

Testimony of

Kenneth J. Clayton

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

United States House of Representatives



Testimony of Kenneth J. Clayton
Before the
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives
March 19, 2009

Chairman Gutierrez, Ranking Member Hensarling and members of the Subcommittee, my name is Kenneth J. Clayton, senior vice president and general counsel of the American Bankers Association (ABA) Card Policy Council, the group within the ABA that deals with card issues. The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$13.6 trillion in assets and employ over 2 million men and women.

I appreciate the opportunity to testify today on H.R. 627, the Credit Cardholders Bill of Rights Act of 2009, and on H.R. 1456, the Consumer Overdraft Protection Fair Practices Act. I will address these issues in series, first dealing with credit cards, then with overdrafts.

Today, credit cards are responsible for more than \$2.5 trillion in transactions a year and are accepted at more than 24 million locations in more than 200 countries and territories. It is mind-boggling to consider the computer network, communications system, billing and processing facilities, fraud protection programs, and customer service requirements needed to handle up to 10,000 payment card transactions *every second* around the world. It is an enormous, complicated and expensive structure – all dedicated to delivering the efficient, safe and easy payment vehicle we have all come to enjoy.

Credit cards are so easy and convenient to use that people often take them for granted. But make no mistake – these are loans, just like loans to buy a car or a home, or to pay for a child's education. Credit cards are incredibly flexible, leaving it generally to the borrower to determine when to borrow the money, in what amount, and how quickly to pay it back. Lenders who make these loans face significant operational, risk management, and funding challenges in making this

product readily available to millions of Americans every day. Credit card issuers have developed sophisticated systems for seamlessly handling the enormous dollar volumes that flow through our economic system.

The ubiquity of credit cards has not always been the case. As recently as thirty years ago, some 38 percent of American families had credit cards. Today, that percentage has nearly doubled. This is a testament to how valuable this important payment instrument has become for meeting the daily needs of most Americans. It also demonstrates how integral credit cards are to our economy, both as a payments vehicle and source of credit. Today's credit card marketplace provides a dizzying array of options and choices for consumers. It is clear, however, that as the marketplace has evolved to provide greater benefits and broader access, it has also become more complex. As a result, the adequacy of disclosure and other regulation in this new marketplace has been called into question, and we recognize the legitimacy of concerns policymakers have raised over the last several years.

In response to concerns, the Federal Reserve Board, Office of Thrift Supervision and National Credit Union Administration released (on December 18, 2008) comprehensive revisions to the regulation of credit cards, fundamentally changing the protections offered consumers while forcing a complete reworking of the credit card industry's internal operations, pricing models and funding mechanisms. These new rules (referred to here as the Federal Reserve's rule¹) carry the full weight of the law, and failure to comply with them subjects the issuer to potentially significant fines – potentially up to \$1 million per day for non-compliance – and enforcement actions. The extensive protections provided to consumers under the new rules were based on four years of intensive work that included consumer testing, review of thousands of public comment letters, and input from important policymakers. The changes are so broad they will affect every aspect of the credit card business.

As Federal Reserve Chairman Ben Bernanke stated, these rules represent “[t]he most comprehensive and sweeping reforms ever adopted by the Board for credit card accounts.” As a consequence, all credit card issuers are currently undertaking a massive overhaul of their business practices.

¹ We use this term for ease of reference throughout this statement, but it is intended to include the rules issued and authority to make changes by the Office of Thrift Supervision (for savings associations) and the National Credit Union Administration (for credit unions).

It is clear that a sea change has occurred in the area of card regulation, and that card industry efforts going forward need to be focused on addressing both the new requirements of the law and the residue of skepticism that currently surrounds business practices. However, we would urge that any discussion over further legislation in this area be viewed in the context of the recent Federal Reserve rule, recognizing its sweeping nature, protection to consumers, impact on operations, and perhaps most importantly, its potential impact on the broader economy and the provision of credit to consumers and small businesses. It is our belief that this impact will be broad and not uniformly positive, potentially leading to reduced access to credit for millions of Americans and small businesses at the very time when they need that access to credit.

The regulators acknowledged the possible negative effects that this complete reworking of the credit card business will have on the provision of credit to consumers and others. To minimize the negative impacts, the Federal Reserve provided for an 18-month time period for implementation. While we understand that some policymakers may view this implementation period to be too long, we urge a full exploration of the potential unintended negative consequences that may occur if a shorter time frame is mandated. In fact, the regulators specifically noted that any shortening of this implementation period could cause “more harm to consumers than benefit.”²

The Federal Reserve’s actions addressed the past evolution of the credit card market and, just as importantly, put in place a regulatory framework to address the future evolution of this market. In fact, the Federal Reserve’s rule provides the necessary authority and flexibility for regulators to take action regarding practices that may be deemed unfair or deceptive in the future, whatever form they may take. It is inevitable that cardholder preferences will change, new payment system technologies will be developed, and competitors will offer new products and choices. We believe that the Federal Reserve is well positioned to oversee and make the necessary adjustments appropriate to this dynamic market. Given all this, we question whether further legislating in this area is necessary.

