House of Commons
Canada

CREDIT CARDS IN CANADA IN THE NINETIES

REPORT OF THE STANDING COMMITTEE ON CONSUMER AND CORPORATE AFFAIRS AND GOVERNMENT OPERATIONS

J
103
H7
34-3
C662
A12

June 1992

BIBLIOTHÈQUE DU PARLEMENT
LIBRARY OF PARLIAMENT
3 2354 00056 216 8

BIBLIOTHÈQUE DU PARLEMENT
LIBRARY OF PARLIAMENT
3 2354 00056 218 4

P AAC J103 H7 34-3 C662 A1
Canada. Parliament. House
Credit cards in Canada in
00056-2168 01-0278082

DATE | NAME - NOM
P AAC J103 H7 34-3 C662 A1
Canada. Parliament. House
Credit cards in Canada in
00056-2168 01-0278082
DATE DUE

AUG AOUT 1 5 1996
NOV 2 2 1996
FEB FEV 1 8 1997
SEPT 28/05

GAYLORD PRINTED IN U.S.A.

J
103
H7
34-3
C662
A12

CREDIT CARDS IN CANADA IN THE NINETIES

REPORT OF THE STANDING COMMITTEE ON CONSUMER AND CORPORATE AFFAIRS AND GOVERNMENT OPERATIONS

June 1992

STANDING COMMITTEE ON CONSUMER AND CORPORATE AFFAIRS AND GOVERNMENT OPERATIONS

Chairperson: Felix Holtmann

Vice-Chairmen: Ron MacDonald
Scott Thorkelson

Members

Don Boudria
Dorothy Dobbie
Gabriel Fontaine
Darryl Gray
John R. Rodriguez

(Quorum 5)

Elizabeth Kingston

Clerk of the Committee

Terrence J. Thomas
Researcher
Library of Parliament

COMITÉ PERMANENT DE LA CONSOMMATION ET DES AFFAIRES COMMERCIALES ET DE L'ADMINISTRATION GOUVERNEMENTALE

Président: Felix Holtmann

Vice-présidents: Ron MacDonald
Scott Thorkelson

Membres

Don Boudria
Dorothy Dobbie
Gabriel Fontaine
Darryl Gray
John R. Rodriguez

(Quorum 5)

La greffière du Comité

Elizabeth Kingston

Recherchiste
Bibliothèque du Parlement
Terrence J. Thomas

Published under authority of the Speaker of the House of Commons by the Queen's Printer for Canada.

Available from Canada Communication Group — Publishing, Supply and Services Canada, Ottawa, Canada K1A 0S9

Publié en conformité de l'autorité du Président de la Chambre des communes par l'Imprimeur de la Reine pour le Canada.

En vente: Groupe Communication Canada — Édition, Approvisionnements et Services Canada, Ottawa, Canada K1A 0S9

The Standing Committee on Consumer and Corporate Affairs and Government Operations has the honour to present its

SEVENTH REPORT

In accordance with its mandate under Standing Order 108(2), your Committee has conducted a study into credit and charge cards in Canada, and has agreed to present this Report.

Table of Contents

BACKGROUND 2

THE FOCUS ON BANK CARDS 5

CHANGES IN THE CREDIT CARD MARKET SINCE 1987 6

DEVELOPMENTS IN THE U.S. CREDIT CARD MARKET 8
- A. The Structure of the U.S. Credit Card Market 9
- B. Congressional Action 10
- C. Disclosure and the Schumer Box 11
- D. The Profitability of Credit Card Operations in the U.S. 11

COMPETITION IN THE CANADIAN CREDIT CARD MARKET 14
- A. Barriers to Entry 15
  - 1. The importance of entry 15
  - 2. Are there barriers to entry in the credit card market? 15
- B. Disclosure and Competition 16
- C. The Possible Role for Interest Rate Caps 17
  - 1. Background 17
  - 2. The case against caps 20

THE RECURRING ISSUE OF CREDIT CARDS IN CANADA 21

RECOMMENDATIONS 22

APPENDIX I — AN ACT RESPECTING THE DISCLOSURE OF CERTAIN INFORMATION REGARDING CREDIT CARDS 23

APPENDIX II — AGENDA OF COMMITTEE TRIP TO WASHINGTON 25

APPENDIX III — PRESS RELEASE 31

APPENDIX IV — LIST OF WITNESSES 33

REQUEST FOR GOVERNMENT RESPONSE 35

APPENDIX V — THE NEW DEMOCRAT MINORITY REPORT ON CREDIT CARD INTEREST RATES 37

CREDIT CARDS IN CANADA IN THE NINETIES

Twice in the 1980s, Parliamentary Committees examined credit cards in Canada, both times concerned with the high level of interest rates on cards. Not only were card rates relatively high compared with other interest rates but card rates remained stubornly high in the face of sharp declines in these other rates. At the end of 1991, similar concerns emerged.

In the year before October 1991, when the Consumer and Corporate Affairs and Government Operations Committee decided to study the credit card market, short-term interest rates in Canada had fallen about 500 basis points, but credit card rates fell much less. The rate on one no-fee MasterCard, for example, fell 175 basis points from 21.50 per cent in November 1990 to 19.75 per cent in October 1991; the rate on a representative Visa card with an annual fee fell 150 basis points from 21.25 per cent to 19.75 per cent over the same period.

At its highest point (November 1991) the spread between the representative Visa rate and the Bank Rate was about 1200 basis points; for comparison, the average spread for the five years January 1987 to December 1991 was around 830 basis points. Since that point, there have been several reductions in credit card interest rates, but the spread remains unusually high — currently around 1000 basis points.

This report will focus on the reappearance of high spreads between credit card rates and other interest rates. The concerns of the Committee are not unique to Canada. Since the mid-1980s in the U.S., several members of Congress have been dissatisfied with the workings of the credit card market there. There have been several proposals in the U.S. House of Representatives and Senate to legislate a cap on credit card rates. In 1988, Congress passed a law requiring uniform disclosure of credit card rates and other terms. This report will examine ways of improving disclosure in Canada as a means of promoting competition.

The credit card market in the U.S. is similar to that in Canada, although there are some important differences. Non-financial companies now take an active role in the market for all-purpose credit cards (Sears, for example, issues the Discover card, while Ford and AT&T issue the so-called bank cards, MasterCard and Visa). This report will try to determine whether there are any barriers to entry that would have prevented similar developments in Canada.

In 1991 the United States Senate actually passed an amendment that would have capped rates at 4 percentage points above the Internal Revenue Service's late payment rate — a ceiling that would have dropped card rates by 500 to 700 basis points — but the amendment was later withdrawn from the proposed legislation. This report will reexamine the possible role of caps for credit card rates.

One noticeable difference between the U.S. and Canada in the working of the credit card market has to do with the change in behaviour seen in the Canadian market since Parliament began investigating credit cards at the end of 1986. As this report will document, these investigations have made a difference. Credit card issuers have introduced new products (or added features to existing products) and have changed card rates more frequently than was the case before Parliament became interested in the topic. Credit card rates have not moved exactly in line with other rates — which is why this Committee is reexamining the issue — but the average spread over the Bank Rate has declined since the years before 1987.

BACKGROUND

The Finance Committee report of 1987 and the Consumer and Corporate Affairs and Government Operations Committee report in 1989 contain useful background information on the credit card market in Canada and on technical matters dealing with the calculation of interest charges on credit cards.

Table 1 provides basic data on bank cards; it extends tables that have been featured in the two previous reports. Each of those reports commented on the growing importance of credit cards in the Canadian economy. Growth is still impressive, especially when compared to other sectors of the economy, but there are signs that the market may be at the point of saturation. As a bank president who appeared before our Committee put it: "Our growth figures in volume terms will be about 7% this year, despite our best efforts, about the same as the VISA system as a whole in Canada. That compares with figures often in the 15% to 20% range earlier in the decade."

As a market becomes saturated, it is more difficult for existing firms to offer a full range of services and maintain profitability. There is also less incentive for new firms to enter the market unless they can attract a narrow, and profitable, segment of the market. In other words, niche marketing replaces mass marketing for credit cards. The development of affinity cards (cards issued to members of a group, such as graduates of McGill University, with the group receiving a fee for each transaction with the affinity card) is one example of niche marketing. Credit cards that offer airline travel points with any use of the card provide an example of niche marketing aimed at business travellers. These developments change the nature of competition in the credit card market; they also indicate the intensity of competition in the market today.

The following list, from a recent publication of the Department of Consumer and Corporate Affairs, provides some useful summary facts and figures from the credit card market in Canada:

> There were an estimated 46 million credit cards in circulation in 1991, or 2.3 cards for every adult Canadian over the age of 18. Of those, more than 24 million were Visa or MasterCard, 14 million were cards issued by large department stores and three million were gasoline cards. Other cards, such as American Express and en Route, and cards issued by small financial institutions and retail stores, constituted the remainder of credit or charge cards in circulation.
>
> The total number of Visa and MasterCards more than doubled from 1981 to 1991 — from 12 million to 24.3 million. In the last three years, nearly five million new Visa and MasterCards were issued.
>
> MasterCard and Visa credit cards were used for more than 617 million transactions in 1991, 2.5 times the 1981 level. The volume of sales in 1991 was $40 billion compared to $11 billion in 1981.
>
> From 1986 to 1991, the number of merchant outlets in Canada accepting Visa or MasterCard increased by 50%, to over 857,000.
>
> At the end of 1991, the accumulated outstanding balance on MasterCard and Visa credit cards was more than $11 billion, which is more than a threefold increase since 1981.
>
> The average sale per transaction charged to Visa and MasterCard increased from just under $42 in 1981 to almost $67 in 1991.
>
> Approximately half of the volume of sales of major department stores is charged to their in-house credit cards.

Source: Consumer and Corporate Affairs, "Credit Card Costs — April 1992," p. 2.

Table 1
MASTERCARD AND VISA STATISTICS

Date Year end:	Number of Cards in Circulation (Millions) (1)	Net Retail Volume (Billions) (2)	Outstanding Dollars (Billions) (1)	Net Dollar Volume (Billions) (2)(4)	Sales Slips Processed (Millions) (2)	Average Sale	Delinquency 90 days & over (3)	# of Cards Reported Lost or Stolen (2)	# of Cards Fraudulently used (2)	$ Amount of Fraudulent Accounts written off (Millions) (6)	Merchant Outlets (5)	Visa / MC Principal Issuers
77/09/31	8.2	3.6	1.4	4.0	118.8	30.5	1.3%	–	–	–	271,150	–
78/09/31	9.0	4.9	1.8	5.4	150.8	32.5	1.3%	–	–	–	290,692	–
79/09/31	9.9	6.6	2.4	7.3	185.8	35.7	1.2%	–	–	–	322,115	–
80/09/31	10.8	8.8	2.9	9.4	218.4	39.5	1.3%	–	–	–	347,845	–
81/09/31	12.0	10.6	3.4	11.5	249.6	42.4	1.0%	–	–	–	371,831	–
82/10/31	11.6	13.8	3.7	13.4	274.9	50.3	1.7%	259,028	–	15.9	382,206	–
83/10/31	12.1	14.8	3.7	14.9	297.6	49.9	0.9%	275,754	19,200	17.4	419,610	10
84/10/31	13.1	16.9	4.4	17.1	325.2	52.1	0.7%	299,152	21,332	16.8	442,928	10
85/10/31	14.0	19.4	5.1	20.4	372.9	51.9	0.7%	330,380	21,026	17.5	527,042	10
86/10/31	15.5	23.0	5.8	23.6	417.2	55.1	0.8%	378,239	22,326	18.6	571,771	10
87/10/31	17.6	26.4	6.8	26.9	450.7	58.5	0.7%	408,571	23,913	15.8	642,429	12
88/10/31	19.4	30.3	7.8	31.2	490.0	61.9	0.7%	460,348	25,773	15.6	646,844	13
89/10/31	20.4	36.1	9.3	36.9	546.7	66.0	0.9%	522,204	30,919	19.2	709,674	14
90/10/31	23.2	38.6	10.8	42.5	591.8	67.2	1.8%	520,716	32,851	28.9	786,288	14
91/10/31	24.3	40.4	11.2	44.1	617.8	67.4	1.5%	624,455	54,003	45.9	857,159	14

Source: Canadian Bankers Association — 17-Dec-91

(1) As at last day of year end.
(2) Reported total of year end.
(3) Percentage of outstandings as at year end.
(4) Equals total of Net Retail Volume (sales) and cash advance volume.
(5) Merchants accepting VISA and/or MASTERCARD. Note that merchants accepting both cards have been reported by each plan.
To estimate # of merchant outlets accepting Visa or MasterCard, divide $\frac{\text{Merchant Outlets}}{2} * 1.1$
(6) Includes total cardholder and merchant fraud to year end.

