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TESTIMONY OF

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ACTING COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

May 17, 2005

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. **Introduction**

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee, I appreciate this opportunity to appear before you today to discuss the Office of the Comptroller of the Currency's (OCC) perspectives concerning credit card disclosures. The OCC's supervision of the credit card operations of national banks includes safety and soundness fundamentals, compliance with consumer protection laws and regulations, and fair treatment of consumers.

In addition to our ongoing supervision of these institutions, and our processing of numerous consumer inquiries and complaints relating to credit cards, we have taken a number of steps – in the form of enforcement actions and preventive supervisory guidance – to address safety and soundness and consumer protection issues that have arisen in connection with the credit card products offered by national banks. It is important to note, however, that the OCC does not have express statutory authority to issue *regulations* that would define particular credit card practices by banks as unfair or deceptive under the FTC Act, or regulations governing specific credit card disclosures under the Truth in Lending Act. Authority to issue regulations in both those areas has been granted exclusively to the Federal Reserve Board.

The credit card industry is highly competitive, and card issuers have responded to increasing market competition with innovations in card products, marketing strategies, and account management practices. The primary goals of these product and marketing innovations have been to gain new customer relationships and related revenue growth, but in some instances an important secondary benefit has been expanded access to credit by consumers with traditionally limited choices. Unfortunately, not all of the product and marketing innovations have had a

uniformly beneficial impact, and the marketing practices of credit card issuers in particular have come in for pointed criticism in recent years.

Regulatory concerns arise when these developments carry costs and risks that are detrimental to consumers and to the safe and sound operations of the credit card issuing bank. They also arise when disclosures intended to enable consumer understanding of the costs and terms of their credit agreements fail to effectively inform consumers about aspects of the credit relationship that are most important to them *and* impose unnecessary burdens on the credit card issuers required to provide the disclosures.

My statement discusses the need to begin a serious re-examination of the processes we have followed historically for developing, designing, implementing, overseeing and evaluating consumer disclosures for financial products and services. I urge that we take a new approach. Credit card disclosures would be a fine place to start.

In my statement, I also describe the OCC's current program for supervising credit card issuers, enforcement actions we have taken to address practices we viewed as egregious, and guidance we have issued to flag practices that concern us and prevent problems from developing in the future.

Finally, I discuss the recent initiative by the Federal Reserve Board to review disclosure requirements for credit card issuers under the Truth in Lending Act (TILA). The OCC is in a somewhat anomalous position when it comes to credit card disclosures required under TILA, for,

while we supervise many of the credit card issuers, we are not authorized to participate in writing the rules under TILA governing their consumer disclosures. Thus, last month, the OCC took the out-of-the ordinary step of submitting a comment letter responding to the Board's Advance Notice of Proposed Rulemaking on Regulation Z's open-end credit rules implementing TILA. My statement describes the most important issues raised in our comment letter.

II. The Need for a New Approach to Developing Consumer Disclosures

In evaluating the current state of disclosures for consumer financial products and services – which I think we can all agree leave substantial room for improvement – and where we should go in the future, it is useful to consider the process we have followed in developing these disclosures. For several decades, disclosures for consumer financial products have been developed by implementation of statutory requirements that typically specify particular content of information to be provided to consumers. These specific requirements have cumulated over the years. And usually, the regulatory agencies charged with drafting the rules to implement those requirements are given short deadlines to finish their work. These approaches may not always have produced or sustained the positive consumer protection results that Congress intended, and thus a fundamental change in our approach to consumer disclosure laws and regulations may be called for.

Compared to the processes we have used to develop consumer financial disclosures, a very different approach was used by Congress and the Food and Drug Administration in the development of the "Nutrition Facts" box that is possibly the most prevalent and frequently used consumer disclosure in the marketplace today. The clear and concise labeling of food nutrition

content has not only enabled consumers to find products with the nutritional characteristics they're seeking, it has influenced food producers to develop products that consumers want. By this measure, the food nutrition disclosures have been effective and useful to consumers, whereas I doubt that we would make a similar statement about many of our current disclosures for consumer financial products. I describe these issues in more detail below in connection with the discussion of the Federal Reserve Board's review of TILA requirements for open-end credit.

The effort that led to the FDA's nutrition labeling began with a clear statement by Congress of the objective the FDA was charged to accomplish. While Congress did specify certain nutrition facts to be disclosed, it also provided the FDA with the flexibility to delete or add to these requirements in the interest of assisting consumers in "maintaining healthy dietary practices." It left to the FDA's discretion the design and format of the nutrition label.

Based on the direction and goals set out by Congress, the FDA took several years, in an effort that involved intensive research not only by nutritionists, but also by experts who polled focus groups to elicit ideas on the kind of information consumers thought was most useful, experimented with dozens of different formats, and tested those formats with target consumer audiences to determine what actually worked. The "Nutrition Facts" box disclosure was the result of painstaking laboratory and fieldwork, notably including extensive input by consumers.

Rather than mandating the precise elements of disclosures, the approach used by Congress with regard to food nutrition labeling was to articulate the goals to be achieved through a particular consumer protection disclosure regime. Congress could follow this model in legislation

affecting disclosures for consumer financial products and services, and direct regulators on the *key goals and objectives* Congress wants particular consumer disclosures to achieve. Applying the FDA model to these consumer disclosures means that Congress would also look for opportunities to require, and provide adequate time for, regulators to include consumer testing as an integral part of the rulemaking processes.

