



GEORGETOWN UNIVERSITY LAW CENTER

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

Re: Docket No. R-1314 (Reg AA)

Dear Ms. Johnson:

We are two law professors who are active in the field of consumer finance. We teach courses in payment systems, consumer protection, bankruptcy, contracts and secured lending. We have written academic articles, testified before Congress, spoken at various public forums (including conferences hosted by Federal Reserve Banks), and blogged on various credit card regulatory initiatives. We are writing to provide our comments on the Federal Reserve's proposed additions to Regulation AA.

As an initial matter, we are pleased to see the Federal Reserve Board, Office of Thrift Supervision, and National Credit Union Administration Board jointly exercising their power to define and ban unfair and deceptive acts and practices under section 5(a) of the Federal Trade Commission Act to bar certain abusive practices in the credit card industry. These reforms have been long overdue; federal regulators have largely allowed the credit card industry to run feral in recent years.

Some of the proposed reforms are quite good, notably barring retroactive application of increased APRs to existing balances, requiring issuers provide consumers with a reasonable amount of time to make a payment before the payment is considered late, prohibiting overlimit fees caused by credit holds, prohibiting double-cycle billing, and placing limitations on "fee harvester" card issuance. Nonetheless, we are concerned that the proposed regulations fail to address a number of other unfair and deceptive acts and practices that should be prohibited or limited:

- The proposed rules fail to address universal cross default. Universal cross default should be prohibited in the consumer context. Universal cross default means that a

default on a credit card, which will result in higher interest rates and/or penalty fees, can be triggered by a billing mistake or bona fide dispute between a consumer and a third-party creditor. The card issuer has no good faith duty to investigate the third-party default—it is entirely discretionary whether or not the issuer treats an alleged third-party default as a default on the credit card. What’s more, consumers have no idea what will trigger a cross-default clause because they do not know the universe of creditors reporting to credit reporting bureaus. Universal cross default is an affirmatively unfair practice in the consumer credit context and is in no wise justified by (alleged) offsetting efficiencies.

- The proposed rules fail to address unilateral term changes other than retroactive application of increased APRs to existing balances. Any time/any reason term changes have much the same effect as universal cross default: they give the issuer complete discretion as to what the terms of the account will be. Even if this cannot be retroactively applied, cardholders face significant switching costs—time, effort, potentially limited credit availability until a switch is completed, and a decreased credit score. Unilateral term changes should only be permitted upon significant notice and affirmative opt-in, a right to repay all existing balances and balances accrued within a limited prospective window under the original terms over time, and notice sent to the three major credit reporting bureaus that the consumer closed the account because the consumer rejected a unilateral change in terms.
- The proposed rules fail to ban “trailing” or “residual” interest. Trailing or residual interest is the imposition of finance charges on balances paid off on time after the closing of the previous billing cycle. To illustrate, say a cardholder is billed \$100 at the end of billing cycle 1 (assume 30-day billing cycles). The cardholder then make an \$80 payment, received on time, 10 days after the close of billing cycle 1. Then, in billing cycle 2, I charge \$50 on day 15. A finance charge is then applied to the average balance of \$71.67: the average of (1) \$100 [\$80 + \$20] for 10 days, (2) \$20 for 5 days, and (3) \$70 [\$20 + \$50] for 15 days. Thus the finance charge is on a significantly larger balance than if it were merely assessed on the average daily balance that was not timely repaid: \$45 (average of 15 days at \$20 and 15 days at \$70).

There is no reason to ban double-cycle billing, but not ban trailing interest. Both double-cycle billing and trailing interest have the same effect—consumers are assessed finance charges on balances that have been paid off on time. Even if disclosed in the fine print, this practice is affirmatively unfair and deceptive—consumers reasonably assume that finance charges will not be applied to any balance repaid during the grace period.

- The proposed rules fail to bar the application of finance charges to fees incurred in that billing cycle. When finance charges are applied to fees, it makes fees effectively larger than what is disclosed to the consumer and thus makes the disclosure deceptively low. Moreover, application of finance charges to fees incurred within the same billing cycle is unfair because the consumer has not necessarily elected to borrow those funds from the issuer. If a consumer later revolves the balance that includes fees, a finance charge would, at that point, be more reasonable. Consumers

should not be charged finance charges for balances (including fees) that are timely repaid.

