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Re: Docket No. R–1314
Docket No. OTS–2008–0004
Proposed Changes to Regulation AA
Unfair or Deceptive Acts or Practices
73 *Federal Register* 28904, May 19, 2008

Dear Sir or Madam:

This letter provides comments of the undersigned concerning the Unfair or Deceptive Acts or Practices Proposed Rule (the "Proposed Rule") described above which was published by the Board of Governors of the Federal Reserve System (the "Board"), the Office of Thrift Supervision (the "OTS"), and the National Credit Union Administration (the "NCUA") in the *Federal Register* on May 19, 2008. We are partners in the law firm of Davenport, Evans,

Hurwitz & Smith, L.L.P., and our law firm represents various financial institutions regulated by the Board and the OTS, as well as a number of national banks and state-chartered non-member banks, that would be significantly impacted by the Proposed Rule. We are writing specifically with respect to the Proposed Rule's limitation on increasing rates on an account when a consumer has failed to make payment in accordance with the account terms.

I. Introduction and Summary of Our Prior Comments

The Board, the OTS, and the NCUA (collectively, the "Agencies") have proposed several new provisions intended to protect consumers against unfair or deceptive acts or practices with respect to consumer credit card accounts and overdraft services for deposit accounts. While we strongly support the Agencies' efforts to protect consumers against unfair or deceptive acts or practices, we believe adoption of the Proposed Rule would likely result in unintended consequences, including increased costs to consumers and decreased availability of credit. We further believe that the Agencies have failed to fully consider and adequately weigh the impact of the foregoing consequences.

In a letter dated November 5, 2007, our firm commented on the Advance Notice of Proposed Rulemaking (the "ANPR") on Unfair or Deceptive Acts or Practices, published by the OTS in the *Federal Register* on August 6th, 2007. As we stated in that letter, we do not believe it is necessary for the Agencies to adopt additional rules with respect to prohibitions against unfair or deceptive practices in the area of consumer credit where there are already extensive federal disclosure requirements in place to protect consumers, including the federal Truth-in-Lending Act and its implementing regulation, Regulation Z[1], and the OTS's Credit Practices Rule.[2] We further stated our belief that any additional guidance with respect to unfair and deceptive practices should be based upon a principles-based approach that could, as stated in the earlier ANPR, evolve as products, practices, and services change. We also stated our belief that it would be inappropriate to determine that additional acts or practices are unfair or deceptive *per se* regardless of the specific facts or circumstances. As recognized in the earlier ANPR, no lists of acts or practices could ever be complete or current. In addition, such a list could not evolve (as could a principles-based approach) as credit products, practices, and services change.

II. The ability to apply penalty rates is a major component of risk-based credit pricing, and the inability to do so will likely result in higher borrowing costs to consumers and a reduction in available credit.

Creditors need the flexibility to immediately impose increased rates on cardholders who fail to pay in accordance with account terms. These so-called "penalty rates" encourage cardholders to pay on time and protect creditors from higher-risk consumers. The inability to impose penalty rates will adversely impact all consumers and will have a negative impact on the economy.

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[1] See generally 15 U.S.C. § 1601 (2007); 12 C.F.R. § 226 (2007).

For the various reasons stated in our earlier letter, we continue to believe it is unnecessary for the Agencies to adopt additional rules with respect to prohibitions against unfair or deceptive practices. However, our comments in this letter are addressed only to the Agencies' proposal to prohibit the application of increased rates to outstanding balances, particularly the prohibition on increased rates unless the cardholder is at least 30 days past due. We would strongly urge the Agencies to reconsider this prohibition as it prevents creditors from adequately pricing an account based upon the risk posed by the consumer and because the prohibition will have a negative impact on all consumers, including those who always make their credit card payments on time.

The Proposed Rule would prohibit institutions from increasing the annual percentage rate applicable to any outstanding balance on a consumer credit card account, except under certain enumerated circumstances. The term "outstanding balance" is defined in the Proposed Rule as the amount owed on a consumer credit card account at the end of the fourteenth day after the institution provides the 45-day notice required by the Truth in Lending Proposed Rule published by the Board in the *Federal Register* on June 14, 2007. Accordingly, the balance to which an institution could not apply an increased rate is the account balance 14 days after the institution has provided the 45-day notice.

