COMMENTS

of the

CENTER FOR RESPONSIBLE LENDING
NATIONAL CONSUMER LAW CENTER (on behalf of its low-income clients)
CONSUMER FEDERATION OF AMERICA
CONSUMER ACTION
NATIONAL ASSOCIATION OF CONSUMER ADVOCATES
U.S. PIRG

on the

Proposed Regulation Z Rules

Regarding

Implementation of Credit CARD Act provisions on
Reasonable and Proportional Penalty Fees and Re-evaluation of Rate Increases
Proposed Reg. Z, §§ 226.52(b) and 226.59

Docket No. R-1384
12 CFR Part 226

75 Fed. Reg. 12334 (March 15, 2010)

April 14, 2010

Via Electronic Submission:

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Secretary, Board of Governors of the Federal Reserve System
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Washington, DC 20551

The Center for Responsible Lending and the National Consumer Law Center (on behalf of its low-income clients),[1] along with the Consumer Federation of America, [2] Consumer Action,[3] National Association of Consumer Advocates,[4] and U.S. PIRG[5] file these comments on the Board's proposed Regulation Z amendments implementing the final two provisions of the Credit CARD Act, Pub. L. 111-24, which are to become effective August 22, 2010:

- Section 149, requiring that penalty fees on credit cards be "reasonable and proportional" to the omission or violation for which the penalty fee is imposed,[6] and

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[1] The **Center for Responsible Lending** (CRL) is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, which consists of a credit union and a non-profit loan fund.

The **National Consumer Law Center, Inc.** (NCLC) is a non-profit corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes and regularly updates a series of sixteen practice treatises and annual supplements on consumer credit laws, including Truth In Lending, Cost of Credit, Consumer Banking and Payments Law, Foreclosures, and Consumer Bankruptcy Law and Practice, as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for tens of thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide comprehensive comments to the federal agencies on the regulations under these laws.

[2] The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

[3] **Consumer Action** (www.consumer-action.org) is a national non-profit education and advocacy organization that has served consumers since 1971. Consumer Action (CA) serves consumers nationwide by advancing consumer rights in the fields of credit, banking, housing, privacy, insurance and utilities. CA offers many free services to consumers and communities. Consumer Action develops free consumer education modules and multi-lingual materials, for its network of more than 11,000 community based organizations. The modules include publications in Chinese, English, Korean, Spanish and Vietnamese.

[4] The **National Association of Consumer Advocates, Inc. (NACA)** is a nonprofit 501(c)(3) organization founded in 1994. NACA's mission is to provide legal assistance and education to victims of consumer abuse. NACA, through educational programs and outreach initiatives protects consumers, particularly low income consumers, from fraudulent, abusive and predatory business practices. NACA also trains and mentors a national network of over 1400 attorneys in representing consumers' rights.

[5] The **U.S. Public Interest Research Group** serves as the federation of and federal advocacy office for the state PIRGs, which are non-profit, non-partisan public interest advocacy groups that take on powerful interests on behalf of their members.

[6] Codified at 15 U.S.C. § 1665d

- Section 148, requiring that increases in the APR on credit card accounts based on the credit risk of the card holder, market conditions, or other factors, be re-evaluated at least every six months.[7]

SUMMARY OF KEY RECOMMENDATIONS

Implementation of these two provisions of the CARD Act represent special regulatory challenges. Congress reacted to what was widely viewed as overreaching and in need of reform. With respect to these two issues, however, how to achieve that reform was largely left to the Board to design. Only time and trial will tell whether the final rules adopted will fulfill Congressional intent. We believe that some of the proposals will further that goal, but that overall, if the rules are to succeed in effectuating change in market behavior, it is necessary to bring more rigor to both the standards and the process by which those standards should be evaluated.

In particular, we believe that a fairly and reasonably valued safe harbor for penalty fees and charges would achieve the Congressional purpose and restore customer confidence while making compliance simple and inexpensive for issuers.

Apart from the safe harbor for penalty fees and charges, effectuating the remainder of the mandates of Sections 148 and 149 will be heavily dependent upon empirical evidence. Accountability requires that there be a transparent system for collecting and evaluating the data used by issuers in complying with the rate re-evaluation provision and penalty fee provisions. Yet there is nothing in the proposed rule that addresses this fundamental precondition for rules that accomplish the goals.

Among the key comments and recommendations included herein are the following:

I. The safe harbor should be set at an amount that reflects non-exploitive pricing, and there should be incentives for encouraging issuers to use the safe harbor. *(Section I)*.

- **The safe harbor should be the lesser of 5% of the amount at issue or $20**. The $20 safe harbor reflects the current level of penalty fees in a segment of the market which appears to reflect consideration of the factors now required to be considered in determining such fees, rather than the exploitive fees which triggered the CARD Act's reforms. The safe harbor amounts should not be tiered.

- **There should be incentives for issuers to use the safe harbor**. For example, the Board could require that penalty fees above the safe harbor be reviewed and pre-

[7] Codified at 15 U.S.C. § 1665c

approved, while issuers using the safe harbor could take advantage of reduced data reporting.

- **The safe harbor amount should not be automatically indexed for inflation**. The Board has authority to review and adjust the safe harbor when directly relevant conditions warrant.

II. Accountability for compliance requires transparent and accessible data. The rule should provide for a data collection system (*Section II*)

Neither the CARD Act itself nor the proposed rules address the question of how compliance will be measured for the non-safe harbor penalty fee rule or for the rate re-evaluation rule. That omission also means that there is no measure for holding regulators accountable for assuring compliance by their supervisees. Without data that is collected and made available to the public, there will be insufficient accountability for both issuers and their regulators. One of our key recommendations is to remedy this omission, as we believe it is essential to assuring that the Act's goals are met.

- **The Board must establish a data collection requirement for both the non-safe harbor penalty fee and rate re-evaluation rules**. It must require issuers to publicly disclose their factors and methodologies for setting penalty fees and rate increases, as well as supporting data. This can be done in a manner which accommodates both privacy and proprietary concerns while facilitating accountability and compliance.

- **The data collection system must be transparent enough to allow for bench-marking** an issuer's data against market-norms, and to allow objective evaluation of compliance by regulators and outside researchers.

III. With respect to penalty fees outside the safe harbor, the rules proposed to implement the Congressional mandate that they be both reasonable and proportional must be strengthened, and must provide clearer guidelines and ground-rules for issuers, for their supervising regulators, and for their customers. (*Section III*)

- **We agree that as a matter of statutory construction and sound policy implementation, losses should be excluded as a factor in determining costs of conduct for which the penalty is being imposed**. That should be part of the upfront pricing of the product. Furthermore, we offer empirical evidence that the current pricing for penalty fees targeted by the CARD Act were not correlated with losses in any event. (*See also Section VI-A and Appendix B)*

- **We support the proposed prohibition on fees for which no cost is incurred, and recommend that the list be expanded to prohibit fees for required TIL disclosures**.

- **Deterrence should not be permitted to be a stand-alone basis for justifying a penalty price outside the safe harbor**. The statutorily-enumerated factors are cumulative, not in the alternative. Deterrence is a soft value, and its measurement easily manipulated. Apart from the excessive proposed 100% cap, there is no benchmark established.

- **The proposal regarding the cost-basis for establishing penalty prices should be refined to prevent over-allocation of overhead and infrastructure and other inappropriate costs to penalty fees**.

- **The proposed 100% cap on penalty fees outside of the safe harbor is excessive. It should be reduced to 50%, with a fixed dollar maximum set at no higher than $29.**

- **Section 226.56(b) requiring that penalty fees and charges be reasonable and proportional should apply to penalty rates, as well as flat fees**. (*Section III-B-7)*

IV. The rule regarding re-evaluation of rate increases is too weak and amorphous to give meaningful effect to the Congressional directive, or to provide compliance standards for supervisory agencies. ***(Section IV)***

- **There should be more specific guidelines as to both legitimate and illegitimate factors to use in the evaluation. Further, the rule and commentary should distinguish between program-wide rate increases and individual rate increases, and guidelines be tailored accordingly.**
    - Appropriate factors for program-wide, market-condition increases include cost of funds (not reflected in a variable rate) and issuer's loss rates for that product. Improper factors would include loss rates for other products or product lines and the inability to charge higher fees or rates resulting from legal reforms.
    - The appropriate factor for individual account rate increases should be empirically tested risk factors related to the ability to repay. Factors relating to price insensitivity or behavorial pricing correlated with protected class status should not be permitted.
    - The guidelines should provide for greater consistency in use of factors sufficient to prevent "cherry-picking" and manipulation.
    - The methodologies used for evaluation should be empirically derived and demonstrably sound.

- **Stronger criteria should be used for rate increases imposed between January 1, 2009 and February 22, 2010,** because customers subjected to those increases did not have the protections afforded after the February 2010 rules became effective and because the interim increases are unlikely to have been justified by legitimate criteria when made.

- The re-evaluation requirement should not be limited to 5 years or other timeframe. Accounts and programs are constantly reviewed for increases as a matter of business practices in any event.

V. The Board should promulgate a rule declaring misleading advertising to solicit opt-in for over-the-limit to be an unfair and deceptive practice. (*Section V*)

VI. Any testing exceptions for non-safe harbor penalty fees should use a methodology which does not exploit behavioral biases and does not permit cherry-picking results. We suggest a methodology that involves downward testing and extrapolation. (*Section VI-B*.)

COMMENTS

I. THE MOST EFFECTIVE AND ECONOMICAL PATH TO IMPLEMENTING THE CARD ACT'S GOAL OF REASONABLE AND PROPORTIONAL PENALTY FEES AND CHARGES IS A FAIRLY PRICED SAFE HARBOR SET AT THE LESSER OF $20 OR 5% OF THE ASOCIATED AMOUNT DUE, AND THE RULE SHOULD PROVIDE INCENTIVES FOR ISSUERS TO USE IT. *Proposed Section 226.52(b)(3).*

Congress provides that the Board may prescribe a safe harbor amount that is presumed to be "reasonable and proportional." Section 149(e). We believe that, provided the amount is set fairly, this provision has the potential to best implement Section 149's goals, while making compliance simple and economical for issuers. It is possible that these advantages for issuers alone will encourage them to take advantage of a safe harbor. But the Board should offer some additional incentives.

A. The Safe Harbor Penalty Fee Amount Should Be the Lesser of $20 or 5% of the Amount Associated With the Omission or Violation. The Board Should Consider a Lower Maximum for Over-the-Limit Fees.

The threshold question, of course, is what the safe harbor amount will be. In this proposal, the Board did not propose a specific dollar amount, stating that it was without adequate data to do so. It requests data as part of these comments.

As proposed by the Board, §226.52(b)(3), the safe harbor alternative would be the *greater* of

(i) $xxx (unspecified in the proposal), or

(ii) 5% of the dollar amount associated with the violation, up to a maximum of $XXX (unspecified in the proposal.)

Under the proposal, both dollar amounts would be adjusted annually to reflect changes in the CPI.

We urge that the maximum safe harbor amount be the lesser of 5% of the associated amount or $20, and that it not be adjusted automatically according to the CPI. Over-the-limit fees should have a lower maximum ($10).

In offering our suggested $20 figure for the safe harbor, we start from these premises:

- The legislation reflects Congress (and the public's) view that the high penalty fees were primarily driven by revenue-enhancement considerations, and as part of an anti-competitive trend toward non-transparent back-end pricing.

- The high end of the current range of penalty fees should therefore most decidedly not be a benchmark for what should constitute the safe harbor. Should that be the case, then the goal of the reform would not have been met.

- The safe harbor amount should reflect penalty amounts that are used by responsible issuers that already tend to the basics. By looking to such lenders as a benchmark for the safe harbor number, the Board can give effect to the Act's purposes, while taking into account the types of factors legitimately considered in establishing such fees.

- With respect to over-the-limit fees, the costs actually attributable to the over-the-limit conduct, without factoring in overhead and infrastructure costs, is likely to be much less than costs associated with late fees. (See Section III-B-3-b**)** Therefore we suggest that the safe harbor maximum for over-the-limit fees be $10.

Setting the safe harbor at the lesser of 5% of the associated amount or $20 also assures proportionality for small dollar infractions. A $20 late fee for a $25 minimum payment that is 2 days late, though an improvement over today's practices, is disproportionate by most standards.

CRL's analysis of penalty pricing found that one of the strongest correlations to the penalty amount was whether the issuer was a bank or a credit union. (See Section VI-A and Appendix B.) While there are, of course, differences in the organizational and legal structures of banks and credit unions, we submit that these differences should not matter for purposes of weighing legitimate factors to determine a presumptively reasonable and proportional safe harbor penalty fee. Both have an interest in avoiding delinquencies and losses, and both have collection costs. While some banks might argue that their customer base included weaker customers, we note that going forward, all issuers are now required to consider ability to pay in granting credit. Reg. Z §226.51. The Board itself pointed out that credit union price policies are a useful benchmark in determining reasonable fees.[8]

[8] 75 Fed. Reg. 12334, 12346 (March 15, 2010).

In examining the policies of the Top 100 issuers, we found that the median, mean and mode late fee charged by credit unions were $20. We therefore recommend that the safe harbor dollar amount be $20. This should also be the maximum amount of the safe harbor amount.

B. The Rule Should Provide Incentives for Issuers To Use the Safe Harbor Amount

As we mentioned earlier, issuers are likely to be attracted to a safe harbor amount because there will be little or no compliance burden associated with this part of the CARD Act if it does so. However, additional incentives should be built into the rule. We believe that such incentives easily dovetail with needed improvements to the rule regarding non-safe-harbor penalty fees.

In Section II of these comments, we argue that implementation of both the non-safe harbor penalty fee provision and the rate re-evaluation requirement of section 148 require mandatory data collection, and a transparent and accessible means of evaluating that data. Issuers using the safe harbor would not be required to submit data relating to Section 226.52(b) compliance, which would reduce compliance costs.

Additionally, as we discuss below, Section III, the proposed rules for penalty fees outside the safe harbor lack adequate standards for assessing the data. Pre-filing and pre-approval of non-safe-harbor fees according to more rigorous standards would better assure compliance with Section 149. At the same time, that would be an additional incentive for issuers to adopt the safe harbor penalty price.

C. The Board Should Not Automatically Adjust the Safe Harbor Amounts for Inflation

Proposed OSC §226.52(b)(3)-2 provides that the Board will adjust the safe harbor dollar amount for inflation using the Consumer Price Index. We oppose the proposed Comment for several reasons. First, as discussed above, many of the costs that the Board permits to be included in the calculation of penalty fees are one-time costs incurred by issuers, such as for programming systems. Such "sunken" costs are not affected by inflation. (Indeed, technology costs have been going down, not up.)

Moreover, the relevance of the CPI to other legitimate factors relating to penalty fee pricing is tenuous, at best. The statutory test is that the costs have to be associated with the "omission or violation" being penalized. Section 148(a). It is difficult to make a sound case that inflation in the household market basket of goods and services can be tied to a presumptive reasonable compensation to a card issuer for late payments.

We also note that, unfortunately, the regulatory pattern of CPI adjustments has tended to be a one-way street. Adjustments for inflation are made where it favors issuers, but neither made, nor even recommended to Congress in order to protect the rights of consumers. For example, the Board has permitted inflation adjustments of the *de minimis* exemption for disclosure of minimum finance charges. Reg. Z § 226.5a(b)(3). However, the Board has failed to date to support an adjustment to the TILA exemption amount in Section 104(3) for inflation.

Finally, the Board always has the authority to actually take a look at economic conditions and costs to determine whether an adjustment – up or down – is actually warranted when taken relevant conditions into account. That is clearly something the Board can – and probably should do. But there is no rational basis for using the CPI as an *automatic, unexamined* basis for raising the safe harbor.

II. THE BOARD MUST PROVIDE FOR TRANSPARENCY TO ASSURE COMPLIANCE AND ACCOUNTABILITY WITH RESPECT TO BOTH THE RULES ON BOTH PENALTY FEES AND RE-EVALUATION OF RATE INCREASES. *Proposed Sections 226.52(b)(1) and 226.59.*

> *Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.*"
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> -Supreme Court Justice Louis Brandeis

In enacting the CARD legislation, Congress left considerable leeway to the Board to effectuate the ban on unreasonable and disproportionate penalty fees and charges, and on the requirement that rate adjustments for individual risk changes or market conditions be a two-way street. By definition, implementation of both Sections 148 and 149 require the use and evaluation of empirical data. One of the many lessons to be drawn from the recent market failures that necessitated reform across several market sectors is that we cannot afford to leave data collection and analysis a secret, shrouded process. In the absence of data that objective regulators, academics and researchers could evaluate, the response to the increasing drumbeat of abuses was to dismiss them as "anecdotes." Access to data to prove or disprove the fears was denied, and then the lack of data was used to justify resistance to reform.

Having adequate, transparent and accessible data is a fundamental prerequisite to assuring that these reforms are effectuated. The omission of any such requirement from the Board's proposal is perhaps its most notable weakness. Rectifying that failure will be central to assuring compliance with both the penalty fee provision and the rate re-evaluation provision.

