Capital One Financial Corporation
1680 Capital One Drive
McLean, VA 22102

April 15, 2010

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

Re: Regulation Z Credit CARD Act 15 Month Rule (Docket No. R-1384)

Dear Ms. Johnson:

Capital One Financial Corporation ("Capital One")[1] is pleased to submit comments on the amendments to Regulation Z proposed by the Federal Reserve Board ("Board").[2] The rule implements the amendments made by the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act) to the Truth in Lending Act ("TILA") that are effective August 22, 2010.[3]

Capital One has long supported the broad goals of the CARD Act and the Board's various rulemaking efforts. Generally, we believe that the Board has struck the appropriate balance between ensuring meaningful new consumer protections and preserving the continued availability of credit. In this regard, Capital One agrees with the premise that credit card pricing should be predominantly concentrated in the front-end

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[1] Capital One Financial Corporation (www.capitalone.com) is a financial holding company whose subsidiaries, Capital One Bank (Europe) plc., Capital One Bank (Canada Branch), Capital One, N.A., and Capital One Bank (USA), N. A., collectively had $115.8 billion in deposits and $212.0 billion in total managed assets outstanding as of December 31, 2009. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients in the U.S., Canada and the UK. A top ten credit card issuer in the UK, Canada and United States and a Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol "COF" and is included in the S&P 100 index.

[2] 75 Fed. Reg. 12334 (March 15, 2010).

[3] Pub. L. No. 111-24, 123 Stat. 1734 (2009).

terms of the product – i.e., the APR and annual membership fees – rather than in back-end terms such as penalty APRs and penalty fees. For this reason, we supported many of the CARD Act's restrictions on aggressive penalty repricing. Similarly, we agree with efforts to ensure that penalty fees remain reasonably reflective of the size and nature of a customer's violation of their account terms. We note, however, that penalty fees function quite differently than penalty APRs. There were legitimate concerns that penalty APRs might be disproportionate to the infraction they sought to redress – most notably, perhaps, in an example where a single day's late payment triggered a high and indefinite penalty APR. Penalty fees, in contrast, are (i) designed to target a specific risky behavior (e.g., late payment); (ii) one time in their impact; (iii) entirely avoidable since they are a direct result of a customer's own actions on the account; (iv) utilized by a wide range of service and governmental entities; and (v) well understood by customers.

As such, there is a critical role to be played by penalty fees in ensuring that front-end terms remain affordable to customers across the credit spectrum, particularly given the CARD Act's significant new restrictions on repricing of APRs. Severely curtailing pricing on penalty fees would deprive credit card issuers of an important risk management tool for customers demonstrating tangibly risky behaviors such as paying late. In response, issuers would likely have to raise front-end pricing still further, placing an even higher cost of credit onto less risky customers.

We see significant issues with the proposed rule, particularly the provisions related to reasonable and proportional penalty fees. The proposed rule will harm customers who will have to subsidize the cost of a segment of customers who engage in risky behavior. In order to more closely align costs and deter risky behavior to the segment of customers that incurred those costs, our letter suggests modifications to the proposed rule on penalty fees. In general, we support the Board's proposed rule on reevaluation of rate increases. We suggest necessary but modest modifications to those provisions.

Limitations on Penalty Fees

The CARD Act added new TILA §149 requiring that the amount of any penalty fee be reasonable and proportional to the omission or violation. The CARD Act requires that the Board consider "the cost incurred by the creditor from such omission or violation; the deterrence of such omission or violation by the cardholder; the conduct of the cardholder; and such other factors as the Board may deem necessary or appropriate."[4]

The Board proposes implementing these requirements by prohibiting the imposition of a penalty fee for a particular type of violation (such as a late payment) unless the fee is calculated based on one of four methods: i) fee based on cost ("Cost Method"); ii) fee based on deterrence ("Deterrence Method"); iii) fee equal to or less than the dollar amount specified in the safe harbor ("Dollar Safe Harbor"); or iv) fee equal to or less than five percent of the dollar amount associated with the violation ("Percentage Safe

[4] CARD Act §102(b) adding TILA §149(c).

Harbor").[5] These methods are overridden by other proposed requirements, including the requirement that the amount of the fee be capped at the dollar amount associated with the violation ("Transaction Cap").[6]

To ensure that the cost of risky behavior is borne by the appropriate segment of customers, and to carry out the intent of the CARD Act, we respectfully suggest the following modifications to the proposed rule.

Charge-off costs should be included in the cost analysis for the Cost Method.

The Board proposes prohibiting issuers from including higher rates of loss and associated costs (such as the cost of holding reserves against losses) in the Cost Method determination.[7] The Board, however, seeks comment regarding whether that exclusion is appropriate.[8] In short, we see no legal, policy or economic rationale for excluding charge-off costs from this calculus. Charge-off costs are a direct result of risky behaviors such as late payment that an issuer cannot control, and constitute the single largest expense related to these costs. Notably, current penalty fee revenues fall well short of compensating issuers for the risk of late payments and other violations of a customer's agreement; thus, further curtailment of penalty fees would compel issuers to make up their costs via other means, including additional increases in purchase APRs and annual fees across issuers' entire portfolios.

In order to avoid a large number of customers having to pay an unreasonable and disproportionate share of the cost for other consumers' violations, we believe that all or some portion of costs due to charge-offs (e.g., the charged-off principal and charged-off interest and fees) should be included in the Cost Method.