The Proposed Rule provides that an institution may apply an increased annual percentage rate to an outstanding balance in three instances, including when the consumer's minimum payment has not been received within 30 days after the due date. We strongly believe that a creditor's ability to increase rates on outstanding balances when the cardholder is delinquent with respect to payment is essential to prevent the cardholder from becoming further delinquent and eventually going into default with respect to the account. The ability to increase rates in a timely manner in such circumstances is also essential to protect the creditor from a higher-risk consumer.

Penalty rates imposed once a consumer becomes delinquent result in more responsible consumer behavior in several ways. The cardholder who knows that his or her interest rate will immediately increase if he or she does not make a timely payment in accordance with the cardholder agreement is more likely to make such payment in order to avoid the increase. This is critical because, as discussed below, the likelihood that a consumer will default significantly increases once the consumer becomes delinquent and default becomes ever more likely as the length of the delinquency increases. Further, if a penalty rate is immediately imposed due to the cardholder's failure to make timely payment, the economically rational response on the part of the cardholder would be to make timely payments going forward, in order to again achieve a lower periodic rate. By the same token, the inability of a creditor to immediately impose a penalty rate when a cardholder fails to make timely payments is likely to delay the cardholder's

resumption of prompt payments and may well lead to the cardholder's eventual default.[3] Increased interest rates based on a consumer's delinquency are intended to protect credit card issuers from potential losses by charging higher interest rates to those consumers with higher risk profiles. In general, creditors typically impose a higher cost of credit on consumers who represent a greater risk of nonpayment. It is doubtful that there is any better predictor of a consumer's performance on a particular account than his or her performance to date on such account. Experience has shown that a consumer's failure to make timely payments in accordance with the credit card account agreement is one of the strongest indicators that a consumer's account is at risk of eventually being charged off by the creditor as a loss. Our experience with various credit card issuers has shown that the likelihood of eventual charge off has a very high correlation to the length of the delinquency.

Prohibiting a creditor from imposing an increased rate on the consumer until the consumer is 30 days past due will lead to negative performance on the part of the consumer and will result in a higher risk that the cardholder will not make further payments on the account. A creditor should therefore be able to impose an increased rate on all outstanding balances immediately upon the consumer's delinquency and should not be forced to provide the consumer with an additional 30-day period in which to make a payment that was already contractually due.[4]

An increased rate due to delinquency is triggered by actual borrower behavior and provides issuers with greater flexibility in pricing credit terms than relying on initial interest rates alone. The initial interest rate imposed on an account is generally an *ex ante* (i.e., before the fact) estimate of a given borrower's likelihood of default. A penalty rate, by contrast, is more closely tied to the borrower's exhibited risky behavior. There is no equally effective way to price for risk with respect to cardholders who become delinquent in account payments. It has been suggested, for example, that creditors may simply decrease the credit line if a cardholder

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[3] We would note that the summary of the Federal Reserve Board's May 6, 2008, meeting with representatives of the American Bankers Association and several large credit card issuers, including Bank of America and Citibank, would indicate that industry representatives agree with the proposition that penalty rates have a positive impact on cardholder behavior. See DOCKET NO. R-1314: MEETING AT THE FEDERAL RESERVE BOARD (May 6, 2008), http://www.federalreserve.gov/SECRS/2008/May/20080513/R-1314/R-1314_67_1.pdf. The summary of the meeting indicates that industry representatives made the point that increasing the interest rate for consumers does not lead to higher defaults, but instead causes some consumers to charge less and pay off indebtedness faster.

[4] The practice of increasing an interest rate due to the greater likelihood of default is similar to using credit-based insurance scores to predict risk under automobile insurance policies. In the insurance industry, these scores predict both the number of claims that consumers are likely to file and the total cost of those claims to the insurance company. The use of effective risk prediction techniques in the insurance industry, including credit-based insurance scores, decreases premiums for consumers with less risky credit based scores and increases premiums for consumers with risky credit-based scores. For example, the Federal Trade Commission ("FTC") conducted a study in which it found that if credit-based insurance scores are used, 59% of consumers in the FTC's database were predicted to have their premiums decrease while only 41% of them were predicted to have their premiums increase. See PREPARED STATEMENT OF THE FEDERAL TRADE COMMISSION, CREDIT-BASED INSURANCE SCORES: ARE THEY FAIR? 6 (Oct. 2, 2007), http://www.house.gov/apps/list/hearing/financialsvcs_dem/rosch_testimony.pdf.

becomes delinquent. While this would protect the creditor with respect to future extensions of credit, it does nothing to protect the creditor with respect to amounts already outstanding. In addition, using credit line decreases as a risk mitigation tool would not be effective for those cardholders whose balances are already very close to or even exceed their credit limit, which is often the case for cardholders who have missed a payment.