Table includes data from all VISA & MASTERCARD issuers.

VISA	MASTERCARD
Bank of Nova Scotia	Bank of Montreal
CIBC	National Bank of Canada
Royal Bank	Credit Union Electronic Services Inc. (CUETS)
The Toronto Dominion Bank	Royal Trust Corp.
Laurentian Bank	National Trust
Central Guaranty Trust	The Canada Trust Co.
Caisses Populaires Desjardins	
Citibank Canada	(Data from Affiliated Issuers reported through Principal Issuers)

Most of the credit cards included in Table 1 or discussed in the Consumer and Corporate Affairs' publication offer a grace period (a certain number of days during which the bill may be paid in full with no interest charges accruing). Card users, at first glance, appear to fall into two broad categories — those who use their cards as charge cards and pay the total balance before the end of the grace period and those who use their cards as credit cards and pay interest on the outstanding balance. The categories are not watertight, however, as some people who usually pay on time may occasionally run an interest-bearing balance, while others who usually roll their balances occasionally pay off the entire balance. There is thus a third category of those who use their card sometimes as a charge card and sometimes as a credit card.

The profitability of card operations depends on the relative size of each of the three categories. As the Vice-Chairman of the Bank of Montreal explained:

> Every month about 50% of our customers pay in full, and about 50% borrow. Now, it's not the same 50% every month. But as we look at the information, it's clear that about 30% of the customers usually pay off in full. About 30% of the customers seldom pay off; they usually borrow. About 40% of the customers are in the middle, who are in and out.

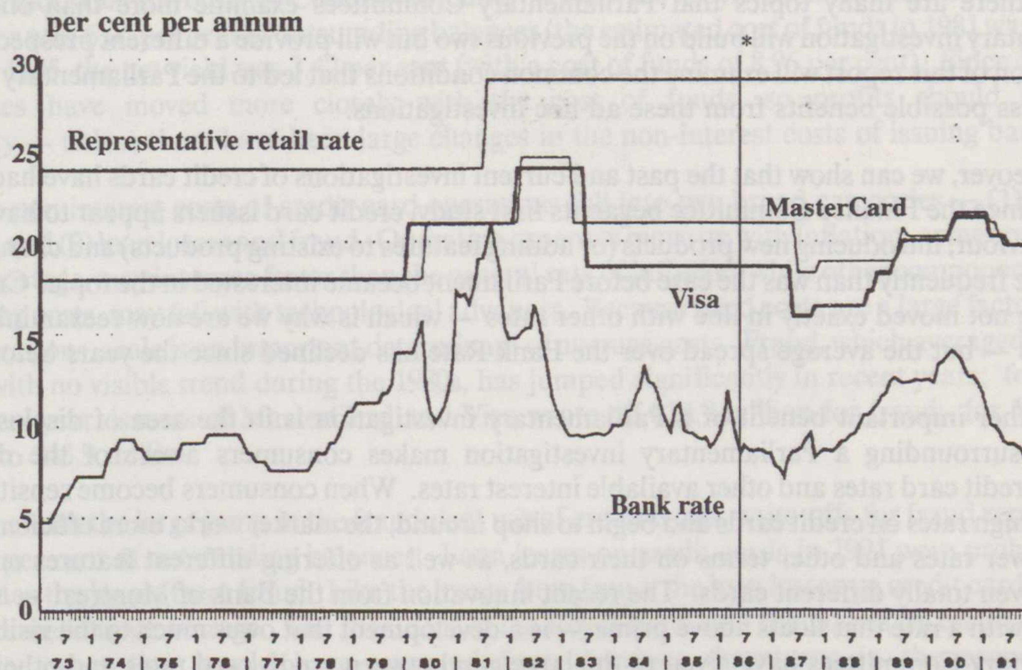
The President of the Royal Bank presented similar numbers, although in a slightly different fashion: 20 per cent of their accounts do not borrow (that is, they always use the Royal Visa card as a charge card), about 30 per cent borrow only occasionally and the remaining 50 per cent include those who borrow regularly, but occasionally pay the total outstanding balance, and those who almost always borrow. Because not everyone who uses a card uses it as a credit card, the effective yield to card issuers is below the posted rate on credit cards.

The posted rate on credit cards is an administered rate, as opposed to a market rate. Market rates move directly with supply and demand; when a financial market is open — and with globalization, some markets are open 24 hours a day — the interest rate may change from minute to minute. Administered rates change less frequently. When bank cards were introduced in Canada, the rate on them was set at 18 per cent, where it remained throughout the 1970s; during this same period, the Bank Rate moved from 4.75 per cent to 14 per cent.

Chart 1 shows the movement from 1973 through 1991 of the Bank Rate and three representative credit card rates — a MasterCard rate, a Visa card rate and a retail card rate. As can be seen, credit card rates are much more stable than the Bank Rate. Also noticeable in the chart is an apparent change in the behaviour of the rates on MasterCard and Visa cards since 1987. This change in behaviour will be discussed in a major section below.

Chart 1

Selected Interest Rates — the Bank Rate versus Credit Cards



* Parliamentary investigations begin.

THE FOCUS ON BANK CARDS

The analysis has and will focus on the so-called bank cards. These cards are also called all-purpose, general-purpose and third-party cards. The most popular of these cards — with over 24 million cards in circulation — are the MasterCard and Visa card, which are issued by financial institutions (14 principal issuers, comprising eight banks, four trust companies and two credit union centrals, and 514 affiliated issuers).

These cards now make up over half the credit cards in circulation, but in terms of outstanding credit, they represent about three-quarters of the market. In the United States, MasterCard and Visa make up about 26 per cent of credit card accounts but provide about 63 per cent of the credit outstanding in the credit card market.

There are, of course, many other cards besides bank cards. Most of the other cards are retail, or two-party, cards that may be used only in the store that issues them. These cards can provide credit, but they are often seen as part of the marketing of the store issuing them — the main business of the store is selling whatever the store offers. Other types of card are the oil company cards and the travel and entertainment cards (such as en Route or the American Express basic card). Some of these other cards are charge cards rather than credit cards, as the user is expected to pay off the outstanding balance each month. All the non-bank cards make up an important part of the credit card market in Canada, but in terms of the provision of credit, bank cards dominate the market. It is more efficient, therefore, to concentrate this report on bank cards.

CHANGES IN THE CREDIT CARD MARKET SINCE 1987

Although this is the third time a Parliamentary Committee will have investigated credit cards in Canada, there are many topics that Parliamentary Committees examine more than once. This Parliamentary investigation will build on the previous two but will provide a different prespective. The final section of this report will examine the common conditions that led to the Parliamentary inquiries and discuss possible benefits from these ad hoc investigations.

Moreover, we can show that the past and current investigations of credit cards have had positive results. Since the Finance Committee began its first study, credit card issuers appear to have altered their behaviour, introducing new products (or adding features to existing products) and changing card rates more frequently than was the case before Parliament became interested in the topic. Credit card rates have not moved exactly in line with other rates — which is why we are now reexamining credit card rates — but the average spread over the Bank Rate has declined since the years before 1987.

Another important benefit of a Parliamentary investigation is in the area of disclosure: the publicity surrounding a Parliamentary investigation makes consumers aware of the difference between credit card rates and other available interest rates. When consumers become sensitive to the relatively high rates on credit cards and begin to shop around, the market works more efficiently. Card issuers lower rates and other terms on their cards, as well as offering different features on existing cards or even totally different cards. The recent innovation from the Bank of Montreal — the Prime Plus card with a rate that floats above prime — is a development that owes much to the visibility that Parliamentary Committees have given to the large gap between credit card rates and other interest rates.

Parliamentary investigations of credit cards and other financial services also draw attention to the role of MPs as unofficial ombudsmen. Because there is no official ombudsman for financial matters in Canada, MP's spend part of their time handling complaints in this area from constituents. The banks have improved their complaint handling procedures (in large measure due to prodding from Parliamentary investigations of financial services), but many consumers want a procedure for dealing with bank complaints that goes beyond the banks themselves. There is now a legislated role for the Office of the Superintendent of Financial Institutions (OSFI) to report the number, nature and disposition of complaints about financial institutions. OSFI is a supervisor only for federally regulated financial institutions; moreover, many people are unaware of OSFI's role in handling complaints, and OSFI does not have the powers of an official ombudsman, especially the power to order some action by a financial institution.

As pointed out above, there has been an apparent change in the behaviour of bank card issuers since 1987. From the early 1970s, when the nationwide market in Canada for the two bank cards was established, until the beginning of 1987, when the Finance Committee was engaged in the first Parliamentary investigation of credit cards, there were only three changes made to bank card rates. All the changes occured, moreover, between 1980 and 1987; the average absolute change was 340 basis points for MasterCard and 380 basis points for Visa.

Between the beginning of 1987 and the end of 1991, there were 11 changes in the MasterCard rate with the changes averaging 81 basis points; over the same period, there were 12 changes in the representative Visa rate with the changes averaging 84 basis points. Since 1987, in other words, changes in bank card rates have been made more frequently and with smaller changes than was the case before 1987. The movement in the Bank Rate since 1987 has been pronounced — a large upward movement of about 625 basis points until the middle of 1990 and then an equally large fall until the end of 1991 — but this movement was similar to other movements seen before 1987.

The change in the behaviour of the rates on bank credit cards indicates a possible change in the pattern of profits on credit card operations. Before 1987, bank card rates were kept relatively constant, so profits should have had a pronounced cycle which would mirror movements in the cost of funds. This is, in fact, what the Finance Committee found: in 1981, the net yield before tax of bank credit card operations was-6.06 per cent of outstanding balances (the estimated cost of funds in 1981 was 18.61 per cent); in 1985, the net yield was 3.42 per cent (with a cost of funds of 8.96 per cent). Since 1987, bank card rates have moved more closely with the cost of funds, so profits should show less variability — unless there have been large changes in the non-interest costs of issuing bank card.

The non-interest costs of credit card operations fall into two broad categories — (1) operating expenses and (2) loan losses and fraud. Operating expenses move up with inflation; some components, such as postage, may increase faster than the general rate of inflation, while other components, such as computing costs, may fall with technological advances. Because fixed costs are a large factor in credit card operations, scale is an important determinant of average costs. Fraud, which averaged about $17 million with no visible trend during the 1980s, has jumped significantly in recent years; for the 1990 bank fiscal year, issuers of MasterCard and Visa wrote off $28.9 million for fraud; for 1991, fraud jumped to $45.9 million.

Even with the large jump in the fraudulent use of credit cards, write-offs for fraud represent less than 0.5 per cent of outstanding balances. Loan losses on credit cards in 1991 were probably six to seven times the losses from fraud. Like the losses from fraud, the loan losses on credit card lending in 1991 were well above average. The President of the Royal Bank said that losses on credit cards were now twice what they would have expected from previous downturns in the economy; the Vice-Chairman of the Bank of Montreal said that credit card losses had doubled during the recession, but that loan losses were still below 5 per cent of outstandings. Amex Bank of Canada had losses in 1991 of 7 per cent on its Optima card; the president of that bank pointed out that these losses may be high because of the relative newness of the Optima card, but he also pointed out that these losses had doubled since 1990. The most detailed data on credit card losses were provided by Canada Trust; in 1991, Canada Trust had write-offs of 7.7 per cent, up from 5.9 per cent in 1990 and about 3.5 per cent in 1989. Even the 3.5 per cent is a relatively high figure. As Canada Trust's Executive Vice-President put it: "We used to think of a good standard as being in the order of 1.5%. But events in the past few years have changed that quite dramatically."

Table 2 shows the movement in personal bankruptcies and credit card delinquencies for MasterCard and Visa since the early 1980s. The delinquency figure is the sum of three categories (30-59 days, 60-89 days, and 90 days and over), so it is not the same as the delinquency figures given in Table 1 above, which includes only the third category of delinquency. Not all delinquencies become write-offs, and a bankruptcy becomes an immediate loss, possibly with no intermediate delinquency stage. The two columns in the table do, however, provide additional support for the argument that losses on credit cards have been extraordinarily high in recent years.

Table 2
Consumer Bankruptcies and Credit Card Delinquencies

	Bankruptcies (#)	Delinquencies (%)
1981	23,036	5.2
1982	30,643	5.7
1983	26,822	4.1
1984	22,022	3.2
1985	19,752	2.9
1986	21,765	3.2
1987	24,384	3.3
1988	25,817	3.2
1989	29,202	3.8
1990	42,782	6.4
1991	62,277	6.3

Source: Office of the Superintendent of Bankruptcy and Canadian Bankers' Association.

