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Regulation Comments, Chief Counsel's Office
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Re: Docket No. OTS – 2007 – 0015; 12 C.F.R. Part 535; Advance Notice of Proposed Rulemaking – Unfair or Deceptive Acts or Practices

Dear Sir or Madam:

This letter provides comments of the undersigned concerning the Advance Notice of Proposed Rulemaking (the "ANPR") described above which was published by the Office of Thrift Supervision (the "OTS") in the *Federal Register* on August 6, 2007. We are partners in the law firm of Davenport, Evans, Hurwitz & Smith, L.L.P., and our law firm represents various federally chartered thrifts, as well as a number of financial institutions regulated by the other federal banking agencies, that would be significantly impacted by the proposed rules outlined in the ANPR.

The stated purpose of the ANPR is to determine whether the OTS should expand its current prohibitions against unfair or deceptive acts or practices. The ANPR describes various models and approaches with respect to adopting further guidance as to unfair or deceptive acts or practices and raises various issues as to each approach.

We do not believe it is necessary for the OTS to adopt additional rules with respect to prohibitions against unfair or deceptive practices. We particularly believe such additional rulemaking is unnecessary 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] In addition, the OTS has not set forth any facts or empirical information that demonstrates a need for additional regulation in this area.

Should the OTS determine that it is necessary to adopt additional guidance with respect to unfair and deceptive practices, we would encourage the OTS to adopt a principles-based approach that could, as stated in ANPR, "evolve as products, practices and services change." Further, we believe that should the OTS adopt additional guidance, such guidance should be based upon the guidance already issued by the Federal Trade Commission (the "FTC").[3] The principles set forth in the FTC guidance are appropriate for the thrift industry, and such principles should be part of any standards adopted by the OTS to determine whether a particular act or practice is unfair or deceptive. Further, we believe that any guidance adopted by the OTS should be similar to and consistent with the guidance previously issued by the Office of the Comptroller of the Currency (the "OCC"), the Federal Reserve Board (the "Board"), and the Federal Deposit Insurance Corporation (the "FDIC").[4] As noted in the ANPR, both the financial services industry and consumers have benefited from consistency in rules and guidance as the federal banking agencies have adopted uniform or very similar rules in many areas.

We do not believe it would be appropriate for the OTS to determine that additional acts or practices are unfair or deceptive *per se* regardless of the specific facts or circumstances. As stated in the 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. For the same reasons, we believe it would be inappropriate for the OTS to use specific examples of unfair or deceptive practices drawn from FTC enforcement actions, as such enforcement actions are fact specific and thus do not lend themselves to general examples that would be informative to other creditors.

Again, while we do not believe additional rulemaking by the OTS is necessary in this area, should the OTS proceed with such rulemaking, we believe any guidance adopted by the OTS should take a principles-based approach. However, should the OTS determine that it will

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

[2] 12 C.F.R. § 535 (2007).

[3] See FTC's Policy Statement on Unfairness, issued on December 17, 1980, available at http://www.ftc.gov/bcp/policystmt/ad-unfair.htm; FTC's Policy Statement on Deception, issued on October 14, 1983, available at http://www.ftc.gov/bcp/policystmt/ad-decept.htm.

[4] See Board and FDIC guidance entitled, "Unfair or Deceptive Acts or Practices by State-Chartered Banks," issued on March 11, 2004, available at http://www.fdic.gov/news/news/financial/2004/fil2604a.html and OCC guidance in Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices" issued on March 22, 2002, available at http://www.occ.treas.gov/ftp/advisory/2002-3.doc.

instead adopt guidance listing specific prohibited practices, we believe the OTS should consult with the other federal banking agencies with respect to such guidance. This is particularly true in the area of credit card lending, as a majority of major credit card issuers are regulated by federal banking agencies other than the OTS. In order to encourage consistency among federal regulators, we believe these agencies should also be involved in any proposed rule-making that will impact credit card issuers, and any guidance issued by the OTS should be issued jointly with the other federal banking agencies. As mentioned earlier and as noted in the ANPR, both the financial services industry and consumers benefit from consistency in rules and guidance, and the most certain way to achieve such consistency is through rules issued jointly with the other federal banking agencies.