These provisions will be enforceable only by supervisory regulators. Unfortunately, the record of vigorous oversight on issues such as the ones addressed by these rules has not inspired confidence.[9] Accountability, compliance and public confidence all require transparency. To that end, we believe that the Board must:

- require issuers to publicly disclose their factors and methodologies for setting penalty fees and rate increases, and supporting data,
- require issuers to regularly submit this information to the Board, and
- the Board must make the information available to the public, with appropriate safeguards for privacy and legitimate proprietary concerns.

A. Data Collection is Required to Assure Transparency and Compliance

Reporting requirements should include data on:

(1) the dollar amounts of the different types and amounts of penalty fees they have imposed;
(2) how many consumers have been subject to such fees;
(3) the amount of their rate increases;
(4) the number and dollar balances of accounts subject to rate increases, broken down by time period and broad categories of reasons for the increase;
(5) the number of accounts for which issuers have conducted a rate re-evaluation;
(6) the number and dollar balances of accounts for which a rate has been lowered;
(7) the number and dollar balances of accounts for which a rate has been raised;
(8) if prices for new accounts are used as a criteria for reevaluation, a comparison of new account and existing account pricing by risk or other relevant cost factor.[10]

This information must be made available for public scrutiny, and, as is discussed in the next section, for benchmarking.

The need for the factors and methodologies for penalty rate and rate increase setting to be transparent is especially great because the proposed rule's requirements for verification of compliance are weak. Both the penalty fee and the rate re-evaluation provision are not subject to Truth in Lending's civil remedy provision, 15 U.S.C. §1640. Without private enforcement, only the banking regulators and the Board can ensure compliance. Yet the Board's proposed rule does not appear to require proactive approval or review of penalty fees or rate re-evaluations. Instead, the Board merely requires issuers to stand ready to justify their penalty fees or rate re-evaluations in the event that such justification is requested by a regulator. Equally problematic is that the standards by which the regulator should then evaluate the data. In the end, we fear these standards are

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[9] For example, the OCC has only taken two section 5 enforcement actions against major card issuers for unfair practices in the past decade, both of which were prompted by state and local officials acting first. . *See, e,g.* Andrew Martin, "Does This Watchdog Have a Bite?" New York Times (March 26, 2010) (regarding history of OCC action against Capital One) *available at* http://www.nytimes.com/2010/03/28/business/28dugan.html?scp=1&sq=John%20Dugan&st=cse; Frontline, *Secret History of the Credit Card* (November 23, 2004).

[10] *See also* Section III-B regarding additional suggested data requirements with respect to non-safe harbor penalty fees, and IV-D regarding changes in evaluation criteria.

so vague as to allow these new provisions to be honored more in the breach than in the letter and spirit of the law.

This level of verification is insufficient. It allows issuers to manipulate what they choose to include as their evidence based on the circumstances surrounding the request by the regulator. Furthermore, exclusive reliance on the banking regulators to initiate review and enforcement of the penalty fee and rate re-evaluation provisions is inadequate given their history of lax enforcement and an overly accommodative regulatory philosophy.

To ameliorate this weak compliance regime, issuers should be required to publicly submit the data they are using to justify their pricing decisions on a regular basis to the Board, regardless of whether a regulator requests such data. This holds issuers to a certain set of facts, and facilitates both public scrutiny and benchmarking. It permits scrutiny of data-based justifications, especially statistical arguments, by experts. It permits development of alternative interpretations, methodological questions, and testing.[11] At a minimum, the data should be available on request to academic and non-profit research institutions seeking to analyze this data.

It is likely that issuers will argue that making these factors, methodologies, and data available to the public will reveal competitive trade secrets. Reasonable accommodations can be made to these and other legitimate concerns.[12] However, potential strategic value will be limited if *all issuers* are required to reveal this information, and if the data requirement is appropriately designed. After all, TILA and the Credit CARD Act themselves require issuers to make data publicly available that has strategic value, such as the terms of issuers' credit card contracts or the APRs that issuers offer. Furthermore, the general price ranges offered to new customers and price changes to existing customers by large issuers are generally known to the competition both through independent vendors of competitive data (such as Mintel Comperemedia and Lightspeed) and through the issuers' own internal competitive analyses. Some information is also available publicly through SEC filings and call reports.

The Board also could make data available in a way that preserves certain strategic value. Issuers need not be required to reveal the full details of how they price for risk. For example, for rate re-evaluations, issuers could be required to provide data by dividing

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[11] We do not purport to describe any particular collection regime in detail in these comments. Including requirements for such data in call reports, for example, may streamline data collection, and the Board may then use the call reports. One of the important lessons to be learned is that effective monitoring requires data collection that keeps up with evolving market practices, *cf* Mark Furletti and Christopher Ody, *Another Look at Credit Card Pricing and Its Disclosure: Is the Semi-Annual Pricing Data Reported by Credit Card Isseurs to the Fed Helpful to Consumers or Researchers?"* Discussion Paper (Payment Cards Center, Federal Reserve Bank of Philadelphia)(July, 2006).

[12] For example, the Board might assign issuers ID numbers and provide some basic issuer characteristics without revealing issuer names. This allows researchers to analyze issuer actions without revealing strategic information regarding a specific issuer. However, when assessing the strategic importance of this information it should be noted that, penalty fees should be at most in place to recover costs and deter behavior—they should not be a strategic advantage in generating revenue.

accounts into ten segments based on risk (without revealing the loss rates or details involved in creating these risk categories publicly) and then provide the distribution of pricing based on these risk categories for both new and existing accounts before and after rate re-evaluation.

To help Congress and the public assess the efficacy of the implementing rules, the Board should issue annual reports based on the collected data. To facilitate accountability for regulators, such a report might break out such data by supervisory regime.

B. Data Collection is Required for Benchmarking, Which is Also Necessary to Assure Compliance.

Public disclosure of information is also critical for benchmarking. The Board in its proposed commentary provides that an issuer does not comply with the requirements for reasonable and proportional penalty fee pricing merely because they are comparable to other issuers' fees amounts.[13] There is a balance which must be struck in the matter of comparability. One the one hand, the jump in penalty fee amounts since fees were deregulated has been marked by "herding" patterns, where major issuers move up in lock-step.[14] However, there is an equal danger in viewing an individual issuer's fee and supporting data in a vacuum. We believe this approach is flawed, and that an appropriate balance can be struck by using valid market-wide data as a benchmark.

Perhaps the most obvious flaw with treating data in isolation is that, even if the issuer's supporting data is free of selective presentation and manipulation, it fosters the anomaly of allowing the *least* efficient operations to charge the highest fees. Further, CRL research has found issuers whose practices are most aggressive (and arguably over-reaching) are correlated with the highest fees. Such institutions are likely to have data to support high fees that match the rest of their profile.[15] And, of course, there is also the likelihood that the data will not be free of selective presentation and manipulation. Therefore, it is vital that each issuer's data be benchmarked against the data presented by other issuers.

[13] Proposed OSC §226.52(b)(1)(i)-1.

[14] *See, e.g* Mark Furletti & Christopher Ody, *Another Look at Credit Card Pricing and Its Disclosure: Is the Semi-Annual Pricing Data Reported by Credit Card Issuers to the Fed Helpful to Consumers or Researchers*?, at 19, 25 (documenting "herding" among larger issuers on late fees.) At least one court has also noted the phenomenon, *cf. Perdue v. Crocker National Bank*, 702 P. 2d 503, 512 (Ca. 1985) ("While it is unlikely that a price set by a freely competitive market would be found unconscionable, the market price set by a oligopoly should not be immune from scrutiny." NSF fees at issue)(Internal citations omitted.)

[15] As we discuss in Section VI-A and Appendix B, below, our review of current late fee practices found that most of the best predictors of high late fees were related to the profile of an issuer engaged in aggressive practices. Certainly we all hope that the CARD Act's impact will be to reduce the overall "aggression index", as it might be termed, in the credit card market. But the CARD Act, of course, did not eliminate all such practices.

While differences in issuer niche can justify some variation in the data, issuers that have unusually high cost schedules or statistical consumer behavior patterns far out of line with other issuers should be red-flagged and the reasonability of their results should be questioned. Likewise, though there are clearly differences in operations that justify some variance, if the top issuers who have aggressively charged the highest penalty fees have costs that seem to be very far out of line with what the largest credit unions show, this again is an indication that more scrutiny is required.

Benchmarking should also include critical evaluation of counter-studies and evidence from third parties that challenge both the claims of costs and the statistical analysis of deterrence. Well-designed outside studies and analysis that challenge industry claims should be given at least equal weight as the industry's own analysis and data presentation in justifying fees. Furthermore, reasonable accommodations should be made to provide data for these third parties since these issuers are providing a useful check on what is reasonable (perhaps requiring issuers who wish to justify their practices by presenting data to make additional data available requested by outside evaluators that the Board considers reasonable and does not create an undue hardship for the issuer).

Adding the requirements for regular submission, outside scrutiny, and benchmarking should result in much more reliable data in support of fees charged. However, it should still be taken into consideration that both accounting and statistical test data present their own challenges. For example, as we discuss in Section III, one highly likely source of accounting data manipulation is discretionary allocation of excessive overhead to penalty fee-related operations. With no auditing requirements, benchmarking or other checks on source data, direct costs may also be over-allocated to the activity.

The burden of supplying the data should not be excessive, since the issuers must have it in any event, and the safe harbor offers an alternative in any event. Furthermore, the data may be useful to address any inherent disadvantage small issuers might have if they wish to use something other than safe harbor or strict cost-based pricing.[16]

III. LIMITATIONS ON NON-SAFE HARBOR PENALTY FEES : PROPOSED SECTION 226.52(b)(1).

A. Background: The Adequacy Of The Proposed Limitations Must Be Evaluated In Light Of The Abuses Targeted By The Card Act.

The backdrop behind the Credit CARD Act's requirement for reasonable and proportional penalty fees is clear. Penalty fees have evolved from being a modest fee to recover costs and to encourage responsible behavior into being a major revenue driver for

[16] We discuss the impact of the rules on small issuers in Section III-D-1. CRL's affiliated retail credit unions offer a credit card program, so we are keenly aware of the costs. However, we also recognize that some issuers who might be considered small issuers are in the "fee-harvester" card business. Therefore, the size factor alone cannot justify exemptions from CARD protections.

many credit card issuers. The role of penalty fees as a revenue source is widely acknowledged.[17] The typical fee amount has increased more than 100% since such fees were functionally deregulated, and such fees amount to some 10% of revenue, as the Board has noted. [18] The penalty fees also became an anti-competitive tool that shifts significant price points to back-end pricing, while advertising on the front-end pricing.[19]

Reliance on penalty fees to increase revenues creates a financial incentive not only to raise fee amounts, but also to encourage the very conduct they claim to want to deter. There are a number of cases where it has been alleged that issuers actively manipulated the situation to facilitate the breach, for example to cause consumers to pay late by shifting due dates, creating times on due dates before the mail typically arrives, locating process centers strategically to maximize mail time, and even holding mail back from processing after it had arrived.[20] (Some of these abuses themselves are targeted for reform by the CARD Act.)

A strong financial interest in causing consumers to violate their account terms has created perverse incentives. Perverse incentives, as we have seen all too clearly, have significant unintended consequences. As a result of the perverse incentives in this market, we've seen unreasonable pricing: amounts disconnected from any rational basis, tricks to generate more such fees, and tactics that led to customer outrage and eventual reform. Therefore, any definition of what is "reasonable and proportional" should be designed to diminish or eliminate such perverse incentives. That was the goal of Section 149, and the proposals must be measured against that goal.

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[17] For example, an article in Cards & Payments, a source of strategic information for industry insiders, acknowledges that the industry is increasingly relying on penalty fees as a primary revenue source (H. Lowe, *Late Fees Take on A Bigger Issuer Role*, Cards & Payments & SourceMedia, Inc., March 1, 2006).

[18] 75 Fed. Reg. at 12338.

[19] *See, e.g.* Joshua M. Frank, *What Does the Credit Card Market Have In Common With a Peacock?* The Lydian Payments Journal 1, 1 24-40 (2009). There is no competition on these fees, and the industry displayed a "herding" behavior as they rose in lock-step. *See, e.g* Mark Furletti & Christopher Ody, *Another Look at Credit Card Pricing and Its Disclosure: Is the Semi-Annual Pricing Data Reported by Credit Card Issuers to the Fed Helpful to Consumers or Researchers*?, at 19, 25 (documenting "herding" among larger issuers on late fees.)

[20] *See, e.g.* Consent Order, *In re* Providian Nat'l Bank, No. 2000-53 (Dep't of the Treasury, Office of the Comptroller of the Currency June 28, 2000), *available at* www.occ.treas.gov/FTP/EAs/ea2000-53.pdf, Lawrence v. Household Bank, 343 F. Supp. 2d 1101 (M.D. Ala. 2004) (9:00 a.m. cut-off for payment posting); Landreneau v. Fleet Fin. Group, 197 F. Supp. 2d 551 (M.D. La. 2002) (9:00 a.m. cut-off for payment posting); Bond v. Fleet Bank, 2002 WL 31500393 (D.R.I. Oct. 10, 2002); Schwartz v. Citibank (S.D.), Nat'l Ass'n, Case No. 00-00078 (JWJX), Clearinghouse No. 53,023 (C.D. Cal. May 5, 2000) (class action settlement notice in case challenging 10:00 a.m. cut-off); Marsh v. First U.S.A. Bank, N.A., C.N. 3-99CV0783-T (N.D. Tex. Apr. 8, 1999). *Cf.* Johnson v. Capital One Bank, 15 Cal. Rptr. 3d 917 (Cal. Ct. App. 2004) (breach of contract claim for failing to promptly post payments; summary judgment granted for defendant on basis that Virginia state law limits defendant's liability to TILA for conduct that could be subject of TIL claim). Miller v. Bank of America, 88 Cal. Rptr.3d 723 (Cal. Ct. App. 2009).
Other cases: *See* Van Slyke v. Capital One Bank, 2007 WL 2874417 (N.D. Cal. Sept. 28, 2007)(alleging that Capital One offered subprime cards with $250 to $300 credit limits, expecting that cardholders would go over-limit on at least one account, allowing lender to charge high fees)

The Board's task is complicated by the fact that data offered by the industry from the past decade and a half will be tainted by these same market perversions, and hence may be misleading. As we discuss in III-B, below, for example, measuring the deterrent value of any particular fee amount will be quite difficult, when many of the issuers adopted practices to increase such revenues. Similarly, a CRL examination of current late fee pricing, including tiered pricing, indicates that they have been designed to exploit market imperfections and failures, rather than any factors related to the now statutorily mandated factors. (See Appendices A and B.)

Given the dominance in the market of such practices over such an extended period, the Board will have a difficult task in separating the wheat from the chaff in the data. The challenges do make three things clear, however: the data submitted now by the industry must be viewed skeptically, more transparency is needed in the future and, as the Board has proposed, periodic re-evaluations are necessary, though they must be more rigorous.[21]

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B. Deterrence Should Not Be Permitted as a Stand-Alone Justification for a Penalty Amount, and The Rules and Commentary Should Provide More Precise Standards on All Factors to Guide Both Issuers and Regulators Evaluating Compliance

The CARD Act lists the factors to be considered in setting the rules for what constitutes "reasonable and proportional" as cumulative: the costs incurred by the issuer as a result of the violation, deterrence, the conduct of the cardholder, ***and*** such other factors as the Board deems appropriate. 15 USC §1664d(c)(emphasis added). Contrary to the explicit statutory language, however, the Board proposes to allow the cost and deterrence factors to be used in the alternative, each as a stand -alone pillar of support. Proposed §226.52(b)(1). (The proposed rule does not offer separate criteria regarding the consumer conduct consideration, other than that which would be subsumed by the cost and deterrence factors, though it seeks comment on whether the proposed safe harbor should permit incremental pricing.[22])

1. Deterrence should not be permitted to be the sole measure for whether the fee is reasonable and proportional. It must be used in combination with the other factors.

We believe that the Board's proposal to allow deterrence alone to be considered as an independent, alternative factor is neither consistent with Congressional intent nor wise. This is particularly important because the measurability of that factor is malleable and there is no objective limiting principal. Presumably in recognition of that fact, the Board has proposed a cap at 100% of the related conduct,[23] which we believe is

[21] See III-B-5.

[22] 75 Fed. Reg. at 12340.

[23] Proposed §226.52(b)(2)(i)(A).

excessive. By allowing deterrence as a stand-alone factor, disconnected from actual costs, the preliminary rules in no way insure that penalty fees are both reasonable *and* proportional, as they must be under the statute.

The Board quite appropriately would require that the deterrent effect of a specific dollar amount be justified.[24] However, it offers no benchmarks to measure the relationship of any dollar amount to any degree of deterrence, apart from the 100% cap. That leaves the door wide open for manipulation and continued excess. For example, if an issuer has data to suggest that imposing a $400 late fee is a deterrent on consumers being a day late on a $400 payment, according to the current rules, this is considered a "reasonable and proportional" penalty. The same logic would also apply for somebody going $400 over their limit.

