COMMENTS
of
National Consumer Law Center
(on behalf of its low-income clients)

and

Center for Responsible Lending
Consumer Federation of America
Dēmos: A Network for Ideas & Action
U.S. Public Interest Research Group

to the

Board of the Governors of the Federal Reserve System
Docket No. R–1314

Office of Thrift Supervision
Docket No. OTS-2008-0004

National Credit Union Administration
12 CFR Part 7706

Notice of Proposed Rulemaking
Unfair or Deceptive Acts or Practices in Connection with
Consumer Credit Card Accounts and Overdraft Loans

I. INTRODUCTION

These comments are submitted by the National Consumer Law Center, on behalf of its low income clients,[1] and U.S. Public Interest Research Group.[2] The credit card

[1] The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts 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 a series of sixteen practice treatises and annual supplements on consumer credit laws, including Truth In Lending, (6th ed. 2007) and Cost of Credit (3rd ed. 2005) 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. These comments are written by Chi Chi Wu and Lauren Saunders of NCLC.

portions of these comments are joined by Consumer Federation of America,[3] Center for Responsible Lending,[4] and Demos: A Network for Ideas & Action.[5] These comments are in response to the May 19, 2008 Notice of Proposed Rulemaking issued by the Federal Reserve Board (FRB), Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA) – collectively referred to as the "Agencies." The Agencies' proposed rule would amend Regulation AA and equivalent OTS /NCUA regulations to prohibit certain unfair or deceptive acts or practices (UDAP) with respect to credit card accounts and overdraft loans. We commend the Agencies for taking strong and substantive action to address credit card abuses using their authority under Section 18(f) of the Federal Trade Commission Act, 15 U.S.C. § 57a(f). We urge the Agencies not to weaken any of their proposals.

With respect to overdraft loans, we are glad to see that the Agencies acknowledge the problems created by these programs. However, we strongly urge the Agencies to adopt a rule that requires the consumer to opt-in to one of these programs, not a rule requiring opt-out.

A. Fixing a Broken Credit Card Market

In general, we strongly support the Agencies' UDAP proposals that address credit card abuses. We believe that the Agencies have appropriately used their authority under the FTC Act to prohibit some of the worst and most unfair credit card practices that exist today. Indeed, we believe that it is about time the Agencies took such actions, which have been warranted for many years.

The proposed rules are perhaps most important for what they do indirectly rather than directly. By banning some of the most egregious tricks and traps that creditors use, the proposed rules help to realign the incentives so that creditors and consumers will share a common goal: ensuring that credit is extended – and serviced – in an honest, responsible, affordable manner. Although the Agencies have not imposed a hard

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[2] **U.S. PIRG** serves as the federation of and national advocacy office for state Public Interest Research Groups, which are non-profit, non-partisan organizations with over one million members nationwide. U.S. PIRG regularly testifies before Congress on credit card reform issues. Its most recent policy reports on credit card practices include "The Campus Credit Card Trap: A Survey of Student Attitudes Toward Credit Card Marketing On Campus" and "Characteristics of a Fair Campus Credit Card," both released in 2008.

[3] **Consumer Federation of America** (CFA) is a nonprofit association of some 300 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through research, advocacy, and education.

[4] The **Center for Responsible Lending** is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. A non-profit, non-partisan research and policy organization, CRL promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is affiliated with the Center for Community Self-Help, one of the nation's largest non-profit community development financial institutions.

[5] **Dēmos: A Network for Ideas & Action** is a non-partisan public policy research and advocacy organization. Headquartered in New York City, Dēmos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world.

requirement that creditors assess ability to pay, eliminating the profit motive for back end underwriting will have the effect of encouraging more responsible front end underwriting – with beneficial effects for individual consumers and the economy as a whole. The proposed rules do not dictate any up front pricing structure, but they do discourage bait and switch tactics that frustrate true competition. Similarly, it is essential to eliminate incentives for creditors to profit from, and trump up, consumer mistakes once credit has been extended.

Creditors and their advocates have argued that the proposed rules will restrict credit. To the extent that these rules restrict some credit, it will be irresponsible, unaffordable, predatory credit that deserves to be restricted. In addition, creditors or their advocates have argued that the proposed rules will require them to impose additional costs on all consumers, such as annual fees, and to restrict reward programs. If this is the case, it is an admission that high penalty fees, often imposed on financially struggling consumers, have been subsidizing the lack of annual fees and credit card rewards. This is especially disturbing because the punitive retroactive interest rates charged by credit card lenders disproportionately impact minorities and low-income consumers.[6]

Furthermore, such claims may be questionable. Annual fees have been dropped primarily because they are a barrier to attracting new customers, and they are one of the few credit card pricing items that consumers actually shop for – because they are front-end costs clearly disclosed and imposed at the outset. The same competitive reasons that have led to the demise of annual fees will prevent them from returning on a widespread basis. The same is true of rewards. Rewards programs have been highly successful in generating consumer loyalty to a particular card, and encouraging consumers to use their cards for every purchase they can, no matter how small. These incentives will continue to drive the rewards market.

Overall, the primary fault in the proposed rules is that they do not go far enough in encouraging responsible behavior towards those consumers who do get into trouble. Decisions should be designed to help these consumers to get out of debt, not punish them so severely that they can never escape. No one would double the interest rate on a homeowner whose mortgage is 30 days late, and we should not do so for credit card borrowers. Borrowers who truly have become more risky should have their credit cut off, not extended at predatory prices. The proposed rules should do more to protect these vulnerable consumers from exploitation.

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[6] Jennifer Wheary and Tamara Draut, *Who Pays? The Winners and Losers of Credit Card Deregulation*, DEMOS, August 1, 2007, *available at* http://www.demos.org/pubs/whopays_web.pdf (noting that African-American and Latino credit card holders who carrying a balance are more likely than whites to be paying an interest rate over 20% -- which is likely to be penalty rates -- and low-income revolvers are five times likely as upper income revolvers to pay that rate).

B. Summary of Recommendations

We make several specific recommendations in these comments to urge the Agencies to go further. Mostly importantly, we believe the Agencies should:

- Protect consumers further from unfair late fee policies by:
    - Requiring that statements be mailed 28 days before the due date, or add a 7-day "leniency" period after the 21-day deadline;
    - Requiring additional time if first class mail is not used; and
    - Recommending to Congress that the grace period rule be amended to conform to the late fee rule.

- Prohibit additional payment allocation manipulations by:
    - Requiring minimum payments to cover all fees and finance charges on each balance and allocating the remainder pro rata or in equal portions;
    - Allocating voluntary payments above the minimum balance entirely to the highest rate balance;
    - Permitting consumers to direct the allocation of their payment in addition to, not as a substitute for, a fair allocation rule; and
    - Banning the retroactive imposition of interest through deferred interest balloon payments offers.

- Protect consumers further from unfair retroactive rate hikes by:
    - Prohibiting all retroactive rate hikes on existing balances, even for consumers who are 30 days late;
    - Prohibiting prospective rate hikes until the card expires, unless the consumer commits a significant violation of the agreement, so that a deal is a deal; and
    - Prohibiting premature revocation of a promotional rate unless the consumer is 30 days late.

- Protect consumers from unfair increases in minimum payments by:
    - Applying the rules on treatment of outstanding balances to all changes in the minimum payment, regardless of the reason; and
    - Providing an estimate of the actual change in minimum payment in the change-in-terms notice sent 45 days before the change.

- Prohibit all unfair over-limit practices, including:
    - Assessing over-limit fees for transactions when the creditor has approved or permitted the consumer to exceed his limit;
    - Assessing multiple over-limit fees in later billing cycles for a single over-limit transgression; and
    - Assessing over-limit fees triggered when the creditor lowers the credit limit on an account to below its current balance.

- In addition to banning double cycle billing, prohibit creditors from assessing interest during the current month on amounts paid during the grace period.

- For subprime fee-harvester cards:
    - Prohibit creditors from assessing fees of more than 10% of the credit line;
    - Prohibit excessive fees even if they are not charged to the credit line; and
    - Establish an absolute ban against charging spurious security deposits to the credit line.

- Prohibit creditors from bait & switch tactics by banning solicitations that include a range of or multiple APRs or credit limits.

II. SCOPE AND DEFINITIONAL ISSUES

A. The Agencies Should Adopt a State Exemption Process.

The Agencies ask whether they should adopt a provision allowing states to seek exemptions from the credit card and overdraft UDAP rules if state law affords a greater or substantially similar level of protection,[7] similar to the existing provision in the Credit Practices rule. In addition, OTS has requested comment on whether the state exemption provision in its Credit Practices Rule should be retained.

We would strongly support a provision permitting a state exemption process to the credit card and overdraft UDAP rules. An exemption process is important because it will enable states to use the credit card UDAP rule to further protect their consumers in several respects.

We respectfully submit that the Agencies' rationale for disfavoring a state exemption provision – that it "may provide little relief from regulatory burden" – is the absolutely wrong inquiry. The purpose of the FTC Act and any regulations promulgated thereunder must be to protect consumers, not to relieve creditors from regulatory burden. Relieving creditors of regulatory burden is not an appropriate consideration for purposes of an FTC Act analysis.

Allowing a state exemption process would further protect consumers in two important respects. First and most importantly, it could give consumers the ability to actually enforce their rights under Reg. AA and the corresponding OTS/NCUA regulations. Second, it would allow states to develop additional protections when creditors think of clever new schemes to circumvent the prohibitions of the credit card UDAP rule.

As the Agencies know, the FTC Act and regulations promulgated pursuant to the Act do not carry a private right of action. Thus, consumers injured by violations of the Act, no matter how egregious, have no right under the Act to take legal action. For

[7] 73 Fed. Reg. 28,904, 28,911 (May 19, 2008).

example, a consumer whose interest rate is retroactively increased in violation of Proposed __.24 would have no remedy under the FTC Act to sue the creditor. An equivalent state law, however, could mirror the Reg. AA provisions but allow the consumer to take legal action or at least not have to pay the amount illegally charged.

Second, a state exemption process could allow states to develop protections to respond to the inevitable evolution of credit card practices to circumvent the credit card UDAP prohibitions. As the Agencies know, credit card companies are well-known for their ingenuity. They are probably already devising methods to avoid the protections of the credit card UDAP proposal. A state with an exemption for its credit card protections can develop new provisions to respond to these circumvention tactics by revising definitions or clarifying amendments. As a laboratory of democracy, a state could test out these potential responses to a creditor's new tactics, so that the Agencies could see whether such responses work.

The Agencies also expressed a concern that a state exemption process would undermine "the uniform application of federal standards." Again, we emphasize that relieving creditors of regulatory burden in the form of uniform standards is not an appropriate consideration in rulemaking under the FTC Act. For consumers, there is an argument that non-uniform state laws might deprive consumers of the benefit of any protections added by the Agencies in the future. To forestall this possibility, we recommend that any exemption process be on a section-by-section basis. The state exemptions would only apply to existing provisions, so that consumers in exempted states have the benefit of new protections added by the Agencies.

For the same reasons as stated above, we would strongly oppose any proposal by OTS to eliminate the state exemption process from its Credit Practices Rule.

III. TIME TO MAKE PAYMENT (Proposed §___.22)

A. Creditors Must be Required to Provide a Reasonable Amount of Time to Make Payment.

i. We support the extension of the time to make payment.

The proposed rule prohibits creditors from treating a payment as late unless the consumer is given a reasonable amount of time to make the payment. It provides a safe harbor for creditors who adopt reasonable procedures to ensure that statements are mailed or delivered at least 21 days before the payment due date.

We support this rule, with the caveats below. As the Supplementary Information to proposed rule describes, it is unfair to penalize the consumer for paying late when the consumer has not had a reasonable opportunity to pay on time. Creditors have an incentive to shrink the time for a consumer to make payment, and to engage in other manipulations designed to make the consumer's payment late, because creditors profit from late fees. The proposed rule corrects this misalignment of interests between the creditor and the consumer, and creates a basic rule of fairness.

The change will not require burdensome changes by creditors. Creditors do not need to change how quickly they send out statements, only how quickly they impose late fees – a simple adjustment.

Creditors will inevitably claim that this rule will reduce their profits and lead to higher costs for all consumers. The profits gained through hair trigger late payment rules, however, are not legitimate profits. Late fees and penalty rate increases triggered by late payments are part of the larger problem of "bait and switch" tactics, by which creditors promise consumers one rate and then hit them at the back end with hidden fees and rate increases.

ii. The Agencies should require creditors to send periodic statements 28 days before the payment deadline.

The proposed safe harbor of 21 days is a very minimal amount of time and scarcely provides consumers with enough time to make their payments. The proposal allows seven days on each end for mailing, leaving the consumer with only seven days to review and pay the bill. A wide variety of circumstances could make it difficult for a consumer regularly, 12 months a year, to pay the bill in seven days, including travel, illness, work demands, family obligations, tight budgets, irregular payment times by employers or self-employed individuals, and the custom of paying bills once or even twice a month. A safe harbor of 28 days would give consumers a more reasonable two weeks to pay their bills and would go farther to eliminate the unfairness of penalizing a customer who makes regular payments.

iii. The due date should be extended if statements are not sent by first class mail.

The proposal should also specify that the safe harbor applies only if the statement is mailed by first class mail. A presumption of seven days for mailing is not appropriate if the statement is sent by bulk mail. **[check on example of bulk mail for credit card statement]** A creditor should not be given the incentive to switch to a slower method of delivery in order to eat away at the 21 days and increase the likelihood of a late payment.

iv. The expiration of a grace period should be the same date as the due date.

