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August 4, 2008

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Regulation Comments
Chief Counsel's Office
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ATTN: OTS–2008–0004

Re: FRB Docket No. R–1314; OTS Docket No. OTS–2008–0004; Unfair or Deceptive Acts or Practices; 73 *Federal Register* 28904; May 19, 2008 (UDAP Proposal)

Ladies and Gentlemen:

The American Bankers Association (ABA) provides these comments on the rule proposed by the Federal Reserve Board (Board), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) covering Unfair or Deceptive Acts or Practices (UDAP) involving credit card practices. ABA brings together banks of all sizes and charters into one association that works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women. Not only does this diverse membership include all the major U.S. credit card issuers, but it includes scores of smaller independent issuers and hundreds of banks that depend on the major issuers to provide the convenience of private label credit cards to their depositors.

Although the UDAP Proposal covers both credit card practices and overdraft service fees, we address these matters in separate letters to better focus on the different issues that they raise. We believe that any reform in this area should travel a different path.

SUMMARY OF COMMENTS

ABA and its members share in Chairman Bernanke's aspiration "to establish a new baseline for fairness in how credit cards plans operate." As competitive and successful as the credit card market has been, ABA and its members recognize that standards are bound to evolve over time as new technologies develop and as the characteristics of cardholders change. In the beginning, credit cards were the province of upper income individuals and corporate executives in the United States. Today, they are a financial mainstay within the reach of hundreds of millions of people throughout the world. In that period of time, credit card plans have not stood still, but have responded to market and regulatory change. Accordingly, where ABA diverges from Chairman Bernanke is not so much with his goal of a new baseline, but with his choice of the regulatory authority to achieve it.

ABA strongly believes that pursuing this new baseline for fairness in credit card plans through exercise of Board, OTS and NCUA rule-making authority under Section 18(f)(1) of the Federal trade Commission Act (FTCA) is inappropriate. First, the proposal suddenly labels "unfair" practices that are well grounded in and expressly provided for by existing law, and that have long passed supervisory muster under the established regulatory framework. Second, it eschews exercising the plenary authority available to the Board under the existing mandate of the Truth-In-Lending Act (TILA) and mounts an ancillary attack on credit cards using a trade practices authority ill-suited to the task of financial practices reform and destructive to credit practice uniformity established under TILA. Third, by virtue of its use of UDAP authority, the agencies apply questionable analysis that threatens to establish unsound precedent that will have adverse unintended consequences for credit card risk management specifically and banking practices generally.

ABA urges the agencies to take special care in establishing appropriate standards for this inaugural exercise of banking agency initiated FTCA Section 18(f)(1) rule-making, to conclude that the banking industry's mainstream credit card practices developed under the governing structure of TILA are not unfair to customers, and to accomplish any reform to help cardholders better predict their costs by acting within the existing framework of Regulation Z.

BACKGROUND

The nature of open-end credit plans

Every time a credit card is used, the transaction constitutes an unsecured, open-ended loan from the issuing bank to the cardholder. The only security the bank has for the loan is the customer's promise to repay. This loan amount can be significantly increased and can be outstanding for a month, a year or even longer. Unlike a closed-end loan there is no set term. The outstanding balance at any point in time is entirely up to the customer within the broad parameters set by the minimum payment and the credit limit. Also, a cardholder's creditworthiness can change while the loan is still outstanding. Since these facts apply to millions of

people each day, it is critical that lenders have the ability to assume and manage the risk that cardholders may suddenly not be able to repay their loan. Hence, the ability of customers to make good on their promises, in accordance with the terms of the credit card agreement, is the foundation upon which the entire business of credit card lending rests

As noted, use of a credit card constitutes a loan. However, unlike nearly every other type of consumer loan, cardholders often have the ability to avoid having the interest accrue from the moment the loan is made by simply paying their balances in full at the end of the next billing cycle. In fact, cardholders are often given additional time after the end of a billing cycle to repay the issuing bank, i.e., they are provided with an interest free period during which payment must be received. Cardholders who pay their balances in full prior to the end of the interest free period incur no interest charges and essentially receive the benefit of a free loan. According to a Board Study published in 2004, between 51 and 55 percent of households since 1992 report always or almost always paying off the total balance owed. The Government Accountability Office (GAO) confirmed this, reporting that almost half of the active accounts paid little or no interest.

How Credit Card Loans Compare to Other Types of Consumer Loans

Type of Loan		**Monthly Interest Charged?**
Credit Card Loan	Convenience Users	**No (Interest Free Grace Period Applies)**
	Revolving Balance Users	**Yes**
Car Loan		**Yes**
Home Loan		**Yes**

As a result, most convenience users get the benefit of interest free loans for all purchases made with their credit cards. On the other hand, revolving balance users do not take advantage of the interest free period and pay interest which usually begins to accrue either from the time the loan was made, or from the beginning of the billing cycle after a balance remains unpaid, depending on the practices of the issuing bank. In essence, such “revolvers” have merely converted their credit card loan into a more traditional bank product, one in which interest is charged from the time the loan is made or some later period.

Cardholders may switch back and forth between convenience use and revolving balance use. Cardholders who regularly pay their balance in full may elect to carry a balance over at any given time and will be assessed interest when they do so. The key factor that cardholders need to understand is that once they convert to a revolving status, interest will accrue just like any other loan, i.e., where a borrower is charged interest for some period of time during which they had use of the money.

Value of the Credit Card Market

Credit cards are responsible for more than $2 trillion in transactions each year in the United States and are accepted at millions of merchant locations and ATMs. There can be little doubt of the significant role they play in our national economy.

Payment cards of all kinds provide the passkey to new sales channels in the 21st Century. Unlike checks, or even currency, cards are accepted around the world as readily as around the corner. Accepting cards as payments exposes business owners to the broadest possible customer base and helps to level the playing field between larger and smaller merchants.

Credit cards are characterized by such ubiquity today that it is easy to take them for granted. Yet, industry participants spend vast amounts of time, money and resources each year to maintain and improve upon the complex electronic payment system in order to make using credit cards so easy and convenient. Thanks to continual innovation and market forces, credit cards have evolved from a simple perk for the wealthy into an everyday, flexible, convenient financial tool that everyday people can use to make purchases and manage their personal finances.

Benefits of Competition

A history of the development of this market helps to show how competition has made credit cards the valuable tool they are today.

The modern credit card industry traces its origin to 1950 when Diner's Club introduced its "charge card" and marketed it to wealthy consumers who could use it at a number of upscale restaurants in New York City. Drawing on the success of Diner's Club, American Express and the precursor to VISA entered the market in the late 1950s, followed by MasterCard in the late 1960s. These entities took the industry a step further because their cards could be used to purchase any retail item from any merchant that accepted the card. Also, the precursor to the VISA card was the first to include payment options, giving customers the choice of paying only a portion of their outstanding balance each month rather than requiring that it be paid in full. MasterCard offered the same repayment flexibility beginning in the 1970s, followed by American Express and Discover in the 1980s.

In the early 1990s, banks focused solely on credit card lending ("monoline banks") entered the market and began to compete for new and existing customers by offering lower interest rates. Up until this time, credit card interest rates averaged roughly 18 percent for all cardholders. This meant that the most creditworthy customers were paying the same rate as less creditworthy customers.

Due to this impetus there was a general decline in credit card interest rates, as reported by the Federal Reserve, between about 1991 and 2005 compared with the

prime rate over this time.[1] Other incentives, including no annual fees, no balance transfer fees, and better rewards programs spurred even greater competition. Because new federal law required these terms to be disclosed on applications and solicitations, it encouraged open competition on interest rates and fees, and encouraged innovation and expansion of services. Cardholders were empowered to price-shop and a very competitive environment for all credit card issuers developed. According to a 2006 study by GAO, 80 percent of accounts were assessed a rate under 20 percent, with over 40 percent of the rates below 15 percent. Prior to 1990, most cards charged a rate of 20 percent.

With competition so intense and interest rates decreasing, credit card issuers were forced to refine their risk assessment capabilities to minimize losses. This spurred widespread use of *risk-based management techniques* and made credit cards widely available, including to those without a credit history or those who had had difficulty managing credit in the past. Risk-based management is the process by which banks assess the likelihood that customers will be able to perform their obligations as agreed. By applying sophisticated modeling techniques to the expanded database of consumer credit experience, creditors can better assess the risk of individual cardholders. With these improved risk management capabilities, credit card issuers are able to offer lower rates to more creditworthy customers and are also able to offer credit cards to a segment of deserving consumers whose creditworthiness was not previously readily evident.

