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Charging Ahead: The Growth and Regulation Of Payment Card Markets Around the World

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**Charging Ahead:  
The Growth and Regulation  
Of Payment Card Markets Around the World**

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# Contents

<b>Tables and Figures</b> .....	<b>Error! Bookmark not defined.</b>
<b>Acknowledgments</b> .....	<b>Error! Bookmark not defined.</b>
<b>INTRODUCTION</b> .....	<b>3</b>
<b>PART I THE BASICS OF PAYMENT CARDS</b> .....	<b>11</b>
1. Paper or Plastic?—Payment System Functionality	<b>Error! Bookmark not defined.</b>
2. The Mechanics of Payment Card Transactions .....	<b>Error! Bookmark not defined.</b>
<b>PART II EASY MONEY</b> .....	<b>Error! Bookmark not defined.</b>
3. In Defense of Credit Cards.....	<b>Error! Bookmark not defined.</b>
4. The Psychology of Card Payments—Card Spending and Consumer Debt	<b>Error! Bookmark not d</b>
5. Over the Brink—Credit Card Debt and Bankruptcy.....	<b>11</b>
<b>PART III THE PUZZLE OF PAYMENT CARDS</b> .....	<b>Error! Bookmark not defined.</b>
6. Explaining the Pattern of Global Card Use.....	<b>Error! Bookmark not defined.</b>
7. The Introduction of the Payment Card.....	<b>Error! Bookmark not defined.</b>
8. Revolving Credit .....	<b>Error! Bookmark not defined.</b>
9. Point-of-Sale Debit .....	<b>Error! Bookmark not defined.</b>
10. Convergence and Exceptionalism in the Use of Cards .....	<b>11</b>
<b>PART IV REFORMING PAYMENT SYSTEMS</b> .....	<b>Error! Bookmark not defined.</b>
11. Indirect Approaches: Regulating Interchange and Encouraging Surcharges	<b>Error! Bookmark not</b>
12. Contract Design.....	<b>11</b>
13. Regulating Information.....	<b>45</b>
14. Product Design: Affinity and Rewards Programs and Teaser Rates	<b>Error! Bookmark not define</b>
<b>PART V OPTIMIZING CONSUMER CREDIT MARKETS AND BANKRUPTCY POLICY</b> .....	<b>Error! Bookmark not defined.</b>
15. Causation, Consumer Credit and Bankruptcy.....	<b>Error! Bookmark not defined.</b>
16. Regulating Consumer Credit Markets .....	<b>Error! Bookmark not defined.</b>
17. Consumer Bankruptcy Reform .....	<b>Error! Bookmark not defined.</b>
<b>CONCLUSION</b> .....	<b>Error! Bookmark not defined.</b>
<b>Endnotes</b> .....	<b>45</b>

## INTRODUCTION

I start in 2003 at a parliamentary hearing in London. The witnesses are an impressive group, the CEOs of most of the large issuers of credit cards in the United Kingdom. The topic is the concerns of a select Treasury Committee about the high cost and excessive use of credit cards. From the perspective of the media, the highpoint of the hearing was a sound bite from an exchange with Matthew Barrett, Chief Executive Officer of Barclays Bank. In the course of questioning Mr. Barrett about the high interest charges on the cards that Barclays issues, one member of the committee jests that “you probably have a Cahoot card in your wallet,” referring to a low-cost card issued by a British Internet bank. In Washington, you could predict with great certainty that the CEO of CitiBank would respond tartly that he of course carries a CitiCard and uses it everywhere he goes. In the more casual British atmosphere, however, Barrett offers us a lapse of apparent sincerity:

I do not borrow on credit cards; it is too expensive.

\* \* \* \*

I have four young adults in my family, and I give them advice on “don’t get too much debt on credit cards” and they are very literate and fluent and extremely well-informed because of who their Dad is, but it does not matter a w[h]it; they still run their credit cards.<sup>1</sup>

The British press, as might be expected, filled stories for weeks with amused commentary on Barclays’ admission that credit cards are too expensive. But the second statement is what intrigues me. What are we to think about this financial product, marketed around the globe by the world’s leading financial institutions? In his capacity

as a parent, Mr. Barrett (like many of us) is filled with trepidation at the thought that *his* children would use the product frequently. And if that is not enough, he tells the committee that despite the expressed fears of a sophisticated, informed, and apparently concerned parent, his children nevertheless use the product excessively. How can such a product be so successful? Why do we tolerate it? Why have so many of the world's largest economies allowed it to flourish?

The pages that follow provide a broad overview of my answers to those questions. In brief, the product is successful because it is one of the most effective mechanisms ever devised for retail purchasing and borrowing. Thus, we tolerate the product because efforts to ban it would do much more harm than good. At the same time, the problematic aspects of the product that motivate Mr. Barrett's trepidation cannot be ignored. Rather, they demand policy responses that allow the card to do what it does well, but limit the harms from excessive spending and debt that afflict many of those that use the card.

The problems have not escaped the attention of governmental policymakers. Australia and the United Kingdom have been investigating card markets for a decade. More recently, initiatives have appeared in the European Union, Spain, and Argentina. Even the United States – where the credit card was invented and has been most warmly welcomed – has begun to consider major market interventions. At the same time, the legislative desire to protect the credit card's place in the American economy was one of the most important motivations for the Bankruptcy Abuse and Consumer Protection Act of 2005.

Academic contributions, by contrast, have largely missed the hard problem – the mix of values and costs that card use offers an economy. That is not to say that

academics have ignored the card entirely. On the contrary, prominent critics like Robert Manning, George Ritzer, and Juliet Schor all have decried the contribution of the credit card to the increasingly consumerist society in the United States. From a wholly different perspective, David Evans and Richard Schmalensee have focused on the structure of the networks that dominate modern credit card markets, arguing that antitrust concerns about those networks have been seriously overstated. Finally, populist supporters of recent United States bankruptcy legislation have argued that the laxity of the consumer bankruptcy system in the United States paved the way for widespread abuse of the freedom that the credit card offers.

To make sense of the phenomenon from a global perspective, it is important to situate the rise of the credit card in the general shift from paper-based to electronic payments. Part I of this book explains the importance of that shift. Among other things, it shows how the United States, despite its affection for the plastic card, is far behind other developed countries in moving away from the wasteful use of traditional paper checks as a device for retail payments. Given the resources the United States wastes – about one-half of one percent of its gross domestic product – on processing paper checks, the United States is the *last* place in which it would make sense to stifle card-based payments as a retail payment system.

Part II of this book provides an empirical understanding of the costs and benefits of the card. The plastic card brings substantial benefits as an effective device for payment and for borrowing. To the extent consumer spending, consumer borrowing, and entrepreneurial activity are important drivers of economic growth, the card is an important component of a modern healthy economy. At the same time, the convenience

of the card – in particular, the credit card – is uniquely associated with an increase in financial distress. The social costs of financial distress offset the benefits of convenience if they do not in fact outweigh them.

To some degree, this should come as no surprise. Academics for more than a decade have noted simple and apparent correlations between increased debt and consumer bankruptcy filings. And there can be no doubt that the rise of the credit card has been associated with a general rise in consumer borrowing. My work here extends the existing work in three important ways. First, the credit card is a global phenomenon, and I analyze data not only from the United States but also from other developed countries in which the card plays an important role in the economy. Second, I quantify the specific effects of credit card debt, as opposed to consumer debt in general. That analysis supports two premises: increased card spending leads to an increase in overall consumer borrowing; and increased credit card debt leads to an increase in consumer bankruptcy (even when I adjust for overall borrowing levels). Third, I emphasize the social costs of consumer financial distress of which previous writers have lost sight. Nearly everyone loses when consumers are mired in debt. Taken together, those points suggest a classic base for regulatory intervention: credit card borrowing as it exists in the globalized West imposes substantial external costs on the economy, not internalized by the networks, issuers, or cardholders.

Part III of the book takes that concern as the basis for a critical examination of global cards usage and the circumstances that have led to its oddly varied pattern. I write from the perspective that regulators dealing with a global phenomenon like the credit card cannot sensibly design policy responses without some understanding of the reasons

for the wide variations in usage patterns around the world. As I explain, fortuitous features of the post-war institutional setting in the United States – a fractionated banking system, the interstate highway system, the lack of serious data protection – made the United States uniquely suited to a rapid uptake and adoption of the card. Those circumstances have left the United States dependent on a credit-centered cards market to an extent unmatched in any other economy.

In countries less dependent on the credit card, the forces of globalization are pushing towards markets in which lending and payment functions are more segmented. That norm – epitomized by the United Kingdom and Commonwealth members like Canada and Australia – is characterized by common use of the debit card as a payment device, coupled with rapid increases in credit card borrowing and consumer bankruptcy (albeit at much lower levels than in the United States). Resisting that global norm is a third pattern, epitomized by the continental European Union. There, the coincidence of strong norms of data protection and resistance to consumer debt has hindered the development of the plastic card, forfeiting the benefits of the card but avoiding its costs.

The natural question, then, is what policies will be useful to confine the problems related to credit cards without creating undue inefficiencies in retail payment systems. Parts IV and V consider that question. The most obvious solution would be to push the United States towards debit cards for paying and credit cards for borrowing. But what policies encourage debit card use? Should the government police the price the card industry charges merchants (“interchange fees”) or the prices merchants charge customers (credit card “surcharges” or cash discounts)? Should the government conduct a press campaign enlisting Oprah or Dr. Phil?



Unfortunately, those initiatives range from counterproductive to ineffectual. Any serious effort must focus on the heart of the problem: the relation between the issuer of the card and the cardholder. That relation, in turn, can be understood only in the context of the unusual contracting practices that dominate the modern cards industry. My analysis builds on the premise that firms use contracting and marketing techniques that focus the attention of myopic consumers on the more favorable parts of a relationship. Where those techniques are effective, consumers will give inadequate attention to the less favorable parts of a relationship. In this context, sophisticated card issuers have learned to exploit the boilerplate terms of their agreements to produce a set of obligations that even the most sophisticated cardholder could not master. What does a government do about this? Should regulators then invalidate agreements that disadvantage cardholders? Indeed, regulatory standardization of cardholder agreement makes a great deal of sense. At a minimum, a strong case can be made for regulatory stabilization of terms, to bar the frequent post-hoc amendments that make it difficult for cardholders to understand their obligations.

