**Comment of**

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**To the**

**Board of Governors of the Federal Reserve System**
**Offfice of Thrift Supervision**
**National Credit Union Administration**

**On**

**Unfair or Deceptive Acts or Practices**

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# "Unfair" Credit Card Practices

I. Introduction and Executive Summary

On May 19, 2008, the Federal Reserve System, the Office of Thrift Supervision, and the National Credit Union Administration ("the agencies") proposed a rule under Section 5 of the FTC Act to define certain "unfair or deceptive" practices in the credit card market. Relying primarily on unfairness, the proposal would prohibit certain contract terms commonly found in credit card agreements, change various practices of credit card companies that are currently matters of contractual agreements between the parties, and require certain disclosures. Although the agencies have previously adopted rules regarding creditor's remedies after the FTC adopted such rules for creditors subject to its jurisdiction, this proposal would be the agencies' first effort to write rules that "define with specificity" unfair or deceptive practices under the FTC Act.

Under the FTC Act, a practice is unfair if it "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[2] Some elements of the proposed rule are entirely straightforward applications of the FTC's traditional unfairness analysis. Proposed Section 22(a), for example, prohibits treating a payment as late unless the consumer has been provided a "reasonable" amount of time to make the payment, and provides a safe harbor if statements are mailed at least 21 days before the payment date. Late payments cause a variety of consumer injuries, and courts would likely hold that a payment cannot be considered late if the consumer did not have a reasonable amount of time to make the payment. Thus, the injury is not reasonably avoidable. Indeed, this provision is akin to the FTC's Mail or Telephone Order Merchandise Rule, which specifies that sellers must deliver the goods within 30 days unless they specifically provide a different time frame for delivery.[3]

Other provisions, however, go far beyond the scope of unfairness under the FTC Act. In particular, this comment will consider in detail proposed Section 24, which would prohibit increasing the interest rate on outstanding balances in a variety of circumstances. The proposal would effectively prohibit common contractual provisions that authorize specified increases in interest rates in circumstances that are clearly disclosed, easy for consumers to understand, and within the consumer's control. Such circumstances include, for example, missing a payment on the account in question or making a payment with a bad check.

As discussed in detail below, the central goal of the prohibition on unfair practices is the preservation of consumer sovereignty. Unfairness analysis demands a respect for the choices consumers make in competitive markets. In highly competitive markets such as the market for credit cards, there is no basis for regulators to second guess those choices. That, however, is precisely what the agencies' proposal would do, particularly with regard to repricing outstanding balances.

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[2] 15 U.S.C. Section 45(n).

[3] Mail or Telephone Order Merchandise Rule, 16 C.F.R. 435. The contract enforcement rationale for the Mail Order Rule is discussed in more detail in Timothy J. Muris and J. Howard Beales III, *The Limits of Unfairness under the Federal Trade Commission Act* (Washington: Association of National Advertisers, 1991) at 37 ("*The Limits of Unfairness*").

In their analysis of the repricing proposal, the agencies have mis-analyzed the substantial injury that is the starting point for unfairness analysis. They have misunderstood the nature of reasonable avoidance. Rather than carefully consider the market efficiency considerations that produce some of the commercial practices the rule would restrict, the agencies have dismissed important offsetting benefits with a mere waving of the hands. Although a proper unfairness analysis can support some proposed provisions, it cannot support the proposed restrictions on repricing existing balances when clearly disclosed, easily understood, and reasonably avoidable consumer behavior on the account itself provides new information about risk.

## II. The Agencies Proposals Go Far Beyond the Scope of Unfairness under the FTC Act

### A. The Goal of the Prohibition on Unfair Practices is Protecting Consumer Sovereignty

The touchstone for analysis of unfair practices under the FTC Act is consumer sovereignty. The goal is not to second guess choices that consumers make in competitive markets; rather, it is to remove impediments that effectively prevent consumer choice. In the Unfairness Policy Statement, the Commission explained that unfairness cases "…are brought, not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decisionmaking."[4] The Commission surveyed prior unfair practices cases involving failure to provide information, coercion, and exploitation of particularly vulnerable groups and noted, "Each of these practices undermines an essential precondition to a free and informed consumer transaction, and, in turn, to a well-functioning market. Each of them is therefore properly banned as an unfair practice under the FTC Act."[5] As the Commission explained in *International Harvester*, ". . . the principal focus of our unfairness policy is on the maintenance of consumer choice or consumer sovereignty, an economic concept that permits specific identification of conduct harmful to that objective."[6]

The Commission used the same approach when it addressed unfair practices in consumer installment contracts in the Credit Practices Rulemaking. It noted that the key to whether contract terms might be unfair was "…whether free market decisions are unjustifiably hindered."[7] The fact that contracts were standardized forms was not sufficient; the Commission noted that "the issue … is whether the contents of these standard form contracts are the product of market forces."[8] When the rule was challenged on appeal, the court also adopted this focus on impediments to competitive market forces. It explained that, "As long recognized, however, certain types of seller conduct or market imperfections may unjustifiably hinder consumers' free market decisions and prevent the forces of supply and demand from maximizing benefits and minimizing costs. In such instances of market failure, the Commission may be required to

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[4]FTC Policy Statement on Unfairness, Letter to Senators Ford and Danforth, December 17, 1980, Appended to International Harvester Co., 104 F.T.C. 949, 1070 (1984) ("Unfairness Policy Statement"). The statutory definition of unfairness in Section 45(n) codified the approach the Commission adopted in the Unfairness Policy Statement.
[5] Unfairness Policy Statement at n. 24.
[6] *International Harvester Co.,* 104 F.T.C. at 1060 at note 47.
[7] Statement of Basis and Purpose, Trade Regulation Rule, Credit Practices, 49 Federal Register 7740 (March 1, 1984), Chapter 2 following n. 25 ("Credit Practices SBP"). Citations are to the chapter and nearest footnote, based on the LexisNexis version of the Statement of Basis and Purpose.
[8] *Id.*

take corrective action."[9] As the Court also noted, however, "… the Commission cannot be allowed to intervene at will whenever it believes the market is not producing the 'best deal' for consumers …"[10] Absent some barrier to the exercise of consumer sovereignty, a practice is not "unfair" within the meaning of Section 5.[11]

Unfortunately, the agencies' analysis departs substantially from the respect for consumer sovereignty that unfairness requires. Rather than protecting consumers' ability to choose for themselves, the agencies are proposing to substitute their own preferences about what contracts should look like for the choices that consumers have freely made in the market. Thus, the agencies' proposals, if adopted, would thwart market outcomes, not protect them.