In addition to credit cards, overdraft protection is a service that is highly valued by bank customers, who appreciate the ability to avoid the embarrassment, hassle, costs and other adverse consequences of having a check bounce or a transaction denied. Whether made by check or electronically, returning a payment usually means the consumer pays additional fees charged by the entity receiving the payment. Overdraft protection also carries a fee, completely avoidable when

² 74 Federal Register 5548

customers keep track of transactions and balances, an activity that is easier than ever. H.R. 1546 attempts to limit overdraft fees by imposing requirements that are operationally difficult for banks, merchants, and consumers, if not completely unworkable. Moreover, the bill attempts to make changes at the same time the Federal Reserve is attempting to promulgate a rule ***based on significant consumer testing*** that would resolve many current consumer issues. Given that many issues addressed by the bill are already being addressed by the new rule due out this year, we believe legislative action is not necessary at this time.

ABA, on behalf of our membership, pledges to work with this committee, bank regulators, and other interested parties to address any issues in these areas.

In my statement, I would like to focus on four points:

- The Federal Reserve regulations constitute sweeping reform of credit card practices and have addressed the core concerns of cardholders.
- The changes already made will have a significant impact on card issuers, consumers and the economy.
- H.R. 627 would dramatically shorten the implementation period for new regulations, which would pose serious risk and harm to consumers and the economy.
- Overdraft protection is highly valued by consumers; legislation seeking to amend current practices proposes technically difficult changes and may result in fewer choices for consumers.

I will address each of these points in turn.

I. The Federal Reserve regulations constitute sweeping reform of credit card practices and have addressed the core concerns of cardholders.

The evolution and increasing complexity of credit cards has raised some concerns about the ability of cardholders to understand the terms and conditions of their cards. While there certainly has been disagreement over how to address these issues, the ABA firmly believes it is in the best interests of all parties that cardholders fully understand the obligations they assume, the interest rate

and fees they should expect, and how the management (or, in some cases, mismanagement) of credit card debt can affect their terms and access to other types of credit. The changes in rules announced by the Federal Reserve are significant and will affect every aspect of credit card lending. Among other things, the changes should provide a better understanding of the terms and conditions, and allow consumers to compare different cards and understand what they are paying for credit. These changes should be allowed to work.

While the focus, understandably, has been on the areas of disagreement about card practices, it must be said at the outset how critically important credit cards are for customers as a convenient, safe, and secure payment vehicle and the vital role that credit cards play in our economy.

We believe that the Federal Reserve's rule – which represents the most sweeping reforms in the history of credit cards – has addressed the fundamental concerns of cardholders. These were many of the same concerns expressed by many members of this committee and, indeed, the changes made mirror many provisions in proposed legislation.³ During that process, the Federal Reserve (and OTS and NCUA) attempted to balance additional consumer protections with the impact that restrictions may have on safe and sound lending and the broader economy.

The rule makes significant changes in three broad categories.

- The rule effectively eliminates many card practices, including “double-cycle billing” and repricing of existing balances (including “universal default”);
- The rule enhances consumer protections, by giving consumers more time to pay bills and limiting up-front fees for cards; and
- The rule simplifies communications to help consumers make better credit decisions.

Specifically, the rule takes the following aggressive actions:

Practice Eliminated: Interest Rate Increases on Existing Balances. Interest rate increases will not be allowed on existing balances, except for promotional rate cards where rate increases are disclosed at account opening, variable rate cards based on a public index, accounts that are 30 days late, or where consumers fail to comply with workout agreements. Issuers have re-priced existing balances, for example, based on some borrowers' actions that suggest they present a higher risk of

³ In fact, the Committee sought to conform its bill in many respects to the rules set forth by the regulators. However, it did so imperfectly, changing its provisions to mirror the then-proposed rule, not to its final version. We would urge the Committee to conform the bill's provisions to those contained in the final regulation.

non-payment or due to increased funding costs. In essence, the regulators have prohibited these re-pricing practices except in certain limited circumstances, and have directly addressed broad-based criticisms over increased interest rates on existing balances. A similar provision was included in Sec. 2 of H.R. 627.

Practice Eliminated: Interest Rate Increases on Certain Future Balances. Interest rates may not increase on balances from transactions made within the first year, except in the circumstances listed above for interest rate increases on existing balances. In addition, consumers will have 45 days prior notice regarding rate changes before an increase in rates can take effect, giving consumers more than enough time to avoid such increases if they occur down the road. This provision of the final rule actually goes beyond proposed versions of the regulation and many versions of proposed legislation, and essentially locks-in interest rates going forward for the one-year period following the opening of an account.

Practice Eliminated: Double-cycle billing. The Federal Reserve eliminated the practice of charging interest on balances from the previous billing cycle due to the loss of an interest-free period. When a customer with no revolving balance makes a purchase, the issuer makes near-immediate payment to the merchant; however, the customer is billed in the next statement, often weeks after the purchase. The customer then decides whether to pay for the purchase or carry it as a revolving debt. Customers who pay the balance in full essentially get an interest-free loan for the period between the purchase and when they pay the issuer. However, in cases where a customer who paid in full the previous month, and then the following month chooses to revolve part of the balance, some issuers then charged interest from the date of purchase – essentially charging interest from the day the loan was taken. In other words, the customer forfeited the interest-free period. This is referred to as “double-cycle billing” because this interest charged is derived from transactions made in a prior billing period. The Federal Reserve has eliminated this practice. This is similar to provisions in Sec. 4 of H.R. 627.

Practice Eliminated: Payment Allocation Methods that Pay Off Low Rate Balances First. Card issuers will no longer be allowed to apply payments to the lowest interest-rate balances first. Under the rule, payments in excess of the minimum payment must either go to higher interest rate balances first, or *pro rata* based on the balances at different interest rates. Issuers often use low, promotional interest rates to encourage prospective cardholders to transfer balances to their new card – often to the cardholders’ significant benefit. Some issuers are able to offer low initial interest

rates to prospective cardholders because they are able to allocate payments on the account to these lower rates first. The rule prohibits this practice. A similar provision was included in Sec. 3 of H.R. 627.