Note, that unlike most bank lending, credit card lending is unsecured and, usually, for relatively small amounts. Recoveries after declared losses are modest on credit card lending. Under bankruptcy, credit card lenders are well down the list of creditors. Because average amounts are relatively small, it may not pay a card issuer to use a collection agency or use expensive in-house collection procedures to go after a delinquent account. For all these reasons, credit card lending is riskier than other types of bank lending. The president of the Royal Bank estimated that the loss rate on credit cards was five to ten times that on mortgages. At the end of 1991, for example, when delinquencies were 6.2 per cent of outstanding balances on credit card lending, arrears of three months or more on chartered bank residential lending were only 0.64 per cent. A mortgage, of course, is a secured loan.

DEVELOPMENTS IN THE U.S. CREDIT CARD MARKET

In February, several members of the Consumer and Corporate Affairs and Government Operations Committee travelled to Washington, D.C. to study the credit card market in the U.S. Over two days the members met with economists and lawyers who were specialists in the credit card field; representatives of the banks and of consumers; central bankers and officials from the Department of the Treasury, the Senate and the House of Representatives. (See Appendix II for the full agenda of the trip).

For some reason the press in Canada reported that the trip was organized to examine the banking system in the U.S. That system was under tremendous pressure with the number of bank failures rivalling the numbers seen in the Great Depression (since 1987, nearly 900 banks with assets of $162 billion have failed). Newspaper columnists questioned the wisdom of studying a banking system that was obviously inferior to the one in Canada; several readers of these columns wrote to the Committee or to individual MPs and complained that the trip was unnecessary and wasteful. It is unfortunate that these complaints were the direct result of incorrect information about the purpose of the trip.

The discussion in Washington was narrowly, and efficiently, focused on credit cards. What the members learned on the trip was invaluable in preparing this report. The trip, moreover, was cost effective: it would have cost much more to bring to Ottawa as witnesses the people the members met in Washington (and it is doubtful that the senior U.S. officials involved would have had the time to come to Ottawa).

A. The Structure of the U.S. Credit Card Market

Two recent studies of the credit card market in the United States agreed that by numbers and concentration ratios that market should be competitive. The two studies disagreed, however, over whether the market behaved as a competitive market should. (See Lawrence M. Ausubel, "The Failure of Competition in the Credit Card Market," *American Economic review*, Vol. 81, No. 1 (March 1991) and Robert E Litan, *Consumers, Competition and Choice: The Impact of Price Controls on the Credit Card Industry*, Washington, D.C.: MasterCard International Inc., February 1992).

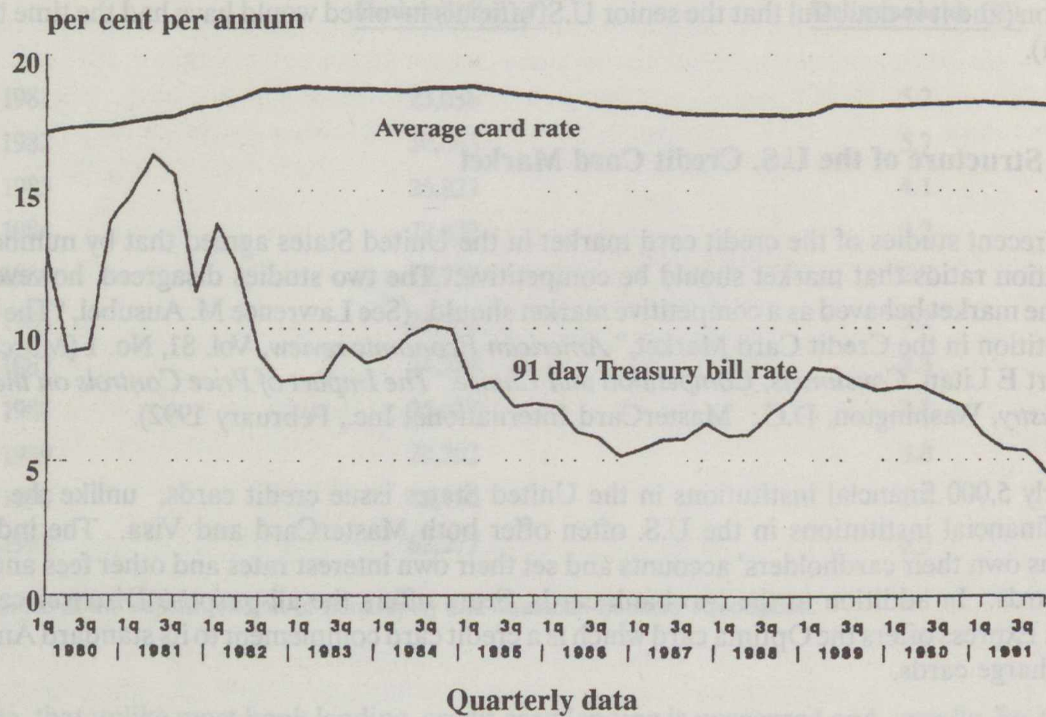
Nearly 5,000 financial institutions in the United States issue credit cards; unlike the case in Canada, financial institutions in the U.S. often offer both MasterCard and Visa. The individual institutions own their cardholders' accounts and set their own interest rates and other fees and terms of their cards. In addition to the two bank cards, Sears offers the all-purpose Discover card and American Express offers the Optima card which is a credit card complement to its standard American Express charge cards.

The market for MasterCard and Visa is also unconcentrated. As Professor Ausubel pointed out in his study: "The top ten firms control only about two-fifths of the market... Moreover, the market is exceptionally broad. A bank that ranked number 100 in 1987 still had approximately 160,000 active accounts, $125 million in outstanding balances and $250 million in annual charge volume." Although most banking in the U.S. is subject to interstate and branch banking restrictions, credit card operations have managed to avoid such restrictions. Aided by a 1978 Supreme Court decision that essentially eliminated effective price regulations for credit cards, a national market has developed with intense competition among the largest issuers.

Entry remains unrestricted, although the capital requirements are large. Recently, non-financial companies have taken an active part in the market. AT&T issues bank cards through a financial affiliate, as does the Ford Motor Company. Sears, which had an extensive retail (or two-party) card system covering its many stores, developed a separate network for its all-purpose Discover card. These non-financial players bring vast capital resources to the credit card market; they can finance broad marketing schemes, and by purchasing the credit card receivables from their financial affiliates, they enable these affiliates to compete across the nation. These new players have put downward pressure on credit card terms, especially on annual fees but also, more recently, on interest rates.

Given the appearance of a strongly competitive market — large numbers of competitors, low concentration and ease of entry — there are two puzzles in the behaviour of the credit card market. Why are interest rates relatively high and insensitive to movements in other rates and why do the returns to credit card operations seem to be above expected competitive returns? The profitability of card operations will be discussed below. Chart 2 presents a comparison of average bank card rates in the U.S. and the 91-day Treasury bill rate from 1980 through 1991. The relative stability of credit card rates stands out in the chart. At the end of 1991, the spread between the bank card average rate and the Treasury bill rate was 13.57 percentage points.

Chart 2
United States Average Bank Credit Card Rates and 91 Day Treasury Bill Rate



Source: Federal Reserve Bulletin

High as the spread in Chart 2 is, it probably understates the spread for most card users. The average bank card rate used in the chart is a simple average calculated by the Federal Reserve, so it gives equal weight to small card issuers and large issuers. At the end of 1991, this average rate was 18.19 per cent; the average for the ten largest issuers was 19.28 per cent (the Fed data are used because they provide a longer time series). Other charges on credit cards in the U.S. are also high. The average annual fee for the ten largest issuers is three times higher than the fee in Canada ($19.50 versus $6.50). U.S. card issuers also charge other fees, such as a late payment fee, that do not exist in Canada.

B. Congressional Action

By the mid-1980s, short-term interest rates in the U.S. had dropped to the single-digit range but average credit card rates remained above 18 per cent. Several bills were introduced in 1985 in the U.S. House of Representatives and in the Senate that would have set a restrictive cap on credit card rates. Many observers, however, felt that the introduction of these bills was meant to prod credit card issuers into voluntarily lowering their rates.

The cost of funds cycled around an upward trend from the mid-to late-1980s, and this movement in interest rates may have kept some pressure off credit card issuers who did not, in general, significantly lower their rates. In 1987, the House and Senate approved stiff disclosure requirements for card issuers (the bill, the *Fair Credit and Charge Card Disclosure Act of 1988*, will be discussed below). In the House, Representative Frank Annunzio added to the disclosure bill an amendment calling for a floating interest rate ceiling of 8 percentage points above the one-year Treasury bill rate. This proposed amendment was defeated by a vote of 56-356.

In 1991, Senator D'Amato introduced to a banking bill an amendment calling for a floating cap on credit card rates of 4 percentage points above the Internal Revenue Service (IRS) penalty rate (which is itself a floating rate of 3 percentage points above a government security rate). The amendment passed the Senate. Immediately after passage — the amendment caught most observers off guard — the stock market fell sharply, with bank stocks suffering large declines. Although there is still some debate over the exact link, if any, between the Senate's passage of the proposal for a cap and the drop in the stock market, the amendment was not included in the version of the bill that eventually passed through Congress.

C. Disclosure and the Schumer Box

One alternative to a cap on credit card rates was improved disclosure on the costs of using a credit card. Accordingly, Congress passed the *Fair Credit and Charge Card Disclosure Act of 1988*, which amended the *Truth in Lending Act*. Under the terms of this Act, which came into force in March 1989, card issuers must provide early disclosure of credit card terms on applications and solicitations. The terms that must be disclosed include:

(a) the annual percentage rate of interest charged on the outstanding balance of purchases;

(b) any annual fee or other periodic fee or membership fee imposed for a card;

(c) the minimum finance charge imposed during a billing cycle;

(d) any transaction fee imposed in connection with purchase transactions;

(e) the length of the grace period; and

(f) the balance calculation period.

Most of the disclosure must be provided in a uniform table now known as the Schumer box after Congressman Charles Schumer who proposed the legislation. The Schumer box must be placed in a prominent position either on or with the application or solicitation.

The Schumer box gives the set of information that must be provided by a card issuer under the so-called "trigger approach" to advertising disclosure; under this approach, if a card issuer specifies one element of the cost of a credit card, the issuer must give all the other elements of the cost of a card. For example, a card issuer that charges a relatively low interest rate of, say, 12 per cent but a $100 annual fee may not advertise the 12 per cent interest rate without also specifying the $100 annual fee and all other terms given in the Schumer box. Note, however, that the card issuer may advertise a "low interest rate" card without being required to specify all terms — in this case, the qualitative description does not trigger the requirement for full and uniform disclosure. A card issuer might also advertise that its card has "no annual fee" or "no transaction charges" without being required to provide full disclosure.

D. The Profitability of Credit Card Operations in the U.S.

Section 8 of the *Fair Credit and Charge Card Disclosure Act of 1988* requires the Federal Reserve to transmit to Congress an annual report on the effects of the Act on the profitability of the credit card operations of depository institutions. To date, there have been two reports (August 1990 and September 1991). The earlier report discussed the theoretical ways in which the Act could affect

profitability; these included the direct and indirect effects on the costs and revenues of card operations. The one direct effect is a slight increase in cost. The indirect effects result from the lowering of search costs to consumers; the Act makes it easier — that is, less costly in terms of the expenditure of time, effort and money — for consumers to hunt out a low-cost card. If consumers switch to low-cost cards, there will be downward pressure on card costs and, in line with this, on the profitability of card operations. The Fed, however, was unable to quantify the indirect effects of the Act, because these are generally swamped by other factors such as changes in the cost of funds, technological improvements and changes in credit card chargeoff rates.

As is the case in Canada, the Federal Reserve faces data limitations in trying to estimate the profitability of credit cards. The Fed uses two sources: the Functional Cost Analysis (FCA) and the Report of Condition and Income (call report). Neither source is ideal; the FCA data, based on an annual and voluntary survey of financial institutions, include none of the large issuers of credit cards; the call report data have a limited time series, so they miss the cycle in profitability seen in the FCA data (and in the limited Canadian data).

Using Functional Cost Analysis data, the first Fed report found that average profitability of bank credit card operations over the period 1974 to 1988 was below that of other types of bank credit. As a percentage of loan volume, the average profitability of cards was 2.20 per cent versus 2.28 per cent for real estate lending, 2.60 per cent for commercial and other lending and 2.41 per cent for instalment lending. Moreover, the profitability on credit cards was more volatile than the profitability on other types of lending. As the report put it:

> None of the other categories of bank lending reported in the FCA data is characterized by such high volatility. The year-to-year variation in credit card earnings reflects changes in a variety of factors, including state regulations on interest rates, costs of funds, marketing expenses, chargeoff losses, the volume of merchant discount fees, and holding and usage patterns of accounts by consumers.