Risk-based management and the competition it helps foster are largely responsible for the ubiquity with which credit cards are used today. Through the 1990s, the percentage of families with at least one general purpose credit card rose from 56 percent to almost 70 percent.[2] By 2004, the number had risen to almost 75 percent.[3]

LEGAL BACKGROUND

The Board and the OTS have based their proposed rule on Unfair or Deceptive Acts or Practices (UDAP Proposal) on the authority bestowed by the Federal Trade Commission Act Section 18(f)(1), 15 U.S.C. 57a and the standards for unfairness that Congress codified in 1994 with respect to the FTC's exercise of such authority. We note that the statutory authority of Section 18(f)(1) provides that the Board and OTS "shall prescribe regulations to carry out the purposes of this section, including regulations defining with specificity such unfair or deceptive acts or practices, and containing requirements prescribed for the purpose of preventing such acts or practices."

The current UDAP rule-making will establish the founding principles of unfairness and deception analysis for all banking practices and must be approached with extreme caution to guard against serious adverse unintended consequences for industry operations, customer service value and market innovation with respect to and beyond the particular circumstances covered by the current proposal. While the

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[1] GAO Study, *Credit Cards*, GAO-06-929, September 2006.
[2] Federal Reserve Bulletin. September 2000 at 625
[3] Federal Reserve Bulletin. 2006 at A31

agencies have relatively recently issued supervisory guidance subscribing to the basic principles applied by the FTC to determine unfairness, this rule-making will elevate those supervisory standards to a regulatory level. Although the Board and OTS have previously adopted the FTC's Credit Practices Rule (Regulation AA), this will be the first exercise of the independent rule-making authority bestowed by FTCA Section 18(f) on the Board and OTS in the more than 30 years of its existence.

Unfairness Standards for the Banking Industry

The Board and OTS are as a legal matter writing on a blank slate since the standards for unfairness contained in the FTCA (15 U.S.C. 45(n)) are expressly imposed only on the FTC[4]. Nevertheless, the Board has previously subscribed to these standards for supervisory purposes[5] and the OTS has acknowledged their applicability as the basis for this proposal.

Succinctly stated, an agency may not declare an act unfair unless:

(1) It causes or is likely to cause substantial injury to consumers;
(2) The injury is not reasonably avoidable by consumers themselves; and
(3) The injury is not outweighed by countervailing benefits to consumers or to competition.

In addition, the agency may consider established public policy, but public policy may not serve as the primary basis for its determination that an act or practice is unfair.

ABA concurs as a policy matter that the four elements of unfairness recited in 15 U.S.C 45(n) constitute an appropriate starting point for establishing banking agency UDAP precedent. However, banks were excluded from FTC jurisdiction and the banking agencies were granted authority in its stead because there are distinctions between the closely supervised banking industry and the unsupervised commercial market, which are relevant when developing UDAP precedent for banks. ABA believes that prime among those distinctions is the safety and soundness obligation imposed on banks. Safety and soundness is the operational and supervisory imperative that must be accounted for within any UDAP framework to be constructed by the rule-making banking agencies.

ABA recommends that, at a minimum, safety and soundness considerations be incorporated as part of the countervailing benefits prong so that the component would now include countervailing benefits to consumers, to competition, and to bank or industry safety and soundness. This is a reasonable extension, since there can be no doubt that competition is enhanced when competitors are financially sound. Furthermore, safety and soundness is uniquely positioned to recognize the importance of consistent supervisory expectations over-time and the need to permit

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[4] Nothing in section 18(f) expressly requires either the Board or the OTS when acting on their own initiative to be myopically focused on the FTC unfairness standards published in 1980 and codified as expressly applicable to the FTC in 1994 under 15 U.S.C. 45(n)—both of which events occurred after the Board and OTS were` granted authority to do rule-making under the FTCA and neither of which purport to constrain the 18(f) agencies for rule-making or enforcement purposes.

[5] See, 2004 Interagency Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks (Interagency UDAP Guidance) (March 11, 2004)

banks a period of adjustment when re-directing operations to match-up with new expectations.

This implied extension of the FTC unfairness standards is not the only addition that should be made to the analytical components used by banking agencies in exercising FTCA unfairness rule-making authority. Application of FTC UDAP unfairness standards to banking transactions must also be done with recognition that the payments system is a special franchise that is already heavily regulated and whose component parts work in an integrated fashion to achieve operational efficiency, reliability, speed, financial soundness, and exceptional consumer convenience. Section 18(f)(1) acknowledges that the banking sector has unique circumstances by expressly providing the Board with the power to diverge from FTC UDAP rule-making on the basis that applying regulatory standards developed in the commercial market to banks "would seriously conflict with essential monetary and payments systems policies of such Board." Although this charge is recited as a limit on the Board's obligation to adopt rules initiated by the FTC, it would be inadvisable for the Board to ignore this obligation when it, or the other empowered banking agencies, initiate their own rule-making. Similarly, the OTS, in applying the public policy criteria of the standard four element test of unfairness, should also consider the payments policy implications of using its UDAP authority.

Credit cards represent a vital component of the payments system. Because the Truth-In–Lending Act (TILA) and its implementing Regulation Z constitute existing Board policy with respect to this form of payment, it is appropriate under the structure envisioned by FTCA Section 18(f)(1) that Board, OTS or NCUA UDAP rule-making authority must not be exercised in a way that seriously conflicts with the policies contained in TILA or Regulation Z.

It follows that neither the Board nor the OTS should exercise their UDAP rule-making authority by specifying what practices are "unfair" under Section 18(f)(1) in a manner that undermines monetary or payment systems policies and that in the interests of comity both should include this consideration among their enumerated standards for exercising such authority.

Requirements to Prevent Unfair Practices

The second part of the statutory grant of rule-making authority under FTCA Section 18(f)(1) is to "prescribe regulations… containing requirements prescribed for the purpose of preventing [unfair or deceptive] acts or practices."

When exercising the preventive requirements part of their authority, the agencies should proceed with special care to tailor such requirements consistent with the underlying unfairness standards. First, they should not impose requirements that go beyond the reach of the underlying "unfairness" rationale to prohibit practices that are neither injurious nor reasonably avoidable. Nor should the preventive requirements so limit permissible conduct that the rule itself undermines countervailing benefits to consumers or competition, or adversely impacts bank or

industry safety and soundness, by unnecessarily eliminating options that are perfectly valid choices under a properly constrained unfairness test.

In other words, the agencies should not impose restrictions that require more than the least necessary to rebut or remedy the alleged "unfairness." To do otherwise tends to preclude variability and creativity in market responses that minimize UDAP risk. While fashioning regulatory safe harbors affords certainty for the industry and they are generally viewed favorably, such provisions should not be established at such a distance from the allegedly offending practices that they improperly prevent banks from offering viable options. Such overbroad preventive requirements or safe harbors will impair product or service development and chill market innovation.

Second, the agencies should always pursue a standard to ***prospectively*** prevent unfairness in bank practices when exercising their authority to prescribe requirements. As with any good "prescription," it is a remedy to be applied prospectively to cure the particular ills diagnosed. Retroactive or instantaneous liability for mainstream practices currently meeting agency regulatory expectations is plainly contrary to accepted norms for safety and soundness. Finally, the agencies should make clear that states should not disrupt the balance that the federal rule-making is attempting to achieve for the application of UDAP to banking using the specially mandated jurisdiction described in FTCA Section 18(f)(1).

CREDIT CARD PRACTICES ADDRESSED IN THE NOTICE ARE NOT UNFAIR

Six of the credit card practices proposals are based on unfairness rationales. Accordingly, they must each begin by satisfying the four fundamental criteria for demonstrating that an act or practice is unfair. As we will see, each proposed rule has its own barrier that prevents it from meeting the required unfairness standards. Taken together these failures demonstrate the inferiority of using UDAP rule-making to establish a workable new baseline for credit card payments in the face of alternative authority under TILA. Accordingly, ABA offers views on alternatives to the proposed requirements for a new baseline of fairness in its discussion of options available under TILA.

Substantial Injury

As the Board and FDIC note in their 2004 Interagency Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks (Interagency UDAP Guidance), substantial injury usually involves monetary harm and includes situations of a small harm to a large number of people. However, it is instructive that the FTC Unfairness Statement (adopted as the source of the unfairness portion of the Interagency UDAP Guidance) describes substantial injury in more pejorative terms than are present in the credit card practices proposals. For instance, the Statement states,

> In most cases a substantial injury involves monetary harm, as ***when sellers coerce consumers*** into purchasing unwanted goods or services or ***when consumers buy defective goods*** or services on credit but are unable to

> assert against the creditor claims or defenses arising from the transaction. ***Unwarranted health and safety risks*** may also support a finding of unfairness." (Emphasis added.)

Charging market rates disclosed at time of contract seem anathema to the label "injury." Although a $7.95 monthly charge to all Orkin[6] customers may be an injury when applied in breach of a termite service contract, imposing fees fully disclosed in accordance with the prevailing regulatory scheme and applied pursuant to the express terms of an account agreement is a very strange notion of "injury" indeed.

In all of the examples above there is the notion of monetary *harm*, not just a monetary value. In fact, under the circumstances that apply to the credit card practices addressed by this proposal, not only is there no monetary *harm*, but instead the practices regularly provide monetary *benefits*.

