. Part 575 [Docket No. NHTSA-2006-25772], “New Car Assessment Program (NCAP); Safety Labeling.”

<sup>32</sup> Data for Figures 2-6 was provided by NCAP Division Chief, Nat Beuse.

<sup>33</sup> GAO (April 2005). The GAO gave two primary reasons for this conclusion. First, the current tests have been eroded by changes in the vehicle fleet, which today includes increasing numbers of large pickups, minivans and SUVs, none of which are not fully addressed by current NCAP test. Second, the program has been so successful that virtually all vehicles today receive a 4- or 5-star rating, which has reduced the “incentive for automakers to continue to improve vehicle safety and [provides] little differentiation among vehicle ratings for consumers.”

<sup>34</sup> See, e.g., Mann (2006); Warren (2003); Center for Responsible Lending, “Credit Card Policy Recommendations,” available at <http://www.responsiblelending.org/issues/credit/policy>.

<sup>35</sup> See, e.g., S. 2655 introduced by Senator Menendez of New Jersey (April 2006); S. 499 introduced by Senator Dodd of Connecticut (March 2005).

<sup>36</sup> Testimony of Janne O’Donnell and Trisha Johnson, Consumer Federation of America, “Credit Card Debt Imposes Huge Costs on Many College Students” (June 1999); see also, Manning (2000).

<sup>37</sup> Obviously, one could easily argue that a safety rating for interest rates and/or fees should be added to this list. However, the dangers of these features may be more adequately addressed through the more traditional regulatory process. One reason for this is that a company may be better able to evade a safety rating based on the amount of interest charged, or the size of a particular fee (for example, by just adding another fee). That said, these features pose significant risks for consumers and should certainly be considered before settling on the areas for testing.

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