Quick fixes without consumer input, and issue-by-issue disclosure "patches" to information gaps, ultimately are not in the long-term best interests of consumers. Before bank regulators issue any new consumer disclosure rules and regulations, we should undertake – or be directed by statute to undertake – thorough consumer testing to discover what information consumers most want to know about in connection with a particular product and how most effectively to communicate that information to them. And any new process for developing consumer disclosures for financial products also needs to take into account both the burden and costs on the industry associated with implementing any new standards, together with the effectiveness of those disclosures.

We have some important choices to make, and this hearing provides an excellent opportunity to initiate a discussion about those choices. We can continue with the current approach to credit card disclosures – indeed, consumer compliance disclosures generally – of critiquing particular practices and gaps in information and then requiring disclosures to address those particular concerns on a piecemeal basis. Or we can, and I hope we will, recognize that a fundamentally different approach is called for. The results, I believe, will be well worth it for consumers and the financial services industry as a whole.

III. OCC Supervision of Credit Card Issuers

The OCC's comments on these issues are strongly influenced by our experience as the supervisor of many credit card issuers, as well as by the information about consumer confusion and complaints that we obtain through the OCC's Customer Assistance Group. National banks supervised by the OCC issue a substantial percentage of the credit cards held by U.S. consumers. (The Board of Governors of the Federal Reserve System (Board) and the Federal Deposit Insurance Corporation also supervise major credit card issuers.) The OCC's supervision of these institutions reflects a comprehensive approach that is designed to ensure safe and sound operations that comply with applicable laws and regulations and treat customers fairly. This approach enables the OCC to supervise the operations of individual banks, to address emerging risks and other issues on an institution-by-institution or broader basis, and, where necessary, to require correction of consumer abuse or safety and soundness problems that we may find. There are four primary tools that we use to accomplish these objectives: examinations, complaint processing, supervisory guidance, and enforcement actions.

Examinations of Credit Card Operations in National Banks

The OCC conducts comprehensive examinations of the business of national banks, including their credit card operations, and OCC examinations monitor whether credit card lending is being conducted in a safe and sound manner and in compliance with consumer protection laws and regulations. The OCC has a corps of compliance specialists, including retail and credit card lending specialists, located throughout the United States, who conduct these examinations of national banks' credit card operations.

The largest national banks, which include many of the major credit card issuers, have on-site examination teams continuously supervising all aspects of the banks' operations. The supervisory time and attention devoted to credit card banks and operations is directly related to their level of complexity, the credit spectrum served, and the risks presented. Thus, our regulatory scrutiny of high risk and complex credit card issuers that are not the largest banks is rigorous, and more frequent than that contemplated by the general 12- to 18- month examination schedule for other banks.

The OCC's supervision of credit card issuers is based on our assessment of the line of business and the market overall. Examiners assigned to the largest and most complex, highest risk operations typically have many years of specialized experience with credit card products.
Our supervision evaluates whether credit card issuers are operating in a safe and sound manner, and we consider consumer compliance, information technology, and capital markets aspects in the overall safety and soundness assessment of the bank. We seek to determine if risks that the bank has assumed are acceptable, and that the risks are appropriately identified, measured, monitored, and controlled.

To make this determination, examiners review fundamentals such as the reasonableness of the business model and strategic planning, the effectiveness of the bank's controls, financial strength, and compliance with laws, regulations, and relevant supervisory guidance. They also assess the adequacy of policies and procedures through reviews of various functions including marketing and pricing, underwriting, account management, collections, and loss mitigation. In addition, examiners review the bank's use of credit scoring and other models, and, as warranted,

bring in quantitative specialists to assess model development and validation. Throughout the supervisory process, examiners routinely make recommendations for improvement, formally and informally. Examiners also advise banks about issues that pose undue credit, compliance, transaction, or reputation risk.

Based on our supervisory experience, we can say that the vast majority of the credit card issuers supervised by the OCC are focused on operating responsibly and in a safe and sound manner, and that they strive to balance their business objectives with customer needs. However, because the credit card market is a highly competitive and, arguably, saturated market, issuers can sometimes implement changes to their products, programs, or practices before fully addressing all of the implications of those changes.

The OCC can address deficiencies in the credit card operations of national banks as a part of our supervisory process. National banks have changed their practices to address specific concerns we raised, including by suspending or withdrawing certain products, re-pricing initiatives, and line increase programs when they have not been supported by appropriate business analyses and controls, and by modifying procedures affecting the assessment of penalty fees and the posting and allocation of payments.

OCC Consumer Complaint Process

Our Customer Assistance Group (CAG) provides assistance to customers of national banks and their subsidiaries, fielding inquiries and complaints from these customers – many of which relate to credit card products. This complaint processing activity not only helps to resolve individual

problems and educate consumers about their financial relationships, in many cases, it also leads to resolution of the complaints by the bank and secures monetary compensation or other relief for customers who may not have a more convenient means for having their grievances addressed.

Consumer complaint data can be used by examiners in the field to identify risks affecting particular institutions that should be reviewed as part of the supervisory process. The data also can be used to identify systemic problems – at a particular bank or in a particular segment of the industry – that warrant enforcement action, or supervisory guidance to address emerging problems.