The complexity of the relationship combined with the tendency of issuers to exploit consumer shortsightedness suggests that the existing system of agreement-based disclosures is at best ineffectual. I recommend a ban of all marketing aimed at minors and college students. I also suggest a revamped disclosure strategy – one that focuses on the critical times, the points at which purchasing and borrowing decisions are made. If one of the major causes of limited borrowing in Japan is the need for consumers to make their borrowing decisions at the point of sale, there is some reason to think that disclosures at that point might lead to more careful cardholder behavior. Finally, the

most direct response would prohibit the rewards programs that issuers currently use to give cardholders such a strong incentive to use their cards as their regular spending device and the teaser rates that encourage them to borrow.

As the data presented in Part II suggest, consumer financial distress is rising rapidly even in the countries that use the credit card much less pervasively than the United States. Thus, even if the reforms discussed above could shift the United States toward the less credit-dominated global norm, they would not solve the problem entirely. Accordingly, Part V closes with a discussion of broader reforms directed to consumer credit markets in general. Starting again from the premise that the issuer/cardholder relationship imposes social costs, I show how modern technology gives the issuer a ready capacity to limit financial distress through actions designed to limit borrowing by distressed cardholders. The natural implication is that a sophisticated regulatory policy would harness that capacity by giving credit card issuers a monetary incentive to limit borrowing by the financially distressed. If that lending is privately profitable only because of the lender's ability to externalize the consequent costs of distress, the natural response is to inhibit lending. Among other things, that rationale supports mandatory minimum payment requirements, a tax on distressed credit card debt, and the subordination of payments to credit card lenders in bankruptcy.

I have a great belief in the ability of the market to drive behavior, and an abiding skepticism in the ability of the government to improve on the results produced even by flawed markets. Thus, it has been most unsettling as the evidence that I have collected and the theoretical frameworks built on it have steadily driven me to the interventionist conclusions presented in the closing Parts of the book. As you read forward, I hope you

can sense the atmosphere of inquiry and the quest for understanding that has motivated my long work on this project.

## Chapter 12: Contract Design

Over the last several years, I have presented this research to various groups: American law faculties, undergraduate students, bar associations, and economists at central banks in different countries. When I make the argument that the problem lies in the cardholder-issuer interface (and then propose ways to redress the imbalance), a common response is that it is simple for any well-educated person to avoid becoming a revenue-generating cardholder. All that is required, one would think, is careful attention to the terms of the contract between the cardholder and the issuer.

Thus, someone usually claims to have found a simple way to avoid the risks of card usage. Some will say, for example, that the trick is to find a card with no annual fee and be sure to pay your bill on time every month. More recently, with increased attention to shortened grace periods, I have heard colleagues explain with pride their careful efforts to pay their bills multiple times a month to avoid interest payments (sometimes doing so even before the purchases are made). Still others claim to have successfully mastered the practice of shopping teaser rates or making the most of rewards programs without paying interest or fees. I have not yet engaged any of those respondents in a conversation without concluding (usually silently) that the person in fact is probably a profitable customer for their card issuer. It surely is true that some cardholders are less profitable than others are, but it is equally the case that most of the people that believe they have outsmarted their issuers are mistaken.

As the discussion above should make clear, and as the great variety of “simple” resolutions suggests, I believe that the problems are intricate. The difficulty with proposing sensible solutions stems from three central points. The first is the blending of

payment and credit features, which has been the source of the credit card's success and is at the same time at the root cause of the problems. The second is the difficulty of designing policies to alter ingrained market networks without abandoning the efficiencies those networks create. The third is the intractable problem of responding to the cognitive failures that plague consumers in financial transactions. This is particularly true in diverse markets like this one, where at least some cardholders believe they are taking advantage of card issuers and benefiting from the less rational tendencies of other cardholders. As I work through potential policy responses targeted at the cardholder-issuer interface, I attempt to keep those three points at the forefront of my analysis.

The relationship between the cardholder and the issuer is based almost entirely on the "boilerplate" form contracts drafted by lawyers for credit card issuers. Cardholders have no opportunity to negotiate the terms of the contracts. The boilerplate forms suffer from many of the problems associated with other standardized consumer lending contracts. They are lengthy, detailed, and written in fine print. It is often hard to locate the contract documents from among the other correspondence and advertising materials that the lender provides, and the contract itself might include multiple documents. Reading the contract documents requires a level of literacy and reading comprehension that is far beyond the grasp of the normal person.<sup>2</sup> More fundamentally, the substantive issues that the agreements raise play into several common behavioral biases that unite to desensitize consumers to the risks of spending and borrowing.

Credit card contracts also raise distinct issues that make them even more complex than other consumer lending contracts. The structure of credit card transactions (with separate points of agreement, purchase and borrowing) deemphasizes the significance of

the contract itself. Consumers make the important decisions when they decide to spend and then later to borrow.

Those decisions seem trivial because of the small amounts involved. To illustrate, on the day when I first wrote this passage, I made eight purchases with my cards, paid two credit card bills, discarded (without opening) three solicitations offering new cards, balance transfer programs, and similar offers to extend credit. Although each of those actions was routine, even trivial, the collective impact can be significant.

Time is also a factor. Because credit card transactions occur over an extended period, issuers generally retain the right to change the terms on which they extend credit. They do so with some regularity. The changes typically apply to outstanding balances, which means that consumers are required to weigh the risk at the sales counter that the credit terms for that purchase will change later. A related concern is that issuers typically provide little or no advance notice when making changes. This means that consumers often are not able to find other credit arrangements in time to avoid retroactive adjustment of the contract terms.

A final point that distinguishes credit cards from other consumer credit transactions is the number of account agreements. Many consumers have not one but several different accounts, with terms that differ in important respects. Indeed, in 2004 the average American household held a stunning *thirteen* credit cards.<sup>3</sup> Consumers that read their card agreements must be able to associate the correct agreement with the particular card they choose to use at the point of sale.

Considering the unique problems with credit card contracting, the lack of regulation of credit card contracts compared to other consumer financial contracts is hard

to justify. Other important consumer financial transactions – purchases of insurance, borrowing money for a home – display a common pattern, in which regulators or intermediaries have standardized terms in a way that focuses competition on the attributes of products that are most readily comprehensible to consumers. Is there a justification for the disparate regulatory approaches? Are consumers immune to the credit card contracting problems? Do issuers have market incentives to internalize the risks? Do courts protect the interests of those consumers by policing credit card contracts?

The remainder of this chapter discusses those questions. In the two subsequent chapters, I broaden the discussion to consider ways to respond to other problematic features of the credit card transaction: information deficits and marketing strategies.

## ***Credit Card Account Agreements***

### **Context**

The issuer-cardholder relationship begins when a card issuer sends a solicitation to a group of prescreened consumers, usually through direct mail. Issuers sent more than 5 billion direct mail solicitations in 2004, for an average of more than five offers per month to more than 70% of United States households.<sup>4</sup> Although the response rate typically is quite low,<sup>5</sup> tens of millions responded last year by submitting a credit card application. Upon approval of the application, the issuer sends the card and a cardholder agreement to the applicant. After receiving the card and the contract, the consumer must validate the card over the telephone – the telephone validation occurs after the cardholder has received the agreement and before the card is used. Thus, to generalize, the contracting process is still primarily paper-based, and satisfies traditional contracting doctrine that looks for mutual assent through offer and acceptance of identifiable and

disclosed terms. Still, the robustness of assent is undermined by the cardholder's investment of time in the relationship before receiving the cardholder agreement.

A consumer probably will not read the agreement. The account is open by the time the cardholder receives it. And the agreement is likely to be hard to read and impossible to revise.<sup>6</sup> If the cardholder does attempt to read the agreement, it is far from clear that a cardholder of reasonable care and intellectual capability will understand it.

A typical credit card agreement, for example, might have about eight single-space pages of small (seven-point) type, including about 80 separately numbered provisions. Many of the terms in the agreement are comprehensible only for cardholders with specialized knowledge. Financial terms such as "annual percentage rate" or "APR" assume proficiency with interest calculations, and legal terms such as "arbitration," "forum," and "default" assume an advanced understanding of the legal process. Further, a single account may have multiple APRs that apply to different types of credit extensions or different periods.

The likelihood that the cardholder will have cards from multiple issuers only exacerbates the complexity of the relationships. The agreements for the thirteen cards that the typical household will have are likely to contain choice-of-law provisions that select the laws of different states. Moreover, unlike the issuers of home mortgages<sup>7</sup> or insurance policies,<sup>8</sup> to take the closest parallels, each credit card issuer is likely to use a standardized agreement that is in form (if not substance) almost entirely different from the forms of other major issuers. Thus, the cardholder that wants to maintain a comprehensive understanding of the status of cardholder agreements will need to understand the relevant legal rules in the applicable states, will need to study a different



agreement for each card, and will need to remember as cards are pulled from the wallet which agreement corresponds to each card. This in a world in which few consumers are likely to notice, much less retain, the relevant agreements as they arrive in their stack of daily junk mail.

Another point is that it is not always easy for a layperson to determine which papers constitute the agreement for each card. The current Bank of America agreement, for example, consists of a separately printed eight-page standardized form, together with a set of “Additional Disclosures” that appear in the billing statement at the bottom of a sheet labeled “Important Summary of Changes to Your Account.” The cardholder that skips the summary after reading the agreement would fail to notice such additional terms as a default provision that permits Bank of America to impose a penalty APR of about ten percent per annum more than the standard APR.

Finally, a cardholder also would need to keep track of the frequent amendments of each of the agreements. It is typical for major issuers to amend their agreements in important respects with remarkable frequency. Amendments are not the typical bargained-for modifications of contract theory. Rather, the typical agreement reserves to the issuer the right to amend the agreement at any time, with the issuer promising at best that it will provide notice of the amendments. When it does provide notice, the notice typically is in the form of a new agreement included in a billing statement together with a variety of other promotional materials. The cardholder that uses a rule of thumb to discard all marketing information that comes with bills is likely to fail to notice such amendments. As a matter of traditional contract doctrine, it is not clear that such

amendments are enforceable; however, several key states explicitly permit amendments based on notices enclosed with billing statements followed by subsequent card use.<sup>9</sup>

To be sure, issuers obtain consent before applying some new financial terms, but consent is inferred from such actions as continuing to use the card after notice of the amendment or failure to close the account and send a prompt written objection to the amendment. Issuers often require a consumer seeking to avoid modified terms to opt out of the modified terms in ways that might not be feasible or desirable for all accountholders.<sup>10</sup> Importantly, amendments often apply to funds already borrowed. For example, a change in the terms of default might substantially increase the interest rate the cardholder will pay on balances outstanding at the time of the amendment.<sup>11</sup>

In evaluating the contracting problems that the card presents, it is important to remember the unusual nature of the reciprocal obligations on which the relationship rests. On the cardholder's side, there is no commitment to use the card. Moreover, even if the card is used, timely payments often obviate any obligation to pay interest or fees. Nor is the lack of a commitment illusory. In many (perhaps most) cases, the cardholder can switch credit sources easily. Viewed on a purchase-by-purchase basis, the typical cardholder makes a different decision for each transaction when it decides which card to present at the checkout counter.

