DISCOVER
BANK

August 4, 2008

Via E-Mail (regs.comments@federalreserve.gov)

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

Re: Docket No. R-1314

Dear Ms. Johnson:

Discover Bank ("Discover") submits these comments in response to the Board's proposal to amend Regulation AA to address certain credit card practices ("Proposed Rule"). As one of the nation's largest issuers of consumer credit cards, Discover is vitally interested in the requirements pertaining to the marketing, issuance and pricing of credit cards, some of which would significantly impact both our bank and the millions of consumers we serve. As we have stated in earlier comment letters and in testimony before Congress, we support addressing these practices through the regulatory process, and are pleased that the Board is doing so.

Together with the Regulation Z proposal, the Proposed Rule would make multiple and far reaching modifications to credit card practices and disclosure requirements that constitute the most important regulatory proposals in more than three decades. Most of these proposals would not significantly impact Discover because they address practices in which we are not engaged or would require changes that are generally consistent with our current practices. The comments below focus on those elements of the Proposed Rule that we believe are contrary to the best interests of consumers: restrictions on changing interest rates on outstanding balances and changes to payment allocation practices. We also comment on the proposal to prohibit the two-cycle method of computing account balances as an unfair practice, and proposed changes in credit card statement mailing dates.

Discover has submitted comments on the Board's Regulation Z proposals. We urge the Board to ensure that both the Regulation Z requirements, and those that are promulgated in this proceeding, are consistently applied and aligned.

I. General

In the early 1960s, credit cards began evolving from convenience devices used primarily by business users in major cities for travel and entertainment expenses to cards used by consumers for everyday purchases from broader categories of merchants. The unique features of the credit card - ongoing access to an uncollateralized credit line that can be increased, and the ability to pay the full balance without interest, or pay down a loan balance over time, with interest - were popular with consumers. These features spurred the rapid growth of consumer credit cards. The emergence of automated credit reporting facilitated the underwriting of credit card loans based on the objective information about the creditworthiness of individual applicants, and enabled financial institutions to offer cards to individuals with whom they did not have a preexisting relationship.

Early consumer credit cards were issued primarily by local and regional banks and looked very much alike: they charged an annual fee, had low spending limits, carried a fixed interest rate (most at 18.9%), and did not offer rewards or other features. Competition and innovation by nationwide issuers changed the product and broadened its acceptance. Discover Card entered the market in 1986 with a no annual fee card that offered rewards (Cashback Bonus), and 24/7 customer service, features that soon became popular. Today, credit cards are widely held by consumers across the economic spectrum, annual fees are rare, interest rates have come down, payments have become easy to make, and a wide variety of reward programs and card features exist.

The evolving regulatory regime for credit cards, a combination of state and federal requirements, has facilitated competition and consumer access to credit. Some attribute the growth in consumer acceptance of the product to the federal limitation on consumers' liability for unauthorized transactions. The Truth in Lending Act and other portions of the Consumer Credit Protection Act have brought about standardized disclosures, uniform rules for billing error resolution, adverse action procedures , and changes to many other aspects of the issuer-consumer relationship. State laws have played an important role as well, as exemplified by the Delaware and South Dakota protections for consumers when the terms of credit card agreements are changed.

The provisions of the Proposed Rule discussed in this letter would abruptly change the regulatory landscape, prohibiting practices that are both commonplace and beneficial. These changes will have unintended adverse consequences for consumers and the economy, and if made under the Board's authority to regulate unfair or deceptive practices, will expose issuers unnecessarily to litigation risk. Each of the proposed changes could be made under the Truth in Lending Act, a statute enacted for the stated purposes of both improving consumers' understanding of credit terms and protecting the consumer against "inaccurate and unfair credit card billing and credit card practices" (15 U.S.C. 1601). Addressing the practices through the Federal Trade Commission Act ("FTC Act") requires an awkward construction of that law in order to characterize as "unfair" longstanding industry practices. Some of these are expressly authorized by law, and have been engaged in with the approval, if not the expectation[1], of regulators. To the extent that some practices are proscribed under the Board's Unfair or Deceptive Act and Practices ("UDAP") authority, a more targeted approach is needed than has been proposed.

[1] For example, the Interagency Account Management Guidance notes that regulators "expect" credit card issuing banks to "actively manage profitability" and provides an example of how this expectation can be achieved: "some issuers use risk-based pricing where they change interest rates and fees based on changes in the status of the account or the cardholder's credit profile." Compliance with this Guidance would be deemed an "unfair" practice under the Proposed Rule.

II. Impact on Economy

Higher costs and reduced credit availability for consumers. As the Board well knows, the proposals are being made at a time when American consumers are facing strong economic challenges. Rising unemployment rates, food prices and energy costs have left many people in need of the open-end credit provided by the credit card industry. Many of them are finding it difficult to gain access to financial assistance products such as mortgages, home equity loans, auto loans and leases, and student loans. Unfortunately, the adoption of the repricing and payment allocation provisions of the Proposed Rule may well cause consumers to experience difficulty in obtaining affordable credit card products, higher interest rates for new credit card accounts, and a loss of attractive money-saving balance transfer and debt consolidation loans. Offers of credit assistance to distressed customers may become less available and reward offerings reduced. Together, these changes are likely to result in a decrease in consumer spending, on both necessary and discretionary purchases, a particularly unwanted outcome in the present economic cycle. In some cases, consumers unable to obtain low-cost credit from mainstream regulated institutions may turn to higher-cost loans (e.g., auto title, payday), further reducing consumer liquidity and economic activity.