Injury Not Reasonably Avoidable

Under the UDAP unfairness standards employed by the Board, OTS and NCUA, the concept of not reasonably avoidable is linked to whether the bank has created an impediment to consumer action to avoid an "injury." The Interagency UDAP Guidance states in paraphrase of the FTC Unfairness Statement: "The agencies will not second-guess the wisdom of particular consumer decisions. Instead, the agencies will consider whether ***a bank's behavior*** unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decision-making." (Emphasis added.)

Although not a Commission document, the paper entitled, "The FTC's Use of Unfairness, Its Rise, Fall and Resurrection," by Howard Beales, III, written when he was FTC Director of the Bureau of Consumer Protection, provides persuasive additional guidance for applying the reasonably avoidable standard:

> If consumers could have made a different choice, but did not, the Commission should respect that choice. For example, starting from certain premises, one might argue that fast food or fast cars create significant harms that are not outweighed by countervailing benefits and should be banned. But the concept of reasonable avoidance keeps the Commission from substituting its paternalistic choices for those of informed consumers.

Finally, being able to *reasonably* avoid an injury does not mean being able to *absolutely* avoid injury or to act with perfect knowledge. This is an important distinction when considering UDAP's application to the credit practices covered by the proposal, because it recognizes the true variety of consumer choice that is present in the competitive credit card market and that is readily acted on.

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[6] *In re Orkin Exterminating Co.,* 108 F.T.C. 263 (1986), *aff'd, Orkin Exterminating Co. V. FTC,* 849 F.2d 1354 (11th Cir. 1988).

Countervailing Benefits to Consumers or Competition (Including Safety and Soundness)

As the Interagency UDAP Guidance states,

> [T]he injury must not be outweighed by any offsetting consumer or competitive benefits that are also produced by the act or practice. Offsetting benefits may include lower prices or a wider availability of products or services. Costs that would be incurred for remedies or measures to prevent the injury are also taken into account in determining whether an act or practice is unfair. These costs may include the costs to the bank in taking preventive measures and the costs to society as a whole of any increased burden and similar matters."

As ABA has indicated above, safety and soundness impacts of an institutional or industry nature are also appropriately considered as countervailing benefits if the special grant of jurisdiction to the banking agencies is given effect. Moreover, they are particularly relevant to evaluating the effect of imposing preventive measures.

Also instructive in considering how to approach this standard is language from the FTC Unfairness Statement:

> Most business practices entail a mixture of economic and other costs and benefits for purchasers. A seller's failure to present complex technical data on his product may lessen a consumer's ability to choose, for example, but may also reduce the initial price he must pay for the article. The Commission is aware of these tradeoffs and will not find that a practice unfairly injures consumers ***unless it is injurious in its net effects***. The Commission also takes account of the various costs that a remedy would entail. These include not only the costs to the parties directly before the agency, but also the burdens on society in general in the form of ***increased paperwork, increased regulatory burdens on the flow of information, reduced incentives to innovation and capital formation***, and similar matters. (Emphasis added.)

The Beales Article provides these additional relevant observations on the countervailing benefits test:

> High prices, for example, are not unfair in part because they provide important signals to other market participants to reallocate resources in ways that ultimately benefit consumers, such as entering the market or increasing production if they are already in the market….[A]pplication of unfairness analysis allows the Commission to weigh the harms caused to consumers against the cost of preventing them. This approach allows the Commission to protect consumers from injury without imposing costs that are unreasonable and ***will surely be passed on to consumers***. (Emphasis added.)

As we will demonstrate, while enactment of any individual rule under the proposal may have differing severities of consequences, the cumulative impact that enacting the entire proposal will have on pricing, access to credit, and therefore consumer spending, amounts to a significant countervailing loss of benefits to consumers from imposing constraints and costs on issuers that "will surely be passed on to consumers."

Consideration of Public Policy and Impact on Payments Systems Policy

According to the Interagency UDAP Guidance, "Public policy, as established by statute, regulation, or judicial decisions may be considered with all other evidence in determining whether an act or practice is unfair. …. [T]he fact that a particular practice is affirmatively allowed by statute may be considered as evidence that the practice is not unfair. Public policy considerations by themselves, however, will not serve as the primary basis for determining that an act or practice is unfair." The FTC Unfairness Statement recites this additional guidance: "…[S]tatutes or other sources of public policy may affirmatively allow for a practice that the Commission tentatively views as unfair. The existence of such policies will then give the agency reason to reconsider its assessment of whether the practice is actually injurious in its net effects."

Although it is incorporated in the Interagency UDAP Guidance as an element of the unfairness analysis, the agencies have not sufficiently considered the public policy factor in developing the proposal on credit card practices. The agencies have also failed to give appropriate consideration to the Section 18(f)(1) admonition not to implement UDAP rules that seriously conflict with Board monetary or payment systems policy.

Practices for re-pricing existing balances

The agencies' application of UDAP unfairness principles to mainstream banking practices for the re-pricing of existing credit card balances constitutes an unwarranted and disruptive intrusion into the existing framework for credit card standards established under the plenary authority of TILA and Regulation Z. The nature of credit card plans is that they are dynamic, not static. Both parties possess and exercise considerable latitude to adjust the relationship over its open-end course. Consumers have control over whether they are convenience users or revolvers, they decide how much of a balance to maintain and how large a payment to make within wide parameters, and they can close the account at the drop of a competitive hat. In general terms the basic understanding upon which this latitude is based is not that the issuer will charge the same rate or apply the same terms in perpetuity, but rather that the price and cost of credit will reflect changing economic and cardholder circumstances. Most people find that it is a good thing that the interest rate they had on their branded credit card ("Member since 1985") is not the same as it was in 1985.

Re-pricing existing balances is not a substantial injury. The first deficiency in the unfairness analysis for re-pricing existing balances occurs in the substantial injury component of

the FTC test. There are three problems inherent in the cryptic conclusion that "application of an increased annual percentage rate to an outstanding balance appears to cause substantial monetary injury by increasing the interest charges assessed to a consumer's credit card account."[7] The first problem is that the substantial injury argument follows from the false premise that customers have a valid reliance interest that the interest rate in existence at the time a purchase is made is a rate that the customer is entitled to claim for that purchase going forward for as long as the balance is unpaid. There is no basis for this reliance in the card agreement. Open-end plans are plans intended to reflect changes during the course of the relationship, including such important components as the interest rate. In the absence of an express limit on such changes, there is no valid reliance interest and therefore no injury from the disappointment of an unfounded expectation that the interest rate extant at time of purchase will continue throughout the period the balance on the purchase persists.

Customers control how much balance they wish to carry and have exposed to monthly finance charges. Borrowers interested in more permanent terms can instead choose closed-end loans. In effect, the agencies are blurring the difference between open and closed-end credit.

The second problem is that an increase in the rate that is bargained for is not an injury. Card interest changes based on an agreed to index is simply a way to calculate the interest charge at any particular point in time. An increase based on cardholder default or other identified risk trigger, and the invocation of a penalty interest rate or other risk rate amounts to a rate change calculation contained in the terms of the agreement, rather than a change by amendment to the agreement. These events may cause an increase in interest charges, but not in comparison to the agreement's included methodology. Increasing interest in accordance with the card agreement's method of calculation is not an injury, it is the agreed upon pricing mechanism at work.

The third problem with the substantial injury analysis is that in an open-end arrangement without a promise not to change the rate, injury is a relative concept. Interest is part of the "openness" of the open-end plan. As noted previously, the proper baseline is not the interest at time of purchases that generate the existing balance, but rather the interest that is available to carry the balance so generated. Given the competitive marketplace, borrowers only pay more for carrying existing balances if there is not a market alternative that they can obtain to finance the existing balances at a lower rate. Simply saying an interest rate increased on existing balances does not translate to a monetary harm unless the borrower could have paid less with some available and accessible other card plan. Of course, if there is such an alternative, then the borrower's existing card's increase is an injury that is reasonably avoidable—which is as it should be in a competitive market for open-end credit. Either the re-price rate is as good as the borrower can get elsewhere and there is no relative higher cost of credit, or the re-price rate makes borrowers momentarily

[7] We assume that referring to the account in general as opposed to existing balances in the account is a misstatement.

worse off until they avoid its impact by transferring their balance and switching away from their existing card issuer.

In either case, there is no unfair practice. The existing balances are being priced at the market rate for the customer's risk profile. This is not monetary harm, it is competitive pricing.

Re-pricing existing balances is reasonably avoidable. The agencies recite several rationales to attempt to demonstrate that re-pricing of existing balances is not reasonably avoidable—none of which stands up to disaggregated analysis. First, they argue that disclosures are not completely effective because consumers ignore them. This flatly fails the reasonably avoidable test as adopted in the Interagency UDAP Guidance that requires the ***bank's behavior*** to interpose an obstacle to consumer choice. Abiding by existing regulatory disclosure requirements cannot possibly be considered a bank behavior designed to take advantage of consumers.