OCC Enforcement Actions Addressing Unfair and Deceptive Credit Card Practices

The OCC also can address significant problems involving individual credit card issuers through formal enforcement actions. The OCC has authority to address unsafe and unsound practices and to compel compliance with any law, rule, or regulation, including the Truth in Lending Act, the Fair Credit Reporting Act, and the Equal Credit Opportunity Act – the principal federal statutes that provide specific protections for credit card applicants and borrowers. This authority allows the OCC to require a national bank to cease and desist unsafe or unsound practices or actions that violate consumer protection laws. Further, the OCC may seek restitution for affected consumers in these and other appropriate cases, and assess civil money penalties against banks and their "institution-affiliated parties."

Since 2000, the OCC also has used its general enforcement authority, in combination with the prohibition in the Federal Trade Commission Act (FTC Act) against unfair or deceptive acts or

practices, in a number of enforcement actions involving credit card lending. It should not be overlooked that the OCC's use of section 5 of the FTC Act in this respect was groundbreaking, was initially greeted with skepticism, but is now the uniform position of all the Federal bank regulatory agencies – although it has yet to be employed by any other banking agency to gain relief for consumers in a public enforcement action. Our enforcement actions, described below, have provided hundreds of millions of dollars in restitution to consumers harmed by unfair or deceptive credit card practices, and have required the reformation of a variety of practices. For example:

- Providian National Bank, Tilton, New Hampshire (consent order – June 28, 2000). We required the bank to provide not less than $300 million in restitution for deceptive marketing of credit cards and ancillary products, to cease engaging in misleading and deceptive marketing practices, and to take appropriate measures to prevent such practices in the future.
- Net 1st National Bank, Boca Raton, Florida (consent order -- September 25, 2000). We required the bank to discontinue its misleading and deceptive advertising of credit cards and to take appropriate measures to prevent the recurrence of such advertising.
- Direct Merchants Credit Card Bank, N.A., Scottsdale, Arizona (consent order – May 3, 2001). We required the bank to provide restitution of approximately $3.2 million for deceptive credit card marketing, to discontinue its misleading and deceptive marketing practices, and to make substantial changes in marketing practices.
- First National Bank of Marin, Las Vegas, Nevada (consent order – December 3, 2001). We required the bank to provide restitution of at least $4 million for misleading and deceptive credit card marketing, to discontinue its misleading and deceptive advertising

practices, and to make substantial changes in its marketing practices and consumer disclosures.

- First National Bank, Ft. Pierre, South Dakota (formal agreement -- July 18, 2002). We required the bank to discontinue its misleading and deceptive advertising practices, and to take appropriate actions to prevent deceptive advertising concerning credit lines and the amount of initial available credit.
- First National Bank in Brookings, Brookings, South Dakota (consent order -- January 17, 2003). We required the bank to provide restitution of at least $6 million for deceptive credit card marketing practices, to obtain prior OCC approval for marketing subprime credit cards to non-customers, to cease engaging in misleading and deceptive advertising, and to take other actions.
- Household Bank (SB), National Association, Las Vegas, Nevada (formal agreement -- March 25, 2003). We required the bank to provide restitution for deceptive practices in connection with private label credit cards, resulting in a pay out of more than $6 million to date, and to make appropriate improvements in its compliance program.
- First Consumers National Bank, Beaverton, Oregon (formal agreement – July 31, 2003). We required the bank to make restitution of approximately $1.9 million for deceptive credit card practices.
- First National Bank of Marin, Las Vegas, Nevada (consent order -- May 24, 2004). We required the bank to make at least $10 million in restitution for consumers harmed by unfair practices, and prohibited the bank from offering secured credit cards in which the security deposit is charged to the consumer’s credit card account.

It is vital to note, however, that the OCC does *not* have express statutory authority to issue *regulations* specific to credit card disclosure practices. For example, the OCC is not granted authority to define unfair or deceptive acts or practices by banks under the FTC Act through regulations. That authority is vested exclusively in the Board. Similarly, Congress has vested the Board with exclusive authority under the Truth in Lending Act to issue regulations governing disclosure practices by *all* credit card issuers.

Nevertheless, through enforcement actions and supervisory guidance, the OCC has sought to fill in the gaps and address circumstances in which existing regulations may not provide specific standards for creditors in making disclosures and in avoiding unfair and deceptive practices. As described in more detail below, additional regulatory standards issued by the Board using its rulemaking authority are needed to address this uncertainty and lack of uniform compliance standards on a comprehensive basis.

IV. Recent OCC Supervisory Guidance on Credit Card Practices

An integral component of OCC supervisory activities is the issuance of guidance to national banks on emerging and systemic risks. We use joint agency issuances and the OCC's advisory letter process to alert national banks to practices that pose consumer protection or safety and soundness risks, and give guidance on how to address these risks and prevent problems from arising. We follow up on how banks are responding to issues flagged in guidance through our supervisory processes.

In the past few years, for example, we have issued a number of supervisory guidelines related to credit card lending, including: [1]

- Credit Card Lending: Account Management and Loss Allowance Guidance (Jan. 3, 2003)
- OCC Advisory Letter 2004-4, Secured Credit Cards (April 28, 2004)
- OCC Advisory Letter 2004-10, Credit Card Practices (Sept. 14, 2004)

The following sections discuss this recent guidance.