Some degree of deterrent value may easily be found for any fee increase, particularly not weighted against other factors, such as actual costs. For example, as the Board noted in its supplemental information, Agarwal et al (2008) found that late fees provide a deterrent, though one that exponentially deteriorates over time.[25] Assume hypothetically that the relationship of deterrence to penalty amount shows a similar functional form to the relationship between deterrence and penalty recency, as in that study. In that case, increasing the amount of the penalty rate *always* results in greater deterrence. However the marginal amount of deterrence value per dollar of fee increase gets smaller the higher the fee (see Figure 1). In this case, *any* degree of deterrence may support *any* penalty, short of 100%, even when that marginal deterrence value becomes low. This in no way provides any assurance that fees will be reasonable and proportional by a common sense definition.

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[24] Proposed OSC§226.52(b)(1)(ii)-1

[25]75 Fed Reg. at 12,339. See Agarwal et al., Learning in the Credit Card Market (Feb. 8, 24 2008) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1091623&download=yes).

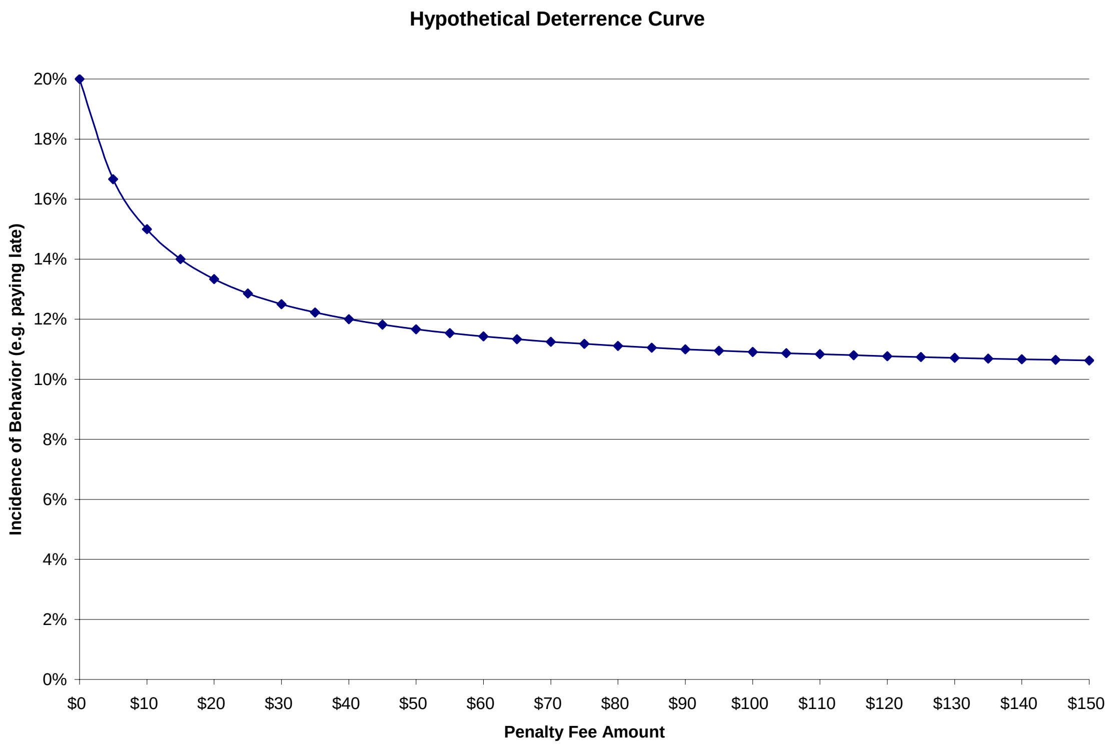

Figure 1: Hypothetical Deterrence Curve

2. Deterrence should only be a factor if issuers actually seek deterrence. Retrospective data regarding deterrent value should be viewed in light of issuers' encouragement of conduct to enhance fee income.

While it is reasonable – and statutorily mandated -- to consider deterrence value as one factor in determining fees, deterrence value should only be relevant for those issuers that have a history of seeking to deter certain behavior. For many large credit card issuers, the evidence suggests that rather than seeking to deter the behaviors in question, the issuers actively sought to create and encourage violations. Therefore, for these same issuers to argue now that they need higher fee levels to provide deterrence is unreasonable. Evidence that deterrence has been an important goal of the issuer should be required for any deterrence-based price justification to be considered acceptable. Both the evidence of deterrence as a goal, as well as data on the effectiveness of a fee as deterrence, should be made publicly available, for the reasons discussed in Section I. Further, claims of deterrence need to be weighed against counter-evidence.

Besides choosing a price structure that appears to minimize deterrence, the correlation with other questionable practices also suggests that issuers with high fees use these fees to seek revenue, not deter behavior.[26] Shifting due dates, unreasonable time cutoffs, dates falling on weekends or holidays, and other tactics (some of which are

[26] *See* Appendix B.

addressed by the Credit CARD Act) to encourage late payment all strongly suggest that deterrence was the furthest things from these issuers' minds. Also revealing of issuer intentions regarding deterrence are the lawsuits and settlements concerning allegations of delaying payments and other manipulations intended to make consumers late.[27] (In fact, the Board should consider banning such manipulations as unfair practices.)

The behavior of the largest issuers also suggests a general strategy of maximizing debt by keeping minimum payments low, as well as by encouraging spending and cash advance check use. Issuers historically have tried to keep balances as high as possible. And while balances far beyond a consumer's limit may be something the issuer wishes to deter from a risk perspective, balances slightly over the stated limit is a behavior that issuers have typically encouraged. Similarly, issuers benefit from balances accruing extra interest because a payment is slightly late. These are opportunities not only for fee income, and potential penalty APRs but also opportunities for issuers to keep a high balance on the books to maximize interest income.

In sum, allowing deterrence-based justifications for fees alone, in the absence of reasonably proportional and objective costs attributable to the violation, encourages the kinds of perverse incentives which created the abuses addressed by the CARD Act. In general, any significant penalty fee that is far out of line with the costs incurred by the issuer should not be considered reasonable or proportional, much less both.

3. The Board must integrate the cost, deterrence, and consumer conduct factors to establish clearer standards for reasonable <u>and</u> proportional.

As a preliminary matter, issuers should be required to disclose the actual cost factors that they are relying upon to justify penalty fees, for the reasons discussed in Section I. They should be required to disclose what they are paying for collection efforts, what they are paying for systems programming, how many violations they are experiencing, and how they calculate the actual per violation cost.

a. The rules and commentary regarding consideration of costs attributable to late payment should be tightened and refined to prevent including improper costs and to encourage appropriate allocation of costs.

The proposed cost factors for late fees are both vague and overbroad. For example, proposed Comment 52(b)(1)(i)-4 would appear to allow 100% of the collection department costs to be paid for out of late fees, notwithstanding the fact that a substantial portion of late payments incur no collection costs at all, and that interest revenue also compensates for delinquencies. (Late payments on interest-bearing debt, after all,

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[27] Supra note **20.** *See also* Press Release, *OCC Requires First Consumers National Bank to Refund Customer Fees* (Dept. of the Treasury, Office of the Comptroller of the Currency August 1, 2003), available at
http://www.occ.treas.gov/toolkit/newsrelease.aspx?Doc=CR79N6BX.xml

generate their own extra compensation to the creditor and impose their own penalty on the consumer in the form of the extra finance charges.[28]) The fundamental purpose of a collections department, of course, is to prevent losses.[29] It is our understanding that with many issuers, typically little or no collection activity takes place in the early stage of a delinquency.

One issuer's experience is illustrative.[30] The majority of delinquencies cure within the first period, and the issuer makes no collection efforts during that period. Only about a third of accounts that become delinquent engender any collection costs. The collection costs, spread across the third of delinquent accounts that require collection efforts, amount to less than $10 per account.

It is likely to be generally the case that a significant portion of accounts cure within one month, while the majority of collection costs are related to accounts more than one month late. The reasonableness and proportionality of the late fees should take into account that the majority of accounts that cure in the first 30 days as well as the portion of collection costs that are devoted to this population. A Commentary illustration could explain that, if only 30% of collections costs are related to accounts less than one month past due, then a cost-based justification for late fees on accounts past due in their first cycle should be limited to: (Collection Costs * 30%/# of accounts past due). This kind of commentary would help add clarity, and reduce the risk of over-allocation. (As we discuss in Appendix A, below, it also would suggest more rational tiered pricing than the market's recent efforts.)

Furthermore, we suggest that the Board add an additional excluded cost[31] -- the costs related to the late fee itself. These costs should be excluded from the costs incurred as a result of late payments, since these are discretionary costs incurred due to the issuer's own policy. For example, consumer concerns over unfairly imposed late fees and requests to reverse these fees are a common cause of customer service calls (sometimes these calls are also routed to collections). These should be excluded from the costs the issuers are allowed to include in their cost accounting. Since the issuers that are most aggressive with penalties are the ones most likely to generate complaint calls, to do otherwise would be to perversely give more leeway to the issuers most likely to be pushing the envelope on compliance.

[28] The interest rate, of course, would also have been set in the first place by considering a variety of factors including risk of loss.

[29] We support the proposed language that prohibits losses, including reserves, from being factored in, proposed OSC §226.52(b)(1)(i)-2, despite the difficulty of separating out the cost of an infrastructure designed to prevent such losses.

[30] CRL consulted a credit union unrelated to Self-Help concerning its experiences.

[31] Losses and associated costs would be excluded costs under the proposal.

b. The proposal regarding costs attributable to over-the-limit fees should be tightened to preclude over-allocation of overhead costs and any allocation of marketing costs.

In defining costs associated with going over-limit, the proposed rule is even more overly broad than the proposal regarding late fees. Proposed Comment 52(b)(1)-6 would allow "costs associated with determining whether to authorize over-the-limit transactions and the costs associated with notifying the consumer that the credit limit has been exceeded and arranging for payments to reduce the balance below the credit limit."

The proposed rule could be interpreted as opening the door for issuers to inappropriately allocate most of the cost of their credit authorization infrastructure through over-limit fees. It is important here to recognize that this infrastructure does not exist primarily to prevent over-limit transactions. This infrastructure would still be necessary for fraud prevention and to verify that a card number is a legitimate account belonging to the issuer, even if a card issuer chooses never to decline a transaction because it goes over the credit limit. Therefore, only incremental costs to the authorization system that would not otherwise exist in the absence of over-limit transactions should be included.

Thus we propose that Comment 52(b)(1)-6.i. state:

i. Costs incurred as a result of over-the-limit transactions. For purposes of § 226.52(b)(1)(i), the costs incurred by a card issuer as a result of over-the-limit transactions include:
A. The incremental costs to the issuer's transaction authorization system that is directly associated with determining whether to authorize over-the-limit transactions; and
B. Costs associated with notifying the consumer that the credit limit has been exceeded and arranging for payments to reduce the balance below the credit limit, but not costs association with collection of over-the-limit fees.

As with late fees, the cost of calls related to over-limit fees from these costs should be excluded. Finally, and critically, there is an additional exclusion that should be explicitly listed for over-the-limit fees – marketing costs. Some issuers are aggressively seeking to market over-limit fees in an effort to get consumers to opt-in to the program. These should be excluded from any costs used to justify a fee level. (In Section IV of these comments we request the Board add a rule to prohibit misleading marketing regarding the opt-in.) Thus we propose that new Comment 52(b)(1)-6.iii. state:

iii. For purposes of § 226.52(b)(1)(i), the costs incurred by a card issuer as a result of over-the-limit transactions does not include any costs of soliciting or otherwise attempting to obtain the consumer's affirmative consent to over-the-limit under § 226.56.

c. The penalty fees used to compare to costs and for other purposes should include indirect penalty fees for the same event.

Many leading issuers eliminate rebate points when a consumer is late. American Express cancels all rewards earned for being late a single time. The rewards can be reinstated for a $29 fee. Discover cancels rewards from being late twice in a row, with no opportunity for reinstatement. Other issuers eliminate reward points for the month when the late fee was incurred. These are all indirect penalty fees and should be included in the penalty fee amount charged by the issuer when determining whether they are justified by costs, exceed the 100% (suggested 50%) threshold or exceed the safe harbor. For example, if the value of rewards lost exceed $29 but the consumer is able to reinstate them for a $29 fee, and the issuer also charges a $20 late fee, then the effective late fee penalty fee is $29 + $20 = $49. Similarly, if a consumer has reward points worth $300 accumulated which are eliminated due to being late with no chance of being reinstated in addition to a regular $20 fee, then the total penalty fee is $320. The same should apply for rewards that are lost for the month when the fee is incurred. While the amount of the reward penalty would be smaller here, it still can be significant. For example, a consumer who charges $3,000 a month and receives a 1% cash reward would lose $30 just from the elimination of that month's reward points. It should also be noted that the issuer typically is earning a higher level of interchange fee income for that month on a rewards card, even if they do not provide the rewards to the consumer.

We recommend an addition to proposed Commentary §226.52(b)-1(i):
(F) The value of any benefits (such as rewards on purchases) that are revoked or reduced as a result of an act or omission that violates the account terms, or any fee or charge to reinstate a revoked or reduced benefit..

4. We do not recommend authorizing tiered and incremental pricing, as there is a record of manipulation to provide a false illusion of proportionality. If it is authorized, the resulting design must still be empirically determined to be reasonable and proportional. The disclosure should be the maximum tier.

The Board solicited comments with respect to penalty pricing regarding both

- "tiering the dollar amount of penalty fees based on the number of times a consumer engages in particular conduct during a specified period" and
- "imposing penalty fees in increments based on the consumer's conduct."

Tiered pricing has become common in recent years. While at first blush, it has a veneer of proportionality, a closer look demonstrates that the tiers were designed not to be reasonable and proportional, but to take advantage of market imperfections and behavorial biases. In fact, they were designed to capture the maximum number of customers at the highest tier. CRL research has documented this 'tier compression," and it is discussed in detail in Appendix A, attached to these comments. (We note that this is an example of the kind of data which should be collected and available for public review for outside experts to review to facilitate compliance with the CARD Act's mandate.)

If tiered and incremental pricing is utilized, it is vital that the total charges remain consistent with what is defined as reasonable and proportional. The specific tiers should be demonstrably related to the permissible factors by empirical evidence. While the disclosure of the "up to" rate should preclude the deceptive advertising of the headline rate (see Appendix A), there should be explicit commentary to assure that the maximum tier is the headline amount disclosed.

One of the specific illustrative example suggested by the Board, in fact, is quite troublesome: "card issuers could be permitted to charge a late payment fee of $5 each day after the payment due date until the required minimum periodic payment is received."[32] The result of such a formula appears to be far outside of the range of what is reasonable or proportional. A cardholder who happens to send their payment one day late over a weekend would be charged $15, while another cardholder that also sends in payment one day late would be charged $5. Even more unreasonable, a cardholder who is two weeks late would receive a $70 late fee. And yet, as we discussed above, it is highly likely that none of those customers would have engendered any collection costs within those time frames. As also mentioned earlier, the accruing interest is also already compensating the issuer for the "detention of money" past the due date.

A more reasonable use of days late would be the following: An issuer typically only makes collection calls after a cardholder is two weeks late. Therefore they set up a tiered system based on the cost of the delinquency to the issuer. If a cardholder is late only 1-13 days, they receive a $3 charge to encourage on-time payment even though the cost to the issuer of the behavior is negligible. If a cardholder is late beyond two weeks, the issuer charges based on the cost of a single collection call they would typically make at this stage of delinquency, which they estimate to be $6 per account.[33]

5. The proposed requirement for reevaluation of penalty fees is appropriate, though the verification process for evaluating compliance is too weak.

We strongly support the proposal to require reevaluation of penalty fees at least annually.[34] This requirement is critical, because pricing on these fees has been an up-only escalator. As we discuss with respect to the interest rate re-evaluation in Section IV-B, the 'stickiness" is at the high end of the range, not the low-end. Further, with penalty fees, there is not even a pretense of competition to work a downward pressure on pricing.

[32] 75 Fed. Reg. at 12340.

[33] As we explained above, one credit union issuer unrelated to CRL's affiliated credit unions has reported to us that their per account collection cost is under $10.

[34] Proposed §226.52(b)(1)(iii).

Consequently, without a set recurring review period, it is inevitable that price reviews would only happen when they would support an upward change, and never a downward change.

However, both initial determinations and subsequent reviews will only be useful if the rules actually do keep the fees within bounds. Both accounting data and statistical data on deterrence can easily be manipulated; rules that are too loose and enforcement that is too lax will result in any price up to the 100% cap making the grade.[35] In addition to tightening the rules and commentary as we've suggested, this issue can be addressed through regular submission of data, public scrutiny and benchmarking, as discussed in Section I.

