National Association of Federal Credit Unions
3138 10th Street North • Arlington, VA 22201-2149
(703) 522-4770 • (800) 336-4644 • Fax (703) 524-1082
NAFCU www.nafcu.org • nafcu@nafcu.org

April 14, 2010

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

RE: No. R-1384

Dear Ms. Johnson:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions (FCUs), I am responding to the Federal Reserve Board's proposed rule implementing the final two provisions of the Credit Card Accountability, Responsibility and Disclosure Act (Card Act). NAFCU is concerned with several aspects of the rule. The proposal is problematic regarding the pricing of penalty fees. Additionally, it would be burdensome to require card issuers to reevaluate accounts every six months for an indefinite period of time. Finally, there are two technical concerns with the proposal.

Reasonable and Proportional Penalty Fees

The proposal makes sweeping changes to the amount of penalty fees, the fees that may be charged, and under what circumstances the fees may be charged. NAFCU has several concerns with this portion of the rule. First, the requirements for setting penalty fees based on costs incurred by the creditor or the cost of deterrence are so burdensome that all but the largest institutions will likely adopt the safe harbor fee. Next, the rule should authorize the institution to include the cost of losses in the penalty fee for late payments. Further, the mechanism for determining the fee – for example, whether the issuer may charge the safe harbor fee or an amount equal to the violation – is unnecessarily complicated. Finally, NAFCU strongly supports authorizing institutions to tier fees.

The proposed rule outlines three ways in which an institution may determine the amount of its penalty fees. The institution may assess a fee based on the costs associated with each violation. Alternatively, the institution may set the fee based on the cost of deterring the violation. Finally, an institution may adopt a safe harbor determined by the Board as reasonable and proportional. The first two methods are unduly burdensome, particularly for smaller institutions. Consequently, the proposal will drive most institutions towards using the safe harbor fee. Certain costs associated with penalty fees are easily quantifiable. However, the most significant direct cost is the staff time required to resolve issues stemming from violations of the account terms. Staff must spend time generating legally required disclosures informing the consumer of the violation. Many credit unions call members in certain situations, particularly as payments become increasingly past due. Returned payments often create a complex unwinding of the transaction as the payment may have been credited to multiple balances with different APRs, each with its own principal and interest. Thus, institutions would need to institute a fairly complex monitoring system to determine how much time staff devotes to each violation. Most credit unions would simply not find it feasible to undertake such a detailed cost analysis.

Likewise, few if any small institutions have the resources available to conduct the sort of detailed economic analysis required to set fees based on the cost of deterrence. Certainly, an institution could contract with a vendor to provide a study that would meet the Board's standards. Nonetheless, it would be a significant added cost. Moreover, smaller institutions would be at a competitive disadvantage compared to larger institutions who could conduct such a study at little, if any, added cost. The result is that larger institutions that have the resources will be more likely to conduct the detailed analysis necessary to charge a higher fee based on costs or deterrence, while smaller institutions will likely have no viable option other than adopting the safe harbor fee.

What's more, the proposed rule would prohibit institutions from including the cost of losses in the calculation of penalty fees. The final rule should authorize institutions to include the cost of losses when assessing late fees. While it is true that a relatively small number of delinquent accounts are ultimately charged off, virtually every charged off account begins with a late payment. Thus, late payments are the single greatest indicator of financial distress. Further, the CARD Act and its associated regulations created strict prohibitions on increasing the APR on a credit card. Even in the event of a late payment, there is a significant period of time that must elapse before the institution can increase the APR. Consequently, institutions are put in a precarious position; the current APR no longer reflects the actual risk, the APR may not be increased to reflect that new risk, nor can fees be imposed to price for the new risk. Given the strict rules on increasing the APR, NAFCU believes it is vital that institutions be allowed to include at least some portion of their losses when calculating late fees.

NAFCU recommends the Board set a safe harbor fee of $30 for late fees and $20 for returned payment fees and over-the-limit fees. NAFCU does not have any recommendation on a safe harbor for declined transactions as few, if any, credit unions charge a fee for a declined transaction.

Next, the rule would limit institutions to charging the lesser of two potential fees. For example, if the institution determines the cost of processing a late fee is $20, it would still be prohibited from charging $20 for a late fee if the minimum payment due is less than that amount. Instead, the late payment fee may only equal the amount of the violation. This rule is unnecessarily complex. Institutions should be able to set a fee based on the cost of the violation, the cost of deterrence or the safe harbor without this overlapping requirement that the penalty not exceed the amount of the violation. The Board's proposal is based on new § 149 of the *Truth in Lending Act*, which directs the Board to consider the "conduct of consumers" when determining whether a fee is reasonable and proportional. The Board's decision in this regard, however, appears to be at odds with the statute.

