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CorTrust Bank

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August 4, 2008

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Regulation Comments, Chief Counsel's Office
Office of Thrift Supervision
ATTN: OTS–2008–0004
1700 G Street, NW
Washington, DC 20552

Mary Rupp, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314–3428

Re: Docket No. R–1314
OTS–2008–0004
RIN 3133–AD47
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 CorTrust Bank, N.A. 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. In particular, we are writing to comment on the proposed prohibitions and limitations on financing fees for the issuance or availability of credit if such fees utilize the majority of available credit on the account.

CorTrust Bank, N.A. ("CorTrust Bank") is a nationally chartered community bank with its main office located in Mitchell, South Dakota. CorTrust Bank originated as Live Stock State Bank in Artesian, South Dakota, in the late 1930s. CorTrust Bank moved its charter to Mitchell in 1977 and in 1993 changed its name to CorTrust Bank. The Bank now has 23 branches in 16 eastern South Dakota communities, with an asset size in excess of $500 million and over 200 employees. The primary ownership of CorTrust Bank has been in the Hopkins family for nearly 50 years.

CorTrust Bank began its prime credit card business in 1988 and entered the subprime credit card business in late 1992. We have approximately 2,100 prime credit card accounts, mainly in our local trade territory, and we currently have over 190,000 nationwide subprime credit card accounts. CorTrust Bank retains all of its credit card receivables.

The Board, the OTS, and the NCUA (collectively, the "Agencies") have proposed a number of new provisions intended to protect consumers against certain credit card practices that the Agencies have determined to be unfair. While we commend the Agencies' efforts to protect consumers against unfair or deceptive acts or practices, we believe that many of the practices outlined in the Proposed Rule do not constitute unfair or deceptive acts or practices. We also believe that adoption of the Proposed Rule, particularly the limitation on fees changed at account opening, would likely have a significant and negative impact on individual consumers and the economy as a whole, and that there are much less restrictive methods to protect consumers that would not result in such harsh economic consequences. Further, we strongly urge the Agencies to conduct additional economic analysis with respect to the proposal prior to taking further action.

Proposed Rule Regarding Security Deposits and Fees for the Issuance or Availability of Credit

The Proposed Rule would prohibit institutions from financing security deposits and fees for the issuance or availability of credit during the12 months following account opening if, in the aggregate, those fees constitute more than half of the initial credit limit. The term "fees for the issuance or availability of credit" is defined to include any annual or other periodic fee, any fee based on account activity or inactivity, and any non-periodic fee that relates to opening an account. The "initial credit limit" is defined as the limit in effect when the account is opened. The Proposed Rule would also prohibit institutions from charging to the account during the first billing cycle security deposits and fees for the issuance or availability of credit that, in the aggregate, constitute more than 25% of the initial credit limit. Under the Proposed Rule, any additional security deposits and fees must be spread equally among the 11 billing cycles following the first billing cycle.

Analysis of Consumer Injury

In discussing the Proposed Rule, the Agencies state, in a conclusory fashion without any empirical support, that "[c]onsumers incur substantial monetary injury when security deposits and fees for the issuance or availability of credit are charged to a consumer credit card account, both in the form of the charges themselves and in the form of interest on those charges." The Agencies further state that such security deposits and fees "diminish the value of that account by reducing the credit available to the consumer for purchases or other transactions."

The Agencies' analysis states the obvious – that security deposits and fees reduce available credit – but then makes an unsupported leap to conclude that this represents a "substantial monetary injury" to the consumer. The Agencies' apparently base this conclusion on the erroneous assumption that if security deposits or fees were reduced or eliminated, the

consumers who qualify only for this type of subprime credit product would receive credit on more favorable terms. This ignores the economic realities of the marketplace and the fact that the degree of credit risk in extending credit to a particular consumer should affect the terms of credit being offered.

The reality is the credit card industry is intensely competitive and consumers with stellar credit records and demonstrated ability to repay qualify on the most favorable terms, while consumers who have less established credit or poor credit histories receive offers of credit commensurate with their credit histories and current repayment abilities. To the extent that the marketplace dictates the pricing of credit based upon past credit history, those consumers with poor credit histories will find it more costly to obtain a credit card, if they choose to do so. However, as discussed later in this letter, the benefits of choosing to obtain ever a high fee credit card are clear, including the ability to establish or re-establish one's credit rating and the ability to participate in many fundamental transactions that in today's economy can only be done with a credit card, such as car rentals, hotel reservations, and online purchase transactions.