Account Management and Loss Allowance Practices

In January 2003, the federal bank and thrift regulatory agencies issued guidance to address concerns with credit card account management practices. The interagency guidance, titled *Account Management and Loss Allowance Guidance*, addressed five key areas: credit line management, overlimit practices, minimum payment and negative amortization, workout and forbearance practices, and income recognition and loss allowance practices. The issues covered by the guidance first surfaced in the subprime credit card market, but follow-up examinations identified similar concerns involving several prime credit card lenders.

It may be useful to describe the highlights of these issues in greater detail. Through the examination process, examiners identified concerns with practices for assigning the initial credit lines to borrowers and increasing existing credit lines, particularly for credit card lenders with subprime portfolios. In some instances, borrower credit lines were increased, seemingly for purposes of increasing the size of the loan portfolios, but without the proper underwriting

[1] In March, 2002, the OCC also issued Advisory Letter 2002-3, Guidance on Unfair or Deceptive Acts or Practices,

analysis to support the increases. Some borrowers were unable to make their payments after their credit lines were increased. The result was an increase in delinquencies and losses. The guidance describes the agencies' expectations for banks when they establish initial credit lines for customers and when they increase those credit lines.

Examiners also observed that loan workout and loan forbearance practices varied widely, and in some instances raised safety and soundness concerns. These workout programs, whereby lenders typically lower interest rates and stop assessing fees, were often not effective in enabling consumers to repay the amounts owed. In particular, some workout programs had extended repayment periods with modest reduction on the interest rates being charged. To address this issue, the agencies reminded the industry that workout programs should be structured to maximize principal reduction and required that repayment periods for workout programs not exceed sixty months. In order to meet the timeline requirement for repayment for workout accounts, it is our observation that credit card lenders have lowered interest rates on those accounts, fostering more effective workout programs.

Examiners also identified weaknesses in income recognition and loss allowance practices. Because of the revolving nature of the credit card product and low minimum payment requirements, a portion of the interest and fees due were being added to the balances and recognized as income. The agencies' guidance reiterated the principle that generally accepted accounting practices require that loss allowances be established for any uncollectible finance charges and fees. The agencies also directed credit card lenders to ensure that loss allowance methodologies covered the probable losses in high-risk segments of portfolios, such as workout

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which includes guidance on avoiding these practices in connection with credit card products.

and overlimit accounts. Based on our observations, the industry responded quickly to this guidance and increased their loss allowances where needed.

Overlimit practices, where a borrower exceeds the credit limit on the account, raise both safety and soundness and consumer fairness concerns. Examiners observed that credit card accounts had been allowed to remain in overlimit status for prolonged periods with recurring monthly overlimit fees. Negative amortization occurred in accounts where the minimum payment was insufficient to cover the finance charges and other fees imposed, including overlimit fees, and consequently the principal balance increased. To prevent prolonged periods of negative amortization, the guidance directed banks to strengthen overlimit management practices to ensure timely repayment of the amounts that exceed the credit limits. We believe the industry has responded positively to this guidance by restricting the approval of transactions that exceed credit limits and limiting the number of overlimit fees assessed when repayment of the overlimit amount became extended.

Finally, over the past several years, examiners observed declining minimum payment requirements for credit card accounts. During the same period, credit lines, account balances, and fees all have increased. As a result, borrowers who make only minimum payments have been unable to meaningfully reduce their credit card balances. From a safety-and-soundness standpoint, reductions in minimum payment requirements can enable borrowers to finance debts beyond their real ability to repay, thus increasing credit risk to the bank. Liberalized payment terms also increased the potential for consumers to accumulate unmanageable debt loads, and raised their vulnerability to default in cases of even moderate cash flow disruptions. The

guidance required banks to address these issues through a systematic reevaluation of payment requirements and fee assessment practices.

From the OCC's perspective, the implementation of this guidance by national banks has been satisfactory, but is not complete. Most national banks addressed the credit-line management, workout program, and loss allowance practices immediately. Issues pertaining to overlimit practices, minimum payments, and negative amortization are taking longer because they require changes to customer account agreements and operating systems. Also, we recognized the need for changes to be phased-in carefully for certain customer segments, in order to enable those customers to adjust to changed repayment expectations. All of the large national bank credit card lenders have submitted plans to address outstanding issues related to overlimit practices, prolonged negative amortization, and required minimum payment amounts for those remaining customer segments. Necessary changes have been and are in the process of being phased-in during 2005, with implementation largely completed by year-end, and the OCC is carefully monitoring the phase-in of these changes.

Secured Credit Cards

The OCC also has issued supervisory guidance that focuses on discrete issues affecting credit card products, such as our guidance on secured credit cards. Secured credit card programs entail a borrower pledging collateral as security for the credit. The borrowers who receive these cards typically are individuals with limited or blemished credit histories who cannot qualify for an unsecured card. In some respects, these products can benefit these consumers by allowing them to establish or improve their credit histories. Traditionally, secured credit cards have required

that borrowers pledge funds in a deposit account as security for the amounts borrowed under the credit card account. In the event of default, the deposited funds may be used to help satisfy the debt.

In recent years, however, some issuers began to offer secured credit cards that did not require the consumer to pledge separate funds in a deposit account as collateral in order to open the credit card account. Instead, the security deposit for the account would be charged to the credit card itself upon issuance. This newer practice resulted in a substantial decrease in the amount of credit that was available for use by the consumer when the account was opened. Unsecured credit card products also have been offered with similar disadvantages, except that account opening fees, rather than a security deposit, are charged to the account and consume the nominal credit line assigned by the issuer.