The law does not prohibit inclusion of charge-off costs.

The CARD Act does not require, explicitly or implicitly, the exclusion of charge-off costs in the calculation of penalty fees. The CARD Act states that penalty fees "shall be reasonable and proportional to such omission or violation."[9] A customer who has paid late has violated the cardholder agreement. In doing so, the customer has shown that he is riskier and joins a population of borrowers who ultimately generate the accounts that charge off. Prior to his paying late, he was part of the population of timely payers who generate virtually 0% of charge-offs, with the rare exception of a customer who declares bankruptcy while current on a particular credit card account. As a result of his greater likelihood to incur charge-off costs, a late fee that incorporates that cost, or some portion of that cost, is reasonable and proportional to his violation of his account terms.

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[5] *See* proposed Regulation Z §226.52(b). The Board proposes a safe harbor whereby an issuer is deemed to have complied with this rule if its penalty fee does not exceed the greater of the Dollar Safe Harbor or the Percentage Safe Harbor. *See* proposed Regulation Z §226.52(b)(3).
[6] *See* proposed Regulation Z §226.52(b)(2)(i)(A).
[7] Proposed comment 52(b)(1)(i)-2.
[8] *See* 75 Fed. Reg. at 12342.
[9] CARD Act §102(b) adding TILA §149(a).

In reaching its conclusion, the Board cites industry data compiled by Argus and reported by Morrison & Foerster, in a letter dated August 7, 2008, that "more than 93% of accounts that were over the credit limit or delinquent twice in a twelve month period did not charge off during the subsequent twelve months." [10] The Board appears to imply that this 7 percent charge-off rate (now closer to 10 percent on an industry-wide basis due to worsening credit losses in the ensuing 20 months)[11] is insignificant. This conclusion, however, fails to acknowledge the impact of this charge-off rate in dollar terms, and thus on the profitability and safety and soundness of the credit card industry. The 7 percent charge-off rate was sufficient to have rendered the industry as a whole unprofitable in 2008, and with the subsequent climb to over 10 percent, to have created a nearly $6 billion loss in 2009 – a trend that is expected to moderate, but continue, through 2010.[12]

The Board appears to have been further persuaded by the approach of the United Kingdom's Office of Fair Trading (OFT) in their efforts to limit late fees in 2006.[13] Such reliance is misplaced since the UK has a materially different legal framework for credit cards.

Foremost, the OFT does not impose the same restrictions on APRs that exist under the CARD Act, namely: (i) restrictions on APR increases for existing balances; (ii) requirements to decrease penalty APRs after 6 timely payments; and (iii) requirements to conduct 6 month periodic reviews of accounts that experience APR increases. In fact, as recently as last month, the UK revisited their prior actions and considered limiting APR increases for existing balances based on the US experience. The OFT, however, explicitly rejected such limitations stating "the initial evidence shows that a ban on the re-pricing of existing debt such as that adopted in America could lead to worse outcomes for consumers through higher interest rates for new customers, annual fees and some people finding it impossible to obtain a card at all."[14] Since the UK rejected imposing similar APR restrictions to those in place in the US, UK issuers have the flexibility to recover charge-off costs by increasing APRs on those customers who present a greater risk of default that US issuers do not have. Since the CARD Act's prohibition on increasing APRs on existing balances went into effect on February 22, 2010, US issuers can no longer meaningfully adjust rates for risky behavior.

In addition, the OFT is bound by long-standing principles under UK law that do not apply in the US. The OFT's interpretation excluding charge-off costs from the calculation of late fees was based in part on a requirement to cap fees to what could have been awarded

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[10] 75 Fed. Reg. at fn. 17 referring to exhibit 5, table 1a of the comment letter from Oliver I. Ireland, Morrison & Foerster LLP (Aug 7, 2008).
[11] Data is the seasonally-adjusted charge-off rate on credit card loans for all commercial banks as reported by the Federal Reserve for third quarter 2009.
[12] Data based on a review of issuers' public quarterly earnings releases.
[13] 75 Fed. Reg. at 12341-2 and fn. 21.
[14] Department for Business Innovation & Skills, *A Better Deal for Consumers: Review of the Regulation of Credit and Store Cards: Government Response to Consultation* (March 2010) ("UK Government Response to Consultation") at para. 42.

as damages under British common law.[15] The OFT was further bound by a UK prohibition against charging penalties.[16] No punitive element is permitted. In contrast, the CARD Act explicitly refers to these fees as penalty fees in acknowledging that the fees are fines to provide incentives to customers to pay on time.[17] Thus, comparison to the UK legal regime is not persuasive.

The Board's policy goals would be better met by inclusion of charge-off costs.

As noted above, we share the Board's stated policy goals of i) promoting transparency and protecting customers from unanticipated increases in the cost of credit,[18] and ii) using penalty fees to pass on the costs incurred as a result of violations while ensuring that those costs are spread evenly among customers and that no individual consumer bears an unreasonable or disproportionate share.[19] The Board is concerned that those who mismanaged their credit card accounts and incurred penalty fees subsidize the cost of credit for those who do not trigger penalty fees.