The proposed longer payment period does not apply to expiration of a grace period – which may occur before the 21 days for payment. We understand that this exception was created to avoid a conflict with the statutory 14-day rule in the Truth in Lending Act (TILA), 15 U.S.C. § 1666b(a). However, the Board has general authority under Section 1604(a) of TILA to promulgate "such classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith."

The Board should use its TILA Section 1604(a) authority to harmonize the grace period and the due date for late fee purposes. The exception creates a confusing and unfair rule for consumers, who may effectively be penalized by a large retroactive interest imposed on a balance that they paid on time. Having, in effect, two different due dates is unfair and deceptive, harms consumers, and creates a harm they cannot reasonably avoid for all the same reasons that the agencies outlined for late payments.

At a minimum, the agencies should recommend to Congress that the grace period rule be extended to confirm to the late payment rule.

v. The growth of electronic payments does not lessen the need for more time to pay.

The proposed rule assumes that additional time is primarily needed for consumers who pay by mail, and asks for comment on the number of consumers who pay electronically. However, electronic payments can also be delayed substantially. A payment made online from a bank account may in fact be mailed by the bank. Both the consumer's bank and the credit card creditor may impose a time lag between the time an electronic payment is initiated and the day it is promised to be credited. Indeed, some consumers report that when they are running close to the deadline, they find they need to mail a payment by regular mail rather than use online payment.

vi. Consumers should be given a leniency period after the due date.

The Agencies asked for comment on whether institutions should be prohibited from treating a payment as late if it is received a certain number of days *after* the due date. We believe that consumers should be given such a leniency period, but it should be in addition to and not instead of the longer payment time proposed. This would be an alternative to a 28-day rule: the rule could give 21 days, plus a 7-day leniency period. However, it is essential that a leniency period not be used as a substitute for the minimal 21-day rule.

OTS has had such a leniency period rule in effect for mortgages for years, prohibiting thrifts from charging a late fee if the payment is received within 15 days of the due date.[8] This is a very workable rule that the industry has lived with for years without complaint.

The reasons for such a rule are even more compelling in the credit card context because homeowners do not need to wait for their mortgage statement to know how much their payment will be, and do not need to review a lengthy list of charges for accuracy. Credit card consumers, however, do not know how much to pay until they receive their

[8] 12 C.F.R. § 560.33.

statement, and the statements are much more complicated and require more careful review for unauthorized charges that do not appear on a mortgage statement.

vii. Consumers should be able to submit proof of timely payment.

The Agencies also ask whether institutions should be required to reverse a decision to treat a payment mailed before the due date as late and, if so, what evidence the institution could require the consumer to provide. We support such a rule, but as a supplement to a longer time to pay and a leniency period after the due date, not as a substitute for such a rule. Having a more reasonable time to pay and a reasonable leniency period together should eliminate many of the disputes about whether a consumer's payment was mailed in a timely fashion. Having a leniency period for the date by which a payment must be received -- a date the creditor knows and already records – is a cleaner rule and is easier to implement than requiring individual consumers to prove that their payments were made on time.

However, if the Agencies retain the strict 21-day rule with no formal leniency period, then a payment should be treated as timely if the consumer produces proof that it was mailed on the due date. If the Agencies insist that the payment be mailed ahead of time, then the deadline should be three days before the due date – the normal delivery time that consumers expect for first class mail. The Agencies should also adopt a parallel rule for electronic payments, pegged to time when the consumer's bank or the credit card creditor promised to credit the payment.

Evidence that a creditor should be required to accept includes a receipt from the United States Postal Service or from a delivery service such as, or comparable to, United Parcel Service, Federal Express, DHL or Airborne Express, or a printout of the computer screen or email confirmation showing the date on which an online payment was scheduled to be made.

IV. ALLOCATION OF PAYMENTS (Proposed § __.23)

Proposed section __.23 addresses creditors' widespread practice of manipulating the allocation of the consumer's payment among balances with different APRs in order to increase interest charges and shift low rate balances into high rate balances. The Agencies have accurately perceived the harm and unfairness of these practices and the inability of consumers to avoid that harm. Any rational consumer, when choosing to make payments above the minimum payment, would pay off more expensive debt ahead of low cost credit. However, creditors uniformly implement the opposite rule, which consumers have no ability to avoid. Indeed, creditors' current practices effectively prohibit consumers from paying off purchases or cash advances if they are carrying a lower interest rate balance.

The proposed rule has three parts: (1) a general rule on payment allocation; (2) a rule for promotional rate balances; and (3) a rule on the interaction between the grace period for purchases and promotional rate balances.

A. <u>The General Payment Allocation Rule Is An Improvement But Needs To Go Farther</u> (Proposed § __.23(a))

Paragraph (a) sets out the proposed general payment allocation rule. This proposal would allow the creditor to allocate the minimum payment in any way it chooses. Payments above the minimum payment would have to be allocated in a fashion no less favorable to the consumer than one of three methods: 1) entirely to the highest rate balances; 2) in equal amounts; or 3) pro rata in proportion to the balance.

The proposed rule is an improvement over the unfair and deceptive methods that most creditors use today and will lessen but not eliminate the harm of payment allocation manipulations. Nevertheless, the rule needs to go farther in some respects.

i. The Rule Should Codify OCC Guidance on Allocation of the Minimum Payment.

The proposed rule does not provide any guidance on allocation of the minimum payment. The OCC has guidance on the minimum payment, but it is voluntary and does not apply to all creditors. The Agencies should codify the current OCC minimum payment guidance, so as to ensure that the monthly minimum payment will cover all finance charges and fees on each balance.

That is, take as an example a consumer's statement that has balances as follows:

Purchases: $3,000, plus $45 in finance charges at 18% APR
Cash advances: $500, plus $10 in finance charges at 24% APR
Transfer balance: $2,000, plus $5 in finance charges at 3% APR
Late fee: $30

We understand that the OCC guidance requires the minimum payment to be at least $145 (all of the fees and finance charges plus 1% of the balance) of which $90 must be applied to eliminate all fees and finance charges and the remaining $55 can be applied as the remaining balances as the creditor chooses.

The Agencies should codify this guidance to ensure that it is mandatory and applies to all creditors. Otherwise, payment allocation manipulations within the minimum payment could be used to undercut the payment allocation rules.

Indeed, the rule should go farther and require that the portion of the minimum payment in excess of fees and finance charges be applied pro rata or in equal amounts to reduce the principal of each balance. Consumers do not understand payment allocation rules and would normally expect that at least some of their minimum payment will be allocated to reduce the principal of each balance, especially the balance that incurs high interest rate charges each month. The same principles of unfairness that the Agencies applied to payments above the minimum payment should apply to the minimum payment itself.

ii. Payment above the minimum payment should be fully allocated to the highest rate balance.

Payments above the minimum payment should be allocated *entirely* to the highest rate balance. When a creditor chooses to adopt a complicated rate structure that imposes different APRs for different types of transactions, the creditor has in essence created different subloans. As long as the consumer has covered the minimum payment that the creditor requires, a consumer who is voluntarily choosing to make an excess payment should be able to choose to which loan that extra payment is applied.

The principle is no different than the one that applies to a bank that holds both the consumer's low rate mortgage and the higher rate credit card. If the consumer wants to make extra payments to make faster progress on her credit card balance, the bank would not be allowed to apply those extra payments to the 4.5% fixed mortgage that the consumer had the foresight to lock in and the bank now wants to get rid of.

The proposed rules governing promotional rate balances eliminate much of this discrepancy, but unfairness remains. Indeed, having two different payment rules in place with simply cause confusion.

This is especially true with respect to cash advances. Creditors continue to push cash advances on consumers, mailing them blank cash advance checks and encouraging them to use them. Some, but not all, such checks carry promotional rates that will give them the protection of the promotional rate rule. In these times of financial distress, many families may be tempted to use those checks to cover short-term cash shortfalls.

Having two different rules apply to cash advance checks, depending on whether or not they carry a promotional rate, will lead to consumer confusion and unfairness. A consumer might use a promotional rate check one day and successfully pay it off. The consumer will then be deceived into thinking that the checks are a convenient form of cash advance, not realizing the dangers of using a check that is not protected by the promotional rate allocation rules.

Under the proposed rules, a consumer who uses a nonpromotional cash advance check, intending it to be temporary advance, is *prohibited* from paying it off until the entire credit card balance is paid off. The situation is identical to the dilemma described by the Agencies for promotional rate balances. Consider the consumer with this statement:

$9,000 purchase balance, plus $145 finance charge (at 18% APR)
$1,000 cash advance, plus $20 finance charge (at 24% APR)

A consumer who makes the minimum payment *plus* $1,000, attempting to pay off that higher rate cash advance, will have only $100 allocated to the cash advance and $900 allocated to the purchase balance. That $900 will continue to generate finance charges at 24% every month and cannot be paid off. Only the full $10,165 payment would pay off the cash advance. The current rules, though an improvement, allow creditors to *aggressively push* high rate cash advances (that also carry no grace period) and *forbid repayment in full.*

Another example is the constituent of Rep. Bachus who was distracted by spending two months in the hospital with a premature newborn and forgot his mortgage payment was due that day.[9] He called his mortgage lender, who encouraged him to put the payment on his credit card to avoid a late charge. When he got home and saw that the mortgage payment was treated as a cash advance and carried 24.9% interest instead of his regular 8% rate, he wrote a check for the full minimum payment plus the full amount of the mortgage payment. However, the creditor's payment allocation rules prohibited him from paying off that mortgage payment and tied him in to high interest charges accruing at 24.9% on a large balance that he could not eliminate until he paid his entire regular credit card balance. The proposed rules would require some of the excess payment to be allocated to the cash advance, but only a portion – never enough to pay it off completely.

iii. Creditors should not be allowed to skew payments towards a balance on which the rate is frozen.

The Agencies ask for comment on whether creditors should be permitted to apply payments first to outstanding balances on which they are prohibited from increasing the rate. Allowing such a practice would completely eliminate the benefit of this payment allocation rule. Creditors would have an incentive to find an excuse for a prospective interest rate hike in order to create an outstanding balance on which the rate is frozen, which would then enable the creditor to avoid the payment allocation rule and instead allocate payments to a lower rate balance rather than a higher rate one.

The proposed rules already enable creditors to accelerate repayment of the outstanding balance through changes in the minimum payment. These proposed minimum payment rules serve the legitimate goal of ensuring that progress is made towards repaying the outstanding balance. On the other hand, allowing payments above the minimum payment to be directed toward that balance have the opposite effect – increasing finance charges and making it more difficult to pay off principal. This rule would frustrate a rational consumer who is trying to pay off higher interest rate balances first and serves only the illegitimate goal of increasing interest charges, not the legitimate goal of reducing debt.

iv. No other methods of allocation should be allowed, and only the one most favorable to the consumer should be used.

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[9] *See Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives*, Hearing Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, 110th Cong. (2007) (statement of Representative Bachus)..

To the extent that the Agencies continue to allow creditors to allocate some portion of the payment above the minimum to a lower rate balance, the creditor should be required to choose whichever of the remaining two options – equal amounts or pro rata – is more favorable to the consumer. Allowing the creditor the choice of methodology encourages creditors to engage in manipulations that disfavor the consumer. The consumer has no control over the choice, does not understand it, and cannot avoid the adverse consequences of allowing the creditor to choose the method that increases finance charges.

The Agencies ask whether other methods of allocation should be listed. The answer is clearly no. The two listed methods are understandable, but listing additional methods further confuses this rule and gives creditors further ability to undercut the rule by selecting the method that increases the consumer's interest charges.

v. Consumers should have the ability to direct the allocation of their payment, but only in addition to, not instead of, a fair baseline rule.

The Agencies asked for comment on whether consumers should be permitted to instruct creditors on allocation of amounts in excess of the minimum payment. The answer is yes, but only on top of, not as a substitute for, a fair allocation rule. The Agencies' consumer testing showed that "a significant percentage of participants still did not fully understand how payment allocation can affect their interest charges,"[10] even after reading improved disclosures. If they do not understand payment allocation, they certainly will not exercise any right to "opt in" to a more favorable allocation. Even with more understanding, "opt-in" options are rarely exercised.

As discussed above, the fairest baseline rule is for minimum payments (after paying off finance charges and fees) to be allocated pro rata or in equal amounts and voluntary payments above the minimum to be allocated to the most expensive balance first. Whatever rule is chosen, it would be helpful to give consumers the ability to direct otherwise, because in individual circumstances it may be important for them to make their payments differently. However, an "opt in" rule does not justify an otherwise unfair allocation scheme that maximizes a consumer's interest payments.

B. Payment Allocation for Promotional Rate and Deferred Interest Balances (Proposed § __.23(b))

i. The proposed rule corrects unfairness and deception in advertised promotional and deferred interest rates.

Proposed section __.23(b) sets forth exceptions to the general payment allocation rules for accounts with promotional rate balances or deferred interest balances. The Agencies have accurately perceived that the unfairness and deceptiveness of payment allocation abuses are especially stark when the creditor purports to offer the consumer a

[10] 73 Fed. Reg. 28,904, 28,914 (May 19, 2008).

discounted rate but then applies manipulative rules to transform those balances into a higher rate balance.

Under current practices, if the consumer transfers a balance in response to a 0% or otherwise low APR offer, every single purchase that the consumer makes – even if the consumer pays it off in full at the end of the month – has the effect of taking an equivalent amount of the transferred balance and transforming it into a purchase balance at the higher APR, *i.e.* 12% or 18%, that applies to purchases. The consumer is *prohibited* from paying off those purchases until the entire transferred balance is paid off.

