

Unfair or Deceptive Acts or Practices (UDAP) Meeting with Members of Public

October 3, 2008

OTS staff met with representatives of the Coalition for Equal Access to Credit to discuss the Coalition's perspective on the May 19, 2008 proposed UDAP rule. The Coalition presented the materials in the accompanying handouts (copies attached). In addition, the Coalition discussed the manner in which subprime credit cards are underwritten.

In attendance for OTS: April Breslaw, Richard Bennett, Steven Lake, David Malmquist, and Eric Hirschhorn

In attendance for the Coalition:

Miles Beacom, Premier Bankcard  
Dana Dykhouse, Premier Bankcard  
Denny Sanford, Premier Bankcard  
Michael Turner, Political and Economic Research Council (PERC)  
Patrick Walker, PERC  
Obrea Poindexter, Morrison and Foerster  
Rick Fischer, Morrison and Foerster  
Jack Hopkins, Coretrust  
David Brown, Coretrust  
Greg Ticknor, Total Card  
Martin DePoy, Bockorny Group  
Stephen Hageman, Plains Commerce Bank

**Office of Thrift Supervision Meeting  
October 3, 2008**

1. Introductions

- Here on behalf of the Coalition and just three issuers.
- Other issuers were not invited to participate.

2. UDAP Proposal and Impact of Account Fee Limitation

- We welcome efforts to address unfair and deceptive practices.
- But proposal to limit initial fees and expand immediate credit availability hurts both issuers and consumers.
- At least 1/3 of all new cardholders default and over 75% of them default immediately—using 97% of their available credit, paying no fees and repaying no principal. But this 1/3 cannot be identified in advance.
- Increasing initial credit availability increases losses and increases costs for other cardholders.
- Low initial credit limit provides controlled-risk environment to identify who will pay and who will not. Those who pay then get more credit.

3. PERC Economic Assessment

- TransUnion analysis shows that both defaulting cardholders and successful cardholders are spread across risk tiers.
- PERC analysis shows that losses under proposed fee cap occur across every risk tier, so underwriting strategies cannot be adjusted to offset these losses.
- A cap on posting initial fees exceeding 50% and required amortization of fees over 25% of credit limit would turn an average per account profit of \$6.60 per account to a loss of \$119.45 per account.
- Because the proposal would make 75% of the credit limit immediately available and more than 1/3 of new cardholders would use 97% of this credit and immediately default, it would take a six-fold increase in the interest rate to offset the losses—from a current average rate of 16.1% to over 92.7%.
- Similar analysis shows that fee caps of 55%, 60%, 65% and 70% also are not currently viable.

#### 4. Alternative Reg AA Approach

- Initial account fees are unfair/deceptive if issuer fails to provide both clear disclosure of total fees and available credit, and adequate consumer choice.
- Safe harbor if issuer substantially complies with stated code of fair practices (example attached).
- Consumer choice includes right to reject account without cost, or right to charge initial fees to account at zero interest.

#### 5. Low Limit Cards are Different

- Not like subprime mortgage loans.
  - Low credit amounts
  - Not secured by homes
- Costs are much higher than those for prime accounts.
  - Higher reserve requirements—55% compared to 8% for prime accounts
  - Higher charge-offs—25% compared to 5.5% for prime accounts
  - Higher operating costs than those for prime accounts—*e.g.*, 10 to 20 times the customer call

#### 6. Important Consumer Benefits

- Few current credit alternatives.
- But proven opportunity to improve credit.
- And small credit lines serve as valuable transaction accounts.
- Multiple use of total credit line each year (use of total credit line every 5 months or 2.5 times per year).
- Small transactions for basic needs (food, gas, tolls)—average transaction under \$30.
- Ability to participate in economy.
  - Internet and telephone purchases
  - Rentals
  - Identification
  - Instant check out

## 7. TransUnion Study and PERC Validation

- Analysis of 360,000 accounts at multiple issuers.
- PERC could independently validate within 1%.
- Significant instability, but 37% with score improvement and 17% with score improvement more than 40 points.
- 24% opened prime card accounts with at least \$1,000 credit limit; 14% at least \$2,500 credit.
- 58% of consumers received prime promotional credit offers.
- Over 11, 000 consumers not scorable in 12/5 now have a viable credit score.

## 8. Questions and Additional Discussion

[www.equalaccesstocredit.org](http://www.equalaccesstocredit.org)

Citizens for Equal Access to Credit is a diverse, national multicultural nonprofit coalition. We are comprised of hundreds of past and present low limit credit card customers from 40 states as well as leading national organizations representing minorities.

Our members also include providers of low limit credit cards, Chambers of Commerce, elected officials, leading national small business associations, and other concerned groups and individuals from across the nation.

Collectively, the groups and organizations that are part of our membership represent over 2 million people in the United States. They include:

- Asociacion Interamericana de hombres de Empresa, [www.aihepr.com](http://www.aihepr.com)
- CorTrust Bank [www.cortrustbank.com](http://www.cortrustbank.com)
- Dominican American National Roundtable [www.danr.org](http://www.danr.org)
- First Premier Bank [www.firstpremier.com](http://www.firstpremier.com)
- Intertribal Agriculture Council [www.indianaglink.com](http://www.indianaglink.com)
- State Representative Pedro Marin (GA) - Highest Ranking Elected Latino Official in the State of Georgia
- Judge Luis Gomez - Former Judge and leading Advocate for at risk youth and young adults.
- Medford/Jackson County, Oregon Chamber of Commerce [www.medfordchamber.com/](http://www.medfordchamber.com/)
- Plains Commerce [www.plainscommerce.com](http://www.plainscommerce.com)
- Reno / Sparks Chamber of Commerce [www.reno-sparkschamber.org](http://www.reno-sparkschamber.org)
- Small Business Entrepreneurship Council (SBEC) [www.sbecouncil.org](http://www.sbecouncil.org)
- Special Defenders, Inc.
- TotalCard [www.credit-card-surplus.com](http://www.credit-card-surplus.com)
- South Dakota Chamber of Commerce [www.sdchamber.biz](http://www.sdchamber.biz)
- Interlakes Community Action Partnership [www.interlakescap.com](http://www.interlakescap.com)
- Sioux Falls, SD Chamber of Commerce [www.siouxfallschamber.com](http://www.siouxfallschamber.com)
- Walker / Thomas Mental Health Services, Bel Air, MD

**Subprime Credit Cards: Likely Impacts  
of Fee Cap and Other Analysis**

*Presentation for OTS*  
Washington, DC  
3 October, 2008

## Questions Driving Impact Analysis

- How would the proposed regulations impact the subprime card industry?
- Could the issuers simply respond to the fee cap by raising interest rates?
- Could the issuers simply respond by choosing less risky applicants by “moving up the FICO risk tiers”?
- Aren’t current industry profits such that losses from the proposed fee cap could be absorbed without harm?

# Empirical Impact Assessment

- PERC coordinated with **3 subprime card issuers**
- PERC simulated impacts of proposed fee cap on the costs, revenues, and net income generated from all **2.7 million accounts** booked in 2007
- **Held Constant:**
  - **All consumer behavior** (likelihood of charging off, paying over draft fees, holding balances, credit utilization, percent of fees paid, etc.)
  - **Costs structure** (booking costs, servicing costs)
- **Not held Constant:**
  - **Basic Fees charged and “Open to Buy” amount** (credit line initially available)

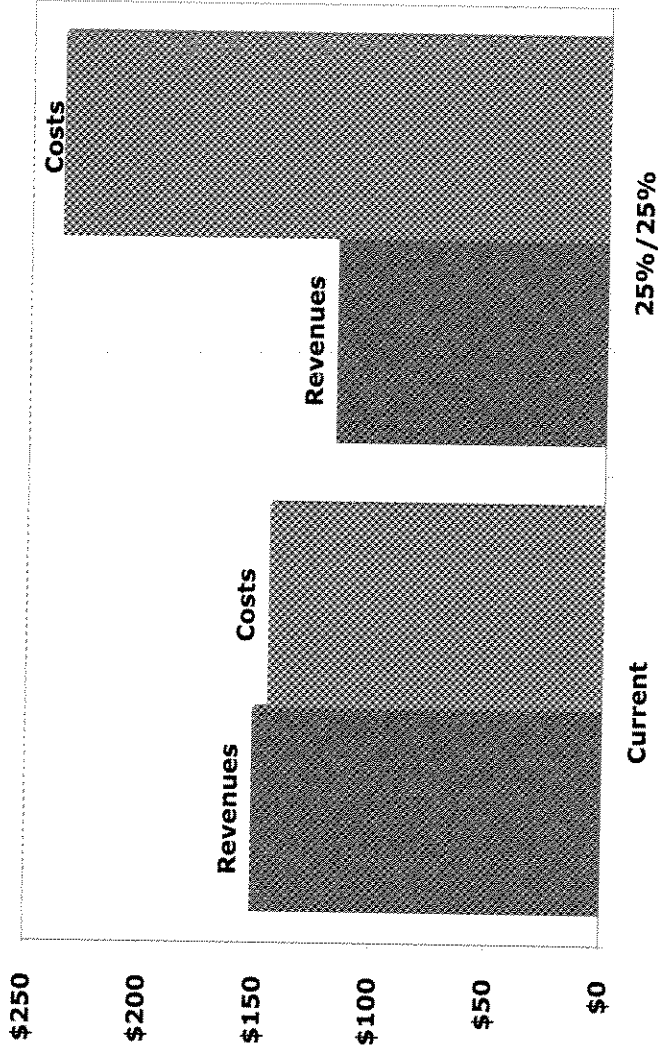


# Empirical Impact Assessment

## Key Findings

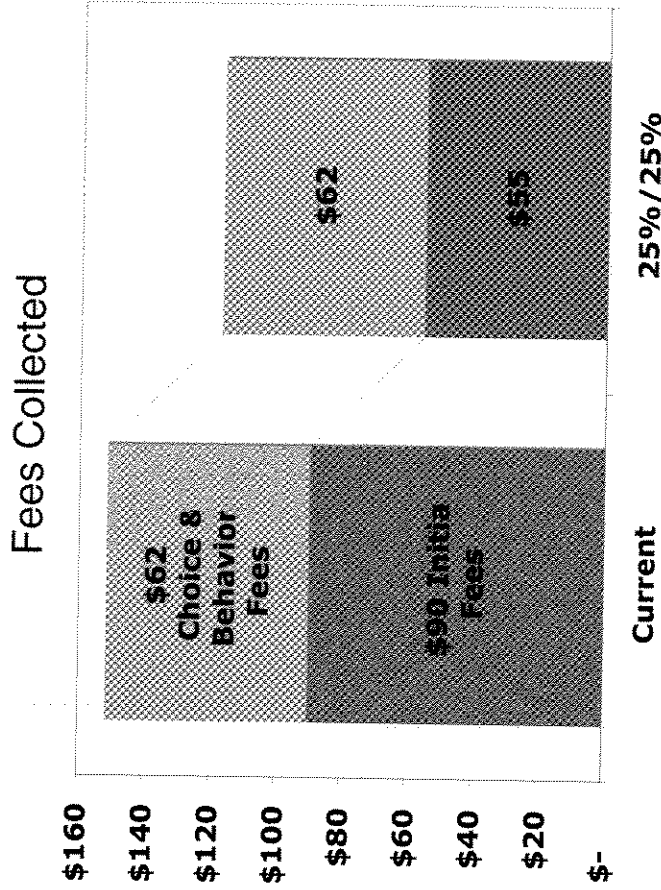
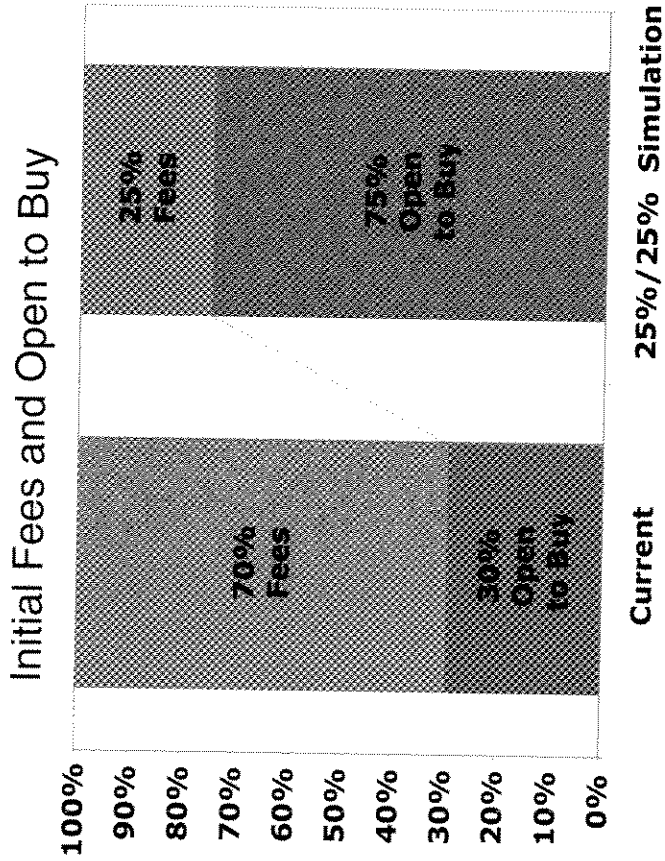
- Subprime net income per card \$6.60 for card issued in 2007. For broader industry it was \$57.01 in 2007.
- Proposed fee cap would have resulted in a net loss per card of \$119.45.
- To offset this shift, APR would have to rise nearly sixfold from 16.1% to 92.7% (likely an unworkable change).
- Under the proposed fee cap, losses occur across every risk tier, so underwriting strategies cannot easily be adjusted to offset these losses.
- Assuming less restrictive regulations of 50%, 60%, or 70% initial fee caps also result in industry losses. A 50% cap produces a loss of \$60.24.<sup>4</sup>

# Costs and Revenues



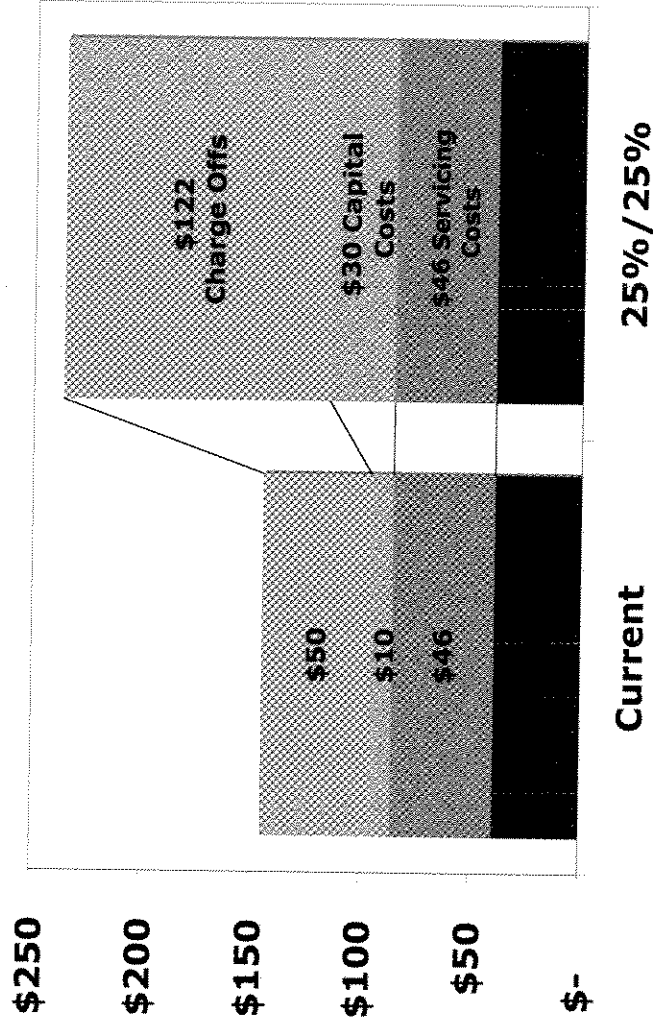
- Net income declines from a gain of \$6.60 per account to a loss of \$119.45 per account.
- Shift due to a decline in revenues and a rise in costs

# Fees and Open to Buy



- Fees collected falls 23% under proposed regulation.
- Initial available credit more than doubles (so do risk, costs, and charge offs).

# How Costs are Impacted



- ⊗ Capital costs triple, and charge offs more than double under proposed fee price restraint.
- ⊗ Three-quarters of those that default are delinquent within 3 months.
- ⊗ Most (97.5%) of the available credit is used among those that default.

# Returns Across FICO Ranges

Returns on Loans by FICO Ranges

|                | Percent of Accounts | Current Return | 25%/ 25% Return |
|----------------|---------------------|----------------|-----------------|
| <b>675+</b>    | 1%                  | -22%           | -103%           |
| <b>646-674</b> | 4%                  | 10%            | -76%            |
| <b>620-645</b> | 10%                 | 3%             | -64%            |
| <b>591-619</b> | 18%                 | 6%             | -65%            |
| <b>560-590</b> | 19%                 | 9%             | -68%            |
| <b>531-559</b> | 17%                 | 12%            | -61%            |
| <b>500-530</b> | 16%                 | 12%            | -59%            |
| <b>451-499</b> | 12%                 | 13%            | -65%            |
| <b>300-450</b> | 4%                  | -23%           | -99%            |
| <b>All</b>     | <b>100%</b>         | <b>7%</b>      | <b>-65%</b>     |

With the pricing restrictions, all FICO ranges have negative returns

# TU Analysis Overview

- \*PERC independently assessed TransUnion study examining value of cards, and conducted empirical impact analysis.
- \*380,000 records of all subprime cards issued in January 2006 by 4 subprime issuers
- \*Of these, 365,000 records contained files that existed at TransUnion in December 2005 and January 2008.
- \*These records included those that maintained their subprime cards, charged off, and graduated to prime cards.
- \*Outcomes derived by comparing credit scores and other credit file data prior to obtaining the subprime card (Dec. 2005) to such data 2 years after obtaining the subprime card (Jan. 2008).
- \*PERC received the raw flat file data from TransUnion and was able to replicate results to within 1% of what TU found.

# Results from TU analysis

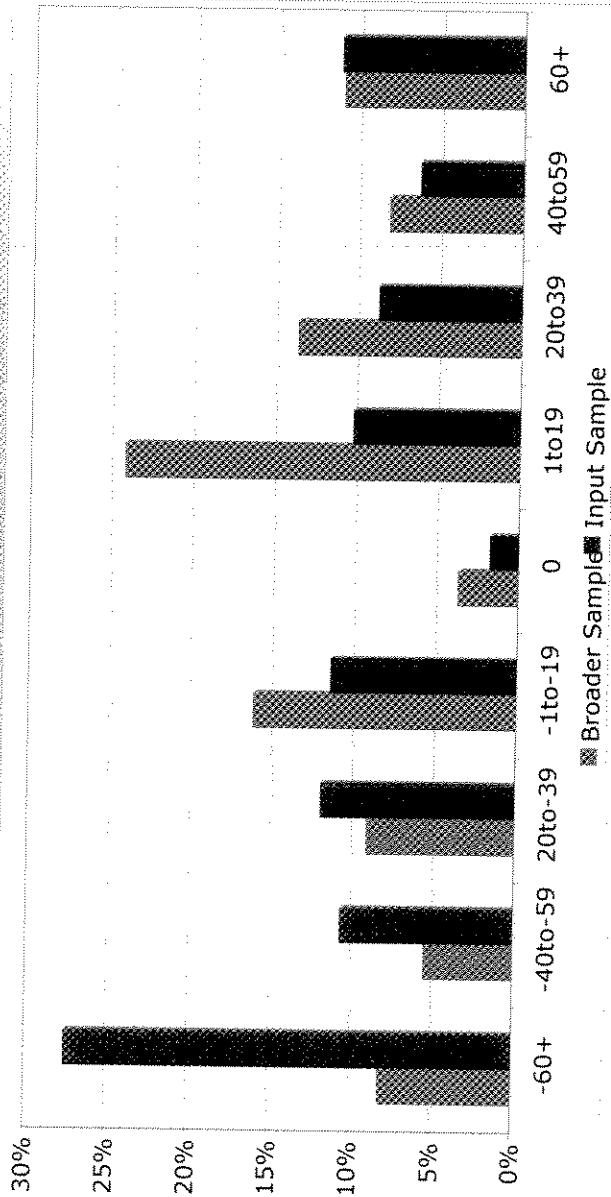
## Score Migration

- 37% experienced an increase in their VantageScore
- 17% experienced an increase in their VantageScore of 40 points or greater
- 11,258 (about 3%) consumers unscorable in December 2005 received a valid VantageScore as of January 2008

## Credit Access

- 10% opened a new bankcard in the last year with a credit limit of \$1,000-\$2,499
- 9% opened a new bankcard in the last year with a credit limit of \$2,500+
- 16% opened a new bankcard in the last year with a credit limit of \$1,000+
- 50% received a promotional offer of credit from a non-subprime lender in the last year (as of Jan. 2008)

# Migration of scores: Dec 2005 - Jan 2008



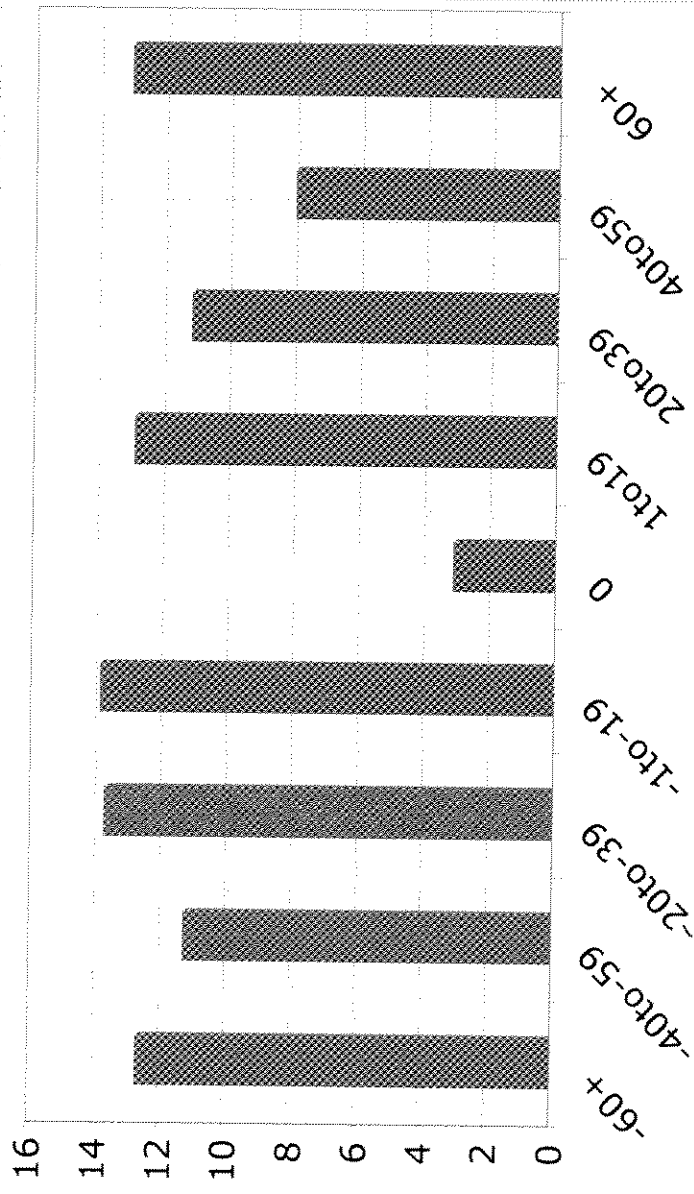
VantageScore predicts the likelihood of a consumer becoming 90+ days delinquent over the next 24 months

Vantage Score migration from December 2005 to January 2008 for Input Sample  
 Vantage Score migration from March 2005 to March 2006 from a Broader Sample

- Sample is riskier and less stable.
- 5 in 10 had one or more 90+ day delinquencies in January 2008.



# Score Migration: Dec 2005 - Jan 2008 (scores below 600 in December 2006)

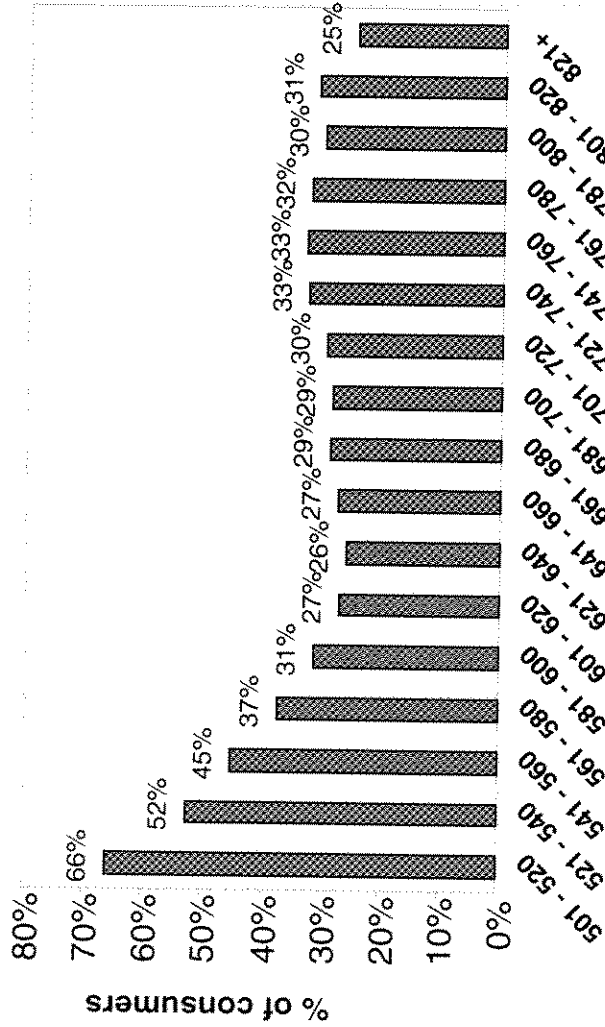


•45% of consumers had an increase in their VantageScore.  
•21% had an increase of 40 or more points.