But the Board's proposed rule prohibiting the consideration of any charge-off costs in the penalty fee, combined with the restrictions on APRs, general fees, and penalty fees, results in another extreme subsidization – those who pay on time subsidizing the costs of customers who pay late. This outcome results in the Board failing to meet its second stated goal as timely customers would now have to bear an unreasonable and disproportionate share of the cost of other customers' violations in the form of higher up-front APRs and higher annual membership fees. Again, we agree with those who believe that the industry had evolved to a point where too much emphasis was placed on less transparent back-end penalty terms, and too little emphasis on more transparent front-end primary terms. It is possible, however, to swing the pendulum too far in one direction or the other – we believe that the proposed rule potentially removes a critical, corrective risk management tool from issuers' hands, and thus forces too much of the cost burden onto less risky consumers.

This belief is underscored by the significant steps taken in the CARD Act to remove any reason that an individual might pay late inadvertently. These factors must be weighed in any consideration by the Board. Purported past practices identified as potentially

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[15] The amount of the default charge "must be compared with the damages which would be awarded at common law in the event that a consumer was individually sued for breach of contract." OFT (United Kingdom), *Calculating Fair Default Charges in Credit Card Contracts: A Statement of the OFT's Position* (April 2006) ("OFT Credit Card Statement") para 3.5. In doing such a comparison, the OFT had to refer back to a British case in 1854 that required the exclusion of certain costs as not being either "general damages" or "special damages." See OFT Credit Card Statement para 3.7 referring to Hadley v. Baxendale (1854) 9 Exch. 341.

[16] "Any provision in the contract which constituted a penalty would be very unlikely to satisfy the test of fairness under the [Unfair Terms in Consumer Contracts Regulations 1999]…." OFT Credit Card Statement at para. 3.24.

[17] *See* CARD Act which titles the applicable section "Reasonable Penalty Fees on Open End Consumer Credit Plans" and refers to "penalty fees" throughout the section. CARD Act §102(b) adding TILA §149.

[18] *See* 75 Fed. Reg. at 12341.

[19] 75 Fed. Reg. at 12339.

detrimental or opaque to customers have been outlawed. As such, requiring timely payers to bear the cost of customers who pay late is particularly unreasonable in light of all the measures the CARD Act and Board have taken to protect customers and ensure that they do not violate the terms of their credit card agreement. Examples of measures the Board took to help ensure customers pay on time include:

- Requiring issuers to provide periodic statements 21 days before the payment due date.
- Requiring that the payment due date be the same date each month.
- Requiring that payments be treated on time if the payment due date falls on a non-business day and the payment is received after that day.
- Requiring that payments be treated as timely if received on or before 5pm on the due date.
- Requiring periodic statements to include the due date and the late payment warning.
- Requiring periodic statements to give a year-to-date running total of fees to remind customers of the cumulative impact of triggering fees.
- Requiring application, solicitation, and account opening disclosures to prominently disclose any fee.

All of the above consumer protections were designed to ensure customers fully understand the consequences of paying late and have adequate time in which to make a timely minimum payment. Thus, for customers who pay late despite all of these new protections, it is appropriate that they bear at least some of the charge-off costs that are a direct result of their risky behavior.

To satisfy the Board's policy goal of ensuring customers do not bear an unreasonable and disproportionate share of the cost of the credit card violations, a different equilibrium between up-front rates and fees versus risk-adjusted rates and fees needs to be established. Permitting consideration of charge-off costs in the Cost Method will result in less subsidization of one group over another.

Safety and soundness concerns would be alleviated by inclusion of charge-off costs.

The proposed exclusion of charge-off costs from the penalty fee analysis, layered on top of other pricing restrictions, results in a limited number of levers to manage credit risk on accounts that may exist for an unlimited and unknown number of years. This outcome materially increases safety and soundness risk.

In addition to the rationales articulated above, the Board further justifies the exclusion of charge-off costs in the Cost Method, stating that "the Board understands that, as a general matter, card issuers *currently* do not price for the risk of loss through penalty fees; instead, issuers generally price for risk through upfront annual percentage rates and penalty rate increases."[20] This statement, while true historically, fails to recognize that the CARD Act and the Board severely limited the ability of issuers to price for risk through changes in purchase APRs, such as by:

- Prohibiting rate increases on outstanding balances (other than upon expiration of a temporary rate; when the rate is a variable rate; and due to the completion of or failure to comply with the terms of a workout arrangement).
- Prohibiting rate increases on outstanding balances due to the customer's failure to adhere to the contractual terms, except where a customer's minimum payment is not received within 60 days of the due date.
- Limiting rate increases on future balances to 45 day advance notice with right to opt out.
- Requiring payments to be allocated to the highest rate balances first.
- Requiring penalty rates for late payments of over 60 days to be returned to the original rate upon six on-time payments.
- Requiring a review every 6 months of accounts where rates have been raised at any time since January 1, 2009 to determine whether the rates should be decreased.

Through the combination of these prohibitions and requirements, the Board has severely limited the levers available to issuers to manage risk when a customer pays late. At the same time, these restrictions have increased the risk to issuers. For example, the combination of requiring 45 days advance notice of a rate increase after a customer has gone 60 or more days late on the account, results in an issuer not being able to reprice a customer until the customer has gone at least 105 days late on the account. At that point, the chances of recouping money from this customer are reduced by over 80% compared to prior to the CARD Act. Notably, these risks are further exacerbated by the interplay between the prohibitions on increasing APRs on outstanding balances and new payment allocation requirements. That combination results in customers taking up to five times longer to pay down the outstanding balance that exists at the original lower rate. The additional years result in additional long term exposure and risk of loss for issuers.[21]

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[20] 75 Fed. Reg. at 12341 (emphasis added).