On the issuer's side, the business of card issuance involves a similar evanescence of obligation. As with most lending transactions, the lender is not in any practical sense obligated to lend until the moment at which the lender actually extends funds to the borrower. Rather, the parties proceed on the useful rule-of-thumb that absent an unforeseen change of circumstances it normally will be profitable for the lender to extend

the credit for which the lender has expended time and energy to structure a transaction. Issuers deal with the possibility of such changes by reserving the right to refuse to extend credit on a transaction-by-transaction basis.<sup>12</sup> If this were not permitted, issuers would be deprived of the ability to terminate accounts based on deterioration of the borrower's credit over time. It would also make it difficult to respond to concerns about unauthorized use.

More broadly, because interest rates and the competitive landscape change rapidly, credit card issuers require a great deal of flexibility to operate. Forcing an issuing bank to adhere to credit terms in a dynamic economic environment would not promote an efficient credit relationship. That is not to say that lenders cannot commit at one time to provide credit at some specified future date. It is to say, however, that lenders typically charge for such a commitment and that the absence of a commitment (and related fee) from the credit card market should surprise nobody. In sum, market conditions require that issuers retain *some* ability to modify the terms of their agreements.<sup>13</sup>

As suggested above, the difficulty of obtaining individual consents from large numbers of cardholders has led issuers generally to reserve the right to change the terms of their agreements when cardholders use their cards after receiving notice of the change.<sup>14</sup> In the context of the business model, however, that provision is much less onerous than it might seem at first glance. Given the lack of obligation – on either side – it makes more sense to view each separate purchase transaction as a separate agreement between the cardholder and card issuer that is completed when the card issuer agrees to extend credit for a particular transaction that the cardholder wishes to enter.<sup>15</sup> When the

cardholder decides to borrow funds from the borrower, it borrows them on the terms available from the issuer at that point, just as we purchase a CD from a bank at the interest rate available on the day we contact the bank to purchase it.

### **Ramifications**

The key question is whether consumers on the ground are making choices with sufficient care and rationality to drive the market to a competitive and optimal set of products and prices. These are complex relationships. It is unlikely that the typical consumer will be able to evaluate all of the attributes of the transaction that have economic significance.

- *Decisionmaking*

I draw here on a long-standing body of experimental literature indicating that the ability of a typical consumer to evaluate separate attributes declines rapidly after the number of relevant attributes exceeds three.<sup>16</sup> Applied to this particular context, Jeffrey Davis has conducted an empirical study of consumer comprehension of consumer finance agreements,<sup>17</sup> using an agreement much less complicated than a modern credit card agreement.<sup>18</sup> Davis found that most consumers that read the agreement could not understand most of its terms. Davis's findings emphasize the difficulty that consumers face in understanding terms that involve complex concepts that are not common in daily experience.<sup>19</sup> Although the study is relatively informal, its findings dovetail with the reality of the modern credit card agreement. In particular, a consumer must account for costs and fees that differ from card to card and shift over time (often after the purchase in question), as well as complex concepts of default and a litany of fees payable as a

consequence of specified actions.<sup>20</sup> In reality, we cannot think it likely that consumers understand most of the terms even when they do review the agreements.

Rather, theory suggests that the typical cardholder will select a product based on a small number of price and service attributes that are of obvious relevance, recognizing that the remaining terms of the agreement are nonnegotiable. For example, a consumer might select a bank based solely on the cost of writing checks, the minimum balance required to avoid a monthly fee, and the location and fees for using automated teller machines to withdraw cash. In the case of a credit card contract, empirical research suggests a typical consumer selects a card based on the brand, annual fee, grace period, affinity or rewards benefits, and the stated interest rate if the consumer expects to pay interest in the immediate future.<sup>21</sup> Because those terms are contained in the advertising materials, consumers in most cases are unlikely even to look at the contract. Thus, a consumer of typical decision-making capacity would not rationally consider the terms defining or explaining the consequences of late payment or excessive borrowing, even though they generate a substantial share of issuer revenue (in the form of fees and default APRs). If consumers do not consider those terms, there is a concern that issuers will not draft them in a competitive way.<sup>22</sup>

A second concern, one to which legal academics have paid considerably more attention, is the likelihood that consumers would not price the risks of card agreements accurately even if they did invest the time and attention necessary to understand and evaluate the relevant financial terms. Tom Jackson has suggested that systematic failures in the cognitive process cause individuals to underestimate the risks that their current consumption imposes on their future well-being.<sup>23</sup> Building on that point, behavioral

economics literature suggests that consumers give excessive weight to the conspicuous “up-front” aspects of a relationship and inadequate weight to less conspicuous “back-end” terms.<sup>24</sup>

The pricing problem is associated with several related cognitive tendencies. One is a so-called “optimistic” bias, which leads people to underestimate the likelihood of adverse events – in this case, to underestimate both the likelihood that they would suffer financial distress and the costs that the distress would impose on them.<sup>25</sup> Another is an “availability” bias, which leads people to overweigh the probability of common occurrences (which are readily available to their decision-making faculties) and underweigh the probability of uncommon occurrences. If financial distress is an uncommon event, that bias might cause consumers to underweigh the likelihood and consequences of financial distress.<sup>26</sup> Another concern is hyperbolic discounting. Generally, this causes consumers to make intertemporal comparisons that are unstable over time – so that future behavior will be systematically inconsistent with present predictions of that behavior.<sup>27</sup> In this context, it can lead to excessive borrowing.<sup>28</sup>

- *Shrouding and Debiasing*

Those cognitive tendencies justify concerns that are exacerbated if card issuers are in a position to exploit them.<sup>29</sup> David Laibson and his co-authors discuss a strategy that they call “shrouding,” in which merchants identify a myopic class of customers and exploit the lack of rationality by systematically backloading the less attractive terms into a less prominent time and place in the relationship.<sup>30</sup> Stewart Macaulay’s work on credit cards before TILA suggests that card issuers used similar techniques to make cardholders responsible for the losses from stolen cards.<sup>31</sup> At that time, the strategy was to omit any

language about lost cards from the application and then include a fine-print clause on the back of the card indicating that the cardholder was responsible for all transactions in which the card was presented (even if the transaction was conducted by a thief with a stolen card). Similarly, Oren Bar-Gill's article on credit card contracting argues that credit card companies use pricing features such as teaser rates to take advantage of a concern for near-term costs by marketing products that depend on systematic underestimation of long-term borrowing costs.<sup>32</sup>

Those strategies are less successful where competition can “debias” markets. Consider, for example, how the entry of Netflix has trumped the earlier shrouding strategy on which Blockbuster relied. Generally, Blockbuster's profit model in the early years of this decade coupled low rental fees with high late fees. If consumers underestimated the amount of late fees or the probability that they would pay them, they would underestimate the costs of renting from Blockbuster. By designing a product that exploited that error, Blockbuster increased its short-term profits. Netflix responded with a two-pronged approach: a pricing model that does not involve late fees and an education strategy designed to create an aversion to late fees. It is too soon to tell whether the Netflix approach will result in a long-term market position for Netflix,<sup>33</sup> but it did disrupt Blockbuster's profit model.

As the Blockbuster/Netflix example suggests, educating consumers of both front-end and back-end costs can disrupt a profit model that relies on back-end costs. In the credit card context, issuers at one time might have been vulnerable to sophisticated cardholders who avoid the payment of interest and fees by using a card with no annual fee and making timely monthly payments.<sup>34</sup> Thus, as the number of sophisticated users

grew, it became increasingly difficult for card issuers to profit by hiding expensive back-end interest payments.

The complexity of the modern credit card transactional structure minimizes the likelihood that issuers will be forced to use transparent pricing models without regulatory intervention. The Blockbuster/Netflix example describes a single market segment with a shrouding technique that was destabilized when consumers were encouraged to develop accurate perceptions of their future behavior. Modern credit card issuers, however, have used at least two tactics to prevent increased customer sophistication from destabilizing their profit models.<sup>35</sup>

- *Segmentation and Multiplicity*

The first tactic has been to develop product features that segment the market into smaller niches. The discussion above describes a single credit-card product, offered to all customers. That product was attractive to the sophisticated because it was free and to the unsophisticated because they failed to understand either the costs of the product or their likely use of it. Responding to the growth of card users that do not borrow, issuers have developed a number of different products that make it harder for sophisticated users to free ride. For example, the sophisticated cardholder that wishes not to pay interest and fees is likely to be attracted to an affinity or rewards card issued by MBNA. For that product, the cardholder is likely to pay an annual fee,<sup>36</sup> which the sophisticated user will rationalize as costing less than the value of the rewards (frequent flyer miles or the like). There is every reason to expect that the cardholder's calculation often will be incorrect.<sup>37</sup> Moreover, those calculations accord no weight to the value of the information MBNA obtains from the relationship.<sup>38</sup> Even if that calculation is correct, the new product



certainly has made the relationship more profitable on a cardholder-by-cardholder basis than it was in years past, when there might have been a direct cross-subsidization between convenience users and borrowers.

The concept of segmentation is not a new one. As Lizabeth Cohen explains in *A Consumer's Republic*, the strategy of segmenting consumers into ever more finely delineated classes has been a dominant strategy for a half century. It was identified in the 1950's in academic writings by people like Wendell Smith and Pierre Martineau, and swiftly transformed the business models of all American businesses aiming at consumers.<sup>39</sup>

The second tactic is to take advantage of the fact that consumers are likely to have multiple account agreements, all of which are likely subject to frequent unilateral modifications, both of which work together to hinder consumer understanding. If each issuer has a different set of rules, and if the pitfalls hidden in the rules differ for each issuer and from time to time, only the most careful cardholder will avoid *any* level of interest or fees. The point of this tactic is that within each of the market segments described above, even for the cardholders that attempt to position themselves as non-borrowing convenience users, it will require an increasing level of attention of detail to successfully avoid paying fees to the issuer.

