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August 1, 2008

Jennifer J. Johnson
Secretary, Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave. NW
Washington, DC 20551
Docket No. R-1314

Chief Counsel's Office
Office of Thrift Supervision
1700 G Street NW
Washington, DC 20552
Attention: OTS-2008-004

Re: Unfair or Deceptive Acts or Practices

Ladies and Gentlemen:

This letter is submitted in response to the request for comment from the Office of Thrift Supervision ("OTS") and the Board of Governors of the Federal Reserve System (the "Board") and (collectively, the "Agencies") on proposed rules relating to unfair or deceptive acts or practices ("UDAP") in connection with consumer credit card accounts and overdraft services for deposit accounts. Washington Mutual appreciates the opportunity to comment on this important matter.

Washington Mutual is one of the nation's leading consumer and small business banks. In operation since 1889, our bank focuses on providing financial products and services to middle-class American consumers and to small businesses. Washington Mutual currently has over $300 billion dollars in assets, operates approximately 2,300 retail banking centers, and employs over 40,000 individuals across the country. Washington Mutual is the eighth largest general purpose credit card issuer in the United States with over 12 million accounts.

I. Introduction

Credit cards and revolving credit are an integral part of the US economy. In 2007, over $2 trillion dollars in purchases were made using credit cards.[1] Card products have achieved this central role in the economy by providing tremendous value and benefits to consumers and merchants. Credit card accounts provide the great majority of American households with convenient access to revolving credit[2] and, for those who pay their balance in full each month, offer the opportunity to borrow money interest-free for 20 to 55 days.[3] Credit cards also provide a secure form of payment for both merchants and consumers and facilitate internet and telephone commerce. This convenient access to credit helps to power the economy, increase consumer buying power, and smooth consumption through economic cycles.

[1] CardFlash, June 17, 2008.

[2] Survey of Consumer Finance, 2004 – 75% of American households had at least one card.

[3] For any particular purchase, the length of the interest-free "float" will depend on the length of the grace period and the point in the billing cycle when the purchase is made.

Intense competition among card issuers has ensured that interest rates and total pricing have declined for most consumers over time while access to credit has steadily grown for a broad set of consumers.[4] Today, consumers and small businesses enjoy a wide variety of credit card products provided by a significant number of capable and motivated competitors. Banks that do not provide consumers with competitive pricing and other competitive card attributes will lose customers quickly. This competitive pressure, along with active regulation, works to ensure that industry practices are fair, easily understood, and clearly disclosed. We support regulation that provides a level playing field for card issuers, and therefore have no objection to five of the seven proposed regulations. These are: time to make payment; balance computation method; fees for exceeding the credit limit caused by credit holds; cards with high-upfront fees; and firm offers of credit.[5]

However, the remaining two proposals – application of increased annual percentage rates ("APRs") to outstanding balances and allocation of payments – will have serious unintended consequences for consumers. If adopted in their current form, these two proposals would materially restrict access to credit (particularly for low and middle income consumers), raise the cost of credit for the great majority of borrowers, and decrease competition (especially price competition). Accordingly, the majority of this letter will discuss these two proposals; explain their potential effect; and present alternatives.

We also feel strongly that most of these proposals should not be addressed under the Agencies' UDAP authority. We believe that most, if not all, of the practices addressed under this proposal are not "unfair" or "deceptive" as those terms are defined in the Federal Trade Commission (FTC) Act. Moreover, even if the Agencies state that the new rules will only apply prospectively, deeming long-standing industry practices to be unfair or deceptive could significantly increase litigation risk for regulated institutions and potentially endanger their safety and soundness. Accordingly, we believe the Agencies should address most of these practices either under Regulation Z, by issuing "best practices" guidance, or both.

If the Agencies decide to address any of these practices under the FTC Act, we would urge you to follow the framework of the proposed rule regarding time to make payment. There, the Agencies did not label any specific practice as "unfair" or "deceptive." Instead, the Agencies noted that failing to provide customers with a reasonable time to pay might be "unfair" under the FTC Act; required issuers to provide such a reasonable time period; and established a safe harbor for institutions that adopt procedures designed to ensure that statements are always mailed a certain number of days before the due date. If the Agencies insist on addressing other practices under the FTC Act, you should follow a similar approach.

While most of our comments are focused on the proposed rules that address credit card practices, we also have some concerns with respect to the proposed rules that would

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[4] GAO – Credit Cards – Increased Complexity in Rates and Fees Heightens Need for more effective disclosures to consumers, September 2006, pp. 4-6. ("GAO Credit Card Study").

[5] As discussed in Appendix 1, we do not agree that some of these practices rise to the standard of being unfair or deceptive, and we question whether they should be addressed under UDAP authority pursuant to the Federal Trade Commission Act.

deem certain overdraft practices as being unfair or deceptive. Our comments regarding these rules can be found in section IV below.

Our letter includes four appendices. Appendix 1 discusses the applicability of the UDAP framework to three of the specific proposals. Appendix 2 provides answers, where relevant, to the specific questions listed under each proposed regulatory section and requests a limited number of clarifications in the other five proposed regulations. Appendix 3 provides examples of disclosures we use to ensure customers understand payment allocation. Appendix 4 explains when overdraft protection might be provided even if a customer opts out of overdraft protection.

II. Application of Increased APRs to Outstanding Balances

The Agencies have proposed to prohibit creditors from increasing the APRs applicable to outstanding balances unless a customer's account becomes 30 days past due.[6] Restricting issuers' ability to reprice existing balances in this manner will prevent them from pricing effectively for risk. This will result in credit card loans becoming less available and more expensive.

A. The Benefits of Risk-Based Pricing

The price of credit in competitive credit markets is fundamentally linked to the underlying risk of the borrower. This principle clearly applies to credit card borrowing. By far the largest cost element of credit cards (and certainly the most variable across borrowers) is the risk that the actual principal amount of the loan itself will not be repaid. Card issuers consider a borrower's credit risk when establishing initial pricing by sorting potential customers into risk groups through statistical models based on publicly-available credit information. These models offer strong directional guidance on risk, provided the customer's risk profile does not change.[7] As discussed below, however, the information available at the time the account is opened must be supplemented by additional information obtained over time in order to realize the benefits of risk-based pricing.

Linking the cost of credit charged to the underlying risk results in expanded access to credit and lower average borrowing costs, both of which increase consumer buying power and benefit both consumers and the economy as a whole. Indeed, the Board of Governors of the Federal Reserve System (the "FRB") and the General Accounting Office ("GAO") have both recognized the benefits of risk-based pricing. For example, in August 2007, the FRB reported to Congress:

> *Risk-based pricing reduces cross-subsidization among borrowers posing different credit risks and sends a more accurate price signal to each consumer. Reducing cross-subsidization can discourage excessive borrowing by risky customers while helping to ensure that less risky*

[6] Creditors would still be able to increase a promotional APR to the disclosed non-introductory rate for that balance category whenever a customer defaulted on the Account Agreement.

[7] These models also have the benefit of being non-discriminatory. Federal Reserve Board of Governors -- Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit, August 2007.

customers are not discouraged from borrowing as much as their circumstances warrant. Finally, risk based pricing expands access to credit for previously constrained populations, as creditors are better able to evaluate credit risk and, by pricing it appropriately, offer credit to higher risk individuals.[8]

The GAO likewise emphasized the benefits of risk-based pricing to consumers in its 2006 report on credit cards. The GAO noted that the average credit card interest rate assessed for purchases has declined from almost 20 percent in the 1980s (before the advent of risk-based pricing) to around 12 percent as of 2005.[9]

B. Risk-Based Pricing is especially necessary in Credit Card (Revolving Credit) Lending

1. Risk Changes over Time

As noted above, relating the initial interest rate to the observed risk at the time the account is opened helps to expand access to credit, lowers the average cost of credit, reduces cross-subsidization among borrowers, and helps banks to manage credit risk. However, the risk that a loan balance will not be repaid is not fixed when the loan is made. Instead, the risk changes (sometimes quite significantly) over time, as the borrower's financial condition changes.

The evolution of risk over time can be illustrated by comparing the relative charge-off rate of balances of accounts that trigger default-based repricing by paying late, exceeding their credit limit, or submitting a payment that is returned (Default Accounts) during the first 24 months of the account relationship to the charge-off rate of balances of accounts that do not default (Non-Default Accounts) during the same period.[10]

	9 Months	12 Months	15 Months	24 Months
Charge-off Rate – Balances of Non-Default Accounts	0.4%	0.7%	1.3%	2.3%
$ Charge-off Rate – Balances of Default Accounts	1.9%	5.1%	11.2%	15.2%

Thus, the charge-off rate for balances on accounts that default in the first 9 months of the account relationship is about 5 times that of balances on accounts that do not default during that time. Balances on accounts that have defaulted in the first year are more than 7 times as likely to charge off as balances on accounts that have not defaulted (accounts that default in the first year often do so multiple times). In fact, balances on Default Accounts are always six to ten times more likely to charge off than balances on

[8] Federal Reserve Board of Governors – Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit, August 2007, p O5.

[9] GAO-06-929, Credit Cards, Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures for Consumers, September 2006 ("GAO Credit Card Study"), p. 31.
[10] Unless otherwise identified, all references to data and statistics are based on reviews of Washington Mutual's proprietary account data. This data is available to regulators at all times.