Table 3 is from the second Fed report. As that report concluded: "Despite recent increases in problem loans and intensified competition in the industry, credit card operations continue to be a strongly performing segment of the banking business." As a frame of reference, the credit card operations of the Bank of Montreal and the Royal Bank would put them in the "large banks" category in the table; the card operations of Canada Trust would put it in the "small banks" category.

Table 3
Net earnings before taxes of credit card banks in U.S., 1986-1990 (1)

Percent

Year	Large Banks (2)	Small Banks(3)
1986	3.67	n.a.
1987	3.35	n.a.
1988	3.04	1.66
1989	3.21	1.76
1990	3.69	3.45

(1) Net earnings before taxes as a percentage of outstanding loan volume adjusted for sales of securitized assets. Derived by taking a weighted average of earnings of individual banks; the weights are the outstanding loan volumes adjusted for sales of securitized assets.
(2) Credit card banks with assets exceeding $1 billion. Figures for 1988 based on 12 banks; 1989 and 1990 values based on 13 banks.
(3) Credit card banks with assets between $200 million and $1 billion. Figures for 1988 based on 10 banks; 1989 and 1990 values based on 12 banks
n.a. insufficient number of banks in size group.
Source: Board of Governors, Federal Reserve System. Figures are based on Report of Condition and Income (call report), quarterly data, 1986-90

The call report data are probably more accurate than the Functional Cost Analysis data. What emerges from the call report data, as seen in Table 3, is that card operations have been an important source of profits for U.S. banks. Do the strong profits reflect what in practice — but not in appearance — is an imperfectly competitive market? Professor Ausubel in his journal article appears to answer yes to this question and posits some seemingly irrational behaviour on the part of some cardholders to explain why card issuers do not compete with lower interest rates.

Several others have suggested that Ausubel is wrong and that the market is actually behaving competitively. It is the idiosyncracies of the credit card market — the high proportion of non-interest costs in the provision of credit card loans, and the high and variable risk in the credit card market — that makes people misinterpret the relatively high and sticky credit card rates as a sign of a lack of competition. Robert E. Litan in the work cited and Dr. Michael Walker in his testimony before the Committee emphasized the importance of risk in explaining the profit figures of U.S. card operations.

One recent study from the Federal Reserve Bank of San Francisco uses a sophisticated model (the Black-Scholes model of the pricing of a risky asset) to capture the idiosyncracies of the credit card market (Randall J. Pozdena, "Solving the Mystery of High Credit Card Rates," FRBSF Weekly Letter, November 29, 1991, Number 91-42). As the study concludes: "The implication of the analysis here is that no such irrationality [as posited by Ausubel] need be invoked. Rather, the high, and insensitive, credit card rates are consistent with the pricing of risky credits in an atmosphere of moral hazard and costly collateralization or service."

This report cannot settle arguments about the competitiveness of the credit card market in the United States. Before moving to a discussion of competitiveness in the Canadian credit card market, however, it may be useful to present a few differences between credit card operations in the two national markets.

The most important difference is that interest rates on credit cards are relatively higher in the U.S. than in Canada. The word "relatively" is important. In absolute terms credit card rates are higher in Canada; at the end of 1991, for example, the average rate on the basic credit cards issued by the top six banks in Canada was 19.54 per cent, while the average rate in the U.S. was 18.19 per cent. Short-term interest rates, however, were much lower in the U.S., so the spread between card rates and short rates was actually higher in the U.S. than in Canada. The spread, based on average credit card rate and the three-month Treasury bill rate, was 153 basis points higher in the U.S. From the beginning of 1987 and the end of 1991, the average difference in the spreads was 248 basis points; the spread was always higher in the U.S.

As mentioned above, credit card fees (annual fees and other fees) are higher in the U.S. than in Canada. The average outstanding balance is about two times higher in the U.S. than in Canada; this, of course, lowers the average overhead cost (in terms of outstanding balance) in the U.S. These factors — higher relative interest rates, higher fees and lower average costs — would make card operations relatively more profitable in the U.S. One important factor lowering the relative profitability of U.S. operations is the higher losses on credit card lending there. One rule-of-thumb suggests that losses are twice as high as a proportion of outstandings in the U.S. than in Canada.

COMPETITION IN THE CANADIAN CREDIT CARD MARKET

During hearings, the vice-chairman of the Committee emphasized the difference between possible concerns of the Committee and the mandate of the Bureau of Competition Policy.

> What I think we are trying to do as a committee is find out how competitive the credit card industry is. The way I understand it is you're concerned about whether there is conspiracy or collusion, and so on. What I think we are concerned about is not so much that, but what degree of competitiveness there is.

The official from the Bureau of Competition Policy pointed out that "imperfect competition doesn't constitute an offence or a reviewable practice" under the Competition Act. The official also pointed out that similarity of rates among credit card issuers was not, in itself, evidence of collusive behaviour; he noted, moreover, the large number of card issuers and the large number of products (different cards with various terms and benefits) as evidence of an apparently competitive market.

Obviously, there is recurring dissatisfaction with the operation of the credit card market in Canada — for the third time since the mid-1980s a Parliamentary committee is concerned with the high and highly inflexible interest rates on credit cards. Even if there are no violations under the letter of the law, there is a deep-rooted feeling that the credit card market operates imperfectly, and the Committee members want to discover why this is so and how competition could be improved. The investigation focuses on three areas: possible barriers to entry in the credit card market, the role of improved disclosure as a means of improving competition and the possible role of interest rate caps in improving the operation of the credit card market. (See Appendix III for the Committee Press Release that identifies and discusses these issues).

A. Barriers to Entry

1. The importance of entry

It is competition that produces the benefits of the unregulated market. Competitors, actual and potential, strive to produce and sell what consumers want. If the market works well, competition drives the price of what is sold down to the cost of the last unit sold (this is the so-called marginal cost and includes a normal return which just keeps the producing firms in business). Freedom of entry is crucial to the efficient working of the market; no firm, or group of firms in the industry, can develop a saleable product and keep the price above cost (and earn excessive profits) if other firms can enter the industry and offer a similar product at a lower price.

In theory, the market result emerges quickly and fully. In practice, it may take time for entrants to make their mark in an industry and existing firms might retain some market power that lets them reap above-average profits. Loyalty to a card issuer might even give that issuer the ability to continue to charge higher prices than an entrant to the market — and not lose customers to the entrant. This last point, however, should not be overemphasized.

The word "loyalty" often conjures up the image of a blind following rather than the rational calculation that would make the market work. The loyalty that card users show to the financial institution issuing the card may, in fact, be quite rational. As the Finance Committee suggested in 1987, loyalty to the large banks may reflect a judgement about the security of those banks and confidence that any large downward movement in the terms on the credit cards of other issuers will eventually be met by the large banks.

If the relative security of the large banks changes or if they do not match innovations by smaller or newer card issuers in pricing or other dimensions of credit cards, customers will move. Consumers must, of course, be aware of any innovations or price changes — the issue of disclosure will be discussed below — and consumers must consider it worth the trouble to switch from one card issuer to another.

2. Are there barriers to entry in the credit card market?

There are two broad categories of barrier to entry--those imposed by governments and those specific to an industry. The former would include tariffs and non-tariff barriers, which would prevent entry from outside Canada; interprovincial trade barriers and government regulations from all levels of government. The latter would include economies of scale, differences in productive factors (broadly defined) and anything else that would increase the costs of operations by newcomers to an industry relative to the costs borne by firms already in the industry.

The Committee was especially interested in the possibility that regulatory barriers were preventing the entry of non-financial companies into the credit card market in Canada. If Sears and AT&T could become important issuers of all-purpose cards in the U.S., why weren't Sears Canada and Bell Canada involved in Canada?

When asked at a Committee hearing whether barriers to entry kept non-financial companies out of the all-purpose card market in Canada, the Senior Deputy Director of the Bureau of Competition Policy responded: "Insofar as the barriers to entry into the credit card business is concerned, as far as I am aware there are no international barriers, no interprovincial barriers, no regulatory barriers preventing non-financial entities."

As noted, regulatory barriers are not the only barrier to entry. The possible role of INTERAC in restricting the access of small players to the network of automatic teller machines (ATMs) was brought up during Committee hearings. Without the cash advance feature of Visa and MasterCard, which represents just over 8 per cent of their net dollar volume, the attraction of an alternative all-purpose card would be limited. The supposed restriction by INTERAC takes the form of high fees for the use of the ATM system. But high fees by themselves do not indicate anti-competitive behaviour, although the official from the Bureau of Competition Policy conceded that "access to a teller machine may constitute a barrier to entry."

The President of the Amex Bank of Canada spoke of the need for "competitive access to the electronic highways that define the rapidly evolving payments system" and of the role of the Canadian Payments Association in ensuring equal access. He went on to criticize the way the system was evolving:

> Our concern is that over the past five years, and certainly we are much more concerned as we look into the future, another group called Interac is in many ways taking control and making decisions on what that electronic highway will look like, who gets on, what price other people besides the schedule one banks will have to pay, which is much, much higher than they pay.

The large banks developed the INTERAC system, putting up funds for what was, at the time, an uncertain return. The system today is obviously successful. How entry to the system should be priced is not a simple question. Potential entrants think the system should be treated as a public utility and priced accordingly. The large banks that developed the system might think that the public utility argument sounds like someone trying to buy a share of a winning lottery ticket after the draw. This Committee cannot determine the ideal price for the system, but notes that the question is important for credit cards and will become even more important as the debit card system gains momentum.

One banker who appeared before the Committee noted that "commercial companies in Canada have been able to — and do — operate trust company subsidiaries." Bell Canada, for example, owns Montreal Trust which offers a Visa card. He then addressed the question of possible competition from non-financial and concluded: "We believe the reason there have not been major new entrants to the credit card business in Canada is the highly competitive nature and the pricing structure of the Canadian marketplace. Quite simply, there is insufficient profit potential to attract them."

B. Disclosure and Competition

Consumer knowledge of relative prices is crucial to the efficient functioning of the market. If consumers do not know of less expensive credit cards, they will not switch from the credit cards they now use — and there will be no incentive for card issuers to match the best terms in the industry. It is not surprising, therefore, that disclosure was an important issue in both of the previous Parliamentary reports on credit cards.

The 1989 report of the Consumer and Corporate Affairs and Government Operations Committee discussed some of the improvements in disclosure that resulted from the earlier Finance Committee report. These improvements include a quarterly report "Credit Card Costs" put out and widely circulated since the end of 1987 by the Department of Consumer and Corporate Affairs, a flyer "Choosing a Credit Card — Tips to Remember" circulated by the Department, a one-time publication "Discussion Paper on Credit Card Interest Charges" released in April 1988 by the Federal-Provincial-Territorial Working Group on Cost of Credit Disclosure, a brochure "How to Minimize Interest Charges on Your Bank Credit Card" developed by the Canadian Bankers' Association and distributed to over 11 million cardholders by the chartered banks.

The 1989 report applauded the efforts to improve consumer understanding of credit cards but noted that improvements were still possible in the area of providing consumers with comparative information on the terms of various credit cards. The Committee recommended uniform disclosure that would provide consumers with the means to compare interest rates and other terms on all credit cards. As examples, the report appended copies of the Schumer box from the U.S. and a promotional flyer from Canada Trust for its credit cards.

Since that report was tabled, Canada Trust has restructured its credit card offerings and altered its flyer. One significant change in the flyer is that the interest rates for Canada Trust's credit cards are no longer given. Instead, the flyer now states: "Canada Trust offers rates that are among the lowest in Canada. Ask for details." This is, unfortunately, a step back in terms of disclosure; consumers must now make an extra effort to discover the rates on credit cards at Canada Trust. This effort must be multiplied by consumers to discover the rates on credit cards at other institutions.

The Members of this Committee want to enable consumers to shop around for the best bargain in credit cards. The costs of searching for the best bargain can be reduced considerably by having all card issuers provide certain basic information on the terms of their credit cards. Accordingly, the Committee has appended to this report (see Appendix I) a draft bill requiring uniform disclosure of credit card terms. The Members wish to ensure that the proposed form be flexible enough to handle any possible pricing changes that might develop with the evolving payments system; the draft bill uses regulations in specifying some of terms that are to be disclosed, thus allowing for relatively easy additions and alterations.