Those strategies make the card industry more resistant to debiasing than parallel industries. That leaves us with a policy question: how to regulate a contracting market in which a seller faces a heterogeneous set of purchasers, some but not all of whom are sufficiently careful and sophisticated to respond rationally to the terms offered by the seller. If purchasers are homogeneous in their preferences, a relatively small number of

sophisticated customers can produce competition in the market that will drive the seller to offer an efficient product.<sup>40</sup> Alternatively, if purchasers are heterogeneous in their preferences but are always sophisticated, then each purchaser will respond rationally to the terms offered by the seller. We would expect this to be the case, for example, in relatively high-dollar markets. We are left here, however, with the case that falls between those simple cases: a market in which only some customers understand the offered terms, and in which the choices of those customers do not produce competition that alters the terms available to the other customers.<sup>41</sup>

### ***Solutions to the Contracting Problem***

If the allocation of risks in existing cardholder agreements is not the result of effective competition or rational choice by cardholders, the natural question is whether and, if so, how the law should respond. Lawrence Friedman describes a common pattern of consumer contract regulation. After an industry develops to a point where a stable set of products and transactions have developed, the typical response is for the legislature to step in and transfer those areas “from the realm of abstract contract law” to the realm of economic regulation.<sup>42</sup> As Stewart Macaulay explains, we can view this as a process by which commercial areas “spin off” for special treatment.<sup>43</sup>

For example, as the mail order industry grew in size, the FTC adopted a set of standardized contract terms, eliminating competition on terms that consumers are unlikely to notice. The FTC Mail Order Rule establishes a set of procedures that retailers must follow if they are unable to ship goods within the time they estimate at the time they take the order. If the delay is moderate, they must give the customer an opportunity to cancel the order. If the delay is extreme, they must cancel the order unless the customer

explicitly consents to the extension.<sup>44</sup> We can imagine that in the absence of such a rule, retailers might have different terms in their contracts to deal with the possibility of delayed shipments. We also can be sure that few consumers would examine and analyze those terms. Therefore, even if the FTC delay term is not optimal, it does serve to focus competition in that industry on the price, selection, and quality of delivered products, terms customers are most likely to notice.

Viewing the regulatory framework within that paradigm, it is striking how little the existing law does to regulate the credit card agreement. Most of the rules that govern credit card transactions are found in TILA and Regulation Z.<sup>45</sup> The legal regime defined by those rules is primarily a disclosure-based system,<sup>46</sup> with only a few substantive constraints on the practices of card issuers. For example, TILA does prohibit banks from issuing unsolicited credit cards to consumers.<sup>47</sup> TILA also has several provisions relating to unauthorized use and merchant disputes that give consumers a right to cancel payment that is much broader than the consumers' rights in any of the competing payment systems.<sup>48</sup> Still, the existing framework assumes, at least if the card issuer makes the required disclosures, that cardholders are best situated to decide with which entities and on which terms to enter card agreements.<sup>49</sup> That framework reflects an almost complete acceptance of the concern that terms established by government fiat will be less flexible, less innovative, and less likely to allocate risks sensibly than the terms selected by parties to a freely negotiated commercial arrangement.<sup>50</sup>

The question is whether there is some reason to think that credit card contracts are sufficiently afflicted by contracting inefficiencies or externalities to warrant “spinning them off” from the general “hands-off” realm of contract enforcement to the realm of

interventionist social planning. On the question whether market obstacles prevent efficient contracting, the preceding section summarizes a number of reasons to think that the process by which cardholders enter into card agreements does not function well. With regard to externalities, I show in Part II that increased credit card borrowing is uniquely associated with an increase in personal bankruptcy filings – even when we hold constant the total level of borrowing and account for general conditions in the economy. Following on that point, the increased financial distress associated with rising card use can cause harms that the borrower might not adequately consider when the borrower makes contracting decisions.

Assuming that some form of economic regulation is called for, it is less clear what type of intervention makes the most sense. If the existing literature makes anything clear, it is that a sensible intervention must pay attention to the situation on the ground, lest it end up doing more harm than good.<sup>51</sup> The biggest concern is that a regulatory intervention viewed as minor and benign by regulators or scholars might in fact undermine the business models prevalent in the industry in ways that harm competition. That is a major problem in this context, because the credit card is an especially efficient payment and borrowing device. Working from that perspective, the rest of this chapter considers a series of possible responses.

### **Running in Place**

To understand the feasibility and effectiveness of interventions in the credit card market, it is important to understand not only the contracting problems discussed above, but also some more general difficulties with consumer behavior in that markets. To that end, one of the themes running through this book is that the excessive borrowing

associated with credit cards results from both a convenience risk (the subject of Part V) and an instrument-induced risk (Part IV). The instrument-induced risk occurs when consumers use a credit card as a payment device and do not intend to borrow. Because some evidence suggests that the credit card encourages consumers to spend more than they otherwise would, and perhaps more than they can repay out of monthly incomes, credit card use can lead to unanticipated debt. The second is the convenience risk. Because the transaction costs of credit card lending are so low, borrowers are more likely to underestimate the risks associated with future revenue streams than they would be in another type of consumer credit transaction. Both of those risks arise against a transaction structure that makes the contracting decision less important to most consumers than the spending and borrowing decisions. Thus, both types of mistakes occur after the contracting decision has been made. Because policy analysis has failed to understand that trifurcated framework and its effect on consumer decision-making, neither the current regulatory framework nor the leading proposals in the existing literature respond adequately.

For example, the simplest possibility is the response of the common law: ex post judicial invalidation of terms as unconscionable. There is nothing new about this idea, which dates (at least) to work by Friedrich Kessler in the early 1940's.<sup>52</sup> A similar idea appears in Section 211 of the *Restatement (Second) of Contracts*. But several considerations limit the effectiveness of that doctrine as a general tool to police contracting problems. For example, judicial decision-making under a vague rubric of “unconscionability” often leads to the disparate readjustment of terms in ways that the parties did not contemplate in their pricing decisions. Moreover, courts that apply such

an approach with sufficient vigor to have a substantial effect on contracting practices are likely to do a poor job of sorting provisions that make economic sense from those that reflect overreaching.<sup>53</sup>

This is not to say that the unconscionability doctrine can serve no useful purpose. For example, the unconscionability doctrine might encourage businesses to think more carefully about the enforceability of the clauses that they write, leading them to use larger print, simpler language and the like. However, it seems more likely the doctrine does not substantially constrain the major industry actors, who easily can obtain legislative redress in areas where questionable practices are important to their business models.<sup>54</sup>

In the credit card context, the use of unconscionability as a tool to police contracting excesses also must overcome the widespread use of arbitration clauses in cardholder agreements.<sup>55</sup> When courts enforce arbitration provisions, they have no serious opportunity to assess the substantive provisions of credit card agreements or to consider whether issuers have complied with those provisions.<sup>56</sup> Still, I doubt that judicial or regulatory invalidation of arbitration provisions will have any substantial impact. For one thing, arbitration clauses might not contribute to the business models that permit excessive cardholder borrowing. Arbitration clauses are at most a detail in the history of the credit card industry. It is clear that most issuers did not use arbitration clauses in the United States until the late 1990's, and they are used rarely overseas.<sup>57</sup> Yet the rise in borrowing and attendant rise in consumer bankruptcy that troubles policymakers was well on its way even before those clauses came into common use. Nor would removal of arbitration clauses respond substantially to the contracting problems at the heart of this chapter. To be sure, arbitration clauses probably deter at least some class

actions. But, the class actions that would be available if the clauses were not enforced would only buttress the weak TILA disclosure regime and increase the ability of cardholders to hold issuers to the terms of the agreements the issuers have drafted.<sup>58</sup> Thus, they would have little effect on the substance of the relationship.

This is not to say that there are not serious problems with arbitration clauses in credit card contracting. For example, there is at least some evidence to support the view that issuers have colluded to adopt the clauses broadly because of concerns that customers care enough to shop for issuers that do not force arbitration.<sup>59</sup> There also is some reason to think that the problems of bias have a serious effect in this industry, where the major issuers have gravitated to a single provider (the National Arbitration Forum) that seems to be competing for business (at least in part) on a reputation for providing results that are satisfying to card issuers.<sup>60</sup>

At bottom, there is good reason to believe that arbitration clauses are not the result of competitive contracting. It is at least possible, however, that the cost savings of arbitration are sufficiently valuable that inclusion of the clauses is efficient.<sup>61</sup> Moreover, arbitration proceedings probably could be constructed in a cost-effective and neutral way if the card networks were inclined to intervene. Regardless of the outcome of that debate, it does not seem likely that prohibiting the use of arbitration provisions or regulating their content will solve the problem of excessive borrowing.

## **Moving Forward**

I turn now to the possibilities of direct regulation of the terms of credit card agreements. Here, I consider two approaches: prohibiting unpriceable terms; and

promulgating agreements that provide a standard contractual template for the relationship.

- *Prohibit Specific Terms Ex Ante*

The first solution would be to prohibit specific terms. That approach is common in other jurisdictions. Consider, for example, the European Union's Unfair Terms Directive,<sup>62</sup> which generally prohibits the inclusion of certain types of unfair terms in consumer contracts unless they are the result of individual negotiation.<sup>63</sup> By American standards, the list is intrusive, prohibiting, among other things, unilateral modification and arbitration clauses.<sup>64</sup>

Such a broad regime might seem almost unthinkable to American businesses. Yet it is not significantly different from the regulatory approach taken in other consumer financial transactions where a small number of important issues dominates the forms. For example, consider the residential lease contract, in which the most important term for consumer protection purposes is likely to be a warranty of habitability. After a period during which courts struggled with property owner efforts to disclaim such a warranty, it is in many jurisdictions now settled by statute or regulation that the owner of a residence provides such a warranty.<sup>65</sup> Similarly, in the home mortgage context, it is now uncommon to see a provision providing for mandatory arbitration.<sup>66</sup>

In this context, there are price terms that consumers might assess more rationally if the contracting process did not obscure them. Provisions that permit retroactive price adjustments interfere with the ability of consumers to assess the risks of default and nonpayment, because they allow price adjustments that come into effect after the time of the purchasing decision to which they apply.<sup>67</sup> For lack of a better term, I call those



“unpriceable” terms, not because consumers can *never* evaluate them, but because few consumers can be expected to evaluate their significance accurately.<sup>68</sup> That impulse would follow naturally from the idea that it is appropriate to ban terms whenever it is likely that all or almost all consumers will fail to respond accurately to the terms.<sup>69</sup>

Thus, regulators could concentrate on the notice and opt-out provisions that accompany retroactive price adjustments. The fifteen-day notice requirement mandated by federal law gives consumers little time to find alternate credit sources.<sup>70</sup> Depending on the requirements of the particular opt-out provision,<sup>71</sup> the absence of another credit source might make compliance with opt-out requirements impractical. For example, a provision stating that the consumer must repay the entire balance immediately will not provide a realistic option to a liquidity-constrained customer. Regulators thus could enhance consumer decision-making by lengthening notice requirements so that consumers would have additional time to find alternate credit sources. Going farther, regulators could explore ways to improve the readability and presentation of change-in-terms notices, broaden consumer opt-out rights, or even ban post-hoc application of unilateral amendments entirely.

