THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.

1001 PENNSYLVANIA AVE., NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-628-2507

E-Mail info@fsround.org
www.fsround.org

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Via www.regulations.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington DC 20552

Re: OTS-2007-0015

Dear Sir or Madam:

The Financial Services Roundtable[1] ("Roundtable") appreciates the opportunity to comment on the Office of Thrift Supervision's ("OTS") Advanced Notice of Proposed Rulemaking ("ANPR") on Unfair or Deceptive Acts or Practices and the Home Owners Loan Act ("HOLA").

The Roundtable *recommends* that the OTS reconsider the regulatory direction reflected in the ANPR with regard to Unfair or Deceptive Acts or Practices. First, the Roundtable does not believe that there is a substantive empirical basis calling for a change in the existing regulatory approach to unfair or deceptive acts or practices. The Roundtable also questions whether there is a substantial empirical basis for consideration of the specific practices noted in the ANPR being considered to be unfair or deceptive.

The Federal Trade Commission ("FTC") Improvements Act of 1980, from which the OTS derives its regulatory authority in this area, established a clear regulatory structure for Unfair or Deceptive Acts or Practices regulations. That structure makes the FTC the lead regulator and directs the banking regulatory agencies to follow the lead of the FTC with regard to Unfair or Deceptive Acts or Practices regulations. The regulations mandate that the banking regulatory agencies only do so absent a finding that the actions defined by the FTC's regulations were not unfair or deceptive or adopting the FTC's rules would interfere with essential monetary or payments systems policies.[2] The FTC has regulatory, enforcement, and economic expertise in evaluating practices that might be considered to be unfair and/or deceptive. The OTS should continue to follow the FTC's lead. To the extent that the ANPR indicates the OTS's desire to operate independently in the Unfair or Deceptive Acts or Practices field, the results will

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine accounting directly for $18.3 trillion in managed assets, $678 billion in revenue and 2.1 million jobs.
[2] 15 USC 57a(f)(1).

unnecessarily result in an unlevel playing field for entities regulated by the OTS when compared with entities regulated by the FTC or other banking authorities.

To the extent that the OTS decides to continue to pursue the approach indicated in the ANPR, the Roundtable *recommends* that the OTS should take a principles-based approach to regulation and adopt guiding principles for its existing and proposed regulation. These guiding principles should include fair treatment for consumers (customers, investors, and issuers); competitive and innovative financial markets; proportionate, risk-based regulation; prudential supervision and enforcement; options for serving consumers; and management responsibilities.[3] By reviewing existing and new regulations according to these principles, the OTS would eliminate unnecessary rulemakings and overly prescriptive laws and enhance financial competitiveness. The principles-based regulation should be issued with enough guidance to allow a company to determine with confidence whether or not its conduct would be proscribed.

In the case of unfair or deceptive acts or practices, the Roundtable *recommends* that guidance would be better for the industry, rather than a new rule since there are no charges of unfair or deceptive practices. Additionally, there are numerous efforts underway both by the federal regulators and the financial services industry to combat unfair or deceptive practices; guidance would help shape these efforts.

Furthermore, there should be consistency and coordination among the regulators on this issue. The effect of any one regulator taking action that is inconsistent with that of the other regulators will lead to confusion in the banking system and uncertainty as to how to conduct operations.

Below, we offer our specific comments on the questions presented in the ANPR.

ANPR Questions (II(C)(1-2))

We respectfully *urge* the OTS not to extend any rulemaking on unfair or deceptive acts or practices to savings association holding companies and subsidiaries of such holding companies and savings associations that are not currently covered (collectively, "Non-FSBs"). Such an extension would be unnecessary and unduly burdensome for Non-FSBs.