**5 in 10 of those with lowest scores see improvement**

168,957 consumers had a VantageScore below 600 in December 2005.

# Positive score migration is occurring across the entire spectrum

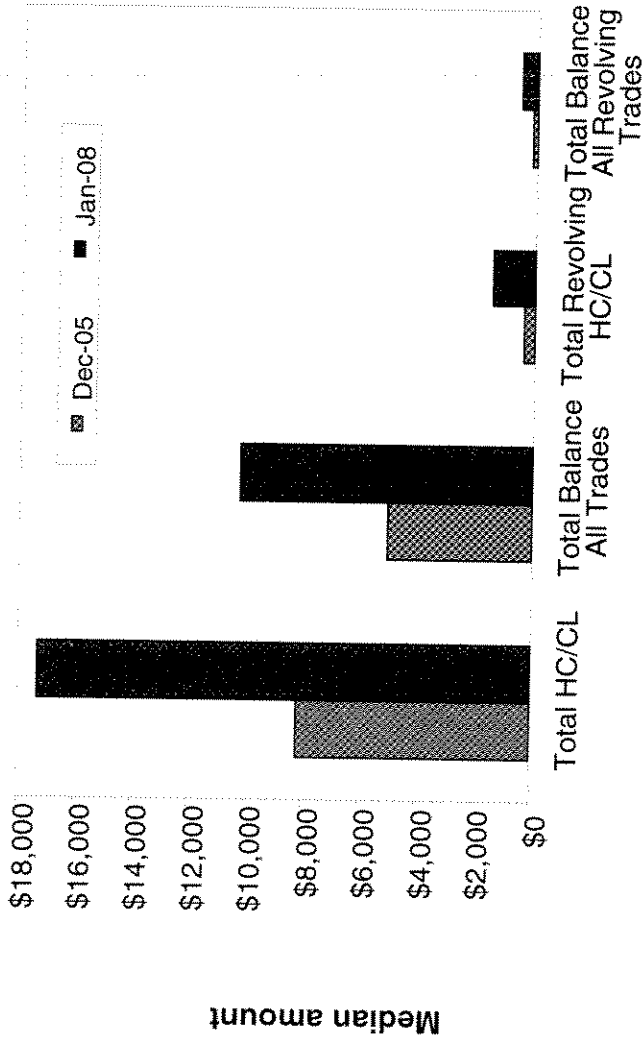


- 66% of consumers in score band 501-520 had positive score migration.
- Each score band saw positive migration of at least 25%

**Greatest score increases found at lowest score tiers**

\*127,000 input consumers had a VantageScore increase from December 2005 to January 2008

# Responsible Use of Subprime Card = Improved Credit Access



- Similar results observed for other credit products
- Results based on consumers with a VantageScore increase from December 2005 to January 2008

Key attribute segments

**Significant increase in median values of high credit/credit limit and balance attributes over a two-year period**

\*127,000 input consumers had a VantageScore increase from December 2005 to January 2008

**PERC**

**RESULTS AND SOLUTIONS**

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October 2008

## CEAC Materials on UDAP Rule Fee Limitations

1. Cover Letter
2. PERC Assessment of Economic Impact
3. Code of Fair Practices
4. TransUnion Analysis on Subprime Graduation
5. Articles
6. Testimonials
7. Comment Letters
  - Premier Comment letter
  - CoreTrust letter
  - PERC letter



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September 25, 2008

Dear Governor Kroszner:

The attached analysis prepared by PERC, The Political and Economic Research Council, for the Citizens for Equal Access to Credit, includes a compilation of simulations demonstrating the likely economic impact of the proposed UDAP Rule fee limitations on low limit credit card accounts for credit impaired consumers. Specifically, the analysis and simulations illustrate that:

- Issuers of low limit credit cards face severe credit and economic risk if they are unable to test consumers in a controlled-risk environment by limiting the amount of available credit and monitoring consumer behavior to identify those consumers who actually make timely payments and those who do not. Those who do make timely payments will have more available credit. However, those who do not make timely payments usually default within three months without repaying any of the money they borrow on their accounts, after exhausting over 97% of their available credit lines.
- Under the proposed fee cap, losses occur across every risk tier so underwriting strategies cannot be adjusted to offset these losses.
- Restructuring the product according to the proposed rule would result in substantially higher costs and the total elimination of profits. For example:
  - The analysis shows that the cap on posting fees exceeding 50% of the credit limit and requiring fees over 25% of the credit limit to be spread over the first year would result in a reduction in net income from a gain of \$6.60 per account to a loss of \$119.45 per account.
  - The analysis also shows that if issuers are precluded from charging to the account fees that are greater than 25% of the initial credit limit and thereby are required to make 75% of the credit limit available immediately, issuers would have to increase the average interest rate nearly six fold—from the current average rate of 16.1% to over 92.7%—to offset the resulting losses, even assuming that any consumer would find a 92.7% rate account acceptable.
- Similar analysis and simulations illustrate that 55%, 60%, 65%, and 70% fee limitation standards currently are not economically viable. The break even point is about 72% and the current average initial fee share of the credit lines of the issuers studied is 70%, since some issuers and customer segments have above average fees. So, even a fee cap above the current industry average would lead to some losses.

Issuers of low limit credit cards have significant experience in pricing risk relating to credit impaired consumers and have likely optimized their business models for this segment of the market. The simulations demonstrate that issuers already provide the maximum or near maximum economically viable levels of available credit to these consumers with their current, likely optimized, business models.

Instead of prohibiting the posting of initial fees and severely constraining the ability of issuers to offer low limit credit cards, and the ability of credit impaired consumers to use those cards to rebuild their credit histories, Citizens for Equal Access to Credit urge you to consider requiring compliance with a specified Code of Fair Practices, which would include clear layered disclosure of the total of fees, total credit limit, and remaining available credit, the option to pay fees upfront or to post fees to the account interest free, and the right to a full refund if the consumer decides to reject the card. A copy of the Code of Fair Practices is enclosed with this letter, along with the PERC analysis.

We wholeheartedly commend the Federal Reserve Board for their commitment to finding viable solutions to protect consumers from unfair and deceptive practices. But, it is our view that the UDAP Rule fee limitations, if approved in their present form, may have an unintentional negative impact on the ability of credit impaired consumers to gain access to credit and/or to rebuild their credit histories. In our view, a Code of Fair Practices can help us to achieve both.

Thank you in advance for your attention to this matter.

Sincerely,

*Javier Cuevas*

Executive Director



# **IMPACT OF PROPOSED FEE CAP ON THE SUBPRIME CARD INDUSTRY**

## **EMPIRICAL RESPONSES TO QUESTIONS POSED BY THE FEDERAL RESERVE BOARD**

Prepared for Citizens for Equal Access to Credit

By

The Center for Competitive Credit

*an applied studies center of*

The Political and Economic Research Council

**September 2008**

### **Principle Investigators:**

Michael A. Turner, Ph.D.  
President & Senior Scholar

Patrick D. Walker  
Director, Research



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## Introduction

Recently the Federal Reserve Board and Citizens for Equal Access to Credit (CEAC) met to discuss the likely impact on the subprime credit card industry of proposed rule changes that would restrict the fees issuers could charge cardholders.<sup>1</sup> PERC participated in those discussions to explain and verify the results and methodology of analysis on subprime cardholder behavior and outcomes conducted by TransUnion LLC for CEAC.

Governor Kroszner queried the issuers in attendance as to their thoughts on how they would respond to the proposed cap on posting fees to a credit card account, and what the likely impact would be on their earnings. In particular, he questioned whether underwriting standards could be adjusted upward, and whether revenues lost from the fee cap could be offset by increasing the price of credit charged to cardholders. In addition, Director Braunstein asked whether subprime issuers already earned excessive profits, and, if so, whether the proposed rules change would have much affect on current profit levels.

At CEAC's request, PERC has undertaken to provide empirical responses to the questions offered by Governor Kroszner, Director Braunstein, and other Federal Reserve Board staff members during the course of these discussions.

## Key Findings

PERC was able to access detailed data on the entire portfolio of cards issued by 3 CEAC members—one large issuer and 2 smaller ones—during 2007.<sup>2</sup> On the basis of this data, PERC was able to simulate directly and coordinate analysis by the issuers of the likely impacts of the proposed fee cap, and other potential variants thereof, upon issuer average annual costs and revenues. PERC also examined the impact on returns by risk tier (as determined by each cardholder's credit score), and measured the ability of issuers to offset lost fee revenue with higher interest rates. The following are the key findings:

- At \$6.60 per card, average net income per card for subprime issuers in this analysis were 88% lower than broader (prime and subprime) industry average of \$57.01;
- Average account acquisition costs for subprime issuers are somewhat lower than the non-subprime industry average;
- The proposed fee cap would dramatically harm earnings, as net income per card declines over 1,800% from a gain of \$6.60 to a loss of \$119.45;
- To offset losses from the proposed fee cap, issuers would need to increase the APR nearly sixfold, from 16.1% to 92.7%;
- Under the proposed fee cap, losses occur across every risk tier, so underwriting strategies cannot be adjusted to offset these losses.

<sup>1</sup> Regulation AA -- Unfair or Deceptive Acts or Practices Proposal – Board Docket R-1314.

<sup>2</sup> No personal identifying information was shared with PERC, and all relevant state and Federal privacy laws, including the FCRA, were fully complied with in all instances.

## Simulations and Limitations of the Analysis

The following simulations are derived from the actual performances of borrowers, costs, and revenues of three subprime card issuers between January 2007 and July 2008 for all the accounts booked in 2007. The data include all accounts--those still active in July 2008 and those that had either been charged off or had been closed by the cardholder prior to July 2008. The results presented are arithmetic averages of the results from each of the three participating issuers and are usually presented in terms of costs and revenues per account.<sup>3</sup>

The first simulation presented below most closely simulates the proposed rule change—a cap on basic fees charged to the account of 50% of the initial credit limit, with any basic fees over 25% of the credit limit spread over the remaining 11 billing cycles of the first year. That is 25% are due in the first month or “up front,” and the remaining 25% is spread across the balance of the year. We refer to this simulation as the “25%/25%” simulation.

The second simulation presented below simulates a 50% cap on basic fees that can be charged to the account up front. We refer to this simulation as the “50%” simulation. Additional results are also presented on the impact of similar caps of 55%, 60%, 65% and 70%.

Both pricing constraints, the 25%/25% and the 50%, would greatly impact the issuers examined in this report. All three issuers charge basic fees in excess of the proposed 50% cap, and they do so for all of the FICO bands for which such data was broken out. This indicates that the fee cap cannot be accommodated by these three subprime card issuers merely by migrating their borrower portfolio marginally up the risk continuum (as measured by a FICO generic scoring model in this case).

The results presented are meant to be illustrative of the magnitudes of the impacts of the various scenarios simulated. They are also intended, importantly, to illuminate how and why such pricing changes impact a subprime card issuer’s bottom line. While the results are based entirely on actual outcomes for the 2007 cohort of cardholders, there are some basic limitations inherent in such simulations.

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<sup>3</sup> PERC staff held separate calls with each of the participating card issuers to describe the methodology and discuss data needs given the variance in account and fee coding and accounting classifications across the issuers. Further, PERC executed separate non-disclosure agreements with each of the three participating issuers expressly prohibiting the disclosure of data to any third party by any means. The information shared with PERC by the issuers was regarded as proprietary and not to be discussed with competitors under any circumstances. Nevertheless, the information received from the issuers is consistent, and as a result, the probability that the data provided to PERC for purposes of this analysis was manipulated is very low.

## **Limitations**

The first limitation is based on the fact that the pricing changes simulated are not by any means slight or marginal. Therefore, the simulations are, in a sense, extrapolating well outside the data and the experiences of the card issuers. How exactly consumers would respond to the changes in pricing is unknown, how costs to book consumers might change is unknown, whether there may be greater difficulty in separating the least risky applicants from the more risky applicants (and thus the impact on the share that charge off and the like) is unknown, whether the number booked would need to decline or rise and impact economies of scale is unknown, and whether a much larger initial available credit would increase fraud is unknown.

While we might be able to reasonably speculate about the direction of some of these impacts, estimating their magnitudes becomes pure speculation. Although we are not sure of the direction of the collective impact of these unknowns on a subprime issuer's bottom line, we believe the analysis fairly represents the likely impact on the issuers, *ceteris paribus*.

The second major factor that would influence actual market outcomes are external factors such as the performance of the economy in general, the performance of subprime consumers and credit markets, and prevailing interest rates. As have been the general fortunes of the larger financial sector, it too appears to be the case for the subprime credit sector. For instance, a major publicly traded subprime card issuer's public financial records show large profits several years ago that have since turned to large losses.

That being said, the analysis presented here represents the clearest picture of how the simulated price restrictions would impact the card issuers. It represents the primary effects of the pricing changes. It is possible that additional analyses that are based on experiments that gauge consumer responses to changes in the price structure, monitor borrower performances, and try a variety of different approaches to lending in this segment could offer greater precision in estimating the impacts of the sorts of pricing changes simulated here. But such experiments require some time for performances to be measured and adjustments to be made. We did not have those luxuries here.

In any case, given the scale of the changes to the current business model that could be required by the proposed price changes, it would be surprising if the impact upon subprime card issuers' bottom line were not as dramatic as the simulations here suggest. And as such, it seems unlikely that the industry could continue to operate in its current manner and with anywhere near as many consumers as it currently serves with the proposed price restrictions.

## Overview of the Simulation Results

The following results indicate how revenues and costs from all subprime card accounts booked in 2007 would be altered under two main scenarios, the first being consistent with the FRB's proposed fee restriction. The results are based on the actual outcomes of all accounts booked in 2007, consumer behavior is held constant as are other aspects influencing costs and revenues that are not directly impacted by the price restrictions. As such, we believe the results obtained provide a good indication of how the subprime card industry and its issuers would be impacted by the price restrictions simulated.

In the first scenario, the 25%/25% case—the scenario most consistent with the proposed fee restriction—the result is a dramatic downward shift in net income from a profit of \$6.60 per account to a loss of \$119.45 per account. In the second scenario, the 50% cap case, the result is a relatively smaller but still substantial downward shift from a profit of \$6.60 per account to a loss of \$60.24 per account.

In both scenarios, though to different degrees, these shifts are brought about by:

- A large reduction in revenues due to restrictions on fees charged and collected.
- A large increase in the initial open to buy amount (initial credit available)
  - This raises the cost of funds as more credit is made available
  - This raises the losses from charge offs as the costs to the issuers from the charge offs is directly related to the initial open to buy amount (since this is essentially the share of the credit line being risked by the issuer, until the issuer has actual experience as to the repayment practices of each new cardholder)

The magnitude of the swings in net income are so large that to offset them with a hike in interest rates charged, average interest rates would need to rise from 16.1% to 92.7% in the first scenario and to 60.8% in the second. Of course, such rates are not practical and would have the perverse impact of severely penalizing those who properly utilize credit, carry a balance, and do not default. Such rates are also well outside the ranges of interest currently charged for credit card products<sup>4</sup>.

Another key result demonstrated by the simulations is that returns are negative across all 9 FICO ranges considered. This is true for both simulations. In addition, with the notable exception of the 4% of accounts with the lowest FICO scores, returns actually tend to fall for the higher the FICO range. The lower returns at the higher FICO ranges may be due to higher booking costs for consumers with higher FICO scores (they have more credit options), lower fees and greater open to buy amounts for higher FICO consumers (need to attract these consumers), and are consistent with findings from the TransUnion analysis that those with higher initial FICO scores when booked were more

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<sup>4</sup> Based on figures of industry interest rate ranges from CardWeb.com.

likely to see score declines (possibly a case of adverse selection). Taken together, it is clear that trying to adjust to the proposed price restrictions by attracting and accepting greater numbers of less risky consumers would not produce a better outcome.

Finally, as is clear from the net income of \$6.60 per account without price restrictions, any significantly binding price restrictions, such as fee caps of 55%, 60%, 65%, and 70% of the credit line, would either dramatically reduce net income per card or would otherwise result in losses.

### Net Income Per Card Under Different Fee Cap Scenarios

| Fee Cap<br>(share of credit line) | Profit/Loss Per Account<br>(dollars) |
|-----------------------------------|--------------------------------------|
| 50%                               | <b>-60.24</b>                        |
| 55%                               | <b>-43.41</b>                        |
| 60%                               | <b>-26.96</b>                        |
| 65%                               | <b>-10.51</b>                        |
| 70%                               | <b>-1.71</b>                         |
| No Cap                            | <b>6.60</b>                          |

*Source: All cards issued during 2007 by three subprime card issuers.*

It is worth noting that even with a fee cap set to the average share of fees currently charged in the industry, there still would be costs from the addition of a cap. This is so since some issuers will have fees above the industry average and, hence, the pricing restraint would be binding for some issuers, reduce their profits, and thus, the industry's. Second, due to the use of risk-based pricing, credit cards issued to those with lower FICO scores, for instance, will have higher fees. Thus, a fee cap even set to a company's average fees would still be binding on those consumer segments served by the company with above average fees.

## Subprime Card Business Model: The Underlying Logic

### ***Why Fees are Assessed and How they Are Structured***

The subprime card industry has evolved to meet the current credit and payment needs of persons with damaged credit, low credit scores or no credit scores. Over the years, subprime card issuers have experimented with different pricing strategies. Pricing models were adjusted to reflect cardholder behavior, risk attributes, and preferences, on the one hand, and the revenue needs of the issuers on the other.

The typical subprime issuer has a portfolio of borrowers with the following risk and behavioral attributes:

- relatively high risk borrowers (85% of cardholders in participating issuers' portfolios had a credit score below 620 FICO);
- a large number of defaulters (figures from a subprime card issuer indicates 42.5% of borrowers that were booked in 2007 defaulted);
  - One should not interpret this as to suggest that no screening occurs prior to accepting a customer, according to the issuers included in this study less than one third of those applying for credit are approved. Instead it points to the difficulty in determining *a priori* who will default.
- defaulting early (of accounts booked in 2007 that were charged off, two subprime issuers reported that 46% of the charged off accounts were delinquent after one month and 76% after three)<sup>5</sup>;
- defaulting after using most of the available credit (figures from accounts booked in 2007 for one of the subprime issuers shows an average credit line usage for those that default of 97.5% )
- lower credit capacity;
- poor or no past credit history.

Given the risk profile of this population, high credit limit cards were not a logical or sustainable option. Further, given the behavioral characteristics of subprime cardholders—immediate default, high credit usage—extending a high level of initial credit without sufficient fees to offset risk is not a sustainable model. The credit solution that ultimately emerged to meet the needs of the subprime population is a low limit credit card with a significant basic fee structure.<sup>6</sup>

Extending high initial credit limits is simply not a financially prudent option for subprime card issuers, the ability to earn significant revenues from interest charges on outstanding debt is constrained by the fact that the cards have low credit limits. In fact, the average interest rate charged by the subprime issuers examined is 16.1% compared to 18.4% for the average standard credit card (see Appendix B).

In fact, given the proposed fee cap at 50% of the total initial credit limit, issuers included in this analysis would have to increase APR by nearly 500% from an average of 16.1% to 92.7%—assuming cardholder behavior is constant. In reality, very few cardholders are likely to be willing to accept an account with an APR close to 100%. The impact of such a hike in interest rates on credit card debt would likely result in an exodus of existing cardholders, a surge in defaults, and a powerful deterrent for new borrowers. This, in turn, would force card issuers to raise rates even higher to offset the resultant lost revenue. Few, if any, issuers are likely to survive this vicious cycle once it is set in motion.

<sup>5</sup> Figures shown are unweighted averages of the respective figures reported by each of the issuers.

<sup>6</sup> Basic Fees are defined as those fixed account fees not imposed by the borrower's choices or behavior.

Finally, given the preponderance of risky borrowers in a subprime card issuer's portfolio at any given time, relatively high up front fees act both as a barrier and as a sorting mechanism. Fees are a barrier to the extent that they prevent early defaulters from having access to the full credit line. And fees act as a sorting mechanism to the extent that those who pay their fees in full are vested in the relationship and have an incentive to use credit responsibly and with reasonable interest rates. Since it is not possible to determine who will or will not default *a priori*, it is important to have a mechanism that (1) does not risk too much of a lender's capital, (2) identifies those that will meet their repayment obligations and (3) covers operational costs. The proposed price restrictions simulated here risk short-circuiting such a mechanism.

### ***How Prices are and Should Be Determined***

Here it will be shown that the subprime credit card industry has characteristics that are typical of a competitive market. It will further be established that in a competitive market, firms act as "price takers," and that the market price for subprime credit cards is reasonable by standards of the broader card industry, especially given the industry cost structure and the relative high risk of their account portfolio. Finally, it will be argued that the price of subprime card credit is willingly born by cardholders to the extent that they derive value from access to a subprime credit card.

#### ***Competitive Pricing in the Subprime Card Market***

One central characteristic of a competitive market is an inability of firms in that market to set prices. In a competitive market, firms earning high rents (excessive profits) will see their margins driven down potentially to near zero as competitors offer lower prices or better value. In essence, firms in a competitive market are price takers.

Markets in which one or a small number of firms can set prices are typically characterized by high levels of concentration and little evident effective competition. While little data is available to use to measure concentration levels in the subprime credit card market—largely owing to the fact that many issuers are privately held companies and they do not make public information about their operations—given the number of firms in this market (including HSBC and Capital One, both of which maintain large portfolios of subprime cardholders but neither of which consider their firms to be subprime issuers), there is good reason to believe that the market is competitive and firms in this market are price takers.

Another characteristic of a competitive industry is relative ease of entry and exit. Consistent with this, the subprime credit card industry has certainly seen firms come and go. Surviving firms have adopted similar pricing methodologies, with some variances. Pricing in a competitive market evolved over years through trial and error. It is difficult to survive in this market, even under best of circumstances. Some issuers that have or had



exited the subprime space either permanently or temporarily are Bank First, Applied Card Bank of Wilmington, Provident, Specialized Card Services, and Barclay's Bank<sup>7</sup>.

And simply comparing net income per account booked in 2007 from the subprime card issuer data used in the simulations (a profit of \$6.60) to the 2007 pre-tax profits per card in the broader credit card industry, \$57.01, does not reveal excessive profits.

All of this is to suggest that an equilibrium price has evolved in a competitive subprime card market, and that government intervention, however well intended, is likely to disrupt the market to the harm of issuers and cardholders alike. To demonstrate this, PERC offers results from two simulations designed to measure the likely impacts of fee caps.

### *Price of Subprime Credit Reflects Perceived Value*

Between 55 and 78 million Americans have a subprime credit score, and a further 35 to 54 million either have no credit file or have insufficient information in their credit file to generate a score.<sup>8</sup> For many with low or no credit scores, a subprime card is the only means by which they are able to enter the credit mainstream, and either build or restore a good credit history. Importantly, payments made on subprime card accounts and other account information are reported to credit bureaus, unlike many other financial services serving high risk/no credit consumers.

Fully reporting payment information to a national credit bureau allows those with no credit to build credit and those with a tarnished credit history the opportunity to rehabilitate their credit via good payment behavior. To this point, a recent TransUnion study of subprime cardholders showed that nearly 4 in 10 cardholders witnessed a score increase or became scoreable over the observation period, and approximately a quarter of those with score increases graduate from subprime cards to more mainstream forms of credit.<sup>9</sup> This opportunity is likely one of the primary benefits attracting many consumers to subprime cards.

For example, since 2006, the three subprime issuers examined here have had over 10.7 million accounts. This combined with the finding from the previous TransUnion analysis

<sup>7</sup> These examples of issuers that had exited the industry were obtained from an employee at one of the 3 issuers that PERC worked with on this analysis at PERC's request.

<sup>8</sup> According to the Fair Isaac Corporation, approximately 27% of consumers with FICO scores had scores below 650, see <http://www.myfico.com/CreditEducation/CreditScores.aspx>. According to Experian, 38% of consumers with VantageScores have score below prime. Assuming an estimated 205 million scoreable consumers (according to an Experian representative), we arrive at 55 million to 78 million. The estimates of the thin-file and no-file population vary widely because two different proxies are used. FICO uses the portion of "unbanked" consumers as measured by the Federal Reserve as a proxy for unscorable files. W.A. Lee, "Eyeing the Unbanked: Fair Isaac Starts Bureau of its Own." *American Banker*, July 8, 2004. Experian bases its estimates on the number of credit eligible people in the United States and subtracts its estimate of scoreable files.

<sup>9</sup> *Ibid.*

that 38% of those with subprime accounts either witnessed credit score increases or became scoreable translates to over 4 million consumers who were able to improve their credit standing through the responsible use of their subprime cards.

Beyond the opportunity to gain credit or improve their credit standing, there are more basic reasons consumers find value in subprime cards. Having a credit card enables consumers to access credit for unexpected expenses and alternatives may be costly and/or undesirable; for example, the Center for Financial Services Innovation (CFSI) estimates that each year 340 million alternative financial services transactions are carried out at an average cost of \$38.22 per transaction.<sup>10</sup> Having a credit card also enables consumers to purchase goods and services without having to carrying cash and utilize services that require a credit card (unattended gas stations, renting a car, getting a hotel room, and internet transactions, for instance).

The five most common purchases on such cards, as reported by three issuers examined, are from:

1. major discount retailers;
2. a major chain restaurant;
3. grocery stores; and,
4. gas stations.