A similar example is the “universal default” provisions that are the focus of current regulatory initiatives. Essentially, universal default terms in credit card agreements permit an issuer to raise the rate it charges one of its borrowers substantially if that borrower commits a default on an unrelated debt to a different lender, even if the borrower has not missed a payment to the credit card issuer in question. It is one thing for an issuer to stop (or raise the rate on) new extensions of credit based on adverse credit information – we expect (and hope) that issuers will do that routinely. It is quite another,

however, for creditors to increase the interest rate on debts already incurred, solely because of a late payment to a different creditor. Regulators, upset by the application of universal default provisions, have responded by insisting that credit card issuers provide better disclosure of the provisions in their agreements with customers.<sup>72</sup>

My analysis shows why a disclosure regime is not the appropriate response. For one thing, it rests on the premise that consumers that receive the disclosures will alter their behavior, which is improbable. An emphasis on disclosure misses the point. The underlying complaint is that the provisions are fundamentally unfair: “We shouldn’t have to pay more to Bank One simply because we were late on a payment to Providian.” Policymakers for the most part have retreated to a disclosure-based response because of their unwillingness to press that fairness argument.<sup>73</sup>

The fairness argument conceals an economic argument for barring universal default provisions. Universal default rules are one of the attributes consumers are least likely to “price” in their contracting and product-selection decisions. This is true because they are a “boilerplate” attribute that will not be of great significance for most consumers selecting products. It also is true because the cost of the provision is difficult to assess up front (depending, as it does, on the interaction between future defaults by the borrower to other lenders and those lenders’ reactions to the defaults). It is difficult when I make a purchase today to factor in the likelihood that the interest rate on that purchase at some distant time in the future will increase by some unspecified amount because of a default I make in a payment to some other creditor. If an omniscient consumer could not take account of the rate differentiation, then the differentiation is not effectively altering

borrowing behavior. Because consumers are not pricing this term, there is no reason to rely on its existence in contracts as evidence of its optimality.

The absence of contracting competition does not prove, however, that the term is less than optimal. It is possible that the provisions operate to shift the net burden of charges by credit card issuers to some extent toward the most distressed borrowers, the ones most likely to default, and away from those least likely to default. The increased collections from those customers might support lower charges for “convenience” users that do not borrow or default. Thus, a rational and fully informed cardholder might think the benefits of such a clause exceed its costs.<sup>74</sup>

More broadly, universal default provisions are part of the developments in the credit card market that have fostered segmentation, which has led in turn to a marked differentiation of rates among cardholders with different risk profiles.<sup>75</sup> Generally, that trend is positive, because it permits more accurate pricing. The role of universal default terms in that market segmentation depends on the odd ramifications of “default” in the credit card market. In conventional commercial markets, an act of default by a borrower is a data point that indicates to the lender that the transaction has become riskier than previously anticipated and thus more likely to produce a loss. Typically, lenders respond proactively by managing the transaction in a way that responds to the increased risk of loss.<sup>76</sup> In the credit card context, however, an event of default (such as a late payment to another creditor or even a late payment to the card issuer) is a signal that the cardholder is financially constrained. To the issuer, such an occurrence is a signal of two cardholder attributes that collectively make the cardholder a likely profit center for the issuer. First, the cardholder is likely to borrow more in the immediately ensuing months. Second, the

cardholder's switching costs have increased because of the difficulty the cardholder will face in repaying the entire outstanding balance in a time of financial distress. Thus, the issuer can respond by substantially increasing the fees charged to the cardholder with a diminished concern that the cardholder will shift the borrowing to a different lender. Indeed, one might imagine that a cardholder's anticipated value as a customer rises almost to the point of a bankruptcy filing.

The issue, then, is whether it matters that cardholders in fact do not understand the clauses (or their consequences) when they enter the agreements. Should we prevent this choice on that basis? If we think of this as tantamount to a unilateral alteration of terms after the fact, we might be inclined to ban it. On the other hand, if we want to protect the ability of convenience users to choose a card that might be cheaper for them because of the increased revenues issuers receive when they exercise universal default provisions, we might want to allow them.

An intermediate approach, parallel to the analysis of opt-out clauses above, would focus on providing cardholders a practical opportunity to respond before adverse action. For example, regulators might forbid issuers to raise interest rates based on application of a universal default clause without providing cardholders a substantial notice, coupled with an opportunity to challenge the relevant information and to shift their outstanding debt to a different issuer.

For me, in the end, the most sensible approach is to ban the clauses entirely. I am driven primarily by the notion that convenience users as a class should be shifted to debit cards and newer payment systems. I recognize that one likely effect of such a ban would be more extensive and detailed default clauses, focusing on events internal to the

cardholder-issuer relationship. That seems positive, at least in part because of the likelihood that it would lessen reliance on external sources of information (with questionable reliability) such as credit reports. Moreover, it might be that cardholders eventually could come to understand and react to those terms.

Another likely effect would be a contraction of credit (or increase in price) to the affected borrowers. Again, that response would be beneficial if financial distress by cardholders imposes costs on society and if current business models encourage borrowers to wait too long before filing for bankruptcy. A system that induces issuers to terminate lending earlier might lower the social costs of financial distress by pressing risky borrowers into an earlier resolution of their financial affairs.

Presumably, the most sensible way to implement such an approach would be for a relatively well-informed regulator (such as the Federal Reserve or the Office of the Comptroller of the Currency (the OCC),<sup>77</sup> or (less plausibly in the current environment) the Federal Trade Commission) to engage in a cooperative examination, with participation by the affected parties, of the relevant terms. The point here is that a regulator that bans a particular term that commonly is part of the product is likely to affect the market for the product in some cognizable way – by either increasing the cost or lowering the amount or quality of the product in some way.<sup>78</sup> The justification for regulation is the idea that contracting is inherently lawmaking,<sup>79</sup> and that standardized adhesion contracts in practice operate as “unilateral codes,” by which the parties that promulgate them “usurp the law-making function,” effectively providing “government by private law.”<sup>80</sup> The idea is not a new one. Indeed, it is at least as old as the work of Arthur Leff, who viewed defective contracts as analogous to defective automobiles.<sup>81</sup>

The decision confronting a regulator, he explains, is whether consumers are better off with the higher price (or lower quantity or quality) of the product that comes in a market without the choice to accept the prohibited term. The Federal Trade Commission has applied such a perspective for many years.<sup>82</sup> Thus, the discussion above suggests banning universal default terms based on the idea that the most likely effect would be a contraction of credit in a market that is both functioning poorly and generating substantial externalities. The analysis is comparable to the decision of the Department of Transportation to require all cars to have airbags – some of us would buy cars without airbags, but the government has determined that we all are better off if we cannot make that choice.

We cannot ban all contract terms that consumers misunderstand solely because they are designed to produce profits for the merchants that draft them. It is natural for merchants to view customers as assets, and to work to acquire customers on the hope that the customers will generate a predictable stream of profits after they have been acquired. If we are not to ban all such tactics, we have to identify something special about the credit card market to make these tactics different. The most obvious possibility is the problems with the credit card as a product. If retailers used the tactics discussed here to increase the use of hotels, few would complain, thinking that there is little social cost from excess consumption of that product. When we see a burgeoning social problem from excessive credit card use, we have a basis for concern about contracting practices that increase that problem.

There are obvious problems with intervention.<sup>83</sup> Among other things, it is not clear that regulators *will do* a better job than courts in identifying terms to be invalidated.

Still, there is at least some reason to believe that an *ex ante* approach – that can be applied evenly across contracts and incorporated into the price – is preferable, because of the likelihood that the opportunity for input from affected businesses will lead regulators to avoid (or quickly repair) truly egregious errors.

- *Standardized Terms*

Term invalidation is probably an incomplete response. Another response would be to develop standard terms for credit card agreements.<sup>84</sup> At first glance, that approach seems more intrusive, because it abandons reliance on the market to develop the optimal terms. The use of pre-approved terms, however, is the conventional approach for remedying contracting problems in other consumer finance markets.

Credit card agreements stand out as one of the rare types of consumer financial transactions that do not proceed on some set of pre-approved terms.<sup>85</sup> Home mortgages, of course, are executed almost entirely on the standard FNMA form. A glance at the form would convince most of us that – although it suffers from many of the readability problems discussed above – it is not a form drafted to exploit consumer myopia or cognitive weakness. Similarly, state regulators largely determine the major terms of insurance policies.<sup>86</sup> Major real estate transactions – such as the sale of a home – typically proceed on forms that in major part are standardized by a government agency<sup>87</sup> or some intermediary that at least in part represents the interests of consumers.<sup>88</sup>

A standard account agreement would include mandatory provisions for the legal aspects of the relationship, with specific options on issues where there are substantial business reasons for product differentiation. Thus, we might expect several variations on the method for calculating the outstanding interest-bearing balance – one without any

grace period, one with a full grace period, and a moderate provision in between. There also would be options for the financial terms on which issuers compete, including the interest rate and the amount of annual, late, and overlimit fees.

Such a proposal would respond directly to the problem of multiplicity of terms and agreements summarized above. Thus, like the FTC Mail-Order Rule, it would funnel competition among card issuers directly into the attributes for which variation is permitted, predominantly price-related attributes as to which consumer understanding is heightened and for which competition is easier to imagine.

