Testimony of Nick Bourke, Manager of the Safe Credit Cards Project at The Pew Charitable Trusts, Regarding HR 3639.

Chairman Frank, Ranking Member Bachus and Members of the Committee:

Thank you for the opportunity to offer comments on H.R. 3639, the Expedited CARD Reform for Consumers Act of 2009. My name is Nick Bourke and I am the manager of the Safe Credit Cards Project at The Pew Charitable Trusts.

Pew is a non-profit, non-partisan research and advocacy organization. My project is part of the Pew Health Group, and one of our key goals is promoting fact-based solutions to important public policy challenges, such as the safety and transparency of consumer financial products.

I have been with Pew working on consumer credit card issues for nearly two and a half years. Before joining Pew I served as a product manager, marketing specialist, strategy consultant and legal advisor serving financial and high tech companies, including in the electronic payments space.

The Pew Safe Credit Cards Project began in early 2007 with a mandate to research perceived dangers associated with consumer credit cards and pursue strategies for making cards safer. Originally, we focused on developing a voluntary, market-based certification program based on a set of safety standards that Pew would establish. Led by a former credit card company CEO, we engaged consumer groups and credit card businesses alike over the course of many months. Our Safe Credit Card Standards are one of the products of that effort.

Over time, we shifted our focus to policy-based reforms, including the Credit CARD Act. Though I am proud to say that we established relationships with many in the industry who were receptive to our work, what we ultimately heard is that the industry would not change significantly unless the government stepped in to establish a level playing field that would foster fair competition based on transparent pricing – which has led us to where we are today.

SUMMARY

What We Studied

Last year, the Federal Reserve determined that certain credit card practices were "unfair or deceptive," and in some cases "harmful."[1] The Pew Charitable Trusts conducted research to identify how widespread these practices are in the market, and to analyze the impact to American consumers. In December of last year, and again in July of this year, we analyzed the application disclosures for all consumer credit cards offered online by the largest 12 credit card issuers – a group that controls more than 90 percent of all credit card debt in America. Our July sample included nearly 400 credit cards.

[1] See: Board of Governors of the Federal Reserve System, Office of Thrift Supervision, Treasury and National Credit Union Administration, "Unfair or Deceptive Acts or Practices," 74 FR 18 (January 29, 2009) at p. 5498 et. seq.

One finding from our research is that between December 2008 and July 2009, before any part of the Credit CARD Act had taken effect, the top 12 banks raised advertised interest rates significantly. In July, median advertised annual percentage rates (APRs) for purchases were between 12.24 and 17.99 percent – or 13 to 20 percent higher compared to last December. (Banks typically advertise a range of rates, with the lowest advertised rates reserved for cardholders with better credit profiles).[2]

More findings from our latest research are discussed below, and we will include additional detail in a report scheduled for publication later in October.

Key Points

Higher rates were not the only bad news cardholders had to contend with. In my testimony today I shall attempt to convey three key messages:

1. **Since passage of the Credit CARD Act, the situation has only become worse for cardholders. Americans remained exposed to widespread practices that the Federal Reserve deemed "unfair and deceptive," and a variety of hefty penalty charges.**

   The Credit CARD Act of 2009 includes many important new consumer protections that are not currently scheduled to take effect until 2010. Until then, banks may continue to raise rates on outstanding balances, impose what the Federal Reserve called "hair trigger" penalty repricing, apply payments in a way that maximizes interest costs and charge unrestricted overlimit fees.

   Our latest research shows that practices labeled "unfair or deceptive" by the Federal Reserve – practices at the core of the consumer protections provided in Title I of the Credit CARD Act – remain widespread, with some policies worsening since our December 2008 study.

2. **While issuers wait to remove these "unfair or deceptive" practices or implement the Credit CARD Act, American families are at risk of significant harm.**

   Many practices, particularly penalty rate increases, can add hundreds or even thousands of dollars in costs per year. These costs are not reflected in advertised interest rates, and when imposed can drastically increase the amount of a cardholder's minimum payment due.

[2] Advertised rates are not the only rates that have been rising lately, as issuers have exercised their contractual powers to raise interest rates on existing balances too. In a one-year period between 2007 and 2008, issuers used their powers to raise interest rates on nearly one quarter of all existing cardholder accounts, or approximately 70 million accounts. See: Ireland, Oliver, Letter to the Federal Reserve, et. al. (Morrison & Foerster LLP, August 7, 2008), at Exhibit 6, Tables 1a and 3a (based on data from Argus; totaling percentage of accounts repriced for penalty or change in terms reasons from March 2007 through February 2008, a total of 22.3 percent of all accounts). Note that these figures may include a number of accounts which entered penalty status or were repriced more than once during the period (this number is not determinable from the data presented). The letter is available at http://files.ots.treas.gov/comments/bdc5cc5c-1e0b-8562-eb23-ff7159e49505.pdf. Overall, we estimate that 70 million accounts were affected based on approximately 315 million total active credit card accounts in 2007 (Nilson Report, Issue 902, May 2008).

3. **Accelerating the effective date of the Credit CARD Act will help Americans quickly; but the long-term benefits will depend on how well the Federal Reserve seizes its mandate to protect consumers from unreasonable or disproportionate penalty fees and charges.**

   The sooner the Credit CARD Act takes effect, the sooner a host of "unfair or deceptive" practices will be eliminated from the list of financial dangers threatening American households. How much the law benefits consumers over time will depend to a large degree on the actions the Federal Reserve takes to enforce it – especially with regard to ensuring reasonable and proportional penalty fees and charges. We have provided several suggestions.

MAIN COMMENTS

1. **Since passage of the Credit CARD Act, the situation has only become worse for cardholders. Americans remained exposed to widespread practices that the Federal Reserve deemed "unfair and deceptive," and a variety of hefty penalty charges.**

"Unfair or Deceptive" Practices Remained Widespread in the Market

The Credit CARD Act became law in spring of this year, paving the way for important new consumer protections. Unfortunately, most parts of the new law will not take effect until 2010,[3] and Pew's research shows that the situation has only become worse for American credit cardholders.

At-will interest rate increases on outstanding balances, so-called "hair trigger" penalty repricing, application of payments policies that maximized interest charges to cardholders – these practices were all part of the vast majority of credit cards offered by the largest banks last December, and they still are today.[4] Based on our July research:

- 97.7 percent of cards allowed issuers to raise any interest rate at any time (even on outstanding balances) by changing the account agreement – up from 93 percent in December.

[3] Most consumer protections under Title I of the Credit CARD Act of 2009 are scheduled to take effect on February 22, 2010. These include the general prohibition of retroactive rate increases (with few exceptions) and double cycle billing, overlimit fee safeguards such as requiring specific consumer opt-in before the fee may apply, and requiring payments beyond the minimum payment due to be applied first to high-rate balances. Some protections have already become effective (advance notice and notice of right to cancel requirements). Other protections will not become effective until August 22, 2010, including "reasonable and proportional" penalty fee and charges rules, and requiring issuers to have policies allowing for the reduction of interest rates following interest rate increases that are predicated on risk factors. See: Pub. L. 111-24.

[4] The research discussed in this testimony is primarily based on our July 2009 review of credit cards. Since July, we have sampled additional card disclosures periodically. We continue to find that issuers have not discontinued the use of these and other practices that are the subject of recent Federal Reserve rulemaking and the Credit CARD Act.

- 90 percent of bank cards included penalty rate increases that could apply automatically to all balances. All but 10 percent of these cards had "hair trigger" repricing terms per Federal Reserve guidelines (triggers of one or two late payments in 12 months).

- 95 percent of cards allowed the issuer to apply payments in a "low-to-high" manner that would violate the requirements of the Credit CARD Act and that were, in the Federal Reserve's judgment, likely to cause substantial monetary injury to consumers. (The remaining five percent did not disclose the issuer's policy).

Altogether, 90 percent of the cards from the largest 12 issuers contained all three of the practices just mentioned. None – not one – of the cards would have met the Federal Reserve's December 2008 final rules against "unfair or deceptive" acts or practices, let alone the requirements of the Credit CARD Act. In fact, we have seen evidence that issuers have been changing their products in ways that would contravene the Act's requirements, or even exploit potential loopholes.

New Trend: Partially variable rates with fixed minimum rate requirements.

For example, a new trend is emerging as bank issuers moved away from fixed fee cards.[5] Many more cards now feature partially variable interest rates that may increase based on an index rate but cannot decrease below a fixed minimum set by the issuer. As of July, partially variable rates with fixed minimum requirement were present on only a minority of cards (about 10 percent of purchase rates and about 40 percent of cash advance rates included the feature). But these numbers were up sharply compared to December.

We have encouraged the Federal Reserve to scrutinize cards with partial variable rates carefully for compliance with the Credit CARD Act. In sum, we urged the Board to rule that cards with partially variable rates are not "variable rates" under the Credit CARD Act and are not entitled to exceptions under the act allowing issuers to raise rates on outstanding balances or avoid the Act's 45-day and right to cancel notice requirements. Our rationale is included in comments we submitted to the Federal Reserve in September of this year, a copy of which is attached to this testimony.

More About Partial Variable Rate Cards with Fixed Minimum Rate Requirements

Our specific comments to the Federal Reserve may be summarized as follows:

- The Federal Reserve should rule that card accounts with variable rates including fixed minimum rate requirements are not eligible for the variable rate exception to the general ban on retroactive rate increases.

[5] Nearly one third of bank cards in our December 2008 study included "fixed" rates, versus less than one percent in July. On credit card products, the term "fixed rate" has meant that rates will not fluctuate according to a third party index rate. However, it has not meant that the rate cannot change, as almost all cards came with caveats that gave issuers the right to change outstanding rates at any time for any reason.

- For similar reasons, the Federal Reserve should enforce the Credit CARD Act's 45-day notice and right to cancel rules on card accounts with minimum rate requirements.

As you know, Section 101(b) of the Credit CARD Act will generally prohibit issuers from raising rates on outstanding balances. Cards with variable rates, which operate according to an index not under the issuer's control, are exempted – meaning their rates can fluctuate up or down as the index moves. The variable rate exception also exempts issuers from Section 101(a) 45-day notice and notice of right to cancel requirements. However, cards featuring this new "partial variable rate" should not qualify for the exception, for at least three reasons:

- First, these partial variable rate accounts do not provide for changes "according to operation of an index."

- Furthermore, by placing a minimum fixed floor against which the index cannot operate, the issuer has exercised control over the index in a way that violates the law's requirement.

- Finally, accounts with minimum rate requirements do not justify an exception allowing rate increases on outstanding balances because they allow issuers to expose cardholders to risk of higher rates if the index rises while limiting cardholders' ability to benefit if the index falls

Our September 21, 2009 comments to the Federal Reserve Board (attached) provide more information about partial variable rate cards and also outline arguments for requiring issuers to send advance notice of changes and notice of rights to reject and cancel as required by the Credit CARD Act.

Penalty Fees and Charges Remained Substantial

The Credit CARD Act will require any penalty fee or charge to be "reasonable and proportional" to a cardholder's "acts or omissions" according to rules to be prescribed by the Federal Reserve. Meanwhile, our research showed that credit card penalties remained substantial, with potentially drastic penalty rate increases applying indefinitely even for relatively minor transgressions.

Penalty Fees

Based on our July 2009 analysis of all consumer credit cards offered online by the largest 12 issuers:

- 99 percent of bank cards included a late fee. The median fee was $39.
  Late fees could apply as soon as the due date passed.