Another significant factor that the Agencies' appear to ignore in their unfairness analysis is the extremely high cost incurred by issuers in connection with subprime accounts. A cost imposed on a cardholder that is based upon the costs incurred by the credit card issuer as a result of issuing the card is not properly characterized as an injury.

CorTrust Bank is fortunate to have both prime and subprime credit card portfolios, which places us in a unique position to compare the opportunities, risks, and costs of both businesses.[1] The differences between these portfolios are many and profound, some obvious, some not so obvious. However, as discussed in detail below, the overriding difference is that the subprime portfolio is much higher risk and has much higher costs, thereby justifying the higher fee structure applied to these cardholders.

Low limit credit cards are simply more expensive than prime credit cards to issue and maintain. These increased expenses include higher reserve requirements and higher operational expenses. The reserve for loan losses is substantially higher for a subprime portfolio. Generally, a bank will have a loan loss reserve of about 1% of its regular loans, while a prime credit card issuer will have a loan loss reserve of about 3% to 6% of its loans (depending upon the credit quality of accounts). A subprime credit card portfolio, however, will generally establish a loan loss reserve of 30% to 50% of its loans. This means that the loan loss reserve for a $100 million prime credit card portfolio would be approximately $3 million to $6 million, whereas the loan loss reserve on a $100 million subprime credit card portfolio would be closer to $30 million to $50 million.

Low limit credit cards are also much more expensive to maintain. For instance, CorTrust Bank's subprime customers are responsible for five times as many hits on our website as are our

[1] We would note that our prime portfolio is small and many cardholders in the portfolio are local bank customers with relatively low credit limits.

prime customers. Because costs are assessed per hit, it is approximately five times more expensive for us to service subprime customers than prime customers via our website. The increased cost to service and maintain subprime accounts can be observed in other areas as well, including our non-dialer outbound call traffic, which averages one and a half calls per month for subprime customers, is 400 times greater than our prime customers; our non-automated voice response inbound call volume for prime is so low that we do not even track it. However, for our subprime customers it averages about one call per month per cardholder. Collection correspondence for subprime is about .3 letters per month which is approximately 80 times higher than for our prime customers.

Another important consideration in pricing subprime cards is the higher level of delinquency rates as compared to prime portfolios. In our prime portfolio, the overall delinquency rate is approximately 3.5%. However, in our subprime portfolio, the delinquency rate is approximately 35%. Creditors must be permitted to price subprime credit cards in a manner that compensates the creditor for this significant increase in risk.

Consumer's Ability to Avoid Purported Injury

Again in a conclusory fashion, the Proposed Rule declares that consumers are not able to avoid the "injury" caused by financing security deposits and fees. Again, this assumes, without foundation, that these costs of credit are "injuries" suffered by a consumer and not simply the realities of the free market system. Despite the Agencies' assertion that the consumer cannot avoid the purported injury, a consumer who does not wish to pay the costs associated with a subprime credit card may freely choose not to apply for or use a credit card, or may seek credit on terms which he or she finds more favorable. We would note, however, that obtaining credit through sources other than financial institutions will likely be both more costly and less protected than obtaining credit from a financial institution, and the Agencies should consider this in their "injury" analysis.

If the proposed restriction on fees is adopted, there are unfortunately a vast number of unregulated lenders who would be more than willing to step in and meet the credit needs of the subprime population. An internet search under the terms "bad credit" and "cash loans" identifies over 440,000 results offering cash loans notwithstanding bad credit. Similarly, a search under the terms "no credit check" results in approximately 1,080,000 listings with respect to potential lenders. A consumer simply seeking a "cash loan" without any limiting criteria such as "no credit check" or "bad credit" would generate a listing of approximately 3,730,000 results offering loan products, and those listed are overwhelmingly not federally regulated lenders. Utilizing the search "money to lend" discloses approximately 2,400,000 results. A review of the listings also indicates that relatively few if any of these sources are federally regulated or federally insured lenders. A representative listing of potential "bad credit" lenders range from payday loan stores, internet-based lenders, local finance companies, and even private individuals offering loans over the internet.