Enhanced Customer Protection: Extended Time to Pay. Cardholders will be given additional time to pay. Statements must be sent at least 21 days prior to the due date, giving customers more time to pay and avoid consequences such as late payment fees. Sec. 3 of H.R. 627 includes a similar provision.

Enhanced Customer Protection: Limited Up-Front Fees. Up-front fees on subprime cards have been criticized as, among other things, misleading the borrower by reducing advertised credit limits through the application of high up-front fees. The final rule caps the amount of any up-front fees and requires that fees over a certain amount be amortized over six months, thus protecting these borrowers. This is similar to provisions in Sec. 6 of H.R. 627.

Enhanced Customer Protection: 45 Days Advanced Notice Before Higher Rates Apply. As noted, the rule prohibits the changing of interest rates for existing balances except under very limited circumstances, and even limits rate increases on **future** balances during the first year of the card. In addition, once card issuers are allowed to change interest rates for future charges (i.e., after the first year), the rule requires that cardholders must be given a 45-day advance notice of any changes, giving them more than adequate time to take action. Similar language was included in Sec. 2 of H.R. 627.

Simplified Communications: Helping Customers Make Better Credit Decisions.

Perhaps the most important changes in the new rules are significant enhancements to credit card applications, account agreements, monthly statements, change in terms notices, and other communication materials. The changes are based on actual consumer testing, demonstrating one of the key advantages of allowing regulators to consider and change regulations as appropriate to changing consumer needs. Major changes will be made to ensure that consumers have information they want, in a manner they will understand, and in a format they will notice. These changes, along with format and terminology requirements, will ensure that consumers understand credit card terms and know what they are paying for credit based on their own use.

Applications will contain a significantly revised summary box that clearly explains the most important terms and conditions of the credit card in a manner consumers will understand. This will

help them select an appropriate card. That same format and terminology will now be carried over and required on the account agreement that comes with the credit card. Thus, important terms will be highlighted in a special, noticeable and understandable box format that arrives with the card. This will make it easier for consumers to understand the terms once the card arrives and also provide a useful reference for consumers to consult later on.

The regulation also imposes comprehensive new requirements for periodic statements that will ensure consumers understand what they are paying for credit and how to avoid additional costs. For example, warnings about late payments and minimum payments will be listed and explained on monthly bills right where the payment information is presented. (See chart at the right for an example.) In addition, totals of interest and fees, for the period and year-to-date must be provided on each periodic statement. Changes in terms will be clearly highlighted, as demonstrated in the example below.

Payment Information

New Balance	\$1,784.53
Minimum Payment Due	\$48.00
Payment Due Date	4/20/12

Late Payment Warning: If we do not receive your minimum payment by the date listed above, you may have to pay a \$35 late fee and your APRs may be increased up to the Penalty APR of 28.99%.

Minimum Payment Warning: If you make only the minimum payment each period, you will pay more in interest and it will take you longer to pay off your balance. For example, if you had a balance of \$1,000 at an interest rate of 17% and always paid only the minimum required, it would take over 7 years to repay this balance. For an estimate of the time it would take to repay your actual balance making only minimum payments, call 1-800-XXX-XXXX.

Please send billing inquiries and correspondence to:
PO Box XXXX, Anytown, Anystate XXXXX

Important Changes to Your Account Terms

The following is a summary of changes that are being made to your account terms. You have the right to opt out of these changes. For more detailed information, please refer to the booklet enclosed with this statement.

These changes will impact your account as follows:

Transactions made on or after 4/2/12: As of 5/10/12, any changes to APRs described below will apply to these transactions.

Transactions made before 4/2/12: Current APRs will continue to apply to these transactions.

If you are already being charged a higher Penalty APR for purchases: In this case, any changes to APRs described below will not go into effect at this time. These changes will go into effect when the Penalty APR no longer applies to your account.

Revised Terms, as of 5/10/12	
APR for Purchases	16.99%
Late Payment Fee	\$32 if your balance is less than or equal to \$1,000; \$39 if your balance is more than \$1,000

II. The changes already made will have a significant impact on card issuers, consumers and the economy.

These changes will provide benefits for many cardholders. However, these changes will have other economic impacts as well. This is because the new rule will affect every aspect of the credit card business, from how cards are funded, to how they are priced, to how they are marketed, and to how credit is allocated among customers of differing credit histories and risk. Because the rules are so strong, card lenders may have to increase interest rates in general, lower credit lines, assess more annual fees, and reduce credit options for some customers. The full impact of these changes will likely not be fully known for several years as business practices are changed and as the credit availability works its way through the economy.

Impact of the new rules on credit availability: Restrictions on re-pricing higher risk accounts means two things: (1) that higher risk customers will likely see less credit available to them; and (2) since the higher-risk customers do not bear the full cost of the risks they pose, lower-risk customers will bear some of added cost. The Federal Reserve acknowledged this impact, as its Vice Chairman Donald Kohn stated: “There will be some reduction in available credit to some people.” Other experts did as well, as Scott Valenin of Friedman, Billings, Ramsey noted: “Because the new regulatory system eliminates preventive pricing..., rates across the board will go up, and availability of credit will go down.”