Second, the agencies note that consumers lack control over circumstances such as cost of funds. Once again, this is not a change attributable to bank behavior, but instead is an economic factor that both the bank and the consumer must react to. In an open-end relationship they both must deal with the changes that are brought about by market forces beyond their control like cost of funds. That the consumer may discount unknown future events is not a bank created barrier. There would be serious adverse repercussions in banking and in business if reasonable avoidance were translated to the inability of the consumer to control external contingencies. It would disrupt the validity of contract law to say it is unfair to freely agree to be subject to uncontrollable future contingencies—especially where a borrowers have complete control over the extent to which they will put themselves at risk by how they use their credit limit and how much they choose to pay to retire their exercise of credit incurred.

Third, re-pricing based on consumer behavior or characteristics unrelated to the account in question is reasonably avoidable, since it is ultimately the consumer's own behavior that is reflected in a mathematical model based on empirically derived, statistically sound calculations. In other words, the models reflect the consequences of the consumer's behavior in the marketplace. Although a consumer may be unable to predict or directly control credit score calculation, that fact does not equate to an inability to behave in a creditworthy manner as captured by the credit scoring mechanism. Reliance on statistically sound credit scoring systems does not constitute arbitrary bank conduct that interferes with consumer ability to avoid re-pricing.

Fourth, a re-pricing of existing balances based on card agreement violation or default is patently avoidable by the prudent exercise of personal account management discretion. Agency reasoning to the contrary is particularly suspect. Customers taking the chance of spending close to their limit but intending not to go over should not be excused when they fail to adequately monitor their transactions, fail to calculate precisely enough their balances, or forget conspicuously disclosed fees. Paying credit card bills with checks drawn on insufficient funds (as suggested by the agencies may

occur) is compounding one poor personal financial habit with another. None of these arguments are bank created barriers to consumer choice.

After evaluating the arguments raised by the agencies, the assertion that the impact of re-pricing existing balances can be avoidable in some cases, but not as a general matter should actually be reversed. The better conclusion is that re-pricing is *reasonably* avoidable in general, even if it is not absolutely or costlessly avoidable in all instances. Certainly there is no substantiated record to the contrary. Indeed, it would be sad precedent for the agencies to arrive at a finding of balance re-pricing being not reasonably avoidable on so thin a record.

The customer's ability to reasonably avoid re-pricing of existing balances by card agreement amendment is also facilitated by the existence of the ability to opt-out of continued use of the card and the ability to pay off the existing balance at the existing rate. This opt-out is available as a matter of Delaware and South Dakota state law and is followed as a standard industry practice even where not mandated. Although the agencies cavalierly dismiss this choice as being irrational, the reality is that it affords customers the ability to lock-in the existing interest rate for existing balances. Those that choose not to opt-out, but instead want to continue using their card for new purchases, accept that re-pricing of existing balances will occur. This is of limited adverse consequence for many whose payments will retire those existing balances in a manageable period of time. In any case, the choice to opt-out is a real one and if exercised forestalls any increased interest rate on existing balances.

Re-pricing of existing balances has countervailing benefits. Given that the customers largely have control over the size of their balance at any point in time, the creditor must retain flexibility in pricing the risk associated with the balance for the open-end relationship to be sustainable. The ability to offer competitive rates at the beginning of the relationship is directly predicated on the ability to re-price that rate when over time circumstances indicate that the cardholder's risk profile has changed and warrants a rate that more accurately reflects the risk than originally presented. This is the nature of the open-end unsecured relationship. Future re-pricing latitude is the quid pro quo for competitive rates at the beginning of the relationship and being able to continue to make such rates available to the most creditworthy customers over time.

ABA believes that consideration of the impact of a limit on re-pricing of existing balances on bank safety and soundness is an appropriate element of the countervailing benefits standard. Interagency Guidance states: The Agencies expect institutions to fully test, analyze, and support their account management practices, ***including credit line management and pricing criteria***, for prudence prior to broad implementation of those practices."[8] As OTS advises:

> Management must also actively manage profitability. For example, some issuers use risk-based pricing, where they change interest rates and fees based on ***changes in the status of the account or in the cardholder's credit***

[8] *Account Management and Loss Allowance Guidance* (January 2003)

> ***profile.*** Management should monitor profitability factors such as average yield, average balance, credit line usage, and account attrition. Larger operations often use behavioral modeling to predict losses and the profitability of groups of accounts.[9] (Emphasis added.)

Average balance and credit line usage are variables that capture the fact that the re-pricing decision must adjust not just to the risk of future purchases, but to the level of the outstanding balance and how much it represents of the credit limit.

As noted by banks who have commented on the proposal, the existing balance is where the risk is from customers whose credit profiles have deteriorated. Restricting existing balance re-pricing discretion based on an unfairness theory that is subject to the few limited exceptions proposed runs counter to agency guidance to manage credit card risk prudently and consequently adversely affects bank safety and soundness. Data on late payments developed by card issuers demonstrates that the risk of further missed payments, longer delinquencies, and actual loss increases dramatically day-by-day for revolvers who pay late. It doesn't take but a few days for a statistically significant difference to become evident among cardholders who are late payers that material numbers of them will default who simply started out as a "little late."

Of course, not all late payers turn into uncollectible accounts—and that is the key to successful risk-based pricing. Because late paying is a behavior that is a predictive indicator of a certain probability of charge-off, it is fair that those so identified be charged more for the increased risk of loss they represent over that represented by the cardholders who do not pay late. It is precisely because most late payers caught early enough in the cycle can return to being on-time payers that re-pricing them enables the bank to generate compensating revenues from the at-risk group rather than from the universe of cardholders. In other words, those who display timely payment behavior get good rates and are not asked to subsidize those who behave as late payers.

Placing constraints on the ability to price for the risk of a targeted risk class – as the re-pricing proposal does – would cause costs to be shifted to the remaining risk classes. This would have the effect of raising interest rates and fees for most borrowers. Based on a recent ABA survey of credit card issuers[10], interest rates would be expected to increase nearly 2 percentage points (an average of 190 basis points) and fees an average of 22 percent. This generates broad countervailing economic consequences. For example, at today's rates, a 190 basis point increase would result in the average interest rate increasing from 13.7 percent to 15.6 percent, a percentage change of 14 percent.

Many survey respondents also stated they will likely tighten underwriting standards and restrict credit to some borrowers. As the risk of loss rises, issuers would have

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[9] *OTS Handbook on Credit Card Lending* Sec. 218 (2006)

[10] *Likely Impact of Proposed Credit Card Legislation* (Spring 2008.) The legislative restrictions subject to the survey are similar to the regulatory constraints contained in the UDAP Proposal. **http://www.aba.com/NR/rdonlyres/365382A4-2EC6-4B41-93A6-28BFAD2779FB/54790/CreditCardSurvey08.pdf**

less flexibility to adjust their pricing to compensate for the added exposure that individual borrowers may present. Based on the survey, there would be a likely reduction in available credit between 5 and 10 percent. Taken together, likely interest rate increases and reductions in credit availability would have a considerable impact on consumer spending. This is another significant countervailing benefit that would be lost were the re-pricing provisions implemented as proposed.

Beyond the countervailing consumer impact, ABA's survey findings suggest that restrictions in risk-based pricing would likely discourage investors from holding credit card asset backed securities (ABS), which are used to fund approximately 50 percent of credit card lending. Subprime securitizations would feel the greatest impact, according to respondents, raising funding costs for lenders and interest rates for these cardholders. While investor's receptivity for securities backed by credit card receivables has held up reasonably well in the face of severe liquidity problems emanating from the housing market problems, respondents were concerned that new restrictions on risk-based pricing of credit cards will add uncertainty to the cash flow that supports the security which, in turn, would raise the return demanded by investors to hold these securities.

Based on the data bank risk models generate, the single exception in the proposal for accounts more than 30 days late is much too deep into the process to provide an appropriate risk-based benefit for consumers or banks. At 30 days late, the risk of default is so high that risk-based pricing would not produce a sufficient yield to offset the risk. In other words, setting the exception at 30 days overwhelmingly unbalances the countervailing benefits scale by eliminating any reasonable benefit to consumers or competition from risk-based pricing. It also undermines the safety and soundness value that risk-based pricing is recognized by supervisory oversight to provide, both on a bank-by-bank level and on an industry-wide level.

From a UDAP perspective, the preventive requirements in the proposal describe too narrow a range of permissible re-pricing practices and thereby eliminate numerous re-pricing options that could be implemented without running afoul of the supposed "unfairness" attributes described by the analysis in the proposal. Accordingly, alternative exceptions must be developed and latitude should be provided in the rule that would permit the bank to select those re-pricing rules that they can validate. By providing re-pricing latitude that is tied to verifiable risk-based methods, the agencies better tailor the proposal's preventive requirements to its fairness goals.