The CARD Act directs the Board to "consider – (1) the cost incurred by the creditor from such omission or violation; (2) the deterrence of such omission or violation by the cardholder; (3) the conduct of the cardholder; and (4) such other factors as the Board may deem necessary or appropriate." Credit CARD Act, Pub. L. No. 11-024, § 102, 123 Stat. 1734, 1740 (2009). The statute certainly could be read to direct the Board to consider all four factors together in determining what constitutes a reasonable and proportional fee. Further, the statute could be read – as the Board seems to have done to some extent – to allow for a reasonable and proportional fee to be based on any one of the four factors. Instead of adopting either of these interpretations however, the Board determined that a reasonable and proportional fee can be based on the cost incurred by the creditor or the cost of deterrence. However, the conduct of cardholder is interpreted by the Board as a limiting factor that must be considered in either case. What's more, the Board also adopted the conduct of the cardholder as a limiting factor in the event the institution adopts the safe harbor, despite the fact that the safe harbor is included in a separate subsection of the CARD Act, which does not direct the Board to consider the conduct of the cardholder. Given the structure of the statute, it does not appear that Congress intended "the conduct of the cardholder" to be a limiting factor on fees in the manner proposed by the Board. Moreover, there is no indication that Congress intended the "conduct of the cardholder" to be a limiting factor on the safe harbor fee. Instead, it appears that Congress intended the Board to set that fee at a reasonable level necessary to cover costs and to allow institutions to charge that fee without additional restrictions.

NAFCU generally supports the proposal to prohibit multiple fees arising out of a single event or transaction. However, the Board has – in our opinion – proposed an unduly broad application of the rule in one specific circumstance. Specifically, the proposal would seemingly prohibit an institution from imposing a returned payment fee and a late payment fee in the same billing cycle in virtually any circumstance. Truth in Lending, 75 Fed. Reg. 12334, 12373 (March 15, 2010) (to be codified at 12 C.F.R. pt. 226). In the examples provided in the staff commentary, such a prohibition arguably makes sense. However, given that cardholders must now receive their statements 21 days before the due date, it is reasonable to believe that there will be many instances in which a check is returned and the consumer notified well before the due date. If a consumer has sufficient advance knowledge that his check has been returned and still fails to make a timely payment the institution should be authorized to assess two separate fees as the fees would arise from two separate events. Accordingly, NAFCU recommends the Board consider an exception to the proposed rule in limited circumstances. For example, if an institution notifies a cardholder that a check has been returned at least seven days before the due date and the cardholder still fails to make timely payment, the institution should be able to charge two fees; one for the returned check and a second for late payment.

Finally, NAFCU strongly supports the proposal to allow tiered penalty fees for cardholders who repeatedly violate the terms of their agreement. For example, after two late payments in a twelve month period, an institution should be authorized to charge a higher late payment fee. Authorizing a higher fee for the third violation in a one year period would be fair and equitable. Penalty fees are intended to penalize and also to discourage bad behavior. Obviously, if a customer repeatedly pays late, the fee is not sufficiently high to discourage the violation and thus there is good reason to increase it. What's more authorizing the fee only on the third late payment in a 12 month span provides consumers protection and only penalizes those who pay late twenty-five percent of the time or more.

Reevaluation of Rate Increases

NAFCU is very concerned with the proposal regarding the reevaluation of rate increases, as requiring institutions to reevaluate rate increases indefinitely will provide little value at considerable cost. NAFCU recommends the final rule include a two pronged approach to the obligation to reevaluate rate increases. First, institutions should not be required to reevaluate rate increases more than three times over an eighteen month period. Second, the obligation should terminate automatically in instances where the consumer's creditworthiness has dropped precipitously and there is no reasonable possibility of a rate decrease.

There is little value in requiring institutions to reevaluate increases more than three times. Limiting the obligation to three reevaluations would provide the consumer eighteen months to repair his or her credit, which is sufficient time to repair minor credit issues. What's more most issuers already will review a consumer's account upon request. Further, the credit card industry is already highly competitive. Consequently, consumers who suffered a credit problem and have since repaired that problem will undoubtedly receive solicitations at a better rate if their current card issuer refuses to lower the APR. Indeed the credit card market is one area in which there are virtually no barriers to a consumer moving from one company to another if a better price is offered. NAFCU understands the need for consumer protection and government oversight. However, requiring three reevaluations and then allowing the market to work is, we believe, a sensible solution that balances competing interests and limits unnecessary costs while still providing consumers considerable benefits.

Next, the obligation to reevaluate should terminate automatically in instances where the cardholder's credit score has dropped dramatically. NAFCU recommends that if a cardholder's credit score drops by a given percentage, the obligation to continue reevaluating the account should terminate immediately. If a cardholder suffers a decrease in credit score of 5 percent, for example, it will take him a considerable amount of time to repair his credit to the point that he is eligible for the initial APR he received prior to his score decreasing. There is no benefit to consumers in requiring card issuers to reevaluate accounts every six months if it will take several times that long in order to repair his credit. There are, however, considerable costs involved for the institution in reevaluating each account every six months. Terminating the obligation in instances where the cardholder's credit score has dropped dramatically is a reasonable way in which to balance the institution's costs against the consumer protection concerns advanced in the CARD Act. Further, as mentioned above, the market will likely ensure that consumers who are able to quickly repair their credit will be able to take advantage of better rates.