6. The Board should require issuers to provide data on the penalty fee amounts that they actually charge.

The Board has proposed revising Reg. Z §§ 226.5a(a)(2(iv) and 226.6(b)(1)(i), as well as its Model Forms at G-18 to require disclosure of the maximum safe harbor fee. In addition, revised Reg. Z §§ 226.5a(a)(2(iv) and 226.6(b)(1)(i) will require bolding of the maximum fee for a range of fees.

We are not opposed to these revisions. However, we note that these changes will make it difficult to gather fee information on the amounts issuers are actually charging for penalty fees. As discussed in Section I of these comments, we urge the Board to require issuers to public disclose the dollar amounts of the different types and amounts of penalty fees they have imposed and how many consumers have been subject to such fees. This information will allow research, analysis and public scrutiny of the penalty fee practices of issuers.

7. Penalty rates should also be subject to the rule that penalty fees and charges be reasonable and proportional.

The Board's proposed rule would not subject penalty rates to the rule that penalty fees and charges be reasonable and proportional. It concludes that Congress did not intend to cover penalty rates,[36] although the most than can be said is that the text alone is ambiguous. The text of Section 148 of TILA states:

> The amount of any penalty fee ***or charge*** that a card issuer may impose with respect to a credit card account under an open end consumer credit plan in connection with any omission with respect to, or violation of, the cardholder agreement, including any late payment fee, over-the-limit fee, or any other

[35] See Section III-C**,** below, for our discussion of the 100% cap.

[36] 75 Fed. Reg. at 12340 – 41..

> penalty fee ***or charge***, shall be reasonable and proportional to such omission or violation. (emphasis added)

Thus, the term "charge" could easily refer to a penalty finance charge, *i.e.*, a penalty rate.

That penalty rates themselves were among the abuses about which Congress was concerned, however, is not ambiguous. It is certainly well within the Board's rule-making authority, both under Section 149 and under 15 U.S.C. §1604. The legal analysis supporting this position is spelled out in detail in comments to this proposal submitted by the Pew Charitable Trusts Safe Card Project. We will not repeat them here, but believe that the statutory analysis contained therein supports the Board's authority to capture penalty rates within §226.52(b).

Penalty pricing has been sometimes justified as risk pricing, and sometimes justified as a deterrent, though, as with flat penalty fees, these rationalizations have never been vetted and verified by neutral experts.[37]

As for the deterrent value of a penalty rate, there is no reason to require demonstration of deterrent value for flat penalty fees, while giving it a pass for penalty rates.

The comments submitted to this proposal by the Pew Charitable Trusts Safe Card Project also include a thoughtful and detailed analysis in support of a recommendation for retrospective penalty fees no more than seven percentage points above the base rate. It further recommends that the Board collect information and monitor prospective penalty rate increases, so that it can evaluate whether better regulation of penalty rates are warranted. We support these recommendations.

C. The Proposal To Prohibit Certain Types Of Fees Is Appropriate And Warranted, But The Proposed 100% Cap Must Be Reduced. Proposed §226.52(B)(2)

1. The 100% cap on penalty fees is too high. It should be reduced to the lesser of 50% of the associated violation or $29. §226.52(b)(2)(i)

We strongly agree that there must be a specific top limit on penalty fees, given the malleability of data and the "soft" deterrent standard. Given how both statistical and accounting data is subject both to manipulation and honest differences in interpretation, it is vital that there be a maximum on fees regardless of the evidence presented if those fees

[37] *See,e.g.* Adam J. Levitin, All But Accurate: A Critique of the American Bankers Association Study of Credit Card Regulation (2007.)

are to be considered reasonable and proportional. However, the proposed 100% penalty fee cap is a far too weak check on reasonability.

As a late fee cap, the relationship of a 100% cap to the minimum payment due is skewed at both ends of the spectrum. Most large issuers already have a policy that sets a minimum payment floor of $20, which would serve as the benchmark for both late fees and returned payment fees. Therefore, somebody who has a $25 balance with a $20 minimum payment, could find themselves with a late $20 fee that is considered "reasonable" if it can be justified based on deterrence or cost. This probably would not fall into the range that most people would consider reasonable and proportional Likewise, a $35 over-limit fee on a $10,000 limit account with a balance of $10,035 is also not what most would consider reasonable and proportional.

Furthermore, the 100% cap is another factor subject to manipulation. At a 2% minimum payment, the issuer would not be able to charge their typical maximum fee of $39 unless a cardholder's balance was $1,950 or higher. For a 3.5% minimum payment, the maximum fee could be charged at a balance of $1,114 or higher, which is close to the $1,000 top tier level issuers had a few years ago.[38] But if an issuer wished to maintain their current fee structure, they could do so easily without changing balance tiers. They would merely have to raise their minimum payment floor from $20 to $39, (i.e. the minimum payment is always at least $39 if the balance is at least $39). This would provide cover to continue precisely the same fee structure that the CARD Act was aimed at, providing *post hoc* rationalization to carry on as before, with no impact from reform.

On the other end of the spectrum, the 100% cap could lead to wholly unreasonable results. For example, in some circumstances, the minimum payment may be quite high. A 2% minimum on a $10,000 balance is a $200 payment, yet a $200 late fee meets no common sense definition of reasonableness. Worse yet, on some programs, certain events might trigger the amount due to show up as an entire accelerated balance. The cap must be both lower than 100%, and there must be a firm outside dollar limit.

A maximum of 50% of the violation allows a much more effective and appropriate check on unreasonable and disproportionate penalty amounts. It would be difficult for an issuer to legitimately claim that a fee higher than a 50% penalty is reasonable.

However, we believe there should also be a specific top dollar amount to the recommended 50% cap. It is clear that the language in the Credit CARD Act is intended to rein in penalty fee levels that often are viewed as reasonable rather than allow for an expansion in these fees. Consequently, we urge that the Board set the outside limit for non-safe harbor penalty fees at $29, which represents a 25% decrease from the current standard fee for the biggest issuers.

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[38] A 3.5% minimum payment is the amount required to pay off 1% of the balance per month if the applicable rate were 29.9%.

The Board, of course, has adequate authority to periodically review these limits and make adjustments as economic conditions warrant. (See also I-C, above.)

2. The Board properly prohibited inactivity and declined transaction fees, and should also make clear that fees for TILA disclosures are prohibited -§226.52(b)(2)(ii)

Proposed Reg. Z § 226.52(b)(2)(i)(B) prohibits penalty fees where there is no dollar amount associated with the violation. In particular, this provision prohibits fees for a declined transaction or for account inactivity. We strongly support this proposed provision and urge the Board to adopt it as proposed.

As the Board notes, neither a declined transaction nor account inactivity constitute an extension of credit. The only costs incurred for issuers for both types of conduct are the costs they incur with respect to all accounts. Indeed, the Board noted in its recent Regulation E rulemaking on overdrafts that declined transaction "fees could raise significant fairness issues under the FTC Act, because the institution bears little, if any, risk or cost to decline authorization...." 74 Fed Reg. 59,033, 59,041 (Nov. 17, 2009). Thus, the Board has rightly banned these fees under Section 149 of TILA.

Furthermore, if there are any costs incurred for inactivity or declined transactions, many of them would primarily relate to the cost of programming systems, which as the Board points out, issuers must bear anyway, as they need to have these systems for all accounts. Costs such as programming expenses traditionally have been paid for in calculation of interest. The costs of programming systems, unless specifically and directly tied to a violation, should not be separately paid for by a subset of consumers as a penalty fee.

Finally, we urge the Board to ban one more type of fee – fees for TILA disclosures.[39] Recently, certain card issuers have been imposing a $1 per statement fee for consumers who have declined to consent to electronic delivery of their periodic statements. One such issuer is World Financial Network, which issues card for various retailers.[40]

Issuers should not be permitted to impose a charge for legally mandated disclosures. Issuers are required to send periodic statements under TILA, and have been required to do so since 1968. Sending periodic statements by mail has been a cost of doing business for over four decades, a cost that has been covered by interest, annual fees, and interchange fees.

[39] RESPA bans charges for preparing TIL and RESPA documents on mortgages. 12 U.S.C. §2610.

[40] Jay MacDonald, New credit card fee: Pay $1 to get your monthly statement, CreditCards.Com, Jan. 20, 2010, at http://www.creditcards.com/credit-card-news/dollar-bill-buck-credit-card-fee-paper-monthly-statements-1273.php (visited Mar. 29, 2010).

A fee for declining to consent to electronically delivered statements is an unfair penalty fee. It is a penalty fee in the same way an inactivity fee is a penalty fee. It is a fee based on the consumer's conduct (or lack thereof) – conduct which is perfectly legal and within the consumer's rights. The fee is punitive in nature, despite the fact that the conduct does not technically violate the account agreement. Most importantly, both are fees that should be banned as unfair.

The fee for non-electronic periodic statements is especially punitive for those consumers, most likely low-income, that do not have readily available Internet access. For those consumers, the fee is unavoidable as well.

Thus we propose amending the following sentence to Reg. Z §§ 226.5(a) and 226.17(a) after the first sentence in both of these subsections:

The creditor shall not impose a fee or charge for making such disclosures.

3. The prohibition against multiple fees for the same violation is necessary and welcome, but there should be additional protections against account manipulation. Subsequent fees should not be permitted unless the prior fee has been unpaid for a full billing cycle. §226.52(b)(2)(ii)

We strongly support the goal of prohibiting multiple fees for the same violation. However, we suggest that an additional protection is required in order to prevent manipulation.

In proposed Comment 52(b)(2)(i)-3, the Board has proposed permitting over-the-limit fees to be assessed at any time during the billing cycle. A recent enforcement action by the FDIC against a bank for unfair and deceptive practices regarding over-limit fees illustrates the weakness of this approach, which permits manipulation of dates on which fees are imposed.[41] The bank assessed an over-limit fee on the last day of a billing cycle followed by a second fee one day later on the first day of the next billing cycle. According to an article on the subject, the bank argues that other issuers were engaged in the exact same practice.[42]

The preliminary rules appear to allow such questionable practices as long as the fees are assessed in separate billing cycles. These are unfair practices, and the Board should not encourage them in this rule, as the current draft would. Such abuses can be eliminated by adding a condition that, while issuers can charge for a violation that occurs at any point in the billing cycle, a second fee cannot be assessed unless that violation is still in place a full billing cycle later. In other words, if somebody is assessed a fee for being over their limit on the 20th day of a billing cycle, a fee cannot be assessed in the

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[41] Consent Order and Order to Pay, In the Matter of 1st Financial Bank USA Dakota Dunes, South Dakota, FDIC-09-s07b and FDIC-09-309k (Dept. of Treasury, Federal Deposit Insurance Corp. Dec. 30, 2009

[42] Anna Bahney, "S.D. bank to pay $140,000 penalty," Argus Leader, January 30, 2010.

next billing cycle for the same condition unless they are over their limit on the 20th day or later of the new cycle.

It is also advisable for this rule to extend this concept to the amount of the fee charged. In other words, if the amount of the violation is based on the amount that the consumer is over their limit on the last day of the first cycle, they cannot use the amount of the violation on the first day of the next cycle to base the charge *amount* for an over-limit fee in the next cycle.

D. Special Coverage Issues With Respect to Penalty Pricing

1. Though analyzing the "soft" deterrence-based justification of reasonable prices may be expensive for small issuers, their interests are protected by the safe harbor, and many of them already have cost-based systems in place.

The Board solicited comments on the impact of the proposed rules on small issuers. The proposed rule's reliance on empirical data for both deterrence and cost-based justifications of fees is likely to significantly disadvantage small issuers that wish to set penalty prices above the safe harbor. While very small issuers may have difficulty presenting credible cost accounting data at the level required, credible empirical tests of deterrence will be particularly difficult even for some medium-sized issuers. These issuers therefore may instead be much more likely to limit fees to the safe harbor provision. However, at the same time, these data requirements are generally a very positive step (especially if tightened as described elsewhere in these comments). Therefore, these provisions should not be eliminated.

As discussed elsewhere in these comments, it is recommended that data on costs and deterrence tests be submitted and made publicly available. Besides improving the integrity of these experiments, this can also be used to mitigate the small issuer disadvantage. Issuers below a certain size (perhaps 10,000 cardholders) could be allowed to rely on the more conservative estimates submitted to and found acceptable by the Board in justifying their own fees rather than collecting separate data.

2. Charge cards

Because issuers do not use upfront annual percentage rates to manage risk on charge card accounts, the Board has solicited comments regarding whether any adjustments to proposed § 226.52(b) are necessary to permit charge card issuers to manage risk.

It is important to recognize that by definition, for charge cards the payment due is the full balance. Therefore, even the safe harbor amount of 5% allows charge card issuers to sufficiently price for risk in their card products. In fact, if anything the charge card rules should be *more* restrictive since they can charge the equivalent of a 60% APR (5% x 12) on late balances while still being considered “reasonable.” This 60% rate would fall under the current safe harbor and therefore would not even require cost or deterrence-based analysis to justify the practice. This suggests that charge cards should have tighter provisions limiting late fees and rejected payments then those currently proposed.

IV. FAIR AND REGULAR RE-EVALUATION OF RATE INCREASES: PROPOSED §226.59.

Proposed Reg. Z § 226.59 implements Section 148 of TILA, which provides:

> (a) IN GENERAL.—If a creditor increases the annual percentage rate applicable to a credit card account under an open end consumer credit plan, based on factors including the credit risk of the obligor, market conditions, or other factors, the creditor shall consider changes in such factors in subsequently determining whether to reduce the annual percentage rate for such obligor.
> (b) REQUIREMENTS.—With respect to any credit card account under an open end consumer credit plan, the creditor shall—
> (1) maintain reasonable methodologies for assessing the factors described in subsection (a);
> (2) not less frequently than once every 6 months, review accounts as to which the annual percentage rate has been increased since January 1, 2009, to assess whether such factors have changed (including whether any risk has declined);
> (3) reduce the annual percentage rate previously increased when a reduction is indicated by the review; and
> (4) in the event of an increase in the annual percentage rate, provide in the written notice required under section 127(i) a statement of the reasons for the increase.

This section also requires the Board to issue rules to implement and evaluate compliance with this section.

A. <u>The Proposed Rule Does Not Set Any Standards for Rate Re-Evaluations, Contrary to Congress’s Intent</u>

The Board has failed to require any sort of standards in its proposed rule for issuer rate-setting and rate re-evaluation. The proposed rule is excessively flexible in that it provides little in the way of real checks and balances on issuer practices. The Board has effectively nullified this provision, turning a key protection into a meaningless, and even harmful exercise, as it may encourage consumers to stay with a excessively priced card thinking that they will get a real review in 6 months after their rates have been increased.

The Board explicitly states that it is refusing to either propose a list of particular factors that card issuers must consider, or more importantly, to prohibit the consideration of other factors. As justification for this lack of standards or constraints, the Board states that it “believes that a prescriptive rule that sets forth certain factors or excludes other factors could inadvertently harm consumers, in part by constraining card issuers’ ability to design or utilize new underwriting models and products that could potentially benefit consumers."

We are extremely disappointed in the Board's decision, in essence, to abdicate all responsibility for the factors and methodologies that issuers use in increase rates and re-evaluating them. Section 148(b)(1) of the CARD Act specifically requires issuers to "maintain reasonable methodologies for assessing the factors" used in setting rate increases. Thus, this provision bans "unreasonable" methodologies to set rates, in other words, methodologies that abuse and extract illegitimate rent-seeking revenue from consumers.

It is difficult to see, in light of recent implosion of the mortgage market triggered at least in part by mythological economic modeling, how restricting inappropriate models can harm either consumers or issuers. Also, if there were ever an instance that a particular requirement or prohibition would deter a beneficial new underwriting model, the Board could always amend or modify rules, or permit an exemption.

The requirement to establish reasonable methodologies is a specific directive in the Act, and we hope that the Board does not abdicate its responsibility to assure that the rules accomplish that.

B. History Shows the Importance of Setting Standards for Rate Increases and Re-Evaluations

The Board must limit the factors that issuers may use to set rates because otherwise the natural tendency of issuers is to set rates as much as, or more, for purposes of rent seeking, not risk pricing. An infamous example of this is the "stickiness" of upward market-condition pricing is when credit card rates took years to come down after the double-digit prime rates of the late 1970s and early 1980s. The credit card rates by major card issuers maintained their high 1970s/80s levels until into the early 1990s. It was the last market segment to come down.

The conventional wisdom says "competition" drove rates down, but that doesn't explain why competition worked so much more slowly in the card space than other spaces.[43] Indeed, it was not until members of Congress became vocal about these high rates that they came down. In 1991, credit card rates were similar to 1982 rates. In November 1991, the U.S. Senate voted 74-19 to cap card rates at 14 % (compared to 19.8% rate of major issuers). The threat of regulation eased by spring of 1992; however, one of the Federal Reserve System's own researchers posited a "regulatory threat" hypothesis to very late "unsticking" of credit card rates.[44] In other words, in a market

[43] Mitchell Berlia, Loretta J. Mester, *Credit Card Rates and Consumer Search*, Review of Financial Economics 13, 179–198, (2004) ("Since there are numerous issuers of credit cards, one might expect pricing to be competitive. Yet the slow response of credit card rates to changes in money market rates is consistent with imperfect competition").