Impact on Credit Card Asset-Backed Securities ("ABS") Market. The sale of ABS provides an important, flexible, and diversified source of funding for credit card lending that complements deposit-based funding. There has been a major disruption in credit card ABS markets over the past 18 months as origination and trading have become difficult, and the market remains fragile. The enactment of the Proposed Rule is likely to exacerbate these challenging circumstances, as investors react to the proposed restrictions, particularly on issuers' ability to manage customer defaults through interest rate adjustments.

Investors in securities backed by credit card receivables have expectations about the strength of the underlying card loans and on issuer's obligation to stand behind those assets. They are well aware of the existing ability of issuers to change interest rates on balances in response to changes in risk.[2] Loss of this tool will increase the risk to the asset pool underlying the securities, and negatively affect the prices investors are willing to pay for the securities. Reduction in investor confidence will adversely affect both the ability to fund future loans and the value of the securities that have already been issued. Ultimately, these costs will be passed along to consumers through increased costs of credit and the reduction in available credit.

III. Specific Comments

A. <u>The Board Should Refrain from Addressing These Card Practices Under its UDAP Authority</u>

Meaningful regulatory change does not require characterizing existing credit card practices as "unfair" or "deceptive." The Board has ample authority to modify or prohibit existing practices under the Truth in Lending Act through changes to Regulation Z, and in the

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[2] See "US Credit Card ABS Rating Criteria" (Fitch Ratings, March 10, 2008).

past has relied on that authority to proscribe practices similar, or identical to, those covered by the Proposed Rule. We note that more than 150 Members of Congress have cosponsored legislation (H.R. 5244) that addresses the very practices covered by the Proposed Rule - with the same substantive requirements as the proposal - but does so by amending the Truth in Lending Act. The House Financial Services Committee approved an amended version of this bill on July 31, 2008. Action taken by the Board should proceed under the same authority.

Characterizing the practices addressed under the Proposed Rule as "unfair" or "deceptive" would require a misapplication of the FTC Act standard. Shoehorning these practices into FTC Act violations requires supposition and hypotheses about their effect, rather than information about the actual consumer impact of the practices, or lack thereof, and the likely countervailing benefits. The result is a loose standard that could be utilized to prohibit virtually any credit card practice that imposes a cost on consumers, from compounding of interest to the charging of fees.

In addition to creating legal uncertainty about the meaning of an "unfair" or "deceptive" act or practice under the FTC Act as applied to financial institutions, the Proposed Rule creates uncertainty about whether current and accepted practices have always been unfair or deceptive or will become so only after the effective date of the rule. Even if the Board and other financial regulators proclaim that a rule prohibiting newly-defined "unfair" practices is prospective only (as we would urge them to do[3]), private litigants and others might not agree, and the risk of state court action would remain.

Under the FTC Act, a practice is unfair or deceptive if it causes *substantial injury*, that is not be *outweighed by countervailing benefits to consumers or competition*, and that consumers could *not reasonably have avoided*. (15 U.S.C. Sec. 45n). The FTC Act also provides that in determining whether an act or practice is unfair, "the Commission may consider established public policies as evidence to be considered with all other evidence." In considering whether a practice "offends public policy" the FTC has historically looked at whether the practice is contrary to policies expressed in "statutes, the common law or otherwise."[4] The Interagency UDAP Guidance follows a similar practice:

> *"Public policy, as established by statute, regulation, or judicial decisions, may be considered with all other evidence in determining whether an act or practice is unfair…. [T]he fact that a particular practice is affirmatively allowed by statute may be considered as evidence that the practice is not unfair."* [5]

The Analysis of the Proposed Rule does not appear to have considered the public policy evidence that certain practices addressed by the proposal are not unfair because they are

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[3] We would also urge the Board to assert that any state or federal regulatory or judicial authorities' action inconsistent with the prospective application of these rules would circumvent the Board's intent.

[4] FTC Statement of Basis and Purpose for cigarette labeling rule, 29 Fed. Reg. 8324, 8325 (1964). See FTC v. Sperry & Hutchinson Co., 405 U.S. at 224 (1972).

[5] Interagency Guidance (March 2, 2004) p.4.

specifically permitted under state law (e.g., change of terms requirements) or Regulation Z (e.g., two-cycle computation method). Such practices are clearly *consistent* with public policy, not contrary to it, and accordingly are not "unfair."

Moreover, the Analysis of the Proposed Rule focuses principally on the "injury" element of the unfairness test, while failing to adequately assess - and in some cases flatly dismissing - the other components: countervailing benefits and reasonable avoidability. These are no less important. For example, the FTC has noted that:

> *"If consumers could reasonably have made a different choice, but did not, the practice is not unfair under the statute."* (FTC Policy Statement on Unfairness 104 F.T.C. 949, at 1073).