C. The Possible Role for Interest Rate Caps

1. Background

Chart 1 above shows the movements since 1973 of three representative credit card rates and the Bank Rate. Before 1987, changes in credit card rates were infrequent; over the entire period shown in the chart, credit card rates did not change as often as the Bank Rate, which since March 1980 has been set at 25 basis points above the tender rate on 3 month treasury bills (before March 1980, the Bank Rate was set by the Bank of Canada, though even then it moved roughly in line with short-term interest rates). As argued above, the behaviour of those setting bank credit card rates has changed since Parliament first examined the issue at the end of 1986.

Chart 3 compares the spread between the representative Visa card rate and the Bank Rate plus 8 percentage points, the margin proposed by the Consumer and Corporate Affairs and Government Operations Committee for a floating cap on credit card rates. If that cap had been in place since 1973 and restrictive (so the ceiling for rates also becomes the floor) the differential between the card rate and the Bank Rate plus 8 percentage points would have shown up in the chart as a horizontal line at 0 per cent. The actual differential moves in cycles around this hypothetical one, showing that credit card rates are more stable than the Bank Rate.

Chart 3

The Credit Card Spread — Visa Rate less the Bank Rate plus 8%

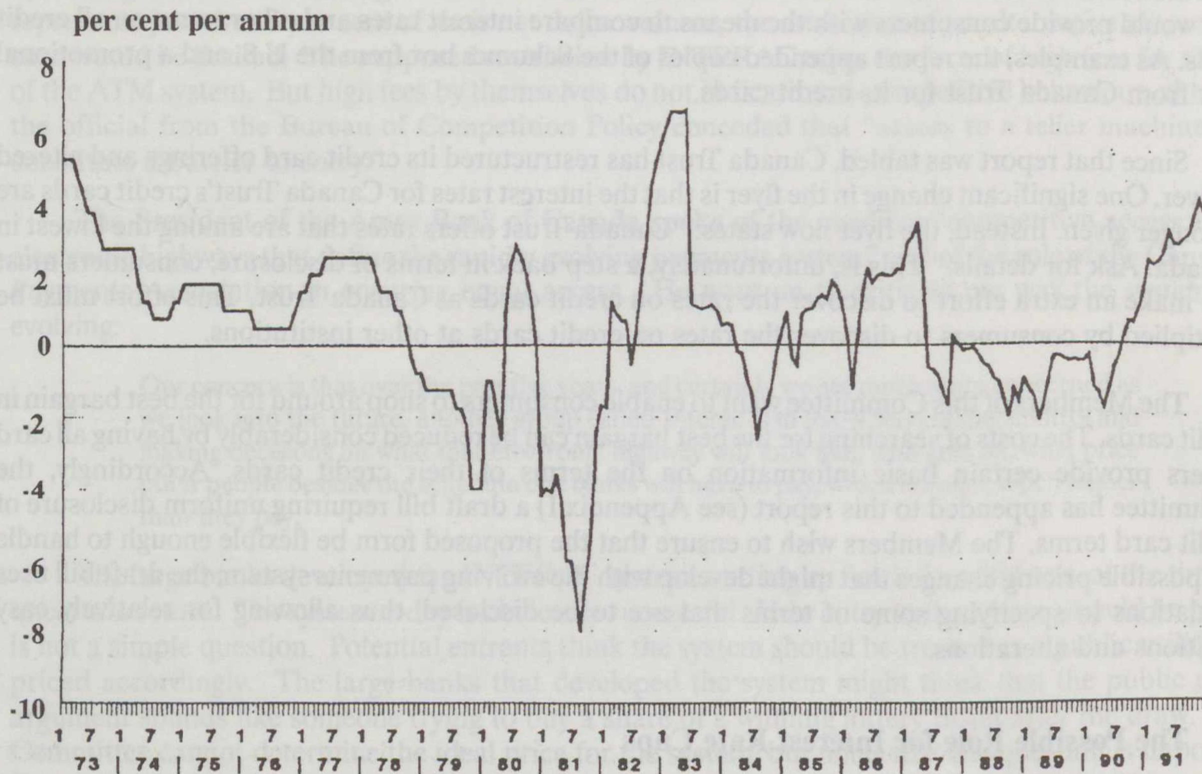
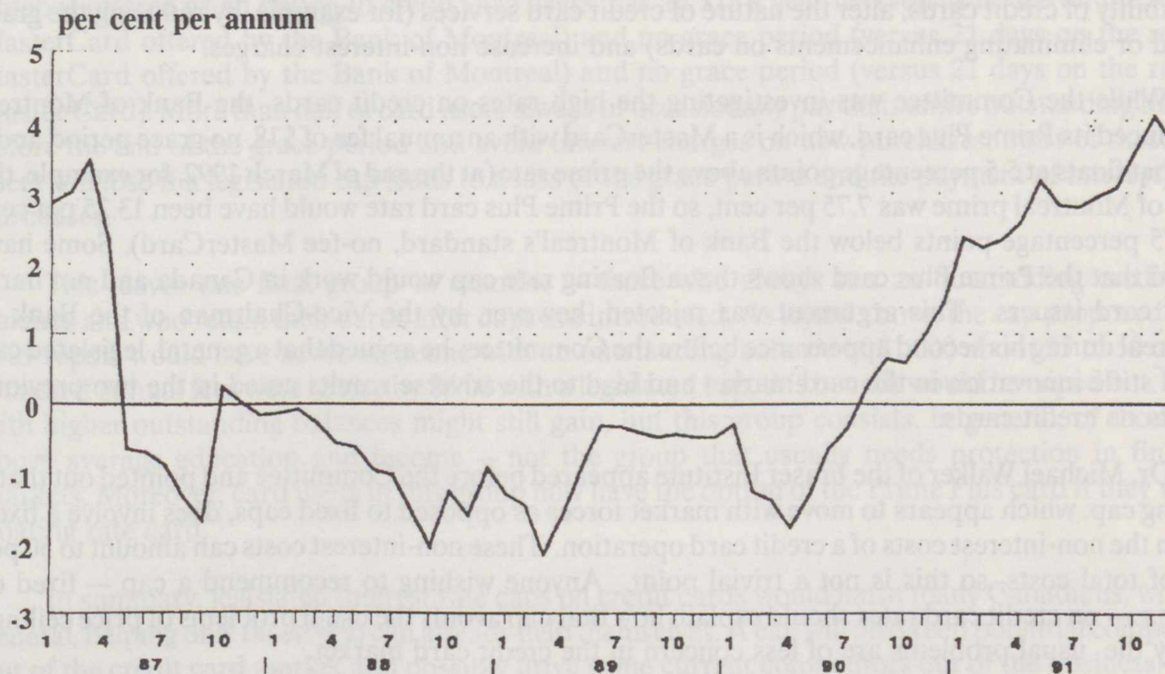


Chart 4 shows the same differentials as Chart 3 but only for the period January 1987 to December 1991. Over this shorter period, the actual spread averaged 8.3 percentage points above the Bank Rate. Again, the credit card rate is more stable than the Bank Rate (or 3 month treasury bill rate) so the cycle in the Bank Rate shows up in the actual spread. On average, therefore, the actual system was only 0.3 percentage points above the system with a floating cap of the Bank Rate plus 8 percentage points. If the cap had been in place since January 1987, someone with an interest-bearing balance of $1,000 would have saved $3 per year or 25 cents per month.

Chart 4

The Credit Card Spread — Visa Rate less the Bank Rate plus 8%



Over a longer period, the proposed floating cap would have saved card users slightly more. From March 1973 to December 1991, the actual system was on average 0.6 percentage points above the floating cap system. The cap, therefore, would have saved a credit card user with a $1,000 balance 50 cents a month in interest charges. The longer series could be adjusted — for example, the unusually large cycle between October 1980 and June 1983 could be removed — but the results stay the same. On average, the actual system is close to the system recommended by the Committee in 1989.

The $1,000 used in the calculations was not chosen arbitrarily. During his appearance before the Committee in November 1991, the President of the Royal Bank said the "average balance outstanding [on cards issued by the Royal] is almost exactly $1,000 as of this fall." The Vice-Chairman of the Bank of Montreal, at the same Committee hearing, used a figure of $800 as the average credit balance. In either case, the average balance has probably grown since 1987 and has certainly grown since 1973. In other words, using $1,000 does not introduce a downward bias to the calculation of the possible effects of a cap on the average card user.

During the recent appearance before the Committee by the Consumers' Association of Canada, an official of that organization mentioned the proposed credit card cap in the United States as an alternative to that proposed here in 1989. The U.S. proposal was for a floating cap of 4 percentage points above the Internal Revenue Service (IRS) late payment rate. This seems much more restrictive than the Canadian proposal. In fact, it is not. The reason is that the IRS penalty rate includes a 3 percentage point margin over a base rate (the average rate on U.S. government obligations of three years or less), so the margin in the U.S. proposal is actually 7 percentage points over a short-term rate. That short-term rate, moreover, is probably higher than the rate on U.S. 3 month treasury bill rates, because rates generally rise as the term to maturity increases.

There is, of course, nothing sacred about a 7 or 8 percentage point margin over the Bank Rate. A floating cap, in a world of fluctuating interest rates, may seem better than a fixed ceiling, but the base rate and margin used for a floating cap are open to choice. One problem with any form of cap is that

policymakers do not have the information needed to set one efficiently (so that any "excess" profits are eliminated, while competition is maintained). If a more restrictive cap is set, card issuers will probably react as pointed out in the two previous Committee reports on credit cards — they will restrict the availability of credit cards, alter the nature of credit card services (for example, by reducing the grace period or eliminating enhancements on cards) and increase non-interest charges.

While the Committee was investigating the high rates on credit cards, the Bank of Montreal introduced its Prime Plus card, which is a MasterCard with an annual fee of $18, no grace period and a rate that floats at 5.5 percentage points above the prime rate (at the end of March 1992, for example, the Bank of Montreal prime was 7.75 per cent, so the Prime Plus card rate would have been 13.25 per cent or 4.75 percentage points below the Bank of Montreal's standard, no-fee MasterCard). Some have argued that the Prime Plus card shows that a floating rate cap would work in Canada and not harm credit card issuers. This argument was rejected, however, by the Vice-Chairman of the Bank of Montreal during his second appearance before the Committee; he argued that a general, legislated cap would stifle innovation in the card market and lead to the adverse results noted in the two previous reports on credit cards.

Dr. Michael Walker of the Fraser Institute appeared before the Committee and pointed out that a floating cap, which appears to move with market forces as opposed to fixed caps, does involve a fixed cap on the non-interest costs of a credit card operation. These non-interest costs can amount to 50 per cent of total costs, so this is not a trivial point. Anyone wishing to recommend a cap — fixed or floating — on credit card rates should explain how that cap avoids the usual problems of price ceilings or why the usual problems are of less concern in the credit card market.

A restriction on the availability of credit could have severe macroeconomic and microeconomic effects. During the Carter presidency in the U.S., a voluntary restriction in the use of credit cards led to a severe recession. The micro effects of a cutback in credit cards would be felt most by those with low incomes; young adults applying for a first card and minority groups would be hard hit by any tightening up in the requirements for obtaining a card.

During the visit to Washington, the Committee members heard that the proposed cap on credit card rates would have led to the loss of cards for 10 to 30 per cent of existing cardholders. The card issuers who appeared before the Committee in Ottawa agreed that a cap would lead to restriction of credit but did not try to quantify the extent of the restriction. Officials from the two large banks that appeared before the Committee stated that they now reject about a third of card applicants. During a recent speech, the President of the Toronto-Dominion Bank said that if a rate cap were introduced his bank would adjust its notion of an acceptable cardholder; he said that the proportion of applications rejected might rise to 50 or 55 per cent from the current level of around 30 per cent. In the U.S., Simmons First National Bank, which is known for having one of the lowest interest rates on its card, rejects about 70 per cent of card applications.

2. *The case against caps*

During the 1987 investigation of credit cards by the Finance Committee, one Member expressed outrage that a single mother using a credit card to buy winter clothes for her children should face the high interest rates on credit cards. It is certainly true that high interest rates can be a financial burden, but a cap on rates will not ease the burden. A single mother with a low income will be most likely to lose her credit card if caps are introduced; without access to credit, of course, the single mother would face an intolerable burden if her income and savings were not enough to buy snowsuits for her children.

Others with low incomes, minorities, young adults, immigrants and those with below-average levels of education, are also most likely to lose their credit cards. How are these people helped by lower rates on credit cards they no longer have?

Many who retain their credit cards, moreover, will not be better off. Previous reports have noted that the non-interest rate terms on credit cards would probably change if caps were introduced. It is worth looking at the Bank of Montreal's Prime Plus card to see what these changes might be. That card, which is offered as an option to credit card users, has an $18 a year fee (versus no fee on the regular MasterCard offered by the Bank of Montreal) and no grace period (versus 21 days on the regular MasterCard offered by the Bank of Montreal) and no grace period (versus 21 days on the regular Master Card). More than half of card users always or occasionally pay their entire outstanding balance before the end of the grace period and avoid interest charges on new purchases; most of these card users will lose if a legislated cap leads to a loss of the grace period and the payment of interest on all purchases.