Another important consideration in determining if the injury is unavoidable in the current context is whether the fees in question must be paid by the consumer if he or she determines not to retain or use the credit card product. CorTrust Bank permits consumers to receive a full refund of any fees paid, and a credit with respect to any fees charged to the account, if the consumer requests that the account be cancelled prior to using the credit card. We believe that most financial institutions have a similar refund policy. Further, CorTrust Bank supports the Board's proposed amendment to Regulation Z with respect to account opening disclosures, which amendment includes a provision that would require an additional disclosure to inform consumers about their right to reject a plan when fees have been charged and the consumer receives account opening disclosures but has not used the account or paid a fee after receiving a billing statement. This new disclosure would highlight to consumers their ability to obtain a refund if they are uncomfortable or displeased with the credit card's fees after having more time to consider such fees.

In discussing consumers' ability to avoid the purported injury, the Agencies reference protecting consumers from "deceptive sales practices [that] mislead consumers about the amount of credit available." This rationale, however, offers no support for whether the particular practice in question is unfair. CorTrust Bank certainly does not condone the use of deceptive sale practices, and we do not believe other financial institutions would do so either. If there are issuers or marketers engaging in such practices, the remedy is not to deprive the entire subprime credit population of the option of obtaining a bank-issued credit card. Instead, regulators should focus on the offenders, not the compliant financial institutions. This is particularly true in light of the Board's proposed changes to Regulation Z. As mentioned earlier and as discussed in detail later in this letter, we believe such changes provide consumers with useful information that will sufficiently address the various issues identified with respect to subprime credit cards.

Weighing the Countervailing Benefits

The Agencies have decided for consumers that "the benefit to consumers from access to available credit is outweighed by the high costs of paying for that credit." This determination on the consumer's behalf was made without the benefit of any supporting economic analysis. We believe that if the regulators recognized and properly weighted the "benefits to consumers" from relatively high-fee credit cards, the benefits of such cards to individual consumers and the overall economy would by far outweigh any alleged injury caused by the existing fee structure on such cards.

The Agencies completely ignore any benefits experienced by consumers with respect to subprime credit cards. Despite the Agencies' stance, however, we believe that the credit cards in question are indeed valuable to individuals who do not have access to traditional forms of credit. The banking community has been charged with serving the "unbanked and under-banked." These individuals are often struggling to improve their credit standing or have little to no credit history. This group includes, for example, low-income individuals, members of ethnic groups who are culturally uncomfortable with debt, and new legal immigrants. The banking community is currently able to serve these individuals by providing low limit credit cards which, in many

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cases, serve as the only tool available to assist these individuals and their families in entering the credit market or in recovering from a financial emergency and restoring credit.

Even the courts have recognized the value of low limit credit card products. For example, in Perry v. First National Bank, the 7th Circuit Federal Court of Appeals stated:

> We recognize that [the Bank's] credit solicitation requires card holders to pay a significant amount of money in fees, which are quite high in relation to the credit line offered. We realize that this is not an attractive deal for the great majority of consumers. However, the card is not without value. If the credit card holder paid off the card each month, the card would allow him or her to make almost $3,000.00 in purchases in one year. The credit card holder would also build up a credit rating, which is useful to individuals who are trying to establish credit for the first time or to reestablish good credit. [2]

Our experience and research has shown that the benefits of low limit credit cards vastly outweigh any potential risk to consumers. Low limit credit cards provide vital financial assistance to consumers encountering emergency situations or unforeseen circumstances, such as medical expenses, loss of a job, or divorce. Further, low limit credit cards allow consumers to participate in many of the most basic consumer transactions, including purchasing goods or services over the internet, renting a car, and booking a hotel room.

Low limit credit cards also serve as an important tool for establishing or re-establishing a good credit history. A study of subprime accounts performed by TransUnion and submitted as part of Dr. Michael Turner's comment letter to the Agencies on behalf of PERC/Information Policy Institute demonstrated that a consumer's low limit credit card can, in fact, assist the consumer in improving his or her credit score, and in turn, his or her access to additional credit.[3] The TransUnion study analyzed 365,000 accounts for the period beginning in December 2005 and ending in January 2008. One component of the study was an analysis as to the change in a cardholder's VantageScore, a predictor of the likelihood that the consumer will become 90 or more days delinquent during the next 24 months. In general, an increase in a consumer's VantageScore correlates to an increased access to credit. The study also looked at the number of new bank-issued tradelines acquired by each cardholder and the number of non-subprime promotional offers made to such cardholders within the 12-month period from January 2007 to January 2008. Both of these latter attributes are indicators of a consumer's access to traditional forms of credit with traditional pricing structures.

