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TESTIMONY OF

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BEFORE THE

**SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT**

OF THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

U.S. HOUSE OF REPRESENTATIVES

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Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

INTRODUCTION

Chair Maloney, Ranking Member Biggert, and members of the Subcommittee, I appreciate the opportunity to appear before you today to provide the Office of the Comptroller of the Currency's views on H.R. 5244, the "Credit Cardholders' Bill of Rights Act of 2008." Although credit cards provide consumers with many benefits, they also generate complaints about fees, billing, and marketing practices. Congressional oversight, through hearings such as this, has encouraged improvements in some of those practices, and this hearing is a valuable opportunity to explore the benefits and consequences of possible legislative responses as well.

The OCC's perspective on these matters is informed by our experience as the supervisor of national banks' credit card operations, which today involve management of over 75 percent of the U.S. credit card debt outstanding.

In testimony before this Subcommittee last year, Comptroller Dugan provided extensive background on the evolution of the credit card industry, benefits and current concerns about credit cards, the OCC's comprehensive approach to supervision of national banks' credit card operations – including our approach to examinations, the consumer complaint process, and enforcement actions – and the need for reform of credit card disclosures and certain other credit card practices.[1] As the Comptroller noted, even though the OCC does not have rulemaking authority with respect to credit card disclosures and marketing practices, we have been proactive in issuing supervisory

[1] Testimony of John C. Dugan, Comptroller of the Currency, before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services of the U.S. House of Representatives (June 7, 2007), available at: http://www.occ.treas.gov/ftp/release/2007-54b.pdf.

guidance that has resulted in improvements in national banks' practices in both areas. The OCC initiated the development of the interagency "Account Management and Loss Allowance Practices Guidance," which led to new standards for minimum payment requirements, workout programs and reforms in overlimit practices. These changes were necessary to deter prolonged negative amortization of credit card debt and to ensure that borrowers with very serious financial difficulty could be enrolled in workout programs that would amortize their debt within 5 years.[2] We also issued guidance to national banks on inappropriate disclosure practices associated with universal default, unilateral change-in-terms, and certain pricing strategies, which resulted in improvements in those practices.

As the Comptroller stated in his testimony, we believe that certain key principles should guide any new credit card legislation and regulation. My testimony focuses on those principles and their application to H.R. 5244.

First, it is important to recognize that credit cards are different from home mortgages or car loans in fundamental respects and, as such, require significant and different credit risk management techniques. Unlike a mortgage or car loan, a credit card is unsecured, revolving, open-end credit. The amount outstanding on a credit card, at any given time, is subject to the customer's credit limit so that as the customer pays down the balance of an account, he or she may then make new charges up to the limit (the extension of credit thereby "revolves" as payments are made and new charges are

[2] OCC Bulletin 2003-1, Credit Card Lending: Account Management and Loss Allowance Guidance (Jan. 8, 2003). Prolonged negative amortization refers to when the required minimum monthly payments are not enough to cover all finance charges and fees assessed during the billing cycle and these unpaid charges and fees are then added to the balance.

incurred). Credit card lenders qualify customers for a specified interest rate, credit limit, and other terms, based on an assessment of the consumer's creditworthiness at the time the account is opened. However, each charge made to the credit card is a new, unsecured extension of credit that is not separately underwritten at the time of the transaction. Thus, given the fundamental nature of revolving, open-end credit, the credit risk faced by a credit card lender is dynamic and changing. And, credit card lenders appropriately rely on risk mitigation tools to address changes in the customer's credit risk profile.

The risk mitigation tools used by credit card lenders to address changes in the credit risk profile of customers may include freezing or reducing credit lines, closing accounts, shortening account expiration dates, and "re-pricing" (changing the rate of interest charged) for outstanding balances on an account. Changes in a customer's creditworthiness and other factors affect credit risk assumed by credit card lenders for both existing balances that a customer has not repaid, as well as for future transactions by the customer. In other words, when a credit card customer does not pay his or her balance in full, that action by the customer creates risk to the lender for the unpaid balance as well as any future charges.

As a fundamental safety and soundness matter, given the nature of unsecured, revolving, open-end credit, credit card lenders need to be able to respond to changing circumstances that affect their risk exposure and operating costs. And, because the nature and degree of these risks can differ on an account-by-account basis, they need to be able to employ appropriate risk mitigation options, such as those described above, to address these risks. As described in more detail later in my testimony, we have serious concerns that certain provisions of H.R. 5244 would deprive credit card lenders of options that are important to effectively manage those risks.

Second, the ability and means by which credit card lenders change credit card terms must not be one-sided – it must take account of implications for the customer. Customers should be given meaningful notice of the terms and conditions of their credit cards, and the circumstances under which those terms may change. This enables them to make informed choices and compare the features of competing credit cards and to recognize when their actions, such as failure to make payments due on the card, or defaults on other obligations, may affect their credit card interest rates, fees or other terms.