- 80 percent of bank cards included an overlimit fee. The median fee was $39.
  None of the application disclosures we reviewed limited overlimit fees to once per billing cycle, nor gave the consumer any option to opt-in or opt-out.

Penalty Rate Increases

In addition to these penalty fees, penalty rate increases could also apply, instantly raising rates on all balances including outstanding balances. The Credit CARD Act will eventually create strong new protections against disproportionate and hair-trigger penalty interest rate increases; for example, the only allowable penalty rate trigger will be a serious delinquency of 60 days past due. Until then, Americans remain widely at risk of these harmful practices. Based on our July research:

- All of the largest 12 bank issuers used automatic penalty rate provisions, including on outstanding balances. 90 percent of their cards included penalty rates.

- Among this subset of bank cards that included penalty rates:

    - 51 percent of penalty rates could be triggered after a single late payment and most of the rest (39 percent) could be triggered upon missing a second late payment in a 12-month period – meaning 89 percent of bank penalty triggers qualified as "hair trigger" repricing per the Federal Reserve.[6]

    - 80 percent of bank penalty rates could be triggered by one or more overlimit transaction, a practice the Credit CARD Act will prohibit.

- The median penalty rate was 28.99 percent. That penalty would add between 11 and 16.75 percentage points on top of median advertised purchase rates, more than doubling the non-penalty rate for many cardholders.

    - Our Safe Credit Card Standards call for a maximum seven-point premium over the standard non-penalty rates of interest.[7]

- Almost 90 percent of penalty rate terms provided no cure period to restore the original non-penalty interest rates – meaning issuers had the right to penalize cardholders indefinitely even after they returned to perfect payment behavior.

    - Our Safe Credit Card Standards call for a rolling six-month cure period that would apply whenever a cardholders makes six consecutive on-time payments, regardless of when that repayment begins.[8]

Since we completed our review in July, we have continued to monitor cards in the market. Though some issuers, such as American Express and Discover, have recently announced that they will remove overlimit fees entirely from their cards,[9] there remains little movement toward implementing the core consumer protections found in Title I of the Credit CARD Act.

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6 74 FR 18 (January 29, 2009) at p. 5527.
7 The Safe Credit Card Standards and related information are available at www.pewtrusts.org/creditcards.
8 Note that the Credit CARD Act requires issuers to provide a 6-month cure period for penalty interest rates, but only if the cardholder resumes on-time payment *immediately* when the penalty rate is imposed.
9 e.g. Aspan, Maria. "Law Hits Home as Cards Opt out of Overlimit Fees", American Banker, August 10, 2009.

2. **While issuers wait to remove these "unfair or deceptive" practices or implement the Credit CARD Act, American families are at risk of significant harm.**

For consumers, there are significant costs associated with the practices that have remained in place but will be prohibited once the Credit CARD Act takes effect. To illustrate these costs, I have outlined a number of scenarios below.

Unless otherwise noted, I take for an example an account with a competitive 14 percent purchase rate of interest and a relatively modest balance of $3,000. I believe that a 14 percent annual percent rate (APR) is a conservative estimate because it is close to the median lowest advertised rate in our sample (12.24 percent) and lower than the "average credit card rate" currently reported on online credit card aggregator sites.[10] *Similarly, I propose that a $3,000 balance is a modest example given that it equals the median family credit card debt and is far lower than the average family credit card debt of $7,300.*[11] *Other estimates have shown significantly higher levels of average credit card debt.*

In the examples below, interest is calculated assuming an average daily balance across the whole year. Monthly required minimum payments are estimated.[12]

Impact of Penalty Fees

The median late fee was $39. Even in cases where the amount of the fee was tiered based on account balance, the maximum fee of $39 typically applied to any account with a balance of $250 or more – i.e., most accounts. All late fees in our study could apply immediately once an account became past due by any amount of time.

Similarly, the median overlimit fee was $39 and could apply regardless of the amount by which the account had exceeded its credit limit. There was no evidence of any opt-in or opt-out programs to give cardholders the choice to be subject to the fee, let alone to having their accounts exceed the credit limit. In other words, whenever issuers received an authorization request for a transaction, they did not have to alert the cardholder that completing the transaction would incur a fee, and it was in the issuer's sole control whether the overlimit transaction plus accompanying fee would be approved.

As demonstrated below, a $39 fee may represent only a small portion of most overall account balances, but it can create significant cash flow issues for cardholders by drastically increasing the amount of the monthly minimum payment due. In the future, whether a fee is reasonable and proportional should depend on an analysis of its relationship to the minimum payment due.

Impact of Penalty Interest Rate Increases

[10] See, e.g., www.indexcreditcards.com (15.39% average credit card rate reported week of October 5, 2009).
[11] Bucks, Brian et. al., "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," (Board of Governors of the Federal Reserve, February 2009).
[12] Calculation: Balance * (APR/12) + Balance * 1 percent principal reduction + current fees = Minimum Payment Due.

Currently, when a penalty interest rate is triggered it automatically applies to all balances, including outstanding balances. As noted above, the median penalty interest rate from our July 2009 study was 28.99 percent. The table below shows the impact when a sample account with a 14 percent standard non-penalty interest rate is penalty repriced to 28.99 percent.

For an account with a non-penalty rate of 14% that is triggered to a penalty of 28.99%

If the average daily balance is:	Then the extra penalty interest each year is:	And the extra monthly interest payment is:
$1,000	$150	$12
$3,000	$450	$37
$7,000	$1,049	$87
$10,000	$1,499	$125
$15,000	$2,249	$187

Summing All the Penalties Up

Penalties can be overlapping – e.g., a late payment can trigger a late fee plus a penalty interest rate. For our sample account with a 14 percent non-penalty interest rate and a $3,000 balance, here is how overlapping penalties can drastically affect the monthly minimum payment due:

Base (non-penalty) monthly minimum required payment:	$65
Late Fee	+ $39 [+ 60 %]
Extra required payment due to penalty interest charges	+ $37 [+ 57 %]
TOTAL:	**$141 [+ 117 %]**

For more than half of all consumer cards from the largest 12 issuers in our study, this penalty could result from missing a single late payment by a single day.

While I have focused here on penalty fees and charges, consumers are also paying significant costs due to current policies such as low-to-high application of payments, at-will change repricing of existing balances, and other practices that will remain legal until the Credit CARD Act takes effect.

3. **Accelerating the effective date of the Credit CARD Act will help Americans quickly; but the long-term benefits will depend on how well the Federal Reserve seizes its mandate to protect consumers from unreasonable or disproportionate penalty fees and charges.**

The sooner the Credit CARD Act takes effect, the sooner "unfair or deceptive" practices may be eliminated from the list of most pressing dangers to American household finances. How much the law benefits consumers over time will depend to a large degree on the actions regulators, especially the Federal Reserve, take to enforce it.

One of the most important rulemaking responsibilities given to the Federal Reserve Board under the Credit CARD Act is ensuring that any penalty fee or charge is "reasonable and proportional" to the "omission or violation" to which the penalty relates. Currently, the Federal Reserve is responsible for creating rules to implement this "reasonable and proportional" requirement by August 2010.

Suggestions at a Glance – Federal Reserve "Reasonable and Proportional" Rules

Pew's June 25, 2009 comments to the Board suggested guidelines for "reasonable and proportional" penalty fees.[13] Below, I summarize these comments. A full copy of our letter to the Board is attached.

The Board should regulate penalty rate increases under its reasonable and proportional rules.

The Credit CARD Act outlaws any unreasonable or disproportionate "penalty fee or charge." Penalty rate increase apply as a punishment when cardholders fail to pay on time. Even under the Act, many consumers will be left at risk of drastic and/or indefinite penalty charges – even after they resume perfect on-time payment behavior. Without strong rules covering penalty interest rate increases from the Federal Reserve, American consumers will remain subject to many unreasonable or disproportionate credit card penalties.

Penalty rates should not be more than seven percentage points above non-penalty interest rates under the Board's "reasonable and proportional" rules

Regulatory review should consider how severely penalty rate increases impact the amount of the *monthly minimum payment due*. Prevailing penalties can add substantially to the cost of a cardholder's required minimum payment. For example, assuming a modest balance of $3,000 (median household credit card debt) and a base interest rate of 14 percent, a 28.99 percent penalty rate would cause the monthly minimum payment due to increase by approximately 65 percent and add over $400 per year in penalty interest costs (this example is demonstrated earlier in this testimony).

By comparison, our recommended maximum seven-point penalty premium would add only 28 percent to the required minimum payment, greatly reducing the risk of insurmountable price shocks to the consumer while still allowing issuers to generate

[13] Bourke, Nick, "Reasonable and Proportional Rules under Credit CARD Act of 2009 (Pub L. 111-24)" (The Pew Charitable Trusts, June 25, 2009). Available at: www.pewtrusts.org/news_room_detail.aspx?id=53840.

millions of dollars of additional revenue to compensate for any marginal costs of delinquencies.[14]

<u>The Board's rules should ensure that cardholders have a guaranteed right to return to non-penalty rates of interest whenever they resume on-time payments for six months.</u>

The Credit CARD Act provides a *partial* right to cure, guaranteeing a right to return to non-penalty rates but only for cardholders who pay on-time during the first six months after the penalty begins to apply. With just a partial cure in place, penalty rates could apply indefinitely, even permanently, for anyone who pays on-time for six months but does not begin doing so immediately when the penalty rate is triggered. This partial cure establishes in law the concept of a pathway back to the original rate, but it is not sufficient to ensure reasonability and proportionality for all consumers. The Federal Reserve must add supplementary rules.

- Any penalty that may last indefinitely should be presumed to violate the reasonable and proportional requirements of the Credit CARD Act.

- The Board should prohibit penalty rate increases on existing balances except where issuers guarantee to restore non-penalty rates automatically after six months of on-time payments, regardless of when repayment begins.

<u>The Board should judge late fees in proportion to the amount that is past due, not the overall account balance, and should be scrutinized closely if they may apply immediately upon the payment due date.</u>

- Generally, the size of a late fee should be in proportion to the amount that is *past due* (i.e. the minimum payment due), not the overall account balance. The median late fee ($39) represents only 1.3 percent of the median household credit card balance of $3,000. But it is equal to approximately 60 percent of the applicable required minimum payment. A fee that increases the minimum payment due by 60 percent may be difficult to justify as being proportional.

- Issuers are unlikely to incur additional costs immediately on the due date. For the fee to be based on deterrence and cardholder behavior factors outlined in the Act, it is appropriate to create a leniency period of several days after the due date to ensure that the late payment is not due to factors beyond the cardholder's control, mail delivery or payment processing delays.

<u>Overlimit fees should be banned because they are not justifiable based on the factors identified in the Credit CARD Act.</u>

[14] More information is provided in our June 25, 2009 comment letter to the Board. See: Appendix B; see also pp. 10-13.

- Because overlimit transactions are processed automatically, it is unclear what additional costs the issuer may be said to incur due to a "violation or omission" of the cardholder. Further, because the cardholder often will have incomplete information about the account's proximity to the credit limit, and because the issuer *always* can control whether the account exceeds the limit, it is difficult to see how an overlimit fee furthers such goals as deterrence or punitive action (indeed, better forms of deterrence and punishment are available, in the form of denied transactions).

- However, if allowed, only de minimis overlimit fees should be tolerated, and only when accounts are significantly overlimit.