The proposed limitation on the timing of the imposition of penalty rates will likely have serious unintended consequences that will not benefit consumers and will instead have a negative effect on all consumers, especially low-income consumers who may represent a higher credit risk but still have a need for credit. Individual risk-based pricing allows a credit card issuer to offer credit cards with lower rates to lower-risk cardholders while still providing credit cards at higher rates to higher-risk consumers who otherwise might be unable to obtain credit. Further, because penalty rates imposed by credit card issuers are generally tied to consumer credit risk, such fees have an offsetting effect on initial interest rates, i.e., the ability of the credit card issuer to cover risk by means of penalty rates reduces the need for the issuer to further increase the initial interest rate on an account. Thus, any limitation on penalty rates would almost certainly lead to increased interest rates for all consumers, or other offsetting adjustments in credit contract terms. Not only will limiting such credit card pricing practices curtail credit to high-risk borrowers, such limitations will also adversely affect consumers with good credit performance. These latter consumers will face more rigid, higher pricing structures due to the need of credit card issuers to cover credit losses that were formerly covered in part by penalty rates.

III. The increase in borrowing costs and the reduction in available credit resulting from the proposed limitation on penalty rates will be significant, and the rulemaking record presented for this proposed limitation does not indicate that any benefit from this proposed limitation will exceed the costs associated with it.

The adverse economic impact of the proposed limitation on penalty rates will be significant. The increased costs to credit card issuers and the resulting increased costs to consumers will have a negative effect on the entire economy. The Agencies should perform an economic analysis as to the impact of the proposed limitation prior to taking further action.

It is standard practice for issuers to determine front-end underwriting criteria and cut-offs based upon expected revenues and expenses, including credit losses over the life of a tranche of accounts. These financial models use several input metrics, including net interest margin, fee yield, credit losses, servicing expenses including marketing costs, account churn rate, and discount rate.

Specifically with regard to net interest margin, due to account seasoning in a given tranche, the interest margin typically increases over time as accounts default and enter penalty pricing (with all other factors being constant). As such the effective interest yield over the life of the tranche is generally higher than the nominal yield. As an example, even though a tranche

may have a nominal interest yield of 9.5%, the average balance-weighted interest yield may exhibit the trend shown in the table below:

Interest Yield					
Metric	Year 1	Year 2	Year 3	Year 4	Average
% of Bal. in Penalty Pricing @24%	3.0%	10.0%	15.0%	15.0%	
% of Peak Balances Remaining	100%	90%	80%	70%	
Nominal Interest Yield	9.5%	9.5%	9.5%	9.5%	
Effective Interest Yield	9.9%	11.0%	11.7%	11.7%	11.0%

Additionally, the proportion of accounts that default or enter penalty pricing in a given tranche typically also varies by the upfront risk profile. For example, while perhaps 20% of the accounts with an upfront FICO of 650 - 679 may enter penalty pricing over the life of that cohort, perhaps only 10% of the accounts with an upfront FICO of 700 - 749 may enter penalty pricing over the life of that cohort. As a result, the profit and loss by FICO score band may look like the following[5]:

With Penalty Pricing					
Metric	650 - 679	680 - 699	700 - 749	750 +	Total
% of Total O/S	30.0%	25.0%	25.0%	20.0%	100.0%
% of Bal. in Penalty Pricing	20.0%	15.0%	10.0%	7.5%	
Revenues					
Interest Yield	13.3%	12.1%	10.9%	10.0%	11.7%
Non-Interest Yield	6.5%	6.5%	6.5%	6.5%	6.5%
Total Revenues	19.8%	18.6%	17.4%	16.5%	18.2%
Expenses					
Cost of Funds	4.0%	4.0%	4.0%	4.0%	4.0%
Charge-offs	7.0%	4.5%	3.0%	2.0%	4.4%
Operations/Marketing/Fraud	6.0%	5.7%	5.3%	5.0%	5.6%
Total Expenses	17.0%	14.2%	12.3%	11.0%	14.0%
ROA					
Pre-Tax ROA	2.8%	4.4%	5.1%	5.5%	4.3%
Taxes (@ 35%)	1.0%	1.5%	1.8%	1.9%	1.5%
After-Tax Profit / ROA	1.8%	2.9%	3.3%	3.6%	2.8%

Note that in this illustrative example, while the overall portfolio is profitable, profitability varies significantly by the upfront FICO score bands due to varying loss and revenue performance. If the ability to reprice accounts to penalty rates were to be restricted in the above example, the profit and loss by FICO score band may look like the following[6]:

Numbers are illustrative only and may not represent the actual performance by FICO score bands.
Numbers are illustrative only and may not represent the actual performance by FICO score bands.