B. Credit Card Markets are Highly Competitive.

As nearly anyone with a mailbox knows, competition among credit card issuers for new customers is intense. In 2001, just over 5 billion mailed credit card solicitations reached 79 percent of all US households, with an average of five offers each month.[12] By 2007, mailings had reached nearly 8 billion, presumably generating even higher levels of penetration and offers per household.[13] More academic analyses have reached essentially the same conclusion – the credit card market is highly competitive.[14]

Moreover, competition in the credit card market has led to substantial innovation and evolution in the contractual terms offered to consumers. Driven by competitive innovations in risk analysis and credit reporting improvements, the market has moved substantially from the standard model that prevailed in the 1980s. Credit card offerings at that time were characterized by APRs that were "high and simple" for all customers who were approved, along with an annual fee.[15]

Beginning in the 1990s, the current model of risk-based pricing emerged. Customers were offered different interest rates depending on the risk they presented, resulting in issuers having "hundreds of different APR price points."[16] The lowest risk customers, who paid the same rate as those with higher risk under the old model, now receive interest rate discounts that are sometimes more than 800 basis points.[17]

Other aspects of credit card pricing evolved as well. Issuers added or increased both risk related fees, such as fees for late payments, overlimit transactions, or bounced checks, and service or convenience fees, such as charges for statement copies or telephone payment. Issuers

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[9] *American Financial Services Assn. v. FTC*, 767 F.2d 957, 976 (D.C. Cir 1985).
[10] *Id*. at 982.
[11] The Limits of Unfairness, supra note 3, at 20-21.
[12] Mark Furletti, *Credit Card Pricing Developments and Their Disclosure*, Discussion Paper, Payment Cards Center, Federal Reserve Bank of Philadelphia (January 2003) at 1.
[13] Cardwatch.com, available at http://www.cardweb.com/cardtrak/news/2007/february/21a.html.
[14] *See e.g*. David S. Evans and Richard Schmalensee, *Paying With Plastic* 228-232 (2d ed. 2005)
[15] Furletti, *supra* note 12 at 6 (APR), 9 (annual fees).
[16] Furletti, *supra* note 12 at 7.
[17] *Id*. at 8.

differ in the particular circumstances in which they impose fees, and in the amount of fees they charge.[18] The result of these changes is that that costs to individual consumers are far more sensitive to how they actually use the card. As one author described the changes, "in lieu of charging all of their customers an annual fee that subsidized the costs associated with the behaviors of a few, [issuers] began to assess fees directly on those customers whose card usage behaviors drove costs higher."[19]

These are precisely the kinds of changes in pricing and in contract terms that one would expect in competitive markets. When costs depend on consumer behavior, an efficient pricing structure will assign costs to the consumers who generate those costs. There is no reason for consumers who can be served at low cost to subsidize consumers who pose higher risks or demand added services, and in competitive markets they will not.

Of course, a pricing structure that imposes costs on those who generate costs will be more complex than assigning everyone a single price, regardless of the costs of serving them. Uniform pricing may be simple, but it is also less efficient, and will result in reduced consumer welfare.

It is precisely because competitive markets are so effective in enhancing consumer welfare that a fundamental premise of unfairness analysis is that regulators should defer to the outcomes of competitive markets rather than second guess those outcomes. Products and services will involve both benefits and costs, which likely differ for different consumers. But it is up to consumers to choose, even if the choice is more complex than regulators might desire. Indeed, the complexity of current pricing is a product of consumer choice, as consumers have determined that cost-based pricing offered them a better deal.

As discussed in more detail below, the agencies have offered no plausible reason for second-guessing the pricing structure that has emerged in the credit card market. These are choices that fairness demands that regulators should leave to consumers themselves.

## III. The Agencies Incorrectly Analyze Substantial Injury

With regard to repricing outstanding balances, the agencies' entire analysis of substantial injury, the foundation of an unfairness analysis, is a single sentence: "Application of an increased annual percentage rate to an outstanding balance appears to cause substantial monetary injury by increasing the interest charges assessed to a consumer's credit card account."[20] To be sure, an increase in price will increase costs to consumers. But when the increase in price is the result of consumer choices about behavior that is clearly disclosed and easy for consumers to understand, it is very difficult to see the resulting cost as an actionable injury, substantial or otherwise.

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[18] Unlike many other issuers, for example, American Express does not charge a fee for telephone payment. American Express and other issuers also do not charge for online payments.
[19] Furletti, *supra* note 12 at 10.
[20] 73 Fed. Reg. 28917.

The agencies recognize in their proposed exceptions to the rule that not every increase in price is an injury, but they offer no principled basis for the distinction. Perhaps most straightforward is the exception for variable rates. When a specified index increases, issuers are permitted to reprice the existing balance under the terms of the agreement and under the proposed rule. That will, of course, increase the cost to the consumer, but the agencies do not appear to see that cost increase as an injury. The magnitude of the change may be different on average, but there is no conceptual difference between an increase due to the operation of a formula and an increase due to the operation of a different contractual provision.

The lack of any meaningful distinction is also clear in the exception for promotional rates. If the promotional rate expires, issuers can reprice the outstanding balance. Moreover, if the promotional rate "is lost for a reason specified in the account agreement (e.g., late payment)," issuers can increase the promotional rate to the "regular" APR, but not to a "penalty" APR.[21] Here, the agencies' example makes clear that the magnitude of the interest rate change may be precisely the same as if there is no promotional rate involved. The example considers a hypothetical issuer with a promotional rate of 5%, a regular rate of 15%, and a penalty rate of 25%. If the agreement specifies that failure to pay by the due date is a trigger for the penalty rate, an issuer can increase the promotional rate to the regular rate, a ten percentage point increase in the rate. But the situation is *exactly the same* if there is no promotional rate involved. If the contract specifies a late payment as a basis for default pricing, the missed payment would trigger an increase in the rate of 10 percentage points, from the regular rate of 15% to the penalty rate of 25%. There is no principled basis for regarding only one of these circumstances as an "injury."[22]

A. Price for an agreed-upon product in a competitive market is not an actionable injury.

The fundamental problem with the agencies' approach is their failure to recognize that paying the agreed-upon price for an agreed-upon product or service is not an actionable "injury" that might trigger an unfairness analysis. Inherent in the nature of a voluntary transaction between consenting parties, the transaction makes both parties better off. Because the transaction is voluntary, if one party thought the terms were unreasonable they would not complete the transaction. Such a transaction cannot constitute an "injury" in any meaningful sense.