[21] While minimum payments may be increased to accelerate pay-off of the outstanding balances, we are concerned about the adverse impact of such an increase on customers. The increase may make it more difficult for customers to meet their payment obligations and increase their chances of charging off. As the UK government noted

> We have considered carefully the merits of increasing the minimum payment....We are aware of the strong views of consumers that an increase in minimum payments might exacerbate financial difficulties and the evidence from commissioned research which confirms the financial impact of an increase in minimum payments on some consumers. We have also taken note of initial research by Professor Stewart and colleagues at the University of Warwick which shows that increasing the minimum payment level could decrease the percentage of consumers who make full or part repayments. Finally, we have been advised by lenders that an increase in minimum payments would have an impact on their profits, which they might seek to recoup from customers in other ways (e.g. increased interest rates, annual fees).

Absent allowing inclusion of charge-off costs, generally, the Board could permit inclusion of a reasonable proportion of charge-off costs.

We recognize that allowing issuers to include all charge-off costs in the penalty fee calculation would result in a fee that is difficult to support. In a study conducted by Argus in conjunction with Morrison & Foerster ("Argus Study"), 10 of the 11 top credit card issuers provided data relating to costs associated with late payments.[22] This data, which will be discussed in detail in a separate comment letter prepared by Morrison & Foerster, assesses these costs using various formulas, including and excluding credit losses. Under a highly conservative formulation, *exclusive of charge-off costs in their entirety*, the Argus Study concludes that an average late fee across the industry would be approximately $29. By way of comparison, when considering the full cost of late payments to issuers, inclusion of charge-off costs would justify a late fee into the hundreds of dollars. This information is provided not to support a fee of that latter size, but rather to underscore the true risk impact of late payment behavior to credit card issuers.

As such, we believe that the potential to exacerbate this revenue gap should reinforce the need for the Board to take a reasonable approach to permitting cost assessments that reflect some portion of credit losses; the alternative would be to compel issuers to seek to recover costs from other sources, including significantly higher front-end terms. To balance the various concerns discussed above, we suggest that a portion of charge-off costs could be included in calculating the penalty fee under various formulas. Examples of how to define which portion of charge-off costs to include are:

- only the charged-off principal, excluding any interest and fees;
- the costs of unrecovered penalty fees; or
- the amount of the lost minimum payments during the period prior to issuers being allowed to penalty reprice late payers.

Under one proposed methodology for inclusion of a portion of charge-off costs (i.e., the cost of unrecovered late fees), the Argus Study arrives at an average late fee of just over $32. If the above or other definitions of charge-off costs are permitted to be included in the Cost Method, the Board would meet its policy goals while also alleviating some safety and soundness risk. In any case, we request that, at a minimum, the Board take

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UK Government Response to Consultation at para. 14. We note that this phenomenon was demonstrated as the industry moved to new, and in the majority of the cases, higher minimum payment calculation formulas instituted by the Office of the Comptroller of the Currency. Comptroller John C. Dugan acknowledged this, stating "[w]e recognize that the change in required minimum payments will make it more difficult for some existing credit card borrowers to pay the full amount of the increased minimum payments due." John C. Dugan's statement before the Consumer Federation of America (December 1, 2005).

[22] *See* comment letter from Oliver I. Ireland, Morrison & Foerster LLP (April 14, 2010) ("Morrison & Foerster April 2010 Letter").

into account some of the charge-off costs in setting the Dollar Safe Harbor amount (discussed further below).

The Deterrence Method, as currently conceived, is unworkable and thus inconsistent with the clear intent of the CARD Act. This Method could be made feasible if issuers are permitted to consider industry data and industry results.

The Board proposes requiring an empirically derived, demonstrably and statistically sound model that reasonably estimated the effect of the amount of the fee on the frequency of violations.[23] The language is borrowed from Regulation B.[24] Regulation B, however, requires such a model for underwriting and not for setting a dollar amount. Further, Regulation B does not preclude the use of third party data. In applying and interpreting such a model for setting fees, the Board makes it a needlessly difficult standard for issuers to meet. By stating that proving that the penalty fees are comparable to fees assessed by other card issuers is not sufficient to satisfy the standards for the Deterrence Method, it is implied that each issuer must perform its own test, make its own determination, and use its own data.[25] Furthermore, the proposed rule implies that any fee derived using this must be tested to the exact dollar amount.[26]

For the Deterrence Method to be feasible and rational, consistent with other current regulatory frameworks, the rule should allow for: i) use of industry data; ii) use of a third party to conduct the modeling; and iii) use of industry or third party results. For example, a third party, such as a national consumer credit reporting agency, could combine industry data with data from a national database (such as income or credit scores) to reach more robust and grounded assessments on what penalty fee dollar amount would deter which segments of customers from paying late.[27] Such a method is more logical in that it recognizes that the deterrence amount may vary by consumer segment (e.g. credit scores, income level) but likely not vary based on who the issuer is. Issuers should be able to rely on such industry and third party data and results in determining the penalty fee amount under the Deterrence Method.