To be sure, this solution would do little to respond to the problem of complexity. Yet the relationship necessarily is a complex one. Even if standardization substantially lowered the number of terms that a typical cardholder would need to understand, it is doubtful that it would simplify the relationship sufficiently to make a fully competitive cardholder reaction a realistic possibility. The number of attributes of relevance to a fair assessment of a modern credit card product, even putting the agreement aside, is sufficiently large as to make it implausible to think that most cardholders can aggregate and assess the attributes rationally.<sup>89</sup>

Still, standardization should over time advance cardholder understanding considerably. I think, for example, of the typical apartment lease, a document of comparable complexity, read directly by few consumers. However, most of us have a reasonable understanding of the typical aspects of that business relationship, predominantly because the terms are relatively standardized and stable over time. If the terms of credit cardholder agreements were uniform, we would expect that through experience many cardholders would come to understand the basic terms that define the



events that lead to late payments, overlimit fees, events of default, and the like. Given the ways in which multiplicity of terms and term cycling exacerbate the role of complexity in the existing market, there is good reason to think that standardization would be helpful.

Further, the oft-cited objections to using mandatory terms are less troubling in this context. The first is that standardization will narrow the range of product attributes that issuers can use to attract and satisfy customers. As suggested above, standardization decreases consumer welfare to the extent that it drives attractive products out of the market.<sup>90</sup> In this context, however, firms do not currently compete to attract customers based on the non-price terms of these agreements. Indeed, the root of the problem is that there are terms that have a substantial economic effect that consumers nonetheless ignore. A regime that eliminates differentiation on those terms would not make the products less attractive to most customers. The dominant effect would be a long-term one, in which customers eventually might come to understand the boilerplate terms sufficiently to consider them in assessing the risks and appropriate pricing of their purchasing and borrowing behavior. To the extent that opportunities for delivering products to odd, insular classes of cardholders are limited, I expect that the benefits to the cardholders in the mainstream would far exceed the harms.<sup>91</sup>

A more difficult problem is the likelihood that regulators will draft the terms less capably than card issuers will. The terms will be more obscure, will not improve over time, will include more unintentional ambiguities, or will not produce the optimal allocations of risks among the parties. In many contexts, such concerns would be serious, and the record of obscure drafting of disclosures by the Federal Reserve suggests that it is

not immune to bad drafting. In this case, however, against the background of existing contract practices, the problems are less troubling. For one thing, the discussion above suggests little reason to think that existing terms are drafted with care to be clear and unambiguous or to create an optimal allocation of risks. Rather, the market currently seems to drive competitive issuers to obscure their terms to escape the notice of their customers. Moreover, as long as the terms are standardized and within some broad range of reasonableness, differences in their impact can be treated by alterations in the price terms that would be left to card issuer discretion (grace periods, interest rates, amounts of the various fees, and the like).

The problems of government drafting suggest an alternate approach that might be useful: pressure from federal regulators on the networks to promulgate uniform terms. Many of the examples to which I refer do not involve direct government regulation. Rather, they involve drafting by intermediaries in a framework that motivates the intermediaries to consider the interests of consumers. In this context, the obvious candidates for standardized drafting would be Visa and MasterCard. If Visa and MasterCard believed that the issuance of uniform and stable terms on a network-by-network basis was a prudent course to avoid federal intervention and government standardization, we might reach the best of all possible outcomes: a well-drafted and sophisticated allocation of risks, with sufficient stability that customers could adapt to it.

For example, if networks were motivated to allocate risks efficiently, they might include a low-cost dispute resolution process like the one used for consumer-merchant disputes governed by TILA. Andy Morriss and Jason Korosec persuasively demonstrate that TILA's shift of the costs of dispute resolution to card issuers has led to an efficient

and technology-driven system for resolving claims of inappropriate charges.<sup>92</sup> A system in which an individual network committed that its issuers could be held to the terms of their agreements at least theoretically could be a powerful marketplace tool. Imagine, for example, if MasterCard advertised that consumers who are troubled by “unfair late fees” and “unresponsive card issuers” should use their MasterCard, knowing that they could rely on MasterCard’s consumer protection guarantee.

Finally, a still narrower solution might avoid the risks of centralized drafting, but still force the production of terms in a way that makes them amenable to evaluation by intermediaries. There is some reason to think that public scrutiny of the terms of cardholder agreements is more effective than person-by-person negotiation with cardholders. For example, a review of cardholder agreements used by major issuers indicates that the flurry of public attention to universal default terms has led several major issuers to remove those terms from their agreements.<sup>93</sup> The current public attention might produce some similar action that would standardize the time by which consumers must send payments to avoid late fees – a bright-line rule, for example, that lenders must treat payments received by mail at 3 p.m. or 5 p.m. as made on that day. Any reader that thinks it is impractical for mail to be processed as quickly as that proposal suggests should become familiar with Netflix’s mail processing routines.<sup>94</sup>

The Internet makes broad dissemination of standard terms much easier than it would have been when TILA was enacted. Thus, credit card issuers could be required to post the major nonprice terms of their agreements in a uniform format on either their own sites or publicly available Internet sites (such as a site hosted by the FTC, the Federal Reserve, or the OCC).<sup>95</sup> The simplest approach probably would be to post them on the

FTC's user-friendly Web site, so that intermediaries reliably could find all of the terms in a single place. Issuers that wished to do so also of course could post their terms on their own sites. Indeed, if the FTC required issuers to provide a URL for an address at which the issuer had posted the terms, it would not matter where the terms technically were posted, because the FTC site could provide a catalog of links to the individual postings. The benefit of requiring the terms to be posted directly at the FTC, however, is that it would facilitate downloading all of the terms in a readily analyzable format such as a spreadsheet.

The business models of credit card issuers do not require them to withhold the terms of agreements until prospective cardholders have submitted applications and received the cards. In the UK, for example, cardholders typically receive the terms *twice* before they receive the card itself.<sup>96</sup> I do not suggest that the United States implement such a reform. Individual cardholders are unlikely to read the terms if they are sent to them. Thus, it would be no more useful to print and send the agreements repeatedly than it was for banks to print and send privacy policies shortly after the enactment of Gramm-Leach-Bliley in 2002. Rather, if the only benefit from disclosure of the terms is that intermediaries would examine them, the most effective course is to require that the terms be posted publicly.

Regulators also could require that any set of terms remain in effect for a certain minimum period (such as 90 days) to facilitate the activity of intermediaries that might examine the postings and provide public assessments of the various terms. In the current environment, terms are not publicly available, so consumers do not see them until they have responded positively to a solicitation and received a card, at which point their credit

rating already reflects the extension of credit. Initiatives to educate consumers about the meaning of unpriceable terms or to persuade responsible issuers to avoid unpriceable terms can have a positive effect only if it is possible for consumers to pick among issuers based on the terms. Public disclosure of the terms is perhaps the simplest way to jump-start such a regime.

## ENDNOTES

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<sup>1</sup> Oral Evidence Taken Before a Treasury Select Committee of the United Kingdom Parliament on Thursday 16 October 2003, at 28-29 [hereinafter UK Credit Card Hearing], available at <http://www.parliament.the-stationery-office.co.uk/pa/cm200203/cmselect/cmtreasy/uc962-v/uc96202.htm>.

<sup>2</sup> See Alan M. White & Cathy Lesser Mansfield, Literacy and Contract, 13 Stan. L. & Pol’y Rev. 233, 235-41 (2002) (discussing incomprehensibility of financial disclosures); William R. Emmons, Consumer-Finance Myths and Other Obstacles to Financial Literacy, 24 St. Louis U. Public L. Rev. 335 (2005).

<sup>3</sup> See Nilson Report, Issue 843 (2005).

<sup>4</sup> Federal Reserve System, Board of Governors of, Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions 5 (June 2005) [hereinafter Federal Reserve, 2005 Report], available at <http://www.federalreserve.gov/boarddocs/rptcongress/creditcard/2005/ccprofit.pdf> (discussing industry study that shows that an estimated 5.23 billion direct mail solicitations were sent by issuers during 2004, up 22 percent from 4.29 billion in 2003, with 71 percent of U.S. households receiving an average of 5.7 offers per month).

<sup>5</sup> Id. (noting that the response rate on credit card solicitations in 2004 was estimated to be 0.4 percent).

<sup>6</sup> See Robert D. Cooter & Edward L. Rubin, A Theory of Loss Allocation for Consumer Payments, 66 Texas L. Rev. 63 (1987); Clayton Gillette, Rolling Contracts as an Agency Problem, 2004 Wis. L. Rev. 679 (2004); Russell Korobkin, Bounded Rationality, Standard Form Contracts, and Unconscionability, 70 U. Chi. L. Rev. 1203 (2003); see also Restatement of Contracts (Second) § 211 cmt. b (“A party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even to read the standard terms.”).

<sup>7</sup> See Arthur R. Gaudio, Electronic Real Estate Records: A Model for Action, 24 W. New Eng. L. Rev. 271, 284-85 (2002) (discussing the development of the standard residential real estate mortgage by the Federal National Mortgage Association (Fannie Mae)); Ronald J. Mann, Searching for Negotiability in Payment and Credit Systems, 44 UCLA L. Rev. 951, 971 (1997) (same).

<sup>8</sup> See, e.g., Kenneth S. Abraham, Insurance Law and Regulation 32 (3<sup>rd</sup> ed. 2000) (“[S]tandardization in insurance \* \* \* involves \* \* \* an offer of the same policy, to all customers, by all companies. Competition in insurance markets, therefore, often tends to be over price, quality of service, or reliability, but rarely over the terms of coverage itself.”).

<sup>9</sup> See *Badie v. Bank of America*, 79 Cal. Rptr. 2d 273 (Ct. App. 1998) (declining to enforce “bill-stuffer” amendment that added arbitration term even though cardholder

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did not close or stop using account upon receipt of amendment with bill). For statutory references, see, e.g., Del. Code Ann. Tit. 5 § 952; Ga. Code Ann. § 7-5-4(c); see also *Strand v. U.S. Bank Nat'l Ass'n* ND, 693 N.W.2d 918 (N.D. 2005) (holding that bill-stuffer amendment waiving the right to file a class action was procedurally unconscionable, but enforceable because the term was not substantively unconscionable).

<sup>10</sup> See, e.g., *Shea v. Household Bank*, 105 Cal. App. 4<sup>th</sup> 85 (2003) (holding that failure to repay outstanding balance was not sufficient “use” to support bilateral modification); *Rossman v. Fleet Bank Nat'l Ass'n*, 280 F.3d 384 (3d Cir. 2002) (noting that interest rate would increase from 7.99% to 24.99% upon closure of account).