There are circumstances, of course, where the price or the change in price is an injury. When the agreement is coerced, for example, the transaction is not voluntary, and the price paid is a reasonable measure of the injury to the consumer.[23] Price may also constitute a measure of injury when the product is not what the seller represented.[24] A change in price may constitute an

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[21] ____.24(b) Exceptions, 73 Fed. Reg. 28920.

[22] Nor is there any difference in reasonable avoidability, because the consumer behavior that triggers the rate increase is precisely the same in either circumstance. Similarly, because the increase in the rate is the same, the offsetting benefits are the same.

[23] In *Holland Furnace,* for example, the company dismantled the consumer's furnace and refused to reassemble it until the consumer agreed to a service contract. *Holland Furnace Co. v. FTC*, 295 F.2d 302 (7th Cir. 1961).

[24] Such cases are more typically analyzed as deception. As the Commission noted in *International Harvester*, however, ". . . unfairness is the set of general principles of which deception is a particularly well-established and streamlined subset." *International Harvester Co.*, 104 F.T.C. at 1060.

injury when it is a unilateral modification of a fundamental term of the contract,[25] or when it constitutes an additional to the contract after the fact and without disclosure.[26] Although credit card contracts routinely give the issuer the right to modify terms of the agreement after providing notice, such changes must be within the scope of the original contract and they must be reasonable.[27] The terms of repricing when consumers make a late payment are clear on the face of the contract, however, as are the circumstances that would trigger repricing. Such changes are not unilateral contract modifications; rather, they are the agreed-upon exercise of precisely specified contractual rights.

Paying an interest rate that accurately reflects risk is not an injury in any meaningful sense. Over time, information about risk improves as the consumer's behavior with the account is observed. By the same token, repricing to reflect specific behaviors, involving the account that is repriced, that are clearly disclosed in the contract and under the consumer's control, does not constitute injury.

B. Injury from contract terms has never involved the contracted price

Although the Federal Trade Commission has, on occasion, found that specific contract terms were unfair in particular circumstances, the injury in those cases did not involve the price that was paid for the product or service. In the Credit Practices rulemaking, for example, the injury was frequently the loss of the consumer's due process rights (confessions of judgment, waivers of exemptions, wage assignments). Indeed, the Commission rejected two proposed provision that would have restricted the contractual allocation of costs between the creditor and the debtor: the proposed prohibitions on late fees and charging attorney's fees to defaulting debtors.[28]

Other circumstances in which the Commission has found specific contract terms unfair were cases where the clause imposed a disproportionate burden on the parties. In banning blanket security interests in household goods in the Credit Practices Rule, for example, the Commission noted that such security interest "elicits minimal benefits in return for substantial injury,"[29] because household goods have little or no value to creditors as collateral but are very costly for consumers to replace. Similarly, the cases finding distant forum clauses an unfair practice are based on the disproportionate cost to consumers of having to defend themselves in a distant forum.[30] Finally, in promulgating the Holder in Due Course Rule, the Commission found that consumers were "'clearly injured' by a system that 'force[d] them to bear the full risk and burden of sales related abuses.'"[31]

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[25] *Orkin Exterminating Co., Inc.*, 108 F.T.C. 263 (1986); aff,d., FTC v. Orkin, 849 F.2d 1354 (11th Cir. 1988) (unilateral breach of a contract to provide lifetime termite protection for a fixed annual fee).
[26] *FTC v. Certified Merchant Services, Ltd*., et al., No. 4:02CV44 (E.D. Tex. 2002) (Defendants unilaterally altered contracts by imposing additional fees that were not part of the original contract).
[27] *See Badie v. Bank of America*, 67 Cal. App. 4th 779 (Court of Appeal of California, First Appellate District, 1998).
[28] Credit Practices SBP, *supra* note 7 at Chapter XII (B) (attorneys fees), Chapter XII (D) (late fees).
[29] Credit Practices SBP, *supra* note 7, Chapter VI at n. 94.
[30] *Spiegel,* 86 F.T.C. 425, 442 (1975) (noting that travel costs of defending in a distant forum may exceed the amount in dispute).
[31] FTC Staff Comment to OTS at 8, quoting Statement of Basis and Purpose for Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 52506, 53523 (November 18, 1975).

C. Any other position leaves the agencies in the position of being the arbiter of the "just" price.

If paying the agreed-upon price in a competitive market is itself an injury, then the agencies are making themselves the arbiters of the "just" price of every aspect of credit. There is always a payment. If that payment itself constitutes "substantial injury," then every transaction results in injury for purposes of an unfairness analysis. Moreover, no market satisfies the textbook conditions for perfect competition; there are always costs of information and transacting that, under the agencies' analysis, mean the injury is not reasonably avoidable. The only questions remaining are whether the agencies think the benefits consumers receive in turn are sufficiently valuable to justify the price. In essence, the agencies' analysis claims that the prohibition on unfair practices gave the FTC the authority to regulate the price of any product subject to its jurisdiction. Even under its most expansive interpretations, however, the Commission has never thought it had such authority.[32] Such an approach entirely supplants consumer sovereignty with the paternalistic judgments of the regulatory agencies. That is not what the prohibition on "unfair" practices is about.

IV. The Agencies Incorrectly Analyze Reasonable Avoidance

A critical component of an unfairness analysis is whether consumers can reasonably avoid the injury that has been identified. It is reasonable avoidability that gives teeth to the concept of consumer sovereignty, because if consumers can make their own choices in competitive markets, any injury *is* reasonably avoidable. In any market, some consumers will in fact make choices that turn out to be unwise, either because they encounter conditions that they did not anticipate at the time of the decision or because they simply make mistakes. The question of reasonable avoidability is whether the impediments to good choices are significant enough to prevent competitive market outcomes.[33] In the credit card market, there is simply no evidence that they are. Moreover, the agencies must articulate the particular barriers that prevent free choice.[34] They have not done so in the proposal.

In the context of default pricing, consumers might reasonably avoid injury in at least two different ways: they might choose to avoid the default itself, or they might choose credit cards with different default triggers or rates.