In the area of credit card lending, the ANPR sets forth five specific practices that the OTS could prohibit under a targeted-practices approach. As discussed above, we do not believe the OTS should adopt a targeted-practices approach. Further, as discussed in detail below, we believe that the examples set forth in the ANPR of specific practices that the OTS might consider as unfair or deceptive in the area of credit card lending are, in fact, not unfair or deceptive and should not be prohibited as such. We believe adopting a prohibition of any of the practices cited in the ANPR with respect to credit card lending would be unjustified as it will first, unnecessarily prohibit reasonable practices of credit card issuers, second, restrict the availability of credit for some borrowers, and third, fail to provide additional protection to consumers.

In particular, we believe that any prohibition that, either directly or indirectly, regulates pricing on a credit product will have a negative impact on consumers. In general, credit pricing is based upon credit risk. Limiting credit pricing by prohibiting certain credit-risk-sensitive practices will very likely result in alternative pricing structures that unduly burden consumers with less risky credit profiles, while at the same time seriously limiting the availability of credit to consumers with high risk credit profiles. Stated another way, limiting credit-risk-sensitive pricing practices will likely mean that consumers with less risky credit profiles will pay more to offset the reduction in revenues collected, and that consumers with higher risk profiles will not have access to credit or their access to credit will be reduced because creditors will be unable to charge such consumers for the higher risk that they represent.

The possible prohibitions listed in the ANPR concerning credit card lending are unnecessary and fail to address the needs of consumers in the following ways:

- The OTS is considering prohibiting credit card issuers from increasing consumers' interest rates based on adverse information unrelated to the credit card account or credit card issuer, a practice commonly referred to as "universal default" or "adverse action pricing." Supporters of this prohibition would argue that these rate increases are based on irrelevant financial information and, as a result, unfairly penalize credit cardholders. This rationale, however, ignores the purpose of universal default clauses. Universal default clauses are intended merely 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. Experience has shown that a consumer's delinquency on one credit account is a strong indication that the consumer may be at risk of not paying other accounts. The imposition of a higher interest rate in such instances is directly related to, and justified by, the cardholder's increased risk profile. If this response were prohibited, credit card issuers would be forced to either terminate access to credit by cardholders with higher risk profiles or increase interest rates or fees charged to all of their credit cardholders, thereby shifting the financial burden from those who are in default on an account to those who are not.[5]

The practice of increasing an interest rate due to the increased 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.[6]

- The OTS is considering prohibiting the imposition of so-called "penalty" fees in certain instances. This proposed limitation would include prohibiting credit card issuers from imposing an over-the-limit fee that is triggered by the imposition of a penalty fee, such as a late charge, and prohibiting the practice of charging penalty fees in consecutive months based on previous late or over-the-limit transactions. Nearly all credit card issuers impose a late fee on cardholders who fail to make the minimum required payment by the due date. Many credit card issuers, especially the larger issuers, also impose an over-the-limit fee on cardholders who exceed their established line of credit. The extension of credit to the consumer, both as to amount and pricing (including fees and interest rate) is based upon the consumer's compliance with the terms of the credit card agreement.

  Regulation Z requires that both an over-the-limit fee and a late fee be disclosed in all solicitations and applications. For contractual reasons, credit card issuers also include in

[5] See Eliot Spitzer, Veto Message No. 109 (Aug. 15, 2007) (vetoing a New York bill that would have prohibited credit card issuers from increasing the interest rates they charge on their credit cards based on the cardholder's indebtedness or failure to make timely payments to another creditor).

[6] Federal Trade Commission, "Credit-based Insurance Scores: Are They Fair?," 6 (Oct. 2, 2007).

the credit card agreement both the amount of the fee and a description of the circumstances under which it will be imposed.

The proposed prohibition on so-called "penalty" fees ignores the fact that such fees tend to reflect consumer default risk.[7] Cardholders who are late or over their credit limit are more likely to default, and thus, risk-related fees help compensate for this increased risk.[8]

Fees such as late fees and over-the-limit fees are triggered by actual borrower behavior and, when used in combination with interest rates, provide issuers with greater flexibility in pricing credit terms than relying on interest rates alone. Interest rates are generally an *ex ante* before the fact estimate of a given borrower's likelihood of default. Late fees, over-the-limit fees, and other similar fees, by contrast, are more closely tied to the borrower's exhibited risky behavior.[9]

The proposed proscription on certain fees will likely have serious unintended consequences that will not benefit consumers and will instead have a negative effect on many 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 fees imposed by credit card issuers are generally tied to consumer credit risk, such fees have an offsetting effect on interest rates, i.e., the ability of the credit card issuer to cover risk by means of penalty fees reduces the need for the issuer to further increase interest rates. Thus, any regulatory efforts to cap or otherwise regulate late fees or over-the-limit fees would almost certainly lead to increased interest rates for all consumers, or other offsetting adjustments in credit contract terms.[10] Limiting such credit card pricing practices is likely to result in more

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[7] See Nadia Massoud, et al., "The Cost of Being Late: The Case of Credit Card Penalty Fees," AFA 2007 CHICAGO MEETINGS PAPER, 34 (Jan. 2006), available at http://www.newyorkfed.org/research/conference/2006/Econ_Payments/Massoud_Saunders_Scholnick.pdf.