While the requirement to reevaluate accounts every six months is included in § 148 of the Truth in Lending Act (TILA) as amended by the CARD Act, the Board would be justified in exempting accounts from the requirement under § 105 of TILA if the accountholder's credit score has declined dramatically. Under § 105 the Board may exempt transactions from the coverage of TILA if "coverage would not provide a meaningful benefit to consumers in the form of useful…protection." 15 U.S.C. 1604(f)(1). In making this determination the Board must consider: (1) whether the provisions provide a benefit to the consumer; (2) the extent to which the requirements would complicate or increase the cost of the credit; (3) the status of the borrower; (4) whether the loan is secured by the consumer's principal residence; and (5) whether an exemption would undermine consumer protection. 15 U.S.C. 1604(f)(2). Nearly all of the factors the Board must consider weigh in favor of providing an exemption in this limited circumstance.

First, requiring issuers to continually reevaluate a cardholder's credit score every six months after the individual's credit score has dropped dramatically will provide virtually no benefit to consumers as the reevaluation is unlikely to result in a lower interest rate. Second, requiring reevaluations for every account that has experienced an increased APR every six months will undoubtedly increase the cost of credit for all consumers as this requirement creates a considerable new cost for card issuers. The third factor – the status of the borrower – does not weigh heavily either for or against such an exemption. Further, this section of the statute only addresses credit card interest rates, thus no loans secured by the consumer's principal residence would be impacted by an exemption. Finally, an exemption would not undermine the goal of consumer protection. This exemption would only be applicable in instances where the consumer's credit score has decreased dramatically. In such an instance, the reevaluation requirement itself, will provide little, if any, added protection as a precipitous decline in credit score generally takes a significant amount of time to repair. For all these reasons, NAFCU urges the Board to consider using its authority under TILA § 105 to provide an exemption to the reevaluation requirement in cases where cardholder's credit scores have dropped dramatically.

Technical Concerns

NAFCU has two concerns with the proposed rule that are technical in nature and that would benefit from clarification. First, comments 226.59 (c)(2) and (3) appear inconsistent. These two comments explain the timing requirements for reevaluating accounts on which the APR has been increased. Comment 226.59(c)(2) explains the general rule and states, "the card issuer may first review the rate increases for the accounts that were repriced on June 1, 2010 on or before December 1, 2010." Id. at 12375. Comment 226.59(c)(3) explains the reevaluation rule for increases that take place prior to the effective date of the rule. This comment states, "[f]or increases in annual percentage rates applicable to a credit card account under an open-end…consumer credit plan on or after January 1, 2009 and prior to August 22, 2010, § 226.59(c) requires that the first review for such rate increases be conducted prior to February 22, 2011." Id. June 1, 2010 – the hypothetical date provided in comment 226.59(c)(2) – falls between January 1, 2009 and August 22, 2010. Under the example in 226.59(c)(2), rates increased on June 1, 2010 need to be reevaluated by December 1, 2010. However, according to 226.59(c)(3), institutions have until February 22, 2011 to reevaluate accounts that were increased on June 1, 2010. This conflict seems like a simple drafting error that can be correcting by using a hypothetical date in comment 226.59(c)(2) which occurs after the effective date of August 22, 2010.

A second concern regards the comment explaining how institutions should disclose the reasons for a rate increase. Comment 226.9(c)(2)(iv)-11 states:

> "For example, the notice of a rate increase triggered by a decrease of 100 points in a consumer's credit score may state that the increase is due to 'a decline in your creditworthiness' or 'a decline in your credit score.' Similarly, a notice of a rate increase triggered by a 10% increase in the card issuer's cost of funds may be disclosed as 'a change in market conditions.'" Id. at 12371.

NAFCU is concerned that this example could be interpreted to mean that an issuer may not increase a cardholder's APR based on a decrease in creditworthiness unless the consumer's credit score has dropped at least 100 points. Likewise, the example might also be read to conclude that an issuer cannot increase the APR based on an increase in cost of funds of less than ten percent. Presumably, that was not the intent of the comment. However, it would be helpful to clarify that the 100 point and ten percent figures are merely examples and that an institution is free to increase the APR based entirely on its own internal standards for both creditworthiness and cost of funds.

In conclusion, the final rule should allow for a simpler pricing mechanism for penalty fees. Additionally, institutions should be authorized to include the cost of losses in the calculation for penalty fees. Further, the Board's use of the "conduct of consumers" as a ceiling for penalty fees creates an unnecessarily complicated fee system. Additionally, using the "consumer conduct" factor in this manner does not seem to conform with the statute, particularly in regards to the safe harbor fee. Next, the reevaluation requirement should be limited to apply for a period of eighteen months. Moreover, the obligation should terminate in those instances where it is likely to provide no benefit to consumers who have suffered dramatic declines in their creditworthiness. Finally, we believe the rule would benefit from clarifications regarding the two technical matters addressed above.

NAFCU appreciates this opportunity to share its comments on the proposed guidelines. Should you have any questions or require additional information please call me at (703) 842-2212.

Sincerely,

Dillon Shea

Dillon Shea
Associate Director of Regulatory Affairs