A. Consumers Can Reasonably Avoid Default

Regardless of the contractual terms in cardholder agreements, the injury from repricing can be avoided if consumers can reasonably avoid the events that trigger default pricing. Although

[32] For a discussion of expansive attempts to use unfairness and the difficulties they created for the Commission, see J. Howard Beales III, *The FTC's Use of Unfairness Authority: Its Rise, Fall, and Resurrection*, 22 Journal of Public Policy and Marketing 192 (2003).
[33] *See The Limits of Unfairness supra* note 3,at 36.
[34] In upholding the FTC's Credit Practices Rule, the majority did not dispute the dissent's contention that the Commission cannot intervene "when it does not know the 'obstacle to free choice.'" Instead, the Court maintained that the Commission had articulated and documented the barriers. *American Financial Services Association v. F.T.C.*, 767 F.2d 957, at n. 29 (D.C. Cir. 1985).

the agencies recognize this possibility, they rely heavily on the FTC's 1985 conclusion that most defaults are not reasonably avoidable.[35] Critically, however, the defaults at issue in the Credit Practices rulemaking were very different from the kinds of consumer behavior that triggers default pricing under credit card agreements. Contractual provisions such as confessions of judgment or waivers of exemption are relevant once the account is in collection. Repricing for late payments is an attempt to manage risk and minimize losses without going to collection.

1. Consumers Can Reasonably Avoid Late Payments

Of course, many consumers are sometimes late with a payment and incur late fees. The GAO estimated that for 10 large issuers, "about one-third" paid at least one late fee in 2005.[36] Other estimates are even higher.[37] Clearly, however, most consumers most of the time make their payments on time. They can, in short, avoid paying late.

Perhaps the most direct evidence that consumers can reasonably avoid choices like paying late is that consumers who pay fees in fact learn to avoid them. An empirical study of late fees, over limit fees, and cash advance fees incurred over time found that "paying a fee last month reduces the likelihood of paying a fee this month by 44%."[38] Each type of fee exhibited a similar pattern. The fact that consumers learn from paying a fee that they can avoid it makes clear that the consequence is, in fact, reasonably avoidable. If paying late or exceeding credit limits are *not* reasonably avoidable, there would be no learning, because there would be no reasonable steps that consumers could take to avoid the fees.[39] That is not what the evidence shows.[40]

Of course, the costs to the consumer of moving to a default rate may be greater than the costs of a one time fee, depending on the consumer's balance and subsequent behavior. That fact may be relevant to the magnitude of the injury, but it is not relevant to reasonable avoidability.[41] Similarly, the size of the late fee imposed is relevant to injury, but not to avoidability. Substantial injury and reasonable avoidability are independent criteria, both of which must be satisfied before a practice is unfair under the statute. It is the underlying behavior, such as paying late, that is avoidable. If the behavior is reasonably avoidable, there is no basis for

[35] 73 Fed. Reg. 28918, n. 52.
[36] Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers* (September, 2006), at 13 ("GAO Report").
[37] *See e.g.* Furletti, *supra* note 12 at 11.
[38] S. Agarwal, J. C. Driscoll, X. Gabaix, & D. Laibson, *Stimulus and Response: The Path from Naïveté to Sophistication in the Credit Card Market*, (2006), presented at FTC Conference on Behavioral Economics and Consumer Protection, available at http://www.ftc.gov/be/consumerbehavior/docs/Agarwal_Driscoll_Gabaix_Laibson.pdf.
[39] In fact, if as the agencies suggest late payments are not reasonably avoidable because they stem from changes in circumstances such as job loss, one would expect to find a positive relationship of fees paid over time – being late this month from such a cause should also increase the probability of paying late next month. The pattern, however, is the opposite.
[40] Although the underlying behavior (e.g., a late payment) may be the same, the triggers for late fees and default pricing often differ. American Express, for example, offers a three day grace period before late fees are imposed. A single late payment is also a trigger for default pricing, but only if the payment is not made by the end of the billing cycle in which it was due. Thus, the trigger for late fees is more sensitive than the trigger for default pricing.
[41] Indeed, many consumers can avoid much of the injury from repricing by paying off the outstanding balance and keeping the account current. Fees, however, once incurred, are unavoidable.

finding the fee or the default rate unfair. Competitive markets should determine the cost of that reasonably avoidable behavior, not regulatory agencies.

Similarly, it is not relevant to reasonable avoidability that rate changes have longer term consequences than fees, at least for those who cannot move the outstanding balance to another card. The agencies are willing to accept long term consequences when a consumer paying a promotional rate engages in clearly specified defaults such as making a late payment.[42] The issue is whether the behavior that triggers the consequence is avoidable, not whether consumers can avoid the consequence after they have engaged in the behavior that provokes it. Most choices that consumers make have consequences, both immediately and over time, but it does not follow that the choice to incur those consequences was not reasonably avoidable.[43] Again, competitive markets should determine the appropriate mix of consequences for particular choices, not regulatory agencies.

2. Consumers Can Reasonably Avoid Writing Bad Checks

Similarly, consumers can reasonably avoid making payments with insufficient funds. Surely, consumers expect consequences from writing bad checks. Indeed, writing bad checks is potentially criminal behavior, subject to far more serious consequences than default pricing. If consumers do not expect bad consequences from bad checks, there will be many more bad checks.

The agencies' analysis confuses mistakes and their consequences with reasonable avoidability. It is true that individual consumers will make mistakes, including writing an occasional check without sufficient funds to cover the obligation. It does not follow that penalizing those mistakes creates unavoidable injury. There are reasonable steps consumers can take to avoid the mistakes. Consumers can inquire about their available balance, or they can check their balance online. Concluding that because mistakes are inevitable, they are not reasonably avoidable, would allow the agencies to second guess market decisions that impose consequences on those mistakes, and would gut consumer sovereignty.

At the very least, it is certainly easier for consumers to avoid late payments and bounced checks than it is for them to avoid changes in the index that controls a variable rate card. But the agency would allow repricing based on a variable rate. How can it possibly be "fair" to make rate adjustments continuously, without separate notice, in accordance with the operation of an index that most consumers surely do not know,[44] but "unfair" to make changes occasionally, in response to specifically identified and easily understood consumer behaviors?

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[42] *See* 73 Fed. Reg. 28920 and the discussion below.
[43] For example, a consumer who chooses a six cylinder car instead of four cylinders will incur consequences in the form of a higher price immediately. The consumer will also incur consequences over time, in the form of worse gas mileage, which may, in the aggregate, cost more than the initial difference in price. Both types of consequences are reasonably avoidable, because the consumer can purchase a four cylinder car. Similarly, a consumer who does not engage in sufficient search to find the lowest available interest rate will incur consequences over time. Again, those consequences are reasonably avoidable, because the consumer could have chosen to search more.
[44] Surely if consumers cannot understand that late payments may lead to an increase in interest rates, they do not understand the operation of LIBOR and its implications for their current APR. It is doubtful that any consumer monitors LIBOR, or any other widely used index, on anything approaching a regular basis.