The OCC has long-advocated a new approach to consumer disclosures – for credit cards and consumer credit generally – based on robust consumer testing to develop disclosures that customers can understand and that effectively convey the information customers most want and need to know. Improved disclosure industry-wide can have multiple benefits for consumers: it can lead to informed consumer choice, stimulate competition to provide consumers the terms they want, and it can lead to transparency in credit card practices. While we do not have rulemaking authority in this area, we have been encouraged by the proposal by the Federal Reserve Board to revise provisions of its Regulation Z governing credit card disclosures, and by the Board's use of consumer testing to develop the proposal. In a comment letter filed with the Federal Reserve Board last year, Comptroller Dugan supported many aspects of the proposed rule, which reflected this new approach – and also urged that the Board do more in certain respects.

Third, and a key element of the Comptroller's recommendations to the Federal Reserve Board, is the need for credit card customers also to have meaningful choice when faced with proposed increases in credit card interest rates. Specifically, the Comptroller urged that before a credit card lender could increase the interest rate on an account for reasons other than the customer's default on the account itself, the customer generally should be given a reasonable opportunity to opt-out of the change and pay off the outstanding card balance according to the old terms. The credit card lender could close the account to new transactions, or could choose to keep the account open under the old terms for a fixed period of time, such as the account expiration date. This would allow the credit card lender either to confine its risk to the existing balance and potentially limited new balances, or to price for the risk of continuing the relationship.

But, where a customer defaults on his or her obligations under the card itself, the risk to the credit card lender is clear and immediate, and, with appropriate up front notice, the consequence of increased rates on the consumer's existing balance and on future transactions should not come as a surprise to the consumer.

Finally, we recognize that many provisions of H.R. 5244 are an understandable reaction to shortcomings in practices – including the lack of meaningful notice and meaningful choice described above. Where the reaction takes the form of a requirement or restriction that reduces returns from one aspect of a credit card lender's operations, there may well be "trade-offs" between the potential benefits and consequences of such a reaction. Credit cards are a fee- and interest rate-based business, and a credit card lender's response to a restriction in one area may well be to alter practices so that the same return can be achieved through other means. Thus, for example, if credit card lenders are restricted in their ability to price particular customer segments for the risks and costs posed by those customer segments, the alternative may be that those costs are spread over a broader range of credit card customers. Put another way, taking aim at risk-based pricing will likely cause prices to increase on some portion of customers that are not engaged in risky behavior. These are not necessarily safety and soundness matters, but they are important considerations in assessing the ultimate benefits that would result from particular legislative responses in this complex and competitive business.

COMMENTS ON H.R. 5244
"THE CREDIT CARDHOLDERS' BILL OF RIGHTS ACT OF 2008"

Provisions Affecting Credit Risk Management

Section 2: "Credit Cards on Terms Consumers Can Repay." Section 2 of H.R. 5244 contains several provisions that would significantly restrict a credit card lender's ability to manage and price for credit risk. Among other things, a credit card lender would be prohibited from using adverse information clearly relevant to a customer's credit risk profile as a basis for increasing the interest rate on an outstanding credit card balance, unless the information pertained to the customer's performance on the credit card loan itself. In those situations where a creditor could increase the interest rate, customers would receive a 45 day advance notice. Customers could continue to use the credit card to incur debt for 45 days after this notice of the proposed rate increase, yet could subsequently opt out of an increased rate thereafter. This section also provides that credit card customers may cancel their cards without penalty at any time from the date they receive notice of the interest rate increase until the third periodic statement after the effective date of the increase is received. The customer would be permitted to repay the outstanding balance that existed before the effective date of the increase under the rate and terms in effect before notice was received.

Finally, section 2 would prohibit creditors from changing any term of the credit card agreement until renewal of the agreement, except for specific material reasons and subject to specific limitations contained in the agreement when the account is opened.

These provisions are complex, but their practical effect is to significantly restrict a credit card lender's ability to respond to increased credit and changing costs. For this reason, we have substantial supervisory concerns about the effect these provisions would have on prudent risk management practices. For example:

- A credit card lender's ability to price for changing risks presented by existing credit card debt that has not been repaid by a customer would be limited solely to circumstances in which the consumer has defaulted on the credit card account itself, and in no other circumstances – even if the customer in those other circumstances were provided with notice of the potential change and the opportunity to opt out of the change and close down the account under its old terms.
- In situations not involving a default on the card itself, a credit card lender could not use information highly relevant to its risk exposure to adjust its pricing for the risk of credit card debt that a customer has not repaid. Specifically, information about deterioration in a customer's creditworthiness,

such as defaults on other credit or deterioration of a credit score, is very relevant to a creditor's assessment of a consumer's credit risk. And, depending upon the severity of the credit risk, it also may justify a pricing adjustment on the account. But a credit card lender could not use this information – even with notice to the customer and with an opportunity for the customer to opt-out – to re-price existing account balances. The effect of this restriction is particularly severe when the existing balance is at the maximum credit limit on an account where credit risk has increased. In such cases, the creditor is left with limited risk mitigation options – to close the account or severely constrict any remaining available credit. However, this result may not be beneficial for or desired by many consumers.