[44] Victor Stango, *Strategic Responses to Regulatory Threat in the Credit Card Market*, Federal Reserve Bank of Chicago, WP 2002-02, February 2002.

where competition doesn't work well, something else has to make rates come unstuck. Congress has determined that "something else" is new Section 148 of TILA.

Another example of abusive and rent-seeking rate increases is much more recent. The arbitrary rate increases experienced by consumers in late 2008 and 2009 were unprecedented both in scope and magnitude. According to survey data from CardBeat, as of June 2009, 52% of consumers had experience a rate increase on their credit card, with 73% of these rate increases occurring in the last 12 months.[45] Since numerous rate increases have been implemented in the second half of 2009 between passage and implementation of the Credit CARD Act, the percentage of cardholders who have had a recent rate increase is probably much higher when this time period is included.

Often these increases were quite substantial, such as raising a consumer APR from the low teens to 29.9%. Sometimes these rate increases used justifications that held little substance or cited general economic conditions. Since operating costs and funding costs had not increased substantially, presumably the general economic conditions must have been related to rising loss levels due to deteriorating economic conditions (the irony of course is that the deteriorating economic conditions were caused by poor lending practices).

Thus, many suspect the true reason for these dramatic and widespread rate increases was simply so that issuers could extract one last round of extra revenue from consumers prior to the effective date of the Credit CARD Act. By raising rates, including on existing balances, issuers got their "last licks" and preserved their right to charge high penalty rate-level APRs on existing accounts.

C. The Board Must Require the Use of Legitimate Factors in Setting and Re-Evaluating Rates, and Ban Illegitimate Factors. Further, program increases and individual account increases are very different, and should have independent guidance in the rule and commentary.

In order to ensure that issuers use "reasonable methodologies" in re-evaluating an account, the Board must consider what factors and data issuers can legitimately use to develop appropriate systems. First and foremost, as discussed in Section I of these comments, the factors used by an issuer should be documented in writing and available to the public. Second, rate increases on individual accounts involve different processes and considerations than program-wide rate increases. The rules on re-evaluation must consider each kind of increase distinctly. Finally, and most critically for the reasons

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[45] Cardbeat, Auriemma Consulting Group, Vol. 15 Issue 6. *See also* H.R. 2382, the Credit Card Interchange Fees Act of 2009 and H.R. 3639, the Expedited CARD Reform for Consumers Act of 2009, Hearing Before the House Financial Services Cmte (October 8, 2009) (Testimony of Nick Bourke and Ruth Susswein).

discussed in Section II above, issuers must be required to publicly disclose these factors and the relationships between the factors and credit card pricing.

1. Market Condition Re-evaluation Limits

For market-condition re-evaluation, legitimate factors include:

- Cost of funds but only to the extent not reflected by a variable rate.
- The issuer's loss rates for that particular card product.

On the other hand, illegitimate factors that should be prohibited for market condition re-evaluation include:

- The issuer's loss rates for other card products or product lines, such as mortgages or auto loans.
- Maximizing revenue.
    - The Board must be able to set the requirements for "reasonable methodologies" that can counter the dynamic of "stickiness." Such requirements should considering factors such as the spread between prime rates and issuers' rates, and whether issuers' returns are indicative of rent-seeking.[46]
- The issuer's inability (due to Credit CARD Act restrictions) to charge higher fees or higher rates on existing balances.
    - The Board must ensure that the limits on penalty fees or retroactive rate increases do not become a basis for prospective rate increases by issuers. In the 1990s, after issuers were forced to keep upfront rates visible, and thus re-pricing was limited, they began to get imaginative in order to keep the same level of revenue. They began charging more back-end fees, aided in great part by the *Smiley* decision. This substitution of fee income for interest income, for reasons unrelated to the cost of either, is responsible for the significant run-up in fees. Conversely, the new limits on penalty fees may put downward pressure on revenues, and issuers may raise rates to compensate to keep up a rent-seeking level of revenue. However, the desire to keep revenues just as high in the face of the new limits on penalty fees is not a legitimate factor for raising rates.

2. Individualized Re-evaluation Limits

For individualized risk-based re-evaluation, legitimate factors include:

[46] On the general idea that the market is not competitive, and there are economic "rents," see Lawrence M. Ausubel , *The Failure of Competition in the Credit Card Market*, The American Economic Review, Vol. 81, No. 1, at 50-81, (Mar. 1991) and Joshua M. Frank, *What Does the Credit Card Market Have In Common with a Peacock?*, Lydian Payments Journal, Vol 1, No. 1, at 24-40, (Nov. 2009).

- Specific, empirically tested risk factors indicative of the cardholder's ability to repay.

On the other hand, illegitimate factors that should be prohibited for individual risk-based re-evaluation include:

- Any factor that measures price (in)sensitivity as much as risk -- or more than risk -- should not be used even if it is correlated with risk.
- Any individual purchase information that is correlated with protected class status.

An issue that arises for individualized re-pricing based on supposed "risk" assessment is that, in the credit card context, individual rate increases seem not to have actually been based on true risk. Rather, "risk" appears to have been the rationalization for the rising penalty rates.[47] We also note the example of a card issuer that recently raised the baseline rate to penalty-rate levels, then offered "rewards" for timely payment to reduce the rate. This appears to be a blatant effort to avoid the mandatory right-to-cure requirement of §226.55(b), and move the individual account holder into the §226.59 bucket, which deprives the consumer of the right-to-cure and gives the issuer discretion. This example highlights again the need for a general anti-evasion rule, which we again urge the Board to consider. But at the very least, regulatory compliance standards under this section must be rigorous enough to prevent such blatant dodges.

Thus, the "reasonable methodologies" must include developing a logical and transparent relationship between individual risk and the pricing of accounts. If issuers claim to price for risk, then there logically must be more than two buckets of pricing in order to permit downward as well as upward pricing after the statutorily required sixth month rate re-evaluation. Otherwise, if issuers only have "premium" and "non-premium" (*i.e.* penalty) APR, it will be too easy for issuers to claim that a consumer does not have the super-prime credit score necessary for the "premium" APR.

3. Issuers Should be Required to Use Empirically Derived, Demonstrably and Statistically Sound Relationships

In addition to limiting the factors that issuers use when re-evaluating accounts, the Board must require that the factors relate to the pricing based upon an "empirically derived, demonstrably and statistically sound" relationship. This relationship should be specific (such as an assignment of points or values), documented, and available to the public. Data used to develop the system should be based on a large sample – at least the issuer's entire cardholder population for a particular card product, or a reasonable sample thereof. Both the relationship and the data used to develop the system should be disclosed or available to the public, for the reasons discussed in Section I above.

We are disappointed that the Board has not required issuers to use "empirically derived, demonstrably and statistically sound" systems when setting and re-evaluating

[47] See note 37, supra. If the industry disputes such analysis, that simply highlights the need for transparency in data in order to implement these provision**s,** as we discuss in Section II.

rate increases. The Board has permitted issuers to use such systems elsewhere in its Credit CARD rulemaking, such as determining income for the ability to pay analysis under Reg. Z § 226.51(a). Such a standard is particularly important if the system purports to be a “risk-based” system, given how much cover to exploitive practices that label has offered in recent years. If the Board is to be perceived as a fair arbiter, such standards should be applied when called for.

D. <u>In Conducting a Six-Month Rate Re-Evaluation, Issuers Should Use Either the Factors Used When the Rate was Increased, or Its Current Pricing Factors in Order to Avoid Manipulating Results</u>[48]

Proposed Reg. Z § 226.59(d) states that a card issuer is not required to use the same factors in its rate re-evaluations as the factors on which a rate increase was based. Instead, the issuer may use the factors that it currently considers when determining whether to increase an APR for its accounts.

We strongly oppose this proposed provision as written, as it opens the door to manipulation. Congress expected that a consumer who has been subject to a rate increase from 11.99% to 29.99% due increased losses would have the APR reduced when losses return to a normal level. This was the intent of the law, and excessive vagueness in issuer requirements in reviewing pricing does little to enforce this intent. Instead, it allows cherry-picking, and only serves to require issuers to stand ready to offer some type of justification for their actions, however flimsy that justification may be.[49]

The Board’s example is one that, itself, is not objectionable. It suggests that if the issuer has changed its approach, it can evaluate old accounts consistently with the way it evaluates new applicants. The problem is that there is nothing in the rule or commentary which limits the discretion to mix and match, and cherry-pick which factors to use to achieve the result desired. Without such ground-rules, that, of course, can easily make a mockery of the Act

As with the lack of standards discussed above, giving issuers the ability to use different factors without limitation when re-evaluating rate increases permits gouging. For example, consider a consumer whose rate is raised from 11.99% to 29.99% due to lack of liquidity in the credit markets making securitization difficult. When liquidity returns to a more normal level, the Board’s proposal would permit issuers to keep that

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[48] Three of the signatories to these comments, the National Consumer Law Center (on behalf of its low-income clients), Consumer Action and USPIRG, believe that issuers should not be permitted to use a different set of factors when conducting a six-month rate re-evaluation, even if those factors are the issuer’s current set of factors for card rates. Congress clearly intended in Section 148(a) to require issuers to use the same factors when re-evaluating a rate increase that the issuers relied upon when they first instituted the rate increase. Without such a requirement, there is too great a risk that issuers would use outlier or “once in a lifetime” type of factors to raise rates, such as has happened in the past two years, but those factors would disappear in rate-setting when "things return to normal".

consumer's rate at 29.99%, because the issuer could change its factors to exclude consideration of lack of liquidity as a factor.

The Board's proposal to allow issuers to use different factors for re-evaluation provides even more ability for issuers to profit from increasing rates for illegitimate reasons, such as making up losses from mortgage portfolios or the enormous rate increases in 2009 slipped in at the last minute before the Credit CARD Act's effective date. Under the Board's proposal, issuers will never be required to return rates to their previous levels, because issuers will not be required to consider the absence of those illegitimate factors when they do not exist six months later.

The Board justifies its decision to permit issuers to use different factors for rate re-evaluations by stating its belief that "competition for new consumers is an incentive that may lead an issuer to lower its rates, and if the rates on existing consumers' accounts are assessed using the same factors used for new consumers, existing customers of a card issuer may also benefit from competition in the market." 75 Fed. Reg. at 12,350.

After a decade and a half of well-documented egregious credit card abuses, the real-world lesson is that competition has absolutely no preventative effect against issuer tricks and traps.[50] This is especially true for changes on existing rates. The reason issuers have relied on unsustainably low promotional rates followed by back-end rate increases is that consumers are known by issuers to be much less sensitive to rate increases after they already have established an account. In fact, most consumers historically were not even aware that they were shifted to a penalty rate.[51] While the notification provisions implemented August 2009 will improve this, it is still likely that many consumers will miss notification of a price increase on an existing account or simply remain less sensitive to it due to behavioral biases. If competition had the ability to prevent unjustified rate increases, Congress would have never been compelled to enact the Credit CARD Act.

To avoid easy evasion of this loophole, we recommend that §226.59(d) delete the first sentence of the proposed rule. By deleting the sentence that grants unlimited discretion, while specifying that the issuer can apply the same standards it uses for new accounts, the issuer has flexibility to respond to changing market conditions without being able to manipulate the factors for the re-evaluation portfolio.

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E. The Board Must Establish a Vigorous Compliance Mechanism

[50] Joshua M. Frank. *Why Free Markets Can Sometimes Turn into "Peacock Markets": The Evolution of Credit Cards*, Journal of Economic Issues, Vol 44, No. 1, (June 2010).
[51] Joshua M. Frank, *Priceless or Just Expensive? The Use of Penalty Rates in the Credit Card Industry*, Center for Responsible Lending (December 16, 2008), available at: http://www.responsiblelending.org/credit-cards/research-analysis/priceless-or-just-expensive-the-use-of-penalty-rates-in-the-credit-card-industry.html.

In addition to the need for some standards for rate re-evaluations, the Board needs to establish measures to ensure that issuers actually comply with the standards and conduct re-evaluations as required by the rule. A vigorous compliance mechanism is needed to ensure that rate re-evaluations are serious and substantial rather than *pro forma* or simply ignored. As we noted earlier, this is necessary as much for regulators who will be responsible for enforcement as for issuers.

For example, if a consumer's rate is raised from 11.99% to 29.99% due to rising charge-offs, the consumer's rate should return to a rate reasonably close to what they had before the rise in charge-offs. If an issuer is to argue that it conducted a reasonable re-evaluation that left the consumer at or near 29.99%, the issuer should be required to present compelling evidence that its decision was reasonable and justifiable based on current conditions. The same would apply for a rate increase driven by rising cost of funds or due to the individual's risk profile. Issuers should be held to a higher standard of proof under these circumstances.

Furthermore, if the consumer is not satisfied with the issuer's justification, the issuer should be required to reconsider its decision if the consumer sends a notice disputing the failure to reduce the rate. This reconsideration should be handled similar to an appeal, by an employee of the issuer (not just a computerized review) in a different department.

F. The Board Must Require Stronger Criteria for Re-evaluation of Accounts from Before February 22, 2010, and Must Require that these Re-Evaluations Be Conducted Immediately

The Board should establish more stringent criteria for re-evaluation of accounts for which rates were increased prior to February 22, 2010. The Board should also require that these re-evaluations be conducted immediately.

The Board has justified some of its proposals based on its observation that cardholders who are unhappy with their rate increases have the option to stop borrowing additional money on their credit cards. While we do not agree with that reasoning, it is completely inapplicable to the very widespread number of large rate increases between January 1, 2009 (the start of the window subject to re-evaluation) and February 22, 2010. These accounts, which typically had their rate increased on existing balances, should be subject to stronger re-evaluation criteria. Many of these rates were also changed before August 22, 2009, and therefore did not have the protections of a right to cancel or a 45 day notice.

It should also be noted that many of these rate changes are perceived by the public (probably rightly) to be an attempt to circumvent the Credit CARD Act's prohibitions on rate increases on existing balances. This fact lends further support to the recommendation that these rate changes be subject to especially strong scrutiny and additional requirements.

Such stronger re-evaluation criteria should include a presumption that for rate increases based on economic or market conditions, such rates will be reduced unless issuers can show that the same economic conditions hold true. In other words, for pre-February 22, 2010 rate increases, the burden of proof should be on the issuer to show that a rate decrease is NOT justified. Likewise, accounts for which the APR on existing balances were increased due to individual risk profile should be returned to their original rate if the consumer's credit score exceeds a certain amount. Other rate increases pre-February 22 for which the basis is too vague to be determined should be assumed to be due to general economic conditions (*i.e.* rising credit losses) and subject to the same presumption once losses abate.

Finally, we strongly object to the Board's proposed Comment 59(c)-3, which permits issuers to delay their re-evaluations of any rate increases between January 2009 and February 2010 until February 22, 2011. This delay has no justification. Issuers simply do not need another 11 months (from the writing of these comments) to institute rate re-evaluations. Every large issuer likely already has risk and profitability scores (that account for costs) in place for every account on their books. In fact, it is likely that pricing of accounts is already reviewed on an ongoing basis for price *increases* on all accounts, therefore there is no reason issuers should not be already prepared to review accounts for a price decrease. This requirement was enacted in May of 2009. Banks have known about it for nearly a year. These requirements are already too weak. Issuers should be required to conduct rate re-evaluations for rate increases pre-February 22 as soon as the regulations go into effect in August of this year.

G. The Board Should Not Allow An Exception for Acquired Accounts

Proposed § 226.59(g)(2) creates an exception for acquired accounts, permitting the acquiring issuer to review all of the credit card accounts it acquires, as soon as "reasonably practicable" using the factors it currently uses in determining rates. There appears to be no compelling reason for this exception. The purchase and sale of acquired accounts is extremely common. This exception has the potential to eventually exclude a large portion of credit card accounts from the protections intended by Section 148 of the Credit CARD Act.

Furthermore, information systems for credit card accounts are very sophisticated. There is absolutely no reason why the recent history of account rate increases would not be available for any large portfolio of accounts. This is especially true since the re-evaluation requirement only holds for rate increases made in 2009 or later. By this date, issuers were already aware that rules were changing regarding what rate increases could be made to existing balance, that future legal changes were likely to occur, and that any price increases they made might be subject to scrutiny. We find it hard to believe that any medium or large issuer would not retain data on rate increases from January 2009 onward, unless the choice was intentional. It should also be noted that issuers can price for the absence of this information and the resulting administrative burden, should they choose to purchase a portfolio that lacked this information.

Finally, retention of price change information should be encouraged rather than excused. Allowing an exception for acquired accounts creates the wrong incentives. If there is any missing data for prior periods, there is still no reason why after August 2010 that issuers cannot make sure to retain such information in their records in the event of future sales or acquisitions.

