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Government is saving the credit card industry from itself.

 [090519_TBM_obama.jpg](#) [1]

Has there ever been an industry so relentlessly at war with its customers as the credit card industry is now? Watching new credit card legislation sail through Congress this week is the industry's reward for giving even its most responsible customers the overwhelming sense that they are getting ripped off. Indeed they are, and there is no more compelling, incontrovertible proof than the flimflammy of "over the limit" charges.

Last week, in a town-hall-style anti-credit card rally, President Obama shared his stage with a woman who had [accidentally charged a payment to the wrong credit card](#) [2], which let the payment go through, then turned around and said she was "over the limit" and raised her rate to 30 percent. This neatly encapsulates the worst practices of the credit card industry. Credit card companies can easily just turn down a charge that put a card over its maximum. No harm, no foul.

Instead they happily let their customers go over their limit (raising the question of why it's called a "limit" in the first place), then say that those customers are in default on their agreements and raise their rates. Pulling out the wrong card to pay for light bulbs at the hardware store turns into a mistake that results in hundreds of dollars of extra interest charges. The credit card companies claim, amazingly, that they do this to spare their customers the embarrassment of having the card turned down.

Over-the-limit rate hikes are the most indefensible example of rate changes—for being late on a payment, for having a lower credit score, or for no reason at all—that give credit card holders the sense that they have fallen into a Queen of Hearts world where the price of credit is whatever the banks say it is. For credit card issuers this is a customer relations disaster. But even setting aside the obvious problem of having customers who hate you, it is also terrible business.

Preventing card issuers from arbitrarily ratcheting up rates—as the legislation now on the table does—isn't just a way of protecting consumers. It is also, just as importantly, a way of saving the banks from themselves.

The most telling example of just how shortsighted the worst practices of the credit card industry really are is a company called [Advanta](#) [3] (ADVNB), the country's 11th-biggest credit card issuer. [A walk through a site such as Ripoff Report](#) [4] will yield several bushels of stories of customers who saw Advanta raise their rates, often to 34.99 percent, for the flimsiest of reasons or no reason at all. Among credit card issuers, Advanta stands out for the number and rancor of the complaints.

You'd think that this kind of customer-gouging would at least be profitable. It is not. On the contrary, it has been an unmitigated disaster. Last week, Advanta announced that it would [shut down all of its customers' credit lines](#) [5] in June and close down its credit card business. Advanta's losses have already hit 20 percent—the worst-case scenario envisioned in the government's bank stress tests—and are certain to rise. Advanta, which two years ago actually issued a press release [bragging about its "stellar" results](#) [6], is now nearly worthless, with a share price at about \$1.

What makes Advanta a telling and important example for the banking industry is that what happens when credit card issuers raise their rates to sky-high levels is largely uncharted territory. In general, the experience of credit card issuers that focused on marginal customers (such as Household Bank, bought by [HSBC](#) [7] (HBC) and dragging down HSBC's results) is not promising. The difference with Advanta is that its customers were not "subprime": A look at a [typical pool of Advanta cards](#) [8] shows that 80 percent of its customers had prime credit, and another 11 percent are what the industry classifies as "near prime." Half its customers have credit scores of 720 and above, the upper end of the prime range. What Advanta shows is that the strategy of starting off by offering attractive rates—Advanta focused on small-business customers—and then gouging your way to profitability may be even more ill-advised.

Bad as this is, this isn't the whole story. In addition to the reliable customers that banks rip off and alienate with arbitrary rate increases, there is another set of customers facing higher rates: the ones whom the banks *want* to alienate. These are people with overextended credit and declining credit scores. For these customers, the banks' fondest hope is that they will be ticked off enough by the new rates to pay off their balances.

For a single bank to raise rates to a sky-high level is a dangerous strategy. When many banks adopt it, however, it gets much worse. Customers who

see the rates on all of their credit cards rise become much less able to pay *any* of them. If banks try to one-up one another's rate increases to get paid the fastest, the likelihood is that in the end fewer will get paid.

Do banks see this? I would guess they do. One reason I think this is the evidence of my own credit cards. Several of them have a "universal default" clause in their contracts, which lets them raise my rates if I'm late on *any* loan or credit card. None of them, however, have exercised that option: I suspect their data crunching tells them (correctly) that if all my rates were to suddenly rise, the likelihood is not that I would magically repay my debts but that I would no longer be able to afford to pay even the minimum.

For every bank to raise rates at once hoping to be first in line to be repaid—essentially what many customers are facing now—amounts to a bankers' suicide pact. Yet, pressed to deliver short-term results to prove that they are back on their feet and desperate to push risky borrowers into repaying credit cards while they still have money available, banks persist in playing the rate-increase game.

I spoke last week with Richard Vague, a onetime banker who was the founder and longtime chief executive of First USA, a major credit card issuer. Vague made the point that credit card issuers are under tremendous pressure to increase their short-term profits right now. "What's changed," Vague says, "is the time horizon." Bank chiefs right now, says Vague, are probably a lot more concerned about the next quarter's earnings than about the years ahead.

Over the long run, charging what amounts to an undefined "market price" is just as bad for banks as for their customers. The Mafia can keep putting the screws on its clients because it has the option of breaking their legs and taking over their businesses. Even the least-scrupulous credit card issuer can't take advantage of these extralegal options. For them, the endgame of arbitrary and outsize rate increases holds not extravagant profits but an epidemic of default. Just look at Advanta.

This is why when all the *Sturm und Drang* is over, a new set of credit card rules will turn out to be not the death knell for the credit card industry but a lifesaver. The competition to squeeze the last bit of profit from overextended customers is one that the banks should be desperately trying to avoid and are clearly unable to on their own. New rules are the best way to curb the banks' own dangerous short-term impulses. The industry's lobbyists have tried to paint credit card reform on as a declaration of war on the banks. Actually, it's the banks' best chance to end the war with their own clients.

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