Indeed, even if the consumer makes *no purchases* or other transactions, many creditors impose a balance transfer fee (i.e. 3% of the balance) and treat that fee as a purchase or cash advance. The balance transfer fee then continues to incur interest at a high rate, despite the consumer's best efforts to pay it off.

The Agencies' proposed rule – that *all* payments above the minimum should be applied first to *other* balances – is essential to eliminate these bait and switch tactics. The creditors are free to require whatever minimum payment they choose towards the transferred balance. However, when a consumer voluntarily pays more, that voluntary payment should be allocated in the way that a rational consumer would choose: to reduce interest charges by paying off higher rate balances.

Creditors have complained that if the Agencies adopt these rules, they will no longer be able to offer promotional rates, because they would lose the interest revenue they make from the higher rate balances. That complaint reveals, however, that the marketing of promotional rates is essentially deceptive – the rates are not truly 0% or 4% because the creditors are relying on consumers incurring higher rate balances that they cannot pay off until the promotional balance is paid off. If the creditors cannot offer promotional rates fairly, without deception, then they shouldn't at all.

Furthermore, creditors are unlikely to give up promotional rates. These offers are a prime way of attracting customers away from their competitors, and they have legitimate benefits far beyond the illegitimate ones of trapping unwary consumers in higher rates than the consumers legitimately expected.

ii. The proposed rule should be adjusted to prevent manipulation.

The proposed rule should be refined in one respect to address the possibility that a nonpromotional rate on one balance could be lower than the promotional rate on another balance – and to ensure that creditors do not engage in further manipulations to distort the intent of the rule. Imagine, for example, a creditor who offers a promotional cash advance rate of 23% instead of the regular 24% rate, but whose regular purchase APR is 18%. Another example could be a cash advance offer in which only 1% of the interest charge is deferred. Thus, the rule should be amended to read:

> (i) In general. When a consumer credit card account has one or more balance at a promotional rate or balances on which interest is deferred, the bank must allocate any amount paid by the consumer in excess of the required minimum periodic payment among the other balances on the account consistent with paragraph (a) of this section. However, if the promotional rate or the rate on a deferred interest balance is higher than another rate, then the bank must allocate the excess payment first to that higher rate balance and then to the other balances. If any amount remains after such allocation, the bank must allocate that amount among the promotional rate balances or deferred interest balances consistent with paragraph (a) of this section.

Note that this complicated rule could be simplified vastly if the Agencies follow our recommendation that the rule of proposed § __.23(a)(1) – all excess payments go to the higher rate – be applied uniformly. In that case, there would be no need for a special promotional/deferred interest rate rule, and no need to address the possibility of loopholes in that rule.

C. Payment Allocation for Deferred Interest Balances (Proposed § __.23(b)(1)(ii)).

The Agencies propose an exception to general rule – that higher rate balances have to be paid before lower promotional rate balances – in order to allow payments to a deferred interest balance in the final two billing cycles before the deferral period ends. The purpose of this exception is understandable: to enable consumers to pay off that balance before the deferred interest kicks in.

We believe that the proposed rule is preferable to creditors' current practices. However, as discussed below, the proposed rule has its own problems.

i. The agencies should ban all retroactive imposition of deferred interest.

As we discussed in our comments on the FRB's May 2008 Regulation Z proposals, the far better rule, and the only one that truly addresses the unfairness and deception of deferred interest balances, is to prohibit the retroactive imposition of interest altogether and ban deferred interest offers.[11] Offers of 0%, with the interest only deferred, not forgiven, are inherently deceptive. They are also often linked to the same types of purchases involved in spurious open-end credit schemes.

The only reason that creditors make deferred interest offers instead of a promotional rate offer (that does not kick in retroactively) is to trap a certain percentage of consumers. Some consumers do not realize that they have to pay the balance in full by a certain date, forget or miscalculate the payment date, or expect to be able to pay the balance in full but for a variety of reasons find that they cannot. In any of these

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[11] *See* Comments of the National Consumer Law Center (On behalf of its Low-Income Clients) et al. Regarding Notice of Proposed Rulemaking Truth in Lending, Federal Reserve System, 12 CFR Part 226, Docket No. R-1286 at 27-30 (July 18, 2008).

circumstances, the consumer is hit with an enormous, retroactive application of interest that causes significant injury, is unexpected and unavoidable, and is not outweighed by the creditors' desire to profit from these tricks and traps.

Disclosure is not adequate to protect consumers because, like payment allocation methods, it is very difficult to explain the problem with deferred interest offers to many consumers. The complexity of the issue makes it almost impossible to formulate a short, simple disclosure necessary to adequately prevent consumers from being deceived. Consumers also cannot anticipate the reasons that they may, ultimately, not be able to or will forget to make the final payment before the interest accrues.

Imposing a huge retroactive interest payment only sends a consumer tumbling into a morass of unaffordable debt that may be difficult to escape. Permitting alluringly low credit card offers with such a dangerous hidden mine are inherently unfair and deceptive.

This conflict is all the more stark in light of the fact that deferred interest offers are typically made in the context of expensive purchases such as a flat screen TV, major appliances, or furniture. As the Agencies pointed out, if the consumer makes regular payments towards the purchase instead of having those payments applied to a balance that is incurring interest, the consumer does not receive the benefit of the no-interest period. However, if the consumer attempts to wait until the last minute to pay off the entire balance in a single balloon payment before the deferred interest kicks in, the consumer risks miscalculating or finding that her economic situation has changed so that she cannot make the balloon payment. This is exactly what creditors are counting on, and the exact reason these offers are unfair and deceptive.

Thus, the Agencies are faced with a Catch-22 in formulating a rule for deferred interest balances. As the proposed rule explains, if payments are allocated to the deferred interest balance instead of to balances carrying a higher APR, then consumers who have no cash flow problems and plan to pay the balance off right before the interest kicks in are deprived of the full benefit of the offer. However, prohibiting payments toward the deferred interest balance could harm a consumer who, for cash flow and discipline reasons, has trouble making a balloon payment at the end of the year and would have been better off making 12 equal payments of that balance – or episodic payments when cash became available – even if it increased interest charges in the short run.

In theory, these concerns could be addressed by allowing the consumer to direct payments at any time toward the deferred interest balance. But the reality, as the Agencies have discovered, is that consumers do not understand payment allocation rules. Moreover, any "opt in" rule of this sort will be used only by a small number of customers. The default rule is the one that will apply to the vast majority of consumers, and it is inevitable that either rule could end up harming some consumers.

For these reasons, the only truly workable rule is one that bans deferred interest offers.

ii. If deferred interest offers are allowed, the two month rule should be mandatory and consumers should be permitted to choose to allocate earlier payments to that balance.

If the Agencies choose not to ban deferred interest offers, the exception for the final two monthly statements should remain, but should be mandatory. Another problem with the proposed rule is that it does not actually require creditors to allocate payments in the final two months to the deferred interest balance. The creditor could permit payoff only in the final month, hoping that consumers will slip up.

In addition, the consumer should be allowed to direct payments at any time towards the deferred interest balance. As we recommended in our comments to the FRB's May 2008 Reg. Z rulemaking, clear disclosures should be developed for each periodic statement that both warn the consumer of the impending payoff date and disclose how much the consumer must pay to avoid retroactive application of interest. In addition, the periodic statement should make it easy to allocate payments to the deferred interest balance.

D. <u>The Proposed Rule Properly Forbids Manipulation of Grace Periods as a Substitute for Payment Allocation</u> (Proposed §__.23(b)(2))

Proposed section __.23(b)(2) prohibits creditors from requiring consumers to repay any portion of a promotional rate or deferred interest balance in order to get the benefit of a grace period to which the consumer is otherwise entitled. This is a necessary corollary to the payment allocation proposal. Without such a grace period rule, creditors could essentially do an end run around the payment allocation rules by using the penalty of imposing immediate interest charges to force payment of the promotional rate balance, thus undoing the protection of the payment allocation rule.

V. RETROACTIVE APPLICATION OF RATE INCREASES (Proposed § __.24).

Proposed section __.24 prohibits interest rate increases from being applied to outstanding balances, except in limited circumstances, and specifies the adjustments a creditor may make to the minimum payment.

We strongly support this proposal, and urge the Agencies not to weaken any aspect of it. The proposed rule stops the abusive bait and switch tactics that have flourished to allow creditors to offer one rate but find excuses to raise that rate. To the extent that an exception is needed to allow retroactive penalty rate hikes when the consumer violates a term of the agreement, the proposed 30-day late rule is a clear, easy, justifiable dividing line between the hair-trigger, ginned-up excuses creditors have been using and a consumer who is unquestionably in violation.

Nevertheless, the rule should go further to prohibit all retroactive interest rate increases, even in a true penalty situation. Imposing a huge interest rate hike only makes it more difficult for a struggling consumer to manage credit card debt. Moreover, prohibiting retroactive interest rate hikes for struggling consumers would help to eliminate abusive marketing that rampantly targets delinquent consumers – who are highly likely to default – with additional credit offered at deceptively low rates.

The proposed rule should also go farther to prohibit prospective interest rate increases until the current agreement expires.

A. General Rule: Retroactive Interest Rate Hikes Are Unfair and Deceptive

The proposed general rule prohibits retroactive interest rate increases on an existing balance except for variable rate increases, expiration or loss of a promotional rate, and penalty rates for consumers who are at least 30-days late.

This proposed rule is well supported by the long history of bait and switch tactics by creditors. Creditors attract customers offering one rate. Then, after the consumer has incurred a large balance based on that rate, the creditor can use a variety of flimsy excuses to double or even triple the consumer's rate.

A long list of reasons shows why these retroactive rate hikes are unfair and deceptive:

- **Retroactive rate hikes are used to pad profits, not manage risk.** Disproportionately large increases imposed in response to minimal changes in the consumer's profile are used as a method of increasing profits after the consumer is on the hook, not dealing with risk.

  - **"Risk" factors do not influence initial credit pricing and should not be used retroactively on the back end.** Late payments, bounced checks, and other supposed indicators of risk do not stop creditors from extending credit or increasing a credit line. Creditors have the ability to see that very behavior ahead of time (such as history on other credit cards or accounts). Indeed, creditors often seek out these factors in the criteria that they use to make prescreened offers to people with bad credit or who are emerging from bankruptcy. This information should be used to set the initial rate and initial credit line, not to change the rate that the consumer has been promised, has accepted, and has relied upon.

  - **The creditor's motive is hard to assess**. Creditors use risk management as an all purpose excuse to justify a wide range of practices. However, there is no evidence that the factors creditors cite correlate strongly with a substantial increase in risk. Allowing an unrestricted list of factors to justify retroactive rate increases provides far too much latitude that creditors have abused. Especially when creditors are losing profits for unrelated reasons such as the losses incurred from the mortgage crisis, it is all too tempting to look for excuses to raise profits elsewhere.

- **Creditors lend to risky consumers, then complain that they are risky.** The example of Citibank, South Dakota, N.A. v. Palma[12] shows how retroactive rate increases are used unfairly to profit, not for responsible risk management. Citibank **doubled Ms. Palma's credit limit despite obvious signs of financial distress as shown by 15 late payments during a three year period**. After Ms. Palma used this increase credit line, Citibank *then* reduced the line and approximately doubled the interest rate. Citibank's response to Ms. Palma's "default" was to give her *more* credit. After she had used the credit, Citibank then re-priced her account. The end result was that Ms. Palma was in much deeper debt than if Citibank had simply cut her off and required her to pay off the account at the old rate.

- **Retroactive rate increases do not represent sound risk management.** An outstanding balance represents credit already extended, just like closed-end loans such as mortgages, auto loans, or installment loans. Creditors obviously engage in risk-based pricing for each of these types of closed-end loans *on the front end*. No creditor has argued that a mortgage or auto loan should be re-priced by doubling the interest rate on the loan ex ante because the consumer's credit score has dropped or their usage shows signs of distress.

  - **Underwrite up front, not after the fact.** Permitting retroactive interest rate hikes gives creditors an incentive to do back end underwriting, with a result harmful to consumers, rather than to make greater efforts to assess risk at the outset, before the consumer has incurred the debt (and before the institution has incurred the risk). For too many years, creditors have failed to properly underwrite new credit card accounts. Until recently, they have relied almost exclusively on credit scores to grant credit, despite other signs that a consumer might be overextended.[13]

  - **Manage risk by limiting credit, not increasing its cost.** The appropriate response to risk is to limit credit – primarily at the front end and, if necessary, at the back end – not to use it as an excuse for predatory lending and predatory pricing.

[12] 646 S.E.2d 635 (N.C. App. Ct. July 3, 2007).

[13] Federal Reserve Board, *Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on Consumer Debt and Insolvency*, at 19-22, June 2006, *available at* www.federalreserve.gov/boarddocs/rptcongress/bankruptcy/bankruptcybillstudy200606.pdf (noting that creditors rely primarily on credit scores and verify the consumer's statement of income very rarely) *See, e.g.,* AT & T Universal Card v. Ellingsworth (*In re* Ellingsworth), 212 B.R. 326 (Bankr. W. D. Mo. 1997) (Consumer sent a pre-approved credit card with credit limit of $4,000 based on her FICO score of 759 even though she had 16 other credit cards); Universal Card Services Corp. v. Akins (In re Akins), 235 B.R. 866 (W. D. Tex. 1999) (Card issuer approved consumer to use a convenience check up to her full $4,000 credit limit based on acceptable FICO score even though she had two other credit cards totaling approximately $30,000 in debt, or 150% of her gross income).

- **Retroactive rate hikes increase risk, not decrease it.** A consumer is more likely to default when interest rates go up. Retroactive rate increases can turn a customer who pays on time into one who does not.