B. Consumers Can Reasonably Avoid Undesirable Contract Terms

When the FTC adopted the Credit Practices Rule, it included a detailed analysis of the contractual terms available to consumers and the potential for consumers to choose loans with different terms. The agencies have presented no such analysis of the availability of alternative terms in the credit card market. Instead, they have attempted to rely on the FTC's findings about the state of competition in a very different market more than 20 years ago. Even given the Commission's conclusion, it simply does not apply to the vastly different credit card market that exists today.

Perhaps the most fundamental difference between the credit card market and the finance company loan market that was the subject of the Credit Practices Rule is the cost of search. The FTC specifically found that search was difficult, and that despite variation at a national level, contract terms were often uniform within a local market. Today's credit card market is national, and competition through prescreening has greatly reduced search costs for consumers. As noted above, a typical household receives an average of five offers a month in its mailbox. For most consumers, searching for a better deal requires no more effort than reading the mail. In addition, the availability of the Internet has greatly reduced search costs for consumers. Both offers from issuers and sites offering comparisons of different card products are readily available to anyone interested. Moreover, the Commission found that the terms of installment loan contracts were often not available until after the loan closed. In the credit card market, key terms are disclosed in the initial solicitation, and the cardmember agreement is available at least when the credit card is sent, if not earlier.

There are, to be sure, costs of search even in the modern credit card market. Cardholder agreements have many complicated terms, but many of the terms at issue in default pricing are not complex. It is surely not difficult for most consumers to understand a contract provision that if they make payments late or have a payment returned by their bank, the interest rate will increase. Moreover, if there is a demand for simpler terms, there is every incentive to provide those terms in competitive markets, to the extent that regulatory constraints and the need for specificity in the contract permit. One study of the market for cell phones, for example, found that increasing competition led to pricing plans that were simpler and more transparent to consumers.[45]

The mere fact that search has costs does not justify the conclusion that bad outcomes are not reasonably avoidable. Consumers who engage in more search, whether for price or for contract terms, will likely realize better results than those who decide the costs of search are not worth incurring. Consumers who choose to buy from the first seller they find, for example, will likely pay a higher price than those who continue to search. That is a perfectly rational choice, and one that consumers make about every market transaction – at what point should I stop searching for a

[45] See E. Miravete, "The Doubtful Profitability of Foggy Pricing," (2007), available at http://www.eco.utexas.edu/facstaff/Miravete/papers/EJM-Foggy.pdf

better deal? For many, it may not be worth engaging in any search at all. Outcomes for such consumers will be worse, but they were clearly reasonably avoidable – the consumer could reasonably have chosen to search.

The critical question for an unfairness analysis is whether the impediments to search are so serious that they impair market performance. As the FTC noted in its analysis of the Credit Practices Rule, if a sufficient number of consumers know about differences in contract terms, "consumers could reasonably avoid undesirable contracts, and there would be no basis for Commission intervention."[46] Not everyone needs to search to assure competitive market outcomes. As long as an informed minority large enough to be worth competing for exists, competition for those who are informed will drive all sellers to provide product characteristics that informed buyers value.[47] It is the marginal buyer who will drive market outcomes, not the average buyer.[48] Even if some buyers are naïve or uninformed, the market equilibrium may reflect the contract terms that sophisticated buyers prefer.[49]

The evidence of effective competition in the market for credit card terms is plain to see in the evolution of credit card pricing since the mid 1990s. Features of credit card pricing such as different rates for different categories of transactions (e.g., purchases vs. cash advances vs. balance transfers) are precisely the kinds of changes one would expect to see in a competitive marketplace facing different risks for different categories of transactions. Similarly, the emergence of fee based pricing to impose costs on those users whose behavior generates costs is the natural outcome of a competitive market for contractual terms.

In fact, there appears to be significant variation among major issuers in the terms relevant to default pricing.[50] In the GAO's study of 28 popular credit card products in 2005, one did not charge default rates at all. Of the 27 with default rates, 26 authorized default rates for late payments; 9 authorized default rates only after two late payments. Of the 28 cards studied, 18 specified that default rates could apply for exceeding credit limits, and 10 authorized default rates for returned payments.[51] Among the major issuers that American Express monitors for competitive reasons, issuers differ in the number of months they consider in the repricing decision, in the number of late payments that trigger a default rate, in whether overlimit transactions trigger default pricing, and if so, how many such incidents are required, and in whether rejected payments trigger default pricing. They also differ in the factors considered in determining the default rate. Some consider how long an account has been open, the timing or seriousness of the default, or other indications of account performance; others do not. Issuers

[46] Credit Practices SBP, *supra* note 7, Chapter III at n. 9.
[47] A. Schwartz & L. L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. Pa. L. Rev. 630 (1979).
[48] E. Lazear, Presentation at FTC Conference on Behavioral Economics, transcript at 14, available at http://www.ftc.gov/be/consumerbehavior/docs/transcript/transcriptopen.pdf.
[49] See Alan Schwartz, *How Much Irrationality Does the Market Permit?* 37 J.Legal Stud. 131 (2008).
[50] Even without variations in terms, however, it does not follow that consumer choice is impaired. Competitive markets do not generally offer all possible choices, simply because there are some choices where demand is insufficient to cover the costs of the option. The fact that most major issuers use default pricing likely reflects the fact that there are not enough consumers in the credit card market willing to pay the higher initial rate that such a card would obviously require. As discussed below, credit is available on terms that do not allow for default pricing, but not combined with the convenience and flexibility of a credit card.
[51] GAO Report, *supra* note 36 at 25.

differ in the minimum duration of default pricing as well. Thus, it appears that consumers have choices, if they care enough to exercise those choices.

In the Credit Practices Rulemaking, the FTC suggested that adverse selection might limit competition over the terms of creditor's remedies, because contracts authorizing fewer sanctions against defaulting borrowers would be most attractive to borrowers who are more likely to default.[52] Perhaps because of substantial improvements in credit reporting and risk assessment since that time, there is no evidence that fear of adverse selection has limited competition in credit card markets. Indeed, the widespread use of balance transfer offers suggests that adverse selection is not a significant problem. Moreover, issuers compete over the terms that are relevant to the kinds of behaviors that can trigger default pricing.[53] American Express, for example, promotes its "Clear" card as having "absolutely no fees of any kind," including no late fees or overlimit fees.