The most common purchases by category are those from pay at the pump gas stations.

The growing use of cards for smaller purchases can be seen in the rapid growth of the value of purchases from transactions of under \$20. In the broader credit card industry, the value of such purchases grew over 700% between 2000 and 2006 (see Appendix B). Consumers are frequently using cards for day-to-day purchases and more often for smaller purchases. Hence, it is likely that cardholders increasingly perceive greater value in low limit cards as they use them more frequently.

Now that we've discussed how subprime credit cards are priced in a competitive market, the focus of this analysis shifts to answering questions concerning the likely impacts of the proposed government intervention in the subprime credit card market. Particular emphasis is paid to the impacts of the proposed credit pricing restraint upon subprime card issuer costs, revenues, and net earnings.

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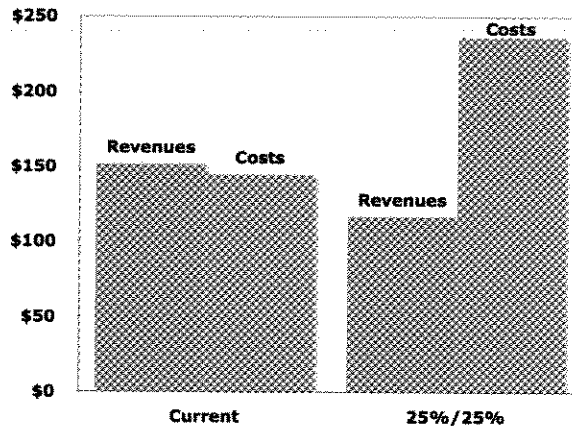
<sup>10</sup> See <http://www.cfsinnovation.com/underbanked-fact-sheet.php>.

## Simulation 1: Actual Proposal (25%/25%)

- Fees capped at 50% of initial credit limit
- Fees up to 25% of initial credit limit charged to account in first billing cycle
- Fees over 25% of initial credit limit spread over a year

Contrary to popular perception, and claims advanced by proponents of a fee cap on subprime card issuers, the current average net income per account, \$6.60, is relatively modest, and compares favorably with the broader industry average of \$57.01 per card account.<sup>11</sup> Issuers in our sample included those earning profits and taking losses. These results are indicative of the difficulty of establishing prices in this market, even when issuers are relatively unfettered by government regulations.<sup>12</sup>

### Costs and Revenues per Account

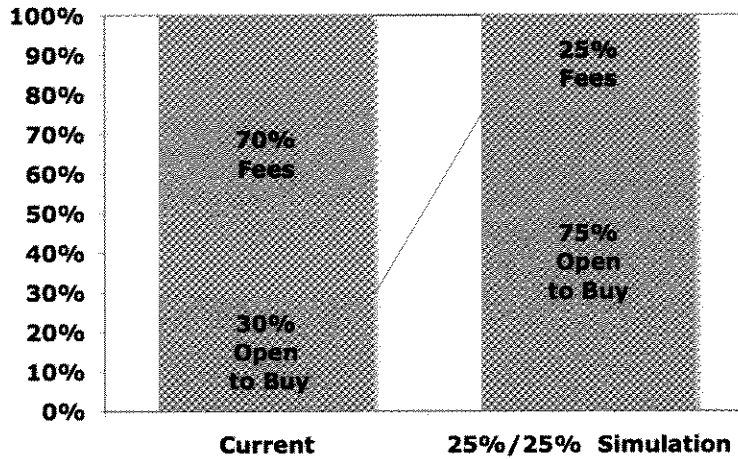


- Net income declines from a gain of \$6.60 per account to a loss of \$119.45 per account.
- Shift in net income driven by a decline in revenues and a rise in costs.
- To offset this loss with additional revenues from credit rate hikes, average interest rates would need to rise nearly sixfold, from the current rate of 16.1% to 92.7%, assuming no change in consumer behavior.

<sup>11</sup> For an example of an oft-cited study, see Jurgens, Rick and Chi Chi Wu. "Fee Harvesters: Low-Credit, High-Cost Cards Bleed Consumers." Boston: National Consumer Law Center, November 2007.

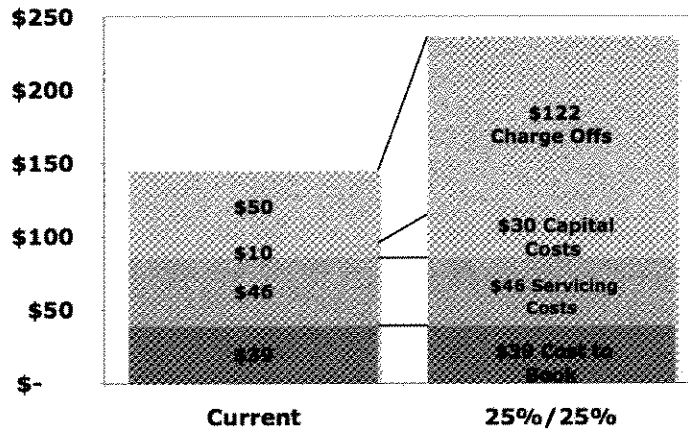
<sup>12</sup> While price historically has not been regulated in the subprime card industry, marketing practices and other business practices have been subject to official and unofficial regulations. For sample of such "unofficial" regulations, see **Appendix A**.

### Fees and Open to Buy Share of Initial Credit Line



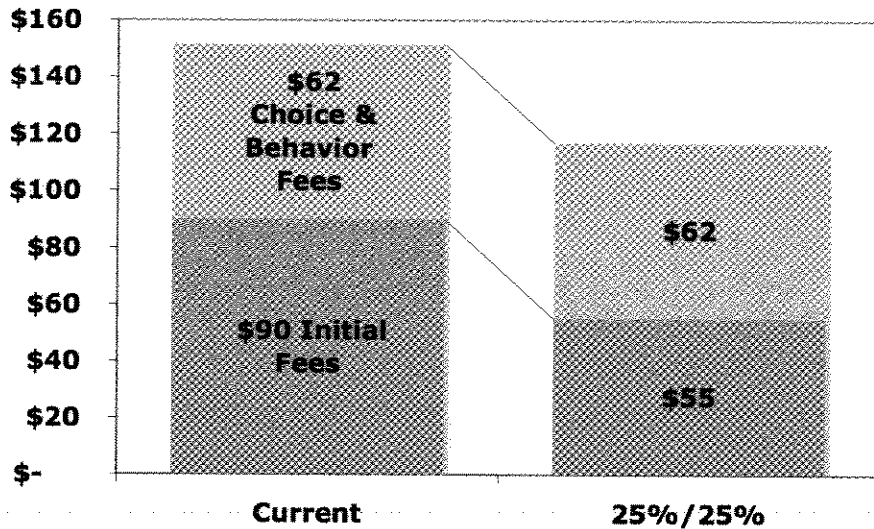
- Under the proposed regulations, the open to buy amount—the share of the credit line initially available to the consumer—would more than double. This raises capital costs and charge offs, and reduces fees.
- As a large share of defaults occur soon after the opening of new accounts, a rise in the open to buy amount will dramatically raise portfolio risk.

### Costs per Account



- Assuming no changes in account servicing or booking costs, the jump in the open to buy amount raises overall costs by increasing charge offs and capital costs.

### Fees Collected per Account



- Assuming no change in consumer behavior, the consumer specific fees (for example, late fees, over limit fees) collected per account are left unchanged.
- Fees collected fall due to fee restrictions under the proposed regulation.
- Assuming the same share of basic fees are collected following the pricing change, total fees collected falls from \$152 per account to \$117 per account.

### Returns on Loans by FICO Ranges

|                | Percent of Accounts | Current Return | 25%/25% Return |
|----------------|---------------------|----------------|----------------|
| <b>675+</b>    | 1%                  | -22%           | -103%          |
| <b>646-674</b> | 4%                  | 10%            | -76%           |
| <b>620-645</b> | 10%                 | 3%             | -64%           |
| <b>591-619</b> | 18%                 | 6%             | -65%           |
| <b>560-590</b> | 19%                 | 9%             | -68%           |
| <b>531-559</b> | 17%                 | 12%            | -61%           |
| <b>500-530</b> | 16%                 | 12%            | -59%           |
| <b>451-499</b> | 12%                 | 13%            | -65%           |
| <b>300-450</b> | 4%                  | -23%           | -99%           |
| <b>All</b>     | <b>100%</b>         | <b>7%</b>      | <b>-65%</b>    |

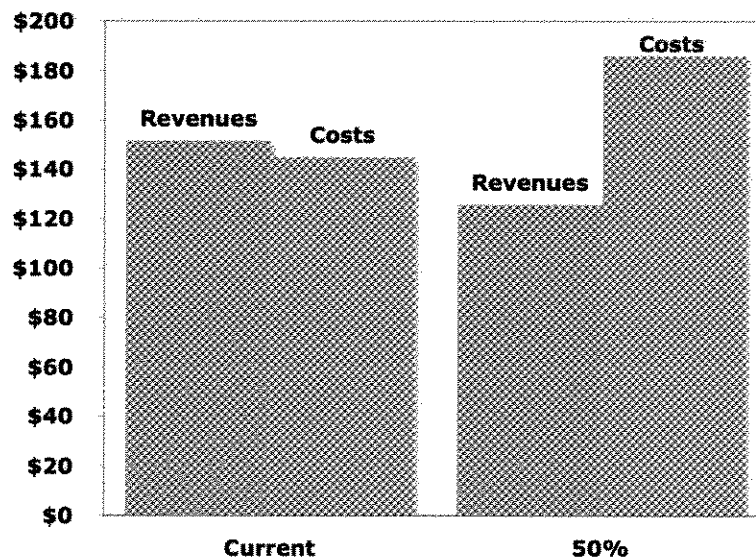
- With the pricing restrictions, all FICO ranges have negative returns.

## Simulation 2: Modified 50% Fee Cap Due “Up front”

- Fees capped at 50% of initial credit limit
- All fees up to 50% of initial credit limit charged to account in first billing cycle

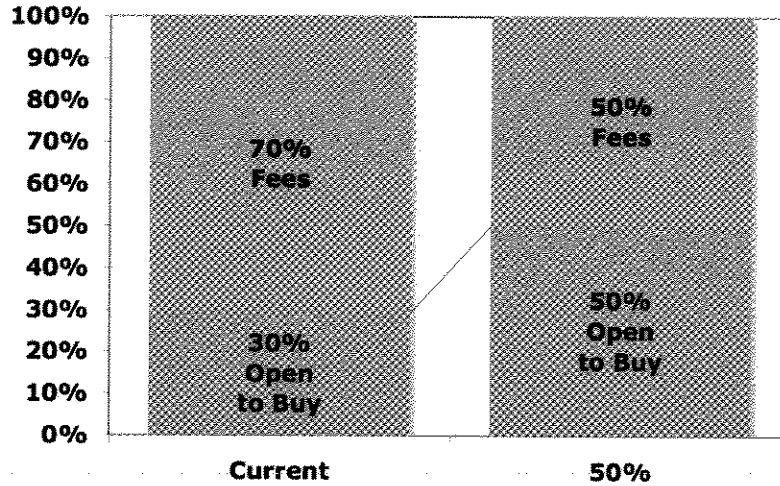
This simulation was designed to gauge the potential impacts of a fee cap that is relatively more favorable for subprime card issuers than the proposed 25%/25% analyzed in Simulation 1. In this scenario, rather than charging cardholders half of the fees owed the issuer in the first billing cycle (given a 50% fee cap, this was assumed to be the maximum permitted or 25% of the initial credit limit), with the balance spread across the subsequent 11 billing cycles, in Scenario 2 cardholders are assessed the full amount of fees in the first billing cycle or up front. Structuring the fee cap thusly has the effect of reducing the open to buy amount and should, therefore, reduce the value of charge offs.

### Costs and Revenues per Account



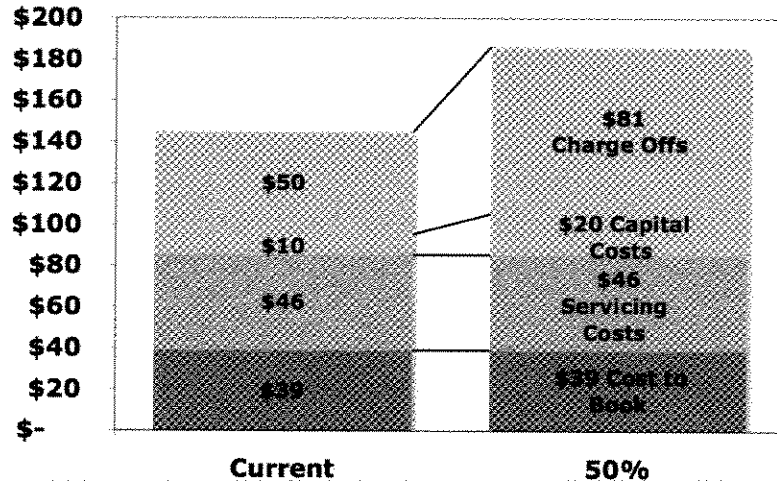
- Net income declines from a gain of \$6.60 per account to a loss of \$60.24 per account.
- Shift in net income driven by a decline in revenues and a rise in costs.
- To offset this revenue loss with a hike in the price of credit, average interest rates would have to nearly quadruple, from the current average rate of 16.1% to 60.8%, assuming no change in consumer behavior.

### Fees and Open to Buy Share of Initial Credit Line



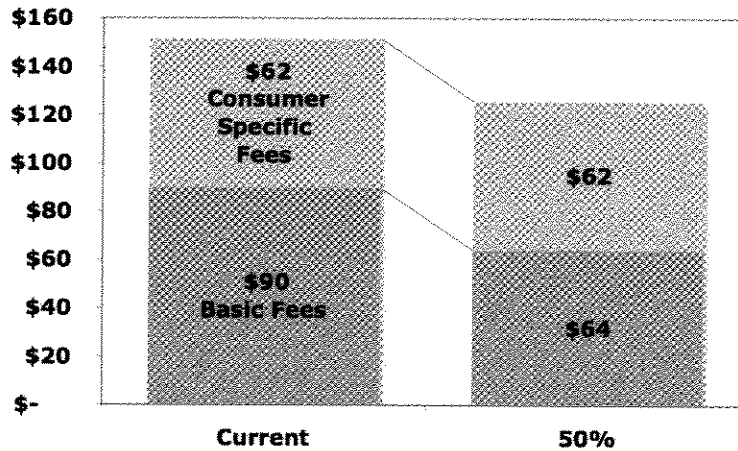
- Under the proposed regulations, the open to buy amount—that is, the share of the credit line initially available to the consumer—would increase by two-thirds. This raises capital costs and charge offs and reduces fees.
- Faced with higher losses and increased capital costs (including reserve requirements), revenues from fees concurrently decline by nearly 30%.
- As a large share of defaults occur soon after the opening of new accounts, a marked rise in the open to buy amount will dramatically raise portfolio risk.

### Costs per Account



- Assuming no changes in account servicing and booking costs, the increase in the open to buy amount raises overall costs by increasing charge offs and capital costs.

### Fees Collected per Account



- Assuming no change in consumer behavior, the consumer specific fees collected per account are left unchanged.
- Fees collected fall due to fee restrictions under the proposed regulation.
- Assuming the same share of basic fees are collected, total fees collected falls from \$152 per account to \$126 per account.



**Returns on Loans by FICO Ranges**

|                | <b>Percent of<br/>Accounts</b> | <b>Current<br/>Return</b> | <b>50%<br/>Return</b> |
|----------------|--------------------------------|---------------------------|-----------------------|
| <b>675+</b>    | 1%                             | -22%                      | -63%                  |
| <b>646-674</b> | 4%                             | 10%                       | -37%                  |
| <b>620-645</b> | 10%                            | 3%                        | -30%                  |
| <b>591-619</b> | 18%                            | 6%                        | -31%                  |
| <b>560-590</b> | 19%                            | 9%                        | -32%                  |
| <b>531-559</b> | 17%                            | 12%                       | -27%                  |
| <b>500-530</b> | 16%                            | 12%                       | -26%                  |
| <b>451-499</b> | 12%                            | 13%                       | -28%                  |
| <b>300-450</b> | 4%                             | -23%                      | -52%                  |
| <b>All</b>     | <b>100%</b>                    | <b>7%</b>                 | <b>-31%</b>           |

- With the pricing restrictions, all FICO ranges have negative returns.

## **Appendix A: Examples of Unwritten Regulatory and Operational Rules Associated with Low Limit Credit Cards (as of 9/12/2008)**

The following are examples of practices to avoid. They were provided by an employee of one of the subprime card issuers who assisted PERC with this analysis at PERC's request. These are not definitively prohibited by law or regulation, but have been defined through enforcement action or regulatory guidance.

I. Available credit at account opening less than \$50 is considered unfair.

- **First National Bank of Brookings Consent Order**
  - <http://www.occ.treas.gov/FTP/EAs/ea2002-61.pdf>

II. A Low limit credit card program with little or no available credit at account opening that represents, either expressly or by implication that any consumer who applies may be able to employ the card for uses that require available credit may be deceptive. Purchasing power or card utility claims must be controlled.

- **First National Bank of Brookings Consent Order**

III. A low limit credit card solicitation that discloses that a consumer may be approved for a credit line that would result in little or no available credit on the consumer's credit card account at account opening without clearly and conspicuously disclosing that if approved, the consumer will have little or no available credit may be deceptive.

- **First National Bank of Brookings Consent Order**
- **OCC Advisory Letter AL 2004-4**

IV. Advertising a credit card as having "No Annual Fee" or "No Annual Membership Fee" if the customer is required to pay a fee in order to open or maintain a credit card account may be deceptive.

- **First National Bank of Brookings Consent Order.**

V. An advertisement or solicitation that does not contain a reference to the limitation condition or cost disclosure in type of at least 10 point type size (other than on the outside of a direct mail envelope may be deceptive.

- **First National Bank of Brookings Consent Order**

VI. An advertisement or solicitation using the terms "Credit limit up to \$xxx" may be deceptive if the issuer is not prepared to or actually offers a substantial number of cardholders the "up to" limit if qualified.

VII. An advertisement or solicitation that promises to improve, rebuild or reestablish credit may be deceptive if the issuer cannot substantiate that the issuers credit product actually improves consumer credit scores.

- **OCC Advisory Letter AL 2004-4**

IX. Using terms such as “Fixed Rates” or “Your Rates won’t change” may be deceptive if the issuer can change interest rates under the contract or if interest rates may change due to default.

- **Capital One Settlement Agreement with Minnesota Attorney General**

X. Using terms such as “guaranteed”, “preapproved” or similar terms may be deceptive if there is a significant chance that the consumer will not be approved.

- **OCC Advisory Letter AL 2002-3**

XI. Credit card programs that allow for negative amortization and make it difficult for consumers to reduce or repay their balance may be unfair.

- **OCC Advisory Letter 2003-2**
- **FFIEC Account Management and Allowance for Loan Loss Guidance**

XII. Issuing any loans, including credit cards, without regard to the ability for the borrower to repay the loan is considered a predatory practice.

- **Treasury Department - Mortgage banking “best practices” – May 2002**
- **OCC Advisory Letter AL 2002-3**

XIII. The practices in the Federal Reserve’s proposal to Regulation AA, Unfair and Deceptive Acts or Practices are technically unwritten until approved, which include:

- <http://files.ots.treas.gov/73419.pdf>
- **The practice known as “universal” default**
- **The practice known as “double-cycle” billing**
- **Prohibit assessing fees due solely due to a credit hold**

## Appendix B: Characteristics of the Broader Credit Card Industry

| Year | Pre-Tax Profits per Card (2008 \$) | Fees Collected Per Card (2008 \$) | Charge-Offs | APR    | Annual Fee Per Card (2008 \$) | Value of Transactions < \$20 per Card (2008 \$) |
|------|------------------------------------|-----------------------------------|-------------|--------|-------------------------------|---|
| 2008 |                                    |                                   | 5.76%       | 18.36% | \$12.04                       |   |
| 2007 | \$57.01                            | \$42.15                           | 4.68%       | 19.32% | \$14.00                       |   |
| 2006 | \$57.38                            | \$36.57                           | 4.29%       | 18.85% | \$15.73                       | \$115.38  |
| 2005 | \$48.57                            | \$38.73                           | 6.28%       | 17.90% | \$18.05                       | \$77.45   |
| 2004 | \$54.78                            | \$42.99                           | 6.71%       | 16.97% | \$20.27                       | \$61.54   |
| 2003 | \$53.81                            | \$38.82                           | 7.42%       | 16.62% | \$21.10                       | \$42.79   |
| 2002 | \$54.17                            | \$38.58                           | 7.27%       | 16.24% | \$21.65                       | \$27.28   |
| 2001 | \$50.89                            | \$40.21                           | 5.36%       | 17.23% | \$22.08                       | \$20.31   |
| 2000 | \$47.64                            | \$47.87                           | 4.78%       | 18.70% | \$23.01                       | \$13.25   |
| 1999 | \$38.33                            | \$53.97                           | 5.18%       | 18.17% | \$23.67                       |   |
| 1998 | \$29.53                            | \$48.96                           | 5.57%       | 18.72% | \$23.88                       |   |
| 1997 | \$31.54                            | \$40.59                           | 5.29%       | 18.24% | \$22.94                       |   |
| 1996 | \$40.41                            | \$29.71                           | 4.70%       | 17.63% | \$22.68                       |   |
| 1995 | \$41.51                            | \$26.71                           | 4.18%       | 18.15% | \$23.31                       |   |
| 1994 | \$41.84                            | \$27.52                           | 4.24%       | 17.11% | \$24.09                       |   |
| 1993 | \$31.71                            | \$29.48                           | 4.67%       | 17.33% | \$24.94                       |   |
| 1992 | \$32.30                            | \$32.30                           |             | 18.32% | \$26.28                       |   |
| 1991 | \$34.86                            | \$34.32                           |             |        |                               |   |
| 1990 | \$37.59                            | \$36.41                           |             |        |                               |   |
| 1989 | \$40.63                            | \$38.60                           |             |        |                               |   |
| 1988 | \$40.64                            | \$39.88                           |             |        |                               |   |
| 1987 | \$38.56                            | \$41.99                           |             |        |                               |   |
| 1986 | \$36.18                            | \$41.89                           |             |        |                               |   |
| 1985 | \$23.64                            | \$43.91                           |             |        |                               |   |
| 1984 | \$23.67                            | \$46.03                           |             |        |                               |   |
| 1983 | \$16.98                            | \$47.86                           |             |        |                               |   |
| 1982 | \$8.65                             | \$48.43                           |             |        |                               |   |
| 1981 | (\$1.93)                           | \$50.18                           |             |        |                               |   |
| 1980 | (\$2.27)                           | \$58.93                           |             |        |                               |   |

All credit card data from CreditWeb.com.

All conversions to 2008 dollars using CPI data from the Bureau of Labor Statistics.

Per Card figures derived using number of cards-in-force.

APR and Annual Fees are for standard cards.

Profits and Fees Collected per Card exclude debit cards and private label credit cards.

Fees collected per card includes late payment fees, over-limit fees, annual fees, balance transfer fees, cash advance fees, other user fees

Charge-offs (%) determined by dividing the gross charge-offs (\$) by the gross outstandings (\$).

## Appendix C: The Results and Assumptions of the Simulations

**Net Income** = Basic Fees + Consumer Specific Fees – Booking Costs – Servicing Costs – Cost of Capital - Charge Offs

**Basic Fees:** “Fixed” fees assessed per account. Such fees, however, may vary by FICO band of the consumer, that is more upfront fixed fees are assessed for consumers in lower FICO bands that open an account.

**Consumer Specific Fees:** All fees that depend on the behavior of the consumer after opening the account. These include, fees collected for late payments, overdraft fees, interest income collected, cash advance fees, and the like.

**Booking Costs:** Costs for booking accounts, this includes marketing and underwriting costs.

**Servicing Costs:** This includes such costs as customer service.

**Cost of Capital:** Cost of funds extended to borrowers.

**Charge Offs:** Cost /losses from customers that default on the account and are charged off.

**Open to Buy:** Share of initial credit line available to consumers (Initial Credit Line minus initial fees charged).

### Behavior of Consumers and Costs Held Constant

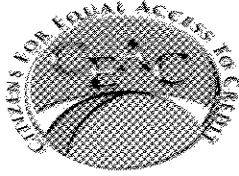
- The same share of basic fees *collected* relative to fees charged was assumed.
- No changes in Consumer Specific Fees assumed.
- Booking costs and servicing costs held constant.
- Charge Offs and Cost of capital varied in proportion to the amount Open to Buy. Consumer behavior held constant in terms of likelihood of defaulting and ultimately the amount of Charge Offs relative to the amount Open to Buy<sup>13</sup>.

The net income functions were estimated by the FICO ranges presented in the Simulation sections. Average amounts per card issuer were then calculated. Unweighted arithmetic averages were then obtained of the three issuers.

### Basic Results of the Simulations

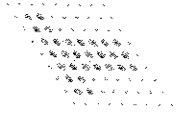
|                        | <b>Current</b>  | <b>50%</b>       | <b>25%/ 25%</b>   |
|------------------------|-----------------|------------------|-------------------|
| Basic Fees             | \$89.91         | \$64.13          | \$55.27           |
| Consumer Specific Fees | \$61.74         | \$61.74          | \$61.74           |
| <b>Total Income</b>    | <b>\$151.65</b> | <b>\$125.87</b>  | <b>\$117.01</b>   |
| Cost to Book           | \$39.18         | \$39.18          | \$39.18           |
| Servicing Costs        | \$46.18         | \$46.18          | \$46.18           |
| Cost of Capital        | \$9.99          | \$19.71          | \$29.56           |
| Charge Offs            | \$49.69         | \$81.03          | \$121.54          |
| <b>Total Costs</b>     | <b>\$145.05</b> | <b>\$186.11</b>  | <b>\$236.46</b>   |
| <b>Net Income</b>      | <b>\$6.60</b>   | <b>\$(60.24)</b> | <b>\$(119.45)</b> |

<sup>13</sup> While the amount of charge offs may not rise 100% with the amount open to buy it would likely rise very near to 100% (analysts with the card issuers suggested it may be in the 90%-100% range). Since there was not time to better estimate the exact multiplier, 100% was used by the issuers. The reader can see that this would make no qualitative difference to the results. It is the case, however, that *total losses* (revenue - costs) from charge offs are essentially a function of the open to buy amount. And, as suggested by an analyst with one of the card issuers, with a change in pricing, a greater amount of open to buy could also attract more fraud, and hence result in a greater than 100% rise in charge offs.