<u>In general, the Federal Reserve Board should narrowly interpret the justification factors for penalty fees and charges under the Credit CARD Act.</u>

Section 102(b) of the Act instructs the Board to establish rules for ensuring that all "any penalty fee or charge" is "reasonable and proportional" to a cardholder's acts or omissions. The law provides three specific factors that may contribute to the "reasonable and proportional" analysis: the cost incurred by the creditor for the associated omission or violation, the deterrence value of the penalty and the conduct of the cardholder. The Board may also identify other factors it deems appropriate.

- The factors identified in the law (cost, deterrence and cardholder behavior) establish a very narrow basis for justifying penalties, including late and overlimit fees. The Board's rules should reflect that narrowing approach, particularly in regard to the cost considerations that may justify a penalty. For example, the only relevant costs incurred by the creditor are those that relate to the specific "omission or violation" that is being penalized. Generally applicable costs of doing business, including risk exposure, must not be included; rather, the only relevant costs are whatever actual marginal costs the issuer incurs in responding to the penalized behavior.

- Similarly, because the law is designed in favor of maximizing price transparency and market efficiency, the Board's rules generally should err on the side of those goals by constraining the proliferation of confusing or potentially "rent seeking" fee structures ("rent seeking" refers to situations in which issuers would have a counter-intuitive incentive to allow or even encourage their customers to engage in "bad" behavior as a way of maximizing penalty fee income).[15]

- For penalties that are not readily justifiable based on the factors provided in the law, the Board should tolerate no more than nominal fees.

More detail on our recommendations for the Federal Reserve's reasonable and proportional penalty fees or charges rules are included in our June 25 comment letter to the Board. A full copy of this letter is attached, and more information is available on our website (www.pewtrusts.org/creditcards).

[15] As we noted in our June comments to the Federal Reserve (p.7), there is evidence of a "rent extraction" or "rent seeking" problem associated with penalty fees.

CONCLUSION

Our research shows that practices labeled "unfair or deceptive" by the Federal Reserve have remained widespread, and cards from the top issuers still do not comply with the consumer protections provisions of the Credit CARD Act. As Americans wait for issuers to change their practices, hefty penalty fees and charges continue to apply. Congress can help bring fast relief to consumers by accelerating the effective date of the Credit CARD Act – but the long-term benefits to consumers depend in large part on the Federal Reserve, and we hope they seize their mandate to protect Americans from unreasonable or disproportionate credit card penalties.

Thank you for the opportunity to present this testimony. As always, we are happy to discuss this or any other aspect of our work at any time.

Summary of Attachments

A. Biographical information about Nick Bourke

B. Truth in Testimony statement.

C. Copy of The Pew Charitable Trusts' letter to the Federal Reserve Board, dated June 25, 2009 regarding "Reasonable and Proportional Rules Under Credit CARD Act of 2009," proposing elements of an analytical framework for creating the rules and suggesting considerations for safe harbor guidelines.

D. Copy of The Pew Charitable Trusts' comments to the Federal Reserve Board, dated September 21, 2009 regarding "Regulation Z; Docket No. R—1364 (Interim Final Rule)," with a focus on urging the Board to rule that credit cards with partial variable rates including fixed minimum rate requirements are not eligible for exceptions to certain 45-day notice, notice of right to cancel and interest rate requirements found in the Credit CARD Act of 2009.

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Attachment A: Biographical Information – Nick Bourke

Nick Bourke is manager of the Safe Credit Cards Project at The Pew Charitable Trusts, a non-profit, non-partisan organization committed to developing fact-based solutions to challenging public policy issues. Previously, he worked with companies in the financial services and high tech sectors, serving as product manager, marketing specialist, strategy consultant and legal advisor, with particular expertise in electronic payments. Most recently, Bourke was senior consultant and project manager for the Ziba Group. His clients included Visa and other financial services firms. Before that Bourke served as senior product manager for Encirq Corporation, where he developed marketing analytics tools for credit card providers and other institutions, and as business analyst for CheckPoint Software. He holds a bachelor's degree from Stanford University and a juris doctor degree from University of California, Davis. Bourke is a member of the State Bar of California.

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Attachment B

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Nicholas ("Nick") Bourke	The Pew Charitable Trusts

3. Business Address and telephone number:

901 E St. NW, 10th Floor
Washington, DC 20004
202.552.2000

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2006, related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No

6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.

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ATTACHMENT C

Copy of The Pew Charitable Trusts' letter to the Federal Reserve Board, dated June 25, 2009 regarding "Reasonable and Proportional Rules Under Credit CARD Act of 2009," proposing elements of an analytical framework for creating the rules and suggesting considerations for safe harbor guidelines.

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June 25, 2009

By Electronic Delivery

Ms. Sandra Braunstein
Division of Consumer & Community Affairs
Board of Governors of the Federal Reserve System
Washington, D.C 20551

RE: "Reasonable and Proportional" Rules Under Credit CARD Act of 2009 (Pub. L. 111-24)

Dear Ms. Braunstein:

I am writing to share comments in support of the Board's rulemaking efforts under the Credit CARD Act of 2009. As you may know, Pew's Safe Credit Cards Project began in 2007 as an effort to protect customers from unfair credit card practices and promote responsible management of debt. Since then, we have published a set of Safe Credit Card Standards as well as various results from our research and analysis. On several occasions we have discussed our work with your team.

We applaud the significant accomplishments you and your team have made recently, particularly in establishing balanced safeguards against unfair and deceptive acts and practices. The new law is in many ways a testament to your efforts. I hope that the comments we enclose below are helpful as your team develops the rules called for in this new law.

Our comments focus specifically on the new law's requirement that penalty fees and charges must be reasonable and proportional to the violations or omissions that trigger those penalties. The law has defined a very narrow basis for justifying these penalties. The Board's rules should reflect that narrowing approach, particularly in regard to the cost considerations that may justify a penalty. Similarly, because the law is designed in favor of maximizing price transparency and market efficiency, the Board's rules generally should err on the side of those goals by constraining the proliferation of confusing or potentially "rent seeking" penalty structures. For penalties that are not readily justifiable based on the factors provided in the law, we urge the Board to tolerate no more than *de minimis* fees.

We look forward to continuing our dialogue with your team, and we are available to discuss these comments or any other aspect of our work on credit cards at any time.

Sincerely,

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CC: Leonard Chanin, Ben Olson

Reasonable and Proportional Penalty Fees and Charges

In 2007, The Pew Charitable Trusts launched an effort, in partnership with the Sandler Foundation, to address growing concerns about abuses in the credit card industry. The project team, led by a former credit card company chief executive officer, researched consumer use of credit cards, conducted economic analyses of credit card practices and revenues, and closely reviewed hundreds of credit card products. Based on these efforts, we published a set of Safe Credit Card Standards to promote responsible lending and borrowing, and to help make credit card products more transparent, simple and predictable. In the following comments, we have drawn on these experiences as well as additional research and analysis specifically intended to address requirements found in the new law.

These comments are divided into the following sections:

A. <u>Definitional Issues</u>. We discuss ways the Board may simplify the analysis regarding which penalties and charges will be subject to the reasonable and proportional rules.
   - The Board should define a set of fees and charges that will *not* be subject to the reasonable and proportional rules, and presume that any other type of fee or charge will be subject to the rule.
   - Taking the further step of requiring all fees for the issuance or availability of credit to be disclosed in the form of a single, annualized figure would greatly enhance pricing transparency.

B. <u>Analytical Factors</u>. This section discusses the analytical factors established in the law.
   - Costs are to be determined based on the actual consequences of the cardholder's violation or omission; therefore, while marginal costs of special mailings or other actions may be considered, compensation for risk or lost revenue may not.
   - The deterrence value of penalty fees is not clear, and must be balanced carefully against established problems of rent extraction.
   - Cardholder behavior is the only purely punitive factor in the analysis; and penalties can only be justified on this basis to the extent they are closely tied to "bad actions" that are in the cardholder's power to control.
   - Other appropriate considerations are timing issues (how quickly, how long and how substantially the fee or charge may be applied) and relationship to the law's fundamental goals of transparency and efficient market behavior.

C. <u>Discussion of Specific Penalty Fees and Charges; Safe Harbor Issues.</u> Key points for late fees, penalty interest rate increases and over-the-limit fees are discussed. Where possible, we suggest safe harbor guidelines.

Appendix A: Data on Penalty Fees and Charges in the Market

Appendix B: Discussion of Proposed Seven-Point Penalty Premium Threshold

Appendix C: Sample State Law Limiting Penalty Fees

A. Definitional Issues

Section 102(b) of the Credit CARD Act of 2009 (Pub. L. 111-24) adds the following language to the Truth in Lending Act:

> **Sec. 149. REASONABLE PENALTY FEES ON OPEN END CONSUMER CREDIT PLANS**
>
> (a) IN GENERAL.—The amount of any penalty fee or charge that a card issuer may impose with respect to a credit card account under an open end consumer credit plan in connection with any omission with respect to, or violation of, the cardholder agreement, including any late payment fee, over-the-limit fee, or any other penalty fee or charge, shall be reasonable and proportional to such omission or violation.

The law requires the Board, in consultation with the federal financial supervisory agencies, to issue rules "to establish standards for assessing whether the amount of any penalty fee or charge… is reasonable and proportional to the omission or violation to which the fee or charge relates." The law specifically authorizes the Board to set "safe harbor" guidelines for penalties that will be presumed to be reasonable and proportional.

The reasonable and proportional requirement applies to "any penalty fee or charge… in connection with any omission with respect to, or violation of, the cardholder agreement…." These fees may include any "late payment fee," "over-the-limit fee," or "any other penalty fee or charge;" but the law does not provide a complete definition. We encourage the Board to define "penalty fees or charges" in a manner that minimizes the incentive for card issuers to introduce new or duplicative fees.[1] By doing so, the Board will help promote the specific legislative intent to restrain penalties to reasonable levels, as well as the general intent to maximize price transparency.

The best way to maximize the efficacy of the rule, and to minimize issuers' incentive to circumvent the reasonable and proportional requirement, is to define fees that will *not* be subject to those requirements and apply the rules to all other fees or charges. In the course of developing our Safe Credit Card Standards[2], we learned that creating a structure to constrain the proliferation of fees was vital to achieving the fundamental goals of transparent and predictable pricing. Similarly, in the present rulemaking, constraining fees in such a way that there is little room for argument about which fees will be subject to the reasonable and proportional rule will be vital to achieving the rule's purpose.

Therefore, we propose that the Board define three types of fees that will *not* be considered penalties for purposes of the reasonable and proportional rules, and declare that all other fees *will* be subject to the rules. The three suggested types of exempt fees are as follows:

[1] There is evidence of a "rent extraction" problem related to penalty fees, which may encourage issuers to allow or even encourage their customers to engage in behavior that maximizes penalty fee income. See further below in these comments for a discussion.

[2] See www.pewtrusts.org/creditcards. The Safe Credit Card Standards were designed to protect cardholders and promote a functional marketplace, largely by ensuring transparent and predictable pricing. Pew developed the Standards after extensive consultation with industry, consumer group and government representatives.

1. *Fees for the issuance or availability of credit.* The Board has already defined this type of fee, and we would encourage the Board to use that definition in its present rulemaking. In § 227.26 of Regulation AA (as effective July 1, 2010), the Board defines "fees for the issuance or availability of credit" to include any annual or other periodic fee for issuance or availability of credit, including any fee based on account activity or inactivity, and any non-periodic fee related to opening an account. Elsewhere, Regulation Z requires disclosures of "any annual or other periodic fee that may be imposed for the issuance or availability of a credit or charge card, including any fee based on account activity or inactivity" and a statement of how frequently it will be imposed and the annualized amount of the fee (§ 226.5a(b)(2) as effective July 1, 2010).