[8] Jonathan M. Orszag & Susan H. Manning, "An Economic Assessment of Regulating Credit Card Fees and Interest Rates," AMERICAN BANKERS ASSOCIATION, 32 (Oct. 2007), available at http://www.aba.com/aba/documents/press/regulating_creditcard_fees_interest_rates92507.pdf (stating that any limits on late fees will harm the effectiveness of risk-based pricing and result in higher prices for all cardholders).

[9] Todd J. Zywicki, "Credit Card Practices: Current Consumer and Regulatory Issues," Testimony before the U.S. House of Representatives Financial Services Committee, 19 (April 26, 2007), available at http://www.house/gov/apps/list/hearing/financialsvcs_dem/htzywicki042607.pdf.

[10] See id. at 23.

rigid pricing structures that create an excessive burden for customers at one end of the risk spectrum and curtail credit to customers at the other end of that spectrum.[11]

Moreover, restricting the ability to impose over-the-limit fees on cardholders for exceeding their credit limit may force credit card issuers to flat-out deny charges that would cause an account to go over limit. Borrowers often go over their credit limit when making a purchase that is of particular importance to them. Although borrowers know they will be charged an over-the-limit fee for exceeding their credit limit, they are willing to pay this fee in exchange for the convenience of being able to make their purchase immediately.

Additionally, borrowers often go over their credit limit in times of emergency or other unforeseen events. If credit card issuers were to respond to limitations on the ability to impose over-the-limit fees by prohibiting charges in excess of a cardholder's credit limit, this could leave borrowers without access to emergency over-the-limit funds.[12] As a result, borrowers could be left stranded during travel or in an unexpected emergency situation.

- The OTS is proposing to prohibit credit card issuers from requiring as a condition of a credit card account the consumer's waiver of his or her right to a court trial and consent to binding mandatory arbitration. In light of the explicit direction from Congress that arbitration agreements are "valid, irrevocable, and enforceable," we question whether the OTS has the authority under existing law to prohibit a certain class of creditors from using arbitration agreements.[13]

  Supporters of a prohibition on binding mandatory arbitration argue that the disparity of bargaining power and transactional knowledge between credit card issuers and their customers places the customer at a disadvantage. This argument both ignores the other credit choices available to the consumer in the financial marketplace and the strong likelihood that prohibiting credit card issuers from requiring consumers to arbitrate disputes will significantly increase the card issuers' cost of doing business, which will in turn increase the cost of credit.

  Arbitration is an expeditious and low-cost method of resolving disputes and is favored by national policy. In enacting the Federal Arbitration Act ("FAA"), Congress declared a

[11] See Oliver I. Ireland, "Credit Card Practices: Current Consumer and Regulatory Issues," Written Statement before the U.S. House of Representatives Subcommittee on Financial Institutions and Consumer Credit, 9 (April 26, 2007), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/iitireland042607.pdf.

[12] Orszag & Manning, supra note 8, at 33.

[13] See 9 U.S.C. § 2 (2007).

national policy favoring arbitration.[14] Arbitration is favored because it is faster, less costly, and more efficient than litigation. In addition, the FAA provides abundant protections to consumers who are parties to arbitration agreements. For instance, section 2 of the FAA reserves to the state and federal courts the authority to invalidate or restrict arbitration agreements. Thus, the courts will not enforce the agreement if grounds exist "at law or in equity" for not doing so.[15] The U.S. Supreme Court has already held that punitive damages are available in arbitration proceedings unless the arbitration agreement unambiguously limits them.[16] In addition, both leading national arbitration administrators, the American Arbitration Association ("AAA") and the National Arbitration Forum ("NAF"), have implemented consumer-protection requirements to ensure that consumers will be treated fairly and that arbitration will be affordable to the consumer, including protections such as special fee schedules that cap the cost to consumers and strict eligibility requirements for arbitrators. In our experience, many arbitration provisions in credit card agreements pass most of costs of arbitration to the card issuer. In addition, the AAA gives arbitrators the authority to order such discovery, by way of deposition, interrogatory, document production, or otherwise, as the arbitrator considers necessary for a full and fair exploration of the issues in dispute.

