THE FINANCIAL SERVICES ROUNDTABLE

1001 PENNSYLVANIA AVE., NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-628-2507

E-Mail info@fsround.org
www.fsround.org

April 15, 2010

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

Re: Federal Reserve Board Docket No. R-1384: Amendments to Reg. Z, the Truth in Lending Act

Dear Ms. Johnson:

The Financial Services Roundtable[1] ("Roundtable") welcomes this opportunity to comment on the Federal Reserve Board's (the "Board") notice of proposed rulemaking ("NPRM") to amend Regulation Z to implement the Credit Card Accountability Responsibility and Disclosure Act of 2009 ("CARD Act"). The NPRM proposes to restrict the application of penalty fees; such fees must be "proportional" to the violation or necessary for deterrence. The proposed rules also create two safe-harbors for penalty-fees (the "percentage" and "dollar" safe harbors) and require biannual reevaluations of Annual Percentage Rate ("APR") increases made since January 1, 2009.

The Roundtable recognizes the Board's diligence in drafting a large number of regulations to implement the CARD Act in a limited period of time. Although the Roundtable supports the spirit of the regulations, we are concerned that both the exclusion of credit costs from the penalty-fee cost-option calculation and the percentage safe harbor capped at five percent are not viable or an effective manner of restricting penalty fees.

I. <u>The Cost of Credit Loss Should be Included in the "Cost Option" Penalty Fee Analysis.</u>

The NPRM proposes to prohibit the imposition of penalty fees unless the penalty fee is calculated in one of four methodologies: (1) cost option calculation; (2) deterrence option calculation; (3) dollar safe harbor; or (4) percentage safe harbor. The cost-option calculation and the deterrence calculation prescribe certain factors that the issuer may or may not consider when determining the amount of the fee.

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine, accounting directly for $84.7 trillion in managed assets, $948 billion in revenue, and 2.3 million jobs.

The Roundtable is concerned that the cost-option excludes credit costs from the calculation of costs associated with particular violations.[2] We believe that violation-related credit costs are a critical factor that issuers should be allowed to consider when determining a penalty fee based on violation-related costs. The inclusion of credit costs is in keeping with the language of the CARD Act, which requires the Board to consider "the costs incurred by the creditor from an omission or violation" when determining the reasonableness of a penalty fee.[3]

Impact on Consumers

The cost-option calculation should factor-in the higher rates of loss associated with certain violations. The Board admits that excluding credit losses will prevent issuers from recouping their losses in penalty fees, and suggests allaying losses by spreading losses amongst all consumers. The Board justifies spreading the costs of credit-loss among all consumers because it believes consumers who mismanage their accounts and incur fees subsidize the average cardholder who does not violate their credit card agreements.

However, the NPRM does not address the fact that excluding credit costs in the consideration of penalty fees, when combined with other restrictions,[4] generates another type of subsidization. That is, if the NPRM is adopted as proposed, less-risky consumers will subsidize the cost of credit for riskier customers. Instead of eliminating any alleged subsidization, the NPRM proposes to shift the burden of losses caused by a few customers onto the shoulders of customers who did not cause the loss. The end result is what the Board professed to eliminate- one consumer segment bearing an unreasonable and disproportional share of the cost of credit.

Comparing British Issuers to U.S. Issuers is not an accurate analogy.

The NPRM also offers data from the United Kingdom's Office of Fair Trading ("OFT") to support their conclusion that issuers should not recoup credit losses through fees. The OFT reported that card issuers should not recover losses and violation-associated costs through penalty fees because that reduces transparency in upfront rates. The Roundtable questions the Board's reliance on OFT's data because the U.S. and the U.K. have substantially different legal, business and structural frameworks for credit cards. Furthermore, the OFT study is girded by the U.K.'s general prohibition against punitive

[2] *See* proposed § 226.52(b)(1)(i).
[3] The CARD Act, Pub. L. No. 111-24, § 102, adding new Truth in Lending Act section 149(c).
[4] When the proposed cost-option (that excludes the cost of credit from the calculation of the fee) is combined with the new restrictions on Annual Percentage Rates, general fees, and other maximum penalty fee restrictions, creditors will be forced to spread a hefty percentage of losses caused by a small percentage of cardholders on the general population of consumers.

credit card fees.[5] In contrast, the U.S. legal and legislative framework explicitly allows penalty fees, including the use of penalty fees as deterrence measures.[6]

Additionally, British issuers are not subject to the same restrictions on APRs as U.S. issuers, who are limited by Board regulations and the CARD Act from increasing APRs. Thus, while U.K. issuers have the flexibility to recover losses and associated costs through APRs, U.S. issuers cannot.