- **Create incentives to deal with customers fairly, not unfairly.**

  - **Creditors should not be allowed to profit by consumer's mistakes.** Under current rules, creditors actually *do better* when consumers slip up. Creditors count on those slip ups to pad their profits.[14] This creates an incentive to develop unfair rules to encourage those mistakes. That incentive feeds abuses involving unfair rate hikes, treatment of late payments, over-limit fees, and charging consumers who are trying to pay by an expedited method.

  - **Don't penalize consumers for following the creditor's rules.** Creditors tell consumers that they have a certain credit limit and a certain minimum payment, and then when the consumer uses that limit and makes that minimum payment, the creditor punishes the consumer. *If using the full credit limit or making only that minimum payment is risky, then the creditor should give a lower limit or require a higher payment.* Creditors want to penalize consumers who are following the rules in anticipation of a breach that may never occur. The creditors should be required wait until the consumer actually breaches the contract first.

  - **Align the consumer's and creditor's interests to encourage affordable, not predatory, credit.** The proposed rule should realign the interests of consumers and creditors so that their goals are the same: ensuring that credit is extended only if it is affordable, and that a consumer whose situation has changed is able to get out of debt. The current situation is similar to the compartmentalization in the mortgage market that created incentives to earn fees by making bad loans.

- **Competition is served by having clear, fixed, up front terms that consumers can compare.** The more that pricing is handled and changed on the back end, the more difficult it is for consumers to comparison shop.

  - **Complex and deceptive pricing structures also make it harder for an honest competitor to compete with a level playing field**. Citibank found this out the hard way when it tried to do the right thing and adopted its "A Deal Is a Deal" policy abandoning universal default. As the New York Times described:

[14] Harry Terris, *New Card Mix, New Issues at CompuCredit*, American Banker (May 10, 2007) ("The Atlanta subprime lender posted a surprise loss in the first quarter. One reason was that a drop in delinquencies resulted in a $22 million hole in projected late and over-limit fees, the company said.") .

> [The] policy did not give Citigroup the edge it hoped for. Most customers did not recognize the benefit, in part because of the difficulty deciphering the fine print among offers from different banks.
>
> "We hoped and expected that these two points of differentiation would lead customers to vote with their feet," John P. Carey, the chief administrative officer for Citigroup's credit card unit, told a Congressional panel in April. "We have been disappointed with the results we have seen so far." [15]

Thus, the incentives right now are for creditors to compete by making the offer that *seems* most attractive, and to make it up on the back end – a recipe for unfair and deceptive practices.

- **Opaque risk factors are unfair to consumers.** The reasons for risk hikes are opaque to consumers, who do not understand them and cannot reasonably avoid the increases.

B. Creditors Have a Variety of More Responsible Methods to Manage Risk

The Agencies ask for comment whether the proposed rule would limit creditors' ability to manage risk. The proposed rule permits a wide range of more legitimate methods of managing risk, including 1) better up front underwriting, 2) more closely monitoring credit quality on an ongoing basis and imposing prospective changes before the debt is incurred, 3) restricting future credit, 4) increasing minimum payments, 5) working with the consumer to help, not hurt, her ability to make payments, 6) charging late, over-limit, bounced check, and other one-time fees for one-time transgressions.

Even if some of the factors that creditors cite have some statistical association with risk, creditors should have an incentive to take them into account in the initial underwriting decision, and to monitor credit actively and prospectively before more credit is extended. Allowing retroactive rate increases reduces the incentives for these more responsible forms of risk management.

After a loan is made, the best way to manage risk is to make it *easier*, not harder, for the consumer to repay the debt if difficulties arise. Imagine if mortgage lenders today were arguing that in order to manage the risk posed by the foreclosure crisis, they need the ability to increase interest rates for homeowners who are at risk of default. Similarly, no one today is defending exploding adjustable rate mortgages as an appropriate type of loan. The idea that credit should be extended at low initial rates and then increased precipitously if difficulties arise is completely discredited as a form of responsible lending.

[15] Eric Dash, *Citigroup Considers Repealing a Pledge, and the Slogan With It*, New York Times, D4 (June 25, 2008).

Creditors complain that the rule would restrict risk-based pricing, but it does not restrict responsible pricing for risk. Irresponsible risk based pricing, on the other hand, should be eliminated. Mob loan sharks and payday lenders who loan at triple-digit rates allegedly price for risk. Right now, credit card lenders do the same, except that they add deception to the mix – they start with a misleadingly low rate and then switch after the fact to a predatory one.

It may seem counterintuitive that creditors would profit from consumers who are struggling to make their payments. The extreme stress that consumers are under right now as a result of the mortgage crisis and worsening economy may well be leading to losses, not profits, for industry. But just as a monopolist attempts to raise prices to the point that profits increase without suppressing demand too much, credit card issuers attempt to push consumers to the point of the "sweat box" – where they are paying a lot of fees and interest – but not beyond to the point where they break and stop paying at all.[16] At times, creditors miscalculate, and their strategy backfires, just as the strategy of subprime mortgage lenders has backfired. The appropriate response is to adopt incentives for creditors to do appropriate underwriting up front, which helps consumers avoid the sweat box and helps lenders avoid improvident lending. The industry's losses today do not justify the sweat box strategy.

With the caveats discussed below, the rule against retroactive interest rate increases appropriately encourages fair, responsible ways of managing risk, not unfair and deceptive ones.

C. <u>The Rate Hike Restrictions Will Not Have A Significant Effect on Securitizations</u>

The Agencies request comment on whether restrictions on retroactive rate increases would have an effect on outstanding securitizations and institutions' ability to securitize credit card assets in the future. We do not believe that the modest restrictions proposed would significantly affect either outstanding or future securitizations.

With respect to outstanding securitizations, retroactive interest rate hikes *increase* risk by making it more difficult for consumers to make payments and more likely that they will simply walk away. At times, the increased profits made from those who manage to continue paying unfair rate hikes may outweigh the losses from those pushed over the brink. Investors may like these excess profits, just as the junk bond investors of the 1980s were happy to finance leveraged buyouts that turned stable companies into risky ventures. The high returns on the junk bonds outweighed, for a time, the inevitable casualties.

But in the end, this is not a prudent investment strategy. In the current economy, the most prudent way to manage outstanding risk is to work with consumers to help them to stay current. Just as mortgage lenders are finding that the best way to manage their

[16] Ronald Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007.1 Ill. L. Rev. 375 (2007), *available at* http://works.bepress.com/ronald_mann/14.

portfolios is to modify loans to ward off interest rate hikes, the best way to preserve the assets of credit card portfolios that have already been securitized is to not make it harder for consumers who are struggling. Exploding ARCs -- Adjustable Rate Credit cards – are no more a prudent investment than exploding ARMs or junk bonds.

Moreover, the base interest rate that consumers in good standing pay is very high, precisely because these are unsecured loans. The average APR on "low interest" cards has been about 11% for the past year, and for students has been 15% to 18%.[17] An 11% home loan would be considered predatory. However, rates are higher for credit cards because the base rate is priced to account for the riskier nature of these loans. For that reason, credit card securities are in far better shape than mortgage-backed securities and do not need the excess profits from predatory retroactive rate hikes to compensate for chargeoffs. As an analyst with Fitch explained, "Securities backed by credit cards are sized to withstand considerable stress …. Those with AAA ratings could withstand chargeoff rates 'well in excess of 25%.'"[18] Current chargeoff rates are no where near that level, generally in the 5% to 7% range for most issuers, with only WAMU having a chargeoff rate up at 11%.[19]

With respect to future securitizations, the proposed rule will encourage creditors to do a better job of underwriting credit initially and monitoring it on an ongoing basis, and to price credit accurately and fairly at the outset. The credit card market does not have to rely on deceptive bait and switch tactics, and there is no reason to think that the securitization market will dry up if those tactics are not allowed.

D. <u>Prospective Rate Increases Should Be Banned Until the Card Expires</u>

The ban on rate increases does not apply to balances incurred 14 days after the notice of a rate increase. In general, we agree that the appropriate line is between a retroactive rate increase and a prospective one, for the reasons discussed above.

However, the prohibition on rate increases should be extended to cover prospective transactions until the date on which the card agreement will expire if not renewed. Credit card contracts are almost unique among consumer contracts in that they allow one party, the creditor, to change the terms at will at a moment's notice. Consumers who shop for cards advertised at a given rate should know, in the words of Citigroup, that "A Deal is A Deal." Once the rate is set, that rate should stay in effect for the term of the contract, at least as long as the consumer does not commit a significant violation of the contract by becoming more than 30 days late.

Although the unfairness of a rate increase is lessened if the increase does not apply retroactively, creditors can still undercut the rule by making regular, incremental, upward adjustments on a prospective basis. Thus, a creditor could successively impose

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[17] *See Credit Card Offers* [Chart], American Banker at 8 (July 28, 2008).
[18] *Card, Auto Losses Seen Rising*, American Banker (Feb. 4, 2008) (quoting Kevin Duignan, Managing Director, Fitch, Inc.).
[19] *See* Harry Terris, *Issuers Vary in Outlooks on Quality*, American Banker, at 1 (July 25, 2008).

1% rate increases that are not large enough to catch the consumer's attention and, because they require no action by the consumer, might escape the consumer's awareness altogether.

The moment when a card expires[20] is the moment when a consumer needs to take some action and can be motivated to look at the terms of the card, see what has changed, and assess whether to continue that card or change to another.

Like the ban on retroactive interest rate hikes, a ban on increases during the term of the card would encourage fair competition and level the playing field between creditors who offer a fair deal that they intend to honor and creditors for whom the offered price is merely the hook for bait and switch.

E. The Exception for Indexed Rates is Appropriately Limited (Proposed § __.27(b)(1))

We have no objection to the exception for variable rates from the prohibition on retroactive rate increases. We support the manner in which the proposed rule defines indexed variable rates that are exempt. The requirements that the index not be under the creditor's control and be available to the general public are essential to ensure that this narrow exception is not manipulated into a means to evade the general rule.

F. The Exception for Loss of a Promotional Rate Should be Eliminated (§ __.27(b)(2))

i. Loss of a promotional rate due to tracks and traps is unfair.

The proposed rule exempts from the ban on retroactive rate hikes an increase in a promotional rate that has expired or has been lost. We of course have no objection to the exception for a promotional rate that has expired.

However, all of the reasons the Agencies set forth to support the proposal to ban retroactive rate increases generally apply to premature revocations of a promotional rate. In fact, in the promotional rate context, creditors have even more incentive to advertise a low, below-market rate they do not plan to keep, and to come up with flimsy, opaque excuses to revoke it. The case against unfairness and deception is even more compelling with promotional rates, as the consumer has been attracted to the card by the promotion. The "bait and switch" effect of allowing the promotional offer to be revoked is even stronger.

The harm to consumers of applying a huge increase to purchases or transactions already made is every bit as great. For balance transfers, in particular, the consumer

[20] We recognize that, under the FRB's proposed Comment 226.11(b)(1)-1 in its Regulation Z rulemaking, only the card and not the agreement is considered to have expired. However, adoption of our proposed rule would encourage creditors to align their card and agreement expiration periods.

likely never would have made the transfer, closed the other account, or incurred the balance transfer fee if the higher rate applied.

The jump from a 0% to an 18% APR is a significant, unavoidable harm. The same range of trumped-up, unintelligible reasons can be used to revoke a promotional rate, which consumers have no more ability to understand or avoid. In fact, if creditors are only allowed to impose retroactive interest rate increases in a promotional rate situation, they are likely to focus their unjustified universal default and hair trigger penalty rate policies in that situation.

Furthermore, the injury is no more outweighed by countervailing benefits in the promotional rate situation. Here again, all consumers are better served by honest promotional rates that they have confidence will not change, even if those rates are a bit higher, than dishonest ones that are artificially low because creditors rely on tricks and traps to change them.

For all of these reasons, there is no reason to carve out increases in unexpired promotional rates from the general rule.

ii. In the alternative, promotional rates should be increased to standard rates only for specific, material violations described in the agreement.

At a minimum, in order to ensure that the general rule is not undercut, the Agencies must put some limits on the type of reasons that can trigger loss of a promotional rate. Mere changes in the consumer's credit score – which can happen even if the consumer has not become a riskier customer – or other "off us" changes should not be allowed. Nor should insignificant violations, such as paying one day late or exceeding the credit limit by $10.

The best rule is the clear, justifiable one that the Agencies developed for nonpromotional balances: the increase is only allowed if the consumer is 30 days late. If the Agencies are unwilling to make the rules clear and uniform, however, the promotional rate exception should be revised to read:

> The expiration or loss of a promotional rate, provided that <u>(i) an unexpired promotional rate may be lost only due to a specific, material action or omission of the consumer in violation of the agreement that is directly related to such account and that is specified in the agreement as grounds for an increase, and (ii)</u> the bank does not increase the annual percentage rate to a rate that is greater than the annual percentage rate that would have applied after expiration of the promotional rate;

Note that this is consistent with the illustration given in the proposed Commentary § __.24(b)(2)-1, which explains that "If the consumer does not make payment by the due date <u>and the account agreement specifies that event as a trigger for applying the penalty rate</u>, the bank may increase the annual percentage rate [on the outstanding balance to the standard rate but not the penalty rate].” Without the change proposed above, however, the rule does not clearly require the account agreement to specify the triggers for loss of the promotional rate, nor does it require that the triggers be material, specific, and understandable to the consumer, not trumped up excuses.