Almost any credit card practice could be found to be "unfair" if the only test were additional cost: paying compound interest is more costly than paying simple interest; paying a late fee is more costly than not paying one. All of these costs can be readily avoided, so the practices cannot properly be characterized as unfair. The practices affected by the Proposed Rule are similar: they might result in additional cost for an individual, but consumers can avoid them with little effort. Moreover, consumers as a whole benefit from them. Thus, the practices do not meet the FTC Act's "unfairness" standard. For instance, consumers can avoid interest rate increases based on default by paying the minimum payment by the payment due date. Consumers can avoid extra costs associated with certain payment allocation practices by not accepting promotional offers that use those methods or by not carrying multiple balances if they accept a low- annual percentage rage ("APR") promotional offer (a common practice). Consumers can avoid risk-based APR increases on current account balances by avoiding behavior that is associated with risk (e.g., failing to pay bills), or by "opting out" after receiving a change of terms notice that the interest rate on their balance will change.

Similarly, the Analysis dismisses the possibility that the practices that it deems "unfair" have any countervailing benefits. As discussed below, some practices that might not appear to have benefits for an individual borrower in the short term (e.g., increasing the APR on an existing account balance) might actually result in changes in behavior that, over time, bring benefits such as reduced credit costs. Consumers often respond to penalty fees or penalty repricing by changing their card usage behavior: reduce spending, make larger payments, pay down the account balance or transfer the account balance to another card. Discover customers whose APRs are increased because of payment defaults automatically qualify for lower APRs if they make nine consecutive on-time payments. Over time, these actions reduce borrowing costs and improve the individual's credit profile - results that offset the temporary costs ("injury") that the consumer's earlier behavior triggered.

The ability to adjust the APRs on existing balances for riskier customers also has a significant benefit for other, lower risk consumers, because it allows issuers to reward them with greater access to credit, lower interest rates, higher credit lines, and richer rewards. The Proposed Rule focuses on the impact of this practice on the small percentage of consumers who are affected by it, without adequately considering the benefits to the vast majority of consumers. Finding a practice unfair because of its short-term impact on an individual consumer is like characterizing a speeding ticket as unfair because of its cost, without considering its impact on future driving behavior and the safety of other drivers.

Alternative to Use of UDAP Authority. Regulation of all of the practices addressed by the Proposed Rule can be accomplished under the Truth in Lending Act. This is consistent with the authority that would be used by legislation currently being considered in Congress. It will ensure that the standards apply to all creditors subject to that Act, not just financial institutions, and will remove uncertainties about inconsistent enforcement, retroactive application and litigation risk.

B. Adjusting Interest Rates on Existing Balances. (12 C.F.R. §227.24)

The Proposed Rule would prohibit issuers from increasing the APR on the outstanding balance of a consumer credit card account, except under limited circumstances - expiration of a promotional APR offered to that accountholder, payment default by the accountholder, and the increase in APR in a variable rate card due to an increase in underlying interest rates. This removes a critical tool for managing the risk of an open-ended lending product. Prior to the use of risk-based pricing, issuers charged higher initial rates to all consumers regardless of risk profile and limited offerings to only the most creditworthy consumers. Today, sophisticated risk models permits adjustments over the life of the account based on information about how the borrower uses credit and on changes in the outstanding loan balance. This affords issuers the ability to offer more consumers access to credit with lower initial rates. In many cases the consumer's risk profile remains relatively unchanged, so changes in the APR are not needed. If the borrower's initial risk profile improves, lower APRs, higher credit lines, promotional offers and other benefits can be offered. When there is deterioration in a customer's creditworthiness, however, an APR adjustment may be made. At Discover, this has been used selectively when risk had significantly increased: customers in this category who were repriced were four times more likely to default on their loan than when their account was opened.

Discover does not Use "Universal Default". Default with another issuer is not used by Discover as the basis for increasing a customer's APR, and APRs are not automatically adjusted to reflect deterioration in a borrower's creditworthiness or risk scores. Changes in consumer credit behavior occur regularly, but account balance repricing is rare, and most Discover customers never experience it. From time to time, however, amendments are made to the APR provisions of a small percentage of our accounts. Statistically sound empirically-derived data is used to identify customers who have become less likely to repay their current loan balance, i.e. are higher risk because the underwriting assumptions used when the credit was extended have changed. For these targeted accounts, the APR established under the outdated information is adjusted accordingly. Affected customers are notified of the change 45 days in advance, and given the opportunity to close their account and pay down the balance at the prior APR. Many Discover cardholders are longtime users (30% have had their Discover account for more than 15 years), who have the ongoing ability to obtain new credit, perhaps with higher credit lines, so the ability to make these adjustments over time is important.

Internal risk modeling allows us to compare credit-relevant characteristics and payment behavior of a Discover customer with those of other Discover cardholders who share similar characteristics. When combined with external information about how the customer uses credit extended by others (total indebtedness, payment activity, credit line utilization, credit applications, etc.) this information is highly predictive of the probability of default or charge off of that account. For example, we can predict with a high degree of accuracy the probability that a customer with a given risk score will cease making payments within a specific number of months.