Savings associations are subject to the exclusive cradle-to-grave jurisdiction and supervision of the OTS under HOLA and OTS regulations. Non-FSBs, however, are subject to oversight by the OTS but also to regulation and enforcement by other regulators. The FTC has jurisdiction to enact rules under and enforce the FTC Act against Non-FSBs.[4] State statutes that prohibit unfair or deceptive acts and practices, often enforced by the state attorneys-general as well as private plaintiffs, also apply to Non-FSBs. Therefore, given the existing legal regimes, as well as the OTS's supervisory authority, it is not necessary to extend an OTS rule on unfair or deceptive acts or practices to Non-FSBs.

[3] The Roundtable is releasing the *Blueprint for U.S. Financial Competitiveness* on November 7, 2007, in which it recommends that Congress and regulatory agencies adopt these guiding principles for regulation of the financial services industry.
[4] 15 U.S.C. §§ 45(a)(2), 57a.

Indeed, any such extension would only multiply the compliance costs of such entities without any consumer benefit. Nor would there be any benefit to the safety and soundness of savings associations, as the risks posed by unfair or deceptive acts or practices, such as reputational risk, are already addressed by existing law that is applicable to Non-FSBs and the OTS's supervisory powers. Further, because the business and activities of Non-FSBs may be very different from the activities conducted by savings associations, rules tailored to savings associations are likely to be ill-suited to the regulation of Non-FSBs. Finally, because any rulemaking should be limited to savings associations and entities currently covered, it is also appropriate to limit the rulemaking to the financial products and services that savings associations are authorized to offer.

ANPR's Targeted Practices Approach regarding Credit Card Lending (Section E)

Difficulty in Defining Specific Practices

One of the reasons we support a principles-based approach to defining unfair or deceptive practices is the difficulty in determining *a priori* if specific practices are "unfair" or "deceptive." This difficulty is highlighted by a close examination of the rationale behind the five practices listed in the ANPR and the role these practices play in card pricing. In fact, each of these practices provides important benefits to cardholders.

Risk-Based Pricing Benefits Consumers

Most of these practices are designed to help relate the price borrowers pay for credit to the underlying risk of the borrower. Doing so benefits all consumers by making credit available to the widest possible number of borrowers at the lowest price appropriate for each borrower.

A fundamental tenet of all lending is that in a free market for credit the price charged to a borrower should be based on the underlying risk that the account will not be repaid. For this reason, the US government can generally borrow less expensively than a corporation; a highly-rated corporation can generally borrow less expensively than most individuals; and individuals who are less risky can borrow money at a lower rate than those who are more risky.

There are many economic advantages to relating the price for a loan to the underlying risk of the borrower. Some of the benefits of this "risk-based pricing" were summarized by the Federal Reserve Board recently as follows:

> "Risk-based pricing reduces cross-subsidization among borrowers posing different credit risks and sends a more accurate price signal to each customer. Reducing cross-subsidization can discourage excessive borrowing by risky customers while helping to ensure that less-risky customers are not discourage from borrowing as much as their circumstances warrant. Finally, risk-based pricing expands access to credit for previously credit-constrained populations, as creditors are better

> able to evaluate credit risk, and, by pricing it appropriately, offer credit to higher-risk individuals."[5]

Accordingly, legislators and regulators should be very careful not to interfere in the marketplace in such a way as to reduce the linkage between the underlying risk of the borrower and the price that the borrower pays for credit. To do so will inevitably decrease competition between banks, restrict access to credit for higher-risk individuals, and raise the price of credit for all borrowers.

Universal Default (Section E(1)(a))

While we agree that card issuers should not raise a cardholder's interest rate based solely on a single incidence of delinquency with another creditor and without notice (the traditional definition of universal default), the definition of universal default used in the ANPR could significantly reduce issuers' ability to price based on risk.

Open-end loans (such as credit cards) are fundamentally different from closed-end loans (such as traditional mortgages) because they are not collateralized (i.e. there is no alternative source of repayment), and there is no fixed amount borrowed or required to be repaid on a fixed schedule. Therefore, with respect to open-end loans, it is the borrower's current credit risk level, not the risk level when the account was opened or when the advancement of funds initially occurred, that determines the likelihood of repayment. Accordingly, it is very important that card issuers be allowed to reprice accounts to reflect incremental risk when the risk of the entire loan amount increases. When issuers see a customer exhibiting risky behavior — and this may include problems with other lenders, it is entirely appropriate to notify the customer of a proposed change which generally is a higher interest rate for outstanding balances.