The Board further justifies the exclusion of higher loss rates and credit costs by adopting a general cost-spreading proposition that would impose increased credit costs *all* customers, instead of on the few consumers whose own actions raise the cost of the credit. The Board justifies this stance by citing a study that claimed only 7 percent of delinquent credit card accounts ultimately charge-off. The Board surmises that because only 93 percent do not charge off, delinquencies do not cause losses to issuers, especially when collection efforts continue after a charge-off.

The Roundtable respectfully submits that delinquencies do impose losses on card issuers. The fact that 93 percent of delinquent accounts are not charged does not translate to zero losses. The Board's interpretation appears to miss the fact that seemingly modest increases in charge-off rates can have a significant impact. When combined with new limitations on rate increases, the provision further curtails issuers' ability to absorb credit losses.

Safety and Soundness

The proposed exclusion of credit loss from penalty fees, layered on top of other pricing restrictions, results in a limited number of levers to manage credit risk, thus increasing the overall risk to fiscal safety and soundness. The Board justifies excluding the risk of loss in the penalty fee analysis because issuers "generally price risk through upfront annual percentage rates and penalty rate increases" in lieu of recouping the risk of loss through penalty fees.[7] This statement ignores the CARD Act's severe limitations on issuers' ability to use upfront APRs and increased penalty rates as risk-pricing mechanisms.

The Roundtable does not protest the changes generated by the CARD Act; we highlight them only to demonstrate the limited means issuers have to price for risk through APRs or penalty-fee increases. In conclusion, we believe that the consideration of higher loss rates and credit costs is consistent with TILA § 149(c) and benefits consumers who would otherwise be forced to subsidize losses caused by a small segment of consumers.

---

[5] "Any provision in the contract which constituted a penalty would be very unlikely to satisfy the test of fairness under the [Unfair Terms in Consumer Contracts Regulations 1999]…" OFT Credit Card Statement at para. 3.24.
[6] In fact, the statute interpreted in Docket No. R-1384 is aptly titled, "Reasonable Penalty Fees on Open End Consumer Credit Plans." *See* CARD Act, Pub. L. No. 111-24, § 102 (adding new TILA § 149).

[7] 75 Fed. Reg. at 12341.

II. Improving the Deterrence Option

The proposed standard for deterrence penalty fees requires issuers to develop an empirically derived, demonstrably and statistically sound model. The model must identify, to the dollar, the lowest fee level, above which additional fee increases have no marginal effect on the frequency of violations.[8] Furthermore, the model must estimate the fee independent of other variables, such as unemployment.

The Board successfully implemented requirements of empirical models to set fees in Regulation B, but the recent proposal goes far beyond what Regulation B imposed. Unlike Regulation B, the proposal requires *each* issuer to (1) design its own model; (2) collect data; and (3) perform the calculation. The proposal explicitly states that the Deterrence Option is not satisfied when issuers adopt penalty fees comparable to penalty fees assessed by other card issuers.

The lack of historical data makes the Deterrence Option extremely difficult to satisfy, particularly because any data collected in the past would have been based on a credit environment in which the issuer could use APRs, instead of penalty fees, as the primary method to deter risky behavior. Issuers could meet the standard only by testing different fees on a statistically significant sample of actual customers. The Roundtable does not believe that it is desirable, or ethical, to experiment with customer's fees in an effort to find the "optimal" level of deterrence.

Suggestions for Improvement of the Deterrence Option

The rule should allow for i) use of industry data; ii) use of industry or third party models and studies; and iii) use of industry/third party results. Fair, Isaaac and Company ("FICO") could provide data at an industry level on what penalty dollar amount will deter particularly consumers from paying late by combining industry data with national data on income and FICO scores.[9] This method would recognize that the deterrence fee may vary depending on customer characteristics, but the fee should not vary based on the identity of the issuer. This method also would protect consumers from being charged disparate deterrence fees; the potential for disparate fees is inevitable if each issuer is required to individually collect data and develop a statistical model to calculate the exact amount necessary for deterrence.