During the period from December 2005 to January 2008, approximately 35% of the cardholders experienced an increase in their VantageScore, while over 17% of the cardholders

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[2] 459 F.3d 816, 825 (7th Cir. 2006).

[3] The data analyzed by TransUnion was provided by two financial institutions that issue subprime credit cards and by two companies that market and service subprime credit cards.

experienced a VantageScore increase of 40 or more points.[4] Nearly 20% of the cardholders with a subprime VantageScore in December 2005 increased their score to near-prime, prime, or super-prime by January 2008. In addition, over 11,000 cardholders who were unscoreable in December 2005 had a valid VantageScore in January 2008. These statistics illustrate that low limit, high fee credit card products provide a viable means by which consumers can improve their credit rating.

The study also showed that improved credit scores resulted in additional access to credit. Over the 12-month period from January 2007 to January 2008, 14% of the cardholders with an improved VantageScore opened at least one bank-issued credit card account with a credit limit of $1,000 to $2,499, another 14 % of the cardholders with an improved VantageScore opened at least one bank-issued credit card account with a credit limit of $2,500 or above, and over 58% of the cardholders with an improved VantageScore received at least one promotional offer of credit from a non-subprime lender.[5]

The foregoing illustrates the strong correlation between an improved credit rating and access to credit, especially credit on more traditional, non-subprime terms. The proposed restriction on low limit, high fee accounts will most likely significantly limit the options by which a high-credit-risk consumer can enter or re-enter the credit market and, in turn, with good performance gain access to both additional and more affordable credit.

The proposed limitation on up-front fees charged in connection with a subprime credit card will have serious adverse economic consequences for high-credit-risk consumers. The inability to access credit could severely limit the ability of such consumers to withstand any downturn in the economy. Although the Agencies appear to acknowledge that the proposed limitations will result in decreased credit availability for subprime consumers, the Agencies have apparently conducted no analysis as to the true impact of such limitations on individual consumers or on the economy as a whole.

The only one of the Agencies to even mention the number of impacted consumers was the OTS, which commented that "[s]ubprime credit cards represent just 5% of all credit cards issued." The reality is, however, that the subprime credit card market is comprised of almost 13 million consumers,[6] and the proposed limitations are likely to have a significant negative impact on these consumers.

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[4] VantageScore shifts of 40 or more points are considered significant.

[5] Of the cardholders with an improved VantageScore, 3.6% opened two or more bank-issued credit card accounts with a credit limit of $1,000 to $2,499, another 4.4% of such cardholders opened two or more bank-issued credit card accounts with a credit limit of $2,500 or above, 25% of such cardholders received between one to 10 promotional offers of credit from non-subprime lenders, and 33% received 11 or more promotional offers of credit from non-subprime lenders. When the test population as a whole is considered, over the 12-month period from January 2007 to January 2008, over 10% of such cardholders opened at least one bank-issued credit card account with a credit limit of $1,000 to $2,499, another 9% of such cardholders opened at least one bank-issued credit card account with a credit limit of $2,500 or above, and over 50% of such cardholders received at least one non-subprime promotional offer of credit.

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

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Further, the effect of the proposed limitations will go well beyond subprime consumers. The diminished access to credit by subprime consumers will curb consumer spending by this segment of the economy. This diminished consumer liquidity and resulting decreased spending will impact not only those consumers whose access to credit has been curtailed, but also the various merchants and individuals with whom such consumers would have conducted credit transactions, which merchants and individuals will then have fewer dollars to spend, and so on. Thus, adoption of the proposed limitations is likely to adversely affect the entire economy.