Because the credit card industry is highly competitive, borrowers who are being charged too high a price (i.e. relative to the market rate for that borrower) can open a new account with another lender, transfer their balance(s), and realize lower borrowing costs. If prices were elastic downwards (cardholders can lower prices without restriction) but inelastic upwards (issuers could not raise rates easily when risk increases), issuers would have no choice but to build a "risk-premium" into the rates they offer customers. This would hurt both low-risk and high-risk consumers. It would restrict competition among banks (there would be fewer low-priced offers for consumers) and raise everyone's borrowing costs (due to the risk premium).

Accordingly, any legislation or regulation in this area should specifically protect an issuer's ability to use credit-scoring models (for example, those provided by the three large credit bureaus and proprietary statistical models developed internally) to measure changes in the risk of an account over time. These statistical models have proven to be accurate, unbiased measures and predictors of risk over time. As such, these models are essential to realizing

[5] Board of Governors of the Federal Reserve System, Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit. August, 2007, page O-5.

the benefits of risk-based pricing for both consumers and lenders. The Federal Reserve Bank makes this point as follows:

> "Credit scoring also increases the efficiency of consumer credit markets by helping creditors establish prices that are more consistent with the risks and costs inherent in extending credit. By providing a low-cost, accurate, and standardized metric of credit risk for a pool of loans, credit scoring has both broadened creditors' access to capital markets and strengthened both public and private scrutiny of lending activities" [6]

OverLimit Fees triggered by Penalty Fees; Multiple Late Fees (Sections E(1) (b) and (c))

Fees are another element of risk-based pricing that is used to link the underlying risk of an account with the total price paid by the cardholder. Through this link, fees are an important tool in holding down costs for the great majority of all borrowers and encouraging banks to make competitive offers to a broader set of customers.

Fees work in two ways. For lower risk customers, they are a relatively efficient and targeted way to charge a slightly greater amount to a customer who has demonstrated higher risk without permanently raising the customer's borrowing costs. Fees also send a signal to the cardholder about the importance of the card agreement and the risk inherent in not abiding by it. To the extent that this deters future defaults, there is also a beneficial impact to the cardholder. Second, in the case of the riskiest accounts, they enable an issuer to recoup some of the losses associated with the account (beyond the amount which can be recouped through finance charges). It is important to realize that, in the aggregate, issuers *lose* money on accounts which repeatedly default on the account terms. Accounts that have multiple default events (the accounts that would be impacted by the situations described in the ANPR) charge off at a rate in excess of 50 percent. The assessment of fees on these accounts merely reduces the degree of loss, and therefore, the degree of cross-subsidization that is required.

Aside from these benefits associated with fees, which we think address the issues of "fairness;" fees are not "deceptive" in the sense that they are clearly disclosed both in the solicitation (in the so-called Fed Box) and in the cardholder agreement. Furthermore, fees are an important method for the issuer to "send a more accurate price signal to the consumer"[7] (again using the words of the Federal Reserve).

Arbitration (Section E(1)(d))

Arbitration is an important resource to resolve customer disputes in a fair and just manner to both the customer and the corporation.