G. The Exception for Payments 30-Days Late Should Be Eliminated and Certainly Should Not Be Expanded (Proposed § __.24(b)(3)

The proposed rule allows retroactive rate increases for consumers who are 30 days late with their payment. The proposal also asks for comment on whether exceptions are needed for other account agreement violations, such as payments less than 30 days late, a payment returned for insufficient funds, or exceeding the credit limit.

As discussed above, consumers who are struggling with their debt – just like consumers at risk of foreclosure – should not be hit with retroactive rate increases that only make default more likely. Creditors should instead work with these consumers to create a manageable plan to pay off the debt.

However, to the extent that the Agencies feel compelled to have an exception for true penalty situations, the 30 days late rule is a very clean, easy to apply, and defensible rule. It eliminates the possibility of manipulation by creditors. It prevents large, injurious increases in interest charges for consumers who, at most, have committed minor transgressions. A consumer who is less than 30 days late is paying her bills every month, and does not deserve a retroactive rate increase on top of the fees she may have to pay. A consumer who is 30 days late is much more likely (though not certain) to be having serious trouble paying her bills.

A consumer who is less than 30 days late will still have to pay late fees every time she is late, over-limit fees every time she is over her limit, and returned item fees every time a check bounces. If the violations happen repeatedly, those fees will add up and have the same effect as a retroactive rate increase. The creditor can impose a prospective rate increase – which, over time, will apply to the vast majority of the credit line. Also, the creditor can increase the minimum payment. However, the 30-day rule will remove the incentive that creditors have right now to find minor transgressions and use them as an excuse for a rate increase.

Some creditors have been arguing that the exception should be expanded to include a consumer who is late twice in a 12-month period – even if it is only by a day or two – or who has a payment returned.[21] That expansion would completely swallow the rule. It would not address in practicality the abuses that have prompted the rule, as it reflects many creditors’ current policies.

There is no evidence that the bulk of consumers who pay late twice in a 12-month period, but pay every month and are never 30 days late, pose a significant increase in risk

[21] Sandra Braunstein, Meetings with American Express on Regulation AA and Z (Docket No. R-1314 and R-1286, June 5, 2008

to justify a retroactive rate increase. The consumer is more likely to be a busy person with the demands of a job and family on her time who does not always find the time to sit down and pay bills. Even the longer time provided under the Agencies' proposal assumes that a consumer will have only 7 days to pay her bill. Missing that short deadline is not an indication of a cash flow or credit worthiness problem.

Indeed, the credit industry's *own* standard for reporting an account as delinquent to the credit bureaus is 30 days after the due date.[22] Thus, a payment that is less than 30 days late is not even considered to affect the consumer's creditworthiness.

Adding any additional types of late payments to the list of exceptions would give creditors an incentive to continue finding ways to make consumers late. Creditors have been shortening payment times, imposing fees for online and telephone payments, and manipulating the posting of payments, all because they have an incentive to collect late fees. That incentive should not be increased.

Similarly, a consumer who has a check returned is also not a significantly increased risk and does not deserve the doubling of her rate on a large balance incurred under different terms. Checks can bounce for a variety of reasons, including excessive deposit hold times by banks, mistakes by merchants, and spouses who forgot to tell each other about the purchases they made. The consumer can be forced to pay a returned item fee and a late fee, and to pay a higher interest rate going forward, but as long as the check ultimately clears or payment is otherwise made within 30 days, a retroactive rate increase is not justified.

Being over-limit also is not a sign of serious delinquency or a justification for a retroactive rate increase. Many consumers do not even know what their credit limit is or the creditor does not give them a firm limit. They cannot readily determine how much they have spent of their limit or whether their payments have been credited. Creditors who do not want consumers to be over their limits have a simple solution: deny those transactions. Creditors instead prefer to encourage consumers to be over their limits because they can then charge over-limit fees. As we discuss in Section VI, a creditor that has approved a transaction should not be allowed to use that transaction as the basis for penalizing a consumer – whether by an over-limit fee, or more drastically by a large retroactive rate increase.

Allowing over-limit transactions to be an exception to the retroactive rate ban also encourages over-limit abuses. BusinessWeek, for example, reported that Capitol One engaged in the practice of extending consumers several low limit cards rather than a single higher limit card – increasing their over-limit fees.[23] Creditors should not have an added incentive to find ways to make consumers over their limits.

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[22] *Credit Reporting Resources Guide*, Consumer Data Industry Association, Inc., 2006 (Metro 2 Manual), at 4-11 and 6-6. Relevant pages are attached as Attachment 1.

[23] Robert Berner, *Cap One's Credit Trap: By offering multiple cards, the lender helps land some subprime borrowers in a deep hole and boosts its earnings with fee income*, BusinessWeek (Nov. 6, 2006).

The 30-day late rule is the only one that goes to the heart of the matter: is the consumer paying or not? Any other exceptions would put us right back in the situation where we are now, with creditors creating rules that create traps for consumers and looking for excuses to find violations.

H. Treatment of Outstanding Balances (Proposed § __.24(c)(1)).

i. The proposed rule recognizes the need for protection against precipitous increases in minimum payments.

Proposed section __.24(c) limits the increases that a creditor may make in the minimum payment when the creditor has increased an APR but is prohibited from applying the increase to an existing balance. The proposed rule allows the creditor to accelerate repayment but limits the degree of acceleration to protect the consumer. It prevents acceleration of the entire outstanding balance from being used as a way of getting around the retroactive rate increase prohibition.

Although we disagree with the premise that the consumers in this situation are riskier and deserve higher payment, it is far preferable to require these consumers to make modest increased payments towards principal than to subject them to higher finance charges that only make the debt more unmanageable. Adjusting the minimum payment – as long as the jump is not excessive – is a much more responsible approach to risk management than turning a reasonable loan into a predatory one. If a consumer's minimum payment is going to increase, it is much better for the consumer to have the increased amount go towards principal than to simply pad the creditor's profits.

A rule that accounts for risk by adjusting the minimum payment rather than the interest rate is also more likely to separate genuine risk management measures from those that are concocted. A creditor is unlikely to accelerate the payment of a balance unless the creditor truly has reasons to fear repayment. Otherwise, the creditor is more likely to prefer a longer repayment period and a longer period of collecting finance charges.

It is essential, however, to limit the extent to which the minimum payment may be increased, as the Agencies recognize. A huge, unexpected jump in the minimum payment would not only be unfair to consumers, it could also be used manipulatively to attempt to trigger a 30-day late payment, which in turn would permit a retroactive rate increase. That is, without limitations on changes in the minimum payment, creditors could use those changes to avoid the ban on retroactive interest rate increases.

ii. The proposed rule governing changes in the minimum payment should apply to any change concerning an existing balance, regardless of the reason.

The proposed rule should be a general one. The Agencies asked about one situation: when the creditor responds to a perceived increase in risk by declining to extend additional credit to the consumer. The limitations in proposed section __.24(c) are appropriate in that situation, but that is not the only situation. Regardless of the reasons, it is unfair to impose a precipitous jump in the minimum payment that the consumer does not expect.

We do, however, have concerns about the precise limitations proposed. Although we generally support higher minimum payments and shorter amortization periods, changing the rules after the consumer has already incurred the debt could lead to a substantial, unexpected increase and could push the consumer over the edge. For example, a consumer who has a $10,000 balance and whose minimum payment includes 1% of that balance could find that her payment jumps by $100 per month. The inability to make that extra payment could trigger a penalty rate increase, so that her 12% rate could go up to 29%, compounding her problems.

Therefore, increases in the minimum payment based on an outstanding balance should not be allowed for consumers who have not violated any term of the agreement. Consumers who incurred a balance under certain terms and expectations should not be penalized when they are complying with the agreement. That is, “universal default” does not justify increasing the minimum payment any more than it justifies rate increases. Thus, “any time any reason” changes in the minimum payment should not be allowed.

iii. Consumers should get 45 days notice and an estimate of changes in the minimum payment.

We support the proposed change to Regulation Z in the FRB’s June 2007 NPRM requiring 45 days notice for a change in the minimum payment. This change is particularly important if creditors begin changing minimum payments more often in response to these proposed rules.

The FRB should specific that in this notice, consumers should get an estimate of how the change will affect her specific payment. Otherwise, the notice is likely to be disregarded, and not to serve the purpose of alerting the consumer to prepare for a higher payment.

I. <u>The Proposed Rules Properly Prohibit Fees and Charges on Outstanding Balances</u> (Proposed § __.24(c)(2)).

We support the prohibition on fees or charges based solely on an outstanding balance for which the APR may not be increased. As the proposal explains, this rule is necessary to ensure that other fees and charges are not used as a substitute for a prohibited increase in interest charges.

J. <u>Opt-Out is Not an Adequate Means of Protecting Consumers</u>

The proposal asks for comment on whether an opt-out is a more appropriate means of protecting consumers from retroactive interest rate increases. The answer is a vehement no. Some states already provide for an opt-out right, and creditors have acknowledged that very few consumers take advantage of it. A variety of reasons can prevent consumers from exercising an opt-out right, including inability to find another line of credit, failure to understand the opt-out right or how to exercise it, and simple inertia. As discussed in Section X.B, the behavioral economics research is clear that opt-outs or opt-ins are rarely exercised, and that the default option is often the one that applies to the vast majority of consumers. The default option should be the rule that is appropriate for that majority.

Substituting an opt-out rule would simply perpetuate the existing system, which gives creditors an incentive to find a consumer in default or to find fault with their creditworthiness, after the fact. These incentives need to be eliminated so that the creditor and the consumer will share the common goal of ensuring that the initial extension of credit is affordable and that it remains affordable.

To the extent that the Agencies continue to permit retroactive rate increases for those who are 30 or more days late, however, they should require creditors to provide an opt-out. Notice of the right to opt-out should be given in same notice as the rate increase required by Regulation Z. In addition, that notice should include an estimate, based on the outstanding balance, of how the rate increase will affect the amount of finance charges and minimum payment. The opt-out notice should be provided in a conspicuous place on the next two periodic statements, including at least one after the increased rate has taken effect. Although this is no substitute for a prohibition on retroactive rate increases, it should be available for consumers who cannot avoid those increases, even if history shows that most will not take advantage of it.

VI. THE AGENCIES SHOULD PROHIBIT *ALL* UNFAIR OVER-LIMIT PRACTICES (Proposed §__.25).

The Agencies have proposed prohibiting creditors from assessing a fee or charge if a consumer exceeds the credit limit solely due to a "hold" placed on the available credit line by a merchant. We strongly support this proposal. Consumers should not be assessed fees for an illusory transgression, when it really was the merchant's practice that resulted in the consumer being technically over the limit.

We believe that the Agencies' proposal could be improved to prohibit not just a fee or charge, but any adverse action based on a supposedly over-limit transgression caused by a credit hold. This would include any negative credit reporting or loss of a promotional interest rate, both of which can be just as burdensome as an over-limit fee.

More importantly, we reiterate our position that the Agencies should ban over-limit fees and other adverse consequences for any transaction that the creditor approves or permits. As we explained in detail in our March 2005 comments to the Federal Reserve Board's Advanced Notice of Proposed Rulemaking, over-limit fees are particularly unfair because the creditor technologically has the ability to decline over-limit transactions, but chooses to approve them in order to reap the fee income.

The practices for which the Agencies request information are further evidence of the abuses in over-limit practices. There certainly have been many examples in which consumers have been assessed multiple over-limit fees in later billing cycles for an over-limit transaction that occurred in a prior billing cycle, for which a fee has already been charged. The testimony of Wesley Wannamaker before the Senate Permanent Subcommittee on Investigations is but one example of this abuse.[24] Mr. Wannemacher was charged $1,500 in over-limit fees for a single transgression. Another example is the infamous case of Ruth Owens in Cleveland, OH, who was charged $1,518 in over-limit fees despite never making a single purchase on her credit card from 1997 to 2003.[25]

This practice of "pyramiding" over-limit fees is unfair, as is assessing more than one over-limit fee per billing cycle or assessing them when the account is over-limit only because of fees or finance charges. Over-limit fees should not be permitted in excess of one per billing cycle. They should also be prohibited if the account is over-limit because of fees or finance charges, and a single event should not trigger over-limit fees in multiple billing cycles. Over-limit fees should also be banned when they are the result of the creditor lowering a consumer's credit limit below the consumer's current balance.

Finally, we believe it to be an unfair practice to assess an over-limit fee in an amount that exceeds a reasonable relationship to the cost of the transgression. For centuries, the common law prohibited a liquidated damages provision in a contract that was intended as a penalty rather than as a reasonable advance estimate of the costs of a violation that is hard to quantify. Both the Section 2-718 of the Uniform Commercial Code and Section 356 of the Restatement (Second) on Contracts require liquidated damage provisions to be reasonable in light of actual or anticipated damages.
Yet of all industries, financial institutions are the only ones who do not have to abide by this sensible common law doctrine, because it is preempted by federal banking statutes.[26]

We urge the Agencies to establish a rule prohibiting over-limit and late fees that are not reasonably related to the damages incurred by the creditor. The Office of Fair Trading in the United Kingdom has established such a rule to protect consumers.[27] If the country from which our common law (and our banking system) originated believes such a rule is required to prevent unfair practices against consumers, surely we should consider the same in this country.