In addition, since the CARD Act requires the Board to consider cost, deterrence, conduct, *and* other factors, the regulation should permit issuers to consider the Cost Method and Deterrence Method together instead of as alternatives to each other. Reading these provisions as separate requirements contravenes the plain language of the statute. A more correct reading of this provision would permit, for example, issuers to apply the Deterrence Method by using as the minimum testing point the penalty amount arrived at

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[23] Proposed Regulation Z §226.52(b)(1)(ii).
[24] See Regulation B §202.6 referring to an empirically derived, demonstrably and statistically sound, credit scoring system.
[25] See proposed Regulation Z comment 52(b)-2.
[26] See also proposed Regulation Z comment 52(b)-2 allowing a card issuer to round any fee to the nearest whole dollar. The commentary provides rounding examples based on a fee of $21.50 versus a fee of $21.49.
[27] These statistically significant conclusions are similar to conclusions drawn by the Board after analyzing data collected from each institution under the Home Mortgage Disclosure Act. *See* 12 USC 2801 et seq.

through the Cost Method. This discrepancy in the proposed rule could be remedied by modifying proposed §226.52(b)(1) to state "one *or more* of the determinations set forth."

Similarly, the Dollar Safe Harbor should comply with the CARD Act's intent to take into consideration cost, deterrence, the conduct of the cardholder, *and* such other factors as appropriate.

The Board proposes specifying a certain dollar amount such that an issuer is deemed compliant with the rule if its penalty fee is not greater than that dollar amount.[28] We agree with the Board that "establishing a generally applicable safe harbor will facilitate compliance by issuers and increase consistency and predictability for consumers."[29] A reasonable Dollar Safe Harbor amount is critical to ensure that the CARD Act achieves its broader objectives – increased transparency, customer-friendly simplicity and appropriate emphasis on front-end terms.

For the Dollar Safe Harbor to be effective, however, it should fully reflect the CARD Act's requirement to take into consideration cost, deterrence, the conduct of the cardholder, *and* such other factors as appropriate. There was a deliberate decision by Congress, through the plain language of the statute, to require not only consideration of cost, but also of deterrence, conduct of the cardholder, and other such factors.[30]

If the Board takes into consideration all these factors as required by the CARD Act and arrives at the correct price point, the Dollar Safe Harbor would serve as a simple alternative – for both customers and issuers – to the more complex analysis contemplated in the Cost Method and Deterrence Method. If the price point is too low, however, it is unlikely that many, or even some, issuers will utilize it. Arguably, this dynamic is likely to exacerbate gaps between larger and smaller issuers, the latter of whom may lack the resources to calculate a penalty fee using the Cost Method or the Deterrence Method.

To provide the Board with the tools necessary to develop a reasonable Dollar Safe Harbor, we urge the Board to consider the findings of the Argus Study.[31]

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[28] Proposed Regulation Z §226.52(b)(3).
[29] 75 Fed. Reg. at 12345.
[30] Prior versions of the CARD Act contained language that would have limited the consideration of the penalty fees solely to the cost to the card issuer. The final language confirms Congress' explicit intent to broaden the range of available considerations. See S. 414 §103 (introduced Feb. 11, 2009) proposing to create a new TILA §127(o) requiring that "[t]he amount of any fee or charge that a card issuer may impose in connection with any omission with respect to, or violation of, the cardholder agreement, including any late payment fee, over the limit fee, increase in the applicable annual percentage rate, or any similar fee or charge, shall be reasonably related to the cost to the card issuer of such omission or violation" (available at http://thomas.loc.gov).
[31] *See* Morrison & Foerster April 2010 Letter.

The Percentage Safe Harbor should be based on the outstanding balance to more accurately reflect risk and costs, and to avoid discriminating among issuers.

The Board proposes the Percentage Safe Harbor whereby a penalty fee complies with this rule if it is 5 percent of the dollar amount associated with the violation, to be capped by a dollar amount determined by the Board.[32] The Board provides the Percentage Safe Harbor in recognition that "violations involving substantial dollar amounts may impose greater costs on card issuers, require greater deterrence, and involve more serious conduct by the consumer."[33]

With late and returned payments, the proposed rule provides that the amount of the violation is the amount of the required minimum payment.[34] For the Percentage Safe Harbor to effectively recognize the impact of violations involving substantial dollar amounts, the Percentage Safe Harbor should be based on the outstanding balance. The outstanding balance, and not the minimum payment, is the true measure of the risk to the issuer. If the customer charges off, the issuer loses the whole outstanding balance, not just the minimum payment.[35]

On a stand alone basis, this provision appears to make little sense and leads to illogical outcomes. For example, a "fairway" balance of $5000 with a 12 percent APR would typically carry a minimum payment of approximately $100. If the customer is a transactor, wherein no interest is charged over the grace period, the minimum payment is only $25. The 5 percent formula would yield a penalty fee of $5 or $1.25, respectively. Conversely, if this formula is applied to a charge card with the same $5000 balance at risk, the minimum payment is the full $5000, yielding a late fee of $250.

The Transaction Cap should be based on the outstanding balance or the amount of the returned payment.