- In addition to restricting a creditor's use of risk-based re-pricing, section 2 also could restrict a creditor's ability to use other risk mitigation tools, such as closing an account or reducing a credit line, even though these steps would be a prudent course in response to adverse changes involving the consumer's creditworthiness or other factors bearing on the lender's costs and risks. This is because circumstances in which a change in terms may be an appropriate response to increased credit risk cannot always be anticipated and specifically identified in a credit agreement at the time the account is opened.

Comptroller Dugan has advocated a principled, but different approach, which we believe is fundamentally fair to credit card customers and consistent with safe and sound credit card lending practices – credit card customers should be provided with advance notice and a right to opt out of certain changes in terms. Specifically, if a creditor seeks to increase the interest rate on an account to address increased credit risk due to a deterioration in a consumer's credit score or default on an account with another creditor, it must first provide the consumer with a reasonable advance notice and an opportunity to opt-out of the changed terms and to pay down the outstanding card balance in accordance with the existing terms. If the consumer opted out of the rate increase, the credit card lender could then mitigate the change in credit risk on that account by using other risk management tools, such as by closing the account to new transactions or reducing the credit line.

An opt-out structured in this manner would preserve the credit card lender's ability to monitor and respond to changes in a consumer's creditworthiness using all relevant information and available risk management tools, while recognizing that certain price adjustments should be preceded by advance notice and an opportunity for the customer to make alternative credit arrangements. It also would provide the customer with meaningful information at a critical point in time in advance of any rate increase, and it would provide the means for the customer to avoid any increased costs. With an opt-out, the customer would have the choice of declining the rate change and seeking a new credit card from another credit card lender, or agreeing to an increase in rates in order to retain use of the card.

By contrast, when a credit card customer defaults on his or her obligations under the terms of the credit card itself, the credit risk consequences are more direct and immediate, and, provided appropriate up front disclosure has been given, the customer should not be surprised when the credit card lender takes action to address this risk. Consequently, while we believe advance notice should be provided in these instances before increased rates become effective for existing and future balances, we do not favor a requirement that these customers be provided the right to opt out of a risk-based pricing adjustment that is based on the customer's repayment performance on the credit card itself.

Section 3(d): "Consumer Right to Reject Card Before Notice is Provided of Open Account." Section 3(d) would prohibit a credit card lender from furnishing any information to a consumer reporting agency before a credit card customer uses the card or activates the account. While this provision may be intended to address concerns about the impact of such reporting on a customer's credit score if the customer declines to accept the card, it also raises substantial risk management concerns. In evaluating the risk posed by a potential customer, it is important for a lender to know the credit lines the customer has available, and what has been used. Section 3(d) would effectively mask this information. Thus, for example, a customer could accumulate multiple, unactivated credit cards, which would be unreported – and unknown to the lenders assessing that customer's risk. The customer's real credit risk could be very different from what it appeared to be.

Provisions That May Have Unintended Consequences For Credit Availability And Costs

Other sections of the bill would prohibit or otherwise impose restrictions on particular credit card practices and fees. The issue here is not necessarily fundamental safety and soundness, but what the practical result of these changes would be – and whether limits on certain practices and charges would have unintended consequences that are detrimental to consumers in other respects. Careful consideration of these potential trade-offs are essential to evaluating the ultimate effect of these provisions H.R. 5244. This issue is illustrated by two provisions discussed below.[3]

Section 3(f): "Pro Rata Payment Allocations." Section 3(f) would require a pro rata allocation of payments among the outstanding balances accruing interest at different rates, with the largest balances receiving the greatest share of the payment. This provision responds to concerns that consumers may not understand how their payments on a credit card may be allocated to portions of their existing balance that carry different rates of interest, and that a creditor's payment allocation practices can increase the relative cost of using the account when it includes features that carry different rates. (For example, a customer's outstanding balance might include a portion reflecting a balance transfer bearing a very low rate, a portion with the regular account rate, and a portion with a typically higher rate for a cash advance.) The Federal Reserve Board has proposed to address these concerns through enhanced disclosures about the allocation of payments to balances subject to different interest rates, such as a lower promotional rate for balance transfers. Their Regulation Z proposal does not impose restrictions on how creditors must apply payments among balances subject to different interest rates.