Claims made by some groups with respect to the unfairness of arbitration are not generally shared by individuals who have actually used arbitration to settle disputes. A 2004 Ernst & Young Study found that 69 percent of individuals that used arbitration to settle a dispute were

[6] Id., page S-4.
[7] Id., page O-5.

satisfied or very satisfied with the process.[8] Additionally, a report to the U.S. Securities and Exchange Commission in 2002 indicates that individuals in 93 percent of the cases reviewed felt their arbitration was handled fairly and without bias.[9]

Outcomes in cases also help to demonstrate the fairness of arbitration in comparison to the courts. An article published in the Georgia State University Law Review indicates that 71 percent of individuals won claims against corporate entities before the National Arbitration Forum, compared to an individual winning less than 55 percent of claims brought against corporate entities in federal court.[10] While some opponents of arbitration attempt to use outcomes of certain types of cases to paint arbitration as unfair, available data shows that outcomes are similar to the outcomes in court for similar cases.

Finally, even though an individual may choose to pursue a claim in the courts, there are still potentially significant obstacles including obtaining counsel and the associated cost of pursuing a judicial action. In many instances companies pay for the cost of arbitration, and the largest alternative dispute resolution firm (American Arbitration Association) limits fees to a consumer, up to $125, or up to $375 depending on the size of the case.[11]

As evidenced by this data, arbitration is a cost effective, fair and efficient method to settle disputes in a timely manner. Without arbitration, our already burdened court system would be clogged with cases delaying resolution and consumers would be saddled with the additional costs that come with litigation. In fact, the majority of disputes are settled before the arbitration process is initiated.

Therefore, the Roundtable *recommends* that the OTS should not characterize as an unfair or deceptive practice or act requiring, as a condition of a credit card account, a consumer's waiver of his or her right to a court trial and consent to binding mandatory arbitration is an unfair or deceptive practice or act.

Payment Hierarchy (Section E(1)(e))

Unlike the examples above, the current industry standard usage of payment hierarchy (applying payments to balances with lower rates before balances with higher rates, so that balances with low introductory rates are paid off first) is not fundamental to the association of price and risk on an account. However, like the practices above, it provides very substantial consumer benefits.

Payment Hierarchy has evolved into a fundamental element of credit lending business systems and practices. There would be high implementation cost associated with changes in this practice

[8] "Outcomes of Arbitration: An Empirical Study of Consumer Lending Cases" (Ernest & Young, 2004).
[9] "Report To The Securities And Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements In NASD And NYSE Securities Arbitrations" (Michael Perino, Visiting Professor Columbia Law School, Associate Professor St. John's University School of Law, 2002).
[10] Eric J. Mogilnicki and Kirk D. Jensen, "Arbitration and Unconscionability,", 19 Ga. St. L. Rev. 764 (2003).
[11] Testimony of Richard Naimark, Senior Vice President of The American Arbitration Association, U.S. House of Representative, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, Hearing on Hearing on: H.R. 3010, the "Arbitration Fairness Act of 2007" October 25, 2007.

and if the current hierarchy of repayment was changed for thrift institutions and not all lending institutions, thrift businesses would be severely impacted.

Current payment hierarchy has evolved as a way to enable and facilitate the use of introductory rates and other subsidized offers that are used to attract new customers. Through these offers, a customer can obtain a low or 0% interest rate for an existing balance by transferring it to a competing product or lender. But previous card balances, not included in the transfer would continue to accrue interest at their prior rate. Other examples include someone who uses their credit card at an ATM to get cash; cash advances generally carry a higher interest rate than purchases, because they involve riskier behaviors. Payments are applied to all current balances with the lowest rate first, and then to balances with the higher rates, except if the customer pays in full, in which case payments are applied to old balances before new balances. This payment hierarchy supports the ability to provide limited duration low-rate credit available to many customers through promotional pricing. The opportunity to borrow money at below-market interest rates for a period of time provides a multi-billion dollar annual benefit to consumers. [12]

If payments were applied to highest-priced balances first (reverse payment hierarchy), that is, if regulation or legislation forced payments to be applied to higher rate balances first, banks would either need to eliminate the promotional offer on low interest fixed term loans or increase rates for standard use of the card. Additionally, applying payments in a reverse payment hierarchy would destroy the ability to use this as a marketing tool to solicit new accounts. With a reversed payment hierarchy, borrowers could avoid paying off any of their below market-rate balances by always keeping a small balance at the market rate. Although banks would undoubtedly continue to compete for customers, a reverse payment hierarchy would mean much shorter introductory periods, higher introductory rates, or both – all of which ultimately impair the benefits that consumers currently enjoy. Market forces tell us consumers want none of these outcomes.