Re-pricing of existing balances is explicitly permissible under current public policy. As demonstrated by the previously cited supervisory guidance on account management practices, existing public policy supports the re-pricing of customer accounts for safety and soundness reasons. Additional supervisory support for this public policy conclusion is found in an OCC Advisory Letter:

> Credit card issuers may increase a consumer's APR to address credit risks that arise when a consumer fails to make timely payments on the account, and some credit card issuers may increase the APR when a consumer fails to make timely payments on <u>other</u> accounts, including accounts with other

> creditors. Some credit card issuers also may raise the consumer's APR for other reasons, such as the consumer's increased use of credit, failure to make more than the minimum monthly payment on the account with the issuer, or other behavior that reflects adversely on the consumer's credit rating. Credit card issuers may take other actions that also effectively increase the cost of credit for some consumers, such as shortening the due date for receipt of payment or raising the amount of fees for late payment, exceeding a credit limit, or obtaining a cash advance. These practices may well be appropriate measures for managing credit risk on the part of the credit card issuer.[11]

The OCC Advisory goes on to condition this risk-based exercise on appropriate disclosure of the bank's ability to exercise risk-pricing changes due to activity on another creditor's account or unilaterally.

Under the public policy standard as interpreted by the Interagency UDAP Guidance, the fact that a particular practice is affirmatively allowed by law may be considered as evidence that the practice is not unfair. As demonstrated above, risk-based re-pricing of balances either due to changes in "on us" or "off us" credit behavior, or for others reasons by agreement amendment, are expressly permissible under existing regulatory requirements and are therefore not unfair.

Practices regarding allocation of payments

The agencies propose three payment allocation rules all predicated on the same faulty premise about what constitutes substantial injury. The agencies assert that the practices in question "appear to cause substantial monetary injury to consumers in the form of higher interest charges than would be incurred if institutions did not engage in these practices. Specifically, consumers …incur higher interest charges than they would under other payment allocation methods…." At root, this is an argument that it is an injury to charge more because one could charge less. It is tantamount to arguing that charging $4.00 dollars a gallon for gasoline is a substantial injury because the gas station decided not to charge $3.95 a gallon. If this were a sound analysis, the FTC could dedicate their entire staff to eradicating the unfairness found at highway exits anywhere in the country.

A closer look at the substantial injury prong for promotional rates connected to balance transfers illustrates how wrong the agencies' analysis proves to be. First, we should recognize that someone who has a balance to transfer is a revolver and not getting an interest free period benefit from their current card account usage. Consequently not getting an interest free grace period on purchases after balance transfer is not putting them in a worse off position. There is no injury from "loss of grace period on purchases."

Second, the rational reason for accepting a promotional balance transfer offer is to reduce one's rate on an existing balance. This consumer objective is invariably

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[11] OCC Advisory Letter 2004-10. The Advisory Letter goes on to caution that these practices should be adequately disclosed, but the practices themselves are not disallowed.

achieved even if the card holder continues to make purchases on the new card—purchases that would have been recorded on the old card had a balance transfer not occurred.

Let's consider the following illustration: Assume that Mr. X who only has Card A with a $1,000 balance and 1.5% monthly finance charge pays the monthly minimum of $25. He will incur almost $15 in finance charges. But now assume Mr. X transfers his entire balance of $1,000 to Zero rate Card B and purchases $100 of new goods in that same initial month. He faces $1,100 balance of which $1,000 is at 0% and 100 at 1.5%. Assume he again pays the minimum $25, but this time he only incurs $1.50 in finance charges instead of the $16.50 that would accrue under his prior card given the same facts. Although the $25 minimum is applied 100% to the low promotional rate balance, Mr. X achieves a substantial reduction in his monthly finance charges. How can this be considered a monetary harm? He rationally achieved substantial savings over his existing circumstances.

Even if Mr. X pays $100 on his first bill from Card B, his finance charge of $1.50 is still much lower than if he had kept his business with Card A and incurred the approximately $16.50 finance charge (depending when in the cycle he made the $100 payment). (Remember he would not have received an interest free period on Card A by paying for his new purchase in full given that the $1,000 balance would continue to revolve.) Although Card B could allocate payments differently and could grant an interest free period (in this case, for not paying off an outstanding balance in its entirety) thereby achieving a zero finance charge instead of a $1.50 charge, such a hypothetical situation generates only a hypothetical injury—not a real one. Yes, Card B could have offered Mr. X a different deal, but the fact that it did not does not mean the deal that was offered, accepted and resulted in lower interest charges constitutes a monetary harm. It does not. Instead, it is a monetary gain. And where there is no substantial injury, there is no need for further analysis. The unfairness syllogism fails.

One can construct a similar illustration with respect to promotional rates for purchases (as opposed to balance transfers) made in certain periods. Again, the blended rate paid for old purchases that make up the existing balance plus the new purchases is lower than the rate would be had the new purchases been made on the card without the promotional rate. For cardholders who are non-revolvers, that is convenience users, at the time they accept the promotional offer, the benefit of the promotion really depends on whether they will change their behavior and stop being a convenience user (and getting an interest free period) to instead build a balance at the promotional rate. That choice is their own—and deciding on whether they will liquidate that balance by the time the promotion ends is entirely their choice. It is not one that is coerced by the bank's behavior. As FTC Unfairness precedent holds, an agency should not substitute its paternalistic rationalization for the consumer's own choice. Although other ways of allocating payments could be imagined, they do not mean that the method applied resulting in lower costs is an injury.

The reality is that consumers who accept promotional rate offers achieve a lower APR as a result. If nothing else, Regulation Z teaches us that the true measure of the

cost of credit is reflected in the disclosure of APR and other fees. To apply UDAP authority in a way that rejects such a fundamental credit cost conclusion runs contrary to established public policy and the payment systems policy contained in TILA. This is another reason to reject the agencies' unfairness rational as it is applied to payment allocation rules involving promotional rates. A UDAP rule that is based on calling practices that lower APRs a substantial injury has no sound payments policy reason for being imposed by a banking agency's rule-making—especially one that is charged with doing no harm to existing Board payments system policy.

Finally, the fact is that current practices for payment allocation are simply part of the pricing mechanism for card utilization. The fact that the rules can be complex does not mean they are unfair. As the FTC Unfairness Statement notes, "Most business practices entail a mixture of economic and other costs and benefits for purchasers. A seller's failure to present complex technical data on his product may lessen a consumer's ability to choose, for example, but may also reduce the initial price he must pay for the article." In other words, limited transparency of complex terms may marginally impact consumer choice without materially diminishing the overall benefit the consumer receives by making the simplified decision.

With respect to the differential pricing for cash advance balances versus purchase balances, there is still no substantial injury. Although a different method of payment allocation can result in a smaller finance charge during a billing cycle, the fact that cash advances are treated differently from purchases is known by consumers at the time of choice. The payment allocation rules that apply do not change to "catch" the customer. Another allocation rule might result in a lower blended rate, but once again that is a hypothetical case with a hypothetical injury—not a real one. People are only being charged what their card agreement provides.

While it would be an impossible challenge for an expert to calculate in advance the APR for taking a cash advance on top of a revolving purchase balance given the different possibilities for payment, what is known is that borrowers are taking a loan that will incur interest from the time of advance at a higher rate than the one for their purchases, and the ability to pay off the cash advance balance is dependent on paying their purchase balance. This information is enough for people to understand that it is wisest to take out a cash advance when they can put it on a card without purchases or when they can pay their statement balance in full. Armed with this knowledge, cardholders can reasonably avoid incurring hard to calculate finance charges—even though such charges are not injuries per se.

If the proposal for allocation of payments were to be implemented, consumers are likely to lose some of the flexibility they now have to manage interest rates on carried balances. Credit card issuers say that they would modify or eliminate entirely balance-transfer or promotional-rate programs if provisions to limit repayment on these balances were enacted.[12] Such a change could adversely affect the one in five credit card holders who take advantage of introductory or teaser rates. Given that some 8

[12] *Likely Impact of Proposed Credit Card Legislation, supra.,* p.3, (Spring 2008.)

million small business owners use credit cards (including personal credit cards) to finance their businesses, these sophisticated borrowers who carefully evaluate their options are likely to suffer the most from this reduction in choice.

Another countervailing factor is that promotional rate offers are a major way that banks compete for business. As a result, overly restrictive payment allocation rules will reduce the willingness of banks to employ promotional offers and lessen the competitive impact that keeps all card interest rates lower.

For all the reasons noted above, mainstream banking practices with respect to payment allocation are not unfair under UDAP and therefore should not be the subject of a preventive requirements rule under the agencies' FTCA Section 18(f)(1) authority.[13]

Practices governing time to make payment

The Board and OTS proposals on payment practices are based on a premise that "treating a payment on a consumer credit card account as late for any purpose (other than expiration of a grace period) unless the consumer has been provided a reasonable amount of time to make that payment appears to be an unfair act or practice." On first impression, this premise seems unassailable. In some ways, it is a natural extension of existing precedent under FTC and OTS enforcement that has found treating payments on mortgage obligations as late when they are in fact received on time to be unfair.[14] However, there are important distinctions between these applications, and ultimately the proposal fails to meet pivotal tests under unfairness standards.