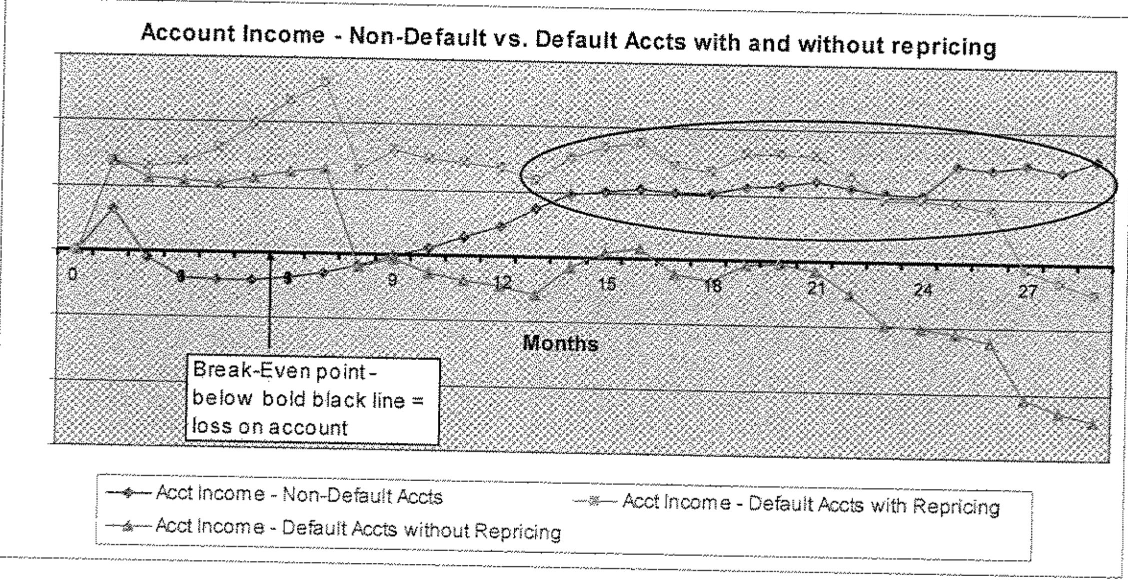
Non-Default accounts. **Most importantly, all of these accounts appeared statistically identical at the time the account was opened. Although we know *some* accounts will default and charge off, we do not know *which* ones will do so at account inception.**

2. Maintaining a Reasonable Rate of Return over Time

According to the GAO Credit Card Study, card issuers have earned a pre-tax return on assets of approximately 3% over time (or approximately 2% after taxes).[11] Since this rate of return has been quite stable over the past 20 years, we believe this represents a reasonable rate of return for the industry and one in line with the expectations of capital markets given the level of risk associated with investing in unsecured, revolving credit.

The following graph (see next page) illustrates the relative profitability over time of Default Accounts compared to Non-Default Accounts with and without repricing. Non-Default Accounts (the blue line) provide the lender with a reasonable of return over time. Repricing allows Issuers also to earn a reasonable return on Default Accounts (the green line) for a period of time (approximately 24 months) before the charge-off risk grows too large. Eventually, Default Accounts result in losses even with repricing.

Without the ability to reprice existing balances, however, banks will lose money on all Default Accounts as soon as charge-offs begin (the red line). Accordingly, to maintain their safety and soundness, card issuers will need to raise prices for everyone and restrict credit to groups likely to include a large number of higher-risk borrowers.



Blue and Green lines combined produce yield consistent with 3% pre-tax net income

3. Risk Inherent in Credit Card Loans Cannot Be Mitigated Easily

These issues are exacerbated by credit card terms that both increase the incentive for borrowers to refinance and encourage refinancing relative to other credit products. With secured loans and closed-end loans, contract terms protect the lender against changes in risk over time. Secured loans require collateral, and closed-end loans have fixed loan

[11] GAO Credit Card Study, p. 75.

amounts and repayment schedules. Such loans may be for relatively short periods of time, or in the case of longer-term loans include origination fees, prepayment penalties, or both. In addition to protecting the lender, these sorts of terms reduce the borrower's incentive to refinance.

Credit card loans are different. Here, the potential savings from refinancing are significant. Because the vast majority of credit card accounts are unsecured, the bank's risk of loss from nonpayment varies tremendously according to the borrower's current credit risk profile. Thus, there is a much greater difference in market price between low-risk and high-risk borrowers for credit card loans. And since credit card loans generally have very low minimum payment amounts (*i.e.*, very long repayment periods), borrowers can realize the savings from a lower interest rate on a higher balance over a longer time. Moreover, unlike other loans, there are virtually no disincentives to refinancing credit card balances. Borrowers generally can refinance existing balances conveniently and with little to no fee (through balance transfers or simply by paying off accounts with some lenders and revolving balances on accounts with other lenders). Thus, lower risk borrowers can and do lower the rate on their existing balances to the market rate (or even temporarily to a sub-market rate)[12]. To prevent this sort of attrition of lower-risk balances, issuers typically take proactive steps – such as promotional rate offers – to enhance their relationship with their best customers.

Therefore, borrowers get maximum flexibility with credit cards by allowing lenders flexibility in changing terms – particularly rates – over time. As noted above, there are many other types of loans where the rate will not change over time with the borrower's risk. Nevertheless, consumers consistently choose the flexibility of credit card borrowing instead of opting for other types of loans. Clearly, consumers place significant value on this flexibility. If issuers are denied the right to reprice existing balances according to borrower risk, they will be forced to take other, less efficient risk-mitigating actions to maintain sound underwriting.

C. <u>Responses to Consumer Criticisms of Risk-Based Pricing</u>

There are three common objections to risk-based pricing. The first is that that there is no need for it, because issuers can price for risk at the outset of the loan. Indeed, some critics argue that issuers do not price for risk at all. These arguments are based on a deeply flawed misunderstanding of the statistical nature of risk and how repricing acts to balance price and risk over time in open-end credit arrangements.

As discussed above, lenders do price for risk at the beginning of the loan. However, since information is incomplete at this time, pricing is only partly risk-based. Pricing can be far more accurate (with all of the attendant benefits such as lower pricing for the majority of consumers, reduced cross-subsidization, and increased market efficiency) if banks are allowed to consider new information about customers over time. This allows lenders to provide low, competitive rates to all customers and then allow more risky customers to "self-identify" themselves over time.

The second objection is that issuers could manage risk either by restricting new credit availability or by raising rates on new balances only. This argument is intuitively appealing but flawed for the same reason as the first objection. Paying late, submitting a

[12] Most lenders offer sub-market "introductory" or "promotional" rates on transferred balances.

returned payment, and revolving a balance that represents a high portion of the available credit line are all demonstrated and material predictors of increased risk.[13]

Aggregate industry data[14] demonstrates that paying even one day late represents a significant increase in the likelihood that the account will default. The following table compares the annual loss rate for customers who consistently pay on time with the loss rate for customers who pay one or more days past due in a particular month.

	Payment Current	Payment 1 day late	Payment 2-5 days late	Payment 6-15 days late	Payment 16-30 days late	Payment 31-60 days late
Average Gross Charge-off Rate	5.4%	7.0%	8.4%	10.8%	13.3%	23.3%

Thus, customers who pay even one day late are 30 percent more likely to charge off than customers who pay on time. Customers who pay between two and five days late are 56 percent more likely to charge off than customers who pay on time. As the table shows, the risk of charge-off increases dramatically the longer the payment is delayed. Consumers who pay more than 30 days late charge off at a rate over 400 percent higher than non-default customers. In Washington Mutual's card portfolio, which is more heavily weighted towards middle-income individuals, the element of risk is even more pronounced.

As explained previously, if the risk of the consumer changes, the risk to the issuer is the default of the entire existing balance, not just default on new balances. Because lenders have no way to require that new borrowing occur on the (repriced) account, repricing only future balances will not solve the problem. Moreover, approximately 60% of accounts that are more than 30 days past due go on to become 60 days past due, at which point accounts are closed. Once an account is closed, no new balances can be added. Therefore, although the theory is appealing, the reality is that adjusting pricing for only new balances is functionally equivalent to not repricing for risk at all, with all the attendant consequences to the availability of credit, the efficiency of the credit market, and the safety and soundness of financial institutions.

A third objection is that issuers raise rates far above the correct risk-based price, in an attempt to earn above-market returns. This argument is similarly misplaced. Because the credit card market is extremely competitive, lenders cannot raise rates on existing balances beyond the fair market price without risking the loss of such balances to other lenders.

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[13] This explains why credit card agreements generally permit repricing existing balances when the borrower defaults by paying late, submitting a returned payment, or exceeding the credit line.

[14] Industry data has been compiled by Argus Information Services, an independent consulting firm retained by the ABA and related counsel ("Argus Industry Study"). Data shown is for a representative month (January 2007). See Argus Industry Study (deliverable 5). Washington Mutual data is available to regulators at all times.

In addition, when an issuer reprices an account through a change in terms, the customer may opt out of the proposed price increases. A customer who opts out closes their account and pays off their existing balance under their current account terms (including their current rates). This is an important safeguard that is often overlooked. Although critics argue that few customers are aware of or understand this option, approximately 10 to 15 percent of the individuals who are repriced through a change in terms do in fact opt out, pay off their loan, or refinance with another lender within one year of the notice.

D. Consequences of Restricting Risk-Based Pricing

If issuers are not permitted to reprice existing balances, they will be left with two alternatives: charge everyone more or stop making loans to borrowers in higher risk groups that include cardholders more likely to default. In addition, the current proposals could materially undermine issuer safety and soundness both through their potential impact existing securitizations and by reducing issuers' ability to securitize debt in the future.

If lenders cannot reprice existing balances, they will be forced to take two corrective actions. First, lenders will increase initial rates for everyone. Consumers who need additional access to reasonably-priced credit will be hurt the most. Second, fewer cards and lower lines will be issued to lower- and middle-income Americans. Millions of current cardholders will lose access to the convenience and security of credit cards and be forced to rely on less regulated and more expensive credit or credit-like options such as payday loans, hard-money lending, and rent-to-own agreements.