The Board proposes a Transaction Cap which would cap the amount of any penalty fee at the amount of the violation.[36] In the case of late payments or returned payments, the Board proposes capping the fee at the amount of the minimum payment.[37] As discussed immediately above, the late payment fee is more appropriately capped based on a proportion of the outstanding balance as that is the true measure of risk to the issuer. In the case of a returned payment, the fee cap should be based on the amount of the returned payment to more accurately reflect the magnitude of the customer's violation. For example, assume the same minimum payment requirement but one customer decides to pay more than the minimum payment (e.g., $500) while another customer decides to just pay the minimum payment (e.g., $10). If both payments are returned, the returned payment of $500 is a more serious violation than a returned payment of $10. The

[32] Proposed Regulation Z §226.52(b)(3)(ii).
[33] 75 Fed. Reg. at 12347.
[34] Proposed Regulation Z comment 52(b)(3)-3.
[35] We note that charge cards, like credit cards, begin charging interest upon delinquency.
[36] Proposed Regulation Z §226.52(b)(2)(i)(A).
[37] Proposed Regulation Z comment 52(b)(2)(i)-1 and -2.

returned-payment fee should reflect the severity of the violation and the risk related to and amount of work needed to collect on a $500 payment versus a $10 payment. Thus while the fee would be capped at $10 for the returned payment of $10, it should not be capped at $10 for a returned payment of $500. To more accurately reflect risk, the Transaction Cap should be based on the amount of the returned payment.

Increases to fees should be exempted from the requirement to provide opt-outs.

The proposed rule contemplates annual adjustments in the penalty fee. The Dollar Safe Harbor is adjusted annually based on the Consumer Price Index.[38] We support this provision. Further, any fee based on the Cost Method or Deterrence Method must be reviewed at least once every twelve months and adjusted accordingly.[39] These required changes to the fees would trigger 45 days advance notice and a right to opt out.[40]

Given that i) these penalty fee reviews are required annually, ii) the penalty fees amounts are already significantly restricted by this rule, iii) any increase in the penalty fee would trigger 45 day advance notice; iv) the penalty fees are entirely avoidable; and v) the penalty fees have a one-time targeted affect (unlike APR increases), we strongly urge the Board to exempt any penalty fee increase from the requirement to provide the right to opt out. The customer does not need the right to opt out in order to entirely avoid incurring this fee. The customer does not even have to stop using his card in order to avoid the increased fee (unlike with APR increases on future transactions). As such, it does not make sense to impose the operational and compliance burden on issuers to offer and implement any opt-outs for penalty fee changes that are caused by this rule. This is especially true where fee increases are merely tied to the CPI, which reflects the Board's logical attempt to ensure that fee amounts codified in regulation retain some measure of flexibility to reflect evolving market conditions without having to engage in new regulatory rulemakings.[41]

At a minimum, in the alternative, the Board could permit issuers to add a cushion in the "up to" amount disclosed. The issuer would not charge the "up to" penalty fee amount if the fee does not meet the requirements under one of the Methods or Safe Harbor. But if one of the Methods or Safe Harbor permits charging the "up to" amount, the issuer could do so without providing advance notice and opt-out for each incremental increase in the fee.

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[38] *See* proposed Regulation Z §226.52(b)(3)(i).
[39] *See* proposed Regulation Z §226.52(b)(1)(iii).
[40] *See* Regulation Z §226.9(c)(2).
[41] As with the CPI adjusted dollar triggers under the Home Ownership and Equity Protection Act, annual amendments to Regulation Z staff commentary of the next year's CPI adjusted dollar amount would be helpful. *See* Regulation Z §226.32(a)(1)(ii) and comment 32(a)(1)(ii)-2.

A separate over-the-limit method to comply with the rule would be appropriate.

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

- No fee is charged unless the customer opts in.
- Customers are provided a separate disclosure about the fee and right to opt in, in addition to the disclosure on their account opening disclosures.
- The customer receives a written confirmation notice of the opt-in.
- Over-the-limit fees cannot be triggered due to fees and interest.
- No more than 3 over-the-limit fee may be charged per event.
- The subsequent over-the-limit fee can be charged no earlier than by the payment due dates.
- The customer may revoke the opt-in at any time.

Given i) the above protections, some of which went beyond what was required by the CARD Act (e.g. written confirmation notice, no fees and interest triggering the over-the-limit fee),[42] ii) that an opt-in is the specific customer's explicit acknowledgement that he believes the fee is reasonable and proportional to any anticipated violation, and iii) that the opt-in regime creates market pressure to force over-the-limit fees to be reasonable and proportional, a separate over-the-limit method to comply with the rule would be appropriate. Creating such a method does not result in permitting the customer to waive away rights under §226.52 as the customer would still be protected by the rule. Such protections include the prohibition against the fee exceeding the Transaction Cap, and the prohibition against multiple fees based on a single event or transaction. Further, to ensure that transparency and consistency objectives are not undermined, the proposed Dollar Safe Harbor would still include over-the-limit fees, as well.

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

A transition period is necessary to implement the rule.

The CARD Act contemplated providing issuers at least six months to implement any final rules when it required final rules to be issued by February 22, 2010 and implemented by August 22, 2010.[43] Congress recognized that issuers needed time to implement these rules.

[42] *See* CARD Act §102(a) adding TILA §127(k).
[43] *See* CARD Act §102(b) adding TILA §149(b).