These developments in secured credit card programs – in combination with marketing programs, targeted at subprime borrowers, that often did not adequately explain the structure or its likely consequences – meant that consumers were misled about the amount of initial available credit, the utility of the card for routine transactions, and the cost of the card. Truth in Lending disclosures generally do not provide information to consumers about credit limits and initial available credit. Moreover, while account opening disclosures prescribed by Regulation Z require, if applicable, a general disclosure pertaining to security interests, there is no such requirement for credit card solicitations or advertisements. Thus, these rules omit disclosure of key information that would provide consumers, at a decision point, a full understanding of a

secured credit card product's cost and terms. They also offer little guidance to lenders that may have wished to present such information in a comprehensible manner.

The OCC took enforcement actions involving this type of secured credit card for violating the FTC Act's prohibition against unfair or deceptive practices. We reviewed marketing materials and found significant omissions of material information about the likely effect that charging security deposits and fees to the account would have on the low credit line that was typically extended, and about the consequent impairment of available credit and card utility. These omissions were accompanied by potentially misleading representations concerning possible uses of the card, such as helping consumers to "be prepared for emergencies." While these marketing practices generally *complied* with the specific credit cost disclosure requirements of TILA and Regulation Z, the OCC determined that they constituted *deceptive* practices under the FTC Act. The OCC's enforcement actions required both changes in the issuers' practices and monetary reimbursement to consumers.

We also reviewed whether the practice of charging substantial security deposits and fees to a credit card account and severely reducing the initial credit availability could also be found to be *unfair* within the meaning of the FTC Act. Evidence available to us indicated that consumers were materially harmed by these practices when the product received by most consumers fails to provide the card utility and credit availability for which consumers have applied and incurred substantial costs. Based on this review, the OCC concluded that this practice posed considerable compliance risks under the FTC Act.

To address these concerns, the OCC issued Advisory Letter 2004-4, "Secured Credit Cards." The advisory directs national banks *not to offer* secured credit card products in which security deposits (and fees) are charged to the credit card account, if that practice will substantially reduce the available credit and the utility of the card. The OCC also advised that national banks should not offer *unsecured* credit cards that present similar concerns as a result of initial fees charged to the card.

Shortly after the OCC issued its advisory, we took enforcement action against a national bank offering this type of secured credit card product that required the bank to reimburse affected consumers and to cease offering products in which the security deposit is charged to the consumer's credit card account. As a result of our enforcement actions, advisory letter, and supervisory suasion, we believe that the significant supervisory concerns we had relating to secured credit card products offered by national banks have been addressed.

Other Credit Card Practices

Other credit card practices, involving marketing and changes in terms, also have been the focus of OCC supervisory guidance recently because of our concern that they could expose national banks to material compliance and reputation risks. The OCC recently issued Advisory Letter 2004-10 to advise national banks concerning the risks that these practices may violate the prohibition in the FTC Act against unfair or deceptive practices. These practices include:

- Catching a consumer's attention in advertising materials with promotional rates, commonly called "teaser rates," but not clearly disclosing significant restrictions on the applicability of those rates;

- Advertising credit limits “up to” a maximum dollar amount, when that credit limit is, in fact, seldom extended; and
- Increasing a consumer’s rate or other fees when the circumstances triggering the increase, or the creditor’s right to implement that increase, have not been disclosed fully or prominently.

Teaser rate marketing. A common marketing technique used in credit card solicitations involves "teaser rates." Frequently, teaser rates are used in promotions seeking to induce new and existing customers to transfer balances from other credit cards. The promotional rate, almost always highlighted prominently in the marketing materials, is usually in effect for a limited period after the account is opened or the relevant balance is transferred. Other important limitations on the availability of the promotional rate, or on the consumer’s ability to take advantage of that rate, often apply -- although they may *not* be disclosed prominently. For instance, the lower, promotional rate may apply only to balances that are transferred, and a higher rate would apply to purchases and other credit transactions during the promotional period. Frequently, a consumer’s payments during the promotional period are applied first to the transferred balance, and only after this low-rate balance is paid off will payments be applied to balances that are accruing interest at a higher rate. There also may be other costs, such as balance transfer fees, that affect whether the consumer will benefit from accepting a promotional rate offer.

In some circumstances, consumers can lower their credit costs when they transfer balances to a new account with an introductory rate. The costs and limitations on these rates and accounts, by themselves, are not unlawful or inappropriate – provided the consumer has a full appreciation of

the terms of the transaction. Problems arise when consumers accept offers without knowing the true terms. This, in turn, can lead to increased complaints and increased exposure to claims of "bait and switch," particularly when the consumer accepts these terms without knowing the circumstances in which the creditor can change the terms, including unilaterally.

The Federal Reserve Board's Regulation Z governs many aspects of promotional rate offers. Direct mail credit card solicitations must display prominently in a tabular format each APR that will apply to purchases and balance transfers. However, Regulation Z currently does not restrict the ability of a creditor to highlight only the teaser rate in other materials included in the mailing without noting any limitations on the offer (or to do so only in fine print).[2] Further, Regulation Z requires no disclosure of the order in which payments will be applied to various balances. Finally, while balance transfer fees must be disclosed in solicitations, they are not required to be disclosed in a "prominent location," even in solicitations expressly offering the consumer a promotional rate on a balance transfer.