This scenario should be familiar – it closely resembles the credit card market before the widespread adoption of credit scoring models that underlie risk-based pricing. Credit cards were a product for the elite; virtually all cards included an annual fee; and everyone who could get a card paid similar – and high – interest rates.

In addition, the proposal will detrimentally affect existing credit card securitizations. These asset-backed securities have been issued in reliance on the credit card lender's ability to reprice existing balances based on customer risk. Prohibiting lenders from doing so will have serious negative impacts on banks, investors, and ultimately consumers. These impacts include reducing the yield on securitization asset pools – this could lead to negative rating agency actions and finance charge and fee revenue being diverted into cash collateral accounts rather than being made available to the issuer. Significant diminution of finance charge and fee yield could result in early amortization of securitizations. This would in turn result in undesirable early repayment to investors, loss of funding to the issuer, and a highly negative shock to the issuers' financial positions.[15]

Moreover, adopting the proposed rules could materially impair banks' ability to securitize credit card receivables in the future by increasing the interest rate banks will need to pay and increasing credit enhancement requirements. The market for securitized card

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[15] Early amortizations of securitizations cause the loan receivables that were previously funded off-balance sheet to return to the issuer's balance sheet. The issuer is then required to increase its capital and reserves to account for these receivables (reducing income, tying up capital, and reducing liquidity). The proposed rule regarding payment allocation will also reduce finance charge yield and therefore exacerbate the problems discussed above.

receivables is already under considerable stress due to the general condition of US credit markets, proposed legislation, and proposed accounting rule changes. Adopting the proposed rules will exacerbate the difficulties banks are now having securitizing credit card receivables, increasing banks' costs of funds and negatively affecting their liquidity. Increasing banks' cost of funds will necessarily increase the cost of credit and lower the availability of credit to consumers.

E. Recommendations

We believe it is possible to revise this proposal to preserve the benefits of risk-based pricing, ensure fairness, and address some of the specific issues appropriately raised by consumer advocates. There are two, separate repricing situations to consider: (1) repricing due to borrower default on the account agreement and (2) repricing due to an observed deterioration in the borrower's creditworthiness.

1. Repricing Existing Balances in case of Account Default

We recommend the following:

- Preserve the benefits of risk-based pricing by allowing repricing of existing balances based on *clearly-disclosed, risk-related* criteria included in the account agreement. At a minimum, these should include accounts that do not pay on time; accounts that exceed the credit limit; and accounts that submit a payment that is later returned.[16]

- Prohibit specific practices which could "trick or trap" consumers and establish a set of required tolerances to ensure that any reasonably diligent consumer can avoid contractual defaults. Examples of additional steps and tolerances are:

  a) Prohibit the use of arbitrary cut-off times for payment receipt – any payment received on the due date should be credited on the due date.

  b) If the due date falls on a non-business day, require lenders to consider payments received on the first business day after the due date as timely.[17]

  c) To account for mail delays, only permit repricing of current balances when: (A) the lender follows procedures to ensure that the statement is sent at least 21 days before the due date and (B) the borrower's payment is not received within a specified period of time after the due date. We recommend three to four days as a reasonable period for the receipt of a late payment with respect to repricing existing balances[18]. Although data clearly indicates that

[16] These behaviors are highly correlated with an increased risk of account default and are the best predictors of future default. Data is available to regulators at all times.

[17] Business day could be defined as a weekday on which U.S. Postal Service offers standard mail service.

[18] One serious flaw with the proposed 30+ day late trigger is that these accounts are in fact so risky that a significant proportion (close to 50%) of these accounts will ultimately be uncollectible, and so the risk mitigation effect is severely limited.

consumers who pay even 1 or 2 days late are substantially riskier than cardholders who pay on time, we believe this is a reasonable compromise. Customers who pay five or more days late – even once – are more than twice as likely to charge-off as customers who always pay on time.

d) Only allow repricing of existing balances for going overlimit on the basis of some tolerance. We recommend 102% of the actual credit limit amount. This 2% cushion (on average, well over $100, which is more than two average transactions) will protect consumers from inadvertently going over the limit by some minimal amount.

e) Require banks to reverse any adverse action as a result of a returned payment item that the customer can reasonably demonstrate is the result of a bank error.

2. <u>Repricing Existing Balances Based on a Material Increase in Customer's Credit Risk</u>

We recommend the following:

- Preserve the benefits of risk-based pricing over time but limit the frequency and reasons for non-default repricing of existing balances:

a) Prohibit "any time for any reason" repricing. This phrase is overly broad and has the potential to be abused, even if such abuse is rare in practice.

b) Allow only one non-default repricing in any 12-month period or at the card expiration date (not less than 12 months). No non-default repricing should be permitted during the first year after an account is opened. Non-default repricing must be based only on a material increase in credit risk as demonstrated by statistically valid credit scoring models.

c) Require that borrowers be given a reasonable period of time (for example, 30 days) to avoid any non-default repricing by closing their account and paying off their balance under the current terms and ensure that consumers understand their option to opt out (as the Fed has done in its earlier Regulation Z proposals).

This adjusted proposal would require an explicit linkage between pricing and risk. It provides consumers with more options, better notice, and some measure of protection against events out of their control. At the same time, it will provide issuers sufficient flexibility to maintain the relationship between risk and price, offer lower overall rates, provide credit to more borrowers, and maintain the safety and soundness of their institutions.

III. Allocation of Payments

The current standard industry practice is to allocate payments of principal to balances from lowest APR to highest APR (the "Low-to-High Method"). This means that balances subject to lower rates (including promotional balances) are paid off before balances subject to higher rates. The main argument offered against the Low-to-High Method is that consumers (especially unsophisticated ones) cannot fully understand it.

Although we appreciate the communication challenges presented, we believe that banning the Low-to-High Method is an excessive response that will result in significantly less price competition. Specifically, it will reduce the availability, length, and utility of promotional offers and impede the ability of smaller issuers to compete with larger ones.

A. The Benefits of the Low-to-High Method

The Low-to-High Method supports the industry's use of promotional-rate pricing. There are four major benefits associated with the Low-to-High Method: (1) it allows consumers to borrow money at a below-market rate for a reasonably long period of time; (2) it reduces lender marketing costs; (3) it promotes price competition; and (4) it gives consumers what they want. Requiring payment allocation methods that are ostensibly more favorable to the consumer will reduce or eliminate each of the benefits.

1. Loans at Below-Market Rates

Promotional rates offer consumers several significant benefits. Obviously, they provide consumers the opportunity to borrow money at a rate below their current rate. We estimate that on average, consumers receive a discount of approximately 10 percent below what the lender perceives the consumer's "market rate" (as indicated by the non-introductory rate included in the offer) to be.[19] And perhaps more significantly, these offers allow borrowers to move their balances from high-cost lenders to lower-cost lenders quite easily. Therefore, borrowers gain not only an average 10 percent discount for a period of time, but also a reduction in their non-introductory rate. We believe this benefit is worth close to $20 billion per year to American consumers.[20] In addition, this intense competition among issuers forces each bank to innovate and reduce costs.

Standing alone, promotional offers are highly unprofitable. Lenders use them primarily as "loss leader" marketing offers. The proposed rule will increase the cost of promotional offers to lenders significantly.[21] As a result, adopting the proposed rule will lead to fewer promotional offers, shorter promotional periods, and higher promotional rates. Customers will end up worse off instead of better off.

2. Reduced Marketing Costs

Promotional offers reduce marketing costs because they are more productive (more consumers respond for a given mail volume). Put another way, by using promotional

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[19] Argus Industry Study, see end note 12.

[20] According to data from the Argus Industry Study, approximately 18% of the $850 billion in card balances are at promotional rates. Assuming that consumers are saving 10% against their new non-introductory rate and 6% against their old rate, this would equate to a cost savings of almost $20 billion even accounting for the impact of payment allocation and balance transfer fees (estimated to be 4%). $850 billion x 18% = $153 billion. $153 billion x (10% + 6% - 4%) = $18.4 billion.

[21] The proposed rule would require promotional balances to be last in the payment hierarchy (except for the minimum payment amount). As a result, promotional balances would paid much slower, and issuers would end up extending credit at below-market rates for a longer period of time.

offers, lenders can share some of their marketing savings with consumers in the form of lower interest rates. Eliminating promotional offers will inevitably raise marketing costs (and by extension the cost of credit) and reduce the choices available to consumers.

Lower marketing costs answer the argument some critics of promotional offers make. They argue that lenders only offer promotional rates because it is in their interest (not the consumer's interest) to do so and maintain that consumers therefore do not obtain "real" benefits from such offers. This argument is incorrect, because product innovation is not a zero-sum game. Promotional rates allow lenders to save a great deal of money on marketing. If lenders share some (not all) of this savings with customers, everyone will emerge better off.

3. Price Competition

Credit card lenders compete vigorously on price in order to acquire new customers and retain their current ones. This helps keep prices for everyone as low as possible. The proposed rule will hinder price competition in at least three ways. First, as noted above, prohibiting the Low-to-High Method will result in fewer promotional offers. Second, if a borrower's ability to refinance balances at lower interest rates is diminished, lenders will have less incentive to keep prices low for their existing customers. Third, increasing the cost of the most effective type of marketing offers (promotional offers) could disproportionately affect smaller banks. It will be relatively easy for larger banks to drive smaller competitors out of business by subsidizing customers in the short term. Smaller banks will be at a significant disadvantage, because they will be disproportionately cut off from the most effective types of marketing offers. This impact will accelerate the trend in concentration in the credit card industry.

4. Customer Preference

Credit card issuers use promotional rates because *consumers have consistently demonstrated that this is what they want.* Card issuers test many different kinds of offers, many different pricing combinations, and many combinations of non-price benefits (such as reward programs, activation incentives, or add-on products). Although each of these benefits appeals to certain types of customers, by far the most popular type of offer is one that offers the customer a very low promotional rate and a relatively low non-introductory rate.