Because these are important substantive rules requiring much analysis, we respectfully request a delayed implementation date for the final form of these rules. This would allow issuers time to digest the rule, analyze our current fee structure against the permitted fees and methods in the final rule, vet our conclusions and response strategies with our regulators to ensure they satisfy consumer compliance and safety and soundness concerns, change our policies, implement the changes into our IT systems, train our customer services representatives, and revise our customer disclosures.

We recognize that it would be unreasonable to ask for an implementation date of 6 months from the date the final rules are released, as originally contemplated in the CARD Act. We suggest instead an implementation date of the later of August 22, 2010 or 2 months after the issuance of the final rules.

In the alternative, there could be an exception for a limited amount of time to the requirement to provide advance notice and opt-out resulting from the implementation of these rules (e.g., changes to the penalty fee or minimum payment amounts). While notice would be provided, there would be no requirement for advance notice and opt-out. This limited amount of time would run through the later of August 22, 2010 or 2 months after the final rules are issued.

Reevaluation of Rate Increases

The CARD Act added new TILA §148 requiring issuers that increased the APR on credit card accounts since January 1, 2009 to review those accounts once every 6 months to determine whether factors have changed such that the APR should be reduced.[44] The statute does not require a reduction in any specific amount.[45] We believe that the Board's proposed general rule accurately interprets the statutory requirements as it mirrors the statutory language.

The reevaluation rule avoids increasing safety and soundness concerns.

The Board correctly observes that a more prescriptive rule could raise safety and soundness concerns for issuers and that specific factors that are most predictive of the credit risk of a particular customer or portfolio of customers may change over time, may vary greatly among institutions, and may vary by the type of credit card (e.g., private label credit card versus general purpose credit card).[46] Furthermore, customers are already well protected against prospective rate increases.[47]

[44] CARD Act §101(c) adding TILA §148.
[45] CARD Act §101(c) adding TILA §148(c) states that "[t]his section shall not be construed to require a reduction in any specific amount."
[46] *See* 75 Fed. Reg. at 12349.
[47] These protections include Regulation Z §226.55 prohibiting increases to the APR applicable to an outstanding balance and Regulation Z §226.9(c)(2) and (g) requiring 45 day advance notice. *See* 75 Fed. Reg. at 12348.

We also note that the potential procyclical impacts of the rule could also increase safety and soundness risks. Compelling a decrease in rates in good times reduces issuers' resiliency in bad times. The impact to customers is that – instead of being able to keep rates relatively steady both in good and bad times – rates would be lower in good times but higher in bad times when the customer and broader economic impact would be most pronounced. Thus, we appreciate the Board's thoughtful approach in avoiding prescribing specific policies and procedures that issuers must use to conduct their analysis.

The reevaluation rule should be limited to only certain accounts experiencing rate increases after January 1, 2009.

The Board proposes requiring a reevaluation of all accounts that experience a rate increase on January 1, 2009 and at any point going forward. This evergreen requirement in combination with the requirement to review these accounts every 6 months in perpetuity becomes unwieldy. As such, the Board should create reasonable limits on the accounts that must be reevaluated. One reasonable limit is to apply the rule only to accounts where the rate was increased on *existing* balances between January 1, 2009 and February 22, 2010. Once the majority of the CARD Act rules became effective on February 22, 2010, numerous consumer protections were implemented, including limitations on increasing APRs. These protections make a review of accounts repriced after February 22, 2010 unnecessary. Similar to the Board's logic in omitting the opt-out requirement for repricing APRs on *future* transactions, a customer's unfettered and unilateral ability to simply stop using the card in the event that they believe that an APR does not reflect their risk profile or market conditions would appear to obviate the need for the periodic review.

In the alternative, the reevaluation could be interpreted as the Board did, to apply to all APR increases occurring on or after January 1, 2009 that would trigger an advance 45 day notice. However, any *lowering* of the APR based on the reevaluation would be applied only to future transactions and not to outstanding balances. Such a rule would parallel the rule prohibiting APR increases on outstanding balances but permitting APR increases on future transactions.[48] In both cases, any change in the APR would apply to future transactions, not to outstanding balances. We recognize that rate increases occurring between January 1, 2009 and February 22, 2010 could have applied to outstanding balances as well as future transactions. As such, we would understand if, for those accounts, any rate reduction due to the reevaluation applies to both the outstanding balance as well as to future transactions.

The obligation to review the accounts should terminate after two years.

The Board requests comment regarding whether the obligation to reevaluate accounts every six months should terminate after some specific time period elapses following the

[48] *See* Regulation Z §226.55.

initial increase.[49] We support terminating the requirement to review the rate applicable to a consumer's account after two years. At that point, the account would have been reevaluated at least four times. Ending the requirement to reevaluate the specific account would recognize that if the account did not merit a rate decrease after that many reevaluations, the rate reflects a long term shift in the consumer's credit profile or market conditions. As grounding for this assessment, it is logical to assume that two years gives customers ample time to shop for and obtain alternative credit. Where a customer does not receive a better credit offer from other creditors during this two year period, the lack of a better offer strongly suggests that the customer's current rate is an appropriate reflection of that consumer's current risk profile and prevailing market conditions. While issuers would likely continue to review accounts for competitive reasons, the cost and burden of complying with this reevaluation rule should end after two years - the point at which further reevaluation is unlikely to benefit the consumer.