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[24] *Credit Card Practices: Fees, Interest Rates, and Grace Periods, Hearing Before the Permanent Subcomm. on Investigations of the Sen. Comm. On Homeland Security and Governmental Affairs* (110th Congr. (2007) (statement of Wesley Wannemacher).
[25] Discover Bank v. Owens, 822 N.E.2d 869 (Ohio Mun. 2004).
[26] *See* In re Late and Over-Limit Fee Litigation, 528 F.Supp.2d 953 (N.D. Cal. 2007) (Section 85 of the National Bank Act preempts common law prohibition against a liquated damages clause that serves as a penalty).
[27] *Calculating Fair Default Charges in Credit Card Contracts*, United Kingdom Office of Fair Trading, April 2006, *available at* www.oft.gov.uk/shared_oft/reports/financial_products/oft842.pdf

VII. DOUBLE CYCLE BILLING SHOULD BE BANNED, AS SHOULD "VANISHING GRACE PERIOD" (Proposed §__.26).

The Agencies have proposed a rule that would make it an unfair practice to calculate the finance charges based on balances owed during days in the prior billing cycle. We strongly support this proposal, which would ban the balance calculation method know as "two cycle" or "double cycle" billing. Double cycle results in significantly higher interest charges for consumers, and it eliminates the benefit of the grace period if a cardholder moves from non-revolving to revolving status and vice versa. It is contrary to consumer expectations about how a grace period works, and the Federal Reserve Board's testing shows that it is not possible to adequately educate consumers about this practice through disclosure.

We believe the Agencies should go further and also prohibit "vanishing grace periods." The "vanishing grace period" phenomenon is actually demonstrated in the example set forth by the Agencies in the Staff Commentary for Proposed §__.26. The example involves the following:

March 1 – the consumer has a $0 balance
March 15 – the consumer makes $500 purchase
April 25 – the consumer pays $400 on the due date

According to the Commentary, the creditor is permitted to charge interest on –
$500 from April 1 to April 24
$100 from April 25 to April 30
No interest charge permitted on $500 from Mar 15 to Mar 31.

We believe that the creditor should also be prohibited from charging any interest on the $400 paid by the due date. That would mean the creditor could only charge interest on the $100 that was not paid by April 24. The creditor could charge interest for that entire $100 from April 1 to April 30.

The Agencies should ban vanishing grace periods, because most consumers assume that they cannot be charged interest at all for any amount that they have paid off by the grace period's end. After all, that would be the natural assumption of a grace period – if you pay off any amount within the grace period, you don't get charged interest on that amount. Thus, even with the current proposal, consumers will be unpleasantly shocked to find they were charged interest on a full $500 for three weeks, when they had paid off $400 of that amount.

The unfairness of vanishing grace periods is even more apparent for one of the most common complaints – when consumers accidentally pay a small amount less than their balance and are assessed interest for the entire balance. For instance, if the above example involved a $501 balance for which the consumer accidentally paid only $500 on April 24, leaving $1 unpaid, it would be unfair to permit interest to be assessed for the entire $501 from April 1 to April 24.

Finally, as we stated in our comments to the Federal Reserve Board's May 2008 NPRM on Regulation Z changes, we urge the FRB to adopt enhanced disclosures for balance computation methods in general. Even without double cycle billing, some balance calculations are still more expensive than others, and consumers should have simple and clear information about these methods. The FRB's own research found that "consumers did not understand explanations of balance computation methods."[28] The only way to adequately educate consumers about these methods is to adopt an "Energy Star" approach, which would provide a numerical or other easily understood rating for each balance computation method.

VIII. FEE-HARVESTER CARDS PROVISIONS (Proposed §__.27)

We support the concept of the Agencies' proposal to limit the percentage of fees that can be charged against the credit line of a credit card account. We also support the concept of limiting the amount of fees and charges that can be charged to the account during the first month. However, we respectfully recommend that the limits on these fees and charges be set much lower – at 10%. Furthermore, we have a number of other suggestions to improve the proposed rule.

A. Current Fee-Harvester Practices are Unfair

We have documented the many abuses posed by fee-harvester credit cards in our November 2007 report on these products.[29] These cards essentially offer sham credit. The high fees imposed by creditors eat up most of an already low credit limit, leaving the consumer with little real, useable credit at a high price. Some of the examples of fee-harvester cards noted in our report include:

[28] 73 Fed. Reg. 28,904, 28,922 (May 19, 2008).
[29] Rick Jurgens and Chi Chi Wu, *Fee-Harvesters: Low-Credit, High-Cost Cards Bleed Consumers*, National Consumer Law Center, Nov. 2007.

First Premier Bank	
Credit Limit	$250
Program Fee	-$95
Account Set-Up Fee	-$29
Participation Fee	-$6 (per month)
Annual Fee	-$48
Total Usable Credit	$72

Capital One	
Credit Limit	$200
Annual Fee	-$50
Diner Club Membership	-$99
Total Usable Credit	$51

Continental Finance	
Credit Limit	$300
Account Set-Up Fee	-$99
Participation Fee	-$89
Annual Fee	-$49
Account Maintenance Fee	-$10 (per month)
Total Usable Credit	$53

Aspire Card (CompuCredit)	
Credit Limit	$300
Account Opening	-$29
Annual fee	-$150
Total Usable Credit	$121

Legacy Visa	
Credit Limit	$250
Acceptance Fee	-$119
Annual Fee	-$50
Participation Fee	-$6 (per month)
Total Usable Credit	$75

CorTrust MasterCard	
Credit Limit	$250
Acceptance Fee	-$119
Annual Fee	-$50
Participation Fee	-$6 (per month)
Total Usable Credit	$75

The Agencies are entirely correct that these fee structures are inherently unfair. The harm that fee-harvesters cause is substantial. The onerous fees, imposed on consumers who are already vulnerable because of limited incomes or impaired credit histories, lead to unmanageable debt consisting mostly of the creditor's own self-imposed fees. At best, the consumers pay off these unconscionably expensive fees, depleting their already limited resources, and in return receive nothing more than puny credit limits. At worst, the consumers walk away from the accounts, and end up with more damage to their credit histories. These injuries are substantial, and are not outweighed by the countervailing benefits of access to credit, since that credit is so limited and so unconscionably priced.

These injuries are also unavoidable. Consumers cannot avoid the harm from fee-harvesters due to a number of factors, such as aggressive marketing by the creditors emphasizing the benefits of credit cards and the pre-fee credit limits. Some of the consumers are desperate for credit -- the fee-harvester creditors prey upon that desperation. For these reasons, disclosures will never be adequate to fully protect consumers from fee-harvester cards.

Furthermore, disclosures are not effective for the significant number of consumers who have limited educational or literacy skills –the very consumers most vulnerable to fee-harvester cards. About 1 in 20 adults in the U.S. is non-literate in English, or about 11 million people. Overall, 14% of adults have below basic prose literacy skills and 22% have below basic quantitative skills.[30] Many consumers lack the ability to make effective use of even straightforward and uncomplicated disclosures. One example of this inability is the failure of many consumers to derive information from FDA food nutrition labels, considered by many to be the gold standard in disclosures. One study found that 40% of consumers could not answer the simple question of "how many carbohydrates were in half a bagel" when the FDA nutrition label stated information about the amount of carbohydrates for a whole bagel.[31]

Finally, the very nature of these cards also makes them deceptive in addition to being unfair. Creditors deliberately structure the pricing on these cards to understate the APR – the price tag that consumers look at – and to move the cost of the credit to fees that are excluded from the APR in the application disclosure. The typical fee-harvester card advertises an APR of 9.9% -- clearly an artificially low price tag – but has fees that consume 50% to 80% of the credit line. Thus, even if the consumer uses the full credit line 365 days a year (a near impossibility, without going over the credit limit), the fees far exceed the finance charges generated by the periodic interest represented by the APR. Even with the improvements in the application and account opening disclosure tables proposed in the Regulation Z NPRM, the fees remain a less prominent feature of the price of credit than the APR – which was developed for the very purpose of being an all inclusive price tag that consumers could use to compare different credit products.

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[30] National Center for Education Statistics, *Literacy in Everyday Life: Results From the 2003 National Assessment of Adult Literacy*, April 2007, at 13.
[31] Eric Nagourney, *Nutritional Information Leaves Many Uninformed*, New York Times, Sept. 26, 2006, at D6.

B. <u>The Limit on Fees Charged to the Account Should Be Lowered from 50% to 10% of the Credit Limit and Should Cover All Fees.</u>

The Agencies have proposed prohibiting creditors from charging to a credit card account security deposits or fees for the issuance or availability of credit that exceed 50% of the card's initial limit. We respectfully recommend that this part of the rule be strengthened, as 50% is simply too high. It makes little headway in combating both the unfairness of fee-harvester cards, and the deceptive nature of their pricing. The Agencies' proposed maximum fee structure (25% of the credit line in fees the first month and 2.75% in fees per month thereafter) would equate to a 217% APR, assuming the consumer used all the available credit and paid off the balance by the end of the year. Furthermore, that 217% APR doesn't include the finance charges from periodic interest.

Instead, the proposed rule should prohibit a card that is structured with fees (other than avoidable penalty fees) that consume more than 10% of the credit line. Even at that percentage, the true cost of credit of a 9.9% APR card would be more than twice the disclosed APR, assuming that the consumer used the full credit line 365 days a year.

All of the reasons cited by the Agencies as to why charging fees that exceed 50% of the credit line is an unfair practice apply equally to fees that exceed 10% of a credit line. First, such fees are not easily paid in full before the grace period ends, and consumers will end up paying interest on these fees. Second, fees that exceed 10% of a credit line still significantly reduce the amount available credit, and pose a trap for consumers to exceed their credit limits, thus triggering over-limit fees. Third, fees that exceed 10% of a credit line constitute an overly high price for access to credit.

A rule that limits unavoidable fees to 10% of the credit line would reduce the deceptiveness of the pricing structure of subprime cards. It would encourage creditors to structure the pricing of their cards in a fairer, more transparent fashion with the APR being truly reflective of the cost of credit.

Finally, the Agencies should include all fees in the calculation of the proposed limit, or at least all fees apart from penalty fees. The Agencies must prevent creditors from evading the proposed fee limit by calling a fee something else to avoid inclusion. While the term "fees for the issuance or availability of credit," is fairly broad, a creditor could charged a non-periodic fee that is not related to the opening of an account and thus arguably not included in proposed __.28(c), such as a "second month" fee. In addition, we believe that certain allegedly "optional" fees must be included in the limit, because one of the biggest fee-harvester abuses has been the imposition of fees for allegedly optional services that are really not optional.

C. <u>The Limit on Fees Should Apply to All Fees Assessed by the Creditor for Issuance or Availability of Credit, Not Just Those Charged to the Account</u>.

The proposed limit on fees suffers from a very significant loophole – it only covers fees charged directly to the account, and does not include fees paid or assessed for the card from funds outside of the account. Given the inventiveness of fee-harvester creditors, we fear that they will use this loophole to continue their abuse of consumers.

Fee-harvester cards currently charge their exorbitant fees against the credit line of the account because that is the easiest method to impose the fees while minimizing the actual amount of credit extended. However, with the proposed limits, we predict savvy fee-harvester marketers will quickly shift their business model by charging some of the fees to the account, and then inducing the consumer to pay the rest out-of-pocket.

Unfortunately, convincing or tricking consumers into paying for nonexistent or limited credit is a common practice. An FTC study estimated that over 4.5 million consumers per year pay an advance fee for a loan or credit card, but don't get any credit.[32]

One way that fee-harvester creditors will be able to grab fees from consumers is by taking the funds out of a consumer's bank account using a demand draft, which merely requires knowing the consumer's account number. Fee-harvesters could give themselves the right to use demand drafts to collect fees by adding such a provision in the fine print in the application. If the consumers don't have the funds available, they may be encouraged to use another credit card or another high priced credit product.

The FTC has already observed problems with the involuntary collection of advance fees in the prepaid debit card contact.[33] In addition, we have seen several examples of abuse involving advance fee payments for subprime credit cards. One example is described in the following email.[34]

> "We've had two cases involving [CSC Financial Services]. It's a credit card issuer that advertises on TV that they will give the consumer a credit card with no credit check -even if you have bad credit. Of course, this appeals to people who are already in financial distress. The victim calls the 1-800 number to get the credit card. The victim undergoes a telephone interview in which he is asked to give his personal information which includes his bank account and routing number. After taking the information, the CSC employee tells the victim that the card has a $250 credit limit and that there is an initial fee of $199.99 to have the card issued. Of course, the victim, who hasn't got $200 or he wouldn't have wanted the card in the first place, says, "No, you do not have authorization to take the money out of my

[32] Federal Trade Commission, *Consumer Fraud in the United States: An FTC Survey*, at 115, *available at* http://www.ftc.gov/reports/consumerfraud/040805confraudrpt.pdf

[33] Federal Trade Commission, *Online Marketers of Prepaid Debit Cards to Subprime Consumers Will Pay More Than $2.2 Million to Settle FTC Charges* (Jan. 24, 2008), *available at* http://www.ftc.gov/opa/2008/01/cards.shtm

[34] Email from Paula Pierce of Victims Initiative for Counseling, Advocacy, and Restoration of the Southwest (VICARS) in Austin, Texas, May 14, 2008.

account." In both cases we've seen, CSC took the money about 90 days after the phone call. Of course, no credit card arrives in the mail. If you check the bloggersphere, there are numerous similar complaints against CSC. We've been successful in getting the banks to refund clients' money; however, CSC is very uncooperative."

Another example comes from a complaint on the Rip Off Report website:

"I was told i was approved for a visa card with a 300.00 credit limit. Payed the fees and activation only to find out it was declined. Tried to call company number on back of my card which was punched out. Tried to find there online site. It no longer exists. Set up an online payment thru bank and they got there money. But am not now or have yet been able to use this card. Keeps coming up declined. Any help i can get would be greatly appreciated.