The proposed regulation will make this type of offer far more costly to lenders. If the regulation is adopted, lenders will continue to compete, but such offers will be much less widespread and less generous to cardholders (*i.e.,* shorter promotional periods, and higher promotional rates). Instead, competition will necessarily focus on card attributes that are less valuable to cardholders (for example, other terms, fees, or reward programs).

B. Responses to Consumer Criticisms of the Low-to-High Method

The principal objection to the Low-to-High Method is that consumers cannot understand it. Although we admit that many of the implications of payment allocation may be a bit complicated, we disagree that the basic idea behind the Low-to-High Method – that payments are applied first to the balance with the lowest rate – is especially difficult to communicate or understand. If this concept is clearly communicated to cardholders at

the outset (as we do in all marketing materials and offers and consistently repeat over the course of the account relationship; see Appendix 3), we believe most borrowers will understand this relatively simple concept and use their account in a way that maximizes their utility. For some borrowers, that may mean minimizing borrowing costs by using the account only for the promotional offer until the offer has expired. For other borrowers, that may mean broader use of their credit line.

The evidence supports our beliefs. First, we receive virtually no complaints from customers about payment allocation. Over a recent 12-month period, only five out of over 12 million customers (0.00004%) wrote to complain about payment allocation.

Second, although consumers may not be able to explain payment allocation precisely, our customers who take advantage of promotional offers demonstrate a clear understanding of payment allocation through their behavior. For example, when we offer promotional rates on initial balance transfers but not on purchases, consumers behave according to their own best interests – they tend to maintain a large transferred balance and minimize purchases during the period of time the promotional rate is in effect. As soon as the promotional period ends, purchase behavior returns to normal and the previously high transferred balance is paid down. Similarly, when a promotional rate is offered only on purchases, purchase activity conforms to a pattern consistent with cost-saving maximization for the customer.[22] Accordingly, we disagree that only a small group of sophisticated consumers understands how the Low-to-High Method works.

C. Recommendations

Consumers are best-served by preserving practices and benefits that have evolved in a highly competitive marketplace. Chief among these is competition based on price, which is enabled by promotional offers. If some consumers do not understand payment allocation, it is far better to address this lack of understanding directly through better disclosures than to take away a widely shared benefit that consumers consistently vote for with their behavior.

We believe consumer understanding could be improved by requiring prominent disclosure in marketing materials as well as in the initial disclosures pursuant to Section 226.6 of Regulation Z. The Agencies might also wish to consider drafting a short explanation of how payment allocation affects borrower costs for various patterns of account use, including specific examples which could be provided either in the application disclosures or account opening materials.

IV. Overdraft Practices

As a general matter, we support the Agencies' efforts to ensure that overdraft protection is provided in a responsible and fair manner. In that regard, we have no objection to the two substantive protections that the Agencies are trying to advance under their proposal: (1) providing customers with the right to opt out of all overdraft protection and (2) limiting overdraft fees for overdrafts caused by holds placed on funds that are in

[22] Consumers use their cards to maximize *utility*, rather than strictly to minimize their costs. Accordingly, not all consumers who take a promotional offer are motivated solely by the interest rate feature of the card. Some may be more interested in the increased line of credit; others may be more interested in a reward program. Thus, not all consumers behave as described above.

excess of the actual purchase or transaction amount. As discussed above, we have concerns about how these protections are implemented under the proposal and believe they would be more appropriately advanced under a consumer protection regime rather than under the agencies' authority pursuant to the FTC Act to prohibit unfair or deceptive acts or practices.

The labeling of what are now considered legitimate banking practices as unfair or deceptive poses a number of concerns. For instance, we note that the 2005 Interagency Guidance on Overdraft Protection Programs indicated that providing customers the right to opt out of overdraft protection was a "best practice," implying that not providing the right to opt out was permissible, but not a best practice. Under the current proposal, however, the agencies would deem the imposition of overdraft fees without providing a consumer the right to opt out to be an unfair or deceptive practice. This dramatic change in the classification of such an activity – from being permissible to being unfair or deceptive – poses legal and reputation risks to the Agencies' regulated entities that should not be underestimated.

To address these concerns, we would suggest that the Agencies look to other statutes and regulations, such as the Truth in Savings Act (Regulation DD), the Electronic Fund Transfer Act (Regulation E), or the Home Owners' Loan Act, to advance overdraft reforms. We would also suggest that the Agencies make clear that the prohibitions of any practices under these alternative legal authorities or the designation of such practices as unfair or deceptive only apply prospectively after the effective date of the new rules.

A. Opt-out for Overdraft Protection

We appreciate the Agencies' concern that customers have the right to opt out of overdraft protection programs. Currently, Washington Mutual provides its customers such a right. In fact, for those accounts with overdraft protection, we also currently disclose to customers on their periodic statements the total amount of overdraft fees they have paid for the calendar year and for the statement period. That being said, we support the FRB's proposed Regulation DD changes to require all institutions that charge overdraft fees to make these same disclosures.

However, we oppose requiring institutions to provide consumers the additional right to opt out of an overdraft program only for ATM and point-of-sale (POS) transactions. Such a requirement would significantly increase the complexity and costs of overdraft programs and cause consumer confusion. For instance, under most overdraft programs, the institution has the discretion to honor or return items that would overdraw an account. Consumers who choose to opt out of having ATM and POS transactions included in an overdraft program could erroneously infer that all other transactions, such as those involving checks, would always be protected from overdrafts. That would not be the case.

We also believe that the practice of assessing overdraft fees without providing a consumer a partial opt out for ATM and POS transaction should not be considered an unfair or deceptive act or practice, because it does not meet the consumer injury standards articulated by the FTC for being unfair or deceptive. Consumers can easily avoid any injury with regard to the assessment of overdraft fees for such ATM and POS transactions by opting out of the overdraft program in its entirety. In addition, consumers

can avoid overdraft fees altogether by managing their accounts in a financially responsible manner. Despite the Agencies' commentary to the contrary, we believe that consumers have access to sufficient information about their accounts to avoid overdrawing them. With the availability of phone, ATM, and online access, customers can get information on their balances, holds, credits and debits quite easily.

In their proposal, the Agencies would provide two exceptions to the general prohibition on an institution charging an overdraft fee when a consumer has opted out of an overdraft program. We support these two exceptions and provide in Appendix 4 a list of circumstances for which additional exceptions would be appropriate. We cannot guarantee, however, that this list covers all scenarios.

B. Debit Holds

We also understand the Agencies' concern with consumers paying overdraft fees for debit holds that exceed the actual purchase or transactional amount. We note, however, that the establishment of a debit hold is an arrangement between the merchant and the customer, and any abuses or concerns regarding such an arrangement would best be addressed directly with these parties, instead of indirectly through depository institutions. If the Agencies insist on addressing this issue through new rules on depository institutions, we urge that the rules be adopted under the Electronic Fund Transfer Act or other authorities, rather than under their UDAP authority, for the reasons noted above.

We further note that implementation of an automated process to systematically identify those occurrences for when an overdraft fee could or could not be assessed for debit holds, as provided for in the Agencies' examples, would require significant technological changes for the industry. This is because a system would need to be developed to compare the original hold to the posted transaction and also assess with respect to each intervening overdraft transaction to see if the overdraft would not have occurred but for the placement of the hold. We therefore propose that any new rules on this subject allow depository institutions to assess an overdraft fee in such instances so long as the depository institution has a process in place to later refund the fee upon the consumer's request. This process would be similar to the one institutions can use to refund overdraft and returned check fees under Regulation CC, where holds are placed after the time of deposit, where the item is ultimately paid and the fee is solely a result of the hold. Notice of this right to request reimbursement could be included on overdraft-related notices, similar to the notice required under Regulation CC for hold notices in the circumstances described above.

V. Conclusion

Consumers benefit most when they are able to choose the products and services they prefer through the operation of a competitive market. Through their decisions, consumers have demonstrated a preference for credit card accounts with very low introductory rates and low non-introductory rates, even at the cost of allowing the issuer to adjust pricing for credit risk over time. The incredible success of the credit card as a vehicle for consumer borrowing and payment illustrates that this agreement between lenders and borrowers is a sound one.

The proposed restrictions on repricing existing balances will limit the ability of issuers to align price with credit risk and fundamentally undermine this lender-borrower agreement.

The restrictions are bad public policy that will hurt consumers, banks, and the American economy by:

- reducing access to credit for millions of consumers;
- increasing prices for the majority of consumers (especially for consumers cut off from the benefits of credit cards);
- allocating credit inefficiently (which, as the Fed has pointed out, both increases banks' exposure to losses and reduces demand in the American economy); and
- potentially undermining the safety and soundness of credit card-issuing institutions.

The proposed rules on overdraft policies, while reasonable and consistent with our practices in substance, should not carve out partial opt-outs and should not be issued under UDAP authority. Doing so would harm consumers through the imposition of difficult and expensive administrative and system-related burdens on all banks.

Once again, Washington Mutual appreciates this opportunity to comment on the proposed rulemaking. If you have any questions concerning these comments, or if we can otherwise be of assistance in connection with this matter, please do not hesitate to contact us. Thank you for your consideration.

Sincerely,

Stephen J. Rotella
President and Chief Operating Officer
Washington Mutual, Inc.

Appendix 1 – Applicability of UDAP regulatory framework to practices cited

There are serious legal issues with this unprecedented rulemaking proposal under UDAP authority. However, these issues are somewhat technical in nature and are thoroughly covered by others, including the comments of the American Bankers Association. We will not repeat those arguments here other than to say that holding long-standing industry practices to be unfair or deceptive, whether explicitly or implicitly in the rule-making, has the potential to open a Pandora's box of liability for regulated institutions that could be beyond the powers of the regulatory bodies to contain and that could endanger the safety and soundness of those institutions. Accordingly, the rulemaking should proceed with an appropriate level of caution.