Of course, some consumers may prefer more certainty about the precise terms of their borrowing than typical credit cards provide. Greater certainty about terms and repayment schedules is available to consumers who value it, in the form of a wide variety of closed ended credit products. Such products generally offer consumers the opportunity to lock in the terms of credit over a specified period of time, regardless of their behavior or changes in their circumstances.[54]

The economics of closed ended credit and open ended credit, however, differ significantly. Open ended credit is generally unsecured; many closed ended products require collateral. Open ended lenders do not know precisely how the payment stream will vary over time, because consumers can choose any payment between the minimum and paying their balance in full. Nor do they know precisely how much credit they will have to fund, because consumers can choose how much to borrow, up to their credit limit. Perhaps for these reasons, the terms on which receivables can be securitized differ between open ended and closed ended credit products. Given the significant economic differences, there is no reason to expect that competitive markets would produce the same pricing structure or the same contract provisions for each.

In return for lower initial rates and greater convenience in varying the amount of credit outstanding, credit card issuers contract for the flexibility to change the terms over time, particularly (and often specifically) if the consumer exhibits behavior that evidences an increase in risk. There are, however, alternative credit products such as installment loans or personal loans where lenders do not retain the option of changing terms over time. Consumers who want to avoid unpleasant surprises from repricing can do so by using credit products that do not allow repricing. Thus, any injury from repricing is reasonably avoidable – many consumers have

[52] Credit Practices SBP, *supra* note 7, Chapter III at n. 25. If a creditor who offered a contract with fewer remedies would only attract bad risks, the costs of offering the contract would be higher. The resulting increase in the interest rate would make the contract even less attractive to low risk borrowers, and, in the extreme, could make it impossible to offer such a contract.

[53] For example, the GAO noted an apparent decline in the fraction of cards that assessed overlimit fees from 85 percent in 2003 to 73 percent in 2005. *See* GAO Report, *supra* note 36 at 22.

[54] Open ended credit agreements typically allow the consumer to repay on the original terms over time, as long as the consumer does not exhibit behaviors on the account that indicate that risk has increased. Under the proposal, this ability would be unconditional.

simply concluded that the benefits of credit cards are worth the costs, compared to the alternatives.

## V. The Agencies' Rationales Regarding Unavoidability Are Unpersuasive And Inconsistent.

### A. General Problems With The Agencies' Rationales

#### 1. Consumers Know that Default has Consequences.

The agencies begin their discussion of reasonable avoidability of repricing with the contention that either "some" or "many" consumers are "not aware" of the circumstances that can cause rates to increase.[55] They assume, based on this contention, that the consumer is only considering the current APR in deciding whether to pay a particular credit card bill versus some other obligation, or whether to use the card for a transaction. Awareness of what constitutes default and the likely consequences of default surely varies with different types of default, however. Consumers are likely aware that failing to pay on time or bouncing checks are likely to have adverse consequences, even if they are unaware of precisely what those consequences might be.[56] When the specific consequences are readily available in the contract, or under the Federal Reserve's other proposals on the statement itself, it is difficult to see how the lack of precise knowledge is a problem. The information about the specific consequences is readily available to anyone who is interested. Moreover, the agencies cite no evidence that consumers consider only the APR in effect at the time of a particular transaction or in deciding to pay a particular bill. Nor is there any evidence that basing such decisions on only the APR will lead to incorrect choices about a particular card, or, as a result, to any consumer injury. Thus, the fact that consumers participating in a survey cannot tell the interviewer all of the precise circumstances that might lead to an increase in rates does not mean that the consequences of reprising are unavoidable. Consumers know there will be consequences for some choices, and they can readily determine precisely what those consequences will be.

#### 2. The Agencies are not Consistent in Their Analysis.

The agencies are not consistent in their treatment of late fees and repricing based on late payments. If late payments are not reasonably avoidable, as the agencies contend, then late fees are not reasonably avoidable either – but that cannot be the case. As discussed above, the evidence is clear that in fact late payments are reasonably avoidable. Similarly, if bouncing checks is not reasonably avoidable, fees for bouncing checks are not reasonably avoidable either – but again, that cannot possibly be the case. The unavoidable implication of the agencies' argument is that any fee for any of these behaviors is a substantial injury that is not reasonably avoidable.

The critical issue in analyzing reasonable avoidability is whether consumers can avoid the behavior, not the balance of benefits and costs of fees versus interest rate changes, or how many instances of a behavior that results in fees are sufficient to justify default pricing. Because the

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[55] 73 Fed. Reg. 28917, where the agencies use both characterizations of consumer knowledge.
[56] *See* Similarly, they are likely aware that violating credit limits is likely to lead to consequences.

behaviors themselves are avoidable, the agencies should not even reach that question. Arguing that the balance is different asserts the agencies' authority – and the FTC's authority – to second-guess the reasonableness of any price in any market. That is not what unfairness is about.

3. Whether or not Consumers are Optimists About the Future is Irrelevant.

The agencies' argument that consumers are overly optimistic in assessing their ability to avoid default pricing or in considering future costs of their choices goes far beyond what the evidence will support.[57] Behavioral economists have made many intriguing findings, including hyperbolic discounting, on the basis of laboratory experiments. These findings are simply not sufficient to support specific policy interventions, and are certainly not sufficient to support a prohibition on default pricing. Key findings are based on experimental evidence of uncertain applicability to real world markets. They do not in general take into account the nature of market equilibrium, and the constraints it imposes on both buyers and sellers. There is little or no evidence about the costs and benefits of particular interventions, including those the agencies are proposing here.[58] As a result, behavioral economists have generally avoided making strong policy recommendations on the basis of their findings. That was also the conclusion of the FTC's recent conference on behavioral economics.[59] Taking the behavioral arguments to their logical conclusion, however, would allow the agencies to regulate any aspect of credit choices in the market.

The fact that consumers make mistakes, as behavioral economists find, or make irrational decisions at times, does not mean that mistakes or irrational decisions are not reasonably avoidable. Consumers can make reasonable choices even if they don't always do so. There is simply no evidence that mistakes are consistent enough or frequent enough to impair market performance. That, however, is the touchstone of reasonable avoidance.

B. The Specific Rationales For Restricting Default Pricing as a Result Of Behavior on a Particular Account Are Without Merit.

