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How Providian misled card holders

by Sam Zuckerman
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In a memorandum to senior executives of Providian Financial Corp., the giant San Francisco credit card company, founder Andrew Kahr stressed the guiding principle that had made the firm one of the nation's most profitable consumer-finance operations.

In lending to the kinds of high-risk customers Providian specialized in, Kahr wrote, the "problem is to squeeze out enough revenue and get customers to sit still for the squeeze."

The memo, introduced in a 1999 cardholder class-action lawsuit against Providian, is one of 12 internal company documents obtained by The Chronicle as the result of a yearlong legal battle.

The Providian documents, including 10 Kahr memos plus strategy and training materials dating from the late 1990s, portray a company bent on misleading and manipulating its customers in order to soak as much money from them as possible.

The documents also offer a startling glimpse of the values, ideas and strategies that specialists in business ethics say have become increasingly common in corporate suites. Company managers, under intense pressure from Wall Street to raise revenue and profit, are pushing the ethical envelope in what they tell consumers about the products they sell.

"This is the essence of ethics in business," said Kirk Hanson, executive director of the Markkula Center for Applied Ethics at Santa Clara University. "Some companies will be very conscientious about disclosure. Others will deliberately obfuscate."

Over the past decade, some of the largest and most recognized U.S. corporations have paid big sums to settle charges of consumer deception.

To name just a few: long distance providers AT&T, Sprint and WorldCom; banking giants Citibank and Chase Manhattan; retailer Sears, Roebuck; medical devicemaker Johnson & Johnson and General Electric Credit Corp. all agreed to multimillion-dollar payouts in consumer-deception cases, without admitting wrongdoing. In the last two years, Providian has paid more than $400 million to settle charges of unfair business practices.

"It is extremely widespread," said Philip Cochran, director of the Center for the Study of Business and Public Issues at Penn State University. "It ultimately boils down to the whole issue of truth-telling."

The deceptive practices that have gotten businesses into trouble -- ranging from hidden long-distance fees to unfair late-payment credit card charges -- are a matter of public record. But rarely does the public get to peer into the minds of the people behind the abuses.

INSIDER MEMOS TELL STORY

The Providian documents provide that opportunity.

Between 1996 and 1999, Kahr wrote a series of memos to top Providian executives offering detailed advice on just about every aspect of credit card marketing.

When 10 Kahr memos were introduced as evidence in the 1999 California lawsuit against Providian, The Chronicle asked the court to make them public.

The court granted The Chronicle's request, but Providian appealed the decision. A higher court denied the appeal earlier this year and the company then gave The Chronicle the documents.

The credit industry is one of the most highly regulated in American business. "Truth in lending" laws and regulations require lenders to disclose interest rates and credit terms, even specifying the print size issuers must use in consumer-information materials.

In the 1990s, the market grew saturated and the wallets of creditworthy consumers filled to bulging with cards. At the same time, bargain-hungry consumers were on the lookout for low interest rates.

Card issuers became increasingly aggressive in finding new sources of revenue, including late fees, penalty charges for exceeding credit limits and fees for add-on products such as credit insurance. And they pushed to the edge of the law -- and sometimes beyond -- in what they told customers about the rates they charged.

In addition to Citibank and Chase, issuers such as Advanta and First USA paid out millions in compensation for abuses such as raising interest costs when customers were guaranteed fixed rates.

'MAKING PEOPLE PAY'

Providian was one of the most aggressive of the lot. In 2000 and 2001, the company reached separate agreements with law-enforcement agencies and lawyers representing cardholders requiring it to repay customers who claimed Providian had deceived them about fees and interest rates. Kahr was not charged with wrongdoing.

Underlying Kahr's philosophy was the realization that many of Providian's high-risk customers were desperate for credit and easily taken advantage of, a point he drove home in a March 1999 memo to Executive Vice President David Alvarez, who had day-to-day responsibility for Providian's credit card business:

"Making people pay for access to credit is a lucrative business wherever it is practiced. . . . Is any bit of food too small to grab when you're starving and when there is nothing else in sight? The trick is charging a lot, repeatedly, for small doses of incremental credit."

In the wake of the settlements, Providian cleaned up its marketing practices. The top executives who managed the company when it ran into legal trouble left Providian last year. Kahr's consulting contract was ended in 2000.

Providian claimed that it never deliberately abused its customers. But the Kahr documents provide compelling evidence that squeezing as much revenue as possible from clients while concealing credit prices and terms was deeply embedded in Providian's culture.

THE BRAINS BEHIND THE COMPANY

Kahr was no ordinary consultant. He was the genius behind Providian's success.

A mathematician by training, by the 1970s he had become the enfant terrible of financial services consulting, known equally for his strategic brilliance and prickly personality. He invented the idea of a combined brokerage and checking account with a debit card, an idea adopted by Merrill Lynch as its wildly successful cash management account.