The impact on credit availability can be large. For example, Oppenheimer analyst Meredith Whitney estimated that card lines could decline by 57 percent (about \$2.7 trillion) because of economic and regulatory landscape.⁴ A study by Morrison & Foerster that covered 70 percent of card balances found that credit lines could be reduced by \$931 billion (an average of \$2,029 per account) and tightening lending standards could put credit cards out of reach for as many as 45 million consumers. It is likely that consumers perceived to have higher levels of risk – including those that are new to credit – will bear the brunt of these reductions, though even those with lower risk levels will feel the pain. Thus, the inability to price risk effectively may well mean less access to credit for very deserving individuals just because card issuers are unsure of the credit risk involved

⁴ "Credit Cards Are the Next Credit Crunch: Washington shouldn't exacerbate the looming problem in consumer credit lines." Wall Street Journal. 11 Mar. 2009: A15.

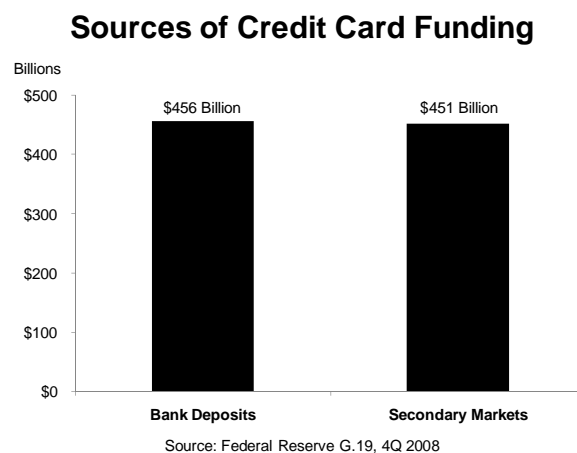
and will not be able to price for that risk as it becomes more apparent. This means that many very creditworthy borrowers who do not have perfect credit histories or who have had limited experience with credit (and, therefore, have less credit history to guide issuers of their true risk of default) may not have access to credit.

It may also lead to higher interest rates or fees (such as annual fees) for all cardholders in order to compensate for the inability to price risk effectively. Thus, the least risky borrowers must now bear the cost for higher risk borrowers because the higher-risk borrowers may no longer bear the full cost of the exposure they pose to lenders. It may also be the case that payment allocation requirements will lead to the elimination of low-rate balance transfers that consumers and small businesses previously used to lower overall debt costs. Simply put, the sum total of all these rules will likely lead to reduced access to credit and higher prices to all consumers.

Impact of the new rules on funding: Credit cards are funded from two primary sources: deposits and secondary market funding, each accounting for about half – approximately \$0.5 trillion dollars – of the total funding of card loans to consumers (see chart below). Funding in the secondary market relies on investors willing to hold securities that are backed by credit card receivables. **Any change** in the terms of issuance can greatly impact the receptivity of investors to holding these securities. If investors perceive that there is greater risk, they are less likely to hold these securities, or may require significantly higher interest rates or other enhancements to compensate them for the risk. This means that less funding will be available, and if available, more costly. This translates into less credit available at higher cost to customers.

Investors are extremely sensitive to changes in the terms and conditions of the underlying asset, as has been evident in the current market, where investors have shunned nearly all forms of asset-backed securities over fears in the underlying economy. The new rule, in fact, may exacerbate these problems, at least in the short term, particularly if time frames for implementation are dramatically reduced. For

example, the new rule restricts the ability of issuers to quickly re-price risk for borrowers who have, for example, missed payments or whose level of borrowings has risen to high levels. Investors may



well be concerned about the performance of the credit cards backing their securities and shy away from holding them.

This problem can become particularly acute if these investors do not believe issuers have had the time to sufficiently vet their new risk models – necessitated by the new rule’s limits on risk-based pricing – in light of challenging economic conditions. In fact, both the Treasury and the Federal Reserve have recognized the severe problems that exist in the funding area, and have proposed the Term Asset-Backed Securities Lending Facility (TALF) as a means of unlocking investor concerns. Shortening the implementation time frame, for example, may well act in direct conflict with the efforts under TALF by creating greater investor uncertainty over bank risk modeling approaches. ***The integral part that investors play in helping fund consumer loans – and the broader economy – cannot be understated***, and we would urge Members to closely examine the consequences of any legislative approach on this important aspect.

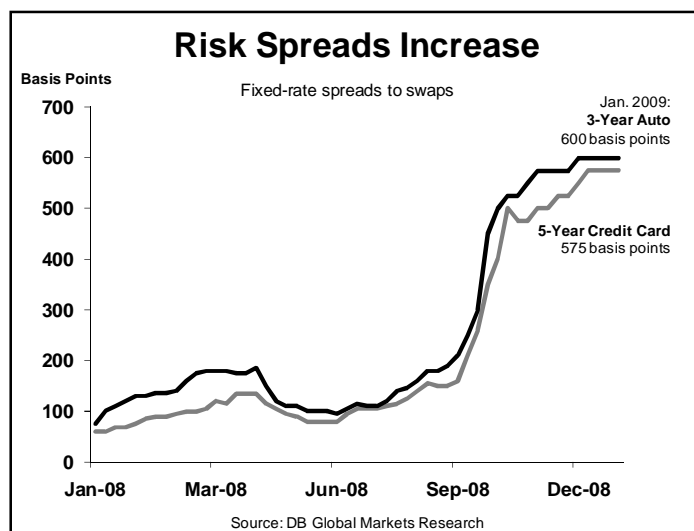
Impact on risk-based pricing models: The requirements will force all credit card issuers to completely overhaul their pricing models to ensure that the risk for any cardholder is appropriately set to satisfy both regulatory concerns over safety and soundness and investor demands for strict underwriting and investment yield. Adequate time needs to be provided to ensure that the pricing is appropriately calibrated to the risk assumed so that the issuers are compensated for the risks they assume and investors are confident that securities backed by card loans will perform as expected. All of this affects the ability of issuers to make loans to consumers.