   Further, we strongly encourage the Board to take the additional step of requiring issuers to disclose all fees for the issuance or availability of credit *in the form of a single, annualized cost figure*. In our Safe Credit Card Standards, we proposed requiring all such account-level fees to be expressed as an annual account maintenance fee. Consolidating fees for the issuance or availability of credit in this way would greatly enhance pricing transparency and reduce incentives issuers may have to embed multiple service fees that make the overall price of credit difficult to identify or compare. It would also help to limit the number of fees that must be disclosed by issuers, evaluated by consumers and analyzed by government authorities.

   This requirement to express fees for the issuance or availability of credit as a single annualized cost figure would fit easily within the Board's existing rule structure. The fee would be disclosed as a single, annualized fee, but could be charged periodically throughout the year as appropriate. Thus, this requirement would not interfere with the requirement, in § 226.26 of Regulation AA, to charge the fee in installments over a period of months in cases where the fee would exceed 25 percent of the initial credit limit for the account.

   This new requirement should take precedence over related disclosure rules. For example, to accommodate the requirement in Regulation Z, § 226.5(a)(b)(2), which will require issuers to label any non-periodic account opening fee as a "one-time" fee, issuers may be directed to provide the single annualized cost figure prominently with a notation underneath indicating the portion of the annualized fee represented by the one-time application fee.

2. *Transaction surcharges*. These fees would be surcharges imposed on any approved transaction meeting specified characteristics based on the place or nature of the transaction. Examples include transactions occurring at a foreign point of sale or requiring foreign currency exchange, cash advances or balance transfers.[3]

   To strengthen the definition of this type of fee, we encourage the Board to create a definitive list of fees which it would consider transaction surcharges, with the

[3] It should be noted that an excess of transaction surcharges on an account would tend to undermine pricing transparency by shrouding the true cost of credit. Though these types of fees may require safeguards to ensure transparency and protect consumers from unfair and deceptive practices, we have not addressed those issues in this comment.

presumption that any other type of charge will not be considered a transaction charge without further analysis.

3. *Customer-initiated service fees*. These fees would result from non-transactional, customer-initiated service requests, such as copy charges or rush delivery of a new card. A fee will not qualify as a customer-initiated service fee unless the cardholder expressly requests the service and explicitly agrees to pay the stated fee.

   As with transaction surcharges, the Board may wish to create a list of fees considered to be customer-initiated service fees, with a presumption that other types of fess will not be categorized as such without further analysis. This list may include: Expedited payment fee, card replacement fee, expedited delivery fee, copy fee, research fee and/or stop payment fee.

All other fees or charges, with the exception of standard (non-punitive) interest charges established at the account opening or via a change in terms notice, should be presumed to be penalty fees or charges for purposes of the reasonable and proportional requirements. (We also note that our Safe Credit Card Standards would prohibit any penalty fee or charge, other than a late fee, a returned payment fee and a limited temporary penalty interest rate increase, and that the Board could consider a similar rule as a way to clarify the analysis and restrict the confusing proliferation of fees and charges).

B. Analytical Factors

Section 102(b) of the law instructs The Board to consider the following in forming the reasonable and proportional standards:

> "(1) The cost incurred by the creditor for such omission or violation;
> "(2) The deterrence of such omission or violation by the cardholder;
> "(3) The conduct of the cardholder; and
> "(4) Such other factors as the Board may deem necessary or appropriate."

Cost

The first factor, cost, is specifically constrained to include only those costs the creditor incurs for the "omission or violation" for which the penalty is being imposed. By delimiting costs to those incurred for the omission or violation specifically, the legislation makes it clear that any costs related to the normal costs of doing business, such as general overhead, risk exposure, customer service, billing and account maintenance costs, must not be included. The only costs that remain to be considered are whatever actual marginal costs may be attributable to any extraordinary efforts an issuer makes in response to the omission or violation, such as sending a special letter or email, making a phone call or suspending a delinquent account.

An estimation of these costs should *not* include an accounting for the marginal risk an account may pose because of the omission or violation.

Compared to commercial and investment banking, the risk involved with retail lending portfolios is both more diverse and more predictable. Though risk concentrations can vary in retail portfolios, risks tend to be spread widely, with credit delivered in small pieces, over an extended period of time, to thousands or millions of borrowers. Consequently, retail lenders can confidently estimate future losses based on their initial underwriting policies. "The high predictability of retail credit losses mean that the expected loss rate dominates retail credit risk and can be built into the price charged to the customer," notes the authors of *The Essentials of Risk Management*.[4]

Though it may be possible for an issuer to demonstrate that accounts with certain violations (such as a late payment) have a higher incidence of chargeoffs, it is not reasonable to translate that risk into a punitive fee or charge that will apply when an account demonstrates the supposedly risky behavior. At a portfolio-wide level, card issuers create complex pricing models that are intended to account for a number of factors, including risk as well as corporate goals such as profitability and market share. In fact, the book *The Essentials of Risk Management* advises that a "well-designed RBP [Risk-Based Pricing] strategy allows the bank to map alternative pricing strategies at the credit score level to key corporate metrics (e.g., revenue, profit, loss, risk-adjusted return, market share, and portfolio value…."[5] Depending on the overall mix of these corporate metrics, creditors will accept more or less risk, set more or less aggressive pricing, and market their products more or less broadly.

It is at the portfolio level, not the specific account level, where issuers make these determinations. Thus, the risk associated with omissions and violations of account agreements may be factored into the price of a credit card account at the front end, so that by the time an omission or violation occurs, risk is not part of the new costs the issuer will incur. Every day, as issuers earn interest on outstanding balances, they are compensated for risk and the costs of doing business in the context of their overall marketing, pricing and risk management strategy.

Deterrence

The second factor relates to deterring the specific omission or violation in question. There is little available research to help identify the deterrence value of fees, let alone how to distinguish between a fee that is used to discourage behavior versus one that is primarily a revenue tool. In a recent paper, Sumit Agarwal, et. al., identified a learning affect associated with fees. It found that cardholders pay "very large" fees immediately after opening an account, but learn to reduce those fees over time, such that monthly fee payments fell by 75 percent during the first four years of an account's life. The more recently a fee was applied, the less likely the cardholder was to incur the fee again in subsequent months.[6]

In theory, credit card issuers will want to take advantage of this learning effect to discourage their customers from missing payment due dates, exceeding credit limits or any other activity which warrants a penalty fee. However, companies also have a powerful incentive to allow, or even encourage, their customers to trigger fees as a way of boosting revenue. As a recent

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[4] Crouhy, Michel, Dan Galai and Robert Mark, *The Essentials of Risk Management* (McGraw-Hill, 2006), at p. 209.
[5] Ibid., at p. 228.
[6] Agarwal, Sumit, John C. Driscoll, Xavier Gabaix and David I. Laibson, "Learning in the Credit Card Market" (Februray 8, 2008). Available at SSRN: http://ssrn.com/abstract=1091623.

Harvard Business Review feature noted, "a company is less likely to help customers make good choices if it knows that it can generate more profits when they make poor ones."[7] The problem extends particularly to penalty fees:

> Such charges may have been conceived as a way to deter undesirable customer behavior and offset the costs that businesses incur as a result of that behavior. Penalties for bouncing a check, for example, were originally designed to discourage banking customers from spending more than they had and to recoup administrative costs. The practice was thus fair to company and customer alike. But many firms have discovered just how profitable penalties can be; as a result, they have an incentive to encourage their customers to incur them – or at least, not to discourage them from doing so.[8]

Given the strong incentive companies have to allow or encourage customers to trigger penalty fees, it is unclear how strongly Agarwal's learning effect may be attributed to deterrence. In learning to avoid penalty fees that are common in the early stages of an account's life, customers may be adopting more responsible behavior based on a deterrent effect; or, they may simply be gaining a fuller understanding of the actual costs they can incur and a sophistication about how to reduce those costs.[9]

Another study, by Nadia Massoud et. al., would suggest the latter. While this study identified a correlation between penalty fees and default risk, no deterrence effect was found. However, the authors did identify a strong correlation between an issuer's market power and the magnitude of penalty fees. Banks with higher market share were able to "extract rents" in the form of penalty fees, even after holding consumer risk constant.[10]

While the deterrence value of penalty fees would seem to be limited, the incentive for companies to allow or encourage customer behavior that maximizes revenues, including fee revenues, is significant. In 2008, penalty fees (exclusive of penalty interest rate increases) accounted for 6.6 percent of credit card revenue, or more than $8.5 billion dollars.[11] The Center for Responsible Lending, in separate comments currently being submitted to the Board, has estimated that these fees have steadily increased as a percentage of revenue since the Supreme Court's *Smiley* decision effectively deregulated credit card fees.

To be reasonable and proportional, a penalty fee or charge should be designed to allow for a modest deterrence effect while minimizing the negative "rent extraction" factors. To accomplish this balance, penalties generally should be kept to a *de minimis* level, particularly absent compelling evidence from issuers that larger fees are both necessary for deterrence *and* can be designed with sufficient safeguards to minimize risks of rent extraction.

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[7] McGovern, Gail and Youngmee Moon, "Companies and the Customers who Hate Them" Harvard Business Review, June, 2007.
[8] Ibid.
[9] For an overview of scholarly studies exploring how sophisticated firms may attempt to exploit consumer ignorance or biases, see: Gabaix, Xavier and David I. Laibson, "Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets" (April 11, 2005), MIT Department of Economics Working Paper No. 05-18 (at footnote 1). Available at SSRN: http://ssrn.com/abstract=728545.
[10] Massoud, Nadia, Anthony Saunders and Barry Scholnick, "The Cost of Being Late: The Case of Credit Card Penalty Fees" (March 2006), AFA 2007 Chicago Meetings Paper (see p.29-32 for a discussion of the correlations among penalty fees, risk and market share). Available at SSRN: http://ssrn.com/abstract=890826.
[11] Cards & Payments, May, 2009.

Cardholder Conduct

The third factor relates to the conduct of the cardholder. Presumably, this factor may be intended to allow for a consideration of the cardholder's prior omissions or violations in setting the rate of a current penalty. It follows that cardholders who repeatedly pay late, for example, may be subjected to a higher degree of penalty fee or charge as a punishment for the repeated bad conduct.

Given that the law sets aside cost and deterrence in separate factors, the conduct factor is the only purely punitive factor in the analysis. As such, any consideration of cardholder conduct should focus on "bad" behavior, such as willful failures to pay on time, and not any additional costs or need for deterrence that may stem from the behavior. The key question regards what may an issuer reasonably do to punish a cardholder's behavior, and whether the punishment is proportional to the behavior.

Similarly, penalties for bad conduct should only respond to violations or omissions that are fully in the cardholder's power to control. The less an issuer can directly tie the punitive fee to the cardholder's willful bad conduct, the less reasonable and proportional the fee will be.

Other Factors

Among the other factors the board may generally consider, we suggest the following:

- *Timing issues*. The timing of when a penalty fee or charge is imposed, and in some cases how long the penalty charge will be applied, will affect the reasonability and proportionality analysis. For simplicity, an issuer may wish to impose a fee or charge according to uniform rules, which may in some cases mean that a penalty is imposed even before the issuer has incurred a cost. While this type of simplification is understandable, even desirable, it may require that the amount of the fee, or the duration of the charge, must be sufficiently low to ensure that the fee is reasonable and proportional portfolio-wide.