This leaves one final group to examine — those who always run an outstanding credit card balance and who retain their cards after caps are introduced. As noted above, the cap proposed in the 1989 report would have saved someone with an outstanding balance of $1,000 about 25 to 50 cents a month; if annual fees were to rise by $6.00 with a legislated cap, this benefit would be wiped out. Those with higher outstanding balances might still gain, but this group consists, in general, of those with above average education and income — not the group that usually needs protection in financial markets. Moreover, card users in this group now have the option of the Prime Plus card if they want a floating rate card.

In summary, legislated interest rate caps on credit cards would harm many Canadians, while, in general, helping only those who can already help themselves. A cap will also keep potential competitors out of the credit card market and possibly drive some current competitors out of the business. Good intentions are not enough; an interest rate cap will not help the average Canadian consumer. What will help the consumer is better information about the choices available in the credit card market, such as would be provided by the disclosure bill given in Appendix I.

THE RECURRING ISSUE OF CREDIT CARDS IN CANADA

For some members of the Consumer and Corporate Affairs and Government Operations Committee, this is the second time they have examined credit cards in Canada. Some organizations that appeared before the Committee this time, moreover, also appeared at one or both of the previous Parliamentary investigations. Several times during the current investigation participants have asked why it was necessary to revisit the issue every few years.

Although previous reports have touched several aspects of the credit card market — for example, the use of credit cards in telemarketing or as a necessary form of identification when making a hotel reservation — the dominant concern of these investigations was the relatively high level of interest rates on credit cards. In the 1986-87 investigation and in the current investigation, short-term interest rates fell sharply while credit card rates remained high and fairly stable; in 1989, between March and July, the Bank Rate went down 30 basis points while credit card rates went up about 175 basis points.

The movement of credit card rates during spring 1989 was a lagged response to an upward movement in short-term rates that had begun in early 1988. The public lost sight of these lags when the spread jumped by more than 200 basis points, even though the spread was still below average. In 1987 and 1991, the spread jumped to over 300 basis points above average. It seems obvious that any large upward movement in credit card rates that is not an immediate response to an upward movement in other interest rates or any large increase in the spread between card rates and other rates will draw public attention.

Although many may be baffled or upset by the recurring Parliamentary investigations of credit card interest rates, these investigations may be an efficient method of drawing attention to movement in card rates that seem out of step with movements in other rates. Consumers may ignore regularly provided information on credit card rates — desirable as this information may be — until something draws their attention to relative interest rates.

Investigations by Parliamentary committees also offer fairness to the issuers of credit cards, as public hearings give the issuers a chance to explain why credit card rates appear out of line with other interest rates and why, despite a possibly large upward movement in the spread between card rates and other rates, profits on credit card operations are not excessive. In the 1987 Parliamentary investigation, the banks provided useful data on the pricing, costs and profitability of their credit card operations and argued that profits were not abnormally high, especially when averaged over the business cycle. In the current set of hearings, the card issuers argued that abnormally high loan losses, not high profits, have kept spreads high. As noted above, two of the four card issuers that appeared before the Committee recorded losses on their card operations in 1991. Although bank profits were at record levels in 1991, credit cards contributed a small amount, perhaps 2 to 3 per cent, to total earnings. In all credit card investigations, the issuers have pointed out that disclosure requirements lead to a lag of about sixty days between an announced reduction in card rates and the actual reduction, so a sudden fall in the cost of funds will not immediately lead to a fall in card rates.

Committee hearings are, of course, far from one-sided. The card issuers that appeared have been able to present their side of the story. But consumer advocates and bank critics have also been invited to appear before the Committee to give their opinions of the issues. Moreover, the card issuers have had to face pointed questioning from Committee members who were often skeptical when it came to the interpretation of movements in card rates. Another advantage of Parliamentary investigations is that most meetings are open to the public and the discussion is on public record for anyone who wishes to pursue an issue.

Critics of recent Parliamentary investigations of credit cards have argued that the hearings are a symptom of unwarranted government interference. In fact, the hearings and the publicity surrounding them help the market process. Parliamentary investigations that pose the threat of regulation may, paradoxically, make the market work more efficiently. That certainly seems to be the case with the credit card market in Canada.

RECOMMENDATIONS

1. **That the Government introduce in the House of Commons credit card disclosure legislation in the form contained in Appendix I.**

2. **That the Government commission a study to examine the Canadian Payments Association, INTERAC and any existing or potential payments system in Canada to determine whether the structure of the payments system, and especially the Automated Teller Machine network, constitutes any sort of barrier to the entry of additional credit card issuers in Canada.**

3. **That the Government commission a study to examine if there are any legal, structural or other impediments that would constitute barriers to entry to potential credit card issuers in Canada.**

4. **That no cap be placed on credit card interest rates in Canada.**

5. **That a comprehensive comparison of interest rates, fees and pertinent credit card terms be released monthly by the Department of Consumer and Corporate Affairs or another Government agency.**

APPENDIX I

AN ACT RESPECTING THE DISCLOSURE OF CERTAIN INFORMATION REGARDING CREDIT CARDS

Her Majesty, by and with the advice and consent of the Senate and House of Commons of Canada, enacts as follows:

Short title

1. This Act may be cited as the *Credit Card Disclosure Act*.

Interpretation

2. In this Act,

"credit card"
"credit card" means any card, plate, coupon book or other device issued or otherwise distributed for the purpose of being used on presentation to obtain, on credit, money, goods, services, or any other thing of value;

"issuer"
"issuer" means a person who issues credit cards.

Applications or solicitations

3. (a) Any application or solicitation to open a credit card account that is made available to the public or contained in any printed advertisement, circular, catalogue, magazine or other publication shall disclose the information described in paragraphs 4(a) to (f).

(b) An application or solicitation described in paragraph (a) shall contain a statement in a conspicuous and prominent location on the application or solicitation that:

(i) the information is accurate as of the date the application or solicitation was printed;

(ii) the information contained in the application or solicitation is subject to change after that date; and

(iii) the applicant should contact the issuer for information on any change in the information contained in the application or solicitation.

Disclosure required

4. Every issuer shall, before issuing a credit card to a person, disclose to that person

(a) the annual rate of interest charged on any extension of credit obtained through the use of the credit card;

(b) any membership fee or periodic fee charged for the use of or availability of the credit card;

(c) any minimum charge imposed for a period during which an extension of credit obtained through the use of the credit card is outstanding;

(d) any transaction charge imposed for the use of the credit card;

(e) the time by which payment must be made by the holder of the credit card in order to avoid incurring a late charge; and

(f) any other information prescribed by regulation.

Regulations

5. The Governor in Council may make regulations

(a) prescribing information for the purposes of paragraph 3(f);

(b) prescribing in what manner any information required to be disclosed under this Act may be disclosed;

(c) prescribing at what time any information required to be disclosed under this Act may be disclosed;

(d) providing for the disclosure of information by an issuer before a credit card is renewed;

(e) prescribing any exemptions from the necessity of making disclosure under section 3; and

(f) generally, for carrying out the purposes and provisions of this Act.

Referred to Committee

6. Every regulation made under this Act shall stand permanently referred to the Standing Committee on Consumer and Corporate Affairs and Government Operations of the House of Commons for review and scrutiny.

Offence and punishment

7. Every credit card issuer who contravenes or fails to comply with this Act or any regulation made under this Act is guilty of an offence punishable on summary conviction and is liable to a fine not exceeding ten thousand dollars, or to imprisonment for a term not exceeding one year, or to both.

APPENDIX II

Agenda of Committee Trip to Washington, D.C.

Canada-U.S. Legislative Visits Program

Legislation to impose interest caps on credit Cards

February 3–5, 1992
Washington D.C.

House of Commons Standing Committee on Consumer and Corporate Affairs and Government Operations

Mr. Felix Holtmann
Progressive Conservative – Manitoba
Chairman

Mr. Jim Edwards
Progressive Conservative – Alberta

Mr. Darryl Gray
Progressive Conservative – Quebec

Ms Diane Marleau
Liberal – Ontario

Mr. John Rodriguez
New Democratic Party – Ontario

Mr. Scott Thorkelson
Progressive Conservative – Alberta
Vice-Chairman

Ms Elizabeth Kingston
Clerk

Mr. Terry Thomas
Research Officer

Centre for Legislative Exchange

Mrs. Barbara Reynolds
Director

Mrs. Barbara Marhoefer
Washington Associate

Committee Program

Monday, February 3

5:00 p.m. Depart Ottawa on U.S. Air 2054

6:20 p.m. Arrive Washington Baltimore Airport
Depart by mini-bus to Hotel Dupont Plaza Hotel
1500 New Hampshire Avenue, N.W.
Washington, D.C. 20036
(202) 483-6000

Tuesday, February 4

8:00 a.m. Depart Hotel by bus for Embassy

8:30 a.m. Ambassador's Dining Room
Embassy of Canada
501 Pennsylvania Avenue, N.W.
Washington, D.C. 20001
(202) 682-1740

BREAKFAST AND BRIEFING

Canada and the U.S.: Bilateral Issues

Mr. Marc Brault
Deputy Chief of Mission
Minister (Economic)

Mr. Michael Kergin
Minister (Political Affairs)

Overview of the American Banking System

Mr. Alister M.M. Smith
Finance Counsellor
The Embassy of Canada

Informal Tour of the Embassy

10:00 a.m. Leave for American Bankers Association

10:30 a.m. Conference Room
American Bankers Association
1120 Connecticut Avenue
(Connecticut and L Street)
Rm 5A, Fifth Floor
Washington, D.C. 20036
(202) 663-5339 (F. Stoner)
(202) 663-5436 (L. Hafner)

Welcome

Ms Lise M. Hafner
Washington Representative
Canadian Bankers' Association

Briefing: Legislative and Political Stories Behind the Interest Rate Cap Issue

Mr. Floyd Stoner
Director, Federal
Legislative Operation
American Bankers Association

Mr. Ed Yingling
Executive Director
Government Relations
American Bankers Association

11:35 a.m. Leave for Capitol Hill
Senate Side, Law Library Entrance

Tuesday, February 4

12:00 noon
U.S. Capitol S–138

LUNCHEON

Interest Rate Caps/Credit Card Legislation in the U.S. Senate

Ms Laura Simone-Unger
Legislative Assistant to
Senator Alfonse D'Amato
(Republican - New York)

1:30 p.m. Leave for Dirkson Senate Office Building
(entrance on Constitution Ave., east of First Street)

2:00 p.m. SD–548 Dirkson Building
From the Senate Committee on Banking, House and Urban Affairs:

The Minority's Perspectives on Interest Rate Caps/Credit Card Legislation

Mr. W. Lamar Smith
Republican Staff Director
and Economist

Mr. Raymond Natter
Republican General Counsel

Mr. John G. Walsh
Republican Staff Director
Sub-committee on International
Finance

3:00 p.m. SD-534 Dirkson Building

The Majority's Perspectives on Interest Rate Caps/Credit Card Legislation

Mr. Steven B. Harris
Staff Director and Chief Counsel
Senate Banking Committee

Mr. Patrick A. Mulloy
Senior Counsel and International
Affairs Adviser
Senate Banking Committee

3:40 p.m. Depart for the U.S. Treasury
(Fifteenth Street Entrance)

4:00 p.m. Room 2127
The Department of the Treasury
15th Street and Pennsylvania Ave., N.W.
Check in at Security Desk and go to Room 2127. Any problems — phone Betty Reeves in Mr. Dugan's Office (202) 343–0255

From the U.S. Treasury Department:

The Treasury Looks at Interest Rate Caps for Credit Cards

Mr. John C. Dugan
Deputy Assistant Secretary
Financial Institutions Policy

Mr. Randal Quarles
Special Assistant to the
Secretary (Banking Legislation)

Ms Ellen Herr
Financial Economist

5:00 p.m. Return to hotel by bus

EVENING FREE

Wednesday, February 5

7:15 a.m. Depart for Capitol Hill Club

7:45 a.m. Executive Room, 4th Floor
Capitol Hill Club
300 First Street, S.E.
(At First and C Streets,
Across from Metro)
(202) 484-4590

BREAKFAST MEETING

Viewpoint of Minority Members of the House of Representatives

Congressman Chalmers P. Wylie
(Republican - Ohio)
Ranking Minority Member
House Banking, Finance and Urban Affairs

Mr. Anthony Cole
Minority Staff Director - Counsel

9:00 a.m. Room 604, House Annex # 1
New Jersey Avenue and C Street
(The old Congressional Hotel)

Credit Card Interest-Cap Issues in the House of Representatives

Ms Nancy Alcalde
Deputy Staff Director
Sub-committee on Consumer Affairs and Coinage
House Banking Committee

10:00 a.m. Visit to the Senate and House Chambers

Courtesy:
Hon. James T. Molloy,
Doorkeeper
The U.S. Capitol H-154
The Doorkeeper's Office
(202) 225-3505

Mr. Jim Kolb
Office of the Doorkeeper
U.S. Capitol

10:30 a.m. Room 2253
Rayburn House Office Building

The Wisdom of Interest Caps on Credit Cards: Two Viewpoints

Mr. Robert E. Litan
The Brookings Institution
Author of a new study on the issue for VISA and MasterCard

Mr. Bert Ely
Ely & Company Inc.
Financial Institutions Consultant

12:00 noon
Room 2253
Rayburn House Office Building

LUNCHEON

VISA and MasterCard Looks at Interest Caps

Mr. L. Richard Fischer
Partner, Morrison & Foerster and Washington Counsel for VISA and MasterCard

1:30 p.m. Leave for the Centre for the Study of Responsive Law

2:00 p.m. Centre for the Study of Responsive Law
1530 P Street N.W.
Washington, D.C. 20005
(202) 387-8030

Ralph Nader's Group Looks at Interest Caps for Credit Cards

Mr. Khalid Khalid
Multi-national Development Project

Mr. Jonathan Brown
Essential Information

Mr. Edmund Mierzwinski
Consumer Advocate
U.S. Public Interest Research Group

Wednesday, February 5

3:00 p.m. Leave for the Federal Reserve

3:30 p.m. The Federal Reserve
Eccles Building (older bldg.)