## Code of Fair Practices for Credit Providers

- *Clear disclosure in solicitations, applications and advertisements of the total of fees, total credit limit, and remaining available credit after fees are applied;*
- *Clear disclosure of consumer's right to pay fees upfront or post fees to the account;*
- *Separate additional disclosure of total of fees and remaining available credit with fulfillment kit accompanying the card;*
- *Clear disclosure of consumer's right to full and immediate refund if consumer changes mind after receiving card and the separate fee/credit limit disclosure;*
- *Reporting of the account payment experience to all 3 major credit reporting agencies;*
- *No reporting to credit reporting agencies if consumer changes mind and opts for a refund (or alternatively, report account as closed at consumer's request); and*
- *No finance charges on fees posted to the account, provided initial payments could be applied to repay the fees.*



TransUnion.

**TransUnion summary of results for  
CEAC Coalition  
SUPPORTING ANALYSIS**

**July, 2008**

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# Table of contents

TransUnion.

- Overview of scores, attributes, and data provided in the analysis
- Summary of results
- Consumers with positive score migration
- Attribute migration
- Attributes indicative of increased access to traditional forms of credit



## TransUnion provided scores, credit attributes, and archive data for analysis

TransUnion.

- 380,246 input consumer records from four national sub prime bankcard lenders for consumers that opened a sub prime credit card in 1/06
- All records matched to 12/05 observation and 1/08 performance archive databases
- VantageScore & 300+ off the shelf attributes, and several custom attributes appended to each record
- Matching to archive databases resulted in 365,000 records for analysis

Data analyzed: 365,000 consumers, observation December 2005 and performance January 2008. 127,000 consumers had a VantageScore increase.

## High level summary of results

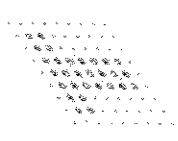
TransUnion.

### All input consumers

- 10% of all consumers opened a new bankcard in the last 12 months with a high credit/credit limit of \$1,000-\$2,499
- 9% of all consumers opened a new bankcard in the last 12 months with a high credit/credit limit of \$2,500+
- 16% of all consumers opened a new bankcard in the last 12 months with a high credit/credit limit of \$1,000+
- 50% of all consumers received a promotional offer of credit from a non-subprime lender in the last 12 months
- 11,258 consumers unscorable in December 2005 received a valid VantageScore as of January 2008

### Input Consumers with a VantageScore increase

- 37% of input consumers experienced an increase in their VantageScore
- 17% of input consumers experienced an increase in their VantageScore of 40 points or greater
- **Of those with score increases:**
  - 19.9% of consumers with a sub-prime VantageScore in December 2005, increased their score to either near-prime, prime, or super-prime in January 2008
  - 14% of consumers opened a new bankcard in the last 12 months with a high credit/credit limit of \$1,000-\$2,499
  - 14% of consumers opened a new bankcard in the last 12 months with a high credit/credit limit of \$2,500+
  - 24% of consumers opened a new bankcard in the last 12 months with a high credit/credit limit of \$1,000+
  - 58% of consumers received a promotional offer of credit from a non-subprime lender in the last 12 months

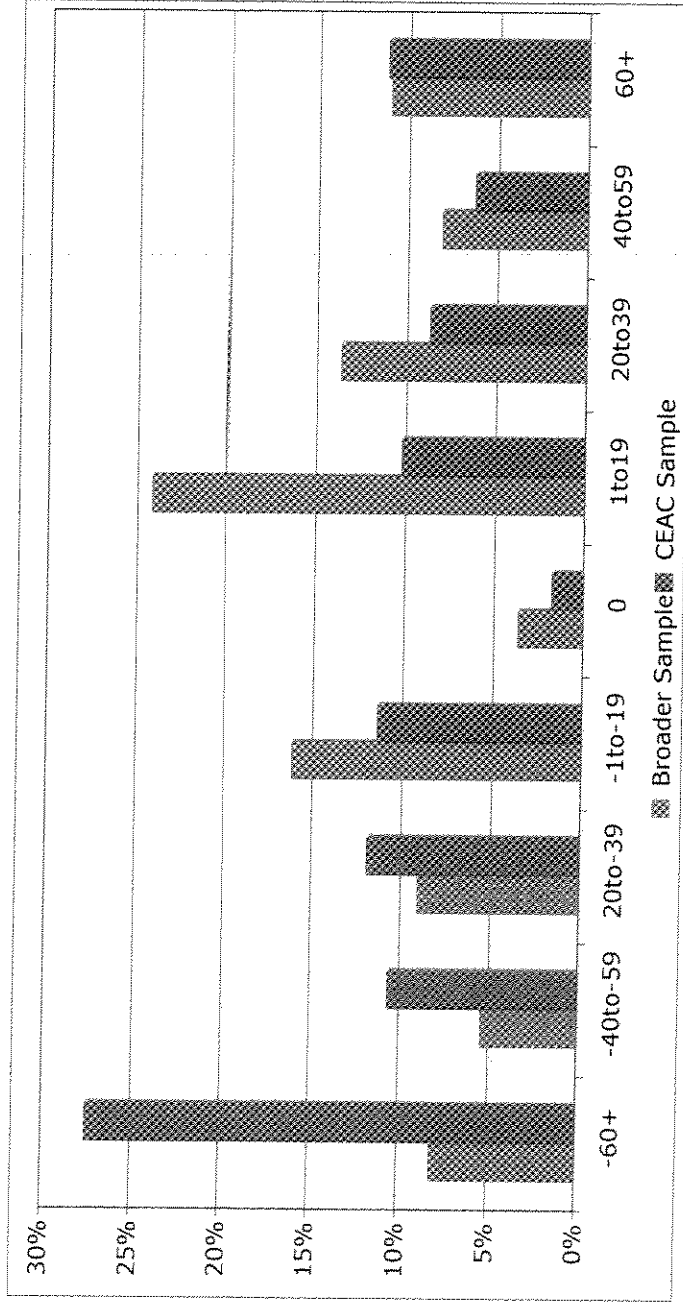


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**Positive score migration leads to  
increased access to credit**

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## Migration of scores over time



Vantage Score migration from December 2005 to January 2008 for Broader Sample  
 Vantage Score migration from March 2005 to March 2006 from a CEAC Sample

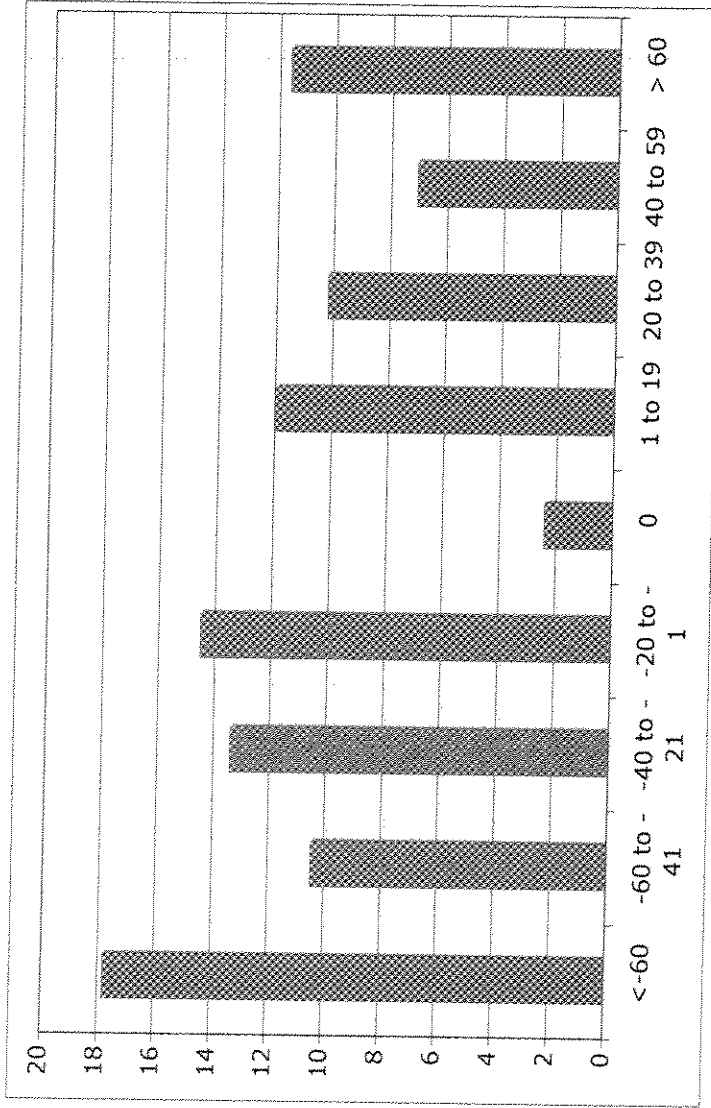
- 36.6% of input consumers had score increase. 17.2% had increase of 40 or more points.
- Average input consumers exhibit less score stability, lower scores, and more downward score movement than average consumers from broader industry sample.
- 52% of input consumers had one or more 90+ day delinquencies in January 2008

TransUnion.

VantageScore predicts the likelihood of a consumer becoming 90+ days delinquent over the next 24 months.

# Migration of scores over time for those with no credit usage in December 2005

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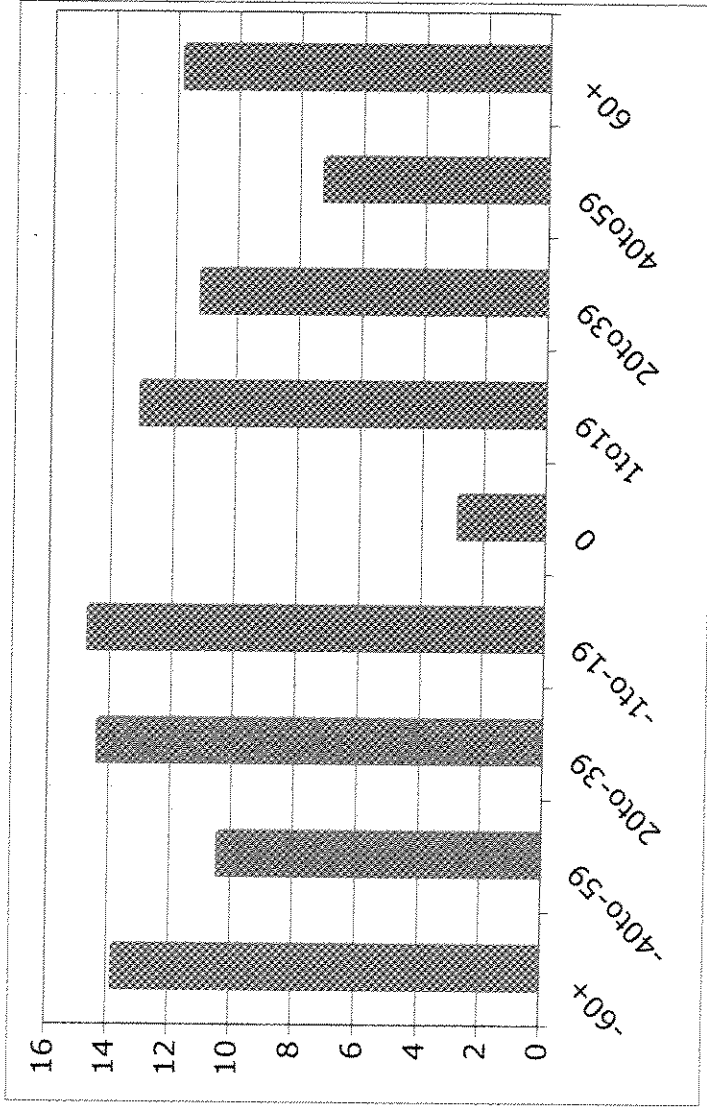
- 41% of consumers had an increase in their VantageScore.
- 19% had an increase of 40 or more points.

Vantage Score migration from December 2005 to January 2008

59,308 of the input consumers had no credit balance in December 2005 and were scoreable in both periods. 59% of these consumers had a positive credit balance by January 2008.

**Migration of scores over time for those with  
no open trades in December 2005**

TransUnion.

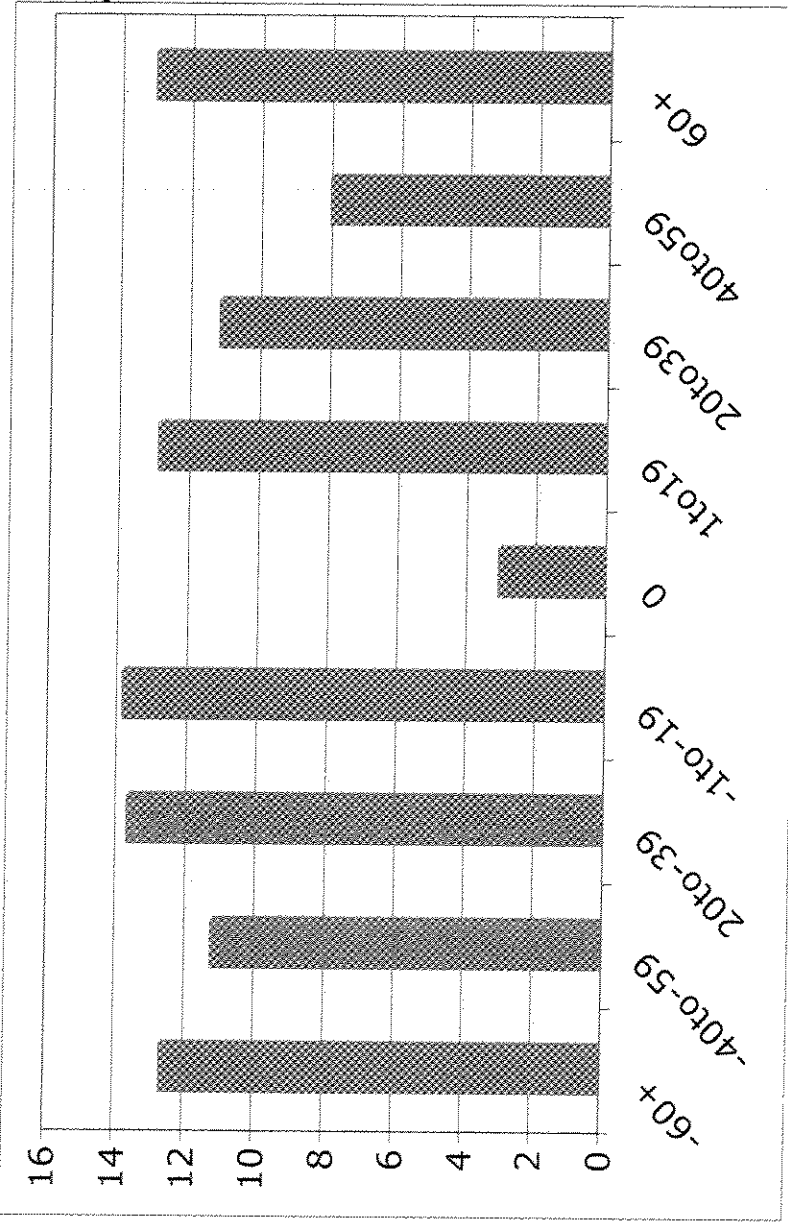


• 44% of consumers had an increase in their Vantage Score.  
 • 19% had an increase of 40 or more points.

**Vantage Score migration from December 2005 to January 2008**

36,103 of the input consumers had no open trades in December 2005.

**Migration of scores over time for those with scores below 600 (the median for input consumers) in December 2005**



TransUnion.

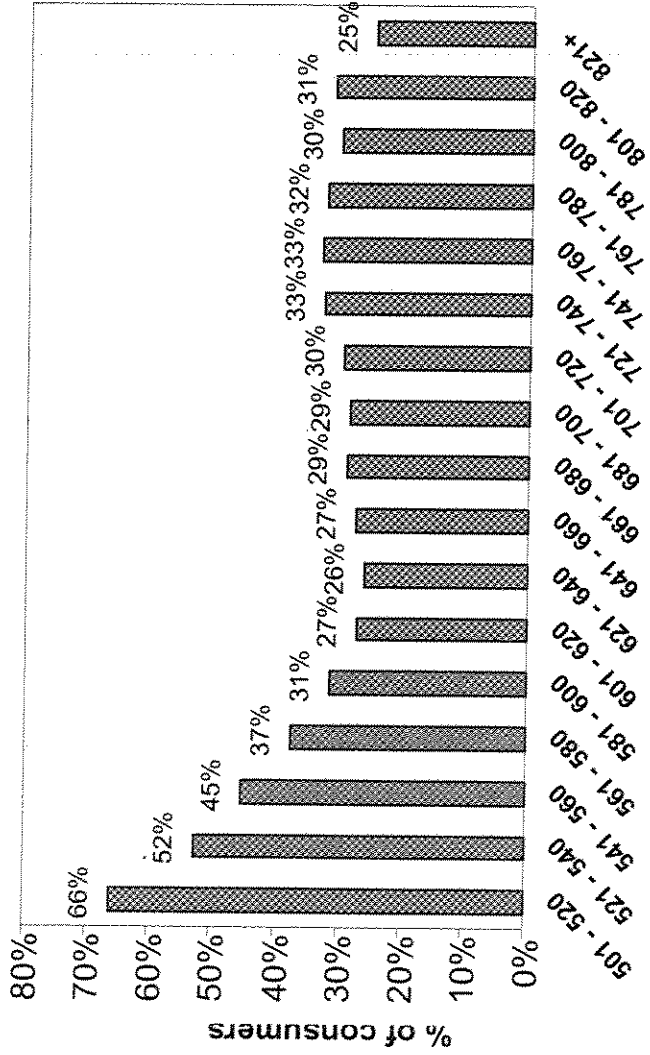
•45% of consumers had an increase in their VantageScore.  
 •21% had an increase of 40 or more points.

Vantage Score migration from December 2005 to January 2008

168,957 consumers had a VantageScore below 600 in December 2005.

# Positive score migration is occurring across the entire spectrum

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- 66% of consumers in score band 501-520 had positive score migration.
- Each score band saw positive migration of at least 25%

VantageScore increase from December 2005 to January 2008

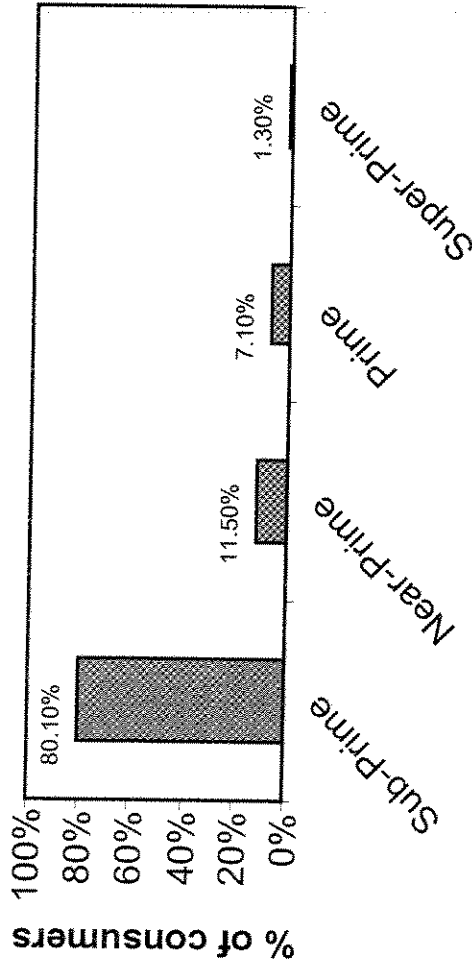
Significant migration in the lower score bands but notable migration is also occurring in the higher score bands

127,000 input consumers had a VantageScore increase from December 2005 to January 2008



For those with score increases, positive migration of scores from sub-prime risk to near-prime, prime, and super-prime leads to increased access to credit

TransUnion.



• 19.9% of consumers with a score rise and a sub-prime score as of December 2005 increased their score to a non sub-prime risk score as of January 2008.

Vantage Score migration from December 2005 to January 2008

22,171 input consumers had a sub-prime VantageScore in December 2005 and either a near-prime, prime, or super-prime VantageScore in January 2008

For those with score increases, positive migration of scores from near-prime risk to prime and super-prime leads to increased access to credit TransUnion.

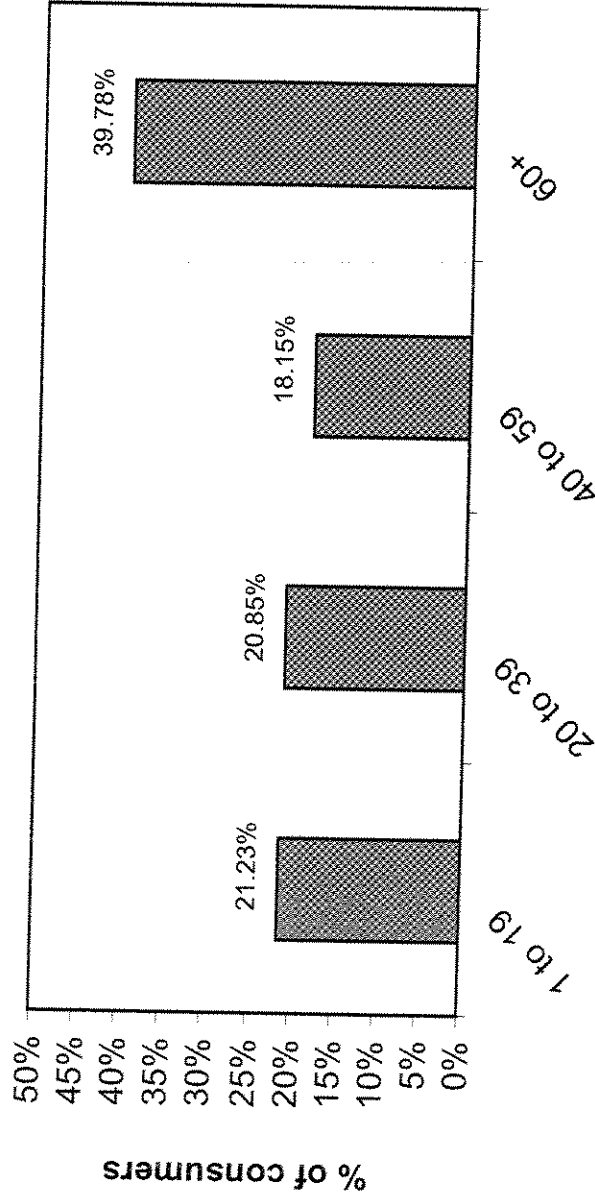


73.4% of consumers with a score rise and a near-prime score as of December 2005 increased their score to prime or super-prime as of January 2008

Vantage Score migration from December 2005 to January 2008

6,344 input consumers had a near-prime VantageScore in December 2005 and either a prime or super-prime VantageScore in January 2008

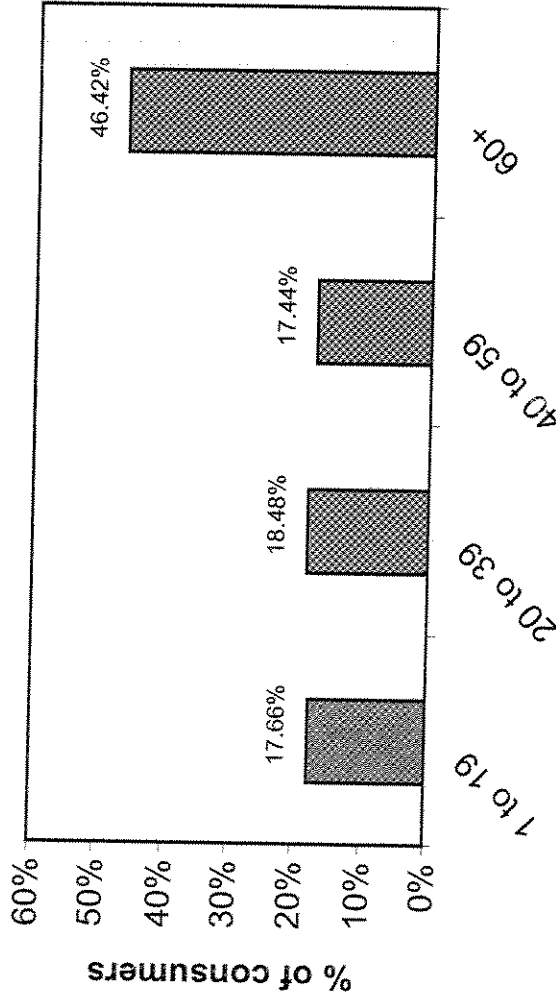
# Positive migration of scores over time leads to increased access to credit



**Vantage Score migration from December 2005 to January 2008**  
-For those (1) with score increases, (2) who received non-sub-prime inquiries, and (3) opened a new bankcard with a credit limit of \$1,000-\$2,499

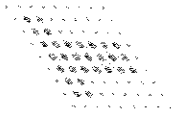
16,447 or 4.5% of all input consumers had a VantageScore increase and received promotional inquiries for credit, and opened at least one new bankcard with a credit limit of \$1,000-\$2,499.