Clarifications Requested

We respectfully request clarification of the situations discussed below:

Limitation on Fees §226.52

- Deterrence Method (§226.52(b)(1)(ii)). As discussed above, the Deterrence Method requires determining the dollar amount of the fee reasonably necessary to deter that type of violation. We request inserting into the commentary the Board's supplemental information example allowing testing in $5 dollar increments. In discussing the development of empirically-derived estimates, the Board states that "[f]or example, in the process of determining that a $20 fee is reasonably necessary to deter a particular type of violation, a card issuer may need to test the deterrent effect of a $15 fee and a $25 fee."[50] Adding that to the staff commentary recognizes that testing in smaller increments is unlikely to cause large changes in incidences of paying late. Such a comment would also help clarify the requirements of §226.52(b)(1)(ii) and comment 52(b)(1)(ii)-2 discussing the use of the models and clarify the relationship with comment 52(b)-2 permitting rounding to the nearest whole dollar.

- Reevaluation of fee determinations (§226.52(b)(1)(iii)). The Board proposes requiring that penalty fees be reevaluated once every twelve months. If upon reevaluation, a lower fee is appropriate, the issuer must impose the lower fee within 30 days after completing the reevaluation. That 30 day time period poses operational challenges to implementing the lower fee given the amount of work and time needed to identify all the accounts, make the IT changes, test to make sure the changes are applied appropriately, revise transcripts for customer service agents, and apply the lower fee. A more reasonable time period operationally,

[49] *See* 75 Fed. Reg. at 12351-2.
[50] 75 Fed. Reg. at 12343.

and one consistent with Regulation Z §226.9(c) and 9(g) rules regarding increasing rates and fees, would be to require implementation within the first day of the billing cycle on or after 45 days of completing the reevaluation.

- Multiple fees based on a single event or transaction (§226.52(b)(2)(ii)). The proposed rule prohibits imposing more than one fee based on a single event or transaction. We request clarification in comment 52(b)(2)(ii)-1.ii that a fee for a late payment and a fee for a returned payment are not fees for the same violation in certain circumstances, for example where the customer makes multiple payments in one billing cycle. Assume the account has a $25 minimum payment due the 25th. The customer makes a $25 payment on the 15th. The customer makes a $500 payment on the 24th, perhaps to increase the available credit line because the customer intends to make a purchase using the card. The $500 payment is returned for insufficient funds on the 27th (before cycle ends on the 28th). The issuer should be able to charge a returned payment fee on the second check because there are costs and expenses associated with the subsequent NSF.

- Transaction Cap (§226.52(b)(2)(i)(A)). Assume the same facts as above. Because the customer made two payments – the first ($25) covering the minimum payment, and the second ($500) returned for insufficient funds – it is unclear if there is a Transaction Cap on the second $500 payment that is returned. We request clarification that with regards to the returned payment in such a situation, the returned payment fee is not capped, or that the cap should be at the amount of the second check.

Reevaluation of accounts §226.59

- Rate increases actually imposed (Comment 59(a)-2). The Board provides an example of the reevaluation rule being triggered when a consumer's account becomes subject to the penalty rate. We request clarification that the reevaluation rule is not triggered when the penalty rate is increased, e.g., penalty APR from 25% to 29%. The customer is already sufficiently protected by the CARD Act and Board through such rules as the prohibition on increasing rates, the mandate to reduce the APR for 6 on-time payments, and the requirement to review the account every 6 months to determine whether the rate should be reduced from the penalty rate.

- Rate increases subject to the 6 on-time payment rate reduction (§226.59(e)). The proposed rule states that when the rate is increased because the minimum payment was late by more than 60 days, and the customer did not subsequently make 6 on-time payments to qualify for the automatic rate reduction, the issuer must reevaluate the rate every 6 months under the general requirement to reevaluate accounts. Since the CARD Act and Regulation Z already created a separate rate reduction mechanism for such accounts under §226.55(b)(4), accounts more than

60 days delinquent should not be subject to the general requirement to reevaluate accounts under §226.59.

- Rate reductions – timing (§226.59(a)(2)). The Board proposes requiring any rate reductions to occur no later than 30 days after completion of the reevaluation. We suggest that to be consistent with the 45 day advance notice rules in §226.9(c) and 9(g), the APR decrease should occur no later than the first day of the billing cycle occurring on or after 45 days after the completion of the reevaluation.

Applications, solicitations and account-opening disclosures §§226.5a and 6.

- Transition rule for disclosures (§226.5a(a)(2)(iv) and §226.6(b)(1)(i)). The Board proposes amending the requirements for application and solicitations and for account-opening disclosures to require the use of bold text when disclosing maximum limits on fees. We request a transition rule such that the disclosures for "up to" fee amounts should apply to disclosures provided on or after August 22, 2010. As such, issuers would not have to recall and fix disclosures already printed to be provided before August 22, 2010.

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Capital One appreciates the opportunity to comment on the proposed Regulation Z 15 month CARD Act rules. If you have any questions about this matter or our comments, please contact me, Ducie Le, at (703) 720-2260.

Sincerely,

Minh-Duc T. Le

Minh-Duc T. Le
Assistant General Counsel, Policy Analysis