C Street between 20th and 21st N.W.
Check in at Security Desk and phone
Ms Driggins for escort
(202) 452-3126

Welcome
Ms Barbara Driggins
Protocol Administrator

The Federal Reserve Looks at Interest Rates for Credit Cards

The Honorable John P. La Ware
Governor

Mr. Griffith L. Garwood
Director, Division of Consumer and Community Affairs

Mr. Donald L. Kohn
Director, Division of Monetary Affairs

Mr. Glenn B. Canner
Senior Economist, Mortgage and Consumer Finance Section
Division of Research and Statistics

Mr. Leonard Chanin
Senior Attorney
Division of Consumer and Corporate Affairs

5:00 p.m. Leave Federal Reserve

9:10 p.m. Depart Washington
Baltimore Airport
on U.S. Air 1640

10:43 p.m. Arrive Ottawa

7:15 a.m. [illegible]

7:45 a.m. Executive Room, 4th Floor
Capitol Hill Club
300 First Street, S.E.
(At First and C Streets,
Across from Metro)
(202) 484-4590

BREAKFAST MEETING

Viewpoint of Minority Members of the House of Representatives

Congressman Chalmers P. Wylie
(Republican - Ohio)
Ranking Minority Member
House Banking, Finance and Urban Affairs

Mr. Anthony Cole
Minority Staff Director - Counsel

9:30 a.m. Room 604, House Annex # 1
New Jersey Avenue and C Street
(The old Congressional Hotel)

Credit Card Interest-Cap Issues in the House of Representatives

Ms Nancy Alcalde
Deputy Staff Director
Sub-committee on Consumer Affairs and Coinage
House Banking Committee

10:00 a.m. Visit to the Senate and House Chambers

Courtesy
Hon. [illegible]
Doorkeeper
The U.S. Capitol H-154
The Doorkeeper's Office
(202) 225-3505

Mr. [illegible]
Office of the Doorkeeper
U.S. Capitol

10:30 a.m. [illegible]
Rayburn House Office Building

The Wild [illegible] Credit Cards: Two Viewpoints

The Brookings [illegible]
Author of a new [illegible]
for VISA and MasterCard

Mr. Bert Ely
Ely & Company [illegible]
Financial [illegible] Consultant

12:00 [illegible]
Room [illegible]
Rayburn House Office Building

LUNCHEON

VISA and MasterCard [illegible] at Interest Caps

Mr. J. Richard [illegible]
Partner, Morrison & [illegible]
Washington Counsel for VISA and [illegible]

1:30 p.m. [illegible]

2:00 p.m. Centre for [illegible]
[illegible]
Washington, D.C. [illegible]
(202) [illegible]

Ralph Nader's Group Looks at Interest Caps for Credit Cards

Mr. Khalid Khalid
Multi-cultural Development Project

Mr. Jonathan Brown
Essential Information

Mr. Edmund Mierzwinski
Consumer Advocate
U.S. Public Interest Research Group

APPENDIX III

House of Commons Committee sharpens focus of Credit Card investigation

news release communiqué

OTTAWA – 11 FEBRUARY 1992

Ottawa –– The House of Commons Standing Committee on Consumer and Corporate Affairs has decided to focus its investigation of credit card interest rates in Canada on three areas: increased competition, improved disclosure and the role of interest rate caps.

Several Members of the Committee travelled to Washington, D.C. recently as part of the investigation. There, concerns about credit cards are similar to those in Canada –– card rates are high and have remained high despite sharply falling short–term interest rates. The highest rates, moreover, are on cards issued by the largest institutions, which control the greatest market share. Last November, U.S. Senator D'Amato introduced an amendment to banking legislation calling for a cap on credit card rates. The publicity surrounding the proposed cap made consumers more aware of the rates they faced and led them to seek cards with lower rates.

INCREASED COMPETITION

In the U.S., new entry into the MasterCard and Visa card market by non–financial institutions (such as Sears, Ford and AT&T) and increased competition from smaller financial institutions with low–rate cards have put downward pressure on credit card rates and fees.

Members of the Consumer and Corporate Affairs Committee would like to see similar developments in Canada, especially an increase in competition that would put constant downward pressure on credit card terms. The Members intend to examine those barriers that would prevent entry into the Canadian credit card market, including entry by non–financial corporations such as Bell Canada and the expansion to all–purpose cards by major retailers such as Sears Canada.

IMPROVED DISCLOSURE

In addition to promoting increased competition, the Members of the Committee will continue to examine ways of improving methods of disclosure. Of interest is the U.S. Fair Credit and Charge Card Disclosure Act of 1988 which provided for uniform disclosure of certain kinds of information (rates, fees, required minimum payments, length of grace period and method of calculating the interest–bearing balance) on credit and charge cards.

THE ROLE OF INTEREST RATE CAPS

The Committee Members wish to emphasize that they will also continue to examine the possible role of a floating cap on credit card rates in Canada. In its 1989 report, *Charge It: Credit Cards and the Canadian Consumer*, the Committee on Consumer and Corporate Affairs recommended that "in no instance should the spread between card rates and the Bank Rate exceed 8% for financial cards and 16 1/2% for retail cards." Mr. John Rodriguez, a Member of the Committee in 1989 and now, has introduced a Private Member's bill that would impose a floating cap on credit cards.

The Committee will hold further hearings with interested Canadians on competition, disclosure and interest rate caps in the credit card market. The Committee would like to hear from consumer groups, economists, institutions now issuing credit cards and potential issuers.

For further information, contact:

Felix Holtmann,
Chairman

Tel: (613) 996-2998

Elizabeth Kingston,
Clerk of the Committee

Tel: (613) 996-1516
Fax: (613) 992-7974

APPENDIX IV

List of witnesses

Associations and Individuals	Issue	Date
House of Commons:	20	November 6, 1991
Garth Turner, M.P.		
Royal Bank of Canada:	20	November 6, 1991
J.E. Cleghorn, President & Chief Operating Officer		
W.R. Fithern Senior Vice-President Card Services & Point of Sale		
Bank of Montreal:	20	November 6, 1991
Alan G. McNally Vice-Chairman		
Derek A. Fry First Vice-Chairman		
Consumers' Association of Canada:	23	November 20, 1991
Marilyn Lister President		
David Simpson Executive Director		
Rosalie Daly Todd Counsel		
AMEX Bank of Canada:		
Morris A. Perlis President and Chief Executive Officer	23	November 20, 1991
Sean McNamara Vice-President and General Manager		
Canada Trust:		
Brent Kelman Executive Vice-President Corporate Affairs	30	February 11, 1992
Mike Woeller Vice-President Card Services		

Associations and Individuals	Issue	Date
House of Commons:	30	February 11, 1992
Don Blenkarn, M.P.		
Bank of Montreal:	31	February 12, 1992
Alan G. McNally Vice-Chairman Personal and Commercial Financial Services		
Derek A. Fry Senior Vice-President Banking Services Personal and Commercial Banking		
Bureau of Competition Policy:	32	February 18, 1992
George Addy Senior Deputy Director of Investigation and Research		
Gilles Ménard Deputy Director of Investigation and Research (civil matters)		
The Fraser Institute:	34	March 16, 1992
Michael Walker Executive Director		
Borrowers' Advocate Ltd.:	36	March 25, 1992
Larry Whaley President		

Request for Government Response

Your Committee requests that the Government table a comprehensive response to this Report in accordance with the provisions of Standing Order 109.

A copy of the relevant Minutes of Proceedings and Evidence (*Issues Nos. 20, 23, 30, 31, 32, 34, 36, and 47 which includes this Report*) is tabled.

Respectfully submitted,

Felix Holtmann
Chairman

Associations and Individuals	Issue	Date
House of Commons:	30	February 11, 1992
Don Blenkarn, M.P.		
Bank of Montreal:	[illegible]	[illegible]
Alan G. McNally Vice-Chairman Personal and Commercial Financial Services		
Derek A. Fry Senior Vice-President Banking Services Personal and Commercial Banking		
Bureau of Competition Policy:	32	February 18, 1992
George Addy Senior Deputy Director of Investigation and Research		
Gilles Ménard Deputy Director of Investigation and Research (civil matters)		
The Fraser Institute:	34	March 16, 1992
Michael Walker Executive Director		
Borrowers' Advocate Ltd.:	36	March 25, 1992
Larry Whaley President		

APPENDIX V

The New Democrat Minority Report on

CREDIT CARD INTEREST RATES

Presented to The Standing Committee of Consumer and Corporate Affairs and Government Operations.

June 10th 1992.

The New Democrat members of the Standing Committee on Consumer and Corporate Affairs and Government Operations strongly feel that the Committee has been, for the past several years a permanent watchdog on credit card interest rates. Throughout these years, the Standing Committee has had a fundamental social concern: the well-being and the protection of the Canadian consumer against economic abuse. One of its main responsibilities has been to identify and study market deficiencies, and put forward policy recommendations which could correct situations where controlling economic forces harm or distort the interests of consumers.

Regrettably, the New Democrat members believe that the 1992 Committee Report on credit cards does not provide public policy recommendations which effectively protect consumers against unjustified interest rate spreads. The 1992 recommendations depart from the spirit of the 1987 and 1989 Reports of the Standing Committee on credit card interest rates and are toothless and ineffectual.

The conventional economic theory on competition is inadequate:

Conventional economic theory on competition is sometimes used as an instrument to entrench market asymmetry between consumers and corporations. In such cases, incorporating conventional economic analysis to public policies is socially damaging, for it mainly reflects the rhetoric and prejudices of established business interest groups. On and on, evidence has amply proven that credit card interest rates and bank service charges in Canada do not respond to the market system but to oligopolistic forces, and that oligopolistic forces are by their very own nature political, and therefore will only respond to public pressure. The same tune has been played for years, and conventional theory has very little to offer in terms of insight as to the determination of the mechanism involved in setting the interest spread hence, the profits of the banks.

The view of the "sovereign consumer" is a myth:

The financial sector has successfully harnessed the major breakthroughs in the technologies of communications but has failed to pass all the benefits to consumers. It is true to say that consumers have profited from the many new services, and that the range of product options has expanded. It is

also true to say that financial institutions are using this new knowledge to expand their powers, increase their control of the market, and manipulate consumers into contributing to their bottom line to offset the losses they incur because of sloppy corporate lending practices. Consumers are not always well-served by imperfect competition. Their vigilance is also weakened by economic instability and an over-abundance of contradictory and paralysing advertisements.

Most credit card advertisements, for instance, contain little useful consumer information and are geared towards increasing demand that encourage consumers to incur higher balances. They fall short in providing consumers with the characteristics and comparative advantages of products, or with sound business advice. Furthermore access to mass media advertising is privileged.

Conventional economics proclaim the myth of the well informed "sovereign" consumer. They provide little help in developing a practical counterweight to the new corporate powers. In oligopolistic or monopolistic situations, consumers invariably end up footing a more than proportional share of the bill. They also pay for their lack of real informational knowledge, and are blamed for it!