We would also note that, in our experience, credit card issuers provide consumers detailed information regarding arbitration and give consumers the opportunity to opt-out of mandatory arbitration at the inception of the credit card relationship.

The practices and protections outlined above belie the argument that mandatory arbitration provisions are unfair to consumers or place consumers in a disparate bargaining position. Because the rights of consumers are adequately protected by the FAA as presently enacted, by the widely used national arbitration administrators, and by the federal and state courts, further regulations prohibiting the use of mandatory arbitration agreements are unnecessary.

- The OTS is also considering prohibiting the practice of applying payments first to balances subject to a lower rate of interest before applying them to balances subject to higher rates of interest or applying payments first to fees, penalties, or other charges before applying them to principal and interest. Some credit card issuers will occasionally

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[14] See Southland Corp. v. Keating, 465 U.S. 1, 10 (1984).

[15] 9 U.S.C. § 2; see Mark J. Levin, "Mandatory Binding Arbitration Agreements: Are They Fair for Consumers?," Testimony before the U.S. House of Representatives Subcommittee on Commercial and Administrative Law, 11 (June 12, 2007), available at http://judiciary.house.gov/media/pdfs/Levin070612.pdf.

[16] See Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 61 (1995) (stating that "due regard must be given to the federal policy favoring arbitration, and ambiguities as to the scope of the arbitration clause itself resolved in favor of arbitration.").

offer promotional interest rates in order to encourage new and existing customers to transfer balances from other credit cards. This lower promotional rate often applies only to balances that are transferred, and a higher rate will apply to purchases and other credit transactions during the promotional period. However, consumers *can* lower their credit costs when they transfer balances to a new account with an introductory rate.[17] Provided the consumer has a full appreciation of the terms of this transaction, these rates are not inappropriate.[18]

We believe that current law requires sufficient disclosure as to the conditions upon promotional rates and the method used to apply payments. Regulation Z already governs many aspects of promotional rate offers, including requiring credit card solicitations to clearly and conspicuously display each annual percentage rate that will apply to purchases and balance transfers.[19] The Office of the Comptroller of the Currency (the "OCC") has provided further guidance to national banks by advising them to fully and prominently disclose in promotional materials and credit agreements any material limitation on the applicability of the promotional rate, which would include a provision regarding application of payments.[20] In our experience, credit card issuers regulated by other agencies, including the OTS, also adhere to this OCC guidance. The significant amount of guidance and regulatory standards already in place regarding the disclosure of the order in which payments will be applied prevents the practice from being unfair or deceptive to consumers and renders the OTS's proposed prohibition unnecessary.

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In closing, we would reiterate that we believe it is unnecessary for the OTS to adopt additional rules with respect to prohibitions against unfair or deceptive practices, particularly in the area of consumer credit where there are already extensive federal disclosure requirements in place to protect consumers. As noted earlier, the OTS does not set forth any facts or empirical evidence demonstrating a need for additional regulation in this area. Further, should the OTS determine it is necessary to adopt additional guidance, we believe such guidance should adopt a principles-based approach, should be based upon the guidance already issued by the FTC, should be similar to and consistent with the guidance previously issued by the other federal banking agencies, and should be issued jointly with the other federal banking agencies.

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[17] Julie L. Williams, "Examining the Current Legal and Regulatory Requirements and Industry Practices for Credit Card Issuers With Respect to Consumer Disclosures and Marketing Efforts," Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, 21 (May 17, 2005), available at http://banking.senate.gov/_files/ACF6A1.pdf.

[18] See id. at 21-22.

[19] Id. at 22.

[20] Office of the Comptroller of the Currency, "Credit Card Practices," Advisory Letter 2004-10 (Sept. 14, 2004).

We do not believe it would be appropriate for the OTS to determine that additional acts or practices are unfair or deceptive *per se*, and we specifically disagree, for the reasons discussed in detail above, that any of the specific practices listed in the ANPR that the OTS might consider as unfair or deceptive in the area of credit card lending should be prohibited.

These comments represent our personal views and the views of Davenport, Evans, Hurwitz and Smith, L.L.P., but do not necessarily represent the views of our clients. We thank you for the opportunity to comment on the ANPR and for your consideration of these comments.

Sincerely,

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