- *Impact on transparency.* Among the primary objectives of the Credit CARD Act of 2009 were improving the transparency of credit card pricing arrangements and protecting consumers from unfair, misleading or deceptive practices.[12] In evaluating whether a penalty fee or charge is reasonable and proportional, the Board should consider whether the penalty in question would tend to undermine these goals. Penalty schemes that would tend to create non-transparent pricing arrangements, complexity, unpredictability regarding the expected cost of an account, or risk of rent extraction should be closely scrutinized.

[12] See, e.g., the report, "Amending the Consumer Protection Act, to Ban Abusive Credit Card Practices, Enhance Consumer Disclosures, Protect Underage Consumers, and for Other Purposes," submitted by Chairman Chris Dodd, May 4, 2009. Available at: http://www.thomas.gov/cgi-bin/cpquery/T?&report=sr016&dbname=111&.

C. Discussion of Specific Penalty Fees and Charges; Safe Harbor Issues

In this section, we review common types of penalty fees and charges. For each, we discuss the analytical factors outlined above and suggest potential safe harbor guidelines.

1. Late Fees

Key Points

- Hair-trigger penalties for the late fee, such as allowing the fee to apply immediately on the payment due date, should be closely scrutinized.
    - Issuers will tend not to incur additional costs due to the late payment immediately after the due date; rather, any additional costs that may arise would not occur before several days have passed.
    - For the fee to be based on deterrence and cardholder behavior factors, it is appropriate to create a leniency period of several days after the due date to ensure that the late payment is not due to factors beyond the cardholder's control, such as delays in the mail or the payment posting process.
- Generally, the size of the fee should be in proportion to the amount of the payment that is *past due*.
    - The median late fee on a credit card account is $39 for accounts with outstanding balances of $250 or more (see Appendix A for data on current market conditions). Most credit card accounts, which have balances significantly higher than the $250 threshold, are subject to this $39 late fee.
    - For an account with a balance of $3,000 (the median household credit card debt[13]), a $39 fee represents only 1.3 percent of the overall account balance. But compared to the *minimum payment due* for the month, which is likely to be approximately $65, a $39 late fee represents a penalty of approximately 60 percent of the past due amount.[14] A 60 fee that increases a cardholder's minimum required payment by 60 percent may be difficult to justify as being proportional.

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[13] Our estimate based on Survey of Consumer Finance Data. See: Bucks, Brian K., Arthur B. Kennickell, Traci L. Mach and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, vol. 95, February 12, 2009, at p. A45

[14] The minimum payment due is demonstrated based on an annual percentage rate of 14 percent (roughly the current average advertised purchase rate – see e.g. www.indexcreditcards.com) multiplied by the $3,000 average daily balance, plus a one percent principal reduction.
[i.e.: $3,000 * (.14/12) + $3,000 * 0.01, or $35 + $30 = $65]

Safe Harbor Considerations

We have not established complete safe harbor guidelines for late fees. However, we refer the Board to a State of California law that may serve as a useful guideline. This law establishes a maximum late fee based on the number of days past due an account becomes (starting at five days past due), and limits issuers to charging only one late fee per billing cycle. This structure helps prevent hair trigger penalties. The relevant section of the law, Cal Fin Code § 4001, is provided in Appendix C.

Note that in separate comments currently being presented to the Board, Center for Responsible Lending and other consumer groups have suggested the Board review common standards for late fees from the time period before the Supreme Court's *Smiley* decision effectively deregulated late fees (e.g., the less of a fixed amount, such as $5-$10 or a specified percentage of the minimum payment due, such as five percent). We agree that these structures provide appropriate models, particularly to the extent they looked to the *past due* amount and not the *total account balance* as the relevant factor in establishing proportionality.

2. Penalty Interest Rate Increases

Key Points

- A penalty interest rate increase is subject to the reasonable and proportional rules because it is imposed in response to a cardholder's violation of the account agreement and would not qualify as any other type of fee or charge.

- In prior comments to the Board we emphasized the importance of three key variables regarding penalty interest rate increases.[15] These variables are the trigger (what actions activate the penalty rate and which balances are affected); the cure (how long may the penalty rate apply and whether the original rate is guaranteed to be restored); and the penalty premium (the difference between the penalty rate and the original rate). These three variables together constitute the penalty interest rate, and any consideration of whether such penalty is reasonable and proportional must consider the three variables together.

- Penalty interest rate increases on *existing balances* are justifiable only to the extent they compensate the issuer for actual marginal costs caused by the cardholder's violation.

    - In general, where separate penalty fees are imposed for the violation that may trigger the penalty interest rate increase, those fees should be looked to first for cost recovery.

    - Penalty interest rates on existing balances may be justified as compensation for costs if the issuer follows policies, such as credit counseling or establishment of workout arrangements, for seriously delinquent accounts (i.e., accounts that are 60 or more days past due, the threshold established in the law).

[15] Comments from the Pew Charitable Trusts, dated October 3, 2008, available at: www.pewtrusts.org/creditcards.

  - The deterrence value of penalty rate increases on existing balances is not shown. Nor is it reasonable to allow creditors to have the power to use retroactive price increases (in effect, a rewriting of the past agreement after the cardholder has incurred the debt) as a tool for deterrence. Similarly, though penalty fees may justifiably punish a cardholder for errant behavior, there is no basis for deeming retroactive price increases an appropriate punitive response to a cardholder's behavior. In contrast, the threat of rate increases on *future* balances as a deterrent to violating the account agreement would be appropriate, but only because it would apply to transactions that have not yet been completed and are therefore still subject to negotiation between the cardholder and the issuer.

  - Retroactive rate increases that can last indefinitely should be presumed to be unreasonable. Definite cure periods, which guarantee automatic restoration of the originally agreed rate after a period of on-time payments, are essential features of reasonable and proportional penalty interest rate increases. Cardholders should always have the opportunity to escape ongoing penalty charges whenever they resume making on-time payments for a reasonable period of time.

  - The appropriateness of the penalty rate increase should be balanced against the potential for price shocks that could trap cardholders in high levels of debt, or for payments that they could not have predicted and may be unable to pay. For example, it may be unreasonable and disproportionate to allow the penalty to have the effect of instantly doubling the minimum payment due for the month.

- Interest rate increases on *future balances* may be justified based on a variety of factors, including cost, cardholder behavior factors and risk factors. However, it is questionable whether such a rate increase can be justified as a *penalty* for specific cardholder violations or omissions, or as compensation for costs specifically related to those violations or omissions, since it is in effect the result of a new underwriting analysis.

Safe Harbor Considerations

We recommend the following safe harbor guidelines for interest rate increases on *existing balances*. These guidelines are based on our Safe Credit Card Standards.

- Triggered only if an account is 60 or more days past due (per § 102(b) of the law).

- Cure period of six months, requiring the original rate of interest applicable to each penalized balance to resume automatically after six consecutive months of on-time payment behavior. This cure would exceed the explicit requirements of § 102 (b) of the law by requiring the cure no matter when the cardholder begins the six-month repayment process.

- Penalty premium of` no more than seven percentage points above the original rate. (For discussion of how we established this threshold, see Appendix B).

Additionally, the Board may wish to require issuers to provide representations or substantiation regarding the actual marginal costs associated with penalized accounts that are not otherwise covered by normal interest rates or specific penalty fees such as late fees.

Regarding penalty interest rate increases on *future balances,* it is our recommendation that (1) the Board impose the same safe harbor guidelines expressed for increases on existing balances; and (2) the Board establish a presumption that any form of automatic penalty rate increase on future balances that does not meet the safe harbor guidelines is unreasonable. Instead, issuers that wish to raise interest rates on future balances under circumstances not covered by the safe harbor should be instructed to use a process of account underwriting and amending the account agreement.

- As noted above, the case for allowing penalty interest rate increase on *future balances* as an automatic response to specific cardholder violations or omissions is questionable; but the negative effects associated with problems of rent seeking are clear. Automatic interest rate increases would create a significant incentive for issuers to allow or encourage specific cardholder behavior, such as exceeding a credit limit, that would trigger a rate increase.

- Though we see possible justifications for increasing *go-forward* interest rates based on a variety of changing factors, including risk factors, we see no reason why automatic penalty interest rate increases would be the proper mechanism for doing so, except perhaps in cases of serious delinquency (60 days past due) as a means to recuperate costs of administering credit counseling or workout plans (as the safe harbor would allow).

Under this formulation, issuers would be free to exercise discretion regarding to whom they will continue to lend and on what terms, and cardholders will experience less risk of experiencing significant penalties for insignificant transgressions (of course, individual fees for late payments and the like may still apply). These rules would benefit issuers by not automatically requiring them to reduce rates on future balances, leaving the issuers free to consider a variety of factors, such as marketing priorities or overall economic conditions, when setting go-forward pricing. However, the law has already provided a mechanism, under § 101(c), to protect cardholders by requiring issuers to review repriced accounts periodically for possible rate reductions. Further, § 101(d) of the law will reduce the risks of “bait and switch” repricing by prohibiting most interest rate increases during the account’s first year. The proposed safe harbor would conform to these requirements.

Finally, we note that this formulation should not exempt issuers from the Board’s authority, including its authority to ensure reasonable and proportional penalty charges, in cases where issuers are found to be engaging in systematic repricing practices that are injuring cardholders, exceeding the bounds of reasonability and proportionality, undermining transparency or otherwise frustrating the law’s purpose.

Should the Board disagree, and allow automatic penalty rate increases on future balances other than according to the safe harbor proposed above, we make the following additional observations:

- Hair triggers, such allowing automatic interest rate increases based on a single late payment or overlimit event, should be prohibited. Instead, triggers should be based on the severity of the transgression and should only apply once the individual triggering event has exceeded a threshold, such as when an account becomes several days past due.

- For any automatic penalty rate increase, a guaranteed cure should apply, restoring the originally agreed rate after any six month period of on-time payment.

3. Over-the-Limit Fees

Key Points

- Whether an account exceeds the credit limit is entirely within the issuer's control. The issuer sets the credit limit, authorizes the transactions and decides how far beyond the limit the account may extend. Conversely, cardholders often have no knowledge or control of their account's proximity to the credit limit, due to factors such as unavailability of information at the point of sale and, potentially, unknowable holds placed against the account due to hotel reservations or for other reasons.[16] Therefore, any penalty fee associated with exceeding the limit should be scrutinized carefully to identify how the fee relates to an omission or violation on the cardholder's part.

- We question whether over-the-limit fees can be justified by any of the factors identified in the law. Because over-limit transactions are processed automatically, it is unclear what additional costs the issuer may be said to incur due to the violation or omission of the cardholder. Further, because the cardholder is often unaware of the account's proximity to the credit limit, and because the issuer *always* can control whether the account exceeds the limit, it is difficult to see how an over-the-limit fee furthers goals such as deterrence or punitive action (indeed, better forms of deterrence and punitive action are available, in the form of denied transactions). Penalties that are triggered at the instant an account exceeds its limit, or which charge more than a *de minimis* amount, are especially difficult to justify.

- In our Credit Card Standards, we proposed to prohibit all over-the-limit fees, both for the reasons noted above and because of the complexity of expressing sufficient safeguards to avoid abuse of the fee (some of these safeguards, such as requiring the cardholder to opt-in and restricting application of over-the-limit fees to once per month, are explicitly provided in the law, while others are left to the Board to determine). We encourage the Board to prohibit over-limit fees, or else restrict all but the most minimal forms of this fee.