The agencies offer specific rationales for restricting default pricing based on other commonly used criteria. In particular, they argue that consumers cannot avoid exceeding credit limit even if they track their expenditures, because of delay in replenishing credit limits after the consumer makes a payment. It is straightforward to argue that delay in crediting payments and adjusting available credit accordingly is itself an unfair practice, and the FTC has done so.[60] The remedy, however, is to require prompt crediting of payments, not to restrict default pricing in

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[57] Although the agencies cite the FTC's conclusion that consumers concentrate their search on terms such as the interest rate rather than terms that are only relevant in the event of default, the agencies would restrict remedies of far more frequent applicability than those the FTC considered. As noted above, for example, one third and perhaps more credit card holders incur late fees in a given year. This is not the same kind of "unlikely" event as the use of a wage assignment or seizure of household goods that consumers might discount.
[58] *See* J. Howard Beales III, *Consumer Protection and Behavioral Economics: To BE or Not to BE?* 4 Competition Policy International 149 (2008).
[59] *See* the discussion in J. P. Mulholland, *Summary Report on the FTC Behavioral Economics Conference* (available at http://www.ftc.gov/be/consumerbehavior/docs/070914mulhollandrpt.pdf),
[60] *See U.S. v. Fairbanks Capital Corp. et al*, No. 03-12219-DPW (D. Mass. 2003) (failure to post payments promptly challenged as an unfair practice).

circumstances where consumers have actually exceeded their credit limits. Moreover, it seems reasonable to expect that consumers who are near their limit could inquire if they are uncertain about whether they have sufficient credit remaining to complete a transaction.

Finally, the agencies assert that bad behavior is avoidable sometimes, but not as a general matter. They cite no support for this proposition. In fact, however, most consumers most of the time *do* avoid the injury that results from late payments and bounced checks. The agencies' conclusion is almost the opposite of reality. It is true that some mistakes are inevitable, but there is simply no basis for concluding that they occur with sufficient frequency to impair competitive market performance.

In essence, the agencies' approach reads "reasonably" out of the statutory requirement that the injury is not "reasonably avoidable" by consumers. Numerous areas of the law require that parties act reasonably, with full recognition that even reasonable actions will not eliminate all bad consequences.[61] It is not reasonable for consumers to skip payments or bounce checks, even though such mistakes will inevitably occur. When mistakes occur, the consequences are not avoidable. But the statutory test is whether the mistakes are *reasonably* avoidable, and these mistakes are.

If the agencies really believe that the actions on a particular account (such as late payments or refused payments) that lead to default pricing repricing are unavoidable, the only rational thing for creditors to do would be to cut consumers off completely when such behaviors occur. Moreover, regulators should require that they do so, on safety and soundness grounds. More such behavior, after all, is inevitable and unavoidable. In fact, however, such behaviors are reasonably avoidable, and most consumers in fact avoid them. When mistakes occur, the evidence is clear that consumers learn from their mistakes, and adjust their behavior to avoid them in the future.

## VI. The Proposed Rule Would Restrict Practices With Substantial Offsetting Benefits To Consumers And Competition.

### A. Risk Management Is at the Heart of Repricing Decisions

Separating consumers based on the risk of default and pricing accordingly is efficient. Risk based pricing reduces the costs of borrowing for consumers who are good risks, an obvious

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[61] Under the prohibition on "deceptive" practices in Section 5 of the FTC Act, the Commission has recognized that a representation is only deceptive if it is likely to mislead consumers "acting reasonably in the circumstances." The Commission has explicitly recognized that the mere fact that some consumers are misled is not sufficient. It noted: "Some people, because of ignorance or incomprehension, may be misled by even a scrupulously honest claim. Perhaps a few misguided souls believe, for example, that all 'Danish pastry' is made in Denmark. Is it therefore an actionable deception to advertise 'Danish pastry' when it is made in this country.? Of course not. A representation does not become 'false and deceptive' merely because it will be unreasonably misunderstood by an insignificant and unrepresentative segment of the class of persons to whom the representation is addressed." *Heinz W. Kirchner*, 63 F.T.C. 1282, 1290 (1963). Rather, "the test is whether the consumer's interpretation or reaction is reasonable." FTC Policy Statement on Deception, Appended to *Cliffdale Associates, Inc.*, 103 F.T.C. 110, 174 (1984), at note 20. Just as isolated misinterpretations do not constitute actionable deception, isolated mistakes are not sufficient to find unfairness.

benefit to those consumers. And, as discussed above, the emergence of risk based pricing has resulted in substantial declines in interest rates for most consumers. The GAO noted that for six major issuers, 80 percent of their cardholders paid interest rates below the 20 percent rate that prevailed before the 1990s, and more than 40 percent paid rates of 15 percent or lower.[62] Risk based pricing has also made credit more available for consumers such as immigrants, lower income consumers, and those with little or no credit experience, who pose greater risks, but those consumers must pay for the risks they impose.[63] In contrast, pooling risk requires lower risk consumers to subsidize those who pose greater risks. It also requires low risk consumers to subsidize those who engage in avoidable bad behavior.

Risk measurements before credit is granted are imperfect. They are based principally on the information available in credit reports at the time the decision to extend credit is made. Although risk measurements substantially reduce the risk of default,[64] the information upon which they are based is subject to change. Moreover, additional information from the consumer's behavior with a particular account allows more accurate separation of different risk categories.

Because default pricing based on new information about the consumer's use of a particular account results in interest rates that more accurately reflect risk, it results in precisely the same benefits as risk based pricing at the time of the initial decision. Incorporating additional information into the pricing decision allows prices to more closely reflect risk. Thus, contrary to the agencies' assertion that "upfront annual percentage rates that are artificially reduced based on the expectation of future increases do not represent a true benefit to consumers as a whole," default pricing based on new information benefits all consumers. Everyone gets a lower interest rate initially, and enjoys that rate for as long as their choices continue to support the initial decision about the risks they posed. Even in the unlikely event that consumers plan to make a late payment or bounce a check eventually, there is a benefit in a lower initial rate that persists for some period of time.

There may, of course, be consumer education issues that surround risk based pricing. Some consumers may not know as much as they should about how their behavior affects their credit terms. The solution, however, is consumer education, not restrictions on efficient pricing mechanisms that offer benefits for all.

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[62] GAO Report, *supra* note 36 at 5.

[63] The benefits of risk based pricing have been widely acknowledged, including by the agencies themselves. *See* Testimony by Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, April 30, 2003, House Committee on Financial Services. *See also* Prepared Statement of the Federal Trade Commission on the Fair Credit Reporting Act, House Committee on Financial Services, July 9, 2003.

[64] Some commentators suggest that using credit scores built with data supplied by credit bureaus results in delinquency rates 20-30 percent lower than lending decisions based solely on judgmental evaluation of applications for credit. *See* Peter McCorkell, "The Impact of Credit Scoring and Automated Underwriting on Credit Availability," in Thomas A. Durkin and Michael E. Staten, eds., *The Impact of Public Policy on Consumer Credit (*2002).