- The proposed rules also fail to bar the application of finance charges from the transaction date, rather than from the posting date (when the issuer actually extends financing). Issuers should only be allowed to charge finance charges from the date on which they actually extend the money and assume the credit risk. Otherwise, the consumer is receiving financing from the merchant, and this should be treated as float for the consumer. Issuers should not be allowed to charge consumers for credit not actually advanced. Permitting issuers to include balances in average daily balances as of the transaction date artificially and unfairly inflates the average daily balance and hence the finance charge. If issuers are displeased with such a system, they would be free to develop more efficient transaction clearing.
- The proposed rules fail to institute definitions for terms like “Prime Rate” and “Fixed Rate.” Consumers should not have to worry that a card issuer is using one of these terms idiosyncratically and deceptively. What’s more, forcing consumers to analyze the fine print of credit card disclosures is affirmatively inefficient.
- The proposed rules fail to require card issuers only to lend upon suitable investigation of reasonable ability to repay in full in reasonable time period. Currently almost all credit card loans are “liar loans.” As a result, consumers frequently end up with inappropriate credit card products and irresponsible and socially costly use result. The card industry should be required to do more than stated income loans.
- The proposed rules fail to prohibit fees or cancellation for on-time payment or payment in full, or fees for non-use of a card. These types of fees are all predatory and designed to keep consumers in a debt trap. As such, they are unfair and deceptive and should be barred.
- The prohibition on overlimit fees should go much farther than just banning ones caused by credit holds. Arguably, no overlimit fees should be permitted whatsoever—if a card issuer chooses to let a cardholder exceed a credit limit—always a discretionary matter—that is a risk the issuer chose to accept, not one that the cardholder necessarily did. Cardholders rarely know the precise amount of their credit limit remaining. Even if a single cardholder is diligent about tracking available credit, if there are other authorized users on the account, such as a spouse, the cardholder may not know what other transactions have occurred until it is too late. To the extent that an overlimit transaction imposes risk, that should be covered by the interest rate, not by a flat fee with no relation to the amount of risk imposed by the overlimit transaction.

If overlimit fees are to be permitted at all, however, they should be limited to one per billing cycle. Permitting multiple overlimit fees in a cycle invites predatory behavior by issuers and bears no relation to risk-based pricing: five overlimit transactions of \$10 each pose less risk than one overlimit transaction of \$100. Also, overlimit fees should not be permitted when the limit was exceeded because of a penalty or fee.

And finally, if overlimit fees are permitted, consumers should be required to affirmatively opt-in to the ability to go overlimit.

- The proposed boilerplate disclosure safe harbor about the criteria issues use for determining APRs and credit limits is so vague as to be meaningless. The Board would do better to simply require a disclosure and permit the appropriate adjudicative bodies decide whether, in the circumstances of the case, a disclosure was so inadequate as to be unfair and deceptive. The current language provides issuers with a liability shield without ensuring that meaningful information is disclosed to the consumer.
- We also note that the limitations on fee harvester cards, while a positive step, are (1) seemingly arbitrary—we cannot determine why limiting fees to 25% of the line of credit is the appropriate amount—and (2) raises a problem of regulatory arbitrage. If the Federal Reserve, OTS, and NCUA place limits on fee harvester cards for issuers under their jurisdictions, then harvester card issuance will simply shift outside FRB/OTS/NCUA jurisdiction to finance companies and insured state banks. UDAP regulation should properly be coordinated throughout the entire consumer credit sphere, not just selected agencies.

Additionally, even within the proposed regulations, there are ambiguities that should be clarified. For example, the proposed rule would require a payment received before 5pm EDT to be treated as timely and to have payments received the day after a day on which the US Postal Service does not deliver mail treated as if received the day before. The rule should clarify that a consumer may prove on-time delivery absent USPS certification.

Likewise, the proposed rules provide that an issuer who mails a billing statement at least 21 days before it is due has given the consumer reasonable time to pay. The 21-day mailing safe harbor should be presumptive, not conclusive, and should have a good faith requirement added; an issuer could mail a billing statement 22 days ahead of time, but include a (intentionally or unintentionally) misaddressed or mis-barcoded return envelope, etc. Such an issuer should not benefit from the safe harbor. Moreover, the rule never addresses what constitutes proof of mailing. Does the issuer only gain the safe harbor if it produces a US Postal Service receipt or certification? It would seem only fair that issuers be required to meet the same burden of proof as consumers.

While we applaud the proposed regulations, to the extent that they finally address long-standing unfair and abusing practices in the credit card industry, we are concerned that they do not go far enough. We would also suggest that attempting to control unfair and deceptive acts and practices by banning specific acts and practices *cannot* be effective in the long run. Federal regulators will always be playing catch-up with an industry that is strongly incentivized to find the most profitable practices, even if they are unfair and abusive. If federal regulators are to truly limit unfair and deceptive acts and practices in the credit card industry, it will be necessary to engage in a much more substantive reconsideration of the regulatory system for credit cards; rather than emphasizing disclosure (for which there is no evidence of effectiveness in the credit card context) plus banning of certain egregious

practices, the Fed, OTS, and NCUA would do better to limit credit card issuers to a small number of fees and interest rates.

Lastly, we recognize that a major argument against regulatory intervention in the credit card market is the claim that the card industry engages in risk-based pricing, so that regulation could result in credit rationing and higher costs of credit. The card industry's assertions of risk-based pricing are bald-faced and unsupported by any data whatsoever. We would urge the FRB, OTS, and NCUA to reject the card industry's argument until and unless the industry presents independently verifiable empirical evidence that its pricing strongly correlates with individual-level risk. The public evidence available contradicts the card industry's claims—most of credit card pricing is based on (1) cost of funds, (2) overall portfolio risk, and (3) opportunity. Individual-level risk profiles are only marginally reflected in total credit card pricing; card pricing is a blunt tool, not a finely calibrated instrument. For more detail regarding risk-based pricing, we refer the Board to Professor Levitin's testimony before the House Financial Services Committee on the Credit Cardholders' Bill of Rights, which is available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/levitin031308.pdf.

We strongly urge the Federal Reserve Board to make the proposed additions to Regulation AA much more comprehensive and to address the shortcomings we have noted above.

Sincerely,

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