In fact, one investment firm has stated that the proposed restrictions under the Proposed Rule will strip liquidity out of the system and that the harm to the economy due to the proposed restrictions will be at least commensurate with any derived benefit.[7] This firm's report also stated as follows with respect to the impact of the Proposed Rule's restrictions on credit card default rates and overall consumer liquidity:

> Without a doubt, we believe the profitability of credit card lending will decline meaningfully, but we also believe lower liquidity will drive higher consumer defaults across all consumer loan product buckets.
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> . . . .
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> As a result of the proposed regulatory changes, we believe deteriorating economics from the lenders will cause said lenders to pull over $2 trillion in outstanding [credit card] lines by 2010. In other words, we expect available consumer liquidity in the form of credit card lines to decline by 45% by 2010.[8]

The foregoing would indicate that while the Agencies are apparently unconcerned about the economic impact of the Proposed Rule's restrictions, industry analysts predict that the adverse impact of such restrictions will be quite severe.

Because millions of consumers will experience a direct negative impact due to the proposed limitations on charging fees to a credit card account, and because the impact to the overall economy could be dire, we believe the Agencies must conduct further research as to the true costs of the proposed restrictions before adopting and implementing such restrictions.

We particularly do not understand the "fairness" distinction between fees charged to the card and fees paid from separate funds. If a consumer was in a position to make a separate payment for any up-front fees imposed in connection with the card, then he or she could also immediately pay any up-front fees charged to the card. The end result (and any accompanying benefit and injury) to the consumer would be identical, i.e. the cost of the card would be the same and the available credit after payment would be the same. The obvious issue, however, is

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[7] Oppenheimer, "Far From Over: We Believe The Credit Crisis Will Extend Far Into 2009," Industry Update: US Banks, 10 (May 2008).

that few consumers in the subprime market have saved funds in a manner that permits them to make cash payment of fees. The ability to charge fees to the card, which has the same economic result, permits the consumer to more quickly enter or reenter the credit market and enjoy the economic and social benefits of a credit card account while establishing or re-establishing his or her credit record.

Regulation Z Disclosures Sufficient to Address Fairness Concerns

It is important to note that the Board's proposed changes to Regulation Z will significantly enhance the consumer's ability to make an informed decision with respect to a particular credit product. CorTrust Bank believes that the proposed Regulation Z changes greatly improve a consumer's ability to understand and weigh the desirability of the fees associated with a low limit, relatively high fee credit card product, and that such changes are sufficient to protect consumers from the concerns raised with respect to such credit card products. With respect to the subprime products in question, the amount of the credit limit, the total and itemized amount of all fees for the issuance or availability of credit, and the amount of available credit after such fees, are important to the consumer's understanding of the costs of the account. Each of the foregoing is specifically addressed in the Board's recommended revisions to Regulation Z. Further, the Board's proposed changes provide that these disclosures will be provided not only in connection with solicitations and applications, but also again at account opening.

As discussed earlier, the proposed revisions also provide greater details as to refunds. Both the ability to obtain the refund, and a full disclosure as to the refund, are important to the consumer's evaluation of the desirability of the subprime account.

Again, CorTrust Bank believes these added disclosures will significantly improve a consumer's understanding of the fees related to a subprime credit card account and will permit the consumer to make better decisions with respect to such an account. Further, we believe such changes should alleviate the fairness concerns with respect to subprime credit card products.

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In closing, CorTrust Bank would again express its support for the Agencies' efforts to protect consumers from unfair or deceptive practices. However, we strongly disagree with the proposed prohibitions and limitations on financing fees for the issuance or availability of credit if such fees utilize the majority of available credit on the account. As discussed in detail above, the Agencies have failed to (i) appropriately assess whether there is, in fact, an injury to the consumer, (ii) consider the ability of the consumer to avoid the purported injury, and (iii) accurately weigh the countervailing benefits with respect to the purported injury. Most importantly, the Agencies completely failed to provide any economic analysis with respect to the proposed limitations. We believe it is imperative that the Agencies conduct such analysis prior to taking further action with respect to the proposed limitations. We firmly believe that such

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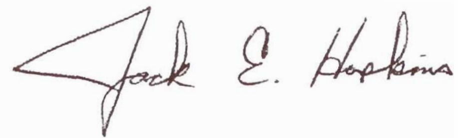
analysis will support our contention that the benefits of the credit card accounts under sc
far outweigh any cost to the consumer with respect to such accounts.

We appreciate the opportunity to comment on the Proposed Rule, and thank you for
consideration of our comments.

Sincerely,

David A. Brown
Vice President/Credit Card Manager



Jack E. Hopkins
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