The OCC's AL 2004-10 provides guidance on how to "fill in the gaps" in these rules for the responsible use of promotional rate advertising. The guidance advises national banks to disclose fully and prominently the categories of balances or charges to which the promotional rate will *not* apply. The advisory also states that a national bank should not fail to disclose fully and prominently other material limitations, such as the time period the rate will be in effect and any circumstances that could shorten the promotional rate period, and related costs. Moreover, if

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[2] We note that the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amends the Truth in Lending Act in several respects to address disclosures affecting credit card accounts, including disclosures related to "introductory rates," minimum payment disclosures, and payment due dates if the creditor may impose a late payment fee.

applicable, a national bank should disclose fully and prominently that payments will be applied first to promotional rate balances.

Marketing based on maximum credit limits. Another marketing practice that we have been monitoring concerns promotions based on the highest attainable credit limit -- such as "you have been preapproved for credit up to $5,000." We became concerned when we observed that this marketing might be targeting consumers with impaired or limited credit history, and enticing them to accept a credit card based on an illusory "firm offer" of a specific amount of credit. Instead of receiving the credit line that is promoted, these consumers may instead receive a "default credit line" (the minimum credit line) that is significantly lower than the maximum. All too often in marketing of this type, the possibility that a significantly lower credit line may be extended is either not disclosed or disclosed only in fine print or in an obscure location. When high initial fees are charged to the card in relation to the credit line extended, consumers who accept the offer will end up with little initial available credit and little card utility.

The OCC has taken enforcement action in three matters involving, at least in part, marketing to subprime borrowers of credit cards with limits "up to" a specified amount. These enforcement actions involved products and marketing techniques like those described above: most applicants received a default credit line substantially less than the "up to" amount featured in the promotion, and security deposits or fees consumed substantially all of the default credit line, leaving the consumer with little or no available credit at account opening. For example, in one program, *almost 98%* of credit card applicants received the default line, rather than the theoretical maximum credit line that was promoted. These enforcement actions resulted in consent orders

or formal agreements containing detailed provisions to prevent misleading or deceptive marketing materials, and restitution for consumers injured by the bank's marketing practices. We also addressed "up to" marketing in AL 2004-10. Even disclosures that may technically comply with Regulation Z remain subject to the FTC Act if they are unfair or deceptive. It may be difficult to assess, however, when practices cross the line into unfairness or deception in a given case. For practices in this gray area, we determined that guidance was needed to prevent consumer confusion and assist national banks in avoiding compliance and reputation risks.

The advisory states three general guidelines for managing risks and avoiding unfair or deceptive practices in these promotions. First, we advised national banks not to target consumers who have limited or poor credit histories with solicitations for credit cards advertising a maximum credit limit that is far greater than most applicants are likely to receive. Second, we advised national banks to fully and prominently disclose the amount of the default credit line and the possibility that the consumer will receive it, if it is likely that consumers will receive substantially lower default credit lines. Finally, we advised national banks not to promote cards on the basis of card utility if the initial available credit most consumers receive is unlikely to allow those uses.

Repricing practices and changes in terms. Coincident with the marketing of credit cards based on high credit limits and low introductory interest rates, many credit card issuers have turned to measures such as penalty pricing, rather than relying solely on the up-front interest rate, to manage risk. For instance, many credit card issuers raise the interest rate on a credit card for consumers who do not make timely payments to the issuer, or even to *another* creditor. Card

issuers may also raise the interest rate on a credit card to address other indicators of increased credit risk, such as the consumer's increased use of credit or failure to make more than the minimum monthly payment. Some card issuers raise the cost of credit in other ways, such as shortening due dates for payments and increasing cash advance, over-the-limit, late payment, or similar fees. These changes in terms have been the object of significant public attention – and criticism – recently, and are the source of many consumer complaints the OCC has received.

It is important to note that federal law, including the Truth in Lending Act, does not restrict the ability of creditors to include in their credit card agreements provisions permitting penalty interest rates, other changes in interest rates, or other changes in the terms of the account. However, while penalty rates are required by Regulation Z to be disclosed in solicitations, the manner of disclosure may not effectively alert customers to these terms. For example, except in certain transactions, the disclosure of when penalty rates will apply is not required to be included in the "Schumer box" disclosures, and need not be as detailed as the explanation later provided in the initial account disclosures. Moreover, Regulation Z rules contain anomalies: in contrast to sometimes detailed disclosures provided to consumers about a credit card's costs, Regulation Z does *not* require a disclosure that a creditor has reserved the right to change, unilaterally, these costs and any other credit terms.

The OCC addressed the compliance and reputation risks that accompany change in terms practices in AL 2004-10. We made clear that to avoid consumer misunderstanding and complaints of unfairness, national banks must do more than merely comply with the technical requirements in Regulation Z. The OCC guidance states that national banks should disclose,

fully and prominently in promotional materials, the specific circumstances under which the card agreement permits the bank to increase the consumer's APR, fees, or other costs (such as for late payment to another creditor). Additionally, if national banks reserve the right to change the APR, fees, or other credit terms for any reason at the bank's discretion, the OCC advisory provides that this fact should be disclosed fully and prominently in both marketing materials and account agreements.