Impact on systems and operations: Overarching all of the key business decisions that must be made under the new rule (funding, pricing, credit availability, and marketing) are operational changes that must be made to business practices, software/programming, product design, periodic statements, advertisements, contracts, testing/auditing for compliance, customer service, training, printing of new forms, training of customer service personnel, just to mention a few. For example, training for customer service personnel and modifications of call scripts could require hundreds of thousands of hours for each of the largest card issuers. The huge technological infrastructure that underpins the entire card system – including billing and account receivables – will demand hundreds of thousands of more hours for each issuer to comply. Periodic statements must be completely revamped, involving programming changes, testing, legal analysis to ensure compliance, focus group testing, and modifications of services from outside vendors. These changes are likely to take an additional hundreds of thousands of hours for large issuers.

Beyond the business decisions and technical changes that must be made, every issuer must make sure that they are in full compliance with the changes. The penalties can be severe for non-compliance. Thus, legal and compliance review are critical, time-consuming, and expensive. The sweeping nature of the rules (which cover all aspects of card practices) and the new disclosures required (which cover all the printed – and electronic – materials, advertising, applications, solicitations, and credit card contracts) means that this undertaking is enormous.

Given the breadth of the changes anticipated, the Federal Reserve rule provided for an 18-month implementation period, with the expectation that card issuers will need all of it. When the rule was published in the *Federal Register* in December 2008, the regulators emphasized that: “If institutions were not provided a reasonable time to make changes to their operations and systems to comply with the final rule, they would either incur excessively large expenses, which would be passed on to consumers, or cease engaging in the regulated activity altogether, to the detriment of consumers.”⁵ In other words, consumers may immediately see much higher costs, and lenders may significantly cut back on lending even more than the regulations already will cause.

The 18-month implementation period is particularly important given the current economic recession, which is expected to last well into this year. There has already been a huge strain placed on the economy as credit from secondary markets – for mortgages, credit cards and auto loans – has largely disappeared due to the large risk-premium now demanded by investors (see the chart at right for autos and credit cards). While the 18-month implementation period may help ease the impact of the new rules, any additional restrictions that limit the ability of issuers to effectively price according to risk, and any shortening of the time period to adopt the new rules, will send further chills in a market already in deep freeze.



We recognize that some observers believe this implementation period is too long. Certainly, we expect that some issuers may be in compliance, at least in part, before the end of the 18-month

⁵ 74 Federal Register 5548

period, perhaps because they did not engage in or had already changed some practices or because they wish to compete on the basis of early compliance. However, because of the massive changes to pricing models, funding options and internal operations precipitated by the rule, overall compliance is going to take time.

III. H.R. 627 would dramatically shorten the implementation period for new regulations, which would pose serious risk and harm to consumers and the economy.

While we have some general and specific comments on H.R. 627, we believe changes made by the bill to the implementation period for the new regulations deserve special mention.

H.R. 627 would allow only three months to implement the new regulations, which will apply to every personal card in circulation in America – currently more than 700 million – and all accounts opened after the implementation date. Implementing these new regulations for every existing account will be a monumental challenge for credit card lenders. When the regulations were unveiled, Federal Reserve Consumer and Community Affairs Director Braunstein, stressed that “card issuers are going to need to rethink their entire business models... [meaning] 18 months is a challenge in and of itself.” In the notice the three federal agencies submitted to the Federal Register, the regulators emphasized the need for sufficient time – otherwise consumers would see higher prices and lenders might just stop lending, “to the detriment of consumers.”

Complying with the new regulations requires a conceptual redesign of each lender’s entire risk and operating models and, indeed, of every aspect of their businesses. The attached document provides a detailed schematic of the many interrelated processes that must be overhauled to ensure compliance with the new regulation. Consider, for a moment, that behind every piece of plastic, there is a complex network of brains, data, and technology designed to give each cardholder convenience and security. The whole, complex network must be completely overhauled, including statements, all customer service support scripting, training and execution, the chargeback system, all marketing materials, and the entire collections system. This simply cannot be accomplished in three months. We believe it would be a mistake to move the time period for compliance up in such a dramatic fashion and that such an action will cause undue harm to both consumers and the broader economy. We provide more detail on this harm below:

Harm to Consumers:

Increased costs would emerge and card lenders would be forced to redirect efforts from opening new accounts, granting credit, and providing customer service in order to meet a reduced time schedule. But even worse, with hasty implementation, billing and other errors that negatively impact millions of consumers become more likely. Given this potential for error, lenders are faced with two options: go forward with lending, inconveniencing millions of people and opening themselves up to significant fines and private suits; or, pull back on lending so as to minimize risk. This will only exacerbate the reduction in credit lines and increase in interest rates that we are already seeing in the marketplace as a result of increased default rates and higher funding costs. And, given consumers' increased reliance on credit to tide them over in times of economic turmoil (e.g., job loss, medical problems), this tightening credit, then, causes an important consumer safety net to disappear or harshly decrease.