The Proposed Rule would prohibit use of this information to change the APR on the account balance. It permits an issuer to adjust the APRs in the event of an *actual* default on the account with the issuer (i.e., after the consumer has missed two payments), but not on the basis of information predictive of *likely* default. The Analysis does not suggest that such information is not reliable or predictive. To the contrary, the Proposed Rule effectively acknowledges the utility of such data by allowing its use in deciding whether to extend credit, in setting credit limits throughout the life of an account, and in changing the APR applicable to future transactions. The proposed restriction on utilizing demonstrably-predictive "off us" signs of risk is akin to making it an unfair practice for automobile insurers to raise premiums on drivers who accumulate speeding tickets or DWI convictions, and allowing adjustments only if the driver files an accident claim or stops paying premiums.

Impact on New Customers. Implementation of the Proposed Rule would have the unintended consequence of increasing the cost of credit to most consumers, and reducing the availability of affordable credit particularly to less affluent applicants. If issuers no longer have the ability to increase rates on existing balances due to a consumer's deteriorating risk profile, the response will include screening out higher risk borrowers at the outset through more stringent approval criteria, and offering higher interest rates to new customers. We estimate that about ten percent of Discover applicants who would be approved under current criteria would be declined if the proposed repricing prohibition is implemented. It is likely that *all* newly approved accounts would be offered higher interest rates than would be offered in the absence of the regulatory prohibition. We estimate that APRs on new accounts would also have to be increased by approximately 20 percent above current APRs.

Impact on Existing Customers. The ability to reduce or freeze credit lines (not affected by the Proposed Rule) is useful to prevent customers who show signs of risk from increasing the amount of indebtedness, but does not address the increased charge off risk on outstanding balances. (Indeed, it may be inconsistent with collecting outstanding indebtedness, because distressed consumers may be less likely to make payments on cards they can no longer use). Reducing the default risk on outstanding balances will have to be managed through a combination of other responses, some implemented immediately, and others when cards expire. These include higher interest rates for accountholders, a reduction in fixed-rate cards, lower credit lines, and shorter card expiration dates (to reduce the accumulation of account balances at APRs that cannot be changed). Making these changes will conflict with the industry's ability to expand access to affordable credit and offer lower prices to consumers who maintain good credit.

Advance Notifications Allows Consumers to Avoid Impact. Changing the interest rate on an account balance based on changes in a consumer's risk profile is not an "unfair practice" when the consumer is notified in advance of the change and provided an opportunity to avoid it, and pay down the account balance at the prior APR. As noted previously, this practice is consistent with state law and has been used by issuers with the knowledge and approval of regulators. The Interagency Account Management Guidance sanctions this practice. Indeed, the Office of the Comptroller of the Currency has warned that depriving card issuing banks of the ability to change the APR on an outstanding balance would "significantly restrict a credit card lender's ability to manage and price for credit risk." The OCC has "substantial supervisory concerns about the effect [such prohibition] would have on prudent risk management practices."[6]

Alternatives to Prohibition. Should the Board determine to impose a restriction on the ability to change APRs on current balances at any time, we urge the Board to preserve the ability to make adjustments in limited circumstances, and not just when an account is 30 days delinquent. The rule should permit APR adjustments based on material changes in customer risk or in market conditions (e.g., changes in the cost of funds). Affected consumers would be offered an opportunity 45 days before the change is made to "opt out" of the increase and pay down the account balance at the prior rate. This process assures that consumers can "reasonably avoid" the increase as contemplated under the "unfairness" test. The Analysis is skeptical of the utility of an opt out notice, suggesting for example that consumers do not receive or understand the notices required under Delaware and other state laws. This concern could be addressed through the use of enhanced and multiple notices: e.g., conspicuous advance notification provided both in separate mailings and on periodic billing statements.

The concern that consumers may find it difficult to exercise their opt out right could be addressed by requiring that issuers provide alternate communication channels (e.g., mail, internet, telephone).

C. <u>APR Changes Based on Customer Default</u>. (12 C.F.R. §227.24)

The Proposed Rule recognizes that when a consumer has violated the account terms, application of an increased rate to an existing balance is a permissible response. We agree. However, we are seriously concerned by the proposal to limit "default" to a single circumstance: a payment that is more than 30 days late.

Defaults that occur earlier than 30 days are predictive of increased risk. Indeed, even accounts on which payment is received a day or two after the payment date are more likely to go into charge-off than those paid on time. A Discover account on which the payment is 5 days overdue is 2 1/2 times more likely to charge off than an account paid on time. Other consumer behaviors are also associated with increased risk. For example, Discover customers whose accounts are over limit, but who have not missed payments, are many times more likely to go into default than customers who have not exceed their credit limit.

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[6] Testimony of Julie Williams, Chief Counsel and Senior Deputy Comptroller, Office of the Comptroller of the Currency, before House Financial Services Subcommittee on Financial Institutions and Consumer Credit, April 17, 2008.

A 30-day delinquency, the only default "trigger" permitted under the Proposed Rule, means that the borrower has missed two payments. *Accounts held by Discover customers who are 30 days late on their account payments are four times more likely than those with current accounts to charge off. More than half of the Discover accounts that are 30 days past due charge off within 12 months*. While the Proposed Rule allows APRs on such accounts to be increased, raising the APR on an account balance that has a more than a 50% chance of never being paid makes no sense: it is highly unlikely to motivate payments and simply increases the dollar balance of an uncollectible debt. In fact, Discover customers whose accounts have reached this stage of delinquency are likely to be offered relief in the form of APR reductions and fee waivers, rather than being subjected to a default-based APR increase.