The OCC advisory does not restrict the ability of a bank to base initial credit pricing decisions, and subsequent changes to pricing, on risk factors. Indeed, default pricing and other changes in terms can be appropriate ways to manage credit risk in credit card accounts and, as noted above, the Truth in Lending Act does not prohibit these actions. But, because of the heightened risks of unfair and deceptive practices involving repricing, we believe that national banks should always fully and prominently disclose this material information before a consumer commits to a credit card contract.

To assist banks in implementing our guidance, we have been reviewing direct marketing materials and credit agreements from eleven national banks with credit card operations, including the largest issuers, to compare how their disclosures on promotional rates and changes in terms conform to the standards in our advisory letter. In general, we found that most of the banks surveyed disclosed restrictions on teaser rates and the possibility of changes in credit terms, but that the prominence and completeness of these disclosures could be improved. The materials we reviewed also generally did a good job of telling the consumer what constitutes a "default" that *will* give rise to higher default pricing. However, the materials typically did not

warn the consumer about the other types of circumstances – short of "default" – under which the terms *may* change. We have provided feedback to the banks we surveyed, and we're working with them now on addressing the issues we identified. In responding to the OCC's supervisory guidance, some banks have also been considering whether to make additional improvements to their marketing and account management procedures to address issues related to change in terms practices. These initiatives are commendable.

V. Regulation Z Review

The OCC supervises the credit card operations of national banks through comprehensive examinations, complaint resolution, supervisory guidance, and enforcement actions. However, there are limitations on the extent to which the OCC can ensure effective disclosures, and otherwise protect credit card customers of national banks, through these actions. For example, as noted above, the OCC has not been granted rulemaking authority to address unfair and deceptive practices by banks under the FTC Act, nor to adopt regulations under the Truth in Lending Act. Therefore, we encourage and endorse the Federal Reserve Board's recent undertaking to review disclosure issues relating to *all* consumer credit card issuers under Regulation Z under TILA.

As this hearing itself demonstrates, the past few years have witnessed increasing public concern about the effectiveness of consumer disclosures, especially in the credit card industry. These increased concerns coincide with – and possibly reflect – significant changes in the way credit card accounts are marketed and managed by card issuers. The Board's initiative is a particularly timely effort. It provides an important opportunity to address recent industry developments and

related issues addressed in the bankruptcy reform legislation, to resolve anomalies that have arisen in Regulation Z, and to remedy sources of consumer confusion and misunderstanding.

The OCC has a strong interest in the issues that are being addressed in this review. I have discussed my concerns about the limitations and effectiveness of Regulation Z disclosures, industry burden, and the lack of uniform standards affecting credit card issuers, in a number of forums, and last month, the OCC took the unusual step of submitting a comment letter responding to the Board's Advance Notice of Proposed Rulemaking on Regulation Z's open-end credit rules. In addition to pointing out a number of specific anomalies and other issues that we believe should be considered in the Board's review of Regulation Z, our comment letter discussed three general themes that may be relevant to the review.

Consumer Research and Testing

The first general theme relates to consumer research and testing. As noted above, the OCC believes that consumer testing should precede regulators' issuing new consumer disclosure rules. Therefore, we applaud the Board's plans to use consumer focus groups and other research in developing proposed revisions to the Regulation Z disclosure rules and the related model forms. We urge the Board to employ both qualitative and quantitative consumer testing to ensure that Regulation Z's requirements maximize the effectiveness of consumer disclosures for credit cards.

Our letter pointed to the development of the Food and Drug Administration's (FDA's) "Nutrition Facts" label as illustrative of the sort of consumer research needed to produce a highly effective

disclosure document. Precedents for thorough consumer testing also exist elsewhere in the financial services world. The Financial Services Authority (FSA) in the United Kingdom used extensive testing in developing revised disclosure requirements for a variety of financial products, and the OCC, the Board, and several other federal agencies are currently engaged in a multi-phase consumer testing project related to financial institution privacy notices. The agencies have issued an advance notice of proposed rulemaking with respect to the privacy notices rules, and hope to follow it with a proposal for a new, streamlined approach to privacy notices that reflects the results of that consumer testing.

The results of the earlier FDA and FSA studies are instructive as to what we might expect to find from consumer testing on credit card disclosures. In particular, those studies indicate that we should expect effective disclosures to:

- Focus on key information that is central to the consumer's decision making (with supplementary information provided separately in a fair and clear manner);
- Ensure that this key information is highlighted in such a way that consumers will notice it and understand its significance;
- Employ a standardized disclosure format that consumers can readily navigate; and
- Use simple language and an otherwise user-friendly manner of disclosure.

Prescriptive Disclosure Rules

A second general theme of our comment letter relates to a particular approach to consumer disclosure requirements: detailed, prescriptive rules specifying (among other things) the content of information to be provided to consumers. Regulation Z and countless other consumer

protection rules in the financial services arena have relied predominantly on this approach for decades. While this approach has been effective, to a certain extent, in informing consumers about many of the most important features of their credit card accounts, it also carries significant potential adverse consequences that should not be ignored as the Board revisits Regulation Z. These include:

- The risk of information overload, as well as the risk that important information will be obscured by the cumulative volume of required specific disclosures;
- The risk of over-inclusion of information that may not be material for the particular product (or target market), as well as the risk of under-inclusion of the information consumers most need about a particular credit card product; and
- The risk that any set of specific requirements will not be flexible enough to adapt to or reflect the inevitable changes in credit products and industry practices over time.