The impact on individuals would likely be difficult, but small businesses would bear a greater burden. According to the most recent Survey of Small Business Finances conducted by the Federal Reserve, 77 percent of small businesses used either a business credit card or personal credit card for business expenses in 2003.⁶ A more recent survey by SurePayroll, an online payroll service provider, puts the figure at 90 percent.⁷ This puts small businesses more at risk in a tightening credit environment. Because of these genuine risks, it is important that the next 18 months provide time for full implementation of the new customer protections.

Harm to the Economy:

As noted earlier, a card lender's ability to lend to customers is assisted by a vibrant secondary market that helps fund about one-half of all consumer revolving debt. Yet these markets are currently frozen, and problems in this area will only be exacerbated by a rushed implementation schedule. To comply with the new regulations, lenders must create entirely new risk models ***during a time of unprecedented economic turmoil***, thoroughly testing these models for performance and to the satisfaction of wary investors. If issuers are perceived to be rushed, investor confidence

⁶ Traci L. Mach and John D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances," *Federal Reserve Bulletin*, October 2006, p. A167.

⁷ News Release, SurePayroll, SurePayroll Insights Survey: Business Owners Share Opinions on Perks and Pitfalls of Business Credit Cards, April 16, 2007, *available at* <http://www.surepayroll.com/spsite/press/releases/2007/release041607.asp>

in the new risk model could be shaken. Failure to allay these fears will have serious consequences for marketplace liquidity, potentially working at cross-purposes with the efforts of the Federal Reserve and Treasury to unlock frozen market through TALF. This economy cannot afford legislative actions that exacerbate the credit contraction in the marketplace.

Further Concerns with H.R. 627

Should the Committee wish to move forward with H.R. 627, we would like to point out some additional concerns:

- The bill was originally drafted to correspond with the Federal Reserve's "proposed" rule and should be conformed to the final rule's provisions so as to avoid unnecessary implementation burden and confusion. This permits the Committee to take advantage of regulators' expertise, the deliberative process in which they engaged, and the broad comments from interested parties.
- The bill also includes several provisions that go beyond the new rules. For example, we are concerned that a provision that allows a cardholder to opt out of over-the-limit transactions would lead card issuers to deny transactions that might, but will not necessarily, exceed credit limits, making it more difficult for a consumer to rely on the ability to use his or her credit card for emergencies. (Sec. 4(m)) Another provision that prohibits issuers from providing information to credit bureaus on the opening of new accounts until the card is activated could allow fraudsters to open multiple accounts without issuers knowing. This poses significant fraud potential that potentially places innocent consumers and lenders at risk, and also hides borrower activity that may have a significant impact on a borrower's ability to pay. This is a serious problem that should be addressed. (Sec. 3(d))

We would be happy to provide additional comments on these and other provisions of H.R. 627 as the Committee's deliberative process goes forward.

As we stated earlier, many of the core issues included in H.R. 627 are already addressed by the new credit card regulations, raising the question over whether legislation in this area is even necessary. Like the bill, the regulations prohibit rate increases on existing balances with some exceptions, ban double-cycle billing, provide more advance notice of rate changes and more time for consumers to pay bills, and require that more payments go to higher-rate balances first.

Addressing consumer protections in regulation, rather than legislation, has some benefits. The rules carry the force of law with significant penalties (up to \$1 million per day), with enforcement authority vested with bank regulators to ensure compliance and corrective action. Rules also have the flexibility to be changed, if problems arise, but only in a manner consistent with the Administrative Procedures Act, which ensures full notice and opportunity to comment. Thus, if changes need to be made, they could be done in an expedient way, subject to broad input and congressional oversight.⁸

IV. Overdraft protection is highly valued by consumers; legislation seeking to amend current practices proposes technically difficult changes and may result in fewer choices for consumers.

Consumers value banks' practice of paying overdrafts. Indeed, they expect it. They value the ability to avoid the embarrassment, hassle, costs and other adverse consequences of having a check bounce or transaction denied. Whether made by check or electronically, returning a payment usually means the consumer pays additional fees charged by the entity receiving the payment. Recently, the Federal Reserve released a study⁹ that documents just how much customers value this service. According to the study, most participants wanted coverage to ensure their transactions went through.¹⁰

While this service may cost the customer money, as there are fees associated with its availability, in many cases it would cost the customer more to endure the inconvenience, embarrassment, and fees charged by the merchant or payment recipient, were the payment to be declined. It is important to remember that ***this cost is completely avoidable***. Consumers have

⁸ It should also be noted that the rule adopted in December 2008 is not the end of the story. The Federal Reserve and other bank regulators will clearly monitor the implementation process. They will aggressively examine institutions for compliance. They will be able to gauge the full extent of the impact of the changes and can propose additional measures as appropriate. Even more significantly, the development and issuance of the rule has established a framework for future developments. In fact, the rule provides the necessary authority and flexibility for the Federal Reserve to take action regarding other practices that may be deemed unfair or deceptive. It is inevitable that card holder preferences will change, new payment system technologies will be developed, and competitors will offer new products and choices. We believe that this framework puts regulators in the best position to oversee and make the necessary adjustments appropriate to this dynamic market in response to the inevitable innovations in the payments system and in changes in customer preferences.

⁹ "Review and Testing of Overdraft Notices," Federal Reserve, December, 2008 p. 8

¹⁰ Ibid. p. 8

many options in order to avoid incurring fees. First, consumers can simply keep track of transactions and balances – which is easier to do now than ever before – by phone, the Internet, ATM, or handheld device. Also, consumers can avoid overdraft fees by keeping a cushion in the account or by linking their checking account to a savings account, line of credit, or credit card account. Finally, consumers can also arrange with the bank to send an alert by e-mail or text message that the account balance has fallen below a set amount – thus avoiding the need for overdraft protections. Simply put, consumers are in control of their finances and can avoid overdraft fees altogether.