The agencies assert that people "cannot reasonably avoid late payments unless they have been provided a reasonable amount of time to pay"—a logical tautology if there ever was one. The real premise to this argument is that "it *may* be unreasonable to expect consumers to make payment if they are not given a reasonable amount of time to do so *after receiving a periodic statement*." The three facts put forth by the agencies for why this *may* be the case are (1) customers have error resolution rights that necessitate statement review, (2) they may be on travel, and (3) they cannot control the U.S. Postal Service delivery performance. None of these reasons support the conclusion that people cannot avoid late fees, penalty rates or adverse credit reports—the supposed injuries—unless the reasonable amount of time for payment is measured from statement receipt.

<u>The first problem</u> with all three of these supposed facts alleged in the proposal is that there is no record evidence to support the frequency of their occurrence. Error resolution rights assertions as a total of all payments are not recited so the prevalence of this "fact" is not known. The frequency and duration of people's travel schedules

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[13] *American Financial Services Association v. Federal Trade Commission,* 767 F.2d 957, 983-984 (C.A.D.C. 1985).

[14] See, *Fairbanks and Ocwen*. *United States v. Fairbanks Capital Corp*., Civ. No. 03-12219-DPW (D. Mass Nov.21,2003, as modified Sept. 4, 2007) and *Ocwen Federal Bank FSB*, Supervisory Agreement, OTS Docket No. 04592 (April 19, 2004).

is not substantiated—nor is how it really translates to late payment frequency. Finally, the track record of the U.S. Postal Service is acknowledged to be within three business days, but can sometimes take longer. Once again, the agencies are using a rationale that elevates the standard from *reasonably* avoidable to *absolutely* avoidable. This is an unwarranted and dangerous precedent to establish for UDAP rule-making.

No more effort is made to substantiate the over-riding tautology that "consumers cannot reasonably avoid late payments unless they have been provided a reasonable amount of time to pay;" because the premise is simply setting up the goal of using the preventive requirements authority of FTCA 18(f)(1) to prescribe a "safe harbor for institutions that have adopted reasonable procedures designed to ensure that periodic statements specifying the payment due date are mailed or delivered to consumers at least 21 days before the payment due date."[15]

The safe harbor that is proposed for a reasonable time for delivery is flawed because its calculation has no real record support and it sets the preventive bar too distant from the supposed premise of "reasonableness."

Here is why the proposed preventive rule is wrong: The 21 day period is more than what would constitute a reasonable time frame when relying on mail service. As the proposal recognizes, no more than a 7 day period is necessary for consumers to conduct a statement review. It should be noted that less time could be substantiated. After all, proper use of credit cards calls for people to track their purchases and transactions by keeping their receipts. They should be prepared to conduct a review of the statement immediately upon receipt. One can certainly make a case that 5 days is adequate for review.

The only additional elements to consider when calculating a permissible period for safe harbor purposes are the methods of delivery of the statement and the payment. Here is where the agencies go beyond what bank experience reveals and once again fail for lack of a substantive record. The most they can say is that mail service is predominately completed within three days or less. The record cannot, by using a standard of reasonableness, substantiate more than a total of 13 days (3+7+3) for the mailing of the periodic statement to enable people to *reasonably* avoid a late payment. Given that Regulation Z already requires 14 days when there is an interest free period at stake, it hardly seems worthwhile to go through the sophistry to arrive at a 13 day safe harbor.

Electronic delivery is virtually instantaneous. Electronic payment and telephone payment are similarly fast. These are growing payment choices. Mobile payment is in its dawn and only going to increase. All of these options demonstrate that even on a statement receipt basis, cardholders can reasonably avoid late payments with far

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[15] We note that although the FTC has jurisdiction over the practices of all varieties of commercial businesses or non-depository financial companies that issue monthly bills, they have never conducted a rule-making to set a preventive standard for delivery of periodic statements. Yet, hundreds of millions of consumers manage to pay their monthly utilities and other periodic obligations on time without an unfairness rule to protect them.

fewer than 21 days notice. If one is intent on creating a safe harbor using FACTA Section 18(f)(1) authority, the agencies should not create a precedent that establishes a standard so far removed from the boundary of what amounts to the unfair practice. This means that with respect to mailing, the total period should be set nearest to 13 days and for any other combination of delivery and payment channel their addition to the baseline of 7 days for review is the most that should be required.

For instance, if people receive mailed statements, but use electronic bill pay, the payment period would not be more than 3 plus 7 = 10. If the person receives statements electronically and pays electronically, the reasonable amount of time to pay would be 7 days from statement receipt.

As previously noted, TILA provides that 14 days notice is adequate for making a decision about whether to pay in full—a more challenging decision than whether you are not going to pay late. The 14 day time frame was established by Congress when mail delivery was the predominant mechanism for receiving statements and making payments. It would be contrary to existing payment systems policy to extend that timeframe given how the speed of delivery and payment alternatives has increased. In summary, the 21 day proposal is contrary to payment policy and payment reality and therefore it is unfounded under the UDAP unfairness standards. Applying the mailing safe harbor to all payment forms is simply not supportable under a rational application of UDAP principles to the banking industry under FACTA Section 18(f)(1)

If the agencies are going to issue preventive requirements under FTCA Section 18(f)(1) authority, they should be limited to the period of providing 7 days for review and any safe harbor based on mailing should continue to be limited to 14 days. To do otherwise, is to distance the safe harbor's requirements from the underlying "unfairness" rationale in such a way as to eliminate other market options that are permissible under the premises of the analysis and that do not display the characteristics considered to be "unfair."

<u>The second problem</u> in the agencies' analysis comes from the use of statement receipt as the trigger for determining the beginning of what constitutes a reasonable amount of time. As becomes evident from parsing the agencies' analysis, using the sum of delivery of statement, review of statement and delivery of payment results in less time for payment than required for grace period situations. This result comes from using statement receipt as the trigger.

Here is why the proposal's analysis gets the reasonably avoidable test wrong: All credit card customers know that they have a monthly billing cycle and will be expected to make a payment once a month to avoid a late fee, possible imposition of default interest, or the possibility of being reported to a credit bureau as late (i.e., the injuries described by the proposal.) This knowledge does not derive from receipt of a statement; it comes from knowing the standard course of dealing between creditor and cardholder reflected in every account agreement and experienced billing cycle after billing cycle. Indeed, this is a pattern for most bills consumers pay. In fact, many card issuers permit their customers to select their bill due date. In such cases,

customers are in complete control of knowing when the monthly payment will be due. Although for other issuers the exact due date may vary within a narrow couple day band for their card plans, the customer has a generally reliable idea of what time of the month a bill will be due. Yet, in either case, there is enough certainty about when in a month a payment is likely to be due to be able to reasonably avoid making a late payment.

People budget their monthly obligations. Most people know what bills they will pay with what paychecks as a regular matter. Whether they are paid monthly, bi-monthly, bi-weekly or weekly, people adjust their expectations about which bills are likely to become due during what pay period. It would be imprudent personal financial management not to anticipate regular monthly bills and to reserve funds to pay them. In fact, it is not getting a statement that allows people to have enough time to avoid a late payment when they are on vacation, it is knowing when they are planning the vacation that a bill is likely to be due at that future time and then making provisions for the bill to be paid while they are not home and their mail is being held by the post office.

In addition to knowing with *reasonable* advance notice and accuracy when the credit card payment is due, cardholders know from the account agreement and their experience what a likely minimum or affordable payment will be for the month. In fact, revolvers are experienced with knowing what the likely minimum or affordable payment will be, because they are generally budgeting to manage their balances and applying limited funds to other obligations. Moreover, customers also know what purchases they have made using their cards because they have the receipts to track their purchases. In today's world, customers also have ready Internet and phone access to their statements to keep informed of their credit balances. Customers' knowledge about the amount of their payment and its due date are much more readily available now than in the past. Monthly billing cycles are much more transparent today than in the pre-electronic world.

Accordingly, the agencies' premise that late payments or similar "injuries" are not reasonably avoidable unless there is a certain amount of time to pay after receipt of a statement is not well-founded.

Practices for computing balances

The target of the proposal's rule on unfair balance computation methods is so-called double cycle billing. While once a common form of balance computation, the practice has fewer adherents today. Although the banking agencies are not restricted by the FTC's rule-making constraints, it is worth noting that the FTC is commanded to determine the prevalence of a practice before imposing a rule. This notion makes some sense from a policy resource efficiency standpoint.

Nevertheless, the agencies have made the proposal that it is unfair to charge interest for any period other than the most recent billing cycle. Almost immediately, the agencies concede that there is no injury experienced by two of the three types of credit card users: consistent revolvers and consistent convenience users. It must

follow that double cycle billing is not unfair to everyone. It turns out that the only people who experience any "injury" are "consumers who pay their balance in full one month but not the next month."