Safe Harbor Considerations

Absent a ban on the over-the-limit fee, we encourage the board to consider safe harbor guidelines that would allow only a *de minimis* fee that could apply only once an account has exceeded the credit limit by a certain threshold. Establishing a buffer threshold would help avoid problems associated with a cardholder's lack of information about the account's proximity to the credit limit, holds placed against the account and potential rent extraction motivations.

Though we have not established complete safe harbor guidelines for over-the-limit fees, we refer the Board to a State of California law that may serve as a useful guideline (e.g., "[n]o overlimit

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[16] The Board discussed similar concerns in its December, 2008, notice of final rulemaking for Regulation AA. The Board declined address credit holds at the time, but the new law adds weight to arguments in favor of creating safeguards on when over-the-limit fees may apply.

fee may be charged unless the charge causes the outstanding balance to exceed the credit limit by five hundred dollars ($500) or 120 percent, whichever is less”). The relevant section of the law, Cal Fin Code § 4001, is provided in Appendix C.

APPENDIX A: Data on Penalty Fees and Charges in the Market

Included below are selected findings from Pew's research on commonly deployed penalty fees in the market.[17] These findings are based on our review of credit card terms of the country's 12 largest issuers, which together hold more than 88 percent of outstanding credit card debt.[18] In December, 2008, researchers gathered available online disclosures for all of the more than 400 Visa®, MasterCard®, American Express® and Discover® branded consumer credit card products offered by these top issuers.

Late Fees

We found that 99 percent of cards included a late fee. The late fee was tiered based on account balance in 98 percent of these instances. For these accounts, the amount of the late fee was expressed in two or three tiers, as follows:

Table A-1: Allowable Late Fees (Tiered Accounts)

	Median Balance Thresholds	Median Late Fee	Range of Late Fee
Late Fee Tier 1	$0 to $100	$15	$15 - $20
Late Fee Tier 2	$100 to $250	$29	$15 - $29
Late Fee Tier 3	$250 or Above	$39	$35 - $39

For most of these accounts, the maximum late fee became applicable once an account's balance exceeded $250. This maximum fee, ranging from $35 to $39, represents as much as 15.6 percent of the entire account balance (and a much higher percentage of the minimum monthly payment due). For the two percent of cards with fixed late fees, the median late fee was $35, with a range from $30 to $39.

Over-the-Limit Fees

Fees for exceeding the credit limit applied to 92 percent of the cards. As with late fees, most overlimit fees were tiered based on account balances (though the figure was lower, at 56 percent). The amount of the overlimit fee for these accounts was expressed in two or three tiers, as follows:

Table A-2: Allowable Overlimit Fees (Tiered Accounts)

	Median Balance Thresholds	Median Late Fee	Range of Late Fee
Overlimit Fee Tier 1	$0 to $500	$15	$15 - $19
Overlimit Fee Tier 2	$500 to $1,000	$29	$15 - $29
Overlimit Fee Tier 3	$1,000 or Above	$39	$35 - $39

---

[17] Some data in this section was published in March, 2009, in a report by the Pew Health Group, *Safe Credit Card Standards*, available at www.pewtrusts.org/creditcards. Other data is published here for the first time.

[18] The largest twelve issuers included the top-10 Visa / MasterCard issuers, American Express and Discover (issuer size is measured by outstanding balances based on data available as of December, 2008). See: The Nilson Report, Issue 895 (January 2008) and Issue 902 (May 2008).

For the 44 percent of cards with fixed overlimit fees, the median overlimit fee was $39, with a range from $29 to $39.

Penalty Interest Rate Increases

Current Conditions. We found that 87 percent of cards allowed the issuer to impose automatic interest rate increases on all balances as a penalty for paying late, exceeding the credit limit or for other reasons. Under present rules, this penalty charge may apply equally to existing balances as well as balances resulting from future transactions. The median advertised (non-penalty) annual interest rates for purchases made with the cards were between 9.99 percent to 17.99 percent (issuers advertise a range of interest rates which may apply depending on a consumer's credit profile). By comparison, the median allowable penalty interest rate applicable to these accounts was 27.99 percent per year. The additional allowable charges represented by this 27.99 percent penalty rate are summarized in the following table.

Table A-3: Allowable Penalty Costs due to Penalty Interest Rate Increases, Market-Wide

Avg. Daily Balance	18-Point Penalty Premium *(27.99% penalty rate applied to card with 9.99% base rate)*		10-Point Penalty Premium *(27.99% penalty rate applied to card with 17.99% base rate)*	
	Annual Cost	Monthly Cost	Annual Cost	Monthly Cost
$1,000	$180	$15	$100	$8
$2,000	$360	$30	$200	$17
$3,000	$540	$45	$300	$25
$4,000	$720	$60	$400	$33
$5,000	$900	$75	$500	$42
$6,000	$1,080	$90	$600	$50
$7,000	$1,260	$105	$700	$58
$8,000	$1,440	$120	$800	$67
$9,000	$1,620	$135	$900	$75
$10,000	$1,800	$150	$1,000	$83

Note: Amounts shown in the table above are only the costs of the penalty interest rate premium, not inclusive of the base interest charges

Significantly, most cards allowed issuers to impose penalty rate increases indefinitely once they were triggered. Only eight percent of cards with penalty rate conditions offered to restore the original rate terms when payments are made on-time, usually after 12 months.

Cumulative Penalties

For all cards surveyed, penalty fees and charges could be cumulative. A penalty interest rate increase, a late fee and an overlimit fee could all apply concurrently to an account during any given time period (in addition to any other applicable fee or charge).

APPENDIX B: Discussion of Proposed Seven-Point Penalty Premium Threshold

In Section C(2) of our comments, we recommend several safe harbor guidelines on penalty interest rate increases, including a maximum penalty premium of seven percentage points above the base, non-penalty rate. In our judgment, this seven-point threshold establishes a simple rule that will in most cases allow for a reasonable and proportional fee, when imposed in connection with an appropriate cure period and penalty rate trigger. We selected this threshold, which is part of our Safe Credit Card Standards, after considering a wide variety of factors and discussing the issue with industry and consumer groups. Some of the considerations are outlined below.

Impact on cardholder

- A seven percentage-point premium would significantly reduce the overall amount of penalties a cardholder may be required to pay compared to today's conditions.

    - A seven-point premium would add nearly $6.00 in interest charges, per month, for every $1,000 borrowed.[19] At an account balance of $3,000 (the median household credit card balance[20]), a seven-point interest penalty would add $17.50 per month[21].

    - The total cost for a cardholder who cures the penalty after six months would be $105 ($17.50 * 6 months). Additional monthly charges of $17.50 could apply, up to a maximum of $210 per year, if the penalty is not cured and removed.

    - By comparison, allowable penalty interest rate increases in the market today typically would add between $25 and $45 per month to this $3,000 balance.[22] Because cures are seldom guaranteed on accounts currently, this premium could last for an unlimited number of months, even in cases where the cardholder resumes on-time payments. A $45 monthly penalty would add $540 in additional charges each year.

    - Whereas a cardholder with a $3,000 balance in a proposed safe harbor account would pay $105 in penalties after six months of on-time payment, a cardholder in today's market would be charged up to $540 in additional penalties *in the first year alone*, with additional charges possible indefinitely thereafter, regardless of his or her subsequent repayment behavior.

[19] $1,000 * (.07/12) = $5.83
[20] Our estimate based on Survey of Consumer Finance Data. See: Bucks, Brian K., Arthur B. Kennickell, Traci L. Mach and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, vol. 95, February 12, 2009, at p. A45
[21] $3,000 * (.07/12) = $17.50.
[22] See Table A-3 in Appendix A, showing current market conditions and demonstrating that current allowable monthly penalties on a $3,000 balance equal $25 to $45 dollars.

- A penalty interest rate increase can create substantial increases in the amount of the monthly minimum payment due. While current penalty premiums can increase the monthly minimum payment due by 50 to 100 percent, a seven-point premium would create a much smaller payment shock.

    - Table B-1, below, estimates the minimum payment due for accounts based on the average daily balance and the applicable annual percentage rate.

    - For example, an account with a balance of $3,000 that is subject to a 14 percent annual interest rate would be have a monthly minimum payment due of approximately $65.[23] Raising the interest rate to 28 percent (the current median allowable penalty rate[24]) would bring the monthly minimum payment to $100, an increase of 65 percent.

    - By comparison, the maximum safe harbor penalty premium of seven points would bring the interest rate to 21 percent. The monthly minimum payment due would reach $83, an increase of only 28 percent.

    - Note: The lower the base annual interest rate, the greater the proportional impact of the penalty. For example, if the base interest rate is ten percent, the minimum monthly payment due on an account with a $3,000 balance would be $55. Raising this account's interest rate to 28 percent would bring the minimum monthly payment to $100, an increase of 82 percent. Limiting the penalty premium to seven points would bring the monthly minimum payment to $73, an increase of 33 percent.

    - The seven-point premium would significantly reduce the risk of payment shock by noticeably reducing monthly penalty charges compared to their current levels. Restricting payment shocks in this way can help cardholders to return to responsible payment behavior and effectively work toward eliminating their debt burden. We believe that this benefit makes the seven-point premium more reasonable than current market conditions allow, and represents a penalty that is more proportional to the cardholder's offense.

Continued on next page…

[23] The current average advertised interest rate is approximately 14 percent (see, e.g., www.indexcreditcards).
[24] See Appendix B for a summary of current market conditions.

Table B-1: Minimum Payment Due Based on Applicable Annual Percentage Rate

Avg Daily Balance	Minimum Payment Due Based on Applicable APR									
	9%	**10%**	**11%**	**12%**	**13%**	**14%**	**15%**	**16%**	**17%**	**18%**
$1,000	$18	$18	$19	$20	$21	$22	$23	$23	$24	$25
$2,000	$35	$37	$38	$40	$42	$43	$45	$47	$48	$50
$3,000	$53	$55	$58	$60	$63	$65	$68	$70	$73	$75
$4,000	$70	$73	$77	$80	$83	$87	$90	$93	$97	$100
$5,000	$88	$92	$96	$100	$104	$108	$113	$117	$121	$125
$6,000	$105	$110	$115	$120	$125	$130	$135	$140	$145	$150
$7,000	$123	$128	$134	$140	$146	$152	$158	$163	$169	$175
$8,000	$140	$147	$153	$160	$167	$173	$180	$187	$193	$200
$9,000	$158	$165	$173	$180	$188	$195	$203	$210	$218	$225
$10,000	$175	$183	$192	$200	$208	$217	$225	$233	$242	$250

Avg Daily Balance	Minimum Payment Due Based on Applicable APR									
	19%	**20%**	**21%**	**22%**	**23%**	**24%**	**25%**	**26%**	**27%**	**28%**
$1,000	$26	$27	$28	$28	$29	$30	$31	$32	$33	$33
$2,000	$52	$53	$55	$57	$58	$60	$62	$63	$65	$67
$3,000	$78	$80	$83	$85	$88	$90	$93	$95	$98	$100
$4,000	$103	$107	$110	$113	$117	$120	$123	$127	$130	$133
$5,000	$129	$133	$138	$142	$146	$150	$154	$158	$163	$167
$6,000	$155	$160	$165	$170	$175	$180	$185	$190	$195	$200
$7,000	$181	$187	$193	$198	$204	$210	$216	$222	$228	$233
$8,000	$207	$213	$220	$227	$233	$240	$247	$253	$260	$267
$9,000	$233	$240	$248	$255	$263	$270	$278	$285	$293	$300
$10,000	$258	$267	$275	$283	$292	$300	$308	$317	$325	$333

Minimum payment due is estimated by multiplying the monthly periodic rate by the account balance and adding an amount equal to a one percent principal reduction:
*Balance * (APR/12) + Balance * .01 = Minimum Payment Due*

Impact on issuer

- In developing our Safe Credit Card Standards we created an issuer revenue model and tested the Standards to determine their impact on issuer revenue streams. Though this revenue analysis is not necessarily relevant to the present reasonable and proportional analysis, we note that our estimates show that issuers would receive a significant amount of penalty interest income even under our proposed safe harbor guidelines, including the seven-point penalty premium.