The remainder of this appendix will be devoted to analyzing the specific practices identified in the regulatory proposals in light of the standards set forth in Section 5(a) of the FTC Act. We believe our analysis will illustrate that many of these practices are neither unfair nor deceptive.

I. Application of Increased APRs to Outstanding Balances

Repricing existing credit card balances does not meet the definition of an unfair or deceptive act or practice under section 5(a) of the FTC Act. To be unfair or deceptive under the FTC ACT: (1) the act or practice must cause substantial injury to the consumer; (2) the injury must not be reasonably avoidable by the consumer; and (3) the injury must not be outweighed by countervailing benefits to consumers or to competition. Increasing the interest rate on an existing balance meets none of these tests. This practice does not injure consumers; is completely avoidable by the consumer; and provides substantial benefits to consumers and the U.S. economy that vastly outweigh any consumer harm.

A. There is no Substantial Injury to Consumers

The Agencies argue that an injury results from increasing the interest rate simply because cardholders will pay more in interest charges than they would have if the rate had not changed.[23] This argument is wrong because it is incomplete.

All borrowers pay for credit on the basis of risk. High-risk borrowers are not "injured" simply because they must pay higher initial rates for a loan. If borrowers are free to moving their balances to other lenders willing to offer lower rates, it is hard to see how the consumer experiences any substantial injury.

Furthermore, "injury" for purposes of the FTC Act generally results from an action of the seller (in this case the lender) that prevents the consumer from enjoying the benefits of the contract that was signed. Here, the lender simply is following the terms of the contract. Some commentators suggest that credit card issuers deliberately create contracts that are difficult to understand and argue that this is evidence of injury. However, this argument ignores the fact that most of the "convoluted" disclosures and

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[23] Unfair or Deceptive Acts or Practices, 73 Fed. Reg. 28,904 (proposed May 19, 2008) (to be codified at 12 C.F.R. pts 227, 535, 706) ("Proposed UDAP Rule") at 28,917.

the resulting lengthy contract stem either from regulatory mandates or from the lender's desire to avoid liability in civil legal actions. Credit cards are a complex product, so the account agreement must envision a wide range of possible scenarios. One wonders if these same commentators would offer issuers a safe harbor for providing a simple set of disclosures that did not lay out all of the terms and conditions of the agreement in as comprehensive a manner as they are now.

B. Consumers can Reasonably Avoid any Harm

The Agencies offer several reasons to support the argument that the repricing of existing balances "as a general matter, is not reasonably avoidable":[24]

(1) consumers may not understand under what circumstances balances are repriced;

(2) consumers may misjudge their ability to repay amounts they have borrowed or their ability to avoid penalty triggers;

(3) consumers may have no control over the circumstances that lead to the repricing (for example, if the bank's cost of funds goes up or if the bank capriciously reprices for "any time or any reason");

(4) consumers may be repriced because their general credit risk has increased rather than because of a specific account default with their lending institution, or may be repriced based on internal credit scoring models developed by the banks that consumers do not understand; and

(5) consumers may be repriced based on violating the account agreement due to circumstances they cannot control (for example, loss of income, unemployment, or illness).

None of the above arguments meets a reasonable standard for unavoidability.

Although we will review these reasons individually, the general theme is that we support addressing specific issues with narrowly-tailored regulation, not with broad-based regulation that will have serious adverse unintended consequences. If regulations were to focus on these specific issues, rather than target all repricing of existing balances, customers could be protected and the benefits of market-based pricing preserved.

1. Borrowers control and can prevent the actions that cause repricing

a. Borrowers do understand why rates increase

We believe that the great majority of borrowers understand that defaulting on a credit card agreement can lead to adverse consequences such as the imposition of a penalty fee or a higher rate. Our account application materials and account agreement clearly indicate that three specific account defaults – paying late, going overlimit, or submitting a returned payment – could lead to increased rates. Moreover, these actions will lead to

[24] *Id.* at 28,918-19.

adverse consequences in almost any credit relationship (for example, a mortgage, an auto loan, a student loan, or a personal loan). Therefore, we believe that a reasonable person can and does understand that defaulting on the account can lead to actions specified in the account agreement. Finally, if the problem truly is lack of understanding, the solution should be steps to improve understanding through better disclosures and more consumer education.

b. Some consumers "misjudge" their ability to honor the card agreement, but that does not mean they had no power to control their finances

We realize that some consumers fail to manage their finances responsibly. Some people borrow money they cannot afford to repay or enter agreements to which they cannot adhere. But simply because a small minority of borrowers end up in trouble does not mean that they had no power to avoid the trouble. There is an important distinction between unavoidable harm and harm due to poor decision-making.

Moreover, such misjudgments are themselves important indicators of risk that were not available to the lender at the time the account relationship began. Indeed, the alternative to penalizing (by fee or repricing) consumers who misjudge their ability to honor an agreement would be to make all consumers pay for the mistakes of a few. One can think of many analogous situations where the public good would be hurt by allowing contract avoidance for consumer misjudgments. For example, if a driver misjudges the speed at which he is driving, he may receive a speeding ticket and his insurance rates may increase. If the public entities were not allowed to raise revenue through assessing a fee specifically on drivers engaging in risky behavior, then: (1) there would be less incentive to drive responsibly; (2) the average cost of insurance would increase; and (3) low-risk drivers would need to subsidize high-risk drivers, not only with respect to insurance but also for the cost of public safety.

c. Consumers should have control over events leading to repricing

We agree that in some cases, where repricing is not based on risk, consumers may have no control over the event which leads to the repricing. For example, a lender may simply want to attempt to increase its profits. The solution for this, however, should be to specify which reasons justify repricing and which reasons do not.[25]

Furthermore, we agree that consumers should be able to reasonably avoid repricing through exercising reasonable diligence. For this reason, we support the proposal to allow an adequate time between the mail date of the statement and the payment due date (21 days). We also recommend prohibiting the use of cut-off times that can be used to "trap or trick" a consumer into being late. If other lenders engage in such practices (we do not), we believe those practices should be banned. In our comment

[25] It seems ironic that one of the examples used in the text of the regulation to justify this point is when a bank's cost of funds increases (which the consumer has no control over), whereas one of the exceptions to the prohibition on repricing existing balances is when an index that underlies a variable rate changes. Indexes and variable rates are used precisely because they allow banks to adjust their pricing with their cost of funds. On the one hand, this is used as an illustration that the consumer cannot avoid harm and on the other, this is considered an acceptable practice!

letter, we also recommend that a cushion of three or four days be provided before a customer triggers repricing.

However, if adequate consumer protections are implemented to mitigate the risk of mail delay (adequate time is given to receive the statement and return the payment; no cut-off time is used; a three or four day cushion is given to the customer; and other, immediate methods of payment are available[26]) and the customer is *still* late in paying, we believe that the consumer has been given a reasonable opportunity to avoid the late payment as a general matter.

Generally, repricing should be allowed when it creates market efficiency (*i.e.*, when it is based on a demonstrable change in the risk of the account) or is fundamentally linked to the cost of supplying the credit in the marketplace (cost of funds, or charge-off risk of the account). Therefore, we agree that issuers should not reprice accounts at "any time for any reason," and *would not object if the Agencies were to prohibit repricing on any basis other than the underlying risk of the account* (or pursuant to the exceptions included in section 227.24(b) of the proposed regulation).

d. Consumers generally can avoid being repriced due to their actions with another lender

Most credit card lenders reprice accounts of some borrowers who have not violated their agreement but who nevertheless demonstrate increased risk through their actions with other lenders. However, borrowers can avoid this sort of repricing in two ways. First, cardholders should manage their finances so that they maintain their overall creditworthiness. Second, non-default repricing requires a so-called "change in terms," which generally is not (and should not be) imposed without giving the customer the opportunity to close the account, avoid the change, and pay off balances at the former rate.[27]

We strongly oppose capricious repricing. We agree that consumers should not be repriced based on any *single* external event (for example, making one late payment to another creditor). However, if the borrower's overall credit risk declines, as evidenced by a decline in statistically valid and tested credit scoring models, *it is better for all consumers if the lender is allowed to maintain alignment between the risk of the account and the price on the account.*

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[26] For example, internet or telephone payments.

[27] The Agencies argue that it would rarely be economically rational for a customer to accept a higher rate in return for keeping the account open. Proposed Rule at 28,919. This is not the case. So long as there are no annual or other account maintenance fees, there is usually no reason to close the account. If a lender raises a customer's rate on existing balances beyond the rate the customer could obtain from another lender, the customer can keep the account open (in case it is needed later) and either transfer those balances or pay them off and revolve with another lender instead. The Agencies also argue that many customers might not be aware of or understand their opt-out right. *Id.* If that is the case, the solution is better disclosures and more consumer education, not a broad-based prohibition that will harm responsible lower- and middle-income consumers most of all.

e. Consumers should not be repriced based on violating the account agreement due to circumstances they cannot control – for example, illness, or loss of employment.

We do not reprice any account based on health or employment status or on any variable which may be correlated with health or employment status such as age or geography. We do not consider such events to be relevant to the issuance of credit. Furthermore, the availability of credit card loans greatly benefits people experiencing commonly recurring events such as illness or loss of employment. In fact, credit cards frequently provide the short-term financial help to get families through such events. And the vast majorities of individuals who are impacted manage their finances responsibly and repay their debts in accordance with their agreement.

Accordingly, the argument that borrowers cannot avoid the causes leading to the repricing of existing balances is incorrect. Repricing of existing balances is caused by the borrower's own actions.