New Democrats believe that only a flexible mixture of market incentives and public intervention will ensure that overall fairness is achieved. Recognizing the asymmetry in the bargaining strength between consumers and financial institutions, and in view of the limited applicability of the reliance on the theories on self adjusting free market processes, we feel it is appropriate that a *Financial Services Ombudsman be established to address the real problems consumers face.*

Banks are increasingly moving away from their traditional source of profits:

Banks, like firms in general, primarily make their profits from the pricing of their "output". However, unlike firms in the industrial sector, banks create money from their activity of loan and deposit creation. Hence, historically, an important source of bank net revenues has been the interest spread — the difference between the interest (the price) they charge on their loans and the interest (the cost) they pay on customers deposits. If this were to be the only source of bank revenue, then this interest spread (multiplied by the average volume of outstanding loans during a given period less the direct and indirect cost of administering these loans) would constitute their net profit.

In more recent times, as the variety of financial services provided has somewhat widened and their "products" have become more differentiated, banks have found it increasingly more profitable to charge directly user fees for such services. The result of these spiralling direct service costs has been that a growing share of net revenues arises from this new source of income. These direct service charges are of crucial importance to banks, especially during times of recession. Indeed, facing declining revenues from the shrinking loan demand, Canadian banks have used their oligopolistic position in the financial services' market to sustain their high level of projected profits.

This would apply equally as well in the area of consumer loans and credit card operations. As before, banks seek to make their profits either by means of the interest they charge on the credit they provide to the public or through the direct user fees.

Conventional economic analysis nevertheless proclaims that credit card interest rates are subject to the discipline of the market and that :

A Lending Institutions must charge higher spreads for credit card rates to compensate for the higher risks and losses they incur.

B Injecting more competition in the market will reduce the spread between the rates banks charge their preferred customers and the rate they charge on credit cards.

New Democrats have a problem with this interpretation:

A There is no evidence that the interest rate spread on credit cards is justified by the historical difference between the loan loss ratio on credit cards, and the loan loss ratio on personal loans. The accepted loan loss ratio for personal loans, industry wide is around O.5%. Adding skips and other defaults puts the effective ratio at 1%.

The delinquency ratio (90 days +) is less than 3% for all products. It is less than 2% for personal line of credits and is *presently* in the vicinity of 1.5% for credit cards. Needless to say that these ratios do not factor in commissions perceived from merchants as a result of credit card use. If this is taken into consideration the credit card business becomes, probably, one of the most profitable segments of the banking industry.

B *The 1989 Committee's report acknowledged that the Canadian credit card market was highly competitive.* Therefore more competition is not the answer in this case. The blunt reality is that:

- The Canadian credit card market will remain oligopolistic.
- Competition in an oligopolistic market will not affect interest rates, because price leaders set the price trends. *It is more a case of product competition rather than price competition*: Competition will tend to work more on the packages of bonuses and benefits that financial institutions market with their cards. As the economy follows the business cycle, financial institutions will move to enhance their position by offsetting their losses elsewhere. Here is roughly how:

1 The Bank of Canada inflation fighting policies cause high interest rates.

2 The rise in the costs of banking activity, due to the rise in the Bank of Canada rate increase the cost of funds and reduces the net income of businesses. Banks start to lose corporate clients — this happens near the peak of the cycle.

3 Banks try to compensate for their losses and protect their profits by imposing harsher lending terms at the risk of critically weakening the fragile payment capacity of their customers. They will also try to minimize further losses, among other things, through a preventive recall of small business loans. They will also hike fees and bank service charges as a "pay-as-you-go" and/or a "pay anyway" tax.

4 When the Bank of Canada is satisfied that "inflation" is under control, it signals a downward trend in interest rates, within a targeted $US/$CAN exchange rate. In the process, the Bank of Canada creates an opportunity for the banking community to work that trend, and reap windfall profits on the relative spread they make between the interest they pay on their deposits and the interest they charge on their loans. These profits somehow compensate for the losses they have incurred as a consequence of recessionary economic policies — for instance in the commercial real estate sector. By shortening the average term of their borrowing and by lengthening the average term of their loans, banks will thus lower the cost of refinancing their loans, while the interest they charge on their loans to businesses and consumers will fall at a much slower and uneven pace. This is perfectly illustrated with credit card interest rates and mortgage rates. *Therefore the spread they charge on credit card rates does not reflect only risk, but also opportunities to make windfall profits. In a market dominated by oligopolistic arrangements, such as the case with the Canadian financial market,*

banks can more than ever use their bargaining power to pass on to dispersed and numerous consumers and to small and medium sized accounts, the brunt of the costs. Hence they are engaged in price discrimination on both the asset and liabilities side of their balance sheets by segmenting their markets. In such a context, competition cannot by itself lower service charges.

In the US, the interest rate spread for credit cards is much higher than in Canada, in spite of the fact that the US financial market is a very competitive market. More than 4000 financial institutions market credit cards, and there are some 12000 banks. Several hundred banks go belly-up every year, mainly because there is no real national banking system and banking is governed by state law. Large US Banks also securitize their credit card receivable ie they sell these receivables on the stock exchange and make a bundle. Higher spreads therefore are needed to lure investors.

As securitization enters the Canadian market, it is very likely that it will cause even higher credit card interest rate spreads.

In conclusion we want to stress that a high credit card rate spread and excessive service charges are choices, among others, that bankers make to pass the buck to consumers. When the Bank of Montreal introduced a credit card with a floating cap of 5.5% above the prime rate, it clearly showed that banks have other options to make money. It also confirmed that a floating cap on credit card interest rates does not defy the laws of finance and will not break the banks!

New Democrat members therefore reaffirm the validity and the pertinence of the major recommendations made by the Standing Committe when it tabled its 1989 report. They are meant to refer to all cards issued in Canada, both charge cards and credit cards:

1. **That in no instance should the spread between card rates and the Bank Rate exceed 8% for financial cards and 16.5% for retail cards.**

2. **That credit card issuers be compelled to calculate interest charges in a manner which fully credits any partial payment by the credit card holder.**

3. **That a Financial Services Ombudsman (FSO) be established to monitor credit card rate and financial service charge abuse. The FSO should be empowered to perform consumer advocacy and referee functions. He/she should report directly to Parliament and maintain a close working relationship with OSFI and the Department of Consumer and Corporate Affairs. This will ensure that consumers have some control over how the cost of financial services are delivered, and at whose cost.**

4. **That the Government introduce in the House of Commons credit card disclosure legislation in the form contained in Appendix I.**

5. **That a comprehensive comparison of interest rates, fees and pertinent credit card terms be released monthly by the Department of Consumer and Corporate Affairs or another Government agency.**

banks can more than ever use their bargaining power to pass on to dispersed and numerous consumers and to small and medium sized accounts, the brunt of the costs. Hence they are engaged in price discrimination on both the asset and liabilities side of their balance sheets by segmenting their markets. In such a context, competition cannot by itself lower service charges.

In the US, the interest rate spread for credit cards is much higher than in Canada, in spite of the fact that the US financial market is a very competitive market. More than 4000 financial institutions market credit cards, and there are some 12000 banks. Several hundred banks go belly-up every year, mainly because there is no real national banking system and banking is governed by state law. Large US Banks also securitize their credit card receivables ie they sell these receivables on the stock exchange and make a bundle. Higher spreads therefore are needed to lure investors.

As securitization enters the Canadian market, it is very likely that it will cause even higher credit card interest rate spreads.

In conclusion we want to stress that a high credit card rate spread and excessive service charges are choices, among others, that bankers make to pass the buck to consumers. When the Bank of Montreal introduced a credit card with a floating cap of 5.5% above the prime rate, it clearly showed that banks have other options to make money. It also confirmed that a floating cap on credit card interest rates does not defy the laws of finance and will not break the banks!

New Democrat members therefore reaffirm the validity and the pertinence of the major recommendations made by the Standing Committe when it tabled its 1989 report. They are meant to refer to all cards issued in Canada, both charge cards and credit cards.

1. **That in no instance should the spread between card rates and the Bank Rate exceed 8% for financial cards and 16.5% for retail cards.**

2. **That credit card issuers be compelled to calculate interest charges in a manner which fully credits any partial payment by the credit card holder.**

3. **That a Financial Services Ombudsman (FSO) be established to monitor credit card rate and financial service charge abuse. The FSO should be empowered to perform consumer advocacy and referee functions. He/she should report directly to Parliament and maintain a close working relationship with OSFI and the Department of Consumer and Corporate Affairs. This will ensure that consumers have some control over how the cost of financial services are delivered, and at whose cost.**

4. **That the Government introduce in the House of Commons credit card disclosure legislation in the form contained in Appendix I.**

5. **That a comprehensive comparison of interest rates, fees and other credit card terms be released monthly by the Department of Consumer and Corporate Affairs or another Government agency.**

moyenne des emprunts et en allongeant la durée moyenne des prêts, les banques abaissent le coût du refinancement des prêts tandis que le taux d'intérêt qu'elles prélèvent sur les prêts aux entreprises et aux consommateurs baisse à un rythme beaucoup plus lent et inégal. C'est ce qu'illustre à merveille l'évolution des taux des cartes de crédit et des taux hypothécaires. *Par conséquent, les marges qu'elles prélèvent sur les taux des cartes de crédit s'expliquent non seulement par le risque, mais aussi par la possibilité de réaliser des profits d'aubaine. Dans un marché oligopolistique comme le marché financier canadien, les banques sont plus que jamais en mesure d'utiliser leur pouvoir de négociation pour nuire à des consommateurs dispersés et nombreux, et à des comptes petits et moyens, le gros des cotes. Elles se livrent donc à de la discrimination par les prix en innovant leur marché tant du côté de l'actif que du passif.* En pareilles circonstances, la concurrence ne saurait par elle-même faire baisser les frais de service.

Aux États-Unis, la marge d'intérêt sur les cartes de crédit est beaucoup plus grande en dépit du fait que le marché financier y est très concurrentiel. Plus de 4 000 institutions financières émettent des cartes de crédit et il y a quelque 12 000 banques. Plusieurs centaines de banques font faillite tous les ans, surtout parce qu'il n'existe pas vraiment de système bancaire national et que l'activité bancaire relève des États. Par ailleurs, les grandes banques américaines titrisent leurs créances de cartes de crédit, c'est-à-dire qu'elles les vendent sur les marchés boursiers, ce qui leur permet de faire énormément d'argent. Il faut donc augmenter la marge d'intérêt pour attirer les investisseurs.

À mesure que la titrisation s'implante sur le marché canadien, il est fort probable que la marge d'intérêt sur les cartes de crédit augmentera encore plus.

En conclusion, nous tenons à souligner que ce sont les banquiers qui choisissent, entre autres, d'alourdir la marge d'intérêt sur les cartes de crédit et d'exiger des frais de service excessifs pour refiler la note aux consommateurs. Lorsque la Banque de Montréal a introduit une carte de crédit assortie d'un plafond flottant de 5,5 % au-dessus du taux préférentiel, elle a fait la preuve que les banques ont à leur disposition d'autres façons de faire de l'argent. Elle a également confirmé que le plafonnement flottant des taux des cartes de crédit ne défie pas les lois de la banque et ne ruine pas les banques!

Les néo-démocrates réaffirment donc la validité et la pertinence des principales recommandations que le Comité permanent formule dans son rapport de 1989. Celles-ci s'appliquent à toutes les cartes émises au Canada, tant les cartes financières que les cartes de crédit. Nous recommandons :

1. **Que, sous aucun prétexte, l'écart entre les taux des cartes de crédit et le taux d'escompte ne dépasse 8 % pour les cartes financières et 16,5 % pour les cartes de crédit.**

2. **Que les émetteurs de cartes de crédit soient forcés de calculer les frais d'intérêt de manière à faire pleinement crédit au titulaire de tout remboursement partiel.**

3. **Qu'un ombudsman des services financiers (OSF) soit établi pour surveiller l'évolution des taux des cartes de crédit et l'abus des frais de services financiers. L'OSF devrait être habilité à défendre les intérêts des consommateurs et à arbitrer les litiges. Il devrait relever directement du BSIF et du ministère de la Consommation et des affaires commerciales. De cette manière, les consommateurs pourront exercer un certain contrôle sur les modalités de prestation et les coûts des services financiers.**

4. **Que le gouvernement dépose à la Chambre des communes un texte de loi sur la communication de renseignements relatifs aux cartes de crédit selon le modèle proposé à l'annexe I.**

5. **Que le ministère de la Consommation et des Affaires commerciales ou un autre organisme du gouvernement produise sur une base mensuelle une comparaison exhaustive des taux d'intérêt, des frais et des conditions rattachés à l'utilisation des cartes de crédit.**