Without Penalty Pricing					
Metric	650 - 679	680 - 699	700 - 749	750 +	Total
% of Total O/S	30.0%	25.0%	25.0%	20.0%	100.0%
% of Bal. in Penalty Pricing	0.0%	0.0%	0.0%	0.0%	
Revenues					
Interest Yield	10.6%	10.0%	9.4%	8.8%	9.8%
Non-Interest Yield	6.5%	6.5%	6.5%	6.5%	6.5%
Total Revenues	17.1%	16.5%	15.9%	15.3%	16.3%
Expenses					
Cost of Funds	4.0%	4.0%	4.0%	4.0%	4.0%
Charge-offs	7.0%	4.5%	3.0%	2.0%	4.4%
Operations/Marketing/Fraud	6.0%	5.7%	5.3%	5.0%	5.6%
Total Expenses	17.0%	14.2%	12.3%	11.0%	14.0%
ROA					
Pre-Tax ROA	0.1%	2.3%	3.6%	4.3%	2.4%
Taxes (@ 35%)	0.0%	0.8%	1.3%	1.5%	0.8%
After-Tax Profit / ROA	**0.1%**	**1.5%**	**2.3%**	**2.8%**	**1.6%**

As illustrated by the above graph, the restriction on penalty rates results in a decline in the overall profitability of the portfolio assuming all other factors remain constant. One of the potential actions that card issuers are likely to take in response in this type of a scenario would be to increase interest rates across the whole portfolio by, for example, 2.5% to recapture the loss interest revenue of nearly 2.0% (assuming an 80% balance revolve rate).

Also, while the 650 – 679 FICO score band was relatively profitable with penalty pricing, these accounts become unprofitable without the ability to impose the increased rate. In such a restrictive environment, it would not be profitable for card issuers to solicit and offer credit to consumers in the FICO score band 650 – 679. The chart below shows the national distribution of FICO scores[7] from Experian's National Consumer Database and shows that there are almost 13 million consumers that have a FICO score between 650 and 679:

[7] Source: Experian National Consumer Database (Orion File), June 2008

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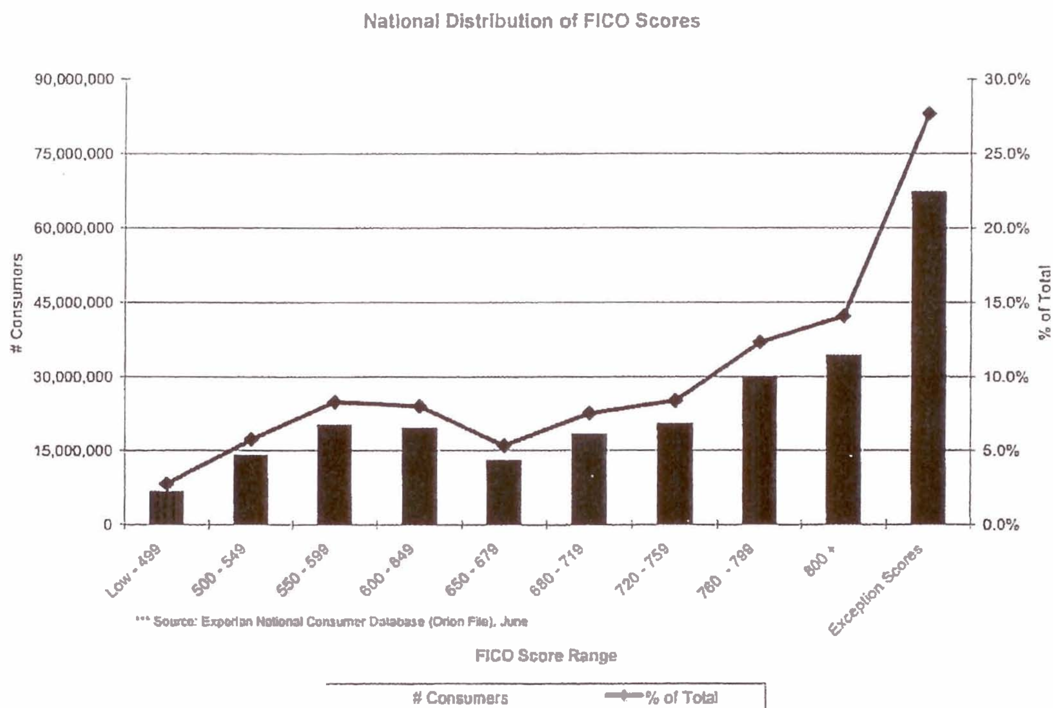