We believe that the benefits of this subsidy are well understood by most consumers today. Indeed, many borrowers actively move money between accounts to minimize total borrowing costs. However, we believe that the disclosure of payment hierarchy should be prominently displayed in all relevant solicitations (in the boxed disclosures) as well as in the account terms and conditions.

Discretionary Pricing (Section E(2)(d))

The Roundtable *urges* the OTS not to characterize as unfair or deceptive discretionary pricing in the area of residential mortgages. Such a characterization would suggest that the OTS believes that discretionary pricing does not have a place in direct lending. This would have serious consequences for unsecured loans and any other forms of lending where the pricing may include a component that reflects the difficulty of originating or selling particular loans. Furthermore, the suggestion that a branch should not deviate from the rate sheet provided by a lender's central

[12] Based on Nilson Report data, there are approximately $800 billion in outstanding credit card debt. We do not know the precise amount of this debt that is at a subsidized rate or the amount of the subsidy. However, based on Argus Q2-2007 Industry data 21% of all revolving debt is priced below the prime rate. In round numbers if 20% of total revolving debt was priced at 10% below the applicable market rate, this would equate to a $16 billion annual benefit to consumers.

office could be interpreted as foreclosing consideration of additional or judgmental risk factors on a localized basis. Far from an unfair or deceptive practice, consideration of such factors can enhance the safety and soundness of the lender.[13]

Garnishment (Section E(4))

The Roundtable *recommends* that complying with a garnishment order should not be considered an unfair or deceptive act or practice. In order to comply with garnishments, levies and other similar court orders, financial institutions must immediately either freeze funds in the account, or withdraw the amount of the funds subject to the order from the account, without knowledge of any benefit funds.[14] Such compliance is generally in accordance with the state laws, as well as to limit the financial institutions' liability risk. If financial institutions fail to comply with state garnishment orders the institution is liable for the entirety of the garnishment amount, even if only a fraction of the funds were ever located in the institution.

Conclusion

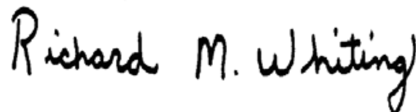
In summary, in addition to the specific recommendations herein, the Roundtable *recommends*:

- evaluation of the regulatory direction reflected in the ANPR with regard to the need for a change in the existing regulatory approach and within the statutory authority of unfair or deceptive acts or practices;
- a principles-based approach to regulation of unfair or deceptive acts or practices;
- adoption of guidance on this issue, rather than new regulations; and
- consistency and coordination among the regulators on this issue.

In this last regard, the Roundtable *urges* the OTS to work closely with the other federal regulators on these issues. Specifically, we encourage the OTS to have discussions with the Federal Reserve Board on these issues since the Federal Reserve is expected to address these issues in its Home Ownership and Equity Protection Act's rule in the next few months.

Thank you again for the opportunity to share our views with you on this subject. If you have any questions, please feel free to contact me or Melissa Netram at 202-289-4322.

Sincerely,



Richard Whiting
Executive Director and General Counsel

[13] It is important to note that current issues relating to subprime emanated from state licensed brokers, not from the federally regulated financial institutions. Therefore, there is no demonstrable need for new rules for federally regulated institutions.

[14] The Roundtable plans to offer comments on the Interagency Proposed Guidance on Garnishment of Exempt Federal Benefit Funds (Docket ID OCC-2007-0015) in late November, 2007. In our comments, the Roundtable *recommends* that the agencies offering this guidance examine the current practices of the financial institutions further prior to issuing this guidance and suggests a few alternatives to the guidance. The Roundtable's comment letter will be posted on our website at www.fsround.org once it is filed.