Prohibiting APR adjustments at earlier stages of delinquency will impede and delay appropriate responses to consumers who pose a higher risk of default. Currently, Discover provides prior notice to customers that their APR may be increased if payments are missed. The disclosure explains that the account APR can be increased to a maximum default APR, but that the percentage increase will depend on their current APR, payment history on the account, and payment history with other lenders.

Rather than using an automatic or one-size-fits-all approach, or increasing the APR on all accounts in default to the maximum default APR, Discover's flexible approach to payment defaults is tailored to individual customers' circumstances. Two-thirds of delinquent Discover accounts are *not* repriced. On accounts that are repriced for default, the APR is set lower than the maximum default APR 60% of the time. First-time defaults, and defaults by customers with superior credit or minor payment delinquencies are unlikely to trigger a default APR, because experience shows that for these customers the delinquency may not be a sign of risk.

These responses are effective, and their benefits outweigh the Proposed Rule's approach of effectively rewarding higher risk customers with protection from default pricing at the expense of low risk customers. APR increases on such accounts actually can motivate changes in consumer behavior, reduce risk, prevent charge offs, and help keep APRs and fees lower. They allow customers who appear to be on the path to charging off and losing credit privileges to become customers who meet their payment responsibilities and retain access to lower cost credit. They allow low risk customers to avoid subsidizing higher-risk customers through higher interest rates or fees.

We also question the proposal to "cap" default-based APRs on promotional balances. When a customer with a promotional APR defaults, an increase beyond the "go to" APR is not unexpected. Before customers accept promotional offers, they receive full disclosure of the fact that upon default, the rate may increase to the default rate. Consumers who accept promotional offers do not expect to receive both a low APR *and* protection from the normal consequence of their default. Promotional rates are merely limited opportunities for consumers to temporarily lower their standard APR, not changes in the terms that would otherwise apply to standard rates, such as the default APR term. Promotional rates are popular among Discover customers. Those who have taken advantage of them have seen their APRs drop by an average of more than 500 basis points. If default APRs on such offers are capped, issuers will be less able to manage risk and less able to make the offers.

Alternative to 30-day default limitation. We believe that the exception for default-based APR increases should be modified to allow issuers to respond appropriately to additional default activity that is predictive of significantly higher risk, for example being in default more than once in a 12-month period, overlimit behavior, NSF charges. The proposed Regulation Z requirements for prior notification of default-based APR increases, and the requirement that the default APR be called a "penalty" rate, addresses the concern that some consumers might not be aware that the interest rate has changed as a result of their default.

D. <u>Payment Allocation Practices</u> (12 C.F.R. §227.23)

The Proposed Rule would prohibit as unfair certain payment allocation practices common in the credit card industry (e.g., applying payments to higher-APR balances first).

The allocation method used by Discover (low APR balances paid first) is consistent with the method used by other issuers and has become well understood by consumers. In contrast, the Proposed Rule would likely result in differences in practices across the industry, complex periodic statement disclosures, and consumer confusion. While justifying changes to other practices because consumers find them confusing, the Proposed Rule would implement payment allocation rules that few consumers could readily understand.

The concern that some consumers may not understand how a particular payment allocation methodology may impact the interest they pay is something that can be addressed by clear disclosure. For example, Discover currently informs customers that receiving the full benefit of a promotional offer depends on their card usage and payment activity:

> *"Q. How are my payments applied after I transfer a balance? Does this affect my actual savings?*
>
> *A. We apply payments to balances with low special/introductory APRs, such as balance transfers, prior to balances with standard APRs. This means making additional transactions or having balances with standard APRs will reduce your savings. In addition, the length of time the special balance transfer rate will apply to your account may be reduced by the amount of your payments."*

The Analysis of the Proposed Rule suggests that current payment allocation practices are unfair because they result in higher interest charges than would be incurred if issuers used other allocation methods. However, under such an analysis, any fee or finance charge an issuer assesses is susceptible to a claim of being unfair if a less costly alternative exists. Fees and finance charges an issuer assesses are simply the cost of the credit and are not "unfair" because lower ones exist. Moreover, the Analysis does not consider the extent to which the proposed change on current payment allocation methods will result in changes in the availability and terms of the offers.

Current practices allow issuers to offer money-saving promotional rates to a wide range of consumers. At Discover, 25% percent of customers took advantage of a promotional offer over the last 5 years. These offers benefit all consumers who accept them, even those who carry other balances at higher APRs, because the effective APR on their total outstanding balances is reduced.

We believe that the Proposed Rule's unfairness analysis of current payment allocation practices fails to appreciate the negative consequence of changing current practices: promotional offers will disappear or significantly change if consumers carry promotional balances at low APRs without amortizing them. If the Proposed Rule were adopted, issuers will more than likely increase the APRs on these offers, and reduce their availability and duration. Consumers will lose the ability to reduce the overall interest costs, and opportunities to consolidate balances at lower rates. Contrary to the assertion in the Analysis, the Proposed Rule will stifle, not enhance competition. Promotional offers are a competitive tool that issuers use to encourage customers to move their business from another lender. If the attractiveness of these offers is diminished, their effectiveness as a way of winning new customers will be reduced. Given the overall benefits consumers experience from promotional offers made under the current payment allocation methods, changing the permissible methods is not justified.