The supposed injury is that this limited class of consumers "incurs higher interest charges than they would under a balance computation method that focuses only on the most recent billing cycle." This sounds familiar and familiarly should fail. The argument is once again the hypothetical injury argument. Because the borrower would pay less if the agreement charged less, there is supposed to be an injury. The reality is that cardholders only pay what they agreed to pay in the first place. They could pay less interest if the deals were different, but that is not the case. And what was the case? Simple: Pay in full in consecutive months for an interest free period; otherwise pay interest from date of purchase.

Although the absence of injury should end our analysis, we address another assertion made by the proposal—people cannot reasonably avoid the "injury" because they cannot understand the balance computation method. The real issue is not how well one can understand the method for computing balances across two cycles; rather it is whether people can know that if they pay one way they will get an interest free loan period, but if they pay any other way they will pay interest from the date of transaction. The Board and OTS already concede that consistent convenience users get the interest free period and are not injured, and that consistent revolvers pay interest from date of transaction and are not injured by the method. That leaves people who inconsistently pay-in full—or what we might describe as "lapsed" convenience users. These people used to pay in full and were not being injured, but have stopped and now pay interest from date of transaction. They certainly know that their status has changed and that their interest expense is different. Whether they know the full impact of the two-cycle balance computation method or not is a disclosure issue that is fully within the Board's ability under Regulation Z to solve. As we've noted above, the rule is fairly simple: Pay in full in consecutive months for an interest free period; otherwise pay interest from date of purchase. The Board has the power to test this disclosure and should do so before abandoning their Regulation Z obligations.

But for UDAP purposes what is more important is that once customers cease being convenience users they know that they will begin paying interest. They also know that they can avoid this interest charge by resuming their habit of paying in full in consecutive months. We believe that understanding the balance computation method precisely is a red herring. Understanding that interest accrues from date of purchase unless you pay the statement balance in full in consecutive months is all the challenge that exists in order to reasonably avoid an "injury."

Finally, in passing the Fair Credit and Charge Card Disclosure Act of 1988, Congress specifically considered the practice of double-cycle billing and concluded that it was appropriate to address by disclosure and charged the Board with devising the right disclosure. To suddenly declare double-cycle billing unfair is in direct opposition to the express findings of section 226.5a(b)(6) of Regulation Z that includes "two-cycle average daily balance" within the list of "most commonly used methods" of balance

computation that the Board was charged with identifying under TILA Section 127(c). As such the proposal runs directly counter to the admonition not to find unfair a practice that is specifically authorized by existing public policy.

It follows that double cycle billing is not an unfair practice under normal UDAP standards. In addition, as pointed out in the section of this letter addressing alternative regulatory options, there are occasions when the balance computation proposal is overbroad and should allow, at least, for specific exemptions. In terms of UDAP analysis, the proposal's preventive requirements are overbroad because they encompass situations that do not display the characteristics that the analysis considers to support "unfairness."

Practices regarding security deposits and fees for availability of credit

ABA agrees that the operations in the secured card market have at times displayed attributes that generate UDAP risk as more fully described in OCC Guidance on Secured Cards[16], but as that guidance suggests this is a complex market and there are a range of features of products offered in this market that may provide welcome consumer benefits to select populations if done appropriately—and the rule-making agencies concede as much by drawing a bright line between acceptable and unacceptable cards.

ABA believes that this is so specialized a situation and fraught with contingencies that it is inappropriate to convert the limited experience in this area into a one-size-fits-all rule under UDAP. The proposal analyzes itself into a corner by distinguishing cards with 49% of credit limit consumed by security deposit from those with 51% of credit limit consumed by security deposit. That a card is or is not judged unfair based on such a slim reed is shaky analysis at best. Using such razor thin margins to separate fair from unfair practices is a dangerous precedent because it basically substitutes arbitrary line-drawing for principled regulation and invites similar arbitrariness and lack of analytical rigor in future UDAP rule-making.

ABA urges the agencies to withdraw the rule and proceed along lines of interagency guidance to govern supervisory and enforcement judgments about particular bank practices in the secured card market. OCC has had demonstrated success using such guidance without any need for rule-making. In addition, the FTC and FDIC have recently demonstrated the viability of coordinated enforcement—not unilateral rule-making—to reach the non-depository parties often involved in these very fact-specific cases.[17]

Finally, as the proposal concedes, Regulation Z has authority to address practices in this area without mobilizing joint rule-making. Although prime credit cards are predominantly depository institution issued, can the same be said for sub-prime card issuers? Since the FTC is not proposing a UDAP rule in this area, we believe the more comprehensive practice would be to proceed under Regulation Z with regard

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[16] OCC Advisory Letter, AL 2004-4 (April 24, 2004.)

[17] *Federal Trade Commission v. CompuCreditCorporation et a.,* FTC File No.: 062-3212. http://www.ftc.gov/os/caselist/0623212/index.shtm

to rule-making and supplementing any particular situation with UDAP enforcement on a case-by-case basis.

Practices for exceeding credit limits due to temporary holds

ABA does not believe that the practices sought to be addressed here have any currency. Were this supposed practice the only reason for exercising banking agency UDAP authority for the first time in over 30 years, we would hope that the agencies would abstain. Establishing UDAP precedent based on the supposed practices described here would be risking bad law from bad facts. Using rule-making to address aberrant practices is a poor use of regulatory authority. The consumer complaint process that FTCA Section 18(f)(1) compels each agency to establish is the proper forum for this issue. Beyond that, supervisory and case-by-case enforcement are available. ABA urges the agencies to withdraw this part of the proposal as an unwarranted mobilization of interagency rule-making resources.

ADDRESSING THE PROMOTION OF FIRM OFFERS OF CREDIT

The agencies have included one proposal that is based on the deception standards of UDAP rather than the unfairness standards. This proposal deals with how "firm offers of credit" are marketed. The proposal would prohibit banks from making firm offers of credit stating multiple APRs or credit limits without disclosing the criteria the bank will use to determine how consumers will be selected for the different terms. As an alternative to listing criteria, a general disclosure safe harbor is proposed.

ABA notes that courts have created new and conflicting requirements for "firm offers" of credit provided to consumers, requirements that simply are not found in the FCRA itself. These differences of opinion over the proper interpretation of the "firm offer" requirements have created considerable uncertainty for banks and other lenders. ABA believes that these new court-imposed requirements are at odds with the statute's language and structure, as well as Congressional intent in enacting the prescreening provisions. Clarification is warranted, but it should be connected to rule-making under FCRA.

Consequently, ABA urges the agencies to withhold final action on the current proposal so that any UDAP rule-making can be coordinated with FCRA rule-making on firm offers so that any problem with promotion is addressed in a comprehensive manner.

APPLYING UDAP ANALYSIS TO CREDIT CARD PRACTICES HAS MULTIPLE DRAWBACKS

Banks generally desire clarity and certainty in the articulation of their compliance obligations. ABA appreciates the agencies' effort to try to bring greater certainty to the application of UDAP to credit card practices. Unfortunately, Section 18(f) UDAP rule-making authority has several disadvantages that can lead to unintended and disruptive policy consequences that undermine its value as a tool for establishing uniform standards. Although the agencies have tried to limit these adverse impacts

by crafting rule text that does not declare particular practices to be unfair, the assertions contained in the proposal's supplementary information legal analysis undermine this care.

Litigation and supervisory risk. Although Section 18(f) restricts rule-making authority under the FTCA, absent a clear statement by this rule-making, the section on its face does not give banking agencies exclusive control over the application of similar standards contained in parallel state UDAP laws. Many state laws empower Attorneys General or private parties to sue banks for unfair business practices and to modify the standards as suits their particular jurisdictions and state legal precedent. In other words, abiding by the proposed rule may not provide any safe harbor for banks from agencies or individuals if the banking agencies conclude or assert that certain credit card practices are not reasonably avoidable and are not outweighed by countervailing benefits. These analyses could be misused under state law situations.

If the Board and OTS articulate a finding, conclusion or authoritative assertion that certain credit card practices are unfair, then significant litigation and regulatory risk may be generated. For example, if the Board and OTS authoritatively find that re-pricing existing balances despite the offer of an opt-out is unfair, Attorneys General, private litigants and even the other state and federal banking agencies will be able to invoke that conclusion in litigation and supervision—including potentially retroactively. Findings or conclusions contained in the rule-making analysis may also be asserted as binding precedent by consumers invoking the banking agencies' own complaint processes established under 18(f). In other words, since the proposed rule derives from the same section of the FTCA as compels banking agency consumer complaint offices, the regulatory standards articulated under a rule-making risk becoming the basis for creative assertions of liability in the complaint process.

ABA emphasizes our serious concern that the analysis contained in the proposal will have a far-reaching effect and serious adverse consequences for a broad range of banking practices that have been industry standards and moving forward, will chill innovation. For example, the analysis of the reasons why re-pricing existing balances is unfair even when there are clear account disclosure threatens to absolve customers of their obligation to be financially responsible for their credit card agreements. This would fundamentally undermine the foundation of payment systems policy in the credit market as established by TILA and its consumer disclosure regime.