2. Borrowers can avoid the effects of repricing

The argument that borrowers cannot avoid the effects of repricing existing balances is likewise incorrect. If a lender misjudges a borrower's credit risk, the borrower needs to find only one lender in the entire market willing to lend at a lower rate. Every year, billions of credit card solicitations are sent to households. Millions of customers transfer balances from one card to another, and millions more actively review offers and rates and plan to switch lenders.[28] Furthermore, credit cards compete in a larger credit market against all other credit products – mortgages, personal loans, home equity lines of credit, auto loans, and so forth. And if not one lender in the entire country is willing to lend to the borrower at a lower rate, then the existing rate cannot logically be termed "unfair."

C. Any Injury is Outweighed by Countervailing Benefits

Paying a market rate of interest (*i.e.,* the best interest rate the borrower can obtain in a highly competitive market) is not an "injury" to the cardholder. However, even if this were purported to be an injury, any adverse consequence is far outweighed by the countervailing benefits of risk-based pricing.

We discussed those benefits at length in our comment letter. They include: (1) lower prices for the majority of consumers (2) expanded access to credit for low- and middle-income borrowers; (3) lower cross-subsidization among borrowers; (4) increased flexibility resulting from open-ended revolving credit products; (5) enhancement of lenders' safety and soundness; and (6) general economic stimulation.

II. Allocation of Payments

Almost all issuers apply payments of principal to balances in the order of lowest to highest APR (the "Low-to-High Method"). We strongly disagree with the Agencies' conclusion that the Low-to-High Method meets the definition of an unfair or deceptive act or practice under the FTC Act. This practice does not cause an injury to the customer in

[28] Card Data, June 18, 2008 – 41% of American cardholders plan to switch credit card balances within 12 months.

any sense that the term injury should be used; is avoidable by the consumer; and provides substantial benefits to consumers and the U.S. economy. In particular, our practices are not unfair or deceptive.

A. There is no Substantial Injury to Consumers

Consumers are not "injured" simply because they may pay more in finance charges under the Low-to-High Method than under some other method. The test for injury should not be whether there is any possible way consumers could pay less. Instead, the test in this case should be whether the lender has coerced or misled the consumer into paying more than the consumer would have paid in a competitive market.

First, we clearly disclose the payment allocation method in the body of our marketing letters. Second, we reiterate how payments are applied to balances in the account terms on the back of our marketing letter – we even highlight it in bold type to draw consumers' attention to this aspect of the account (see Appendix 3). Finally, the proposed revisions to Regulation Z will require even more conspicuous disclosure of the payment allocation method.

Therefore, we believe there is no element of deception in using this contract term. We do not believe the cardholder can be considered injured by the terms of a contract that they willingly agreed to. If customers do not understand how payments are applied, the solution is better disclosures and more consumer education, not a broad-based regulation that will do far more harm than good.

B. Consumers can Reasonably Avoid any Harm

The Agencies argue that this so-called injury is not reasonably avoidable for three reasons. First, consumers do not have control over the institution's allocation of payments or use of grace periods. Second, disclosures may be inadequate to fully understand the impact of payment allocation. Third, consumers may not be able to fully realize an expected or offered benefit because of the consumer's own financial condition.[29]

Once again, these arguments do not seem to be consistent with previous case law in determining whether an injury is reasonably avoidable. We believe the test has been, and should continue to be, whether the lender's actions in some way prevent the consumer from avoiding a purported injury.

We certainly agree that banks have a legal obligation to disclose clearly and conspicuously all relevant terms of a credit agreement so that consumers can make an informed choice about using the product on the terms offered. As noted above, we disclose our payment allocation method in the body of our marketing letters and highlight this term in the terms and conditions on the reverse (see Appendix 3). We support the enhanced disclosure of this term set forth in the proposed revisions to Regulation Z. We also support increased consumer education. Examples demonstrating the effect of payment allocation in different circumstances might enable consumers to see more clearly how the allocation method impacts finance charges. However, arguing for

[29] *Id.* at 28,915.

enhanced disclosures is very different from asserting that consumers have been treated unfairly because some of them may not completely understand the impact of their actions.

In fact, as we have discussed above, there is strong evidence to show that consumers do in fact understand how payment allocation works and that they consider the effect of payment allocation in maximizing the utility of their credit card. Many consumers seek to maximize the value of promotional offers and their behavior clearly indicates that they behave accordingly. Other consumers may value other aspects of their card such as their ability to purchase goods and services or earn rewards and do not care at all about the promotional offer aspect of their card at all. Again, this behavior can clearly be observed in any group of customers. Furthermore, as noted in our letter, we receive virtually no complaints about payment allocation methodology from our customers.

Finally, this issue almost always involves either cash advances (which typically have a higher interest rate) or promotional offers (which have lower rates). With respect to cash advances, consumers can avoid any purported injury by not using their card for cash advances.[30] And with respect to a promotional offer, customers generally can avoid any injury either by not taking the offer or by using their account only in conjunction with the offer until the offer has expired.

C. Any Injury is Outweighed by Countervailing Benefits

As noted in Section III.A of our comment letter, the Low-to-High Method supports promotional pricing. Customers benefit in two ways: through direct savings and through enhanced price competition.

The Agencies argue that the direct and immediate benefit a consumer receives from the ability to transfer a high-rate balance to a lower-rate balance is not a "true" benefit to consumers as a whole. The Agencies further suggest that the proposed regulations are pro-competitive, because competition will shift away from "artificial subsidies" and be forced to compete on a "truer" non-introductory rate. [31]

Both of these arguments are incorrect. First, as outlined in the body of our response, even if revenue per account were neutral over the lifespan of the customer (so that any initial subsidy to the customer was offset by higher charges later on), consumers benefit when lenders take different business approaches, because there are more choices available. Some consumers may prefer lower rates now (when they need to borrow money) in exchange for higher ones later (when they do not anticipate such a need). Other borrowers may prefer their costs to be more evenly distributed.[32]

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[30] In fact, well-established data shows that cardholders who use their card for cash advances default at a much higher rate than cardholders who do not.

[31] Proposed UDAP Rule at 28,915-16.

[32] This is akin to mortgage lending, in that some borrowers prefer to pay points and a lower periodic rate, whereas other borrowers prefer to minimize up-front costs and pay a higher periodic rate.

Second, there is no reason to believe that revenue per account is in fact neutral over the lifespan of the customer. As pointed out in Section III.A.2 of our letter, promotional offers are the most effective marketing strategy for attracting credit card borrowers. Accounts obtained through promotional offers therefore have lower acquisition costs. Consequently, promotional offers allow lenders to get less revenue per account but still make the same or more profit per account. To the extent that the regulation increases lenders' per-account acquisition cost, it will simply raise the price and decrease the supply of credit.

The proposal also argues that there is a benefit to consumers of competition on criteria other than promotional rates. Presumably, it is perceived as beneficial to consumers to compete on such criteria as the non-introductory rate, reward programs, or other terms and conditions instead of on promotional rates. This argument, however, ignores the fact that banks already compete on each of these factors. Credit card offers can easily be found with any combination of these attributes. Nevertheless, the reason promotional offers are the cheapest and most effective way to market credit cards is because *consumers want them*. It is difficult to understand how consumers will benefit from a proposal that not only will reduce the type of offer consumers want most but also will increase marketing expenses and the overall cost of credit.

III. Balance Computation Method

Although Washington Mutual currently uses a version of the two-cycle average daily balance (Two-Cycle ADB) method, we do not object to the Agencies proposal to eliminate the assessment of finance charges on balances in previous billing cycles for three reasons. First, the Two-Cycle ADB computation method permits both legitimate practices (assessing interest from the date of the loan) and practices we neither condone nor use (such as so-called "trailing interest"). Second, we agree that it is very difficult to explain this balance computation method and to distinguish between legitimate variations of this method and other variations that we do not support. Finally, the Two-Cycle ADB method impacts very few customers, and for the customers impacted, the effect is quite small.

Once again, however, we do not believe that our practice (which does nothing more than eliminate the grace period when a customer switches from paying in full to revolving a balance) is, or could be considered, unfair or deceptive. Our practice is clearly disclosed both in the Fed Box (as is required by current regulations) and in bold print in two places in the account agreement. At a minimum, the Agencies should draw a distinction between this practice (which merely assesses interest *from the date the loan is made* if the cardholder chooses to revolve a balance) and the practice of "trailing interest" (which assesses interest on balances previously paid in either the prior *or* current billing cycles).

Certainly, our practice does not meet the legal definition of unfair or deceptive. A customer is not injured simply because an alternative methodology may exist. All banks disclose their methodology as prescribed in existing regulations. If consumers are free to choose their card and enter into the contract willingly, consumers are in no sense injured by the mere operation of the contract terms they have agreed to.

In addition, consumers can avoid any purported injury associated with this balance computation method by choosing a card with the balance computation method they prefer. Not all banks use the two-cycle method; indeed, most do not. We believe that

consumers are free to choose the card (and computation methodology) that best meets their needs. Consumers who consistently revolve balances may prefer an account with the two-cycle method and slightly lower rates. Consumers who often switch between paying in full and revolving a balance may prefer an account with a single-cycle method and slightly higher rates.[33]

Third, as the Agencies note, the prohibition of this balance computation methodology could result in higher pricing for cardholders across the board as issuers seek to offset the revenue loss from this practice. This prohibition could also potentially result in limiting the use of grace periods for some groups of consumers.

As an alternative to the current proposal we suggest the Agencies consider a more targeted regulation that addresses the practice known as "trailing interest." Significantly, this practice can occur in both the one-cycle and the two-cycle balance computation methodologies and therefore is not explicitly addressed in the current proposal.