<sup>11</sup> To give context: one major issuer recently amended its agreement to provide that it can charge its default rate to any cardholder that is late or overlimit twice in a single year. Thus, a cardholder with a \$12,000 annual limit that makes two \$50 overlimit transactions on a single day thus might be exposed to a default rate on the existing \$12,000 of debt, even if that type of conduct would not have been an event of default at the time the funds were borrowed. This seemingly minor amendment reflects a shift from a model in which issuers welcome overlimit transactions (as an identifier of borrowers likely to pay interest) to a model in which issuers rely on cognitive difficulties that cardholders face in tracking their outstanding balances to collect fees on accidental overlimit transactions by liquid borrowers.

<sup>12</sup> Some courts have rejected the argument that payment of an annual fee precludes the issuer from modifying or terminating the agreement for that period. E.g. *Gaynoe v. First Union Direct Bank, N.A.*, 2001 WL 34000142 (N.C. Super. Ct. Jan. 18, 2001) (holding that annual fees are not fees paid for services to be performed over time, but rather in consideration of issuing a card).

<sup>13</sup> Regulation Z, 12 C.F.R. § 226.1 et seq. requires a credit card issuer to give 15 days' written notice of a change in terms if the term was required to be disclosed initially under 12 C.F.R. §226.6 or if the required minimum payment is increased. 12 C.F.R. § 226.9(c)(1). The timing requirement does not apply if a rate or fee is increased due to the customer's default, and the notice requirement does not apply if the change involves late payment charges, over-the-limit charges or other specified occurrences.

<sup>14</sup> See James J. White, *Autistic Contracts*, 45 *Wayne L. Rev.* 1693, 1700-01 (2000) (asserting that modification of credit card agreements following notice and use is consistent with the objective theory of contracts and practical necessity).

<sup>15</sup> See *Garber v. Harris Trust & Savings Bank*, 104 Ill. App. 3d 675 (1982) (holding that a separate contract was created each time the card was used according to the terms of the cardholder agreement at the time of such use).

<sup>16</sup> See David M. Grether et al., *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 *S. Cal. L. Rev.* 277, 296-97 (1986); James R. Bettman, *An Information Processing Theory of Consumer Choice* (1979); Herbert A.

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Simon, Rationality as Process and as Product of Thought, *Am. Econ. Rev.*, May 1978, at 1, 13; see also Susan Block-Lieb & Edward Janger, The Myth of the Rational Borrower: Rationality, Behaviorism, and the Misguided “Reform” of Bankruptcy Law, 84 *Tex. L. Rev.* (forthcoming 2006) (reviewing the literature).

<sup>17</sup> Jeffrey Davis, Protecting Consumers from Overdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer-Credit Contracts, 63 *Va. L. Rev.* 841 (1977).

<sup>18</sup> The agreement is set forth in 63 *Va. L. Rev.* at 908-11. It is perhaps one-quarter the length of a modern credit cardholder agreement.

<sup>19</sup> See Davis, *supra* note 17, at 854-56.

<sup>20</sup> See Philip Schuchman, Consumer Credit by Adhesion Contracts, 35 *Temple L.Q.* 125, 134-35 (1962) (discussing some of the detailed legal acumen required for understanding consumer credit contracts).

<sup>21</sup> Jinkook Lee & Jeanne M. Hogarth, Relationships Among Information Search Activities When Shopping for a Credit Card, 34 *J. Consumer Affairs* 330 (2000) (documenting rarity with which consumers evaluate anything other than the most basic financial terms).

<sup>22</sup> See Jon D. Hanson & Kyle D. Logue, The First Party Insurance Externality: An Economic Justification for Enterprise Liability, 76 *Cornell L. Rev.* 129, 154-58 (1990) (discussing lack of competitive pressure on terms not examined by consumers); Korobkin, *supra* note 6 (explaining incentive of drafters to include one-sided terms regardless of whether the terms are efficient when terms are not within the limited number of attributes that consumers are expected to price).

<sup>23</sup> See Thomas H. Jackson, The Fresh-Start Policy in Bankruptcy Law, 98 *Harv. L. Rev.* 1393 (1985).

<sup>24</sup> See Xavier Gabaix & David Laibson, Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets (unpublished April 2005 manuscript) (summarizing literature), available at [http://papers.ssrn.com/abstract\\_id=728545](http://papers.ssrn.com/abstract_id=728545).

<sup>25</sup> See, e.g., Jon D. Hanson & Douglas A. Kysar, Taking Behavioralism Seriously: The Problem of Market Manipulation, 74 *NYU L. Rev.* 630, 654-58 (1999); James R. Bettman et al., Cognitive Considerations in Presenting Risk Information, in *Learning About Risk: Consumer and Worker Responses to Hazard Information* 15, 17 (1987); Neil D. Weinstein, Unrealistic Optimism About Future Life Events, 39 *J. Personality & Soc. Psychol.* 806, 809-12 (1980).

<sup>26</sup> See, e.g., Amos Tversky & Daniel Kahneman, Availability: A Heuristic for Judging Frequency and Probability, 5 *Cognitive Psychol.* 207, 208 (1973); Amos Tversky



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& Daniel Kahneman, Judgment Under Uncertainty: Heuristics and Biases, 185 Science 1124 (1974); Jon Hanson & David Yosifon, The Situational Character: A Critical Realist Perspective on the Human Animal, 93 Geo. L.J. 1, 40 (2004); Cass R. Sunstein, Group Judgments: Statistical Means, Deliberation, and Information Markets, 80 NYU L. Rev. 962, 991 (2005).

<sup>27</sup> See George Ainslie & Nick Haslam, Hyperbolic Discounting, in Choice over Time 57, 69 (George Loewenstein & Jon Elster eds. 1992); Stefano Dellavigna & Ulrike Malmendier, Contract Design and Self Control: Theory and Evidence, 199 Quarterly Journal of Economics 353 (2004); Christine Jolls et al., A Behavioral Approach to Law and Economics, 50 Stan. L. Rev. 1471, 1539-40 (1998); David Laibson, Golden Eggs and Hyperbolic Discounting, 112 Q.J. Econ. 443 (1997).

<sup>28</sup> Oren Bar-Gill, Seduction by Plastic, 98 Nw. U. L. Rev. 1373 (2004); Dellavigna & Malmendier, *supra* note 27.

<sup>29</sup> See Hanson & Kysar, *supra* note 25; Jon D. Hanson & Douglas A. Kysar, Taking Behavioralism Seriously: Some Evidence of Manipulation, 112 Harv. L. Rev. 1420 (1999); Todd Rakoff, Contracts of Adhesion: An Essay In Reconstruction, 96 Harv. L. Rev. 1174, 1230 (1983) (noting that “intense competition will, if anything, make the situation worse, for it tends toward degradation of any [consumer]-protective provisions of the contract”).

<sup>30</sup> See Gabaix & Laibson, *supra* note 24 (presenting model that explains why firms shroud the negative attributes of their products, particularly high prices for complementary add-ons, and shows why competition will not induce firms to reveal information that would improve market efficiency).

<sup>31</sup> Stewart Macaulay, Private Legislation and the Duty to Read – Business Run by IBM Machine, the Law of Contracts and Credit Cards, 19 Vand. L. Rev. 1051, 1069-74 (1966).

<sup>32</sup> See Bar-Gill, *supra* note 28; see also Lawrence Ausubel, Adverse Selection in the Credit Card Market (unpublished June 1999 manuscript).

<sup>33</sup> See Gabaix & Laibson, *supra* note 24 (pointing out that it is difficult for any single firm to capture the profits from debiasing consumers).

<sup>34</sup> See Gabaix & Laibson, *supra* note 24 (noting that sophisticated credit card users take advantage of “free miles” and avoid interest rate charges and late payment fees).

<sup>35</sup> *Id.* (noting that innovation creates new opportunities for shrouding and undermines the effects of education).

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<sup>36</sup> The card issuer also might receive a higher interchange fee for these cards, which would be passed back to consumers at the point of sale in the form of higher prices.

<sup>37</sup> The emphasis here is on rationalization, not rational calculation. Stewart Macaulay's early study compared contracts for gasoline cards (issued primarily to less wealthy individuals) and T&E cards issued to more wealthy individuals. He provides some interesting empirical evidence suggesting that the wealthy are no more likely to be "debiased" than the impecunious – perhaps because a sense that their time is more valuable decreases the likelihood that they will pay attention to details of small transactions. See Macaulay, *supra* note 31, at 1086-1107.

<sup>38</sup> MBNA's annual reports explain the valuable uses it makes of that information.

<sup>39</sup> See Lizabeth Cohen, *A Consumers' Republic: The Politics of Mass Consumption in Postwar America* 292-309 (2003).

<sup>40</sup> See Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 *Va. L. Rev.* 1387 (1983); Gillette, *supra* note 6, at 691-693.

<sup>41</sup> See Steven P. Croley & Jon D. Hanson, *Rescuing the Revolution: The Revived Case for Enterprise Liability*, 91 *Mich. L. Rev.* 683, 772-79 (1993); Gillette, *supra* note 6, at 691-693; Hanson & Logue, *supra* note 22; see also Rakoff, *supra* note 29, at 1231 (1983) (results of competition say nothing about consumer preferences when consumers do not in fact understand contracts).

<sup>42</sup> Lawrence Friedman, *Contract Law in America* ch. 4 (1965). I write consciously in a line of recent scholarship that analyzes how responses to social problems that traditionally are characterized as "public" and "private" in fact are closely intertwined and interdependent. E.g., Jacob S. Hacker, *The Divided Welfare State: The Battle over Public and Private Social Benefits in the United States* (2002); David A. Moss, *When All Else Fails: The Government as Ultimate Risk Manager* (2002).

<sup>43</sup> Macaulay, *supra* note 31, at 1056.

<sup>44</sup> 16 CFR Part 435.

<sup>45</sup> The Uniform Commercial Code does not cover payment cards. See 4-104(a)(9) ("Item \* \* \* does not include \* \* \* a credit or debit card slip."). But see *Broadway Nat'l Bank v. Barton-Russell Corp.*, 585 N.Y.S.2d 933, 938 (Sup. Ct. 1992) (reaching a contrary conclusion under pre-revision Article 4). Although some states have enacted statutes that govern certain aspects of the issuer/cardholder relationship, it seems fair to say that none of those statutes has any significant impact, largely because the National Bank Act would preempt any substantial regulation. See Mark Furletti, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards*, 77 *Temp. L. Rev.* 425 (2004). To

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the extent there is any substantive regulation by the states, it is in the form of statutes authorizing specific business practices, like the Delaware bill-stuffer statute discussed above.