We disagree with the suggestion that consumers who take advantage of a promotional offer are harmed under current payment allocation practices because they are denied a grace period on new purchases. Consumers who transfer balances to take advantage of lower APR offers are often revolving the balance at higher interest rates and paying those rates on new purchases. As a result, they do not incur higher interest on new purchases after accepting the offer than they would have paid had they not taken advantage of the promotional offer. Instead, accepting the promotional offer reduced the actual interest rate paid.

In addition, the impact of current payment allocation practices can be readily avoided. Consumers are not required to carry balances at different APRs, and most do not. Consumers can choose whether or not to take advantage of a promotional offer and either enjoy the benefit of a lower effective APR, or reject the offer and continue paying the standard rates on their account. Thus, most consumers are not affected by the manner in which payments are allocated, and others can avoid the impact by not accepting promotional offers, or by accepting them and avoiding transactions that carry higher APRs.

Alternative to Payment Allocation Proposal. We believe the intent of the proposal can better be accomplished through the adoption of enhanced disclosure requirements under Regulation Z. As was demonstrated in the Board's testing of model disclosures, many consumers who have taken advantage of promotional offers already understand the effect of current payment allocation methods. Our own experience indicates that consumers understand the current payment allocation methods, and we receive few consumer inquires or complaints on this issue. It is in the consumers' best interest to work towards enhanced disclosures so that promotional offers based on existing payment allocation practices can be preserved.

Should the Board implement changes in payment allocation practices, one allocation method that should be considered is to require the minimum payment to be allocated among all balances on pro-rata basis, without regulating the allocation of payments above the minimum. This would ensure that a portion of every payment is used to amortize part of each balance, and would preserve some of the benefits of promotional offers that would be lost under the Proposed Rule.

Any changes in payment allocation practices should not apply to existing balances – loans that were underwritten and offered under different repayment and balance amortization assumptions. Other changes would also be advisable. We believe that restrictions on APR changes on existing balances may over time result in more frequent card re-issuance and forward-looking APR changes, so many more consumers will carry balances at different APRs. The rule should include tolerances so that issuers are not subject to strict liability for errors related to the application of payments. The rule should also provide that: (i) issuers are not required to allocate any payment to the disputed portion of a balance; (ii) issuers may allocate payments to billed balances before unbilled balances to ensure customers can pay their statement balances in full; and (iii) issuers have flexibility in determining how to apply payments within each balance (e.g., to fees before interest and principal, etc.).

Finally, in response to the Board's specific request for comment, Discover does not support giving individuals the ability to choose their payment allocation method, a requirement that would be difficult for issuers to implement and consumers to understand due to the operational complexity involved in changing payment allocation methods on multiple-balance accounts. We believe issuers should be afforded flexibility in determining how to allocate payments to balances on which they are not permitted to increase rates.

E. 21-day Proposed Rule for Mailed Payments. (12 C.F.R. §227.22(a))

The Proposed Rule would prohibit an issuer from treating a payment as late for any purpose (except expiration of a grace period) unless the consumer has been provided at least 21 days to make that payment. The intent is to give consumers additional time to make a payment and avoid late fees or delinquent credit reporting.

Discover agrees that consumers should be provided with a reasonable amount of time to make payments. However, we are concerned that the proposed 21-day rule identified as a safe harbor could result in unintended consequences for issuers. The current 14-day time-frame was designated by Congress under the Truth in Lending Act and approved by the Board in under Regulation Z. The 14-day time-frame has proven to be adequate to allow consumers to remit payments on time. It also affords issuers the flexibility to address operational concerns, such as changes in due dates requested by customers, statement holds to correct errors, and the small percentage of mail that is not received timely from the post office.

In determining that 21 days is the appropriate safe harbor, the Analysis surmises that 7 days are needed for a periodic statement to reach the consumer by mail, 7 days for the consumer to review the statement and make a payment, and 7 days for that payment to reach the institution by mail. However, the vast majority of mail is delivered in 2-3 days. Advances in alternative payment technology and mailing and payment processing practices further enhance the ability of Discover customers to receive their statements in time to make timely payments. Periodic statements are prepared and mailed within 2-4 days of the close of the billing cycle (or 21-28 days before the payment is due), and millions of statements are sent electronically before mailed statements are posted. Because fewer than half of payments received by Discover are made by mail, the majority of customers do not have to worry about mail delays when they make payments.

Alternative to Statement Mailing Proposal. Statement mailing issues should continue to be addressed under Regulation Z. However, if the Board determines to address this issue in Regulation AA, we urge the Board to incorporate appropriate safe harbors to account for operational exceptions and circumstances outside of an issuer's control.

F. Balance Computation (12 C.F.R. Section 227.26)

The Proposed Rule would prohibit the use of the two-cycle computation method of computing the purchase balance on which interest is assessed.