[33] As practiced by most issuers, the two-cycle method undoes the effect of a grace period in any cycle where the borrower switches from paying in full to revolving a balance. Therefore, the two-cycle method will have no effect on customers who pay in full each month and almost no effect on customers who always revolve a balance (the only effect will be the loss of the grace period in the first billing cycle).

Appendix 2 – Responses to Specific Questions

Time to Make Payments

- We believe the proposal to provide a "safe harbor" if a lender adopts procedures designed to provide a 21 day period between the mailing date of the statement and the payment due date is reasonable.
- We would not incur material costs to comply with this requirement.
- We believe that Agencies should not adopt a rule that prohibits institutions from treating a payment as late if received within a certain number of days after the due date. Adopting such a rule would effectively be the same as changing the due date or mandating a late fee grace period. Further, we believe that the phrase "treating the payment as late" is vague since various events can be covered as a result of "treating the payment as late."
- We believe consumer protection can be enhanced by a two-step process that addresses the two main adverse consequences which can result from a late payment. First, the Agencies could require that all payments received at any time on the calendar day of the due date be considered as "on-time" payments. Second, the Agencies should allow repricing of existing balances if the payment is received more than three to four days after the due date.
- We believe it would be reasonable to require banks to reverse late fees if consumers provide proof that a reasonable effort was made to make an on-time payment. We believe evidence that the payment was placed in the mail at least 5 business days before the due date would be a reasonable standard of proof. However, regulators should *not* place the burden of proof on issuers. Requiring a bank to check the postmark on over 10 million pieces of mail each month would be a significant (indeed, nearly impossible) task that current payment processing systems could not support.

Section 227.23 – Allocation of Payments

As noted above, our objection to this proposal is based on the harm it will do to consumers and the impact it will have on the bank.

- Our systems are currently not capable of: (1) applying the minimum payment amount differently than amounts above the minimum; (2) applying payments on a pro-rata basis or on an equal basis among balances; (3) applying payments to promotional balances last; and (4) providing a grace period on new purchases even when promotional balances are not paid in full. We are working with our transaction processor, Total System Services, Inc. (TSYS), to determine the cost and time necessary to satisfy these requirements. Preliminary feedback from TSYS has indicated that they would need 24 months to modify their systems to comply with this proposal. Accordingly we would request that the implementation date for any proposed regulation concerning payment allocation be no sooner than January 2011.
- We are working with TSYS to estimate the cost of this work.

- The Agencies definitely should not require a payment allocation methodology based on consumer instructions. We believe such a requirement would be impossible to implement, because it would require processors to handle an almost unlimited number of allocation methodologies.

- The Agencies should also clarify that this proposal is not intended to require issuers to provide a grace period or promotional balances on all accounts nor to impose restrictions on the amount or calculation method of the minimum payment.

Section 227.24 – Application of Increased Rates to Existing Balances

- Washington Mutual will *consider* increasing rates when an account demonstrates materially different risk in one of two ways: when cardholders default on certain account terms or when a review of the account indicates increased overall credit risk.

- With respect to account default, we use the three standard default criteria described in the proposal (paying late, going overlimit, or submitting a returned payment), because each of these actions is highly correlated with an increased likelihood of charge off. Borrowers who default in one of these ways actually charge off at a rate more than double that of borrowers who do not demonstrate these behaviors. In each case, we use "tolerances" (some of which are similar but may not be identical to the ones proposed in our comment letter) to ensure that the customer is treated fairly and is not tricked or trapped into having the account repriced. In fact, well under half of these account default events actually lead to a higher price on the account.

- With respect to reviews of the overall credit risk, no single factor is dispositive. Our reviews are based primarily on a proprietary statistical credit model that correlates the account's performance with us to overall credit risk. This risk model is supplemented by using two other industry-standard credit scoring models to improve the predictive power of the combined model. Once again, we use numerous tolerances and exclusions to protect consumers from repricing events not correlated with a material increase in risk from the time the account was opened.

- We do not offer cards that do not permit the two types of repricing events described above.[34] All of our account agreements state that customers have the right to opt-out of any repricing event that is not directly related to account default. About 10 to 15% of customers subjected to non-default repricing through a "change in terms" either opt out of the change or voluntarily close the account and move their balances to another lender.

- Washington Mutual will only increase the interest rate on a credit card based on new information concerning an elevated level of risk in the card account as described above.

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[34] In the past, we have tested similar products ("stress less" cards) and it was determined that these types of cards and programs were less popular with consumers than alternative offers.

- As noted in section II.D.3 of our letter, we believe that the proposed regulations could significantly – and adversely – impact the securitization market for credit card receivables. It is not possible to quantify precisely the impact this will have on our bank, but we are certain that the impact will reduce liquidity.

- As we have discussed in the body of this letter, we view the ability to reprice existing balances as an important risk-control tool. Indeed, it is the primary means of risk control for open-end revolving credit agreements where lenders have foregone the use of other risk controls such as collateral or fixed loan periods. If the proposal is adopted in its current form, the only options banks will have are to dramatically reduce lending to riskier populations, raise pricing for all remaining cards, or change the product construct of credit cards themselves.

- The issue of risk mitigation is particularly important during downturns in economic cycles. The ability to raise prices in a targeted way when risk generically increases across a portfolio is an important factor to enable banks to continue to lend through the economic cycle. In the absence of this ability to reprice for risk, banks would have no choice but to reinforce the impact of economic cycles by further curtailing lending when the economy slows.

- We believe consumers should have a minimum of 30 days to receive and review a notice of a change in terms. That is to say, banks should be required to mail a notice of change in terms at least 30 days prior to the opt-out date specified in the notice.

- We believe our recommendation in the body of this letter is the best way to: (1) meet the consumer's need for clear and understandable credit card terms and consistent and fair market-based pricing; (2) allow consumers to realize the tremendous economic benefits of market-based pricing; and (3) meet banks' need to operate in a safe and sound manner. With respect to the actual questions posed, we feel strongly that repricing of existing balances should be allowed much sooner than the proposed 30 days delinquency. The great majority of accounts that are delinquent to this extent will default, so there is little benefit to repricing these accounts at all. As written, the proposal effectively prevents banks from spreading the risk of default among a population with similar risk criteria in a meaningful way.

- In addition to our request that the Agencies reconsider the proposed limitations on repricing existing balances, we respectfully also request the Agencies to reconsider their proposal with respect to the repayment of outstanding balances. The ability to manage repayment is also an important risk-mitigation or control tool. If banks are effectively required to keep all loans outstanding for at least five years, it will unquestionably increase the bank's exposure to losses. As noted above, banks forego the control inherent in a fixed loan period in exchange for flexibility to adjust pricing based on risk. If banks lose the ability to price for risk (as the current proposal effectively does), then the Agencies would effectively be attempting to require banks to allow consumers to have their cake and eat it, too. Banks would necessarily have to include in their upfront pricing and loan decisions the increased risk not only of not being able to effectively reprice the loan, but also having to live with the added exposure of loans for a longer period of time.

Section 227.25 Fees for Exceeding the Credit Limit caused by Credit Holds

- Washington Mutual will assess no more than one overlimit fee related to the activity within any one billing cycle regardless of the number of times the limit is exceeded or the dollar amount by which the limit is exceeded.

- Washington Mutual reserves the right to assess an overlimit fee in subsequent billing cycles even if the consumer has not engaged in subsequent transactions. We believe this is fair, because only one fee is assessed within the billing cycle in which the event occurs; the customer will have had adequate time to bring the account's balances within the terms of the account by the beginning of the next billing cycle; and the failure to bring the account within the account terms within a reasonable amount of time after the overlimit event occurred is an important indicator of additional risk.

Section 227.27 – Security Deposits and Fees for the Issuance or Availability of Credit

- Washington Mutual does not engage in any practice covered by this proposal.

Section 227.28 – Firm Offers of Credit

- Washington Mutual believes that the proposed language is appropriate to inform customers of the criteria used to determine the line of credit and/or APR they may receive as a result of the marketing offer.

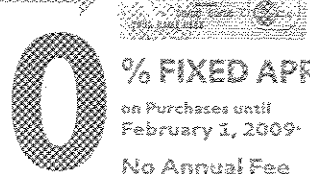
- We believe the language should be included in the body of the marketing offer, neither more nor less prominently than the standard size of the text or copy used in the body of the offer and in reasonable proximity to the discussion of the credit line and/or APR offer in the body of the offer. The Agencies should not require that the safe harbor sentence be as prominently displayed as the most prominently displayed element of the offer (for example if one aspect is highlighted or bolded). The Agencies likewise should not require that the safe harbor language be in immediate proximity to the most prominent mention of the offer, so long as it is included in the body of the offer. However, banks should not be permitted to put the safe harbor language in a footnote or in markedly smaller text than the main body of the offer.

- We do not make offers to customers where the customer has no possibility of receiving the lowest APR or the highest credit line disclosed. We also disclose to customers the minimum, maximum and average lines issued under each offer so that the consumer has additional information about the account they can expect to receive. However, we would request that these disclosures not become required by regulation.

Appendix 3 – Disclosure of Payment Allocation – Examples

You're Pre-Approved for a WaMu Platinum MasterCard

Now—for our valued customers!



Eddie Wan
123 Mission St. Fl. 4
San Francisco, CA 94105-5122

Dear Eddie Wan,

As a valued customer, you're pre-approved* for a new WaMu MasterCard credit card with no annual fee and all the other great benefits you expect from WaMu.

Reply now to get 0% FIXED APR on Purchases until February 1, 2009*

You'll receive a low 0% FIXED APR until February 1, 2009 on purchases (not on balance transfers or cash advances). To enjoy this low rate for the full offer duration, simply follow the terms of all account agreements with us; otherwise, your rates may increase. Payments are applied to balances with lower APRs before those with higher APRs. Please see the back of the letter for Terms and Conditions.