# Positive migration of scores over time leads to increased access to credit



**Vantage Score migration from December 2005 to January 2008**  
- For those (1) with score increases, (2) who received non-sub-prime inquiries, and (3) opened a new bankcard with a credit limit of \$2,500+

16,982 or 4.6% of all input consumers had a VantageScore increase and received promotional inquiries for credit, and opened at least one new bankcard with a credit limit of \$2,500+

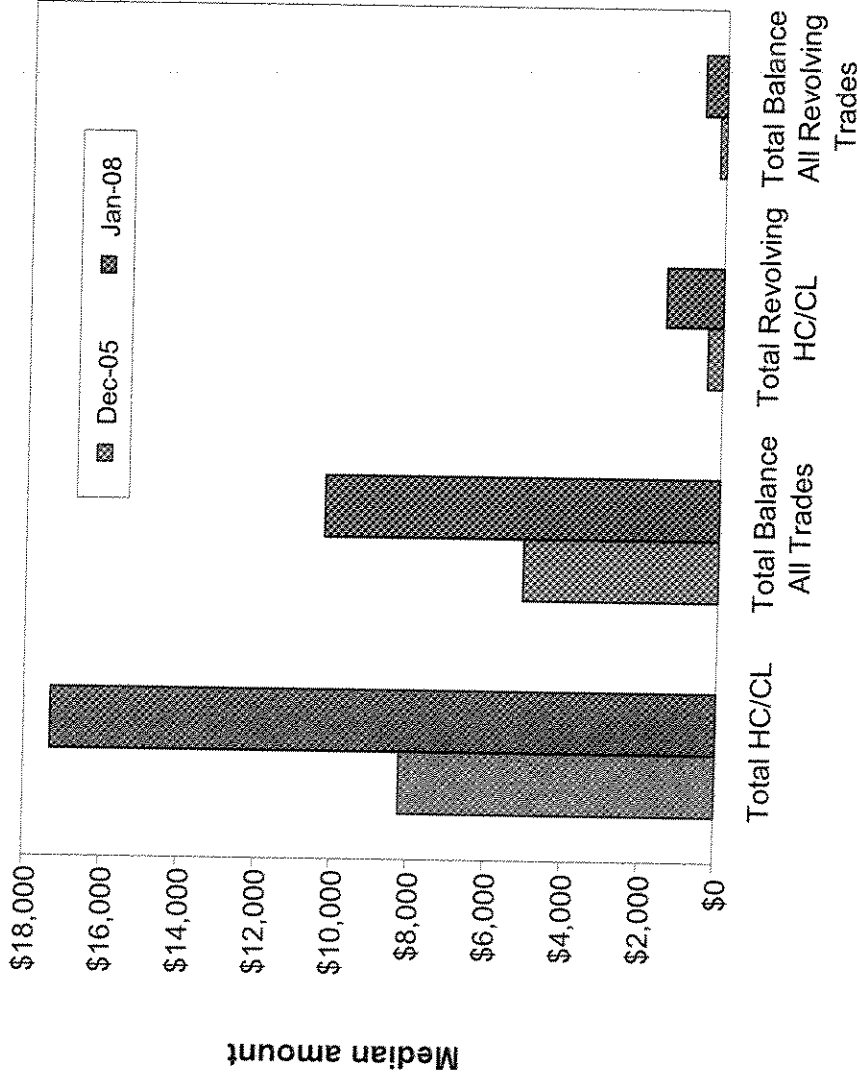


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**Increases in attribute values can be  
indicative of improvement in credit  
behavior**

# For those with score increases, important credit attribute values are increasing

TransUnion.

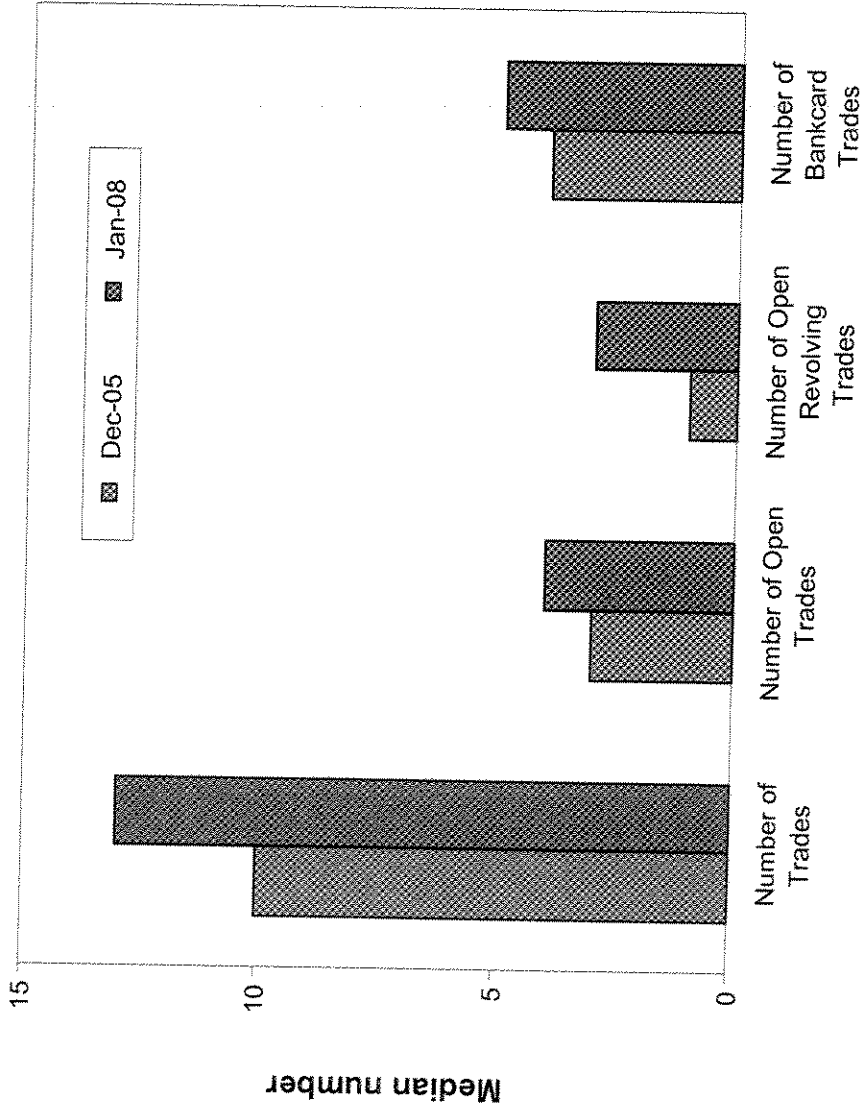


- Similar results observed for other credit products
- Results based on consumers with a VantageScore increase from December 2005 to January 2008

Significant increase in median values of high credit/credit limit and balance attributes over a two year period

127,000 input consumers had a VantageScore increase from December 2005 to January 2008

**For those with score increases, important credit attribute values are increasing**



TransUnion.

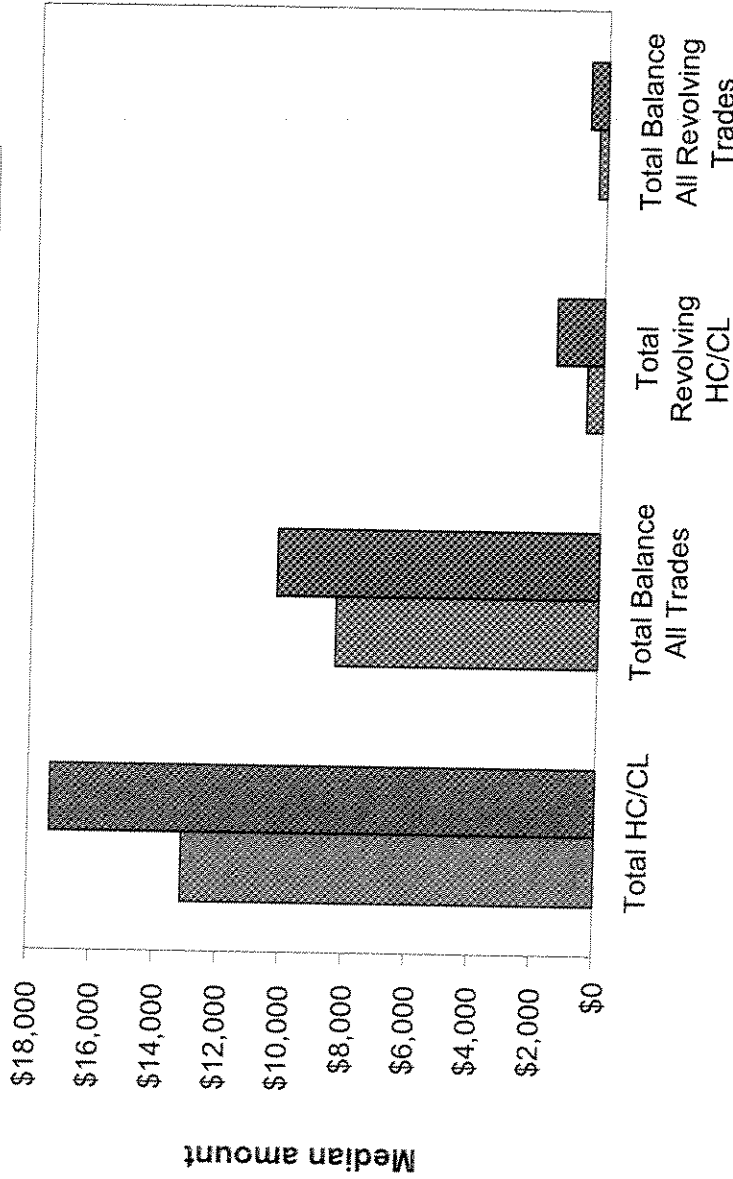
- Similar results observed for other credit products
- Results based on consumers with a VantageScore increase from December 2005 to January 2008

**Significant increase in median values of number of trade lines attributes over a two year period**

127,000 input consumers had a VantageScore increase from December 2005 to January 2008

# Increasing credit scores can lead to more access to credit and higher credit activity

TransUnion.



- Similar results observed for other credit products
- Comparison of results for consumers with a VantageScore increase to all input consumers from January 2008 data

## Key attribute segments

Consumers who improved their VantageScore had higher high credit/credit limits and higher balances than the overall population

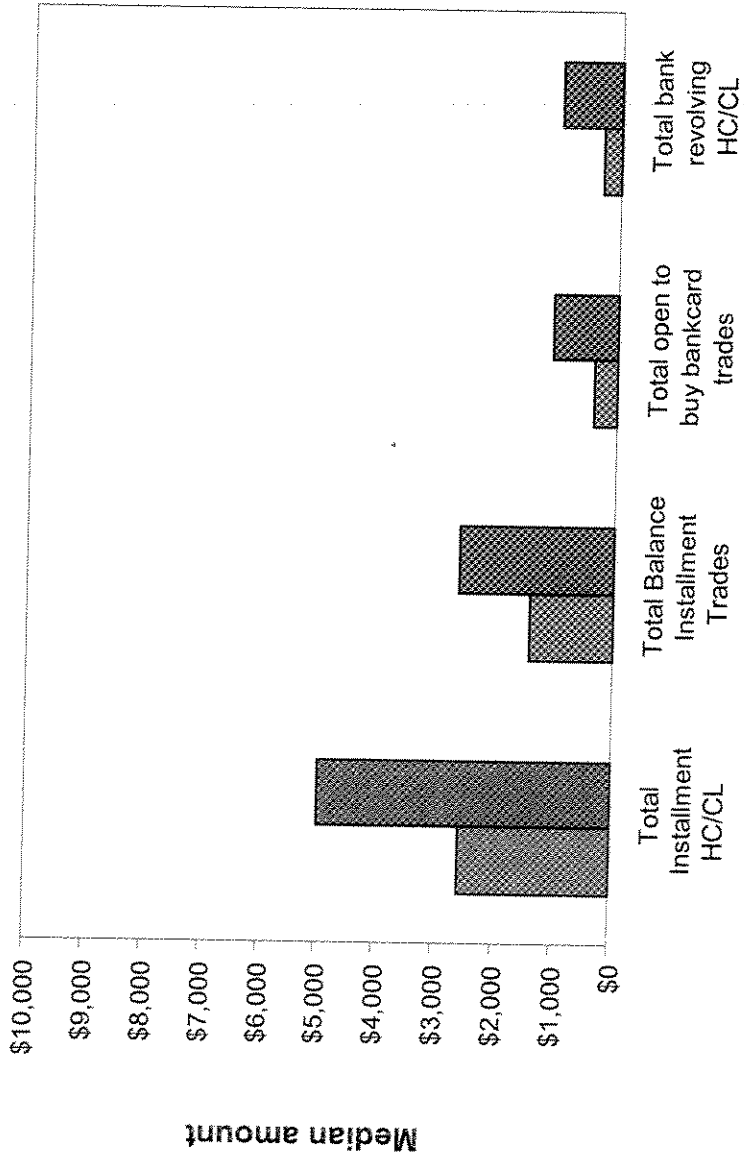
Data analyzed: 365,000 input consumers, observation December 2005 and performance January 2008. 127,000 consumers had a VantageScore increase.



# Increasing credit scores can lead to more access to credit and higher credit activity

TransUnion.

All input consumers
  Consumers with a score rise



- Similar results observed for other credit products
- Comparison of results for consumers with a VantageScore increase to all input consumers from January 2008 data

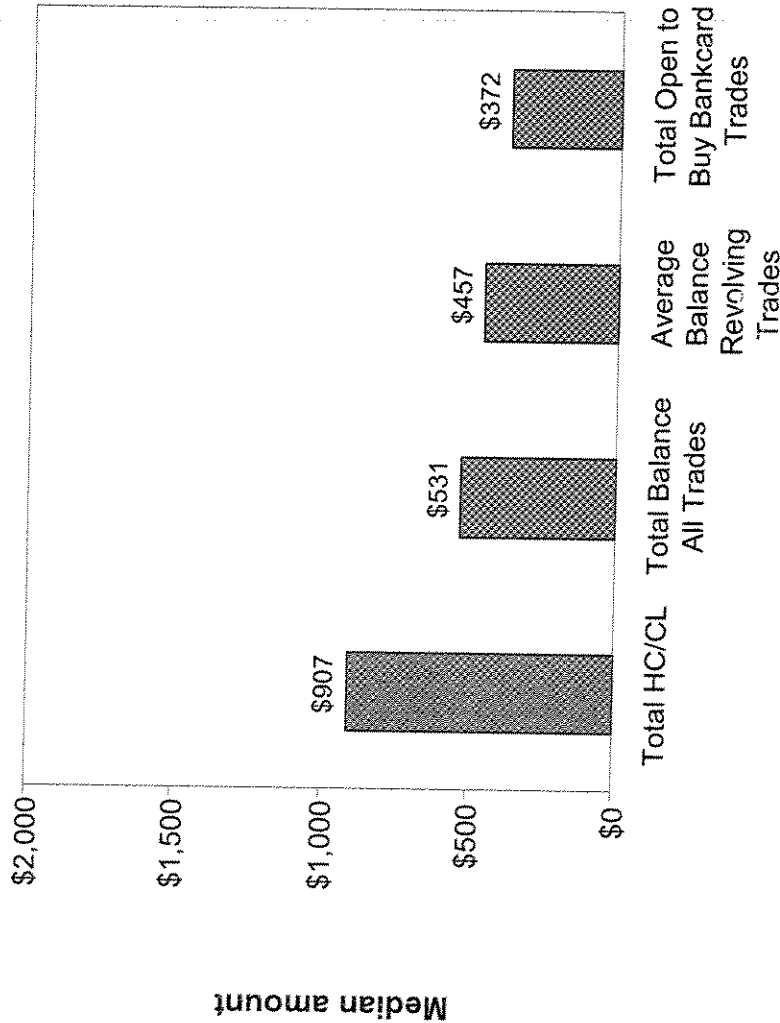
## Key attribute segments

Consumers who improved their VantageScore had higher high credit/credit limits and higher balances than the overall population

Data analyzed: 365,000 input consumers, observation December 2005 and performance January 2008. 127,000 consumers had a VantageScore increase.

# Consumers booked without a valid score in December 2005 due to insufficient credit, are scoreable two years later

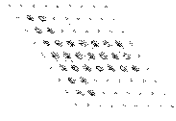
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- Results for consumers unscorable in December 2005 based on their credit profile in January 2008. VantageScore scored 88% of this previously unscored population as of January 2008.

Access to credit and balance build occurring for this population. Median VantageScore in January 2008 is 547, which is considered sub-prime risk

12,769 input consumers unscorable in December 2005. VantageScore scored 11,258 or 88% in January 2008



TransUnion.

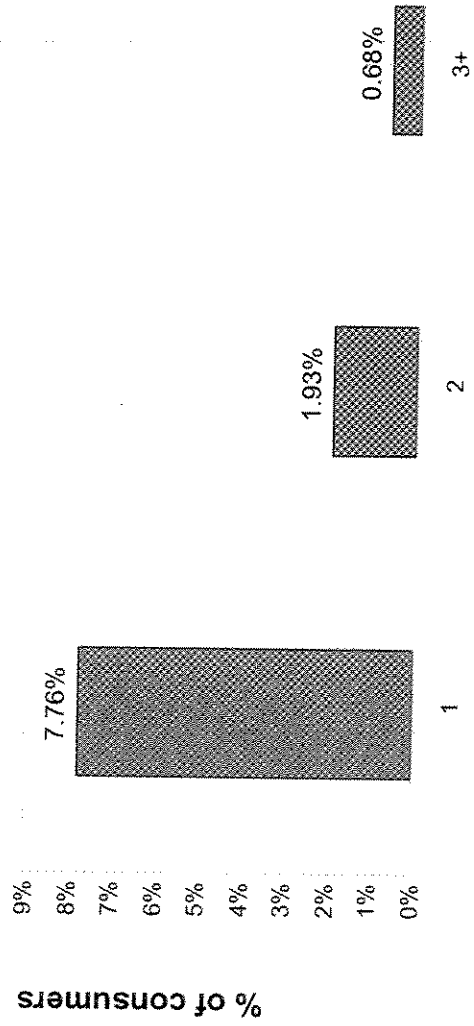
**New account openings and promotional  
offers of credit are indicative of access  
to traditional forms of credit**

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# Attributes provided indicate consumers access to traditional forms of credit has increased

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All input consumers



- Number of new bankcard trades is indicative of consumers access to traditional forms of credit at possibly more favorable terms

- 7.8% of consumers opened 1 new bankcard and 2.6% opened 2 or more new bankcards with a credit limit of \$1,000-\$2,499

Number of non-subprime bankcards opened w/in last 12 months with a credit limit of \$1,000-\$2,499

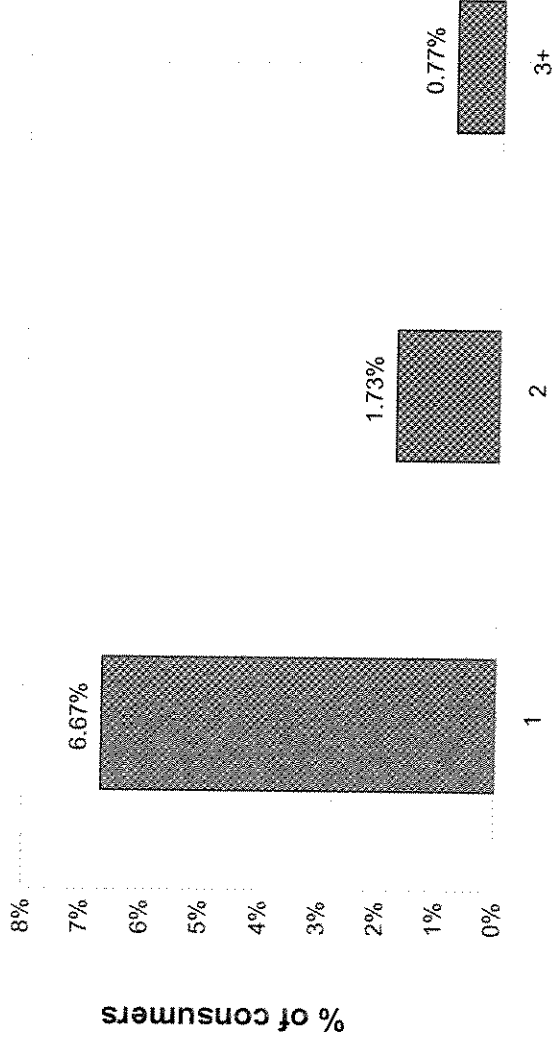
10.4% of consumers opened at least 1 new non-subprime bankcard in the last 12 months (prior to January 2008) with a credit limit of \$1,000-\$2,499

Data analyzed: 365,000 input consumers, observation December 2005 and performance January 2008

# Attributes provided indicate consumers access to traditional forms of credit has increased

TransUnion.

All input consumers



- Number of new bankcard trades is indicative of consumers access to traditional forms of credit at possibly more favorable terms

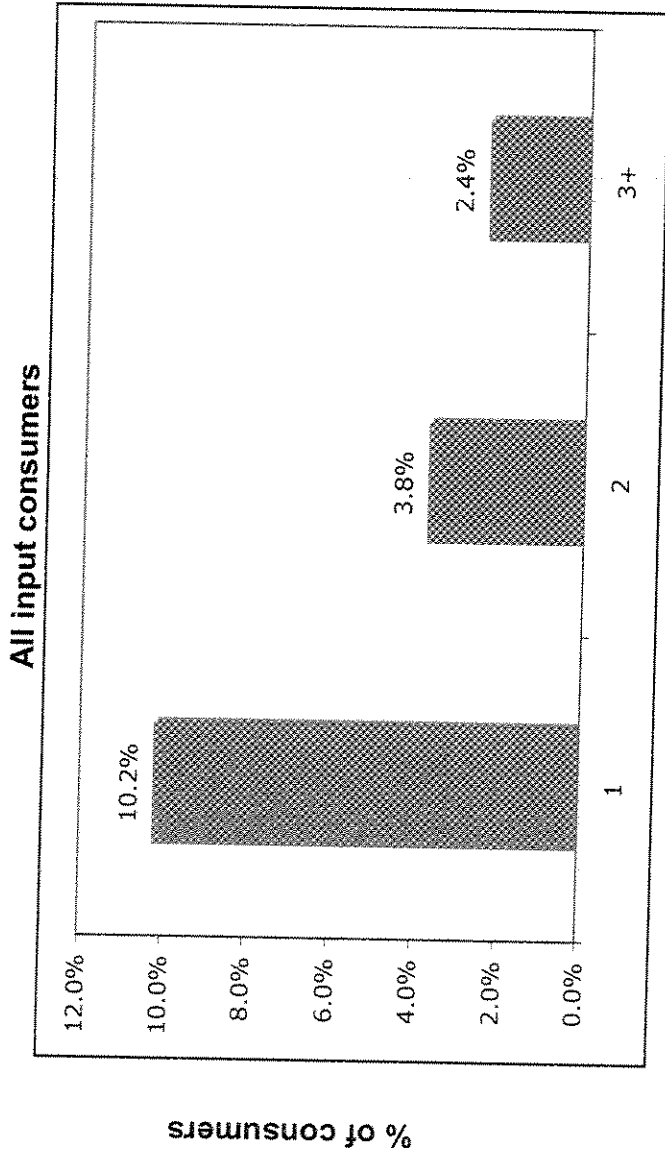
- 6.7% of consumers opened 1 new bankcard and 2.5% opened 2 or more new bankcards with a credit limit of \$2,500+

Number of non-subprime bankcards opened w/in last 12 months with a credit limit of \$2,500+

9.2% of consumers opened at least 1 new non-subprime bankcard in the last 12 months (prior to January 2008) with a credit limit of \$2,500+

**Attributes provided indicate consumers access to traditional forms of credit has increased**

TransUnion



**Number of non-subprime bankcards opened w/in last 12 months with a credit limit of \$1,000+**

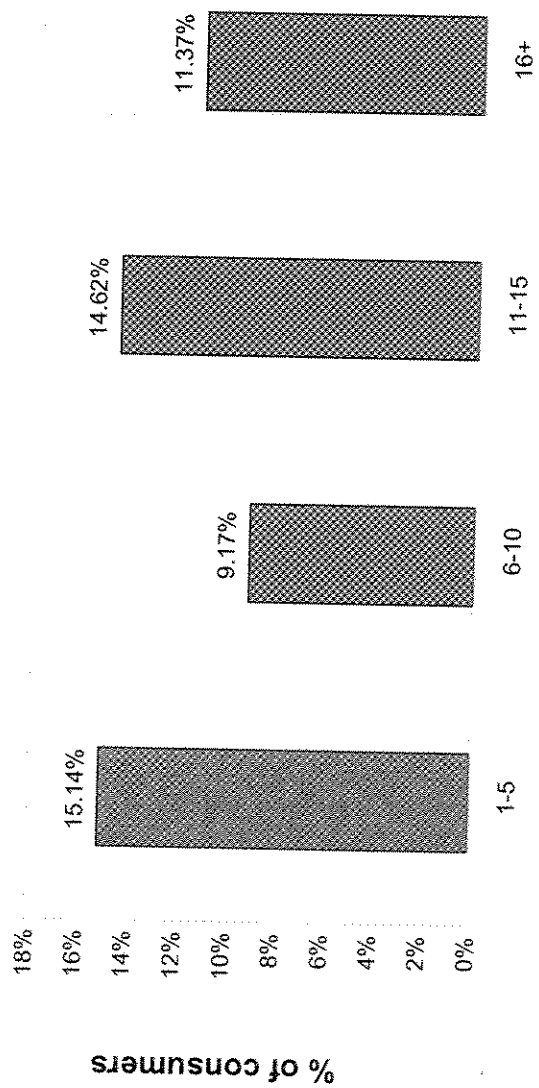
**16.4% of consumers opened at least 1 new non-subprime bankcard in the last 12 months (prior to January 2008) with a credit limit of \$1,000+**