H. The Board Should Not Allow Issuers to Cease Rate Re-evaluations After Five Years

The Board has solicited comments on a proposal to permit issuers to cease engaging in rate re-evaluations after five years. We strongly oppose this proposal. There is simply no basis in the statutory language, or any practical reason, to allow issuers off the hook after five years.

Simply put, economic conditions do not always end in five years. For example, consider what would happen if we experienced a repeat of the 1980's interest rate environment. An issuer would raise interest rates on their cardholders and justify the increase due to rising cost of funds. However, if the interest rate environment is similar to the 1980's, the elevated cost of funds can last for over five years. And, as we saw then, too, the rates can stick to a high point for more than five years even if the cost of funds decline: "Sticking high" lasts longer than "sticking low." (See Section III-A, above.) These consumers deserve the right to have their account re-evaluated when those conditions change. This was clearly the intent of Congress in passing the Credit CARD Act.

As for individual risk pricing, certainly consumers do not stop experiencing changes in their individual credit profiles after five years. After all, adverse credit information remains in a consumer's credit history for up to seven years, as permitted by the Fair Credit Reporting Act. A consumer who experiences a significant adverse event, such as a period of unemployment causing missed bills, should be entitled under the Credit CARD Act to a review of his or her interest rate increases once the statutory seven years has passed.

I. The Board Should Require Disclosure of The Specific Reasons for a Rate Increase Comparable to Disclosure Under Other Federal Laws

The Board has proposed revisions to Reg. Z § 226.9(c)(2) and (g) to implement the requirements of Section 148(b)(4) of TILA. That subsection requires issuers to include a statement of the reasons for a rate increase in the 45 day notices required under Reg. Z § 226.9(c)(or (g). Unfortunately, the proposed rule, at OSC §226.9(c)(2)(iv)-11 and 9(g)-7, permit issuers to provide extremely vague and non-specific reasons to explain a rate increase, such as "a decline in creditworthiness" or "a change in market conditions" These types of reasons are so vague as to be meaningless, providing no useful information to consumers.

We are perplexed as to why the Board chose to permit issuers to provide such vague and meaningless reasons, when issuers can easily provide more meaningful information. After all, issuers are already required to provide specific reasons when they take an adverse action under other federal laws, such as the Fair Credit Reporting Act and Equal Credit Opportunity Act. In fact, for individual risk-based pricing, issuers can simply use the "reason codes" supplied by the credit reporting agencies and scoring providers that are already used for FCRA and ECOA notices. The Board should require a standard under TILA that is at least as specific as that under the FCRA and ECOA.

J. Retroactive Rate Increases Should be Subject to Re-Evaluation If the Consumer Does Not Qualify for a Rate Reduction for Six Months of On-Time Payment

In Proposed Reg. Z § 226.59(e), the Board has exempted issuers from conducting a rate re-evaluation for accounts subjected to a retroactive rate increase under Reg. Z § 226.55(b)(4) during the six month period after the effective date of the increase. During that time, the consumer must make six months worth of on-time payments in order to qualify for a reduction to his or her former rate. However, the Board has also proposed that, if the consumer fails to make six months of on-time payments, then the rate re-evaluation required by Reg. Z § 226.59(a) must occur during the second six month period.

We support this proposed provision. Making six months of on-time payments may be a difficult task for a financially distressed consumer who is over 60 days late. Furthermore, that first minimum payment required after the rate increase goes into effect will be large, since it will be three months worth of minimum payments (the two missed payments plus the current month's payment, plus late fees). There may be many consumers who cannot make six months of on-time payments, but will eventually recover financially and be less risky. (For example, this recession has seen an uptick in unemployment lasting longer than six months.[52]) It is only fair that that consumer receive the statutorily-mandated re-evaluation, especially since that right is ongoing, and applies much later than that first six months of the "cure" period.

V. THE BOARD SHOULD PROHIBIT DECEPTIVE OR MISLEADING STATEMENTS IN SOLICITATIONS FOR OVER-THE-LIMIT OPT-INS

The Board has proposed amending Reg. Z, § 226.56(e)(1)(i) to revise the disclosure of over-the-limit fees. The Board is proposing to allow disclosure of the maximum amount of the fee, based upon the proposed Reg. Z § 226.52(b) protections. We do not oppose this revision to the over-the-limit fee disclosure. We would like to take this opportunity to raise another issue with respect to the disclosure of over-the-limit fees – the need for the Board to prohibit deceptive or misleading statements in solicitations to seeking consumer consent, or opt-in, for over-the-limit coverage.

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[52] Bureau of Labor Statistics, Current Population Survey at http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000

Issuers have been engaged in aggressive tactics to solicit the consent, or opt-in, of consumers for over-the-limit transaction coverage. In particular, one issuer has reportedly called consumers offering to lower the amount of the over-the-limit fee for opting in (but failing to tell the consumer that declining to opt in means no over-the-limit fee can be charged)[53] and suggesting to consumers they should opt-in in case of an emergency. One consumer described a call from this issuer as such:

> The phone call I received from one credit card company made it sound like they would decline the purchase that put me even $1 over my limit unless I decided to "opt-in". I was led to believe I would need to "opt-in" should an emergency arise and I must temporarily go over my credit card limit. But if I want to have the ability to go over my limit and "opt-in" an over limit charge would be approved but, of course, would have that over limit fee charge. "No change to your account provisions Ma'am." So what's the harm?"[54]

Another consumer describes how:

> However, they wanted to graciously offer me the ability to "opt-in" to keep this "over the limit" option available "in case of emergencies" and as part of this offer and option, they will lower the over the limit fee from $39 to $29. She explained this was to protect me in the event of an emergency that I needed to access my card for amounts above my limit, and I would "enjoy a reduced over the limit fee."[55]

One reason that issuers might be able to convince consumers to opt in to over-the-limit transaction coverage is that issuers are not required to disclose that the cost of declining to opt-in is "$0." Thus, the Board should include a disclosure in Model Form G-25 that if the consumer declines to opt-in, the cost of doing so is "$0." Consumers must be given information about the comparative costs of opting in versus declining in order to make a truly informed and meaningful choice.

The statements above verge on being deceptive, or at least misleading.[56] The Board should not permit any statements that deceive a consumer, create a misleading

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[53] Ben Popken, Capital One: Waive Your Rights, Get $10 Off Your Next Overlimit Fee!, Consumerist.com, Nov. 2, 2009, at http://consumerist.com/2009/11/capital-one-waive-your-rights-get-10-off-your-next-overlimit-fee.html (visited Mar. 29, 2010).

[54] Should I "Opt-In" or "Opt-Out"?, Dec. 23, 2009, at http://messageboards.ivillage.com/n/mb/message.asp?webtag=iv-mldebtqa&msg=7854.1 (visited Mar. 29, 2010).

[55] Anyone else get a call from Capital One for "voluntary opt-in" to OL fees?, FicoForums, October 23, 2009, at http://ficoforums.myfico.com/t5/forums/forumtopicprintpage/board-id/creditcard/message-id/189210/print-single-message/false/page/1 (visited Mar. 29, 2010). See also http://800notes.com/Phone.aspx/1-866-536-9022/4 (visited Mar. 29, 2010).

[56] A related problem is that issuers are inaccurately blaming the CARD Act for their actions—both with over-limit fees and other things. For example, we have been informed that issuers have been telling consumers that they are going to lose the credit line they have for emergencies now due to the CARD Act

impression, or implicitly contradict Regulation Z or the information in the Model Form G-25. We urge the Board to add a provision to Reg. Z §226.56 (j) prohibiting such statements.

> *New 226.56(j)(5)* ***Deceptive, misleading or contradictory statements prohibited****. An issuer shall not make any written or oral statement that is deceptive or creates a misleading impression regarding its over-the-limit coverage, including any written or oral statements contradicting any of the protections of this section or any of the information required to be disclosed under this section.*

Finally, we recommend that the model form require disclosure of the minimum amount of an over-the-limit transaction that would trigger a fee. This is a critical piece of information for consumers deciding whether to opt in. We note that in the context of fee-based overdraft coverage, participants reacted strongly to this information in the Board's consumer testing—they "reacted negatively" and found the practice "unfair."[57] This disclosure is especially important because of the attempts by issuers to play on the fears of consumers of declined credit card transactions in case of an "emergency." Such statements make consumers focus on over-the-limit amounts that are significant and for important purchases. In contrast, this statement reminds them that they will be charged fees for extremely small amounts over their limits, potentially for trivial purchases.

Finally, if issuers are promoting over-the-limit coverage as emergency coverage, should they be required to state (if applicable) that they still retain complete discretion to decline any charge, that large charges may be declined, and that the consumer is not getting a fixed amount of additional line.

VI. TECHNICAL ISSUES REGARDING THE REASONABLE AND PROPORTIONAL PENALTY FEE RULE.

A. The Board's Decision to Disallow Risk as a Pricing Component was Proper, and Should be Reflected in the Final Rule.

The Board's proposed rule regarding calculation of reasonable and proportional penalty fees does not include risk calculations, a decision we strongly support. We agree that the statutory language actually mandates this result. Section 149(a) requires that the fee or charge be reasonable and proportional to the omission or violation. That is a transactional standards, not a statistical correlation standards.

The Board nevertheless requested comment on that decision. We believe it was the right one, and urge the Board to reflect that position in the final rule. Even if the

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unless they opt-in. Another example is an issuer that told a consumer that the CARD Act prohibits fixed rates.

[57] *Review and Testing of Overdraft Notices* at iii and 7, Macro International (Dec. 8, 2008).

Board had discretion under the statute to allow it, we believe not only sound policy, but empirical evidence supports the decision that losses and late fees have not been correlated in the past. Given the clear intent to rein in penalty pricing, there is even less reason to start linking them now.

First, risk is a factor in setting interest rates at the outset. Upfront, transparent pricing that captures basic business considerations like cost of funds, overhead, infrastructure, and risk is how competition is supposed to work to favor efficient providers who do well for shareholders by serving their customers well. That's the theory. But the credit card market is a perfect example of an imperfect market where pricing is non-transparent and non-competitive.[58] The Board can help foster a truly competitive, efficient credit card market, as Section 148 was intended to do, by assuring that risk considerations are in the rate.

It is also appropriate to exclude risk to avoid the perpetuation of another market perversion of the recent past. Over the course of the past two decades, "risk-based pricing" has served more as an excuse for abuse than a meritorious explanation for market practices run amuck. Penalty fees are not an appropriate method of compensating for risk because they are subject to the forms of abuse that made this part of the Credit CARD Act necessary, and because (as one-time fees that are difficult to scale to the true risk level) they are poorly designed to price for risk. Pricing for risk with penalty fees also circumvents the clear intent of the law, since it makes almost any price justifiable.

Finally, our evidence suggests that issuers have not historically used fee amounts to compensate for risk. It is clear that the structure of penalty fees within a typical issuer's pricing does not vary based on risk. There is instead evidence that the prevailing tiered fee structure in place by large issuers is intended to create an illusion of low and proportional fees while instead allowing for hidden price increases.[59]

There has been little research in general regarding penalty fees in credit cards. Massoud, Sanders, and Scholnick conducted the only known prior study examining the relationship between penalty fees and risk across issuers.[60] Their study did find that market share in part drove prices in that market dominance correlated with higher prices. However, the study found evidence that penalty fees are positively related to consumer default risk, a finding that, as the authors state, "supports the position of defenders of

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[58] *See* note 19, supra.

[59] See separate analysis of tiered fees within this comment, Section III-B-4 and Appendix A.

[60] Nadia Massoud, Anthony Saunders, Barry Scholnick, *The Cost of Being Late: The Case of Credit Card Penalty Fees*, 32-33 (October, 2006), http://www.newyorkfed.org/research/conference/2006/Econ_Payments/Massoud_Saunders_Scholnick.pdf .

penalty fees such as banks. But it did not explore other reasonably likely alternative reasons why higher risk issuers will have higher penalty fees:[61]

1) *Issuer Aggressiveness:* If certain issuers are "aggressive" in their revenue seeking practices while other issuers "conservative," aggressive issuers will tend to have high fees in general as well as aggressive practices regarding market expansion, leading to higher risk for aggressive issuers as well as high fees, with no direct causation between the two.
2) *Issuer Profile:* If certain issuer types tend to have high losses as well as high fees, then the two will be correlated despite a lack of causation. For example, assume there are three types of issuers: 1) Issuers that consider credit cards a primary revenue source and solicit consumers outside of their normal customers, 2) Regional and other issuers that issue credit cards primarily within the context of a larger customer relationship and do not consider it the primary profit driver, 3) Credit Unions that are likely similar to the second group. It is likely that the first group will have the highest penalty fees since their goal is to maximize credit card revenue, while the other two groups may be more concerned with maintaining customer good will. Separately, groups two and three will likely have a lower loss rate due to their ongoing relationship with their customer base.

To the extent that penalty fees move with losses, if this relationship is due to issuer aggressiveness or issuer profile, then the fee levels are not in fact compensation for risk. Instead, fee levels are driven by other factors. In fact, if issuer aggressiveness is measured by potentially exploitative practices in general, then a positive relationship might be evidence that penalty fee pricing is instead driven by a desire among aggressive issuers to raise revenue through back-end pricing rather than to price in a clear, up-front manner.

CRL tested whether any correlation between losses and late fees is due to outside factors or whether alternatively the two are causally related. Details regarding the analysis are contained in Appendix B to these comments. To cut to the chase, of 29 possible explanatory variables examined, credit losses had the *second lowest* correlation with the level of late fees (see Table 1).

Table 1: Factors correlated with late fee levels

[61] An additional cause of possible correlation that is not addressed here is that causation may be the reverse of what Massoud et al implies. In other words, instead of high prices being a result of high losses, high prices *cause* high losses.

Rank (most to least predictive)	Type of issuer--factors related to **Lower** fees	Type of issuer--factors related to **Higher** fees	Consumer-Friendly pricing--factors related to **Lower** fees	Deceptive/Aggressive pricing--factors related to **Higher** fees	Other Aggressiveness measures related to **Higher** fees
1	Issuer is a credit union				
2				Cash/Purchase APR spread	
3				Cash advance fee amount	
4				Minimum Finance Charge Amount	
5				Cash advance floor amount	
6				Penalty/Regular APR spread	
7				Whether issuer uses a penalty APR	
8				Hairline trigger for penalty APR	
9				International transaction fee amount	
10				Teaser/Regular APR spread	
11			Ceiling on cash advance fee		
12				Penalty rate cure is "hard"	
13		Issuer is a credit card bank			
14				Issuer utilizes "pick-a-rate"	
15			Extra time allowed before late fee		
16					Cash advance check mail volume
17				International fee includes dollar transactions	
18				Teaser is short	
19		Percent of Loans Securitized			
20		Issuer Size			
21					Recoveries as percent of losses
22					BBB Complaints
23					Issuer growth rate
24					Solicitation mail volume
25				Sells fee-based add-ons in offer	
26		Card loans/total loans			
27		Net Losses			
28			Longer grace period		

The single best predictor of late fee amounts was whether the issuer was a credit union, with credit unions charging lower fees than other issuers. A number of practices were also highly predictive of late fee charges. While it could be argued that a few (such as the cash/purchase APR spread) are somehow linked to risk, others that are significantly linked to loss pricing, such as the minimum finance charge amounts, international fee levels, and the use of the "pick-a-rate" practice, clearly have nothing to do with risk pricing. A number of these practices may also be considered efforts to use deceptive, back-end pricing strategies rather than up-front understandable pricing (for example the "pick-a-rate" practice which the Board in prior rules determined disqualifies a variable rate from the exception on changing rates on existing balances). Therefore, the most likely explanation is that they are part of an issuer profile that prices aggressively or deceptively to maximize short-term revenue.[62] Being a credit union is also significantly correlated with a lower credit loss rate, as are a number of other significant variables. Therefore, any correlation between losses and fees is indirect. Even if there is some underlying direct connection, it is certainly a much weaker cause of penalty fee pricing than the type of issuer and whether they aggressively seek to boost revenue and use hidden pricing techniques.

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[62] Part of the explanation may be indirect such as practices being correlated with whether an issuer is a credit union. However, some practices do retain significant explanatory power when included in a regression with whether the issuer is a credit union. Therefore this is not the full explanation. It could also be argued that causality runs the other way (i.e. the nature of practices are the driving variables for penalty fee levels which happens to be correlated with whether an issuer is a credit union). Either way, the important point is that any correlation of penalty fees with losses is likely indirect.

These results suggest that issuer practices (which probably reflect an underlying revenue and pricing philosophy or orientation such as aggressive vs. conservative) as well as issuer type (most notably whether an issuer is a credit union) drive any relationship observed relationship between losses and penalty fee prices. Issuers do not price penalty fees for risk. Instead, they price based on an over all pricing philosophy (e.g. up-front pricing versus back-end revenue generation), and this is reflected in their fee structure.