The two-cycle computation method is becoming increasingly rare in the marketplace[7] and there is no need to prohibit it. Should the Board determine otherwise, it should not brand this method as an "unfair" practice. The two-cycle computation method is expressly permitted under Regulation Z, has been widely used for more than two decades with the consent of regulators, and does not meet the unfairness standard under the FTC Act. In the past, the Board has used its authority under the Truth in Lending Act to change the computation methods permissible for credit cards, while retaining the two- cycle method. A decision to change this policy could similarly be made through an amendment to Regulation Z in accordance with prior practice

No Finding of Substantial Consumer Harm. The Proposed ban on the two-cycle computation method is based on a hypothetical assessment of how the computation *could* affect a consumer, but does not appear to be based on information about its actual impact on consumers. Without consideration of the number of individuals who actually pay additional interest under the computation, or the individual or aggregate costs of the computation, there is no factual predicate for the determination that the practice is disadvantageous to consumers, much less that it causes "substantial harm."

Reasonably Avoidable. The two-cycle computation method *can* be readily avoided by all consumers, and *is* avoided by almost all. This method is used by few issuers, and it has no impact on most of the consumers who hold cards that utilize it. Thus, most consumers avoid this

[7] Once commonly used by card issuers on all or some of their products, the two cycle method of computing account balances is becoming increasingly rare as major issuers have discontinued its use. Discover began phasing out this method in 2005, a process that is scheduled to be completed by mid-2009, and offers cards that do not use this method.

computation method by using credit cards that do not employ it, or by using cards that utilize the two-cycle computation method in such a manner as to be unaffected by it. Again, under the FTC Act, "if consumers could reasonably have made a different choice, but did not, the practice is not unfair under the statute."[8]

The Analysis discounts the possibility that concerns about the practice could be addressed through enhanced disclosures. This conclusion is based on testing of hypothetical disclosures, not those actually used by any issuer, and did not consider whether current disclosures could be improved. We note that in promulgating changes to Regulation Z, the Board's testing of balance computation method disclosures found that consumers have difficulty in understanding disclosures of *all* methods. This testing does not support singling out the two-cycle computation method as an unfair practice.

The Analysis erroneously concludes that consumers cannot avoid the two-cycle computation method because once consumers use a card, "they have no control over the methods used to calculate finance charges on their card." This after-the-fact "test" of avoidability is not the proper standard. Otherwise, it could be used to brand virtually every credit card practice as unavoidable and therefore unfair. For example, using the analysis set out in the proposal:

– imposing a late fee would be an unfair practice because once a consumer misses a payment, there is "no control" over the method by which late fees are assessed;

– compounding interest, or charging any APR above 0%, would be an unfair practice because once a consumer incurs interest by making less than the full payment on the account, there is "no control" over the interest rate or how it is computed.

In fact, every consumer has *complete* control over whether a two-cycle computation method will increase interest costs *before* it happens, because this impact is entirely dependent on how the consumer elects to use the account.

As the Analysis indicates, most consumers either "revolve" their account balance (pay less that the full balance each month, incurring interest on all transactions beginning on the transaction date) or are "convenience users" (or "transactors") who pay the full account balance each month, and incur no interest charges. At Discover, about 98% of cardholders fall into these categories. When such individuals use credit cards that employ the two-cycle computation method, they are not actually affected by it, i.e. they pay no additional interest. The two-cycle computation method affects only a narrow class of card users, individuals (predominately more affluent consumers) who ordinarily pay the full account balance each month. If such consumers change their usage pattern and begin to carry an unpaid purchase balance, interest in that cycle is calculated on the average daily balance from the date of the purchase transaction - i.e., there is no grace period. This results in additional interest in that cycle, the amount of which depends on the size of the new purchase balance, the purchase date the APR, and the amount of payments made. However, these consumers tend to have relatively small purchase balances, so the additional interest amount is typically small (e.g., $4 on a $600 balance). In most cases the additional

[8] FTC "Unfairness Policy Statement" at 1073.

interest is incurred once a year, because the consumer, in the following cycle, either continues to "revolve" a balance or once again begins paying the balance in full, and is no longer affected by the two-cycle computation method. A consumer who pays an additional $4 in interest a year (less than the postage costs of mailing monthly payments) is not the victim of a practice that inflicts "substantial harm" that could not be avoided.

Charging interest on a purchase from the transaction date is the same way that interest is computed, industry-wide, on cash advances and on balances transferred from other cards. Consumers who borrow via cash advances, and those who transfer balances from other cards, pay interest from the transaction date and receive no grace period. There is no basis for arbitrarily branding this same practice as "unfair" when it is used under the two-cycle computation method.