Data analyzed: 365,000 input consumers, observation December 2005 and performance January 2008

# Attributes provided indicate consumers access to traditional forms of credit has increased

TransUnion

All input consumers



- Number of non-subprime promotional inquiries is indicative of consumers access to traditional forms of credit at possibly more favorable terms
- 24% of consumers received 1-10 promotional inquiries and 26% received 11 or more promotional inquiries for credit from non-subprime credit issuers in the last 12 months

Number of non-subprime promotional inquiries w/in last 12 months

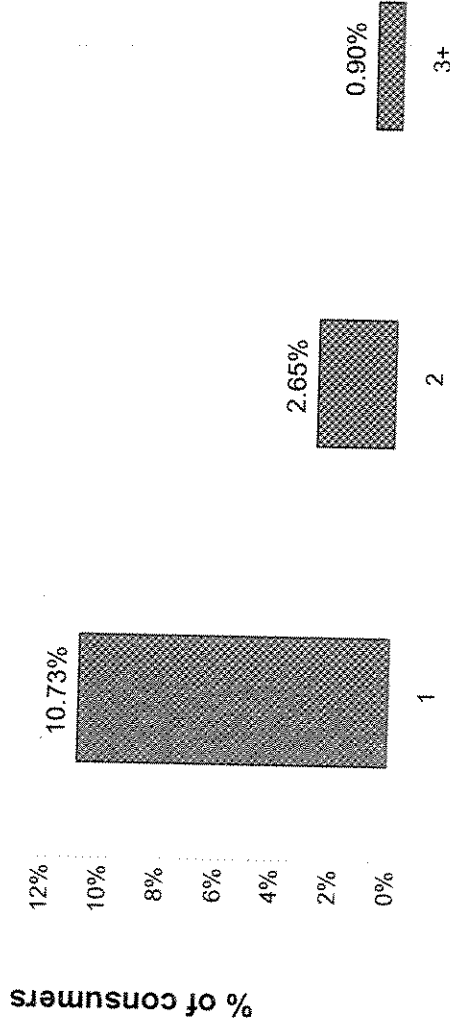
50.3% of consumers received at least 1 non-subprime promotional offer of credit in the last 12 months (prior to January 2008)

Data analyzed: 365,000 input consumers, observation December 2005 and performance January 2008

# Attributes provided indicate consumers access to traditional forms of credit has increased

TransUnion

Input consumers with a VantageScore increase



- Number of new bankcard trades is indicative of consumers access to traditional forms of credit at possibly more favorable terms

- 10.7% of consumers opened 1 new bankcard and 3.6% opened 2 or more new bankcards with a credit limit of \$1,000-\$2,499

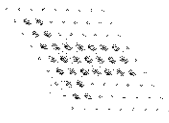
Number of non-subprime bankcards opened w/in last 12 months with a credit limit of \$1,000-\$2,499

14.3% of consumers with a VantageScore increase opened at least 1 new non-subprime bankcard in the last 12 months (prior to January 2008) with a credit limit of \$1,000-\$2,499

127,000 input consumers had a VantageScore increase from December 2005 to January 2008

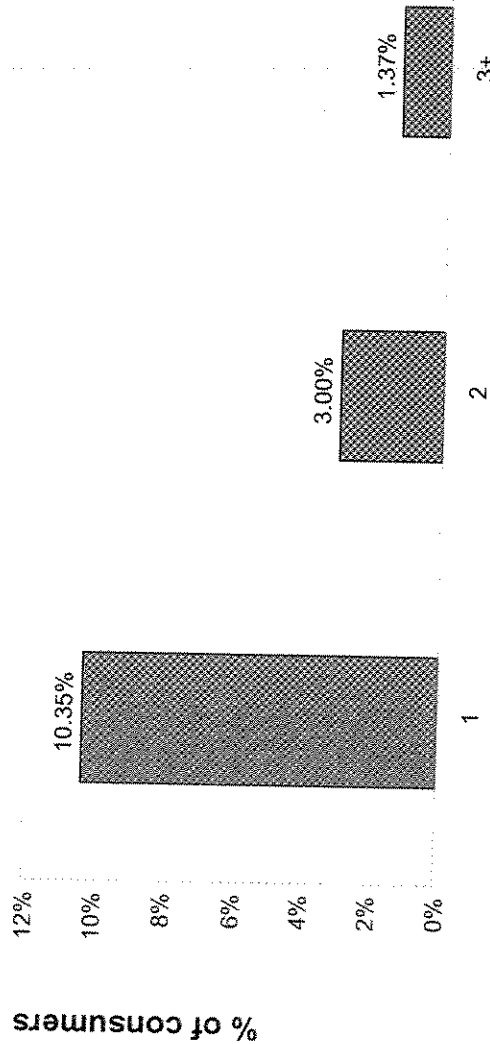


# Attributes provided indicate consumers access to traditional forms of credit has increased



TransUnion.

Input consumers with a VantageScore increase



Number of bankcards opened w/in last 12 months with a credit limit of \$2,500+

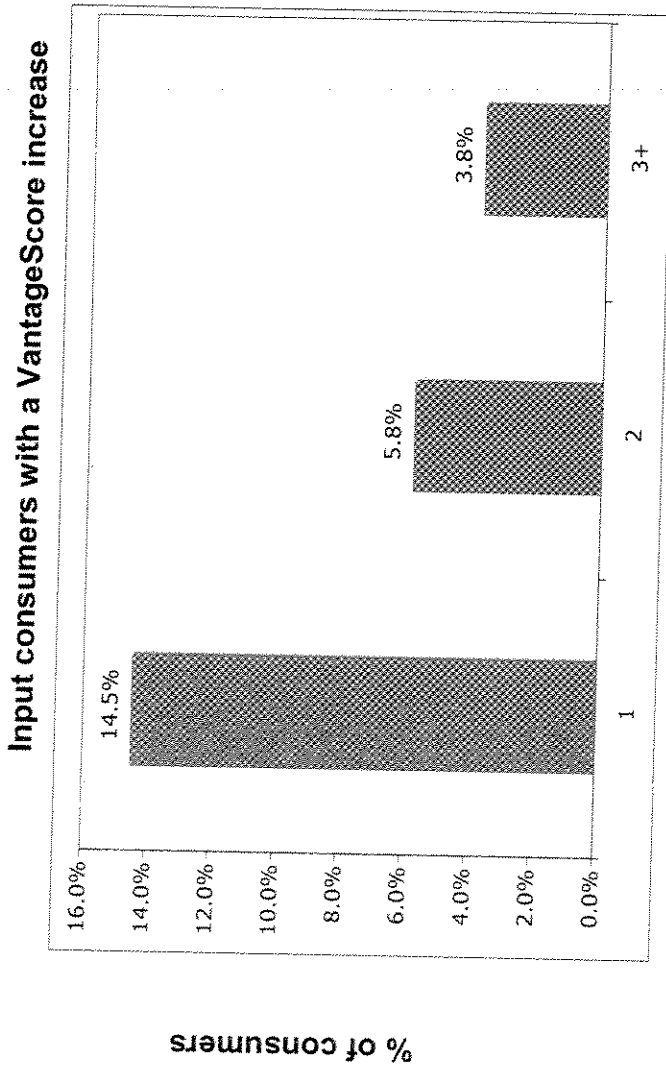
- Number of new bankcard trades is indicative of consumers access to traditional forms of credit at possibly more favorable terms
- 10.3% of consumers opened 1 new bankcard and 4.4% opened 2 or more new bankcards with a credit limit of \$2,500+

14.7% of consumers with a VantageScore increase opened at least 1 new non-subprime bankcard in the last 12 months (prior to January 2008) with a credit limit of \$2,500+

127,000 input consumers had a VantageScore increases from December 2005 to January 2008

Attributes provided indicate consumers access to traditional forms of credit has increased

TransUnion.



**Number of non-subprime bankcards opened w/in last 12 months with a credit limit of \$1,000+**

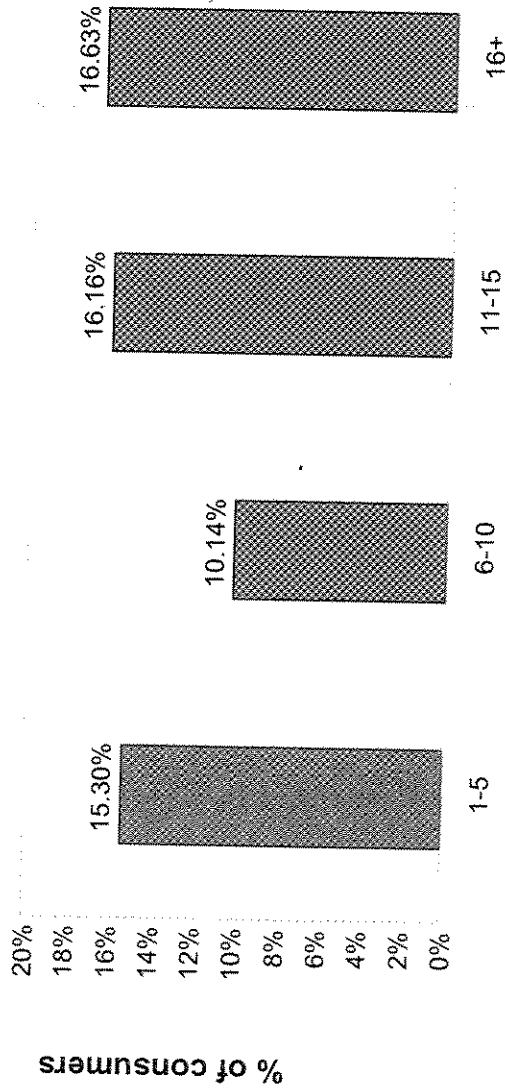
**24.2% of consumers with a VantageScore increase opened at least 1 new non-subprime bankcard in the last 12 months (prior to January 2008) with a credit limit of \$1,000+**

127,000 input consumers had a VantageScore increases from December 2005 to January 2008

# Attributes provided indicate consumers access to traditional forms of credit has increased

TransUnion.

Input consumers with a VantageScore increase



- Number of non-subprime promotional inquiries is indicative of consumers access to traditional forms of credit at possibly more favorable terms
- 25% of consumers received 1-10 promotional inquiries and 33% received 11 or more promotional inquiries for credit from non-subprime credit issuers in the last 12 months

Number of non-subprime promotional inquiries w/in last 12 months

58.2% of consumers with a VantageScore increase received at least 1 non-subprime promotional offer of credit in the last 12 months (prior to January 2008)

127,000 input consumers had a VantageScore increase from December 2005 to January 2008

# The Providence Journal

## Karen Kerrigan: Beware proposed rules on credit cards

01:00 AM EDT on Saturday, September 20, 2008

KAREN KERRIGAN

WASHINGTON

When making public policy, particularly in areas that could broadly affect our economy and people's financial future, it is important to remember the old adage: "first do no harm." This could be especially true of the Federal Reserve Board's new set of proposed rules regarding low-limit credit cards.

The Fed's proposal contains a number of new regulations to protect consumers, including holding card issuers to higher standard in disclosing terms to customers. The new rules, if approved, would also dictate how some credit card companies price their products and could cause many of them to leave the marketplace altogether.

In today's world, credit cards are vital tools that are responsible for generating and driving a wide range of commercial activity. One can scarcely rent a car, book a flight or book a hotel room without one. The mortgage crises and tightening credit conditions have made it increasingly difficult for many consumers to gain access to credit — especially those with credit history problems. It has been estimated that over 70 million individuals in America — that's one-in-three people — do not qualify for a "prime" credit card. This puts them in the low limit, or "subprime" category.

Of course, the credit crisis, compounded by our credit crunch is having a profound effect on our economy. The current situation makes it even more important that federal regulators strike a balance between protecting consumers while also protecting fair access to credit.

Low-limit credit-card providers charge fees to their customers because they are in a higher-risk category. Pricing a product to risk is a well-established principle of our market economy that can be found in a range of commercial transactions. Just as auto-insurance companies charge higher premiums for customers with fender benders on the driving record, low-limit credit-card providers charge more for those with dents in their credit history.

Ironically, the federal government is one of the main reasons why low limit is more expensive to obtain. Unlike prime issuers, low-limit card issuers are legally required to hold a significant portion of their funds in reserve, sometimes up to 56 percent. Should regulators prevent companies from pricing their products to risk, many if not all of these companies will no longer be able to meet these requirements and cover their costs.

Such an outcome would mean that low limit credit disappears; while millions of otherwise qualified applicants would be forced to turn to pay lenders, pawn shops or perhaps more risky and troubling options when confronting a financial crisis.

The millions of families, individuals and small business owners who would otherwise qualify for low limit credit deserve a second chance to get back on their feet. It has been estimated that low limit cards are responsible for generating over \$2 billion in commercial activity a year in our economy. If low-limit cards were regulated out of the economy these important dollars and commercial activity would disappear — causing further injury to our already ailing economy.

The Fed should be commended for its move to hold credit-card companies to high standards in disclosing obligations to consumers. Likewise, issuers should be required to use, consistent stringent standards when selecting applicants to receive a card. The Fed should also look at common-sense ways to make credit safer and more accessible to consumers without dictating the pricing and structure of how fees apply.

Naturally, it is vital that we do not allow abuses in the marketplace. As federal regulators move forward, they should seek changes to protect consumers while avoiding price control policies and restrictions that will do more harm than good.

*Karen Kerrigan is president of the Small Business and Entrepreneurship Council.*

[http://www.hispanicbusiness.com/news/2008/9/19/leading\\_minority\\_organizations\\_lobby\\_for\\_fair.htm](http://www.hispanicbusiness.com/news/2008/9/19/leading_minority_organizations_lobby_for_fair.htm)

## HispanicBusiness.com

Leading Minority Organizations Lobby for Fair Credit Practices

Sept. 19, 2008

Richard Kaplan--Associate Editor, HispanicBusiness.com

The nonprofit advocacy coalition Citizens for Equal Access to Credit (CEAC) joined today with leading minority organizations, business groups and leading elected officials to announce a push for reform of the credit card industry.

The advocacy group issued a "Statement of Principles" calling for companies to make credit cards less risky and more accessible to consumers, in particular, poor and minority communities. The group targeted low limit credit cards as especially in need of reform.

CEAC's statement of principles called on the Federal Reserve Board and Congress to recognize that "low limit cards represent a bridge to the economic mainstream for persons from underserved and unbanked communities."

Low limit cards impose a relatively low level for maximum total credit charges, for example, \$500. Such credit cards are often used by young adults and the poor to establish credit records or to move toward greater financial stability.

Among the reforms desired were federal laws requiring credit providers to meet high standards in disclosing rates, fees and penalties to consumers, and also offering customers flexibility in making payments. In addition, CEAC urged companies to supply information to consumers in Spanish as well as English, and to give the consumer have the right to return the card and gain an immediate refund upon receiving the card and rate information.

The proposal for reform of the credit card industry emerged out of a virtual summit hosted on August 28, 2008. Those participating or consulted represented a broad range of minority advocacy groups and leaders, and economic interest groups, including the League of United Latin American Citizens, the Inter American Entrepreneurs Association, the Dominico-American Society, and the Small Business Entrepreneurship Council.

Victor Capellan, president of the Dominican American National Roundtable, endorsed the statement of principles, saying, "We believe the common sense proposal that we have put forth today will protect consumers while also protecting consumer access to credit. ... It is essential that policy makers in Washington protect consumers while also protecting continued access to credit in underserved communities."

Juan Andrade, Jr., president of the United States Hispanic Leadership Institute, supported the participation of minority groups in discussions of needed credit card industry reforms: "Bringing leading minority organizations, and low limit credit card customers together with providers of credit to develop a consensus proposal is a great way to provide a roadmap for reform."

# The Washington Post

## The Color Of Credit

By Charles Steele Jr.  
Monday, June 23, 2008; A15

The subprime mortgage fiasco is sending tremors through Wall Street and has brought the U.S. economy near (if not into) recession. For African Americans and Latinos -- the primary victims of the debacle -- the mortgage meltdown may widen the considerable gap in wealth that already exists between whites and people of color. Even worse, some proposals to fix the problem of limited access to credit may end up doing more harm than good.

"We estimate the total loss of wealth for people of color to be between \$164 billion and \$213 billion for subprime loans taken during the past eight years. We believe this represents the greatest loss of wealth for people of color in modern U.S. history," the Boston-based organization United for a Fair Economy noted in its report "Foreclosed: State of the Dream 2008."

To understand how the damage goes far beyond these mortgages, one has to understand the importance of owning a home. It is the cornerstone of the American dream. For many, it is also the first step to creating wealth. As with numerous aspects of American society, there is a wealth gap in this country: According to the Census Bureau, the median net worth of a household headed by a white adult in 2004, the latest year for which data are available, was \$118,300, compared with just \$11,800 for black-headed households.

The bureau also reported that three-fourths of white households owned their homes in 2004, while less than half of black households owned theirs. A variety of factors, some economic and some based on racial discrimination, account for that ownership gap.

As a result of laws enacted to address housing discrimination, the rate of African American homeownership rose from 42.3 percent in 1994 to 49.1 percent in 2004, the highest level in U.S. history. As great an achievement as that is, a 49.1 percent rate is about where white U.S. ownership stood in 1900.

Led by former housing and urban development secretary Alphonso Jackson, the Bush administration made expanding homeownership a top priority. In fact, some critics say the administration did so while ignoring signs of an impending crisis in the subprime mortgage market.

Even at the rate African Americans were progressing before the crisis, noted the United for a Fair Economy report, it would have taken 594 years for black median household net worth to equal that of whites. Sadly, the declines in the housing market have only made things worse.

Yet some of the proposed reforms relating to credit may ultimately be counterproductive. For example, the Federal Reserve is accepting public comment until Aug. 4 on a rule that would prohibit certain fees in

connection with subprime credit card lending. While one might hope that capping fees for subprime credit products would result in better credit terms for borrowers, it is more likely that many issuers will cut back on offerings or simply exit the market.

That's what happened with guaranteed student loans after Congress engaged in price-fixing last year: The student lending market evaporated. Justifiably panic-stricken parents, students and education advocates forced Congress to hastily craft corrective legislation, which President Bush signed into law last month.

Consider also the Credit Cardholders' Bill of Rights Act (HR 5244), which would require that many consumers pay -- upfront -- all fees assessed during the first year of a new account, before the card is even issued. Because an ability to pay over time makes such cards affordable for many consumers, this provision would effectively deny credit to millions of those whose rights such reforms are meant to protect.

Our government should protect every consumer -- regardless of race, religion or credit score -- from fraud and fly-by-night lenders. Policymakers should also promote a consumer credit market that helps people whose credit scores are less than stellar to bridge their way back to prime.

Lack of access to credit for those with low credit scores, or no credit whatsoever, is an important and growing problem. Credit scores, traditionally used for mortgages and auto loans, are increasingly used in determining eligibility for employment, auto insurance, apartment rentals, utility connections, and opening and maintaining checking accounts.

Like homeownership, credit is a cornerstone of wealth creation. The FDIC recently stated that "it is very difficult to build wealth without access to credit." That's an extreme understatement. It is almost impossible to build wealth in America without credit.

Dr. Martin Luther King Jr. often said that the cause of economic justice is the cause of social justice. We must continue to work together to achieve that timeless goal in lending and, more broadly, in our nation's economic sector.

*Charles Steele Jr. is president and chief executive of the Southern Christian Leadership Conference.*

<http://www.washingtonpost.com/wp-dyn/content/article/2008/06/22/AR2008062201550.html>



## pasadena citizen > opinion

### Don't take away my credit card

By ERASMO FLORES

[Print Page](#)

Published: 08.12.08

It is disheartening to learn that the Federal Reserve Board may impose severe restrictions on the terms and fees of low-limit credit cards. The proposed rule would hinder consumers from charging necessary fees to their customers. That may sound odd, but it makes sense when you consider the whole picture. The low limit credit card company that I use was very up front with me regarding the fees I needed to pay in order to obtain the card. The charges are the credit provider's way of protecting themselves when dealing with folks that have had trouble in the credit history. Restricting a provider from pricing their products accordingly would likely eliminate low limit cards as an option for millions, and it does not make much sense.

As a salesman who spends a good amount of time on the road, it is essential that I have the use of a credit card for things such as rental cars and hotel rooms. Thanks to my low limit credit card, I don't have to pay cash for dinners with customers, or when I need to make other purchases while away from home. I also feel that I am financially more protected with my low limit card as it is not linked to my checking account. Plus, the best thing is that with each monthly payment, I am improving my credit.

Our government should protect consumers against the predatory practices that have contributed to the mortgage crisis. However, it is critical that regulators understand that the way low limit credit providers operate is dramatically different than subprime mortgage lenders. When I applied for my card, the credit provider used stringent standards in screening me and all the other applicants. Although I was able to secure a card, a significant majority of folks who apply do not receive cards.

Lawmakers and regulators accept this kind of arrangement in other industries. That's why life insurance companies charge higher premiums to smokers. And it's why auto insurance companies charge more for those with an accident or speeding tickets on their record. When it comes to low limit credit cards, the same basic principle applies.

Low limit cards are a vital lifeline for millions of Americans like me, who are just looking to pull themselves up by their bootstraps to re-enter the economic mainstream. In fact, my story is by no means unique, as hundreds of thousands of consumers have restored their credit and have graduated to higher limit cards and better credit using a low limit card.

As the Fed proceeds, they should adopt several common sense reforms that will protect us, while protecting our continued access to credit. First, they should hold credit card companies to high standards when it comes to disclosing terms and requirements to consumers. My credit card company was very clear about this, but if there are companies out there who are not, they should be required to meet the same high standards. Second, they should ensure that consumers receive a full refund if they do not use their cards and wish to opt out within a reasonable time. I am happy with the flexibility that I have been afforded by my company, but all consumers should have options in how they make payments. One thing the Fed should not require that fees be paid up front, though it should remain an option. Many of us who apply for a low limit card do not have several hundred dollars lying around to pay up front, or we would not be applying for the card in the first place.

What the Fed should avoid doing at all costs is substituting their judgment for that of the individual who is facing a financial crisis or needs to reestablish their credit. Provided everyone is clearly informed of the obligations and process involved, and has the needed flexibility in meeting those obligations, we should be allowed to make our own decisions about how to move forward.

Erasmio Flores is a resident of Houston.

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# **SMALL BUSINESS EXCHANGE**

## **Leading Minority Organizations, Officials, Issuers Come Together to Propose Credit Card Reform**

### **Need to Protect Minority and Underserved Community Access to Credit Identified as Top Priority**

Citizens for Equal Access to Credit (CEAC), a diverse, multicultural nonprofit coalition, joined with leading minority organizations, business groups, elected officials and credit card customers from across the nation to announce a comprehensive proposal for low limit credit card reform and a Statement of Principles regarding access to credit. The Code of Practices proposal for low limit credit providers is the product of a Virtual Summit on Minority Access to Credit held on August 21, 2008. The Summit was convened by CEAC to enable a direct dialogue between communities of interest and card issuers to discuss concerns and ideas for improving current practices. To read the full Statement of Principles and Code, visit [www.equalaccesstocredit.org](http://www.equalaccesstocredit.org).

The Statement of Principles hopes to inform decision makers and the public about the sensitivities, goals and concerns of cardholders, minorities, and businesses regarding credit card reform. One of the key principles in the Statement is: "The Federal Government should understand, and remain sensitive to, the reality that low limit cards represent a bridge to the economic mainstream for persons from underserved and unbanked communities."

The Code of Practices includes a number of important reform proposals, such as a requirement that no finance charges on account opening fees be posted to an account, provided initial payments could be applied to repay the fees. The Code also calls for clear disclosure of consumer's right to a full and immediate refund if a consumer changes their mind after receiving a credit card.

Here is what Summit Participants, Elected Officials and Organizations have to say about the Code and Statement of Principles:

- "As the Federal Reserve Board and Congress move forward with their proposals, it is essential that underserved communities and minorities have a powerful voice in this process," said Dr. Juan Andrade Jr., President of the United States Hispanic Leadership Institute (USHLI). "Bringing leading minority organizations, and low limit credit card customers together with providers of credit to develop a consensus proposal is a great way to provide a roadmap for

reform that encompasses the priorities and concerns of underserved communities.”

- “It is very important that as the Federal Reserve Board and Congress make decisions about how people gain access to credit they understand the financial realities that a great many in minority communities are facing right now and the full impact of their proposals on those communities,” said Rep. Lois DeBerry, Speaker Pro Tempore, Tennessee House of Representatives. “I am very pleased that so many groups and individuals who would be directly affected by proposed changes have been able to make their voices heard about the need to protect and maintain access to credit.”

- “It is essential that policy makers in Washington protect consumers while also protecting continued access to credit in underserved communities,” said Victor Capellan, President of the Dominican American National Roundtable. “We believe the common sense proposal that we have put forth today will protect consumers while also protecting consumer access to credit.”

- “The Code of Practices will hopefully be an important reminder to the Fed that it should look at common sense ways to make credit safer and more accessible to consumers without dictating the pricing and structure of how fees apply,” said Karen Kerrigan, President of the Small Business & Entrepreneurship Council (SBEC). “Naturally, the government should protect consumers from abuses in the marketplace but should seek changes to do so while avoiding price control policies and restrictions that will do more harm than good.”

The groups and individuals that took part in the Virtual Summit had the opportunity to discuss ideas for credit reform and submit changes and recommendations to the Code. Elected officials also participated in the Summit including Hon. Pedro Marin, State Representative, Georgia; Hon. Julio Guridy, and Allentown City Councilmember, PA and Dominican American National Roundtable Board Member.