Credit card lenders compete for new customers by offering temporarily low interest rates on balance transfers, and many consumers who receive meaningful disclosures can benefit – sometimes substantially – by lowering their borrowing costs when they transfer credit balances to a lower-cost account. If restrictions are imposed on

[3] Other such provisions are section 3(g), which would require that periodic statements be sent by the creditor to the consumer not less than 25 days before the payment due date, and section 4, which would regulate fees and practices relating to overlimit transactions.

payment allocation methods, instead of addressing these issues through enhanced consumer disclosures, the likely consequences will be reduced lender competition, fewer low-rate promotional programs that benefit customers, and changes to the way credit cards are priced – including the re-imposition of annual fees. These are examples of the trade-offs that should be considered in connection with requiring the approach to payment allocation that would be dictated by this section.

Section 3(a): "Double Cycle Billing Prohibited." As many observers have noted, some issuer practices that have prompted many customer complaints also may be so complex and difficult to explain that disclosures cannot adequately inform consumers so that they can avoid adverse effects of such practices. A frequently-cited example of such a practice is so-called "double-cycle billing." Double-cycle billing permits a creditor to compute the finance charge based on two billing cycles if a consumer, with no prior balance, makes only a partial payment of the balance by the payment due date. In effect, with double-cycle billing, the "grace period" for making payments without incurring a finance charge is retroactively eliminated.[4]

Section 3(a) would prohibit creditors from charging interest on any amount, even if less than payment of the full balance, if it would otherwise be subject to a grace period and is paid within that time period. While the heading on this provision indicates that it is intended to prohibit double-cycle billing, it would in fact apply much more broadly.

[4] To illustrate, if a consumer who made $1,000 in purchases in month one pays only $990 of the balance on the payment due date, $10 is carried over into the month two billing cycle. If the credit card issuer uses the double-cycle billing method and no new transactions are made in month two, finance charges on this account would be calculated taking the average daily balance of $1,000 in month one and $10 in month two, instead of calculating it on just the average daily balance of $10 in month two. U.S. Government Accountability Office Report No. 06-929, "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," at pp. 27-28 (Sept. 2006).

Section 3(a) would apply to, and limit the use of, the average daily balance method of computing interest on credit cards, which is one of the most common balance computation methods used.[5] In contrast to double-cycle billing, the average daily balance computation method generally has not been the source of consumer complaints.

Here again, if the average daily balance computation method ultimately is prohibited in addition to double-cycle billing, costs will increase and creditors will look for other sources of compensation. If prohibition of the average daily balance computation was not the intent, however, we would be pleased to provide the Subcommittee with technical comments on how the scope of section 3(a) could be revised to specifically target double-cycle billing.[6]

The Congress may make the determination that disclosures alone are not adequate to address consumer protection concerns about credit cards, and may conclude that it is appropriate to prohibit certain market practices. As noted at the outset of my testimony, this decision will involve weighing the benefits and consequences, or "trade-offs," of particular responses. When weighing the merits of such proposals, it is important to bear in mind that creditors may react to stringent new regulation by increasing the price of credit cards for all consumers and by reducing the type and amount of credit that is available. Also complicating the equation is the possibility that a severe reaction by card issuers to market restrictions could add stress to general consumer economic conditions.

[5] With the average daily balance method, a borrower that revolves the balance by not paying the entire amount due by the due date must pay interest charges that are computed by multiplying the average daily amount outstanding for that billing cycle (only) by the daily rate of interest. Section 3(a) would bar this because it provides that "the creditor may not impose or collect an interest charge on the portion of the credit that was repaid" within the specified grace period for the current cycle.

[6] *See, e.g.,* 12 CFR 226.5a(g)(2) (Regulation Z definition of "two-cycle average daily balance").

Finally, there is no doubt that the recent scrutiny of credit card practices by Congress and this Subcommittee in particular, and the debate over legislative and regulatory responses such as H.R. 5244 and the Federal Reserve Board proposal, have yielded positive results. Some practices that the bill targets – such as double-cycle billing – already have been largely eliminated by national bank credit card issuers. As described earlier in my testimony, better disclosure has multiple benefits – informed consumer choice, greater competition by lenders to provide consumers with the terms they want, and the benefits that flow from transparency. Enhanced transparency, aided by the spotlight of Congressional oversight, has prompted credit card lenders to change practices that were difficult to explain and defend. This hearing continues the valuable process of enhancing transparency as well as exploring the benefits and consequences of legislative responses.

CONCLUSION

Thank you, Chair Maloney, for the opportunity to testify on these issues. I will be happy to respond to any questions you might have.