III. The Percentage and Dollar Safe Harbors.

The Board proposes to adopt a safe harbor cap with a hard dollar limit in addition to a "percentage" safe harbor that would limit the maximum fee to five percent of the infraction (as opposed to five percent of the outstanding balance). The Roundtable asks

[8] Proposed comment 52(b)(1)(ii)-2.
[9] These statistically significant conclusions are similar to what Board arrives at after analyzing HMDA data collected from each institution.

the Board to reconsider the permissible percentage allowed under the safe harbor. We are concerned that a five-percent fee will not discourage future violations or enable issuers to recoup costs associated with the average violation.

The Board supports this rule by citing an example where the cardholder is delinquent on a $500 minimum payment. Under the five percent safe harbor rule, the cardholder is subject to a $25 penalty. But the Board's example assumes that the cardholder has an outstanding balance of $50,000 ($50,000 x one percent = minimum payment of $500). Most cardholders do not carry outstanding balances that large. If a cardholder with a $5,000 balance makes a late minimum payment of $50, under the five percent safe harbor the issuer cannot charge a penalty fee greater than $2.50. We do not believe that the Board intended this result, and we respectfully request that the Board reconsider the five percent formula, because absent a reasonable "hard cap," the five percent safe harbor is not a viable option for issuers when it is applied to the average violation.

IV. Notice and Opt Out.

The Roundtable believes it is appropriate to add an exception to the notice requirement of proposed opt-out provision because the rule contemplates yearly adjustments to the amount of the penalty fees. The safe harbor contemplates the possibility of annual increases to the penalty fee in conjunction with an annual CPI adjustment to the safe harbor and review of fees under the Cost Option and Deterrence Option.

Such increases should not be considered a change-in-terms ("CIT") that trigger notice and opt-out. In the alternative, CIT notice may be provided but without the opt-out provision. Alternatively, if the Board is compelled to require CIT notice and opt-out, the Board should permit a certain dollar amount (*e.g.,* $5) to be built into each of the penalty fee options as a cushion, so penalty fees aren't adjusted annually. Building in a small cushion absorbs CPI inflation for several years before an increase in the penalty fee occurs. In the alternative, the Board could permit issuers to add a cushion in an amount "up to" amount that is disclosed, although the issuer may not charge that penalty fee if the fee does not meet the requirements under one of three options.

V. Separate Over-the-Limit Method.

As a result of the CARD Act and Board's extensive protections regarding over-the-limit fees, issuers should have the option of complying with a different and additional method to satisfy the reasonable and proportional requirement. These protections include:

- No fee is charged unless the customer opts in.
- Customers are provided a separate disclosure about the fee and right to opt in, in addition to the disclosure on their account opening disclosures.
- The customer receives a written confirmation notice of the opt-in.
- Over-the-limit fees cannot be triggered due to fees and interest.

- No more than 3 over-the-limit fee may be charged per event.
- The subsequent over-the-limit fee can be charged no earlier than by the payment due dates.
- The customer may revoke the opt-in at any time.

In addition to the above protections, some of which go beyond what was required by the CARD Act (e.g. written confirmation notice, no fees and interest triggering the over-the-limit fee),[10] an opt-in is a customer's explicit acknowledgement that he or she believes the fee is reasonable and proportional to any anticipated violation. Further, the opt-in regime creates market pressures to ensure over-the-limit fees are reasonable and proportional. In light of these protections, the Roundtable believes that the Board should create a separate and additional over-the-limit method to comply with the rule. Creating such a method does not result in the customer being able to waive away rights under §226.52 as the customer would still be protected by the rule. Such protections include the prohibition against the fee exceeding the Transaction Cap, and the prohibition against multiple fees based on a single event or transaction.

The Board has the authority to create a separate method under subsection (d) of the new TILA section 149, which states that "[i]n issuing rules required by this subsection, the Board may establish different standards for different types of fees and charges, as appropriate." The separate method could appear as an option under §226.52(b)(1) or as a safe harbor in §226.52(b)(3) stating that the over-the-limit fee (of an appropriate amount) is deemed reasonable and proportional if the issuer has complied with the over-the-limit consent requirements in §226.56.