Thus, if credit card issuers respond to the proposed restriction by not soliciting consumers with FICO scores between 650 and 679, the result would be to severely limit access to credit for those nearly 13 million consumers.

The foregoing would indicate that the proposed change limiting creditors' ability to impose increased rates could have a significant negative impact on a large segment of individual consumers. While the Agencies state that they have considered these effects and believe that the benefits of the Proposed Rule will outweigh the costs in the form of curtailed credit opportunities for millions of higher-risk credit card consumers or higher interest rates for available credit, the Agencies have produced no detailed analysis that estimates the number of consumers who will no longer have access to credit cards or how much more all consumers should expect to pay for credit. In addition, we are not aware of any detailed analysis from the Agencies showing the social and economic costs that those higher-risk consumers will bear as they are forced to turn to payday and car title lenders, pawn shops, or even less-regulated sources of short-term credit. Nor have the Agencies shared with the public any analysis as to the macroeconomic impact of this credit curtailment on the U.S. economy, which currently appears to be poised quite precariously at the edge of recession, if not already in one.

The Agencies appear to recognize that certain features of the Proposed Rule may increase the overall cost of credit, as well as limiting access to credit for some portion of the population. Further, the Agencies appear to find this an acceptable trade-off for eliminating certain practices

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o securitize credit card assets in the future. Due to the risk- based pricing restrictions in the Proposed Rule, traditional investors in credit card securitizations will be less able to rely on the iistoric performance of credit card portfolios. This reduced ability to rely on historic erformance will introduce greater uncertainty into the securitization process leading to higher osts to both issuers and consumers. Because of greater uncertainty in the securitization process ind increased costs to securitizing issuers from the Proposed Rule, it may also result in a eduction in credit card securitizations, which up until this point has been a stable and liquid narket. A reduction in credit card securitizations would likely result not only in higher costs to onsumers but also in decreased funds for operations and, ultimately, diminished credit vailability for consumers.

The issues with the respect to the restrictions on imposing an increased rate on consumers vho have failed to make payment in accordance with the cardholder agreement is exacerbated by he proposed revisions to the change-in-terms requirements of Regulation Z. The Board has roposed that Regulation Z Section 226.9 be revised to provide that cardholders must be given 5 days notice with respect to an increase in rates due to the failure to make a payment. This 45-lay notice requirement would mean that the higher rate should be applied to balances after the xpiration of the notice period, which would occur during the next billing cycle. However, credit ard processing systems may currently not be able to apply higher rates in that way during the niddle of billing cycle. To accommodate this notice requirement would result in significant osts for system programming changes, which most likely would need to be passed on to the onsumer. In the alternative, absent programming changes, the 45-day notice requirement would ffectively become a 60-day notice requirement, which means that the higher rate could not be harged on balances until after the next billing cycle ended. Having to wait more than 60 days to icrease interest rates if the account has been delinquent would significantly increase the credit isk to the issuer as the odds of a cardholder that far into delinquency making future payments ecreases significantly.

We would also note that the 45-day notice requirement is likely to be inconsistent with, nd result in preemption of, various state laws regarding change-in-terms requirements. South Dakota, for example, requires that cardholders be given a 30-day advance notice of any change. 1 the alternative, under South Dakota law, issuers may provide notice of the change by the ffective date and provide cardholders a 25-day period to opt-out of such change. The etermination made by any state, such as South Dakota, with respect to the appropriate timing of change-in-terms notice will now be preempted by the Regulation Z requirement. The reemptive effect relating to this change is not discussed by the Agencies in the Proposed Rule, or by the Board in connection with its proposed Regulation Z changes. The record is icomplete on this point since the Agencies have failed to establish the reasons why state law iould be preempted.

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In closing, we would again commend the Agencies on their efforts to protect consumers gainst unfair or deceptive practices. However, for the reasons discussed in detail above, we rongly disagree with the proposed limitations on a creditor card issuer's ability to impose rate