Other advocacy groups that were consulted included the League of United Latin American Citizens (LULAC), the Inter American Entrepreneurs Association (AIHE), and Dominico-American Society, The Small Business Entrepreneurship Council (SBEC); and the Intertribal Agriculture Council (IAC).

In addition to its institutional members, Citizens for Equal Access to Credit includes low limit credit card customers from across the nation. The Code was circulated to the Coalition’s individual members, who also had the opportunity to offer thoughts and provide direct input. For a complete list of the coalition’s individual members go to <http://www.equalaccesstocredit.org/OurMembers.aspx>

Source: Citizens for Equal Access to Credit

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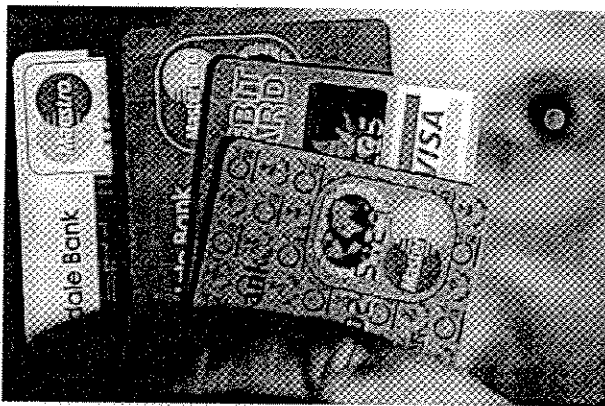
## The Credit Crunch: Where Is It Happening?

By BARBARA KIVIAT Tuesday, Sep. 30, 2008

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While Congress bickers over how to fix the financial meltdown, there's a decent chance you haven't even felt it. Why, you may be asking yourself, does everyone think there's such a big a problem when you're still being offered credit cards in the mail and 0% financing at the car dealership? Maybe you used to bank with Washington Mutual or Wachovia and overnight you've become a Chase or Citi customer, but if your money's still there, why does the rest matter?

The tumult at the top of financial markets has not filtered down evenly, but that doesn't mean it's not seeping. There are cracks on Main Street, but whether or not you see them largely depends on where you stand. Just ask anyone who wants to buy a house with a subprime mortgage —

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they're not all evil, but these days they are exceedingly rare — or with a jumbo loan, which now carries an average rate 1.2 percentage points above a regular mortgage. (In normal times, the spread is closer to a quarter of a percentage point.) "Some people are saying, 'Credit crunch, what credit crunch?' and others are ready to cry uncle," says Greg McBride, a senior financial analyst at Bankrate.com. "It shows it really matters where you fall on the risk spectrum."

Now, about those credit card offers. You may not feel it, but there are fewer of them going out — 1.1 million during the second quarter, down 17% from the same time last year, according to Synovate, a research firm that tracks direct mail. Who's being ignored? Well, subprime borrowers (no surprise there), but also anyone who doesn't make a lot of money: 52% of households with an annual income of less than \$50,000 received at least one offer in the second quarter, compared with 66% of such households during the same period last year.

Already got all the credit cards you need? You're still not immune from higher delinquency fees or lower limits. American Express typically cuts the credit limit on about 4% of its members in any given year. That figure now stands closer to 10%, as the card company takes a hard look at customers' credit profiles — including data on who lives in the areas with the most house-price deterioration.

For car loans, the division between those who feel the crunch and those who don't often comes down to credit score. The average 60-month new car loan is priced at 7.10%, not much different than in the spring, according to HSH Associates, Financial Publishers — and the average rate on a 60-month used car loan, 7.54%, has actually been drifting downward. (Those 0% financing deals still exist, too, from struggling car companies desperate to move inventory.) The difference is, you're probably not going to get that rate (or any at all) unless your FICO score is north of 700, whereas six months or a year ago, a score as low as 620 would have gotten you behind the wheel. "Some of this just represents moving back to standards that were in place five or six years ago,"

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says Paul Taylor, chief economist at the National Automobile Dealers Association. "But if you're a customer, not getting credit you could've gotten a year before looks like a credit crunch to you."

The situation with student loans doesn't break down quite as neatly. Since the summer of 2007, 137 lenders have stopped funding federal loans, and 33 have suspended private programs, according to Mark Kantrowitz, publisher of FinAid.org and other financial aid websites. Part of that had to do with a cut in federal subsidies, but part was directly related to the credit crunch — issuers that pulled out tended to be those that packaged and resold loans, a market that has evaporated.

Students at community and technical colleges, especially institutions that are for-profit, are having the toughest time of it. The reason: those students are more likely to use private loans (whose credit standards have tightened), and lenders under profit pressure are less willing to write loans for shorter, one- and two-year programs — especially at schools with historically high default rates.

Federal loans aren't completely unaffected. While Stafford loans, which are made directly to students and don't take into account credit history, were up in the second quarter compared to a year ago, loans made to parents through the Parent PLUS program have plummeted — down 29% in dollar volume year-over-year, according to Department of Education data analyzed by Kantrowitz.

The mood at banks more generally is cautious. The most recent Federal Reserve survey of loan officers showed a plurality of banks tightening credit standards across the board. Add in anecdotal evidence — like Bank of America declining to increase lending to McDonald's franchisees even though the two companies have a long-standing partnership — and things do seem to be cascading down to Main Street, or whatever road is home to your local fast food joint. In August, 67% of small-business owners said they'd been affected by the credit crunch, compared with 55% in February, according to surveys by the National Small Business Association.

It's not hard to find anecdotes of business booming at credit unions and community banks, which rely on deposits rather than financing in the capital markets. But even there's nuance even there. The amount you can expect from a top-yielding certificate of deposit has fallen from about 5.5% to 4.25% over the past year, according to Bankrate.com. On the surface that seems to indicate banks aren't that worried — if they really needed cash, wouldn't they up their

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rates to attract more money? Well, over the same period of time, the federal funds rate has been cut from 5.25% to 2% — a much wider margin. "Banks are hungry for deposits, and that's why yields haven't fallen all that much," says Bankrate's McBride. And CD yields are now on the rise.

Does that mean you're feeling the credit crunch? Maybe not. But it might be an indication that the cracks on Main Street are spreading.

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[Read Barbara Kiviat's daily take on business and the economy here.](#)

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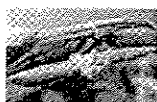
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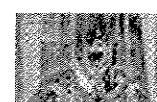


Photo Bacon Tate

Carolyn Sobolik  
108 DEBORAH LN  
Wheeling, IL 60090

Board of Governors  
Secretary Jennifer J. Johnson  
Federal Reserve System  
20th St. and Constitution Ave.  
Washington, D.C. 20551  
RE: Docket No. R-1314

Dear Board of Governors-

Hello, my name is Carolyn Sobolik, and I am writing this letter to you because I have concerns regarding the new Federal Reserve regulations that they are now trying to impose on creditors who loan available credit lines for those whom have substandard credit histories. I was one of those less fortunate and needed that second chance to rebuild a better, more substantial life for myself. Without the credit lenders, I would not have been able to do that.

I am a five-year cardholder of First Premier to which I applied after going through a divorce. Since, I have been keeping up with my payments, established other credit as well with better percentage rates, and I have built my credit report substantially. Being a grateful cardholder of First Premier, I intend to keep this card open. It has been my crutch when I needed the help, and when I was unemployed for a short period, I was able to carry myself through.

Now that I have a good credit reputation, I am able to use my credit card for vacation, motels and gasoline when and if need be. The nation's economy is that much better when people are given a second chance and take their responsibility. Without it, people will continue to use payroll advancement establishments, homelessness would increase, and loitering would triple.

I believe the government needs to allow those second chances, rather than take away the only chance the substandard population has to regroup. First Premier has offered that helping hand, please do not take it away.

Thank you,

Carolyn Sobolik





Secretary Jennifer J. Johnson  
Board of Governors  
Federal Reserve System  
20th St. and Constitution Ave.  
Washington, D.C. 20551  
RE: Docket No. R-1314

Dear Secretary Johnson-

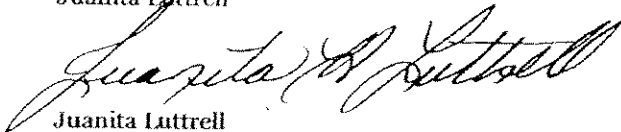
I am writing about the proposal of the Federal Reserve to restrict credit card companies from assessing fees. I understand the need to ensure fair business practices, but this will hurt American consumers. Moreover, First Premier provides full fee disclosures and it is up to the individual to decide whether or not to accept the card. If these regulations pass, First Premier and other companies will not be able to offer their services to people who have subprime credit ratings.

My late husband passed away from cancer and, during that time, we incurred many medical bills which negatively impacted our credit. As a result, I needed a chance to reestablish my credit. First Premier gave me that chance. I am happy to report that I am back on track and was approved for a home loan. If companies like First Premier were not in business it would be difficult for people like me to rebuild their credit.

Unfortunately, there are many stories such as mine that may include catastrophic illness, bankruptcy, or divorce. These individuals need a chance to get a fresh start. Today I use my card for emergency purposes or for small purchases when I do not have cash on hand. I am grateful for the opportunity to repair my credit history. I hope my story expresses the necessity for companies like First Premier so that people may have a second chance.

Thank you for your help,

Juanita Luttrell



Juanita Luttrell  
185 Camarillo Way  
Twin Falls, ID 83301

Carl Bruner

---

114 Cook Rd

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Yorktown, VA 23690

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Secretary Jennifer J. Johnson  
Board of Governors  
Federal Reserve System  
20th St. and Constitution Ave.  
Washington, D.C. 20551  
RE: Docket No. R-1314

Dear Secretary Johnson-

I do not think it is fair for the Federal Reserve to place restrictions on credit card companies. I decided to get the First Premier card to work on reestablishing my credit. Additionally, somewhere down the line I hope to move toward home ownership as well. Companies, like First Premier, cater to a subprime clientele and enable them to gain access to traditional credit sources.

If regulations are imposed that prohibit fee assessment, it will impact First Premier's ability to offer this service to millions of people in my same position. Moreover, people with less than perfect credit may not get the opportunity to attain credit. The alternative offers available may be secured cards that require upfront costs of three to five hundred dollars. Unfortunately, a lot of individuals cannot afford this large out of pocket expense to repair their credit.

These days it is imperative that you have a credit card, not only for credit rating but for purchases and emergencies. This past winter I did not have the money to pay for oil to heat my home, but I was able to buy the product on my card. One of the main benefits of having my First Premier card is that I have it in case of emergencies. Please consider the negative ramifications of imposing regulations on companies like First Premier. The repercussions would hurt many Americans who need someone willing to give them a second chance.

Thank you for your service,



Carl Bruner

Secretary Jennifer J. Johnson  
Board of Governors  
Federal Reserve System  
20th St. and Constitution Ave.  
Washington, D.C. 20551  
RE: Docket No. R-1314

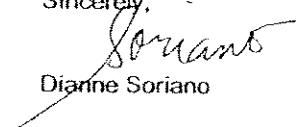
Dear Secretary Johnson-

When I hear about how many people and businesses that have had to file bankruptcy today, I believe that there are more people in this country who have credit issues than those who do not. While paying a higher interest rate than an individual with spotless credit is an obvious drawback, it is better than not being able to obtain credit at all, which could happen with the newly proposed regulations. I urge you to vote against these measures.

I work in medical billing and can see how someone's credit rating could be affected by a severe illness or injury. There are many people who find themselves in this predicament through no fault of their own. I obtained my first credit card with a First Premier Bankcard. Once I was able to build my credit sufficiently, I was approved for higher credit lines at lower interest rates. Now that my credit rating has improved, buying my own home in the future is no longer an impossible dream. I would not have been able to do this without a company like First Premier, who was willing to take a risk for me.

America is going through difficult times right now, and so many people are struggling to make ends meet. Every time I turn on the television, I hear another story about the government getting involved in another area of our private lives. These regulations seem to be just another in a long line of government interference. I believe that every American should have the opportunity to repair their credit, and they cannot do so with the government involving themselves in this way.

Sincerely,

  
Dianne Soriano

Dianne Soriano  
2913 Edmonton Street  
Bakersfield, CA 93309

Secretary Jennifer J. Johnson  
Board of Governors  
Federal Reserve System  
20th St. and Constitution Ave.  
Washington, D.C. 20551  
RE: Docket No. R-1314


Dear Secretary Johnson:

It really frustrates me that at every turn the government wants to have their hands in something when it is not necessary. I do not want the government to regulate fees for First Premier. I realize that I am a high credit risk, and I simply do my best to pay my bills on time. I would be devastated if First Premier was not able to continue providing me with the credit that I have come to rely on for necessary expenses.

I rely on oxygen 24 hours a day, 7 days a week, and I am on disability. Not having a credit card would be devastating, because I currently am able to pay for my medication with a credit card. I have also been able to assist my daughter-in-law by helping pay for my grandchildren's doctor visits. Other credit card companies cater to the wealthy, and I really appreciate First Premier taking a chance on me and others like me.

It is my belief that government should not interfere in matters such as this. Restrictions on credit lenders, such as First Premier would only hurt those who seek an opportunity to restructure their lives. Prime lenders such as Discover Card and American Express are not looking out for the little guys. It is companies like First Premier that are willing to take a chance on people to help them to rebuild their credit. I am thankful for companies like them. Thank you for considering my thoughts on this very important issue.

Thanks,

  
Judy Moore

Judy Moore  
15851 W 1st Drive  
Golden, CO 80401



July 31, 2008

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

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

Ms. Mary Rupp  
Secretary of the Board  
National Credit Union Administration  
1775 Duke Street  
Alexandria, VA 22314-3428  
**Attention: RIN 3133-AD47**

Dear Ladies and Gentlemen:

This letter is submitted by PREMIER Bankcard ("Premier") in response to the May 2008 proposed rulemaking issued by the Federal Reserve Board ("FRB"), the Office of Thrift Supervision and the National Credit Union Administration (collectively, the "Agencies") seeking comment on a number of proposed revisions to Regulation AA concerning unfair or deceptive acts or practices ("UDAP Proposal"). Premier appreciates the opportunity to comment on this critical matter. We applaud the Agencies for efforts to ensure that consumers are not harmed by unfair or deceptive credit card practices. Moreover, Premier supports empowering customers with clear and conspicuous disclosures and commends the Agencies for moving towards this goal.

July 31, 2008

Premier is a leading provider of credit to the non-prime credit rehabilitation segment of the consumer lending market. We are the tenth largest issuer of Visa and MasterCard credit cards, and we focus on providing credit products to the sub-660 FICO segment of the market. We pride ourselves in being an industry leader, having responsible lending practices, employing top-quality and highly-seasoned management, and maintaining strong relationships with state and federal regulators.

### **Executive Summary**

- While Premier believes that the overall intent of the Agencies to address specific unfair or deceptive acts or practices is laudable, we strongly disagree with the suggestion that the mere posting to a credit card account of deposits and/or fees for the issuance or availability of credit is an unfair act or practice within the meaning of Section 5 of the Federal Trade Commission Act ("FTC Act").
- Low limit credit cards are vitally important to consumers, and provide them with significant benefits. In particular, low limit credit card accounts provide access to credit for consumers who otherwise would have no credit, and provide an invaluable tool, in many cases the only tool available, to assist families recovering from financial emergencies. In doing so, low limit credit cards allow consumers to participate in many basic consumer transactions, including purchasing goods or services by telephone or over the Internet, rentals and engaging in preauthorized transactions for bridge and highway tolls.
- Importantly, low limit credit cards can, and actually do, enable many consumers to rebuild a positive credit history. And, by improving his or her credit score, a consumer can qualify for other credit, and can save thousands of dollars through better rates on a mortgage or automobile loan, and even insurance. Millions of cardholders successfully rehabilitate their credit and graduate to higher limit credit cards. At Premier, 22.5% of our low limit credit card holders "graduate" to higher limit credit card accounts within 24

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months. Further, 35% of consumers with low limit credit cards improve their credit score within 24 months. In other words, these consumers accepted and successfully used low limit credit card accounts to rebuild their credit record and advance to higher limit credit accounts, mostly with card issuers who would not offer them credit cards when Premier was willing to do so.

- The imposition of upfront fees, even significant fees, is justified given the risk and expense associated with offering low limit credit cards. By design low limit credit cards are structured to factor in the substantially higher risk. From an account management standpoint, it is critical that Premier and other card issuers have the ability to deal with this risk on the front end. A prime credit card issuer commonly has a 4% to 5% delinquency rate, while a low limit credit card issuer experiences about a 20% delinquency rate. While approximately 22.5% of Premier's cardholders "graduate" to higher limit credit card accounts, many other cardholders do not; approximately 30% of our customers charge off without paying all or part of the balance due. Thus, it is critical for card issuers to price their products in a manner that allows them to absorb the losses by those who default, while giving other consumers the opportunity to demonstrate their ability to handle credit responsibly and graduate to other products.
- Conversely, eliminating the ability to charge and collect upfront fees, including posting such fees to credit card accounts, would make it difficult, if not impossible, for Premier and other low limit credit card issuers to continue to offer such accounts. And, eliminating low limit credit cards would have a significant adverse impact on both the local and national economy. An independent financial analyst suggested that the UDAP Proposal will result in a significant reduction in credit availability over the next two years,<sup>1</sup> and such a reduction in the availability of credit before the financial markets have fully recovered could further harm economic growth and impede economic recovery.

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<sup>1</sup> Meredith Whitney at Oppenheimer & Co. Inc.; Oppenheimer Industry Update, US Banks, *Far From Over We Believe The Credit Crisis Will Extend Well Into 2009* (May 19, 2008).

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- In lieu of prohibiting the posting of such upfront fees and security deposits to credit card accounts, Premier urges the FRB to implement a code of best practices, even a mandatory code of practices, as described more fully below, including clear and repeated disclosure, the right to either pay the fees up front or post them to the account, and the right to reject the credit card when sent by the issuer and receive a full refund or credit for fees paid or posted to the account.

\* \* \* \*

**Charging to a credit card account a security deposit or fees for the issuance or availability of credit is not an unfair practice under FTC Act**

Premier commends the well-intended efforts of the Agencies, but believes that the Agencies have mischaracterized the mere posting to an account of a security deposit or fees for the issuance or availability of credit as an unfair practice under Section 5 of the FTC Act. Specifically, the Agencies claim that consumers suffer substantial injury when security deposits and/or fees for issuance or availability of credit are charged to a credit card account. Based on our extensive experience, however, consumers do not incur substantial injury, or for that matter any injury at all. Instead, low limit credit cards are valuable to millions of consumers who do not have access to traditional credit.

It is undeniable that low limit credit cards provide vitally important access to credit to consumers who otherwise would have no credit. Millions of consumers do not have access to traditional credit and low limit credit cards provide an invaluable tool, and in many cases the only tool available, to assist families in recovering from financial emergencies. In fact, as can be seen from the FRB's public comment letter files, many consumers attest to the fact that low limit credit card issuers were the only issuers willing to issue them credit cards, given their insufficient or poor credit history, and the importance to them of receiving those credit cards.

In fact, one of the primary benefits of having a low limit credit card account is the ability to rebuild a positive credit history. Once a consumer has been able to improve his or her credit score by consistently making payments on a low limit credit card account, he or she can qualify



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for better credit terms in the future, and can also save thousands of dollars in connection with better rates on mortgage or automobile loans, and even on insurance premiums. Over the years, Premier has received letters from consumers confirming this very point, similar to the many positive comments submitted to the FRB by consumers in connection with the UDAP Proposal. For example, one Premier cardholder wrote that her Premier credit card allowed her to re-establish her credit following a divorce, and that she is no longer worried about her ability to care for her children. Another cardholder wrote that his medical bills had adversely affected his credit rating, but through careful use of his Premier credit card, he was able to restore his credit, which enabled him to finance an automobile he needed for his job. Another cardholder wrote that her Premier credit card allowed her to improve her credit score and helped her continue her college education. There are thousands of similar success stories resulting from Premier's credit card practices that cannot fairly be characterized as either unfair or deceptive.

It is also important to understand that low limit credit cards allow consumers to participate in many of the most basic consumer transactions, including purchasing goods or services over the telephone and Internet, renting a car, booking a hotel, participating in membership plans, renting DVDs, and using preauthorized transactions for services like bridge and highway tolls. The ability to be able to participate in such basic consumer transactions gives consumers hope that financial security is obtainable and a sense of their ability to participate in society. It is fundamentally important that consumers with impaired credit histories not be precluded from engaging in such activities, and that they continue to have the ability to improve their financial situation. Thus, Premier believes that the Agencies have unjustifiably characterized the posting of upfront fees as "unfair" without fully understanding the benefit and value of such cards to consumers—that is, the benefit such credit can provide notwithstanding the imposition of such upfront fees.

The Agencies also suggest that consumers cannot avoid the injury caused by financing security deposits and fees on their credit card accounts. To the contrary, Premier strongly believes that through clear and conspicuous disclosures consumers can and do understand that fees will be posted to their credit card accounts and that the fees will reduce the credit available on those accounts until the fees are repaid. While Premier agrees that the current Regulation Z

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disclosure scheme could be improved, we also believe that consumers are fully capable of understanding the structure of low limit credit card accounts and the related pros and cons of having such accounts. It has been our experience that given Premier's layered disclosure approach, our cardholders fully understand the fees imposed and that financing those fees will reduce the credit line available to them. Further, most of our cardholders have found low limit credit card accounts to be beneficial. Specifically, based on a 2008 survey of Premier customers, 93% of customers surveyed gave positive ratings relating to their overall account satisfaction. In addition, 91% of consumers said that they understood that high fees would be imposed and the reason for imposing such high fees. Also, 91% of consumers were not opposed to the fees they paid to obtain access to a credit card.

Consistent with proposed revisions to Regulation Z, Premier also has long provided consumers with the ability to obtain a full refund of fees if, after receiving the account-opening disclosures, the consumer decides not to open the credit card account. Specifically, at the time of application or solicitation a consumer is informed of his or her right to close the account within 30 days of receiving the credit card contract and before purchases are made on the account. In addition, Premier, as a leader in the industry, would be willing to take the additional significant step of foregoing the imposition of finance charges on any fees for the issuance or availability of credit a new cardholder elects to post to his or her account, provided that Premier could first apply payments on the account to repayment of such fees.

The Agencies also suggest that the benefits associated with low limit credit card accounts do not outweigh the cost of financing such fees. In fact, many consumers indicate that low limit credit card accounts have been extremely beneficial, and that such cards provide vital financial assistance to consumers who have encountered emergencies and other unforeseen circumstances, such as medical expenses, death of a spouse, loss of a job, divorce or bankruptcy.

It is undeniable that low limit credit cards can and do help consumers re-establish good credit. Millions of cardholders successfully rehabilitate their credit and graduate to higher limit credit cards. On average among leading card issuers, 20% of low limit credit card holders "graduate" to higher limit cards within 24 months. And, Premier actually experiences a higher "graduation" rate of 22.5%. Since Premier, like other leading card issuers, reports to all of the

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major credit reporting agencies on a monthly basis, cardholders have a readily available way to re-establish their credit. Credit rehabilitation, especially for members of minority groups, has been instrumental in helping consumers obtain long-term financial goals.

Premier also provides credit education for its cardholders and follows customer-friendly practices, such as providing additional grace period days, in an attempt to encourage and assist cardholders in making timely payments so that they can “graduate” to more traditional products. For example, Premier provides numerous positive educational messages to consumers through statement messaging, consumer brochures and VRU messages encouraging consumers to make timely payments and keep balances under prescribed credit limits. Also, when an account begins to go delinquent, Premier provides a message alerting the consumer about the consequences of missing the next payment.

**Imposing upfront fees is justified given the additional risk and expenses related to the accounts**

Premier believes that the Agencies inappropriately characterize the imposition of upfront fees as unfair when, in fact, the imposition of such fees is justified given the additional risks and expenses associated with offering such cards. It is important for the Agencies to fully understand the costs and risks associated with low limit credit cards, and the need for issuers to impose upfront fees. It also is important to understand that most low limit credit card issuers do not approve accounts indiscriminately to simply gather such fees. To the contrary, for example, Premier’s overall approval rate for credit card applications was only 33.2% for 2007, because Premier is very selective with respect to the applicants it will accept for its credit card accounts. So, contrary to claims by some consumer group representatives, low limit credit card issuers do not accept unqualified credit applicants merely to generate fee revenue. At Premier, we use underwriting criteria which is designed to approve applicants who have the most promise of successfully performing on their accounts, and hopefully then obtaining higher credit limits with Premier and with prime creditors.

Furthermore, it is critically important for the Agencies to understand that by design low limit credit cards are structured to address substantially higher risks and costs. From an account management standpoint, it is critical for Premier to have the ability to address credit risk on the

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front end. A prime credit card issuer normally has a delinquency rate of between 4% and 5%, while low limit credit card issuers typically experience a delinquency rate of about 20%. While a significant number of cardholders “graduate” to higher limit cards by repaying their balances as agreed, many cardholders do not. Thus, it is critical for card issuers to be able to price their products in a manner that allows them to absorb the losses by those who default. Also, as discussed above, consumers understand that there are fees imposed for opening these accounts and many consumers believe that the fees associated with the opportunity to re-establish credit through the use of a low limit credit card account are an acceptable price to pay for the thousands of dollars that they can save in the future with better rates on auto, mortgage, and other loans, and even on other products like insurance, once they have restored their credit history.