Note: Clear disclosure of payment hierarchy in marketing text right next to other key terms

Platinum MasterCard benefits

You can use your card to make purchases at millions of locations that accept MasterCard credit cards. You'll get all the travel and shopping benefits you'd expect from a MasterCard account, plus you'll enjoy added benefits like free online access to your FICO® credit score,* money-saving discounts to popular restaurants and retailers,* automatic credit line reviews, and $0 liability for unauthorized charges. Plus, this card has no annual fee.

Respond to this pre-approved offer now

Use your reservation number **2PL-27734-7228-G** and visit **www.WaMuCreditCard.com**, complete and mail the Reply Form below, or call toll-free at **1-800-206-2277**.

Sincerely,

Craig Schmeizer
Senior Vice President

P.S. Eddie Wan: Reply now to get the lowest rate—0% APR— on purchases until February 1, 2009.

Respond before 05/19/08

Visit www.WaMuCreditCard.com,
Mail back your reply form,
or Call 1-800-206-2277

*Please see the Terms and Conditions on reverse for important information about this pre-approved offer and applicable rates.

HPVD_GXAK_0_0209_9 029138*00109*20

You can choose to stop receiving "prescreened" offers of credit from this and other companies by calling toll-free 1-888-567-8688. See PRESCREEN & OPT-OUT NOTICE on other side for more information about prescreened offers.

Terms and Conditions

Pre-approved means you received this offer because a preliminary review of your credit report from a consumer reporting agency showed that you met our credit requirements for a MasterCard® account. The card issuer, Washington Mutual Bank ("we"/"us"/"our"), will review your credit, household income, credit relationships with us, and all other information you provide to ensure that you meet all of our requirements when you respond to our offer. If you meet these requirements, you will receive a MasterCard account with a credit line of up to $30,000, or at least $500, and the rates below. Your initial credit line will be determined by your credit profile at the time we open your account. If you do not meet these requirements, we may not extend credit to you.

Annual percentage rate (APR) for purchases	0% through your statement date in February 2009 ("Introductory Period"); after that: 9.99%
Other APRs	Promotional Balance Transfer APR: 9.99% (see explanation below‡) Cash Advance APR: 19.99% Default APR: The Prime Rate† plus 23.99% (currently 29.99%) and may vary (see explanation below*)
Variable rate information	Your APRs may vary Purchase APR: 9.99% or the Prime Rate plus 3.99%, whichever is greater Promotional Balance Transfer APR: 9.99% or the Prime Rate plus 3.99%, whichever is greater Cash Advance APR: 19.99% or the Prime Rate plus 13.99%, whichever is greater
Grace period for purchases	At least 25 days if the New Balance is paid in full by the Payment Due Date
Balance calculation method	Two-Cycle Average Daily Balance (including new purchases)
Annual fee	$0
Minimum finance charge	$1
Transaction fee for purchases	For purchases made outside the U.S. and its territories: 1% of each purchase

Cash advance fee:	3% of the advance ($10 minimum)§
Balance transfer fee:	$0 for balances transferred within the first 30 days of account opening. For future offers, a fee of up to 5% of each balance transfer ($5 minimum per transfer) may apply.
Late fee:	$39 if balance is $200 or greater; $19 if balance is less than $200
Overlimit fee:	$39 if you exceed your credit line at any time during a billing cycle

We may change the APRs, fees, and other terms of your account at any time to the extent permitted by applicable law and the Account Agreement, which we will send you when your account is opened. Factors we may consider in determining whether and how to change your terms include the frequency and severity of defaults and other indications of overall credit risk.

***Default APR:** Each time you default on this or any Washington Mutual credit card account because you fail to make at least the minimum payment when due, exceed your credit line or make a payment to us that is not honored by your bank, we may increase the APRs on your account up to a maximum of the Default APR. Factors considered in determining whether and by how much to increase your APRs include the frequency and severity of defaults and other indications of account usage and overall credit risk.

†**Prime Rate:** The Prime Rate used to determine your APRs is the highest Prime Rate published in *The Wall Street Journal* on the first business day following the 22nd day of the calendar month before the month in which the billing cycle began. Variable rates are current as of March 2008.

‡**Balance transfer information:** Based on the credit line you receive, you may be able to transfer balances when your account is opened. The Promotional APR and fee terms disclosed above apply to balance transfers requested within the first 30 days of account opening. After that, balance transfers will be available only through special offers. Your eligibility for these offers will depend on your credit profile. We will disclose the terms of any future special balance transfer offer when the offer is made.

§**Purchases of Cash Equivalents:** Charges for the purchases of cash equivalents such as money orders, traveler's checks, foreign currency, lottery tickets, casino gaming chips, and the like are treated as Cash Advances and are subject to the Cash Advance fee described above.

Cash line: The amount available for cash advances will be at least 20% of your total credit line and will be shown on your statement.

How payments are applied: Payments will be applied first to finance charges and fees, then to Balance Categories (including new transactions) in the order of the lowest APR to the highest APR. **This means that balances subject to promotional or introductory APRs will be paid before balances subject to higher APRs.**

By submitting your application, you acknowledge and agree that: (1) you are at least 18 years old; (2) all information you provide is accurate and complete; (3) your account will be used only for personal, family, or household purposes; (4) we may check your credit and the information you provide; (5) we reserve the right to change the terms of your account; (6) we obtained a report from a consumer reporting agency to make you this pre-approved offer; (7) we may request credit reports in connection with this application and to review your account; and (8) we may call you at any number you provide or at any number at which we reasonably believe we can contact you, including calls to mobile, cellular, or similar devices, for any lawful purpose, including, but not limited to, suspected fraud or identity theft, obtaining necessary information, your account transactions or servicing, or collecting on your account. Numbers you provide include numbers you give us and/or numbers from which you call us.

Upon request, we will tell you if we obtained credit reports and the name and address of any consumer reporting agencies that provided the reports. We may report information about your account to credit bureaus. Late payments, missed payments, or other defaults on your account may be reflected in your credit report. When you use the account, you agree to be bound by the Account Agreement. **The Account Agreement provides that disputes relating to the account are subject to binding arbitration (the "Arbitration Provision"). You may opt out of the Arbitration Provision within 45 days of the date your**

Key aspect of payment hierarchy is bolded for customers.

Appendix 4 – Scenarios Where Overdrafts May Occur On an Opted-Out Account

Payment network rules require banks to pay certain transactions when presented, even when there are insufficient funds available in the account to cover such transactions. Generally, these rules provide for the following:

- Transactions under a specified threshold do not have to be preauthorized by the bank and must be paid by the card issuing account holding bank.
- Transactions above the specified threshold must be paid once preauthorized.

In addition, transactions may have been preauthorized, but the bank does not always place a debit hold on the preauthorized amount.

Below is a list of scenarios for which a bank is required to honor a transaction regardless of the available balance in the account. This is not an exhaustive list. The regulations should make clear that financial institutions may charge overdraft-related fees in instances such as those described below and for similar situations where the payment of the transaction is required.

1. **Fees Causing Subsequent "Must Pay" Debits To Post into Overdraft**: In this scenario, there may have been sufficient funds in an account at the time a transaction was authorized, but bank fees may have posted in the interim, reducing the available balance in the account.

2. **"Must Pay" Debits Under Threshold** Transactions under a specified threshold do not have to be preauthorized by the bank and must be paid by the card issuing account holding bank when received from the merchant.

3. **"Must Pay" Debits Authorized in Stand-In**: This scenario is cited by the Agencies in the proposed rule and occurs when real time data is not available while in Stand-In mode. Transactions authorized while in Stand-In mode on an account may not be debited from the Stand-In balance, resulting in a higher stated balance than is actually available. Once the system returns to normal functionality and all transactions are processed, the account could be in an overdrawn status or become overdrawn once the preauthorized transaction is received for posting.

4. **Signature POS Excluded from the Restraint Process Due to the Merchant Category Code (MCC):** For customer service and other operational issues, banks may not place holds for transactions that have been preauthorized. This is often the case for gas purchases and travel expenses, which often preauthorize in excess of the actual transaction. The Debit Hold portion of the proposed regulations recognizes this as an issue. Banks should not be penalized for allowing customers to use their funds, notwithstanding a preauthorized transaction, particularly for types of transactions noted in the proposal. (Note: funds on hold due to preauthorization are not available to pay other transactions in the interim. Thus, placing the hold could result in other transactions bouncing or going into overdraft, which might have been paid without issue (or fee) but for the hold.)

5. **A Non-Opted Out Transaction (*i.e.*, ACH or Check) Posts into Overdraft between the Authorization and Completion of a Signature Debit Card Purchase:** This scenario is unique for those customers that partially opt out of overdraft protection, as provided for in the proposed regulations. With a partial opt-out, all real time/authorized transactions (ATM/Debit Card) would be declined if the resulting available balance is negative regardless of the overdraft limit. Returnable transactions (ACH / Check) may be paid into overdraft if the overdraft limit is sufficient. For accounts that have both ATM/Debit Card and ACH/Check transactions, it may create scenarios where the signature debit card transactions will be posted into overdraft. This could occur if the signature debit card transaction is preauthorized into a positive available balance. On average, it takes one to three days for a signature debit card transaction to settle and post to the account. If an ACH or Check is posted in batch processing between the time of the signature debit card authorization and settlement, the Check or ACH may exhaust the positive balance causing the signature debit card transaction to settle into an overdrawn balance. One way the Agencies could address this issue would be to have the opt-out apply to the decision whether to preauthorize a transaction or not at the time the transaction is first received or of posting (if it can be rejected), but that the bank's right to charge the fee not be hindered if at the time of posting the account is actually overdrawn due to intervening events.