- An example calculation illustrates that issuers can earn significant income even from constrained penalty interest charges. For every one million credit card accounts held by an issuer, several thousand will be delinquent at any given time. In 2008, the average overall delinquency rate (accounts 30 days past due) was approximately five percent.[25] Though we do not have data showing the number of accounts that are 60 days past due(the minimum trigger for applying penalty interest rate increases on existing balances under the new law), we will assume the figure to be between two and three percent for the present illustration. If 2.5 percent of accounts are 60 days past due, 25,000 accounts per million would be subject to a penalty interest charge. If the average minimum charge were $105 for a six month penalty, as noted above, the issuer's *minimum* revenue on the penalty interest rate increase would be $2.6 million per one million accounts. The actual charges are likely to be higher because some accounts will take longer than six months to establish the cure.

- Even if a percentage of these charges would not be collected due to chargeoffs, the example illustrates that issuers may expect to receive an amount of revenue from the new safeguarded penalty charges that is significant enough to cover the marginal costs associated with workouts or counseling of seriously delinquent accounts. We are unaware of any data showing otherwise.

In the final analysis, we agreed with the seven-point threshold suggested in several proposed pieces of legislation in the 110th Congress, including those from Senator Levin (S.1395) and Senator Menendez (S.2753). A set threshold based on the number of allowable percentage points sets a clear and easily understandable rule. We believe that a seven-point threshold is both reasonable and proportional because it offers cardholders substantial relief from the risks of price shocks found in the market today, while retaining a significant revenue stream that issuers can rely on to cover the costs of responding to seriously delinquent accounts.

[25] Federal Reserve Statistical Release

Appendix C: Sample State Law Limiting Penalty Fees

Cal Fin Code § 4001

§ 4001. Permissible amounts to be charged by supervised financial organization or charge card issuer

(a) A supervised financial organization or charge card issuer may not charge more than any of the following amounts:

(1) If set forth in the consumer credit or charge card agreement, one of the following fees:

(A) Seven dollars ($7) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within five days after the date the payment is due.

(B) Ten dollars ($10) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within 10 days after the date the payment is due.

(C) Fifteen dollars ($15) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within 15 days after the date the payment is due.

(2) In lieu of the fee permitted by paragraph (1), if the consumer has already incurred two late payment fees during the preceding 12-month period, the fee charged may be no more than ten dollars ($10) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within five days after the date the payment is due.

(3) Ten dollars ($10) with respect to any charge that causes the outstanding balance to exceed the credit limit by five hundred dollars ($500) or 120 percent, whichever is less. No overlimit fee may be charged unless the charge causes the outstanding balance to exceed the credit limit by five hundred dollars ($500) or 120 percent, whichever is less. Not more than one overlimit charge may be assessed with respect to any monthly billing cycle.

* * *

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ATTACHMENT D

Copy of The Pew Charitable Trusts' comments to the Federal Reserve Board, dated September 21, 2009 regarding "Regulation Z; Docket No. R—1364 (Interim Final Rule)," with a focus on urging the Board to rule that credit cards with partial variable rates including fixed minimum rate requirements are not eligible for exceptions to certain 45-day notice, notice of right to cancel and interest rate requirements found in the Credit CARD Act of 2009.

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September 21, 2009

By Electronic Delivery

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

RE: Regulation Z; Docket No. R–1364 (Interim Final Rule)

Dear Ms. Johnson:

In the following comments, we respond to the Board's Interim Final Rule under Regulation Z, published at 74 FR 139 (July 22, 2009) at p. 36077 et. seq., according to new requirements found in the Credit CARD Act of 2009. Our comments include the following key points:

1. Exceptions to § 226.9 notice requirements for fluctuations in variable interest rates should not apply to any account for which the issuer requires a fixed minimum interest rate to apply.

2. There is no basis in the Act for the proposed exception to the right to reject changes in terms for increases in minimum required payments, and it should be deleted.

3. The proposed exception to the requirement to notify cardholders of their right to cancel and avoid interest rate increases or other significant changes in cases where accounts are 60 days past due is unwarranted, and overbroad.

4. Issuers should be required to provide notice to cardholders within 45 days of the expiration of deferred interest periods.

Pew's Safe Credit Cards Project began in 2007 as a research-based effort to protect consumers from unfair credit card practices and promote responsible management of debt. We have published a set of Safe Credit Card Standards as well as various results from our research and analysis. Recently, we completed a new analysis of all credit cards offered by the largest 12 bank issuers and the largest 12 credit union issuers. We have included in our comments selected findings from this research, which will be published soon. Additional results will be available in our future comment letters to the Board. As always, we are available to discuss these comments or any other aspect of our work at any time.

Sincerely,

Nick Bourke
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1. **Exceptions to § 226.9 notice requirements for fluctuations in variable interest rates should not apply on any account for which the issuer requires a fixed minimum interest rate to apply.**

Pew's latest analysis of all consumer credit cards offered by the largest bank and credit union issuers found that bank issuers moved away from "fixed" interest rates and toward "variable" rates during the first half of this year.[1] We found that there is a related and possibly troubling trend emerging. A growing number of credit cards include terms designed to ensure that even variable rates will not fall lower than a fixed minimum set by the issuer. For these cards, issuers will benefit as interest rates rise according to operation of a third-party index rate, but many cardholders will be prevented from enjoying the benefits of falling index rates due to the fixed minimums set by issuers. For these cards, the issuer's chosen fixed minimum rate will apply regardless of the disclosed variable interest rate formula. We call this mechanism a *minimum rate requirement*.

The following example, taken from the application disclosures for the Wells Fargo Visa Platinum Card, demonstrates how the minimum rate requirement works.

Example: Wells Fargo Visa Platinum Card – Minimum Rate Requirement

Annual percentage rate (APR) for purchases	Introductory APRs range from 0.00% to 5.90% for the first 6 or 9 billing periods the account is open.[1] After that, APRs range from 8.65% to 22.65% depending on applicant's credit qualifications.

Variable rate information	Your APRs for purchase, cash advance and overdraft protection balances may vary. The purchase APR is determined by adding a margin ranging from 2.90 to 16.90 percentage points to the Index Rate. The cash advances and overdraft protection advances APR is determined monthly by adding 17.74 percentage points to the Index Rate. The Default Rate varies and is determined monthly by adding up to 23.99 percentage points to the Index Rate.[3]

[3]This Index Rate is equal to the highest prime rate published in the Money Rates column of *The Wall Street Journal* three business days prior to your billing statement closing date, subject to the applicable minimum APRs. The standard APRs for purchases are subject to minimum rates ranging from 8.65% to 22.65% and will not decrease below the applicable minimum rate regardless of changes to the Index Rate. The standard APRs on cash advances and overdraft protection advances are subject to a minimum rate of 23.49% and will not decrease below 23.49% regardless of changes to the Index Rate.

Source: Wells Fargo website, July 9, 2009

Since December of last year, use of this minimum rate requirement has increased among credit cards issued by the largest banks, from one percent to nine percent of cards (for purchase rates) and from ten percent to 38 percent of cards (for cash advance rates). In the

[1] Pew will soon release the second in our series of reports on credit card practices. In July of this year, we analyzed application disclosures for all consumer credit cards offered online by the largest 12 bank issuers and the largest 12 credit union issuers (a total of nearly 400 cards). Research of this analysis showed that, while nearly one-third of advertised purchase rates on bank cards were "fixed" in December, fewer than one percent were "fixed" in July. Additional results of this survey may appear in our future comment letters to the Board.

example above, this mechanism added a premium of 2.5 percentage points to the rate that would otherwise have applied based on the disclosed variable rate formula (assuming a current 3.25 percent index rate). The largest minimum rate requirement premium observed in our study was five percentage points.

Section 101(a) of the Credit CARD Act adds new Truth in Lending Act (TILA) Section 127, which requires 45-day advance notice of increases in interest rates, except under three conditions. These exceptions are referenced directly from new Section 171 of TILA, an excerpt of which follows [emphasis added]:

> SEC. 171. LIMITS ON INTEREST RATE, FEE, AND FINANCE CHARGE INCREASES APPLICABLE TO OUTSTANDING BALANCES.
>
> (a) In General- In the case of any credit card account under an open end consumer credit plan, no creditor may increase any annual percentage rate, fee, or finance charge applicable to any outstanding balance, except as permitted under subsection (b).
>
> (b) Exceptions- The prohibition under subsection (a) shall not apply to--
>
> > * * *
> >
> > (2) an increase in a variable annual percentage rate in accordance with a credit card agreement that provides for changes in the rate **according to operation of an index** that is **not under the control of the creditor** and is available to the general public;
> >
> > * * *

This exception, reflected in the Board's proposed paragraph (c)(2)(v)(C) of § 226.9, should not apply to cards including a minimum rate requirement because these cards do not provide for changes "according to operation of an index." Furthermore, by placing a minimum fixed floor against which the index cannot operate, the issuer has exercised control over the index in a way that violates the law's requirement.

The Board noted that changes based on operation of an index generally would not require notice because none of the terms required to be included in application disclosures have changed. 74 FR 139 at p. 36085. However, new Section 127(i) specifically requires 45 day advance notice before any "increase in interest rate" unless one of the three provided exceptions apply. The Board should clearly state that accounts including a minimum rate requirement are subject to the 45 day notice requirement because they do not meet the requirements set in new TILA Section 171(b)(2) for changes in rates according to operation of an index not under the control of the creditor. Since no other exception would apply, issuers should be required to send notice before rates increase.

Similarly, in its upcoming rulemaking efforts, the Board should make clear that accounts with minimum rate requirements will not qualify for the variable rate exception to the prohibition against interest rate increases on outstanding balances (new TILA Section 171(a)). As with the notice requirements, accounts with minimum fixed rates fall short of the law's exception for cards that operate in accordance with an index that is not under the control of the issuer. Furthermore, accounts with minimum rate requirements do not justify an exception allowing interest rates on outstanding balances to increase because they allow issuers to expose cardholders to risk of higher rates if the index rises while limiting cardholders' ability to benefit if the index falls.

2. There is no basis in the Act for the proposed exception to the right to reject changes in terms for increases in minimum required payments, and it should be deleted.

The interim rule concludes that an increase in the required minimum payment is not a change that the cardholder has a right to reject. 74 FR 139 at p. 36084. The effect of the Board's rule, taken to its conclusion, is that issuers can on 45 days notice require payment of all outstanding balances in full. This effect is not consistent with the clear intent of the legislation to eliminate practices under which issuers can unilaterally dictate repayment terms different from those to which cardholders agreed when they borrowed the credit.

For changes in terms that a cardholder has a right to reject, the Credit CARD Act provides protection from undue acceleration of the outstanding balance. Specifically, new TILA Sections 127(i)(4) and 171(c)(2) provide that when a cardholder rejects a change in terms, the issuer can close the account for future purchases but cannot require repayment of the outstanding balance on new terms less favorable than a five year repayment, or a minimum payment that no more than doubles the percentage of the balance due.