B. Restricting Repricing for Risk Will Likely Increase Defaults

Even if default is not entirely avoidable, it is clear that consumers can do many things that will increase risk. Creditors need the ability to reprice accounts to reflect increases in risk. The agencies recognize this fact in their treatment of payments that are 30 days late. As the proposal notes, "even when the delinquency was not reasonably avoidable, it appears that the harm in such cases is outweighed by the benefit to consumers as a whole (in the form of lower annual percentage rates and broader access to credit) from allowing institutions to reprice for risk once a consumer has become significantly delinquent."[65]

This is an entirely empirical question. There is little doubt that the longer the delinquency, the greater the risk of eventual default. The crucial question is how much risk changes with increasingly late payments. The agencies have apparently concluded that the benefits of repricing exceed the costs after 30 days, but they offer no evidence that would allow them to say that repricing when a payment is 5 or 10 days late does not have benefits exceeding costs. Indeed, the agencies make no attempt to quantify either the increase in risk or the likely changes in defaults from alternative treatments of late payments. Both are essential to assessing offsetting benefits.

In fact, the agencies are simply substituting their judgment for the competitive process of risk assessment and risk management.[66] Issuers have strong incentives to assess and mange risk as well as possible. It is their money that is at stake. Moreover, better risk assessment allows issuers to compete for borrowers they might otherwise reject, or retain customers they might otherwise lose to a competing offer. There is no reason to think that the agencies' judgment that drawing the line at 30 days late is correct, and every reason to think that issuers have the proper incentives to draw the line efficiently.[67]

C. The offsetting benefits of repricing exceed any "injury" to consumers.

Although most issuers retain the ability to reprice based on new information, the vast majority of consumers are not repriced.[68] Thus, restrictions on repricing will increase interest rates for the vast majority of consumers. In a competitive market, the loss of revenue from issuers' reduced ability to reprice high risk consumers (or from delay in doing so) will increase interest rates to cover costs of default that are now recovered through repricing. This increase in interest rates is a pure transfer, from low risk consumers to higher risk consumers who engage in "bad" behavior. If there is no change in consumer behavior, the offsetting benefits would precisely equal the "injury." The only effect would be a cross subsidy, from low risk consumers

[65] 73 Fed. Reg. 28919.
[66] Moreover, there is no particular reason to assume that the relationship between risk and the length of delinquency is the same for every issuer and every product. Just as different creditors find that different risk scoring models work best for them, they may find that different default pricing policies are appropriate.
[67] Given the lack of data and the possible variation from portfolio to portfolio, if the agencies believe they must proceed they should provide issuers with as much flexibility as possible to address late payments. For example, the agencies might specify a reasonable approach to analyzing the risk and allow issuers to act based on that analysis. Similarly, they might allow shorter periods for creditors who make enhanced efforts to inform consumers of both the time and the consequences of failure to make the payment.
[68] GAO Report, *supra* note 36 at 13.

to those who are higher risk, imposed by regulatory decree. The consistent competitive pressure in the market has been to eliminate such cross subsidies, giving low risk consumers the terms they deserve and imposing costs on those who create them.

Consumer behavior, however, is unlikely to remain unchanged. Reducing the costs of engaging in bad behavior is likely to increase the frequency of those behaviors. *Any* increase in default behavior – more late payments, more payments with insufficient funds – represents a net cost to consumers as a whole. Although there is little evidence about the precise magnitude of the increase in default behavior, it seems undeniable that there will be some increase. Thus, in the aggregate, offsetting benefits of default pricing necessarily exceed the injury to consumers.

Moreover, issuer behavior is not likely to remain constant either. Instead, issuers will likely seek to minimize losses by tightening the criteria for granting credit initially. Thus, some consumers who now get credit will not, including some who are in fact good risks but will not get the chance to prove it. Again, these reductions in credit availability constitute a net loss to consumers as a whole.

Reduced ability to reprice may adversely affect consumers in other ways. In particular, it may lead to more aggressive management of credit limits. Adjusting credit limits (or rejecting overlimit transactions that would otherwise be approved) is an alternative risk management tool. With less ability to manage risk by changing the price, issuers are likely to make more intensive use of other available tools.

More aggressive credit limit management will likely result in significant costs for the intended beneficiaries of the rule. Consumers are likely to incur additional overlimit fees when credit limits change. Moreover, they will face an increased likelihood that transactions will be declined.

Finally, the interplay between the proposed payment allocation rule and the repricing rule will create additional costs for consumers. The agencies recognize that once notice is given, a higher interest rate should apply immediately to new transactions. The proposed payment allocation rules, however, prevent issuers from allocating payments to pay off the old balance first, even though it is at a rate that does not reflect risk appropriately. The effect is to require low risk borrowers to subsidize higher risk borrowers for an extended period of time while the existing balance is paid off.

None of the (dubious) rationales for the payment allocation restrictions are relevant in the context of repricing decisions. Thus, the agencies should permit issuers to allocate payments entirely to the balance that was outstanding at the time the default rate was imposed, until that balance is paid in full.

## VII. Conclusion

It is at least plausible to argue that some forms of default pricing cannot be disclosed with sufficient clarity to enable consumers to reasonably avoid the consequences of repricing. The most plausible case is repricing for behavior that is permitted under the terms of the account, such as being near, but not over the credit limit, or making only the minimum payment for several months in a row. Repricing in such circumstances is very much akin to unfair unilateral modification of contract terms even if it is permitted under the literal terms of the contract, because it takes back part of the benefit (the ability to borrow up to the credit limit and to make only the minimum payment) that was the basis of the original bargain. As discussed above, issuers cannot use their ability to modify terms to "'recapture opportunities foregone' when the contract was entered into."[69]

These arguments, however, do not apply to default pricing of existing balances, for violations of clearly disclosed and easily understandable contractual conditions. Such repricing is simply not an unfair practice. Specified penalties for clearly stated and easily understandable violations of the specific terms of an account are not an "injury" in any meaningful sense; they are the agreed-upon consequences of a choice that the consumer made. In this context, there is no rational basis for distinguishing between penalties imposed in the form of fees and those imposed in the form of a change in the interest rate. Such penalties are reasonably avoidable, because consumers can choose different behaviors. They can, in short, pay their accounts on time. They can also choose different forms of credit (e.g., closed end credit) or different contract terms. Moreover, repricing existing balances in these circumstances provides offsetting benefits to consumers and competition that outweigh any injury, because initial interest rates are lower for all, and enjoyed by the vast majority for as long as they use the card.

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[69] Badie v. Bank of America, 67 Cal. App. 4th 779, 796 (Court of Appeal of California, First Appellate District, 1998) (citations omitted).