If issuers have historically not used penalty fees as risk compensation, then there is no reason to expect that to change. Arguments in favor of this are more an excuse to raise fees than an honest justification for practices. Allowing issuers to claim they are pricing for risk when setting penalty fees would simply provide issuers with cover for continuing the same aggressive penalty fee pricing tactics that they have utilized in the past. These tactics have nothing to do with pricing for risk, while the fact that there is a slight correlation with risk due entirely to such other factors would make enforcement of reasonable and proportional pricing nearly impossible.

B. While exceptions to non-safe harbor penalty fees for purposes of testing may be acceptable, there should be rules establishing adequate safeguards.

The Board has solicited comments on whether it is appropriate to permit card issuers to test the effect of penalty fee amounts that exceed the amounts otherwise permitted by § 226.52(b)(1). The Board is right to be concerned regarding the potentially large loophole presented by fees that violate the Rule put in place for testing purposes.

Experiments can be manipulated in a number of ways. One is through selective submission. Fortunately, a program of submission, scrutiny, and benchmarking (along with pre-announcement of any tests as discussed elsewhere in these comments) should minimize selective submission. Thus, as discussed in Section I, it is absolutely critical to make the data and methodologies from such penalty fee testing available to the public.

A separate issue is that such experiments may be naturally biased. This is particularly true of the type of short term tests implied by the Board's comment. Assume, for example, that an issuer normally charges a $20 fee, but decides to test the deterrence impact of a $35 fee by increasing the fee for a three month period. The first step, would of course be a change of terms agreement to the test group announcing the $35 fee. Similar to learning after being assessed a fee in Agarwal et al (2008), Section II-B-1, above, it is likely that the deterrence impact of learning of a $35 fee may be quite high at first, but would deteriorate over time.[63] Therefore, a short term test may greatly exaggerate the deterrence impact of a permanent shift in fee schedules.

[63] For example, it may be that in the month following the late fee announcement, late payments would be cut in half, but that a year later with the same fee, late payments would be close to their original level. Part of this deterrence may be due simply to the reminder that there is a late fee; therefore the control group should also receive a mailing notifying them of their existing late fee level as a similar reminder. However, this in no way eliminates the short-term bias inherent in such an experiment.

In addition to this inherent source of bias, it is possible that issuers, with their sophisticated knowledge of consumer responsiveness, could intentionally bias an experiment. For example, the font, color, and nature of a late fee announcement could make a significant difference in its impact on deterrence. And if these factors are not all accounted for, an issuer could conduct a test that maximizes deterrence by maximizing consumer fee awareness, while in practice when the fee is fully implemented design announcements to minimize consumer sensitivity to the fee by minimizing awareness while still staying within the parameters of the law.

A final source of manipulation in data analysis would be statistical model manipulation. An issuer could change model structure and included variable until they achieve the results. Furthermore if submitted to regulators, variables that might lead to questioning of the stated results can be selectively excluded. Outside scrutiny and benchmarking would serve as at least a partial check and balance on this.

To address these problems, and avoid opening a loophole, we recommend a different approach from that suggested by the Board's approach,which could be termed "Downward Testing and Extrapolation." In particular, it is recommended that issuers test various price points below their current penalty fee level. Issuers would then be permitted to use regression analysis (or similar techniques that result in a mathematically defined relationship between variables) to extrapolate upwards up to a fixed, limited interval in their determination of the deterrence effect of specific price. The extrapolation would be based on the same functional form that is found to be the best fit or otherwise most appropriate for the data. We suggest an appropriate interval might be 20%. Any further fee increases would require a new test and new extrapolation.

For example, assume a card issuer has a late fee of $20. They are considering increasing their late fee and therefore run a test with price points at every $2 between $10 and $20. If they find a significant relationship in the form $D=b_1+b_2\ln(F)$ where D is the deterrence as measured by the frequency of delinquent accounts and F is the late fee amount, they can then extrapolate this function up to $24 in justifying a fee up to this level. If they later wish to raise their fee to $27, they would need to run a new test using price points of $24 and lower.

Besides eliminating concerns regarding the abuse of allowances for using fees outside of normally acceptable parameters for research purposes, this type of testing has another important advantage. As previously discussed, experiments on short-term deterrence are likely to overstate the long-term deterrence impact of an upward fee change. However, when experiments concern downward movements in fees, deterrence value is no longer overstated.[64]

[64] While it could be argued that deterrence value may be understated using this methodology, since the Board's rules place the burden of proof that fees are reasonable and proportional on the issuer, a methodology with conservative results are most consistent with this position. Also, it may not be the case that it underestimates deterrence value if the notification itself causes a reduction in late fees.

After raising a penalty fee based in part on extrapolation, issuers should be required to retest using the actual fee and a nearby lower value. A regression technique can be used in this analysis. However, the new price point should also be compared to the nearest lower price point to see if these two price points are statistically significantly different in deterrence impact aside from the statistical effects of adding other lower price point data into a full regression.

If the Board opts against the suggested approach, it is still recommended that experiments be as small as possible. At a maximum, the experiment should involve no more than 10% of the portfolio under consideration for a fee change.

It is also vital that planned experiments be pre-identified with explicitly defined parameters. Current competitive intelligence at most provides a small sampling of issuer actions. Therefore, experiments can easily be missed, and broad fee changes by issuers could be justified after the fact when identified by chance through a complaint or mail sample as simply an experiment. Pre-identification of experiments also plays another important role. It prevents issuers from choosing to submit after the fact only those experiments that give the preferred results. For this last reason, it is recommended that planned experiments that may be used later to justify new rates be publicly pre-identified even when they involve the “Downward Testing and Extrapolation” methodology previously described.

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APPENDIX A:
Current Practices—The Use of Tiered Late Fees by Top Issuers

In order to understand what is reasonable for penalty fees, it is first useful to understand what the top issuers who hold the vast majority of credit card balances are currently doing with penalty fees. An analysis of this topic was conducted as part of the Center for Responsible Lending report "Dodging Reform."[65]

In 2002, the top issuers started to introduce tiered late fees, varying charges based on the consumer's balance. For example, in 2003 one top issuer charged $15.00 on balances up to $150.00; $29.00 on balances between $150.00 and $1,200.00; and $35.00 on balances of $1,200.00 and over. This practice spread rapidly so that by the beginning of 2005, all of the top 8 issuers -- who hold 86% of all balances -- used tiered late fees. However, the ranges for balances used in tiered late fees have become compressed over the past five years so that an increasing number of people fall in the highest category.

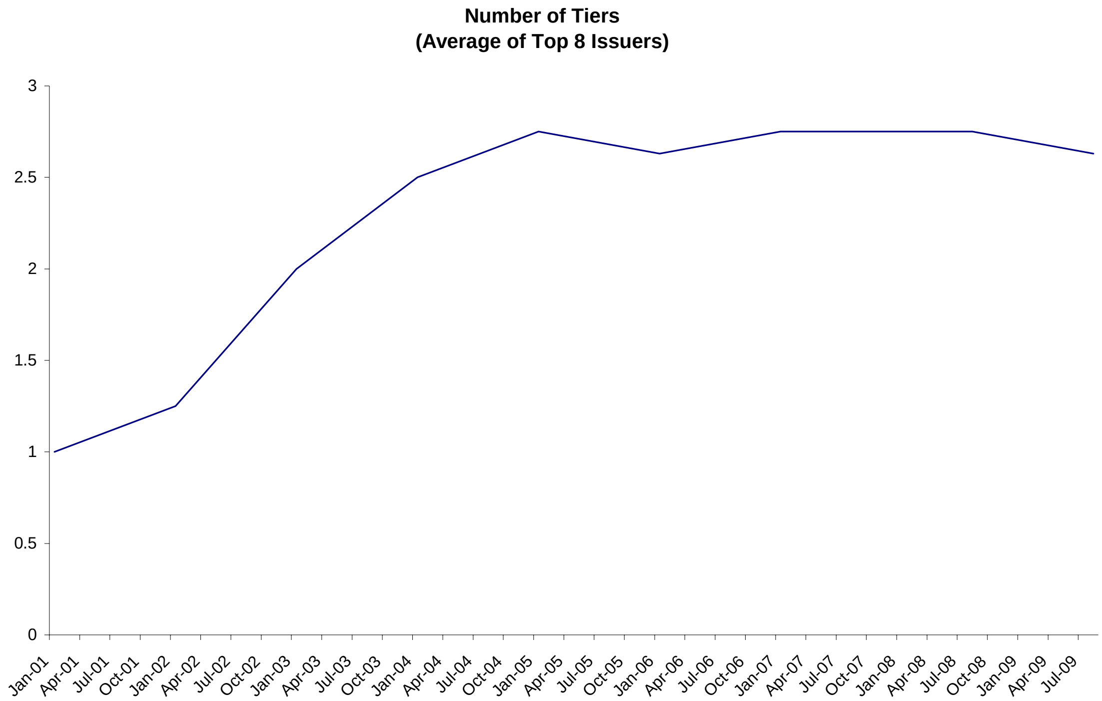
For example, many top issuers used three balance categories five years ago with the highest range typically being $1,000 and above. Today there normally are still three ranges, but the highest category is typically $250 and above. Rather than making fees proportional to the violation, tiered late fees seem designed to appear low while in reality a high fee is assessed.

There are two possible motivations for issuers to introduce tiered late fees: one to make fees more proportional to the violation and, two, to give the appearance of lower fees by showing a low rate that few people receive. If the first amount is relatively low, by showing multiple late fee amounts, people who are glancing quickly at a lengthy and complex list of numerous terms and conditions are unlikely to focus on the fine details of the late fee tier structure. They may focus on the first number they see and ignore other rates as well as ignoring the ranges for the tiers. Cardholders may also underestimate the likelihood of incurring the higher late fees.

In understanding issuer motivation in moving to a tiered late fee structure, it is noteworthy that this approach was first implemented for most top issuers simultaneously with a fee increase for the top tier. If a tiered structure is added at the same time as a fee increase for the top tier, the impact appears ambiguous to consumers. Cardholders see a new lower fee for some conditions, and a higher one for others. However, in reality, most cardholders are charged the highest fee, making the net impact a hidden fee increase.

Figure 2: Growth in the Number of Late Fee Tiers

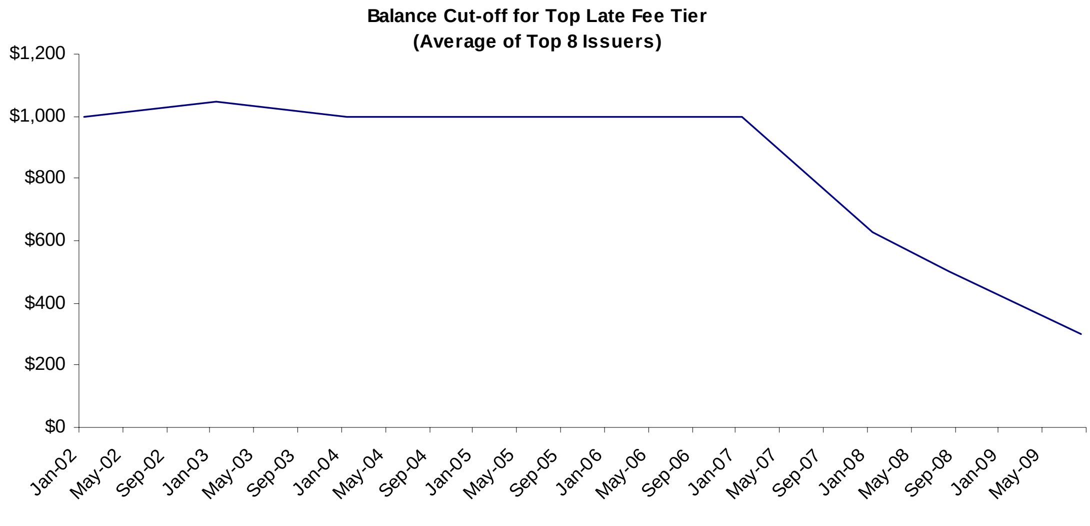
[65] Joshua M. Frank, *Dodging Reform: As Some Credit Card Abuses are Outlawed, New Ones Proliferate.* Center for Responsible Lending, (December 10, 2009) http://www.responsiblelending.org/credit-cards/research-analysis/ .



Source: Mintel Comperemedia, Center for Responsible Lending

While the number of late fee tiers used has grown over time (see Figure 8), this does not mean that the fees have necessarily become more proportional to the balance. In fact, while average consumer balances have been rising since the initial implementation of tiered late fees, late fees categories have undergone "tier compression" in which the balance categories are closer together rather than further apart. In particular, the lower fee levels were squeezed together more so that an increasing proportion of people were charged the top fee level (see Figure 3).

Figure 3: Late Fee Tier Compression Using Balance Cut-off

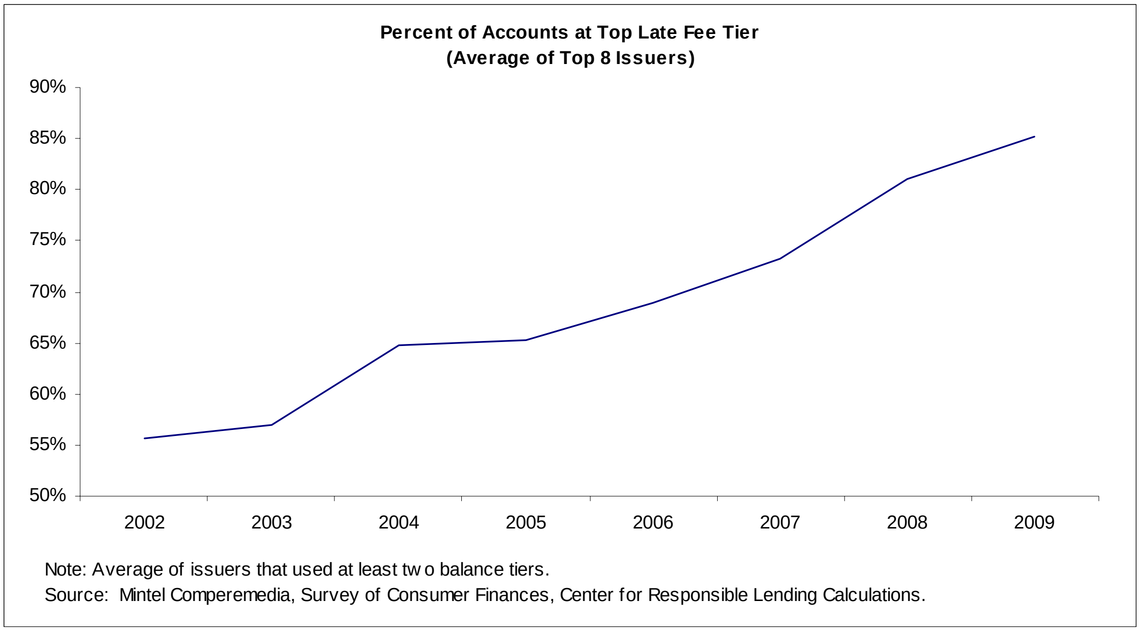


Note: Average of issuers that used at least tw o balance tiers.
Source: Mintel Comperemedia, Center for Responsible Lending Calculations.

Three to five years ago, the top late fee tier typically was applied only to about half (53 percent) of active accounts. Today, the top late fee tier is applied to 87 percent of active accounts.[66] Therefore, tiered late fees now do not have much impact in creating a proportional fee since the vast majority of people are charged the highest fee.

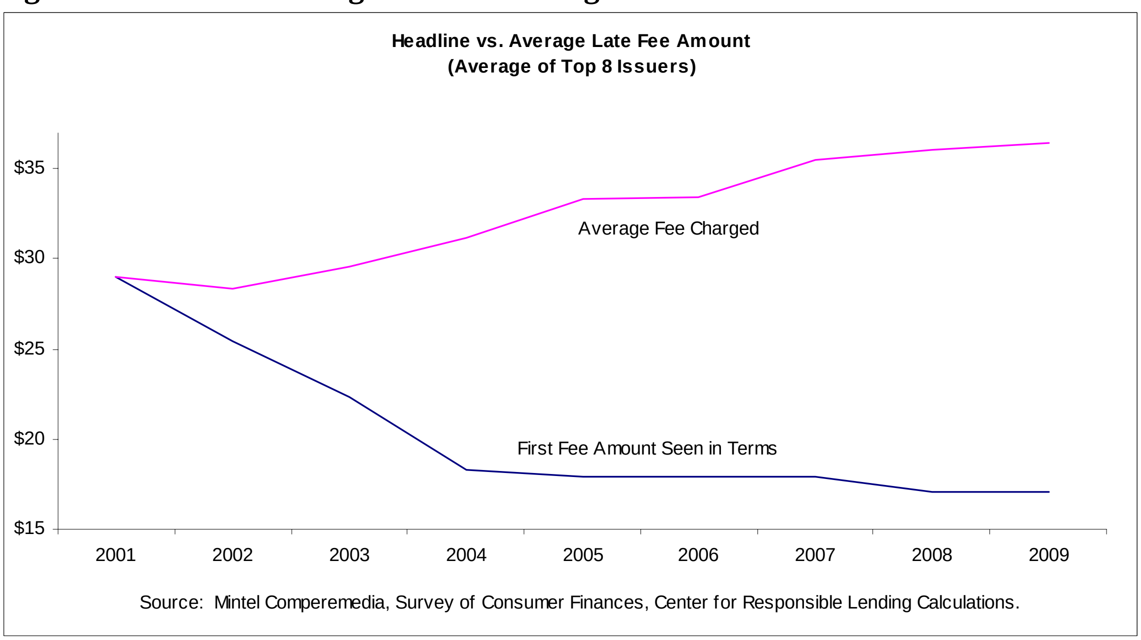
Figure 4: Late Fee Tier Compression Using Percent of Accounts in the Top Tier

[66] Late fee tiers each year for the top 8 issuers were taken from mail samples in a database from Mintel Comperemedia. Estimates of how many people fall into each category are estimated based on data from the Survey of Consumer Finances (the survey from 2004 was used since this was approximately in the middle of the time period studied). Since late fees are based on balance at the end of a billing cycle, people who did not revolve a balance are assigned a balance equal to the amount of purchases they made on their credit card. The portion of people charged the highest tier late fee is likely to be somewhat underestimated here since this survey is known to underestimate average balances, and also because consumers charged a late fee probably have higher than average balances (some consumers are late by accident but others are late because of inadequate cash flow—the first group may be randomly distributed across balance size, but the latter group probably tends to have higher than average balances).