Legislation introduced last week, H.R. 1456, the “Consumer Overdraft Protection Fair Practices Act,” attempts to limit overdraft fees, though we believe it will have much more far-reaching effects. We remain very concerned that this legislation will impose operational challenges that are nearly impossible to implement and that may have the effect of reducing the availability of this service to many consumers who benefit from it. We would also suggest that it is unnecessary, given the pending Federal Reserve proposed rule, currently open for comment, which seeks to deal with this complex subject. That rulemaking was initially proposed in May of 2008, and was later re-proposed in December, as the Federal Reserve became more aware of the complexities involved through the comment process. The rule is now nearing completion. We would urge the Congress to withhold judgment on this issue pending completion of that process.

To give you an example of potential unintended consequences of the bill, one provision in general prohibits banks from imposing an overdraft protection fee for electronic fund transfers “initiated at an automated teller machine.” The bank may impose a fee for such transaction if: (1) the bank notifies the customer at the time of the transaction that an overdraft fee will be imposed and the amount of that fee, and (2) the consumer has “opted in” to have automated teller machine (ATM) and point of sale (POS) transactions paid. In the alternative, if such a notification system is not “feasible,” institutions may not impose a fee for any ATM or POS debit card overdraft. However, given the reality that current systems cannot technologically provide such notice (explained below), this provision would essentially eliminate *for everyone* overdraft services *for all debit card transactions* – including increasingly popular bill-pay transactions. To make matters worse, these are precisely the type of transactions that the Federal Reserve’s consumer testing found *customers want paid*, yet the legislation would preclude that from happening.

In general, the notification system described by the bill is infeasible as systems are currently arranged. Transmitting the required notice, the amount of the fee, the customers’ response, and the

final authorization would necessitate prohibitive, technical changes. Bandwidths used by the ATM (and POS, if applied to POS) networks and the financial institutions would have to be increased to accommodate additional message traffic. Software would have to be developed and installed at all points in the system to allow systems to recognize and process related messages. The ATM software would have to be altered in order to provide the necessary notices. To provide the amount of the fee, institutions may have to apply a single overdraft fee to all accounts and eliminate tiered structures where the customer pays less for the first overdraft, for example. If also applied to POS terminals, POS terminals and software would have to be changed or replaced in order to comply. It is not clear how depository institutions would know whether the merchants' terminals can convey the notice. As such, there are enormous technical hurdles that would have to be overcome before the bill's requirements could even possibly be met.

Even if such a system were feasible, it is clear that costs for providing the service would increase significantly, as the ATM and POS networks would charge the depository institution for the cost of the additional message processing.¹¹ Beyond the costs and challenges (as acknowledged by a recent GAO study), including significant expansion and modifications to the networks systems and the upgrading or replacement of millions of merchant terminals (if applied to POS), there are other challenges posed by such a systems update. For example, determining the real-time account balance, addressing privacy and security concerns, and allowing for the increased time to conduct the transaction must all be considered. Moreover, if applied to POS terminals, providing a notice and option to not continue would not be feasible in some newer applications. One new application is "tap and go" or contactless debit cards for mass transit payments that have been created in order to reduce costs, increase customer convenience, and improve the speed of traffic flow. Application possibilities range from subways, to toll highways, to buses, to regional railroads, to taxis. Key to these applications, however, is minimal equipment and minimal processing time. The screen requirement necessary to provide notice under the bill would increase costs, and the time needed to provide and respond to the notice would stall information flow, nullifying the benefits of this application. For similar reasons, the notice requirements would make it infeasible to use debit cards at vending machines.

¹¹ *Bank Fees: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*. General Accounting Office, January 2008 (GAO-08-281), p. 59-71. This appendix provides many details on the issues involved with implementing this requirement.

Overdraft debit card transactions represent a small percentage of debit card transactions. Simply put, the cost of revamping the entire system would not justify the expanded functions. Therefore, in effect, the bill would prohibit debit card overdrafts at POS and ATMs, even for customers who want the service.

However, the prohibition would go far beyond just ATM and POS transactions. It would also prohibit debit card bill-pay overdrafts. More and more consumers use their cards for both recurring and one-time bill payments. For example, consumers may and do use a debit card number to pay a credit card or other bill. If the customer is paying close to the due date, for example, they may use a debit card number rather than a checking account number (if that option is available) because the checking account number or checkbook is often not readily available, whereas the debit card is typically carried in a wallet. Customers may also use debit cards for recurring bills, such as utility bills.

However, from a processing standpoint, bill payments are indistinguishable from any other debit card transaction. For example, a customer's online debit card authorization to pay a store credit card bill is indistinguishable from the customer's debit card transaction to make an online purchase with that store. Accordingly, from an operational standpoint, it would not be possible to allow customers to choose to have *purchases* declined, but have *bills* paid: the bank cannot distinguish between them. This means that if there is a choice of having overdraft debit card transactions paid, the choice for consumers is to have all debit card transactions, including bill payments, paid or declined.

Indeed, even that choice will not be available to most consumers. In effect, overdraft services will not be available for any debit card transactions for most bank customers because most depository institutions can only provide overdraft services on debit card transactions on a payment channel basis; they cannot offer it on an account-by-account basis. This means that if the overdraft service is not to be available to some customers, it will not be available to *any* customer. In effect, the bill will mean that most customers will have no choice but to have all debit card overdrafts (purchases and bill payments) declined or returned. Yet, the Federal Reserve found that most consumers want important payments paid, which would include debit card bill payments. They want to avoid the costs, inconvenience, and other consequences of having an important payment declined or returned.