Gratuitous reputation risk. Exercising UDAP rule-making authority is distinct from much of the consumer protection regulatory area in that in order to issue a rule to prevent a given practice; it must first be specifically defined as unfair or deceptive.[18] Because a rule-making tends to deal in a general record rather than the detailed circumstances presented by an enforcement case; the rule sweeps in a broad range of different facts that on a case-by-case basis may not prove to be unfair. This means that in order to establish a preventive rule existing practices tend to be pejoratively labeled unfair even though particular circumstances would refute that conclusion.

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[18] *American Financial Services Association v. Federal Trade Commission,* 767 F.2d 957, 983-984 (C.A.D.C. 1985)

This leads to the agencies generating gratuitous reputation risk for banks whose practices are labeled unfair when their particular circumstances could very well be legally defensible, financially sound and fully compliant with existing consumer protection requirements.

Risk of uneven application. If the agencies truly intend to establish clarity and certainty for the application of UDAP to credit card practices, it must make the preventive rules prospective and they must occupy the field. It would undermine the goal of establishing a uniform new baseline of fairness if UDAP rules issued by the federal banking agencies allowed states to create different rules imposing additional obligations. Although the OCC and the OTS possess strong pre-emption powers that can leverage the UDAP rules for their respective charters, state chartered banks may have more exposure to additional burdens unless the rule-making agencies interpret FTCA Section 18(f)(1) rule-making authority as occupying the field.

For the reasons articulated above and for others articulated throughout this letter, ABA believes that exercising UDAP unfairness authority creates a multitude of risks unlike most other banking regulatory powers. In an industry as closely supervised as banking almost all mainstream practices have been developed with some level of agency endorsement so that chartered institutions can safely navigate supervisory oversight and meet agency expectations. Suddenly changing the rules and labeling existing practices as "unfair" is not a sound approach to banking regulation. Accordingly, ABA urges the agencies to establish any new baseline of credit card practice fairness using the established consumer protection powers rather than UDAP.

If the agencies proceed under UDAP, they should do so in a way that is prospective and that imposes requirements that are least intrusive, so that banking efficiency and market innovation are not compromised by overbroad preventive requirements. In addition, to limit the over-breadth of the unfairness analysis contained in the proposal's supplementary information, the agencies must recast the preamble of any final rule to retract unfounded assertions, findings or conclusions about unfairness, and with respect to other points in the analysis, acknowledge that there is sound refutation of any such points. Finding that there may be risk of unfairness is better than concluding that unfairness is actually demonstrated by particular facts or the absence of a particular form of notice. Finally, the agencies should make clear that states should not disrupt the balance that the federal rule-making is attempting to achieve for the application of UDAP to banking.

AN ALTERNATIVE APPROACH TO PROMOTING RESPONSIBLE CREDIT CARD PRACTICES.

Chairman Bernanke stated when the proposal was released that the Board's goal is to establish "a new baseline of fairness in how credit card plans operate." He further explained, "Consumers relying on credit cards should be better able to predict how their decisions and actions will affect their costs."

This then assumes that there already exists a "baseline of fairness," which arguably is well established in TILA's Regulation Z. For nearly four decades, Regulation Z has addressed numerous credit card disclosures and practices and related consumer protections that are closely related to those the proposal addresses. It does not make sense to divorce these related items by installing them in separate regulations, especially if to do so, the agencies have to contort and distort arguments in order to make them "fit" into a UDAP framework. Rather than force a square peg into a round hole, the agencies should utilize the logical existing legal framework of Regulation Z.

Regulation Z contains not only disclosure requirements, but numerous substantive consumer protections related to credit cards including:

- Dispute rights;
- Limits on liability for unauthorized transactions;
- Requirements to credit payments promptly;
- Requirements to refund credit balances;
- Limits on card issuance;
- Prohibitions against offset; and
- Requirements to deliver periodic statements within certain timeframes under certain circumstances.

Because Regulation Z contains not only disclosure requirements, but also substantive provisions, the agencies could house new credit card requirements in this regulation.

The proposal's provisions relate to issues already contained in existing Regulation Z. For example, Regulation Z contains specific advance notice requirements for credit card term changes. The proposal's requirements related to increases in interest rates on outstanding balances would logically and rationally fit in this same space. Re-pricing of existing balances should be addressed by clearly distinguishing between default pricing and re-pricing by amendment. Default pricing could be constrained to those default events that can be demonstrably correlated to a material risk of default and adequately described in appropriate disclosures or the card agreement. Re-pricing by amendment could be addressed by requiring a standard that reflects material risk or market or economic changes. Additional restrictions to the timing of the changes could also be considered as an element of the Regulation Z framework.

Regulation Z could also implement an opt-out mechanism that comports with state law as found in Delaware. This opt-out would create a nationwide standard available to all cardholders and governing all card issuers.

A similar approach could address the Proposal's requirement to establish a specific timeframe for sending out mailed periodic statements. Section 226.5(b)(2) of Regulation Z currently contains a requirement that under certain circumstances, creditors must mail or deliver periodic statements at least 14 days before the due date. It makes sense that both these provisions that address periodic statement mailing timeframes be contained within the same regulation.

Some of the provisions, as Chairman Bernanke suggested when he said, "Consumers relying on credit cards should be better able to predict how their decisions and actions will affect their costs," could be addressed through better disclosure, which could be accomplished through Regulation Z. For example, Regulation Z already contains disclosure requirements related to balance computation methods, including double cycle billing, which the proposal addresses. The agencies should again test how to explain the loss of the interest-free period when borrowers do not pay in full before prohibiting the practice. In any case, issues related to one of the balance computation methods already described in Regulation Z, could also be addressed under that regulation.

Regulation Z is also the better location to deal with necessary exceptions to the proposal to limit finance charges to the current billing cycle. As other commenters have noted, there are naturally occurring transactions that need to be accommodated under a current billing cycle limit: First, cash advances that occur in one statement, but do not post until the next statement. There is no interest free period for such advances, but the proposal would impose one unless these circumstances were made an exception from the rule. Second, payments made in one cycle, but returned in the next cycle would need to be corrected to properly reflect the lack of valid payment and the need to collect appropriate interest for the prior billing cycle. This too needs to be subject to an exception.

The agencies should also not cede the issue of payment allocation to UDAP rule-making. The real issue is not the unfairness of practices; it is the comprehension of them. Revised, understandable disclosures could substitute for the severe proposal that in effect would eliminate or significantly reduce the impact of this tool that not only benefits customers who take advantage of low and zero interest rates, but also enhances competition. In addition, Regulation Z could address advertising practices so that the promotion of promotional rates conveys an accurate albeit simplified description of the basic impact of accepting the offer and is consistent with the message contained in the required disclosures. ABA members agree that people should have a fair understanding of what they are and are not getting from a promotional rate offer.

If the Board desired to go beyond improved disclosure and specify particular methods, they should be sure to establish requirements that are both operationally efficient and able to be reasonably described to consumers. Among the methods that should be permitted that address these two goals is a First in, First out (FiFo) method that retires balances in the order of the transactions that make them up.

The proposed disclosure requirement related to firm offer of credit would be more logically addressed in coordination with regulations implementing FCRA. FCRA contains not only disclosures related to firm offers of credit, but also notices related to risk-based pricing, which the Proposal specifically addresses.

Rather than invent an artificial and strained argument to justify use of a UDAP framework, the agencies should update existing "baselines" as found under

Regulation Z and FCRA regulations. Both of these existing regulatory structures are financial in nature and provide the necessary scope to reach all creditors. They do not depend on a piecemeal assembly of joint rule-makings under generalized trade practices authority, but rather would reflect a consistent extension of baseline financial practices regulation.

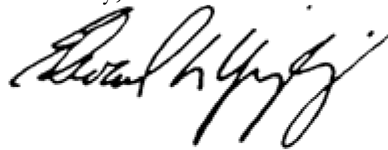
CONCLUSION

In summary, ABA believes that the Board, the OTS and the NCUA should proceed cautiously in establishing unfairness rules under their UDAP rule-making authority. UDAP situations are often characterized by case specific facts that defy industry-wide generalization. In exercising their FTCA Section 18(f)(1) rule-making authority, the agencies must be mindful to apply standards that properly consider the unique attributes of the banking sector and take extra care in performing their analysis because it will have precedent setting application far beyond the particular practices at issue. If the agencies proceed with policy foresight and analytical rigor, they should conclude that the banking industry's mainstream credit card practices, developed under the governing structure of TILA, are not unfair to customers.

While ABA believes that there are limited occasions where a UDAP rule should be promulgated, redefining the baseline for credit card plans is not such an occasion. Ultimately, ABA urges the agencies to accomplish any reform to help cardholders better predict their costs by acting within the existing framework of Regulation Z.

ABA appreciates the opportunity to provide our comments on this significant proposal and is prepared to provide additional information for your consideration upon request. If you have further questions, please contact Nessa Feddis at (202) 663-5433 or Richard Riese at (202) 663-5051.

Sincerely,



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