Increases in minimum payment are by the Board's proposed rule effectively exempted from this protection. The proposed rule would mean that while cardholders must get 45 days notice of an increase in the minimum payment, they have no remedy. The debtor must accept the increased payment requirement or be prepared to pay off the balance in full and close the account – not a solution that will help cardholders for whom an increase is a problem.

Thus, the Board's treatment of minimum payment increases creates a significant loophole in the protections Congress envisioned limiting acceleration of repayment of outstanding balances when cardholders choose to close an account. An issuer seeking to avoid the carefully crafted repayment protections of the law has only to increase the minimum payment to take away those protections from the cardholder and force repayment of the balance on a schedule far more accelerated than the Act otherwise provides.

The Board justifies forcing cardholders to accept unilateral minimum payment increases by pointing to Congress's concern that cardholders understand the result of paying only the minimum amount. 74 FR 139 at p.36085. Indeed, amended TILA Section 127(b)(11) requires that issuers disclose to cardholders that making only minimum payments will maximize the amount of interest they pay and the amortization period. Clearly Congress wanted cardholders to have this information to foster informed judgments about whether to pay more than the minimum required payment.

But the mandate that consumers have better information about the effects of minimum payments does not lead to the Board's conclusion that cardholders should not be able to reject an increase in the required minimum payment imposed by the issuer. If anything, that mandate points in the opposite direction. If cardholders do not have the right to continue making the minimum payment amounts they originally agreed to, even if doing so would lead to longer and more expensive payouts, the disclosures required by the Act about the adverse effect of such a choice would be meaningless.

3. The proposed exception to the requirement to notify cardholders of their right to cancel and avoid interest rate increases or other significant changes in cases where accounts are 60 days past due is unwarranted, and overbroad.

As explained below, we strongly encourage the Board to require issuers to provide cardholders with notice of the right to cancel any significant change in the account terms, even if the account is 60 days past due. Even if the Board finds that it can and should create an exception such that cardholders may not reject penalty rate increases after accounts become 60 days past due, the exception should be narrowly tailored so that only penalty interest rate increases triggered by the 60 day delinquency are exempted from the right to cancel requirement.

Section 101 of the Credit CARD Act of 2009 ("*Protection of Credit Cardholders*") requires issuers to provide advance notice of interest rate increases and other significant changes, and gives consumers the right to reject these changes by canceling the account. New Section 127 of TILA, as amended by the Credit CARD Act, includes the following language [emphasis added]:

> (i) Advance Notice of Rate Increase and Other Changes Required-
>
> > (1) ADVANCE NOTICE OF INCREASE IN INTEREST RATE REQUIRED- In the case of any credit card account under an open end consumer credit plan, a creditor shall provide a written notice of an increase in an annual percentage rate (except in the case of an increase described in paragraph (1), (2), or (3) of section 171(b)) not later than 45 days prior to the effective date of the increase.
> >
> > (2) ADVANCE NOTICE OF OTHER SIGNIFICANT CHANGES REQUIRED- In the case of any credit card account under an open end consumer credit plan, a creditor shall provide a written notice of **any significant change**, as determined by rule of the Board, in the terms (including an increase in any fee or finance charge, other than as provided in paragraph (1)) of the cardholder agreement between the creditor and the obligor, not later than 45 days prior to the effective date of the change.
> >
> > (3) NOTICE OF RIGHT TO CANCEL- **Each notice** required by paragraph (1) or (2) shall be made in a clear and conspicuous manner, and **shall contain a brief statement of the right of the obligor to cancel** the account pursuant to rules established by the Board before the effective date of the subject rate increase or other change.

This right to cancel found in paragraph 127(i)(3) attaches to "each notice" required by either 127(i)(1) or (i)(2). The law specifically allows only three exceptions when notice and right to cancel requirements do not attach, based on incorporating three of the four exceptions outlined in paragraph 171(b) of the law: for accounts that experience increased interest rates due to (1) expiration of a promotional rate, (2) changes in the rate according to operation of an index not under the control of the issuer, or (3) a cardholder's failure to complete a workout plan. The fourth paragraph and final 171(b) exception, for penalty rates triggered by delinquencies of 60 days or more, is pointedly not incorporated. Consequently, even in cases where accounts are 60 days past due, the new TILA Section 127(i) notice and right to cancel requirements should apply.

The Board's rules correctly reflect that issuers who reprice outstanding balances on accounts that are 60 days past due will be required to give 45 days advance notice of the increase. But the proposed rules create a new exception, excusing issuers from providing notice of the right to cancel and avoid the rate increase. Part of the Board's justification for creating this exception is based on "new TILA Section 127(i)(3)'s express grant of authority to establish rules implementing the right to cancel." 74 FR 139 at p. 36089. But while the relevant sections of the new law quoted above give the Board responsibility for determining what constitutes a "significant change" that triggers a right to notice (Section 127(i)(2)), and for establishing rules governing the manner in which an obligor can cancel the account (Section 127(i)(2)), they do not give the Board authority to create exceptions to the substantive right to receive these notices. The legislative text clearly incorporated a list of allowable exceptions, and this list pointedly did not include reference to the exception that the Board would create. In interpreting the new law, the Board should avoid allowing exceptions to a statutorily prescribed list in the absence of a specific mandate to do so.

The Board also based its authority for creating the exception to the notice of right to cancel requirement on its general authority under 15 U.S.C. 1604(a) to "make adjustments and exceptions to carry out the purposes of TILA. 74 FR 139 at p. 36089. The Board noted that, absent the creation of this exception:

> [A] consumer who is more than 60 days delinquent could use the right to reject a rate increase to override the exception specifically created by the Credit Card Act for such circumstances. The Board does not believe that this was Congress's intent because the Credit Card Act's exception for delinquencies of more than 60 days contains its own remedy for consumers. Specifically, the exception provides that, if an increased rate, fee, or finance charge is applied to an outstanding balance based on a delinquency of more than 60 days, the creditor must 'terminate such increase not later than 6 months after the date on which it is imposed, if the creditor receives the required minimum payments on time during that period…. Thus, based on its review of the Credit Card Act as a whole, the Board believes it would be inconsistent to extend the right to reject to circumstances where a consumer is more than 60 days delinquent. 74 FR 139 at p. 36090.

We disagree. The proposed exception would run contrary to the both the plain language and the purposes of the new law. The "exception specifically created by the Credit Card Act" referenced by the Board is an exception to a rule designed to protect cardholders from interest rate increases on outstanding balances, something the Board itself has determined to cause "substantial consumer injury," particularly in cases where issuers impose penalty rates using "hair trigger" repricing that can cause "unfair surprise." 74 FR 18 (29 January 2009) at pp. 5522 and 5527. Congress created the 60-day exception as a bright-line rule indicating where outstanding balances could *possibly* be subject to an interest rate increase, but Congress did not intend for issuers to have unfettered power to raise rates in these cases. The cardholder's rights continue to apply. Congress specifically established that consumers have a "right to cancel" that includes the right to avoid disclosed changes that are the subject of the notices required in new TILA Section 121(i)(1) and (2), including notices of penalty interest rates triggered by 60-day delinquencies.

Even if the Board holds that this exception to the right to cancel is necessary and appropriate, the proposed rules are overbroad, and go too far in exempting all accounts that are past due by 60 days from the right to reject *any* significant change. The Board's true concern in creating the exception appears to be preventing cardholders from rejecting penalty charges triggered according to the provisions of new TILA Section 171(b)(4). However, proposed Section 226.9(c)(2)(iv)(D)(1) of the rules would prevent cardholders from rejecting *any* of the changes covered by paragraph (c)(2)(ii) of that section, including changes in annual percentage rates but also changes to fees for issuance or availability of the account, transaction charges, grace periods or a variety of fees and methods of calculating charges. While the Board is correct to note that a specific remedy for penalty increases is available, the Board's proposed rule would create a loophole for non-penalty-related changes that would leave cardholders with no remedy at all.

This blanket exemption is overbroad and would not meet the law's goal of giving consumers the option to reject substantive amendments to their account agreements. The Board should amend the proposed rule, either to remove the exemption completely or, at a minimum, to exempt issuers from the notice of right to cancel requirement *only* for penalty-related charges triggered by 60-day delinquencies (to which the law's six-month cure period would apply). For all other significant changes identified by the Board, the notice of right to cancel should be provided for all accounts regardless of delinquency status.

4. Issuers should be required to provide notice to cardholders within 45 days of the expiration of deferred interest periods.

The Board stated that it intends to apply the exception to notice requirements found in Section 226.9(c)(2)(v)(B), regarding expiration of promotional interest rate periods, to deferred interest arrangements as well. 74 FR 139 at p. 36085. Because deferred interest promotions contain a unique danger to consumers (i.e., significant lump-sum interest charges that have accrued for 12 months or more *before* the promotion expires), we request that the Board refine its position so that issuers will be required to notify cardholders before the expiration of the deferred interest period even if cardholders will not have the right to reject imposition of deferred interest at the end of the period.

Our Safe Credit Card Standards call for the prohibition of deferred interest rates because they can be confusing and dangerous to consumers.[2] Deferred interest arrangements allow

[2] Pew's Safe Credit Cards Project began in 2007 as an effort to protect customers from unfair credit card practices and promote responsible management of debt. Since then, we have published a set of Safe Credit Card Standards as

borrowers to avoid all interest if a promotional balance is paid in full by the end of the deferment period, or else pay the entire sum of accrued interest. Creditors providing deferred interest offers must count on a certain portion of debtors finding themselves unable to pay off a balance within the allotted time, or forgetting when the balance is due. Though none of the general purpose consumer cards we studied from the largest bank and credit union issuers currently include deferred interest arrangements, we are concerned about the dangers these arrangements pose on the margins.[3]

Without arguing for the prohibition of deferred interest arrangements at this time, we urge the Board to change its proposed rules to help improve price transparency and reduce the risk of large debt shocks to cardholders. Specifically, issuers should be required to send notice to cardholders at least 45 days prior to the expiration of a deferred interest period. The general exception for promotional rates should not apply. Unlike the expiration of promotional rates, which merely marks the beginning of higher interest charges on outstanding balances going forward, expiration of deferment periods results in instant and potentially significant increases in a cardholder's debt burden. This change in debt burden is more akin to a significant change in the account agreement than it is to expiration of a temporary promotional rate.

Requiring issuers to notify cardholders prior to expiration of a deferred interest period is consistent with the overall goals of the Credit CARD Act, including the establishment of "fair and transparent practices" relating to credit card plans. It would also complement Congress's intent to give cardholders a chance to repay deferred interest amounts fully before the end of the deferment period. In amended TILA Section 164, Congress required issuers to apply payments (beyond the minimum payment due) first to high-rate balances before low-rate balances, but created an exception that allows cardholders to pay off deferred interest arrangements during the last two months of the deferment period. Requiring issuers to send notice at this time would further that goal by helping cardholders make informed decisions about paying off the deferred balance.

The Board may address its concerns about unintended adverse consequences (74 FR 139 at p. 36085) by requiring notice that the deferred interest period is about to expire without requiring notice of a cardholder's right to cancel and reject the imposition of accrued interest. Cardholders would thus be required to pay off the deferred interest balance prior to the end date or accept the lump sum accrued interest charge as provided in the original deferred interest agreement.

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well as various results from our research and analysis. The Safe Credit Card Standards and related information are available at www.pewtrusts.org/creditcards.

[3] Recently, we completed a new analysis of all credit cards offered by the largest 12 bank issuer and the largest 12 credit union issuers. See footnote 1, supra.