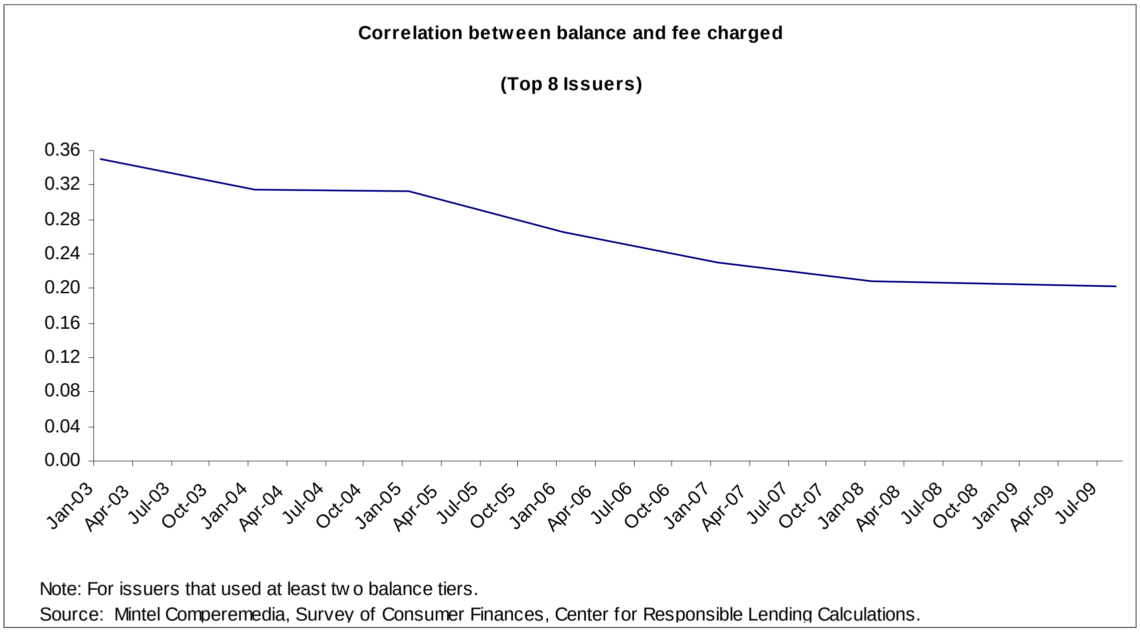
While the clear trend of late fee tier compression may not make sense if issuers are trying to create fees that are proportional to balances, it does make sense from a marketing perspective. As shown in Figure 5, it creates a situation in which the first late fee amount consumers see in their terms and conditions declines even while the actual average fee charged rises.

Figure 5: Trend in Average Late Fee Charged vs. First Fee Consumers See



The weakening relationship between the customer's balance and the late fee charged can also be seen statistically through the use of the correlation statistic. As Figure 6 shows, rather than becoming more proportional to balance amounts, the amount charged in late fees has actually become less correlated with balances over time.[67]

Figure 6: Late Fee Tier Compression: Correlation between Balance and Fee



In drawing conclusions from current issuer practices, it is important to note that the Credit CARD Act's provisions on penalty fees were put in place partially in response to the widely held perception that current late fee policies were not reasonable. Furthermore, this analysis shows that the fees were also only proportional in the most illusory sense. Therefore, an interpretation of the rules that largely allows these fee practices to remain in place does little to enforce the intent of Congress in passing this legislation.

[67] For each year, the correlation was calculated using Survey of Consumer of Finance data for the closest year. For each of the top eight issuers, the fee that would have been charged to each survey participant if they had been late was calculated. The correlation between this fee and the balance was then calculated for all issuers that used tiered late fees combined in one file (i.e. each observation in the Survey of Consumers dataset is replicated up to 8 times—once for each hypothetical issuer to take into account their different fee structures). The observations were weighted by the Survey's internal weight amounts when calculating the statistic. In 2003, four issuers were used in the correlation statistic. In 2004, seven issuers were used. For 2005 and later years, all top eight issuers were used.

Appendix B:
What Drives Current Late Fee Price Levels?

There has been little research in general regarding penalty fees in credit cards. Massoud, Sanders, and Scholnick conducted the only known prior study examining the relationship between penalty fees and risk across issuers.[68] Their study did find that market share in part drove prices. However, the study found evidence that penalty fees are positively related to consumer default risk. A finding that, as the authors state, “supports the position of defenders of penalty fees such as banks.” Since this is the only study that addresses the relationship between penalty fee levels and risk, it is important to reevaluate this relationship.

While the statistical analysis employed in this study is sophisticated, there are some important alternative hypotheses that have been overlooked and that we find fit the data better. In particular, the authors find that issuers with higher loss rates also have higher penalty fees, and conclude that this is consistent with these fees being compensation for risk. However, there are two reasonably likely alternative reasons why higher risk issuers will have higher penalty fees:

3) *Issuer Aggressiveness:* If certain issuers are “aggressive” in their revenue seeking practices while other issuers “conservative,” aggressive issuers will tend to have high fees in general as well as aggressive practices regarding market expansion, leading to higher risk for aggressive issuers as well as high fees, with no direct causation between the two.
4) *Issuer Profile:* If certain issuer types tend to have high losses as well as high fees, then the two will be correlated despite a lack of causation. For example, assume there are three types of issuers: 1) Issuers who consider credit cards a primary revenue source and solicit consumers outside of their normal customers, 2) Regional and other issuers who issue credit cards primarily within the context of a larger customer relationship and do not consider it the primary profit driver, 3) Credit Unions that are likely similar to the second group. It is likely that the first group will have the highest penalty fees since their goal is to maximize credit card revenue, while the other two groups may be more concerned with maintaining customer good will. Separately, groups two and three will likely have a lower loss rate due to their ongoing relationship with their customer base.

To the extent that penalty fees move with losses, if this relationship is due to issuer aggressiveness or issuer profile, then the fee levels are not in fact compensation for risk. Instead, fee levels are driven by other factors. In fact, if issuer aggressiveness is measured by potentially exploitative practices in general, then a positive relationship might be evidence that penalty fee pricing is instead driven by a desire among aggressive

[68] Nadia Massoud, Anthony Saunders, Barry Scholnick, *The Cost of Being Late: The Case of Credit Card Penalty Fees*, 32-33 (October, 2006), http://www.newyorkfed.org/research/conference/2006/Econ_Payments/Massoud_Saunders_Scholnick.pdf .

issuers to raise revenue through back-end pricing rather than to price in a clear, up-front manner.

To test whether the any correlation between losses and late fees is due to outside factors or whether alternatively the two are causally related, data was collected related to issuer practices and issuer type for the top 100 credit card issuers.[69] Some of the practices identified here were those covered in the report "Dodging Reform,"[70] including cash advance floors, ceilings, and amounts, the use of "Pick-a-Rate," minimum finance charges, international fees, and the definition of international fees. Other measures include how disparate rates are from each other (such as the spread between cash and purchase APRs or the spread between the regular and penalty APR), which was described as a possible sign of deceptive signaling in Frank (2009)[71]. Some other practices have to do with aggressive new account solicitation or selling of cash advance checks as measured by mail volume. Recoveries as a percentage of losses was included because it was hypothesized that issuers profiled as "aggressive" in general might extend that practice into collections and therefore tend to recover more losses, even if this comes at the expense of reputation or questionable practices. Variables related to issuer profile or type include whether the bank is a credit union, whether it is defined by regulators as a credit card bank, what percentage of managed receivables are owned, what percentage of loans are from credit cards, how big an issuer is, and how fast they are growing. There is considerable overlap between practices and type of issuer as well as correlation between the two, and a number of variables could be defined as falling into either category.

Of 29 possible explanatory variables examined, credit losses had the second lowest correlation with the level of late fees (see Table 2). Though credit losses had a sign that was in the expected direction (i.e. higher losses are correlated with higher fee levels), it was not statistically significant.[72] Of 28 other variables, 22 were statistically significant (or about 80%) and most were significant at the 1% level. Therefore, credit losses are,

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[69] Rankings came from PaymentSource, individual terms and conditions were obtained both through electronic copies of offers from Mintel Comperemedia and from direct examination of solicitations online when no database records were available. Financial data came from public filings as well as compiled data regarding public filings from SNL Financial and PaymentSource. Data was targeted to be from solicitations from around August of 2009, with some information for smaller issuers varying from that date if public data was limited. Cash advance check and new solicitation mail volumes were compiled from Mintel Comperemedia data. Complaint levels were aggregated using data from the Better Business Bureau.

[70] Joshua M. Frank, *Dodging Reform: As Some Credit Card Abuses are Outlawed, New Ones Proliferate*. Center for Responsible Lending, (December 10, 2009) http://www.responsiblelending.org/credit-cards/research-analysis/ .

[71] Joshua M. Frank, *What Does the Credit Card Market Have In Common with a Peacock?* The Lydian Payments Journal 1, 1 (2009b):24-40.

[72] While it could be argued that this indicates these results, with a smaller sample size, have less power than Massoud et al (2006), it is quite clear that the regression had sufficient power in general to detect any strong relationships. As noted in the text, all of the other variables had the expected sign, and 80% of the other predictive variables were statistically significant, with most being significant at the 1% significance level. Furthermore, as discussed in the text, the lack of significance was not due to the simplicity of the initial correlation methodology--raising the sophistication of the methodology by considering variable simultaneously in a multiple regression did not improve the relationship. It instead eliminated any positive correlation.

relatively speaking, a very weak predictor of late fee amounts. The single best predictor of late fee amounts was whether the issuer was a credit union, with credit unions charging lower fees than other issuers. A number of practices were also highly predictive of late fee charges. While it could be argued that a few (such as the cash/purchase APR spread) are somehow linked to risk. Others that are significantly linked to loss pricing, such as the minimum finance charge amounts, international fee levels, and the use of the "pick-a-rate" practice, clearly have nothing to do with risk pricing. A number of these practices may also be considered efforts to use deceptive, back-end pricing strategies rather than up-front understandable pricing (for example the "pick-a-rate" practice which the Board in prior rules determined disqualifies a variable rate from the exception on changing rates on existing balances). Therefore, the most likely explanation is that they are part of an issuer profile that prices aggressively or deceptively to maximize short-term revenue.[73] Being a credit union is also significantly correlated with a lower credit loss rate, as are a number of other significant variables. Therefore, any correlation between losses and fees is indirect. Even if there is some underlying direct connection, it is certainly a much weaker cause of penalty fee pricing than the type of issuer and whether they aggressively seek to boost revenue and use hidden pricing techniques.

Table 2: Correlation of various factors with Late Fee Amount

[73] Part of the explanation may be indirect such as practices being correlated with whether an issuer is a credit union. However, some practices do retain significant explanatory power when included in a regression with whether the issuer is a credit union. Therefore this is not the full explanation.   It could also be argued that causality runs the other way (i.e. the nature of practices are the driving variables for penalty fee levels which happens to be correlated with whether an issuer is a credit union). Either way, the important point is that any correlation of penalty fees with losses is likely indirect.

Best Single-Variable Predictors of Late Fee Amount

	Correlation Coefficient		P=Practices(Aggressiveness) T=Type
Whether issuer is a credit union	-0.68	**	T
Cash/Purchase APR spread	0.67	**	P
Cash advance fee amount	0.62	**	P
Minimum Finance Charge Amount	0.58	**	P
Cash advance floor amount	0.58	**	P
Penalty/Regular APR spread	0.57	**	P
Whether issuer uses a penalty APR	0.57	**	P
Hairline trigger for penalty APR	0.57	**	P
International transaction fee amount	0.50	**	P
Teaser/Regular APR spread	0.49	**	P
Cash advance ceiling	-0.45	**	P
Whether penalty rate cure is "hard"	0.44	**	P
Whether issuer is a credit card bank	0.35	**	T
Issuer utilizes "pick-a-rate"	0.35	**	P
Issuer allows extra time before late fee	-0.35	**	P
Cash advance check volume/outstndgs	0.30	**	P
Whether issuer charges intl. fee if in $	0.29	**	P
Whether teaser is short	0.28	**	P
Percent Securitized	0.27	**	T
Issuer Size	0.24	*	T
Recoveries as a percent of losses	0.23	*	P
BBB Complaints/outstandings	0.22	*	P
Issuer growth rate	0.17		T
Solicitation volume/outstandings	0.13		P
Sells fee-based add-ons in offer	0.12		P
Card loans as % of total loans	0.12		T
Net Losses	0.10		
Length of grace period	-0.09		P

* Significant at 5% level

** Significant at 1% level

When other factors were controlled for using multiple regressions, there was no longer any positive relationship whatsoever between losses and late fees. Four regressions specifications are shown in Table 3, each with and without the loss variable included. The first equation uses the three independent variables that have the highest simple correlation with fee levels. The second and third regressions use the top three lender type variables and the top three practice-based variables respectively. The final regression shown is a stepwise regression using all possible practice and lender type variables as potential predictors. Four independent variables were retained in the model (aside from credit losses which was forced into the model even though it did not meet the criteria for inclusion) Aside from credit losses, all variable retain their expected sign and 10 of 13 were statistically significant. In general, while most practices remained significant predictors in the multiple regression models, when the credit union factor is accounted for, other lender type variables no longer held significant explanatory power.

However, the key result is how credit losses performed in the multiple regression models. The performance of this variable was remarkably consistent across models. In every model it was small and insignificant. The loss variable also changed sign from what it was using the simple correlation statistic in every model (with a beta value between -0.05 and -0.09 in all cases), indicating that if anything, higher losses are associated with lower fees when other factors are accounted for. The importance of this sign should not be overstated since the coefficient was insignificant. However, it does indicate that losses have absolutely no positive relationship with fee levels in any of the regressions.

Table 3: Multiple Regressions: Factors Associated with Late Fee Pricing

	Combined		Lender Type		Practices		Stepwise (Combined)	
		w/Losses		w/Losses		w/Losses		w/Losses
Credit Union Dummy	-5.91** *(2.25)*	-8.17** *(2.47)*	-15.76** *(1.68)*	-14.81** *(1.81)*	---	---	-8.14** *(1.99)*	-9.64** *(1.97)*
Credit Card Bank Dummy	---	---	0.55 *(2.26)*	1.07 *(2.23)*	---	---	---	---
Percent Securitized	---	---	0.02 *(0.04)*	0.01 *(0.03)*	---	---	---	---
Cash/Purchase APR spread	0.87** *(0.20)*	0.61** *(0.21)*	---	---	0.91** *(0.20)*	0.80** *(0.20)*	---	---
Cash advance fee amount	1.81* *(0.73)*	1.80* *(0.78)*	---	---	2.49** *(0.65)*	2.69** *(0.74)*	1.33 *(0.73)*	1.30 *(0.74)*
Minimum Finance Charge	---	---	---	---	3.21* *(1.64)*	3.23 *(1.73)*	---	---
Hairline trigger for penalty APR	---	---	---	---	---	---	6.96** *(1.62)*	5.57** *(1.60)*
Extra time before late fee	---	---	---	---	---	---	-8.49** *(2.59)*	-9.11** *(2.74)*
Net Losses	---	-0.09 *(0.07)*	---	-0.06 *(0.08)*	---	-0.05 *(0.07)*	---	-0.05 *(0.06)*

* Significant at 5% level
** Significant at 1% level

The results suggest that issuer practices (which probably reflect an underlying revenue and pricing philosophy or orientation such as aggressive vs. conservative) as well as issuer type (most notably whether an issuer is a credit union) drive any relationship observed relationship between losses and penalty fee prices. Issuers do not price penalty fees for risk. Instead, they price based on an over all pricing philosophy (e.g. up-front pricing versus back-end revenue generation), and this is reflected in their fee structure.