Furthermore, legislation is not necessary, as the Federal Reserve is in the process of promulgating regulations related to overdraft services – ***based on actual consumer testing***. In May 2008, the Federal Reserve published for comment a proposal that would have required depository institutions to allow consumers to opt out of having overdrafts paid and a fee assessed. Subsequently, based on those comments and consumer testing, in December 2008, it published a second proposal which sought to take into consideration the further complexity of the issue as learned through the process. Comments are due on March 30. The latest proposal would limit the ability of a financial institution to assess an overdraft fee for paying ATM withdrawals and one-time debit card transactions that overdraw a customer's account, unless the consumer is given the notice of the right to opt out of the payment of overdrafts, and the consumer does not opt out. As an alternative approach, the proposal would prohibit imposition of overdraft fees unless the customer has affirmatively consented or "opted in" to have such overdrafts paid. We believe that Congress should allow the rulemaking process to continue and permit the Federal Reserve Board to adopt regulations based on public comment and consumer testing before taking any action.

ABA is concerned about several other issues included in H.R. 1456. The bill would require consumers to consent in writing to having overdrafts paid and require depository institutions to calculate an Annual Percentage Rate (APR) when overdraft fees are charged. We offer further comments on these changes below.

Opt-in Overdraft Accommodation. Under the bill, banks cannot pay more than three overdrafts per year and charge a fee unless the consumer has provided specific written consent. We believe that bank customers will be greatly inconvenienced and upset when their checks and electronic payments are returned unpaid and they incur additional fees from merchants and others because they forgot or were unable to notify the bank in a timely manner in writing that they wish these items to be paid. They will also be confused and unpleasantly surprised when the fourth item is returned after the first three are paid, expecting the same courtesy for the fourth item as they received for the first three. As discussed above, consumers today expect their banks to cover them for those situations. Again, consumers typically pay even more when their transactions are not honored due to nonsufficient funds.

Effective APR Calculation. H.R. 1456 appears to classify as a "finance charge" – and hence include them in disclosed calculations of interest rates – any overdraft fee beyond the first

three fees paid in a year.¹² This means that banks would have to calculate an effective annual APR for those fees, that is, those overdraft fees beyond the first three paid in a year. Given that the number, amount, and duration of overdrafts are unknowable in advance (and are entirely within the control of the customer), it is not possible to incorporate them in an effective APR calculation.

More importantly, bank customers don't understand the term "effective" APR, raising questions over whether this cumbersome process for calculating interest rates in the bill makes any sense. In a recent study, the Federal Reserve noted, "The quantitative consumer research conducted by the Board validated the results of the qualitative testing conducted both before and after the June 2007 proposal; it indicates that most consumers do not understand the effective APR, and that for some consumers, the effective APR is confusing and detracts from the effectiveness of other disclosures."

Further, even if it were possible to calculate an "historical" APR, that is, an APR calculated *after the fact*, based on the consumer's actual behavior, it would not be helpful or meaningful to consumers. Any time an *annual* percentage rate is calculated for a term *less than a year*, the inclusion of a fixed fee, even a modest one, will distort and overstate the APR. The shorter the repayment period, the greater the APR will appear in instances where there is a fixed fee. This means that the *sooner* the consumer repays, the *greater* the calculated APR – a difficult concept to explain to consumers, as it appears that paying *earlier* actually *increases* the cost of credit.

Given the nature of overdraft fees, the APR will be greatly inflated to the point of distortion. In these cases, the fee is fixed, the overdraft often small, and the term of repayment short (as the banking agencies encourage banks to request prompt repayment). It is easy to see how triple digit APRs would result. However, it is not at all clear how this would assist consumers. Rather, the inflated and distorted APR will confuse consumers as they attempt to reconcile this APR with other APRs with which they are familiar, such as the APRs for credit card, home, auto, and personal loans. The result will be to dilute the effectiveness of the APR generally, rather than enlighten them with regard to overdrafts. In the overdraft fee context, consumers understand a dollar amount far better than an inflated and meaningless APR.

¹² "Overdraft protection fee" is defined as "any fee or charge imposed in connection with any account on which checks or other debits are paid . . . even though there are insufficient funds. . . unless such fee or charge "is imposed on an incidental basis as a customer accommodation and no more than three such overdraft fees are imposed during any calendar year."

For over forty years, the Congress and Federal Reserve Board have worked to produce a calculation that consumers can use to compare the cost of credit in a meaningful way. For the reasons given above, classifying overdraft fees as finance charges simply undermines those efforts and goals.

In sum, these requirements would not only cause immediate and significant costs, inconveniences, and confusion for debit card users, they would limit customer choices and significantly curtail new applications under development that seek to expedite day-to-day transactions that are beneficial and attractive to consumers. As such, we believe that Congress should refrain from acting in this area for fear that such action will actually create problems for consumers that outweigh the benefits. Given that many of the issues addressed by the legislation are being addressed by the new rule which is due out this year, forced action at this time is unnecessary.

Conclusion

Mr. Chairman and members of the committee, ABA believes that both overdraft protection and credit cards provide an invaluable service to consumers and small businesses. Any additional actions on either of these topics must be carefully considered. This is particularly important given the current weak economy. We stand ready to work with this committee as it continues to review the pros and cons of any further changes.