Lu
Calumet, Michigan
U.S.A."

http://www.ripoffreport.com/reports/0/286/RipOff0286620.htm

This particular consumer complaint involved the Salute Card, which was issued by CompuCredit and Urban Trust Bank. As you know, CompuCredit was recently sued by the Federal Trade Commission for violating the FTC Act in its marketing practices for fee-harvester cards.[35]

We are concerned that if the Agencies simply adopt the proposed limit on fees charged to an account, without prohibiting the same fees from being charged to another source, we will see many more examples similar to the ones above. Thus, we respectfully recommend that the Agencies adopt a restriction on fees that exceed a certain percentage of the credit line, whether or not such fees are charged to the account's credit line.

D. The Agencies Should Ban Security Deposits Charged To the Account.

The Agencies have included security deposits in the list of fees and charges that cannot exceed 50% of the credit limit if charged to the account. The Agencies should go further than limiting the amount of security deposits charged to an account; the Agencies should ban them altogether as inherently deceptive.

There is no reason to charge a security deposit to an account except to deceive the consumer into thinking that she is receiving more credit than the creditor actually grants. The so-called security deposit provides no real collateral and thus no "security" for the creditor. Thus, the only reason to create a bogus security deposit is to create the misleading impression of a higher credit limit. Furthermore, the consumer is required to

[35] Complaint, Federal Trade Commission v. CompuCredit Corp., 1:08-cv-01976 (N.D. Ga. June 10, 2008).

pay finance charges on this bogus security deposit, incurring expenses for an imaginary item.

In the early 2000s, the Office of Comptroller of Currency (OCC) brought a handful of enforcement actions against subprime card issuers. At least two of these actions involved bogus security deposits – First National Bank in Brookings[36] and First National Bank of Marin.[37] In these cases, the banks advertised that there was no "up-front security deposit" required, yet subsequently charged these phony deposits.[38]

Subsequent to these enforcement actions, the OCC issued an advisory letter stating:

> In addition to presenting increased risks of default, customer confusion, and other adverse consequences, this structure [secured credit card programs in which security deposits (and fees) are charged to the credit card account] may constitute an unfair practice under the applicable standards of the Federal Trade Commission Act (FTC Act). Accordingly, the OCC has determined that this type of secured credit card product is not appropriate for national banks, and should not be offered by them.[39]

If the OCC has advised national banks not to offer credit cards with security deposits charged to the account because such cards may constitute an unfair practice under the FTC Act, the Agencies should adopt a similar rule for all banks.

E. <u>The Fee-Harvester Restriction Should Apply to All Open-End Accounts.</u>

We respectfully suggest that the restriction in proposed section __.27 should apply to all consumer credit accounts, rather than solely to "consumer credit card accounts." This change should be made to prevent creditors from circumventing the proposed rule by reconfiguring the product to fall outside the definition of a "credit card." As we discussed in our comments to the FRB's June 2007 NPRM on Regulation Z, new technologies are being developed to create the next generation credit cards. It would be easy enough to develop a credit card-like product that could be designed to arguably fall slightly outside of the definition in proposed section __.21(c), but in all other respects operates like a high fee credit card. Such a product might rely on multiple "convenience" checks, which the FRB has excluded from the definition of "credit card." Or it might simply use an account number or be accessed using biometric methods.

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[36] *In re* First Nat'l Bank in Brookings, No. 2003-1 (Dept. of the Treasury, Office of the Comptroller of the Currency January 17, 2003), *available at* www.occ.treas.gov/ftp/eas/ea2003-1.pdf

[37] *In re* First Nat'l Bank of Marin, No. 2001-97 (Dept. of the Treasury, Office of the Comptroller of the Currency December 3, 2001), *available at* www.occ.treas.gov/ftp/eas/ea2001-97.pdf.

[38] Note that First National Bank in Brookings (now known as First Bank & Trust) was recently the subject of enforcement action by its now-regulator FDIC for issuing fee-harvester cards. Notice of Charges, In the Matter of First Bank & Trust, Brookings, South Dakota, FDIC-07-228b and FDIC-07-260k (Dept. of the Treasury, Fed. Deposit Inc. Corp. June 10, 2008).

[39] OCC Advisory Letter AL 2004-4 (April 28, 2004), *available at* http://www.occ.treas.gov/ftp/advisory/2004-4.doc.

The exclusion of a debit card with a linked credit feature from the definition of "consumer credit card account" for purposes of Regulation AA also creates a potential loophole for fee-harvester cards. Creditors could easily design a fee-harvester credit card that ostensibly serves as a debit card, but is linked to a line of credit. In fact, there is currently a pre-paid debit card on the market that operates in such a fashion - the Metabank AccountNow prepaid card, which has an "iAdvance" line of credit attached.[40] The MetaBank product carries an APR of 150%. A clever fee-harvester could design a similar card with a nominal prepaid feature, and attach a line of credit in which fees consume over half the line. Applying the fee-harvester restrictions to all consumer open-end credits accounts rather than only to consumer credit card accounts would prevent attempts to circumvent this section.

IX. THE AGENCIES SHOULD NOT PERMIT CREDIT CARD OFFERS WITH A RANGE OF OR MULTIPLE APRS OR CREDIT LIMITS (Proposed §__.28).

The Agencies have proposed requiring a new disclosure in any credit card solicitation that makes a "firm offer of credit" under the Fair Credit Reporting Act, 15 U.S.C. § 1681a(1), if the firm offer contains a range of or multiple APRs or credit limits. This disclosure would require creditors to disclose the criteria for eligibility for the rates or credit limits that consumers will receive. However, this disclosure can be satisfied with boilerplate language stating "If you are approved for credit, your annual percentage rate and/or credit limit will depend on your credit history, income, and debts."

This boilerplate language will be absolutely useless in protecting consumers. Allowing disclosure of a range of or multiple APRs or credit limits permits creditors to engage in "bait & switch" tactics. Sneaky creditors emphasize their lowest APRs and highest credit limits, then send consumers much more expensive products and/or cards with lower limits. Because the proposed disclosure consists of rote boilerplate language, it will be seen as a formality and as the Supreme Court has noted "formalities tend to be ignored."[41] The disclosure will be simply inadequate to counteract the lures of solicitations that loudly promote "as low as 4% APR" and "credit limits up to $3,500." Consumers will ignore the proposed disclosure, and it will do no more than take up space on the solicitation.

The Agencies should instead ban credit card solicitations that contain a range of or multiple APRs or credit limits as inherently deceptive. The problems with bait & switch advertisements of "up to" credit limits are well-documented, especially with fee-harvester subprime credit cards, such as the recent enforcement action taken by the FTC and FDIC against CompuCredit and its partner banks.[42] The New York Attorney General

[40] http://www.accountnow.net/services/iadvance-loan.aspx
[41] Safeco Ins. Co. of America v. Burr, 127 S. Ct. 2201, 2214 (2007).
[42] Complaint, Federal Trade Commission v. CompuCredit Corp., 1:08-cv-01976 (N.D. Ga. June 10, 2008).

has also taken similar enforcement actions over deceptively advertised credit limits for fee-harvester cards.[43]

As for bait & switch APRs, they will be a problem due the FRB's own proposals to revise Reg. Z. In the FRB's June 2007 NPRM on Reg. Z, the FRB proposed permitting creditors to disclose a range of APRs or multiple APRs in application disclosures. As we discussed in our comments to this proposal, permitting disclosure of a range of APRs or multiple APRs almost seems to deliberately invite creditors to engage in bait & switch tactics.

Creditors, especially if they have exercised the privilege of intruding on consumers' privacy by seeking their confidential credit bureau files to market credit, should be required to offer and disclose the actual APR that they are offering to the consumer. They should be required to disclose the actual credit limits as well. Otherwise, the creditor's claim that the consumer is "pre-approved" is false and deceptive. While a creditor could be permitted to confirm that the consumer does actually meet the criteria for the offer being made, the criteria should be the same as the criteria used in the prescreening. If the consumer no longer meets the criteria, the creditor can make him or her a new offer, but should not automatically issue a credit card with a higher interest rate or lower credit limit.

Finally, although we oppose permitting credit card solicitations that offer a range of APRs or credit limits, if the Agencies choose to permit this approach, we recommend a much more specific and tailored disclosure – a disclosure that actually tells the consumer something. Such a disclosure should state exactly what criteria the consumer needs to fulfill to receive a certain APR or credit limit *i.e.*, the actual credit scores or other credit history information necessary to qualify for a certain APR, or the actual income necessary for a certain credit limit. Such a disclosure would be similar in format to the following:

"To receive the following APRs, you will need the following credit scores

12% APR – 720 or higher FICO
18% APR – 620 to 719 FICO
24% APR – 560 to 619 FICO

To receive the following credit limit, you will need the following minimum income and debt-to-income ratio:

Credit Limit Min. Income Debt-to-Income Ratio

[43] People v. Applied Card Sys., Inc., No. 2073-03 (N.Y. Sup. Ct. May 28, 2004) (transcript of proceedings), available at http://www.oag.state.ny.us/press/2004/jul/6a.pdf; Assurance of Discontinuance, *In the Matter of Columbus Bank and Trust Co. and CompuCredit Corp.*, New York Attorney General's Office, June 30, 2006, *available at* www.oag.state.ny.us/press/2006/jul/Aspire%20Visa%20Assurance.pdf. *See also* OCC Advisory Letter AL 2004-10 (Sept. 14, 2004), *available at* www.occ.treas.gov/Advlst04.htm.

$300	$25,000	65%
$1000	$40,000	60%
$5000	$50,000	50%”

Only a disclosure that is this specific and detailed stands a fighting chance of counteracting the bait & switch tactics made possible by permitting a range of or multiple APRs or credit limits in solicitations.

X. THE AGENCIES OVERDRAFT LOAN PROPOSAL DOES NOT ADEQUATELY PROTECT CONSUMERS FROM DANGEROUS, COSTLY AND ABUSIVE OVERDRAFT LOANS (Proposed §__.31).

We appreciate that the Board has acknowledged the significant harms posed by overdraft loans. We respectfully submit that the Agency’s core approach of requiring financial institutions to provide a right to opt-out of overdraft services, and a disclosure of that opt-out right, does not adequately protect consumers from the unfairness associated with these loans. Instead, the Agencies must require institutions to (1) obtain an affirmative opt-in for overdraft loans; (2) provide Truth in Lending disclosures to show the cost of using overdraft loans as credit; and (3) prohibit high-to-low check/transaction clearing practices that result in institutions unfairly maximizing overdraft fees.

We discuss each of these concerns below. In addition, we also join the more extensive comments filed on this particular topic in this rulemaking submitted by the Consumer Federation of America.

A. Overdraft Loans Harm Consumers.

i. *Overdrafts are the most expensive form of predatory credit in existence.*

Overdraft loans cause substantial injury to consumers, injury that far outweighs any countervailing potential benefits they might have. As the Agencies themselves admit: “Consumers incur substantial monetary injury due to the fees assessed in connection with the payment of overdrafts.”[44]

Overdrafts are clearly a form of credit, as discussed below in Section X.C.i. Furthermore, they are an extremely expensive form of credit. According to the Center for Responsible Lending, consumers pay $17.5 billion in overdraft loan fees, yet receive only $15.8 billion extended in credit for the related overdrafts - or $1.11 in fees for every $1 of credit.[45] Assuming an overdraft is repaid within 1 week (and many overdrafts are repaid in a matter of days), the equivalent APR for a closed-end loan would be 5,772%. For debit card transactions - the most common trigger of overdrafts -the average overdraft is

[44] 73 Fed. Reg. at 28,929.
[45] Eric Halperin & Peter Smith, *Out of Balance: Consumers Pay $17.5 billion Per Year In Fees For Abusive Overdraft Loans*, Center for Responsible Lending, July 11, 2007, at 11, at http://www.responsiblelending.org/pdfs/out-of-balance-report-7-10-final.pdf.

under $17, yet they trigger an average fee of $34, or about $2 in fees for $1 of credit extended. An equivalent 1 week closed-end loan would have an APR of over 10,000%.

In other words, overdrafts may be the most astronomically expensive form of credit in existence. Payday loans and auto title pawns carry APRs of 390% to 780%,[46] but overdraft loans exceed even these exorbitant rates. The Agencies have recognized the predatory nature of payday loans by banning financial institutions from partnering with payday lenders. Yet payday lenders can justifiably claim that their loans are less expensive than overdraft loans, are fairer because consumers choose to sign up for them, and provide full TILA disclosures.

Moreover, overdraft loans impose more in fees than the dollar amount of the credit extended. The Agencies have stated that such fee structures in the subprime credit card context are patently unfair.[47] If $1 in fees for $1 of credit is unfair in the credit card context *by the Agencies' own standards*, why is it fair for overdraft loans?

ii. *Overdraft loans are especially unfair when accessed by ATM and debit cards.*

Overdraft loans on ATM and debit cards serve no other purpose except to trigger overdraft fees and earn undeserved profits for institutions. As the Agencies themselves admit "While the payment of overdrafts may allow consumers to avoid merchant fees for a returned check or ACH transaction, there are no similar consumer benefits for ACH[48] withdrawals and point-of-sale debit card transactions."[49]

ATM and debit card transactions are on-line and real time. The availability of funds is confirmed, and prior to the advent of overdraft loans, transactions were declined with no fee when consumers had insufficient funds in their accounts. We believe that the decision of institutions to program their computers to add an involuntary line of credit, by approving transactions when their systems know there are insufficient funds, was a deliberate and unfair act to permit overdrafts where none would have occurred previously, solely for the purpose of collecting additional fees.