VI. Re-Evaluating APR Increases

The Roundtable supports the Board's proposal to terminate the re-evaluation requirement after a specific period of time. We believe it is appropriate to terminate the re-evaluation requirement after two years. Terminating the six month re-evaluation requirement after two years recognizes when customer situations, economic realties and costs of funding have permanently shifted. We agree with the Board's finding that Congress did not intend for the re-evaluations to continue in perpetuity.

VII. A Transition Period Between the Final Rules and the Compliance Date is Appropriate.

The statutes authorizing new TILA sections 148 and 149 contemplated that issuers would have at least six months of transition period between the release of the final rules and the regulations mandatory-compliance date.[11] The statute's inclusion of a six-month period

[10] *See* CARD Act §102(a) adding TILA §127(k).
[11] Section 102(b) of the CARD Act (adding TILA §149) states "RULEMAKING.—The Board shall issue final rules **not later than 9 months** after the date of enactment of this section to implement the requirements of and evaluate compliance with this section, and subsections (a), (b), and (c) shall become effective **15 months** after that date of

between the final rules implementing new TILA sections 148 and 149 and the mandatory compliance date indicate that Congress recognized that issuers' need a moderate amount of time to successfully implement the new provisions.

In light of demonstrated Congressional intent and the substantive nature of these rules, we respectfully request that the Board briefly delay the mandatory-compliance date. A short delay will allow issuers to receive the final rules, analyze the available options under the final rules, and make the necessary (and costly) policy, business, information-technology, and consumer disclosure changes.

Because we recognize that the importance of these rules and the prodigious effort expended by the Board to publish a series of new rules and amended regulations in a short period of time, we ask that the Board extend the mandatory-compliance date by two months (October 22, 2010). A two-month delay balances the legitimate needs of issuers to implement the new regulations with consumer protection.

If the Board declines to delay the overall implementation date, we hope the Board will consider extending the implementation date of the requirements that: (1) issuers provide 45 days advance notice before applying a rate increase;[12] and, (2) of issuer provided opt-out provisions in consumer statements.[13] During the extension, issuers would continue to provide notice to consumers regarding rate increases, and where appropriate, the right to opt out. A brief delay would be helpful to issuers who are in the midst of redesigning their policies and procedures to comply with the advance-notice and opt-out provisions.

VIII. <u>The Roundtable requests additional clarification.</u>

Finally, the Roundtable requests further clarification or additional guidance on the following interpretations of the proposed amendments:

1) The re-evaluation of a credit account is triggered by an increase in the APR, and it is not triggered because the rate changes from a variable-rate to an equal, or lower, non-variable rate, or vice versa.

2) The reevaluation requirement (§226.9(c) or (g)) is not triggered when a penalty APR increases (*e.g.*, an increase of the penalty APR from 25% to 29%). However, the reevaluation provision and the termination of the penalty rate after six on-time payments[14] will apply when a consumer's account is moved from the original APR to a penalty APR, although the actual amount of penalty APR is outside the scope of evaluation provisions.

---

enactment.'' (emphasis added). *See* CARD Act, Pub. L. No. 111-24, § 101(c), 102(b) (adding new TILA sections 148 and 149, respectively).

[12] Proposed §§ 226.9(c)(2) and (g).

[13] Proposed §226.9 (c)(2)(iv)(3)

[14] Revised TILA § 171(b)(4)(B); § 226.55(b)(4)(ii).

3) The APR increase, for operational reasons, may occur on the first-day of the billing cycle that occurs on, or after, the 30 days.

4) When calculating the penalty fee for a delinquency, the "amount" of the violation is the amount of the delinquent minimum payment, and not the amount of the returned or late partial payment submitted by the consumer, when the partial late or returned payment is less than the amount of the minimum payment. (e.g., the minimum payment is $50, but the consumer submits a late payment of $25).

5) The transition rule for disclosures – the proposed disclosures for "up to" fee amounts applies to disclosures provided on or after August 22, 2010. Issuers are not required to alter disclosures that were intended for distribution before August 22, 2010.

The Roundtable appreciates the opportunity to comment on the proposed regulation. Thank you in advance for considering our comments. If you have questions or comments on these matters, please contact Brian Tate or me, at (202) 589-2417

Sincerely,

Richard M. Whiting

Executive Director and General Counsel