Moreover, low limit credit cards are more expensive to issue and maintain, including higher operational expenses and reserve requirements. Reserve requirements, for example, can be up to 56% for low limit credit card issuers, while as little as 8% for prime credit card issuers. Thus, for example, the reserve for losses would be \$8 million per \$100 million prime portfolio, whereas the reserve for losses could be up to \$56 million per \$100 million in a portfolio of low limit credit card accounts. In addition, the servicing costs for low limit issuers are higher than a prime issuer. For example, a prime customer contacts the issuer on an average of once per year, while a low limit customer contacts the issuer on average once or twice a month.

**Prohibiting the posting of upfront fees could have a dramatic impact on the availability of credit to consumers and on the national economy**

While Premier offers consumers the ability to pay fees upfront, rather than to post them to the account, the simple fact is that most new cardholders prefer not to pay the fees upfront. Given the additional costs and risks associated with low limit credit card accounts, companies like Premier simply would not be able to provide credit to consumers in this higher risk population. And, eliminating low limit credit cards at a time when consumers most need credit could hurt millions of consumers. With the increased price of gas and food, the average consumer is finding it increasingly difficult to make ends meet, and at times must use credit to do so. Moreover, limiting access to credit for millions of people, especially given current

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economic challenges, could have a significant impact on both the local and the national economy.

The UDAP Proposal, even if modified to address industry concerns, will inevitably result in the most significant changes in credit card operations since the adoption of the Truth in Lending Act ("TILA") in 1968. For example, one financial analyst<sup>2</sup> has projected that certain of the regulatory proposals would reduce outstanding credit lines by \$2 trillion over the next two years. There also are concerns about the macroeconomic effects of the UDAP Proposal. A loss of confidence in the ability of credit card issuers to effectively price risk could cause the panic currently being experienced in the mortgage securitization market to spread to the credit card securitization market. This would increase the costs and decrease the availability of credit, with a corresponding reduction in the volume of credit card transactions and consumer purchases generally. And, a reduction in the availability of credit because of the UDAP Proposal before the financial markets have fully recovered could further harm economic growth and impede economic recovery.

Although the potential market impact may be similar, it is critically important that the Agencies understand that the policy issues relating to low limit credit accounts are dramatically different than those relating to subprime mortgage lending. Low limit credit cards are designed to limit high risk consumers from incurring debt they cannot handle and most of these credit card accounts are unsecured. Thus, low limit credit cards cannot burden consumers with substantial debt, nor do they put consumer homes at risk. In fact, the availability of low limit credit card accounts may assist consumers in responding to the credit report damage being done by the current mortgage crisis.

In this regard, it has been estimated that wealth for people of color has been reduced by up to \$213 billion in connection with subprime mortgage loans, and many of these individuals will need the opportunity to re-establish their credit.<sup>3</sup> Specifically, for African Americans and Latinos, who have been especially hurt by the mortgage crisis, the considerable gap in wealth that already exists between whites and people of color will likely widen. In fact, a Boston-based

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<sup>2</sup> Meredith Whitney at Oppenheimer & Co. Inc., See Industry Update, *supra* note 1

<sup>3</sup> Charles Steele Jr., Op-Ed, *The Color of Credit*, Wash. Post, June 23, 2008, at A15

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organization, United for a Fair Economy, estimated in its recent report, *Foreclosed: State of the Dream 2008*, that the “total loss of wealth for people of color to be between \$164 billion and \$213 billion for subprime loans taken during the past eight years. We believe this represents the greatest loss of wealth for people of color in modern US history.”<sup>4</sup>

**Instead of prohibiting the posting of upfront account-opening fees, the FRB should consider implementing or mandating a code of practices**

In lieu of prohibiting the posting of upfront account-opening fees, and thereby effectively eliminating the ability of card issuers to offer low limit credit card accounts, Premier strongly recommends that the FRB consider requiring compliance with a set of best practices, including layered full and clear disclosure of key terms. Such a code of practices would protect consumers by ensuring that issuers fully disclose key account terms in a clear and conspicuous manner and by facilitating consumer education and understanding, including an understanding of the costs associated with the upfront fees and the consequences of financing those fees, such as reduced available credit. Unlike an outright prohibition, best practices would continue to allow consumers who believe that low limit credit card accounts are beneficial to obtain such products. In this regard, the following is a list of practices that could be included in such a code of practices:

- Full disclosure on or with applications, solicitations and the fulfillment educational kit accompanying the card of the total of the account-opening fees, the total credit limit for the account, and the remaining available credit after posting the account-opening fees;
- Clear right of the consumer either to pay the account opening fees up front or post those fees to the account;
- Disclosure of such fees and the remaining credit limit in a written statement separate from the TILA disclosure and/or cardholder agreement;
- Right to a full and immediate refund if the consumer changes his or her mind within 30 days of receiving the card and the separate fee disclosure;

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<sup>4</sup> Amaad Rivera et al., *Foreclosed: State of the Dream 2008*, United for a Fair Economy, at vii (Jan. 15, 2008), available at <http://www.faireconomy.org/dream>

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- Reporting of the account to all three major credit reporting agencies;
- No reporting if the consumer changes his or her mind and opts for a refund (or alternatively, report the account as closed at the consumer's request).

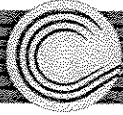
If the Agencies are determined to address this issue under Regulation AA through the UDAP Proposal, they could characterize the imposition of unauthorized account-opening fees as an unfair or deceptive act or practice, but provide a safe harbor for a card issuer that is in substantial compliance with the code of practices specified by the FRB in their final rule. In addition, other practices could be encouraged or required. For example, as indicated above, Premier would be prepared to forego the imposition of finance charges on any account-opening fees that the consumer elects to charge to his or her new account, provided that Premier could apply the initial payments on the account to repay those account-opening fees.

Thank you again for the opportunity to comment on this important matter. Please contact me at 605/357-3410 if you should have any questions about these comments.

Sincerely,



Miles Beacom  
President and Chief Executive Officer  
Premier Bankcard



August 4, 2008

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

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

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

Re: Docket No. R-1314  
OTS-2008-0004  
RIN 3133-AD47  
Proposed Changes to Regulation AA  
Unfair or Deceptive Acts or Practices  
73 *Federal Register* 28904, May 19, 2008

Dear Sir or Madam:

This letter provides comments of CorTrust Bank, N.A. concerning the Unfair or Deceptive Acts or Practices Proposed Rule (the "Proposed Rule") described above, which was published by the Board of Governors of the Federal Reserve System (the "Board"), the Office of Thrift Supervision (the "OTS"), and the National Credit Union Administration (the "NCUA") in the *Federal Register* on May 19, 2008. In particular, we are writing to comment on the proposed prohibitions and limitations on financing fees for the issuance or availability of credit if such fees utilize the majority of available credit on the account.

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



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

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

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

The Proposed Rule would prohibit institutions from financing security deposits and fees for the issuance or availability of credit during the 12 months following account opening if, in the aggregate, those fees constitute more than half of the initial credit limit. The term “fees for the issuance or availability of credit” is defined to include any annual or other periodic fee, any fee based on account activity or inactivity, and any non-periodic fee that relates to opening an account. The “initial credit limit” is defined as the limit in effect when the account is opened. The Proposed Rule would also prohibit institutions from charging to the account during the first billing cycle security deposits and fees for the issuance or availability of credit that, in the aggregate, constitute more than 25% of the initial credit limit. Under the Proposed Rule, any additional security deposits and fees must be spread equally among the 11 billing cycles following the first billing cycle.

#### Analysis of Consumer Injury

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

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

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

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

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

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

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

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

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

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

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

#### Consumer's Ability to Avoid Purported Injury

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

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

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

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

#### Weighing the Countervailing Benefits

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

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

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

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

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

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

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

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

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<sup>2</sup> 459 F.3d 816, 825 (7th Cir. 2006).

<sup>3</sup> The data analyzed by TransUnion was provided by two financial institutions that issue subprime credit cards and by two companies that market and service subprime credit cards.

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

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

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

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

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

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<sup>4</sup> VantageScore shifts of 40 or more points are considered significant.

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

<sup>6</sup> Source: Experian National Consumer Database (Orion File), June 2008.

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

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

Without a doubt, we believe the profitability of credit card lending will decline meaningfully, but we also believe lower liquidity will drive higher consumer defaults across all consumer loan product buckets.

.....

As a result of the proposed regulatory changes, we believe deteriorating economics from the lenders will cause said lenders to pull over \$2 trillion in outstanding [credit card] lines by 2010. In other words, we expect available consumer liquidity in the form of credit card lines to decline by 45% by 2010.<sup>8</sup>

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

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

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

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

<sup>8</sup> *Id.* at 11-12.

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

#### Regulation Z Disclosures Sufficient to Address Fairness Concerns

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

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

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

\* \* \*

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



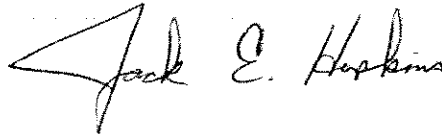
analysis will support our contention that the benefits of the credit card accounts under scrutiny far outweigh any cost to the consumer with respect to such accounts.

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

Sincerely,

A handwritten signature in black ink, appearing to read "David A. Brown". The signature is stylized with a large, sweeping "D" and "B".

David A. Brown  
Vice President/Credit Card Manager

A handwritten signature in black ink, appearing to read "Jack E. Hopkins". The signature is written in a cursive style.

Jack E. Hopkins  
President & CEO

August 4, 2008

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

Re: Regulation AA – Unfair or Deceptive Acts or Practices Proposal –  
Board Docket R-1314

Dear Chairman Bernanke, Members of the Board, and Board Secretary Johnson:

The Political and Economic Research Council (PERC) is a non-profit, non-partisan, centrist policy research organization based in Chapel Hill, North Carolina. PERC's primary focus since its inception has been on market-based economic development with an emphasis on matters pertaining to credit access. Since 2002, and its applied studies centers—the Information Policy Institute, the Center for Competitive Credit, and the Center on the Global Information Economy—have undertaken a series of pioneering quantitative social and economic impact analyses on a range of retail and commercial credit issues in the United States and globally. PERC has been consulted on consumer credit matters by the Federal Reserve Board, the White House, the US Congress, the Federal Trade Commission, the Federal Deposit and Insurance Corporation, and government agencies and legislative bodies in more than 12 countries.

**1. Summary and Overview of Comment**

Given our well-developed interest in credit access policy issues, and our expertise in quantifying potential impacts of proposed statutory and regulatory rules changes, PERC was invited by the Coalition for Equal Access to Credit (“CEAC”) to assess the methodological rigor of analyses conducted by TransUnion Corporation, and to assess the validity of the inferences and conclusions drawn by TransUnion in their analysis. We have attached a copy of a slide deck encapsulating the body of TransUnion's analysis for the Board's review and consideration. The methods employed by PERC to assess TransUnion's analysis, and a discussion of our findings are contained in the following section.

First, we'd like to state PERC's position on Regulation AA, specifically in reference to proposed caps on fees that sub-prime card issuers may charge their customers. Given developments in the US sub-prime credit market over the past year, PERC fully understands the impetus for the Board's interest in non-collateralized elements of the sub-prime consumer credit market, and their Notice of Proposed Rulemaking intended to ameliorate alleged unfair practices therein.

In that PERC's primary focus is upon credit access for traditionally credit underserved populations, and the identification of market-based solutions for broadening and deepening credit access for this population—witness our ongoing Alternative Data Initiative with the objective of bringing “thin-file” and “no-file” consumers into the credit mainstream by means of having energy utility and telephone payment data (so-called “alternative data”) fully reported to consumer credit bureaus—for those who qualify, PERC considers many sub-prime lending instruments as valuable alternatives to payday loans, check cashing services, and predatory or black market loans. For many, the responsible use of a sub-prime credit card—even those that carry high fees and offer relatively low initial credit limits—is the only available means of building a good credit history in order to qualify for more favorable prime credit.

While the issues surrounding sub-prime card fee and interest rate regulation are complex, based upon its examination of TransUnion's analysis conducted for CEAC, and an examination of publicly available data, PERC is concerned that the Board's proposed rule change that would limit fees that a sub-prime card issuers could charge their customers, and restrict their ability to engage in risk-based pricing with respect to account maintenance, may possibly result in:

- a reduction in credit access;
- an increase in the price of credit; or,
- some combination of both.

It is for this reason that PERC urges the Board to conduct an impact analysis of the potential economic consequences from its proposed fee cap on sub-prime card issuers before making a decision on the proposed fee structure and credit pricing changes. Whether and to what specific levels a cap is set, and the ability of lenders to calibrate the price of credit to changes in a borrower's risk profile, may have measurable consequences for credit access.

#### **1.a. Understanding sub-prime card issuer profits**

A casual read of articles in the mainstream press provides a compelling, though inaccurate description of the state of the sub-prime credit card industry's profitability. Generally, such articles contain boilerplate language about hundreds of millions of profits earned from “fee harvester” cards on the backs of economically disadvantaged populations that is derived from a handful of reports.<sup>1</sup> While such characterizations about the profitability of firms in the industry, and even the

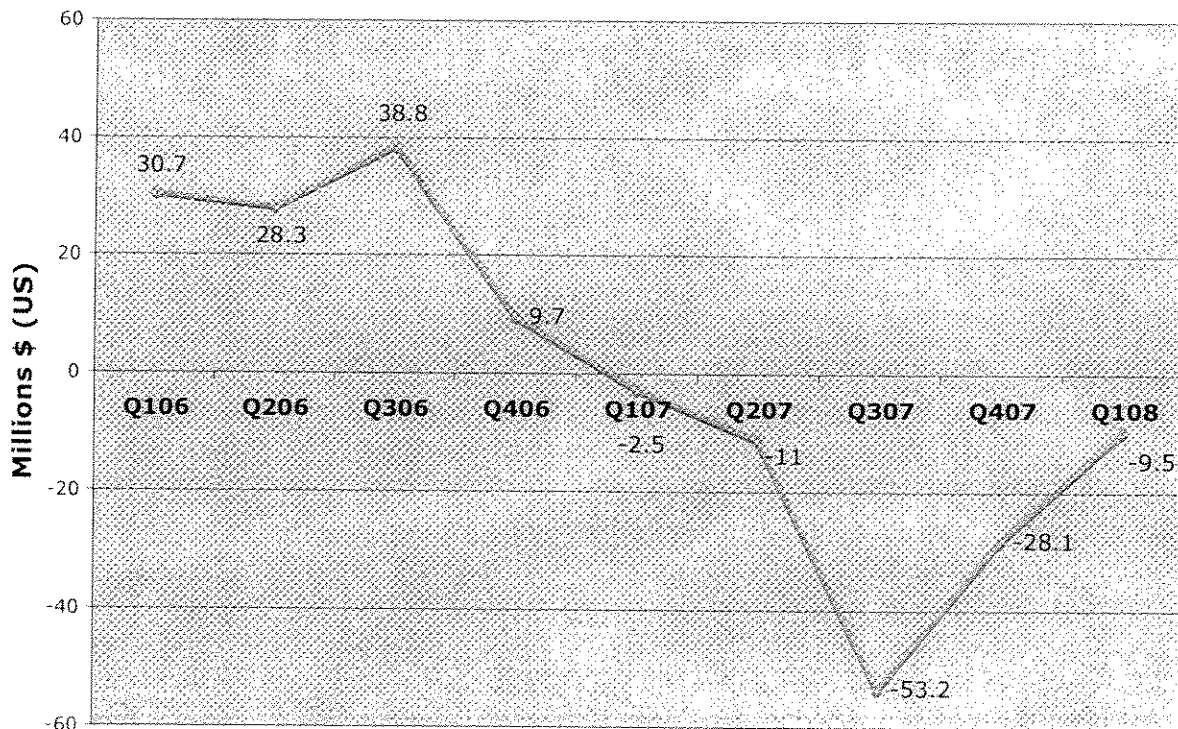
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<sup>1</sup> For an example of an oft-cited study, see Jurgens, Rick and Chi Chi Wu. “Fee Harvesters: Low-Credit, High-Cost Cards Bleed Consumers.” Boston: National Consumer Law Center, November 2007.

industry are accurate at varying points in time—typically during periods of credit expansion—they are less likely to be accurate during periods of credit contraction.<sup>2</sup>

Rather than looking at firm level profit margins in a given quarter or year, a far more relevant assessment of a firm or industry's profitability comes by viewing profits across a business cycle. For example, the graph below shows quarterly profits for CompuCredit, a major sub-prime credit card issuer in the United States. If the quarterly results for 2006 are considered independently, or combined into annual profits, the firm and the industry look extraordinarily lucrative, with annual profits of \$107.5 million US. By contrast, if one examines the profits of the same company during 2007 and 2008, a very different picture emerges, as the companies profits of 2006 were nearly entirely offset by losses totaling \$104.3 million US.<sup>3</sup>

### CompuCredit Profits (Q1 2006 - Q1 2008)



Sources: 10-K SEC Filing of CompuCredit Corp. on 2/29/08; *Atlanta Business Chronicle*; *BusinessWeek*; *The Motely Fool*.

<sup>2</sup> "CompuCredit Corp., a Major Sub-prime Credit Card Issuer, Reports 346% Increase in Profits," CardRatings.com. 18 August 2005. Downloaded from <http://www.cardratings.com/creditcardnews/2005/08/compucredit-corp-major-sub-prime-credit.html>

<sup>3</sup> CompuCredit Corp. is expected to release its 10Q filing for the second quarter of 2008 on 5 August 2008. As a result, these weren't available for inclusion in these comments.

### 1.b. Credit Contractions Likely Result of Proposed Rules Changes

Thus, if regulations capping fees and restricting the ability of sub-prime card issuers to engage in risk-based pricing are intended to offset perceived supra-normal rents while preserving current credit access rates, they are unlikely to have that effect.

In fact, the result of a fee restriction—such as the proposed rules changes that would cap fees at 50% of the initial credit limit—may result in a contraction in credit. Some borrowers, whose expected life-time value to a card issuer made them attractive under the current regime, might become economically non-viable with fee caps and risk-based pricing restrictions as proposed by the FRB.<sup>4</sup> In that the prevailing business model of sub-prime card issuers relies on volume of business and not individual margins, the percentage of current borrowers likely to be affected by the proposed fee cap is likely to be non-trivial. To the extent that this dynamic might be the case, we urge the Board to work with issuers to better understand how this is likely to affect credit access before coming to a final decision.

With regard to the proposed rules change that would limit the ability of card issuers to adjust the APR on outstanding balances as a result of changes in a borrower's risk profile—usually discovered as a result of routine account maintenance—there are good reasons to believe that this too would result in a credit contraction and possibly higher prevailing prices for credit across all risk tiers. First, in that a credit score is an odds ratio (e.g. a generic scoring model measures the probability that a borrower will be 90 days or more late on a payment over a two-year period), and not a tool by which lenders can identify specific individuals who will default, given the proposed limitation on risk-based pricing a likely response of sub-prime card issuers is to adjust the acceptance criteria and reject applicants from the lower score tiers. In addition, to recoup lost revenues from credit contraction and to offset revenues from behavioral adjustments, issuers are likely to charge a marginally higher interest rate for all borrowers. The result will be a cross-subsidy from good borrowers (those that make timely payments and have higher or improved scores) to higher risk borrowers (those who are consistently late or whose scores trend downward over time).

Again, PERC fully understands the Board's desire to explore the full range of issues relating to the price of sub-prime credit in an attempt to protect borrowers from unfair or deceptive trade practices. In that risk-based pricing based upon credit scores has opened the door to mainstream credit for untold millions of Americans,

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<sup>4</sup> For example, assuming a card with an initial credit limit of \$250 and total initial fees of \$175, the portion of borrowers who currently qualify for credit from sub-prime card issuers, but who would be rejected if the FRB's proposed rules changes were to take affect, would be those who's estimated life-time value is justified with fees at \$126 and above, but not at \$125 and below. This from the proposed 50% initial credit limit rate cap.

and in light of the theoretical and empirical considerations just offered, PERC urges the Board to more fully examine the likely credit access consequences from the proposed rules changes affecting fee structures and risk-based pricing.

As discussed above, the bulk of PERC's comments on this matter pertain to our assessment of analysis undertaken by TransUnion Corporation at the behest of Citizens for Equal Access to Credit, or "CEAC." The following section summarizes the results of PERC's assessment of the TransUnion analysis.

## **2. PERC Verifies TransUnion's Calculations**

PERC was able to replicate all of the findings of TransUnion's analysis either perfectly, in most cases, or to within only a very small difference. When such small differences did arise they were qualitatively inconsequential. The differences were likely due to rounding differences or subtle choices in the exact procedures of the calculations, such as whether to include the unscorable consumers (in the denominator) when reporting the proportion of the sample that witnessed score increases. While PERC had access to the exact data TransUnion used, PERC independently analyzed it and did not receive any programming code with which to analyze it. These small differences speak to the robustness of the findings in that two teams independently analyzed data and came up with very nearly identical results. Thus, it is not likely subtle differences in the analysis would result in meaningful changes to the findings.

While PERC was not able to independently verify the integrity of the underlying sample selected, no irregularities were observed by PERC. The sample consists of:

- (1) all consumers that opened a new sub-prime card in January 2006 that were issued by one of four national sub-prime bankcard lenders;
- (2) those that had a credit file in December 2005; and,
- (3) those that had credit file data in January 2008 for which performance and outcomes could be obtained.

The outcomes observed in January 2008 were compared to the initial credit profiles observed just prior to when the consumer opened the sub-prime account, in December 2005.

Importantly, the analysis omitted those that were "no-hits" in December 2005 due to the lack of the "benchmarking" data.

### **2.a. Credit Scores and Score Migration**

As with TransUnion, PERC found that consumers that opened sub-prime cards tended to have lower credit scores than the typical consumer and witnessed declining scores on average over the observation period. They also exhibited less score stability than we would expect for the typical consumer.

A deeper analysis of the drivers behind these differences might be useful as well as, importantly, a longer-term analysis, looking at multiple periods. While the observation period of two years is more than sufficient for analysis needed to answer the basic questions surrounding the impact of sub-prime cards on changes in credit access, there are additional questions that can be better answered by knowing how the consumers stood before and after the observation period.

Indicators of the risk of the sub-prime card consumers include the very high rates of serious delinquencies found in January 2008. What would be interesting to know is whether such high delinquency rates witnessed for this group of consumers during the observation period is typical of similar groups 4 or 5 years earlier or whether it is driven by more recent macroeconomic factors or recent problems in the credit market.

The findings on the movement of credit scores over time among the sub-prime card consumers are consistent with the following:

- most consumers experienced score declines;
- a greater likelihood of score rises among those that had the lowest scores in 2005; and,
- a greater likelihood of score rises among those with either no credit balance or no open accounts in 2005, presumably those newer to credit.

This raises the question of whether there are two main types of sub-prime card consumers. First, those that have little credit history and usage or have very low credit scores and are more likely to see score rises concurrent with their open sub-prime account. These may be those consumers that are using the sub-prime cards to build or rebuild their credit. And second, there may be a second type that have higher initial scores and balances but have hit credit and financial trouble and have falling scores. This would be consistent with result that a number of near-prime, prime, and super-prime consumers had the sub-prime cards in December 2005, but disproportionately experienced score declines. A better understanding of the differences between the higher score and lower score sub-prime consumers may help our understanding of how sub-prime cards are used by consumers.

#### **2.b. Many of the score increases are consequential**

Where score changes occur may be more crucial than the magnitudes of the changes. To demonstrate that a portion of the score increases witnessed would be consequential to consumers, TransUnion calculated the share of increases for those with sub-prime credit scores in December 2005 that moved consumers to near-prime or better. This was about 20 percent. And for those that had score increases and near-prime scores in December 2005, 74 percent moved to higher credit tiers (prime or super-prime). This should not be confused with result that most near-prime

consumers saw score increases (from the TransUnion analysis we know that 37% of all consumers saw score increases).

What this does tell us is that many of the score increases are, likely, consequential for the consumers.

TransUnion's analysis also demonstrates the potential consequential impacts of the score increases by comparing a number of attributes, such as number of open accounts and credit limit, for those with score increases before and after their score increase and to the entire group (those with and without score increases). As one would expect, access to credit is expanded for those with score increase, relative to prior to the score increase and relative to the larger group. This finding is unsurprising.

Taken together, it is reasonable to conclude that the score rises that occurred are consequential in terms of movement across credit score tiers and increased access to credit.

Therefore, it may be the case that for those groups of sub-prime card holders who are more likely to see score rises—those with the lowest initial scores and who initially had no open accounts—holding a sub-prime card would coincide (on net) with expanded access to credit (in terms of the attributes measured). It would be useful if this were verified directly in later analysis, as these groups may be those about whom policymakers are most concerned.

### **2.c. Overall credit opportunity**

Finally, TransUnion's analysis measures the degree of credit opportunity enjoyed by those with sub-prime cards in two ways:

- (1) the proportion with relatively high credit limit cards opened within 12 months of the end of the observation period; and,
- (2) the proportion receiving non-sub-prime credit inquiries.

It is noteworthy that 16.4% of the consumers had opened a new card with a credit limit of over \$1000 and about half received non-sub-prime credit inquiries. And, as one would expect, the figures were higher for those that experienced score increases (24% and 58% respectively). While these are clear signs of credit access and opportunity, it would be useful to benchmark these results in future analysis against non-sub-prime card holders.



### 3. Conclusion

First, it should be noted that the analysis described here may underreport the actual benefits (score rises and access to credit) accruing since the analysis excluded those accruing to consumers with no credit files prior to opening their sub-prime card (“no-hits”). As the analysis has shown, it may be these consumers that most benefit from the sub-prime cards. And related to that, the figures on those with score increases does not include the 3 percent of consumers that had files in December 2005 but became scoreable only after that (likely due to the sub-prime card). Second, more analysis should be conducted on those that witness score declines, which this analysis did not focus on. Though, these consumers *may* be of less concern as they seem to be the relatively higher score consumers in the sample.