All of these risks may imperil the effectiveness of disclosure rules. Moreover, they raise the possibility that the consumer benefit is insufficient to justify the significant burdens that these detailed disclosure rules place on creditors. Accordingly, we urged the Board to consider, as it conducts its review of Regulation Z, whether this approach is best suited to consumer and industry needs in today's rapidly evolving consumer credit markets.

Industry Developments

The third general theme of our comment letter relates to the need to ensure that credit disclosure rules keep pace with the evolution of credit products and industry practices. For example, as mentioned above, one source of an increasing number of consumer complaints is the exercise by

creditors of change-in-terms provisions to reprice credit card accounts, and the information that consumers receive about those practices. Typically, a credit card agreement provides that the interest rate on the account may increase upon the occurrence of a “default” (as that term is defined in the particular credit card agreement). Card agreements also typically provide for a general reservation of rights to the issuer that permits it, unilaterally, to change any term in the agreement, including the interest rate and fees, and the method of allocating payments, and thereby increase the consumer’s costs.

We believe it is important that lenders retain the right to close, reprice, and/or limit further credit advances on accounts due to factors such as fluctuations in the interest rate environment, adjustments in business strategy, market developments, or an increased credit risk associated with an individual consumer or similarly situated groups of consumers. At the same time, customers need to know the circumstances under which their rates will be, or may be, changed. Absent effective disclosure of this information, particular changes in terms may be not only unexpected, but also perceived by the customer to be unfair, such as the application of a penalty rate to *existing* balances, rather than to only new transactions. Understandably, consumer confusion and concern about these matters are heightened when an interest rate increase on an account is not tied to an increase in general interest rates or to deterioration in the borrower’s performance with the particular credit card.

Amendments to Regulation Z could address some of this confusion and concern. Although matters relating to repricing may well be more important to consumers than other information that is currently disclosed in a prominent or conspicuous manner (for example, balance

computation methods), Regulation Z currently addresses the various ways in which an account may be repriced in very different – and perhaps anomalous – ways. For example, the Schumer box disclosure requirements do not treat all repricing mechanisms the same:

- *Variable Rates.* Specific disclosure is required of the fact that the rate may vary and an explanation of how the rate will be determined, as well as detailed rules about the actual numerical rate that is disclosed.
- *Promotional Rates.* Specific disclosure of the promotional rate and a large print disclosure of the rate that will apply after expiration of the promotional rate is required, but *no disclosure* is required of the different circumstances under which the promotional rate will be or may be terminated.
- *Penalty Rates*. Specific disclosure of the increased penalty rate that may apply upon the occurrence of one or more specific events is required, but the disclosure of those events is not required to be particularly detailed, or necessarily prominent, and *no disclosure* of the duration of the penalty rate is required.
- *Reservation of Rights*. *No disclosure* is required of the issuer's reservation of a unilateral right to increase the interest rate, fees, or any other terms of the account.

We urged that one objective of the Board's review should be to find the most effective way to ensure that consumers understand how material terms may change. We suggested that an approach to explore is the possibility of an integrated description of potential changes of pricing and other terms, regardless of the cause or source, that would permit consumers to understand and readily compare this aspect of different credit offers. This type of description could also include disclosure, for example, of whether pricing changes would apply retroactively to existing

balances, and whether and how consumers may be able to “opt out” of the changed terms. In addition, the disclosure anomalies described above should be carefully reviewed – for example, the absence of any disclosure requirement with respect to unilateral reservations of rights (even for accounts advertised as “fixed rate” accounts) in contrast with detailed requirements relating to standard variable rate accounts (as well as certain required disclosures for promotional and penalty rates). We also encouraged the Board to address the adequacy of current requirements relating to penalty rates (especially in light of the rise of cross-default provisions commonly referred to as “universal default” clauses) and promotional rates.

We noted in our letter a number of other areas in which, similarly, the Board should review Regulation Z to determine whether new technologies, marketing strategies, or account management practices warrant changes to existing disclosure requirements or other consumer protections. These issues point to the general challenge in the pending review of credit card rules – how to build flexibility into Regulation Z so that it will not be outpaced by rapidly evolving market practices. Without this flexibility, regulators – and industry, for that matter -- will continue to need to "fill in the gaps" to ensure that consumers have the information they need to understand the terms of their credit card accounts.

VI. <u>Conclusion</u>

Credit card terms, marketing, and account management practices have been changing over the past several years in response to intense market competition. These changes have significant implications for safety and soundness and consumer protection. The OCC has addressed many

of these concerns through its supervision of national bank credit card operations, its enforcement actions, and its supervisory guidance.

However, given the tremendous volume of credit card solicitations in the market today, we remain concerned that consumers are not always provided information that will be effective in helping them to sort through these offers and to understand the benefits *and* material limitations of the various products being marketed. The Board's review of the credit card rules in Regulation Z holds promise for a disclosure regime that is more effective for consumers.

More importantly, we need to rethink our current approach to credit card disclosures – indeed, consumer compliance disclosures generally – of critiquing information practices affecting particular issues and then pushing for correction on a piecemeal basis. We can, and I hope we will, recognize that fundamental changes to our approach are needed. It will take time to achieve, but the results, I believe, will be well worth it for consumers, complementary to a competitive market, *and* less burdensome for lenders.

Once again, Mr. Chairman, thank you for the opportunity to present the OCC's views on these matters.