In the past, financial institutions have defended overdraft loans by claiming they save consumers from merchant penalties, late charges, and embarrassment. As the Agencies admit, merchant penalties do not apply to ATM or debit card transactions. Neither does the consideration of late charges. Embarrassment is a minimal factor when it comes to ATM or debit card overdrafts. With ATM cards, the transaction is to provide cash directly to the consumer - there is no merchant or other third party involved. One CEO of a credit union that offers overdraft loans even admitted that ATM cash overdraft loans are abusive and that "we're talking entertainment dollars in a lot of cases."[50]

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[46] Jean Ann Fox & Patrick Woodall, *Cashed Out: Consumers Pay Steep Premium to "Bank" at Check Cashing Outlets*, Consumer Federation of America, November 2006, at 1.
[47] 73 Fed. Reg. 28,904, 28,924 (May 19, 2008).
[48] We believe that the Agencies meant to say "ATM withdrawals."
[49] 73 Fed Reg. at 28,929.
[50] Paul Gentile, *Overdraft Protection at the ATM is Pushing it, says CEO*, Credit Union Times, July 3, 2004.

Because debit card transactions are at the point-of-sale, if the transaction is declined or at least the consumers warned that they are about to overdraw their account, the consumer often has the ability to undo the transaction (*i.e.* put the merchandise back on the shelf) or use an alternative form of payment (credit card or cash) without incurring a hefty penalty. While there is a third party involved and perhaps a chance of slight embarrassment if a transaction is declined, that risk is preferable to a hefty $20 to $35 fee. At a minimum, consumers should have the affirmative choice whether to risk that chance of embarrassment or pay a fee up to $35.

We urge the Agencies to use their authority under the FTC Act to ban overdraft loans through ATM and debit card transactions. At a minimum, the Agencies should require an opt-in, not opt-out, for these extremely expensive loan products.

B. <u>The Agencies Must Require Opt-In Not Opt-Out for Overdraft Loans</u>

The Agencies should require institutions to obtain the consumer's affirmative opt-in for overdraft loans. Requiring institutions to provide an opt-out simply does not adequately protect consumers. As the Agencies know, there is a tremendous difference between an affirmative opt-in versus a negative option opt-out. Behavioral economists had repeatedly shown the "stickiness" of default options.[51] This is why few consumers "opt out" of overdraft loans currently, even when institutions do permit them to do so. The Agencies must protect consumers by prohibiting institutions from setting overdraft loans as the default option.

Recent academic scholarship argues that the proper role of government is to choose default options that are most beneficial to consumers.[52] A rational consumer would choose either to avoid a $35 overdraft fee by cancelling a purchase or ATM withdrawal if funds are unavailable, or find a less expensive form of overdraft protection. We doubt that any of the Agency officials reviewing these comments would choose overdraft loans for themselves or their college-age children.

Allowing overdraft loans to be the default option is especially outrageous because it is essentially involuntary credit. We can think of no other form of loan product in the United States that is imposed on consumers without their request. Every other form of credit product, from the most beneficial to the most abusive, requires the consumer to actively request or apply for the loan. This includes mortgages, credit cards, car loans, retail installment loans, payday loans, auto title pawns, and rent-to-own transactions.

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[51] *See, e.g.*, Richard H. Thaler and Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, August 2001, available at http://faculty.chicagogsb.edu/richard.thaler/research/SMarT14.pdf (consumers much more likely to contribute to retirement plans in they are automatically enrolled but permit an opt-out, than if consumers are required to affirmatively opt-in).

[52] Richard H. Thaler & Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (2008).

Indeed, we can recall only one time that consumers were sent loan products without their affirmative opt-in – when creditors sent unsolicited credit cards to consumers in the 1960s.[53] As a result of the outcry over this practice, Congress stepped in, amending TILA in 1970 to ban unsolicited credit cards.[54] According to the Senate report that accompanied this TILA amendment, nearly all new credit card accounts during a previous year had been started with unsolicited credit cards.[55] These cards had encouraged consumers to incur unmanageable debt and spurred bankruptcy filings.[56] The Senate report noted:

> many consumers find unsolicited credit offensive per se and an unwarranted intrusion into their personal life. The decision to use or not use a credit card is a personal one, and many consumers resent having a bank or other creditor try to make up their minds for them by sending an unsolicited credit card. Credit card issuers also intrude into family affairs by sending unsolicited credit cards directly to dependents, thus preempting the parent (or head of household's) right to decide whether the dependents are to have credit cards or not.[57]

The same problems cited by this Senate report nearly 40 years ago hold true today for unsolicited overdraft loans – they cause severe financial distress and represent an intrusion on the lives of consumers. Indeed, a similar outcry occurred recently when Citibank, which had bought Macy's credit card portfolio, began sending unsolicited general-purpose credit cards to consumers whose Macy's accounts had been dormant for many years.[58]

Note that in the case of unsolicited credit cards, the consumer at least has to affirmatively and knowingly take action to *use* the credit card, by making a purchase or taking a cash advance. In the case of overdraft loans, the consumer not only receives a credit line without requesting it, the consumer often unknowingly and involuntarily *uses* that credit when she triggers an overdraft, especially in the debit card situation where most consumers don't realize they can overdraw their accounts.

Thus, overdraft loans represent an even worse problem than unsolicited credit cards did nearly 40 years ago. The Board must address this problem and ensure fairness to consumers by prohibiting unsolicited issuance of overdraft loans, *i.e.*, requiring an active opt-in, not a default opt-out.

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[53] Note that the same "stickiness" of default options was observed with respect to unsolicited credit cards as with unsolicited overdraft loans. When unsolicited credit cards were permitted, very few consumers opted out – only 1% returned the card. However, when prospective customers were asked whether they wanted to receive a card, only 0.7% said they would. Jack Metcalfe, *Who Needs Money*, New York Sunday News, Nov. 24, 1968, *reprinted in* 115 Cong. Rec. 1947, 1951 (Jan. 23, 1969).
[54] Pub. L. No. 91-508, 84 Stat. 1126-27 (Oct. 26, 1970).
[55] S. Rep. No. 91-739, at 2 (1970).
[56] *Id.* at 2-3.
[57] *Id.* at 4
[58] Kathy Chu, *Citi Sends Unrequested Credit Cards*, USA Today, Sept. 28, 2007; Suzanna Kapner, *Macy's Card Sharks*, New York Post, Aug. 22, 2007.

C. <u>Overdraft Loans are Inherently Deceptive without Truth in Lending Disclosures.</u>

As noted above, overdraft loans are perhaps the most expensive form of credit in this country. Yet ironically, they are one of the few forms of credit for which TILA disclosures are not required, due to a 40 year old loophole in Regulation Z that was created for a far-different type of courtesy overdraft. This failure to require TILA disclosures not only deprives consumers of the ability to knowledgeably shop for credit, it makes overdraft loans inherently deceptive.

TILA disclosures will be even more critical given the Board's requirement of an opt-out (or hopefully opt-in) for overdraft loans. In order to make an informed decision as to whether to opt-out from (or opt-in to) this form of credit, consumers need information about how much these loans will cost them.

i. *Overdrafts are clearly a form of credit.*

Overdraft loans are clearly a form of credit. They fit under TILA's definition of credit, because the ability to access overdrafts constitutes "the right … to incur debt and defer its payment."[59]

Two of the Agencies that promulgated this rulemaking have explicitly acknowledged that overdrafts constitute a form of credit. In the Joint Guidance on overdraft loans, the FRB and NCUA, among others, stated that "[w]hen overdrafts are paid, credit is extended" and "[o]verdraft balances should be reported on regulatory reports as loans."[60] While the Joint Guidance did state that this language "is not intended as a commentary on [TILA]"[61] in an attempt to shield institutions from liability, there is no conceptual or logical distinction why overdrafts are credit for safety and soundness considerations, but not for TILA disclosures.

Note also that the Joint Guidance states the Equal Credit Opportunity Act's prohibition against discrimination for credit transactions applies to overdraft loans.[62] The definition of "credit" in the ECOA is the same as in TILA.[63] Furthermore, the Office of Comptroller of Currency had at one point recognized that overdraft loans are credit as defined by TILA,[64] as had several state regulators.[65]

[59] 15 U.S.C. § 1602(e).
[60] Joint Guidance on Overdraft Protection Programs, 70 Fed. Reg. 9,127, 9,129-30 (Feb. 24, 2005).
[61] *Id.* at 9,128.
[62] Id. at 9,131.
[63] TILA's coverage is narrower than the ECOA because TILA is limited to "creditors" who regularly extend credit subject to a finance charge or repayable in more than four installments.
[64] Daniel P. Stipano, Deputy Chief Counsel, Office of Comptroller of Currency, Interpretive Letter No. 914 (Sept. 2001), available at www.occ.treas.gov/interp/sep01/intsep01.htm; Peter Liebesman, Assistant Director, Legal Advisory Services Division, Office of the Comptroller of Currency, Interpretive Letter, 1984 WL 164096 (May 22, 1984).
[65] Indiana Department of Financial Institutions, Newsletter--Winter 2002 Ed. (Nov. 2002), at 2; Letter from Assistant Attorney General Paul Chessin, Colorado Department of Law, Consumer Credit Unit, Mar. 21, 2001.

Other regulations and FRB guides define overdrafts as credit. For example, overdrafts are defined as "credit" under Regulation O, which governs loans to bank insiders.[66] The FRB itself pays overdrafts on a daily basis, when institutions use the Fedwire system, and the FRB considers these overdrafts to constitute credit as well.[67]

ii. *Failure to provide TILA disclosures makes less expensive alternatives deceptively appear more costly.*

In its Regulation DD rulemaking, the FRB has proposed requiring a notice informing consumers of their right to opt-out and about the existence of less costly overdraft alternatives, particularly traditional overdraft lines of credit. While this information about alternatives is beneficial, it is less than completely useful because of the FRB's failure to require TILA disclosures. This failure creates a significantly deceptive effect, because it makes the traditional line of credit seem more expensive -- the creditor is required to disclose an APR for the traditional line of credit but not for the overdraft loan. Thus, an unwary consumer might think the line of credit is more expensive because it costs 18% APR, not realizing that 18% APR for a week's interest is far cheaper than a $35 overdraft fee.

Indeed, requiring TILA disclosures for overdraft loans is only fair, given that banks essentially treat these products the same as traditional overdraft lines of credit in terms of transaction approval. For example, in our litigation against one provider of overdraft loans, we have found that this institution basically added the amount of the overdraft loan limit to the accountholder's available balance, just as the institution did with an overdraft line of credit.[68]

Furthermore, traditional lines of credit are not the only alternative to overdraft loans for cash-strapped consumers. There are competing sources of short term credit available, which are very expensive and much-criticized, but can be cheaper than an overdraft loan. A consumer facing a short term financial crunch can choose from finance company loans, credit cards, pawnshops, payday loans, auto title pawns, and refund anticipation loans. All of these other forms of credit are required to provide cost information as mandated by TILA; overdraft loans are not.

D. <u>The Agencies Should Ban Manipulative Transaction Clearing Practices.</u>

The Agencies have asked for comment on the impact of a proposal that would require institutions to pay smaller dollar amounts before larger dollar amounts when received on the same day. We strongly believe the Agencies should establish such a requirement to protect consumers from institutions' blatant manipulation of transaction

[66] 12 C.F.R. § 215.3(a)(2).
[67] Guide to the Federal Reserve's Payments System Risk Policy on Daylight Credit at 1 (July 2007), *available at* http://www.federalreserve.gov/PaymentSystems/psr/mainguide.pdf.
[68] Exhibit 1 to Plaintiff's Motion for Class Certification, Duff v. Washington Mutual Bank, Case 2:04-cv-02309-MJP (W.D. Wash. Dec. 19, 2007). Relevant pages attached to this comment as Attachment 2.

postings to drive up the number of transactions that trigger overdraft fees. In addition, institutions should be required to post deposits to an account before debiting withdrawals.

For many years, consumer groups have complained to the Agencies that institutions use transaction processing order to maximize revenue from overdrafts. According to the Consumer Federation of America, almost half of the large financial institutions disclose that they use a high-to-low debit clearing procedures,[69] which causes more overdraft fees to be levied when the largest debit processed first causes other transactions to overdraw the account. This artificial increase in the number of overdraft fees creates a substantial injury to consumers. The injury is unavoidable because consumers have no control over the order in which their transactions are processed, or what date or time their transactions are presented to an institution for payment.

Furthermore, the practice of high-to-low transaction clearing has no countervailing benefits for consumers. Institutions justify the practice by arguing that consumers want to make sure that their largest and most important transactions are paid. However, that rationale cannot justify high-to-low transaction clearing for institutions that provide overdraft loans, *because the overdraft credit ensures that all debits will get paid*. Thus, the only purpose for clearing the largest transactions first is to maximize the number of transactions that overdraw an account, and trigger fees for low balance customers.

Thus, we believe that institutions which provide overdraft loans while using processing order to increase the number of overdrafts are using unfair practices to enhance revenue at the expense of their customers. We are not the only ones – in 2005, the OTS advised thrifts in its Final Guidance on Thrift Overdraft Programs that transaction-clearing rules (including check-clearing and batch debit processing) should not be manipulated to inflate fees.[70]

The Agencies should ban high-to-low transaction clearing by institutions. They should also require that credits be processed before debits.

[69] Jean Ann Fox and Patrick Woodall, *Overdrawn: Consumers Face Hidden Overdraft Charges from Nation's Largest Banks*, Consumer Federation of America, June 9, 2005. Another 24.2% of large banks said they reserved the right to process in any order.
[70] Office of Thrift Supervision, Guidance on Overdraft Protection Programs, 70 Fed. Reg. 8428, 8431 February 18, 2005.