In the early 1980s, Kahr started a credit card company in San Francisco called First Deposit Corp., which eventually became Providian. But Kahr hated the gritty business of managing a company. In 1988, after selling his interest in the company and tapping engineer Shailesh Mehta as his successor, Kahr stepped down as chief executive and moved to the south of France. He continued to guide the company as a consultant.

Kahr's memos from the late 1990s are full of ideas on how to mask the costs of products and services.

In a July 1998 memorandum to Alvarez and Dawn Greiner, the head of new product development, Kahr urged the company not to tell customers that some credit cards don't have "grace periods," a limited time for paying off balances before finance charges kick in.

"Why shove 'no grace period' in their eye? Why not use one of the numerous ideas for a 'limited' grace period that have been put forward. 'Limited' meaning that the customer responds to (it) as if there were a grace period, but in reality almost no one gets the benefit of it."

And in a September 1998 memo to marketing executive Greg Pacheco, Kahr suggested how to promote a for-fee cardholder buyers club program that in most cases offered tiny 1 percent rebates at selected stores:

"A 1 percent rebate is a 'discount on everything you buy.' We could easily make that discount 'up to 30 percent' just by randomly or systematically giving a few customers a big rebate."

MISLEADING WORDING

Kahr objected to straightforward explanations of the cost of credit. He recommended promoting "no-annual-fee" cards that required customers to pay for credit protection, an add-on service of dubious value that in one case cost $96 per year.

In a September 1998 memo to Mehta, Kahr advised calculating the credit protection charge as a percentage of the customer's credit line.

"The (credit protection) fee can be denominated at 9.8 cents per hundred dollars of line, or whatever, and this has the additional merit of making the $96 go away from the disclosure box."

The recommendation was underlined and the notation "excellent suggestion," followed by the CEO's initials, was penned in the margin.

THE PENALTY TRAP

One of Kahr's favorite strategies was to trap customers with penalty fees for late payments or going over credit limits. That had the virtue not only of providing direct fee income, but also of permitting Providian to raise interest rates as high as 24 percent annually.

Writing to Alvarez in October 1998, Kahr proposed a tactic to boost penalty fee income.

"We should authorize to 110 percent of (credit) line, we should charge an (overlimit fee) proportional to line, we should allow overline (balance transfers), we should not add (overlimit) amount to minimum payments, and we should trigger (higher interest rates) on a single instance of $1 (overlimit)."

Beyond his specific recommendations, Kahr's memos were crammed with offhand comments that showed his hostility to disclosure and his running disputes with Providian's lawyers over truth-in-lending requirements.

His July 1998 memo to Greiner and Alvarez noted that the company used to use promotional brochures "to hide disclosure text, but we have figured out other ways of doing that." Later in the same memo he advises making a minimum finance charge the same as a late fee so that "no one will notice it."

Asked about the documents, Providian distances itself from its founder, noting that his consulting role ended two years ago.

"Kahr and his memos are simply irrelevant to today's Providian," spokesman Konrad Alt said. "Our current management is committed to clear disclosure and customer satisfaction. We totally reject and would never tolerate the attitudes these memos display."

DEFENDING LACK OF DISCLOSURE

Kahr, for his part, is unrepentant. In a telephone interview, he said he always strived to obey the law. He said he was shocked by allegations that Providian broke the law by, for example, charging customers for add-on products they hadn't ordered. (Providian denies that it ever deliberately "slammed" customers.)

But he gave no ground on the principle of disclosure.

"I want results. If I thought more disclosure sold the product, I would do more disclosure. If I thought less disclosure would do it, I would do less," Kahr said.

"If disclosure tended to distract from marketing and reduce the response rate, then the heck with disclosure."

Kahr also emphasized that Providian never adopted most of his recommendations.

That may be true when it comes to specific marketing proposals and product design features. But Kahr's fundamental approach and his broad strategic advice set the company's basic course, both when he was CEO in the 1980s and a consultant in the 1990s.

In legal action against Providian two years ago, bank regulators and the San Francisco district attorney cited two deceptions that seem to come straight out of the Kahr playbook: a "guaranteed savings rate" program in which customers were never told what interest rate they would be charged and marketing of a "no annual fee" credit card that forced customers to buy credit protection.

Consumer advocates say the documents confirm their darkest suspicions about consumer finance companies.

"We've always assumed this was the attitude in the industry," said Boston lawyer Gary Klein, formerly a lawyer with the National Consumer Law Center. "It is rare to get this confirmed so baldly."

Industry representatives reject that view.

"You just don't have that mentality in the business conference room," said Randy Lively, president of the American Financial Services Association, a trade group representing nonbank lenders. "If it creeps in somewhere, it is usually an aberration and it is something to be decried."

What is certain is that few marketing professionals spell out plans to mislead customers as plainly as Andrew Kahr did.

In a book about consumer finance innovations written a decade ago, before Providian's legal troubles made headlines, writer Joseph Nocera described Kahr as "cold and ruthlessly logical. He was neither a philosopher nor a moralist; to him, if something was not illegal, it was, therefore, possible."