<sup>46</sup> Regulation Z requires that a bank issuing a credit card provide the consumer a written disclosure that summarizes the applicable legal rules. Regulation Z §226.5, 226.6. Appendix G to Regulation Z contains model disclosures.

<sup>47</sup> TILA § 132; Regulation Z, §226.12(a).

<sup>48</sup> TILA §§133, 161 and 170. Oddly enough, those provisions might be counterproductive if they encourage consumers to use credit cards instead of debit cards.

<sup>49</sup> That is not to say that I think the existing disclosure regime is sensible, see White & Mansfield, *supra* note 2, at 260-62 (arguing that the disclosures are too complex to be comprehensible to typical consumers), or that it could not be improved. I argue in Chapter 13 that the existing disclosure regime should focus on disclosure at the point of purchase.

<sup>50</sup> See Richard Craswell, Property Rules and Liability Rules in Unconscionability and Related Doctrines, 60 U. Chi. L. Rev. 1, 49-50 (1993) (explaining that problems in market competition for contract terms do not justify administrative promulgation of terms if the administrative terms will not be better than the market terms).

<sup>51</sup> See Colin Camerer et al., Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism”, 151 U. Pa. L. Rev. 1211 (2003); Macaulay, *supra* note 31.

<sup>52</sup> See Contracts of Adhesion – Some Thoughts About Freedom of Contract, 43 Colum. L. Rev. 629 (1943).

<sup>53</sup> Jim White has an excellent discussion of the cases interpreting Section 211. James J. White, Form Contracts Under Revised Article 2, 75 Wash. U.L.Q. 315 (1997). See also Gillette, *supra* note 6, at 712-14; White & Mansfield, *supra* note 2, at 254-56.

<sup>54</sup> See, e.g., statutes cited *supra* note 9.

<sup>55</sup> See Jean Sternlight, Creeping Mandatory Arbitration: Is It Just?, 57 Stan. L. Rev. 1631 (2005).

<sup>56</sup> See *Discover Bank v. Boehr*, 30 Cal. Rptr. 3d 76 (S. Ct. 2005) (invalidating such a clause in Discover’s cardholder agreement); Samuel Issacharoff & Erin F. Delaney, Credit Card Accountability, 73 U. Chi. L. Rev. (forthcoming 2006) (arguing that functional judicial review of arbitration clauses would curtail unscrupulous behavior by card issuers by allowing the class-action lawyer to be an agent for myopic consumers).

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<sup>57</sup> I rely here on the pleadings in *Ross v. Bank of America*, No. 05 CV 7116 (S.D.N.Y.).

<sup>58</sup> A survey of reported opinions in credit-card related class actions suggests that the great majority involve either challenges under TILA for disclosure violations or claims that issuers are imposing improper fees. There are other, more unusual cases – my favorite is *Cie v. Comdata Network, Inc.*, 656 NE2d 123 (Ill. Ct. App. 1995) (challenging the enforceability of gambling claims on a Discover card) – but it is safe to say that class actions have not been a major device for bringing substantive change to the credit card industry.

<sup>59</sup> This is the core allegation, as yet unproven, in *Ross v. Bank of America*, No. 05 CV 7116 (S.D.N.Y.).

<sup>60</sup> Again, this has been alleged in *Ross v. Bank of America*, No. 05 CV 7116 (S.D.N.Y.).

<sup>61</sup> See James J. White, *Contracting Under Amended 2-207*, 2004 *Wis. L. Rev.* 723, 742 (“For a nickel or a dime, almost all of us would \* \* \* agree to arbitrate.”). Cf. *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 594 (1991) (“[I]t stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued.”).

<sup>62</sup> Council Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts.

<sup>63</sup> As Larry Bates has shown, several other countries have developed administrative approaches under which bureaucrats generally approve form contracts. See Larry Bates, *Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection*, 16 *Emory Int’l L Rev* 1 (2002). For example, consider Israel’s Standard Contract Law of 1964, which allows users of form contracts to obtain government approval of “restrictive terms.” Approval immunizes the terms from court challenge for five years. *Standard Contracts Law (Isr.) 1964*, 18 *L.S.I.* 51 (1963-1964).

<sup>64</sup> See Annex to Unfair Terms Directive ¶¶ 1(j), 1(q).

<sup>65</sup> See, e.g., W. David Slawson, *The New Meaning Of Contract: The Transformation Of Contracts Law By Standard Forms*, 46 *U. Pitt. L. Rev.* 21, 49-50 (1984); *Tex. Property Code* §§ 92.006, 92.052 (establishing a nonwaivable warranty of habitability).

<sup>66</sup> The most obvious reason is that the Federal National Mortgage Association (FNMA or Fannie Mae) will not purchase a mortgage that includes such a provision. E.g., *Fannie Mae, Announcement 04-06* (Sept. 28, 2004), available at <http://www.mortgagebankers.org/resident/2004/fannie-04-06.pdf>.

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<sup>67</sup> As I discuss in Part V, the retroactivity concern arguably poses an objection to the entirety of the consumer bankruptcy provisions in the Bankruptcy Abuse and Consumer Protection Act of 2005.

<sup>68</sup> Todd Rakoff refers more elegantly to “invisible” terms – terms the consumer does not notice. See Rakoff, *supra* note 29, at 1250-55. I have in mind here a narrower category – terms that not only are invisible in practice, but that are all but impossible for a consumer to assess (generally, because they operate *ex post facto*).

<sup>69</sup> See Schwartz & Wilde, *supra* note 40, at 1457-85; see Camerer et al., *supra* note 51.

<sup>70</sup> Regulation Z (12 C.F.R. §226.9(c)(1)).

<sup>71</sup> See *supra* note 10 and accompanying text.

<sup>72</sup> See Linda Punch, *Getting Tough?*, *Credit Card Management*, Feb. 2005, at 42 (discussing Comptroller proposals).

<sup>73</sup> A bill has been introduced that would ban these provisions entirely, by prohibiting any alteration of interest rates based on events “wholly unrelated to the consumer’s credit card account.” Consumer Credit Card Protection Act of 2005, H.R. 3492, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess., § 2. For discussion, see Kathy M. Kristof, *Late on One Card? Rates Can Rise on All of Them*, *L.A. Times*, Aug. 7, 2005, at C2.

<sup>74</sup> I discount the possibility that the clause provides signaling benefits by sorting customers that do not expect to default (who would not be concerned about such a clause) from those that do expect to default (who would be concerned). Tolerance of a clause that goes unread can send no signal.

<sup>75</sup> See Mark Furletti, *Credit Card Pricing Developments and Their Disclosure* (Fed. Res. Bank of Philadelphia, Payment Cards Center, Discussion Paper) (January 2003).

<sup>76</sup> See Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 *Mich. L. Rev.* 159 (1997).

<sup>77</sup> National banks dominate the major card issuers, because only national banks are entitled to the preemptive provisions of the National Bank Act. Because the OCC regulates all national banks, the OCC would be in a position to regulate major credit card issuers if it chose to do so. See Furletti, *supra* note 45. To date, however, the OCC for the most part has limited itself to safety and soundness regulation – criticizing practices that might undermine the solvency of the institution (such as unduly risky lending practices).

<sup>78</sup> See White & Mansfield, *supra* note 2, at 258-59.

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<sup>79</sup> See W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 *Harv. L. Rev.* 529, 530 (1971).

<sup>80</sup> See Schuchman, *supra* note 20, at 130.

<sup>81</sup> See Arthur Alan Leff, *Contract as Thing*, 19 *Am. U. L. Rev.* 131, 144 (1970).

<sup>82</sup> See Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 *B.U. L. Rev.* 349 (1988).

<sup>83</sup> See Leff, *supra* note 81; Gillette, *supra* note 6, at 717-719.

<sup>84</sup> Jeffrey Davis made a similar proposal two decades ago. See Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 *Va. L. Rev.* 1333 (1982).

<sup>85</sup> The phenomenon is not new. For early discussion, see Nathan Isaacs, *The Standardizing of Contracts*, 27 *Yale L.J.* 34, 37-40 (1917); Rakoff, *supra* note 29, at 1182.

<sup>86</sup> See Abraham, *supra* note 8, at 32-33; Macaulay, *supra* note 31, at 1062; Slawson, *supra* note 65, at 50-52.

<sup>87</sup> See, e.g., *Texas Prop. Code ch. 5* (articulating various provisions and notices that must be used in residential real estate transactions).

<sup>88</sup> In many geographic areas, a residential real-estate transaction proceeds on a form prepared by a group of real estate brokers. That group might not be biased in favor of consumers – their primary interest doubtless is to prod the transaction toward consummation (so that a brokerage commission is due) – but that interest typically results in a reasonably balanced form.

<sup>89</sup> See Grether et al., *supra* note 16, at 296-97.

<sup>90</sup> See Grether et al., *supra* note 16, at 298-99.

<sup>91</sup> See Camerer et al., *supra* note 51. The most obvious potential harm to consumers would be a contraction of the credit markets in response to limitations on ex-post-facto terms. My analysis here assumes that the likely contraction will affect for the most part consumers that are already in serious financial distress. To the extent lenders stop lending to those people sooner, a strong argument can be made that the contraction in fact is desirable.

<sup>92</sup> Andrew P. Morriss & Jason Korosec, *Private Dispute Resolution in the Card Context: Structure, Reputation, and Incentives* (unpublished 2005 manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=735283](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=735283).

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<sup>93</sup> See Kathy Chu, Credit Cards Quitting Rate-Bumping Game, USA Today, Oct. 19, 2005 (discussing effect that public scrutiny has had on policies of Chase, CitiBank, American Express, and Discover).

<sup>94</sup> See CardFlash (May 18, 2005) (discussing Federal Reserve consideration of such a proposal).

<sup>95</sup> See Robert A. Hillman, On-Line Consumer Standard-Form Contracting Practices: A Survey and Discussion of Legal Implications (March 23, 2005) (Cornell Law School Research Paper No. 05-003), available at <http://ssrn.com/abstract=686817> (making similar proposal for electronic contracts).

<sup>96</sup> See UK Credit Card Hearing, *supra* note 1, at 3 (testimony of CEO of MBNA Europe).