Countervailing Benefit. The Proposed Rule's simplistic analysis of the "unfairness" of the two-cycle computation method fails to take into account the fact that the use of the two-cycle computation method allows issuers to offer other benefits to large numbers of cardholders - including those whose usage triggers the two-cycle computation method - that outweigh the additional costs that impact some consumers. The Board once raised this very possibility in Congressional testimony on legislation that would have prohibited the use of the two-cycle computation method (and computation methods other than the average daily balance method.). Not only did the Board refrain from endorsing a legislative ban of the two-cycle computation method (on unfairness or other grounds), it actually *opposed* the legislation because of its potential unanticipated consequences:

> *"[R]egulating the balance computation area might result in restricted credit availability, the elimination of grace periods, or higher interest rates, annual fees or merchant discounts. It is uncertain, therefore, whether the benefit of having a uniform balance computation method would exceed the associated costs to consumers after such adjustments have taken place."*[9]

Senator Chris Dodd observed at the same hearing:

> *"I am not sure if it is possible to mandate a specific balance calculation method, given that the particular circumstances surrounding the timing of acquisitions and payments by a card user makes some balance calculation methods favorable to one user and unfavorable to another."* (S.Hrg. 99-951, p. 53)

The proposed rule fails to acknowledge that all consumers with credit cards that utilize the two-cycle computation method, even the small subset of users who sometimes pay additional interest under that computation method, might benefit more by its retention than its prohibition. For example, as noted previously, the two-cycle balance method impacts individuals who usually pay their account balance in full each cycle. Because these individuals pay no interest, they are particularly benefited by cards with longer grace periods, like the one offered by Discover. (If

[9] Statement of Emmett J. Rice , Member, Board of Governors of the Federal Reserve System, to Senate Banking Committee, Financial Institutions Subcommittee May 21, 1986 (S. Hrg. 99-951, p. 53).

they carry a "rewards" card like Discover Card, they also receive cash, air miles, or other rewards that may exceed the extra interest that they incur if their card usage triggers a two-cycle computation method). Thus, if card issuers react to a ban on the two-cycle computation method by reducing grace periods, that "adjustment" would negatively impact the very card users the ban is intended to assist, along with millions of others who are not affected by the two-cycle computation method.

The Analysis dismisses a consideration of such potential benefits with the unusual and unsupported conclusion that although the prohibition might result in "higher annual percentage rates or fees" for card users, it "would nevertheless benefit consumers because it would result in more transparent pricing." We question whether, given a choice, actual consumers would elect to pay more or lose benefits in exchange for "more pricing transparency." The Board does not appear to have tested this theory, or to have considered requiring issuers that utilize the two-cycle computation method to offer borrowers either more information about how to avoid extra interest or the option of switching to another computation method.

No Contravention of Public Policy. As noted previously, Section 5(n) of the FTC Act provides that in determining whether a practice is unfair, evidence of "established public policies" may be considered. There appears to have been no consideration of "public policy" in defining the two-cycle computation method as an "unfair" practice, but we think it is particularly pertinent. Section 226.5a(g) of Regulation Z authorizes the use of the two-cycle computation method. Surely a practice used and disclosed in accordance with Regulation Z is consistent with, rather than in contravention of, the Truth in Lending Act and the public policy it fosters. Thus, a public policy analysis would compel the conclusion that the use of the two-cycle computation method is a permissible practice consistent with established public policy rather than an unfair practice that is contrary to it.

*Language of Proposed Section 227.26***.** We urge the Board to consider whether the proposed language that is intended to address the two-cycle computation method actually has broader implications. While the two-cycle computation method affects only the computation of purchase balances, the restriction as proposed appears to cover balances attributable to other transactions, such as cash advances, and it appears to require grace periods for such transactions. The proposed rule would also seem to prohibit issuers from recovering interest owed on a returned payment. Any restriction should apply only to the computation of purchase balances.

Alternative to Proposed Rule. Any changes affecting the two-cycle computation method should be made through amendments to Regulation Z.

IV. Reasonable Implementation Period

Discover respectfully requests that the Board provide an implementation period of at least twenty-four months. This is needed to make the systems and operational changes that would be required under the Final Rule, to perform analysis of the impact of the Final Rule on risk management, underwriting, marketing and collection practices, and to implement changes to these practices that may be required.

V. The Board Should Engage in a More Intensive Examination of Some of the Proposed Changes

Discover is concerned that an expedited notice-and-comment process may not be adequate to provide the Board with the information it needs to evaluate some of the credit card practices discussed above, and to consider the impact of the proposed changes on issuers, consumers and the economy. A 90-day comment period (and the absence of tools that have been used in the past, such as extensive consultation with industry, an advanced notice of proposed rulemaking, and public hearings) may not allow a consideration that we think is necessary especially to the extent that the Board determines to issue rules pursuant to its authority under the Federal Trade Commission Act. As noted above, one of the required changes could cause significant stress to the industry and consumers during a difficult financial environment.

It may therefore be appropriate to bifurcate this process so that some provisions of the Proposed Rule can soon be adopted as a Final Rule, while deliberation and discussions on other, more difficult and sensitive issues can continue to ensure that the proper result is achieved. Among other things, this would allow the Board to test and validate the results of the consumer research that the staff assembled as part of the Regulation Z rulemaking and its use in this proceeding. Validation of such research includes allowing consumers familiar with the practices in question to weigh the benefits that might result from the proposed changes to those practices against higher APRs or fees and/or loss of existing benefits that might result if issuers adopt the new rules.

Conclusion

Discover appreciates the opportunity to provide the Board with comments on the Proposed Rule. The proposal would make significant changes in the current rules governing credit card practices, and would do so through standards that could impact the legality of other industry practices in the future. It is our hope that the Board will proceed cautiously, invoking its UDAP authority only where other regulatory tools cannot be used. We would be pleased to provide additional information to assist the Board as it continues to formulate its regulation.

Respectfully submitted,

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