DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

April 14, 2010

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave. N.W.
Washington, DC 20551

Dear Ms. Johnson,

This letter responds to the request of the Board of Governors of the Federal Reserve System (the Board) for comment on its Proposed Rule of March 15, 2010, (the proposed rule) to implement two sections of the Credit CARD Act of 2009 (the Act) that take effect on August 22, 2010.

The Act was passed with the strong support of President Obama and bipartisan majorities in both houses of Congress. Building on the important and careful work of the Federal Reserve, the Act imposed common-sense requirements on credit card companies to act with greater transparency, fairness, and accountability in dealing with American families. For instance, the Act generally banned rate hikes that apply to existing balances or that occur within a year of opening a new card account. The Act also required credit card companies to mail statements and account change notices further in advance, to be consistent in their cut-off dates and times for determining when payments are made on time, and to give card holders more information about how long it will take and how much it will cost to pay off their balances.

I want to express appreciation for the hard work of the Board and its staff in implementing the Act, most of which took effect on February 22 of this year. The Board has engaged in a thoughtful rulemaking process concerning credit cards.

The Act and its implementing regulations are already helping families by giving them the tools they need to manage their finances more effectively. *However, the two sections of the Act that will take effect on August 22 are among the most important in the entire Act for addressing complaints about unwarranted rate and fee hikes.* Specifically, the rules will require (1) that any late fee, over-the-limit fee, or other penalty fee be "reasonable and proportional" to the violation or omission for which it is imposed; and (2) that credit card companies begin conducting periodic reviews of any account on which they have imposed a rate increase based on certain factors since January 1, 2009, to determine whether changes in those factors now warrant a rate reduction.

These requirements are critical to addressing concerns that certain credit card companies may have used the time provided for orderly implementation of the Act as an opportunity to increase revenues at the expense of American families. The Administration is deeply concerned by reports that credit card issuers have imposed steep increases in fees and interest rates in the last several months, at the same time that there are reports that some companies may have developed complex new pricing structures and other account features that appear designed to work around the Act's requirements.[1] The Board rightly prohibited some troubling practices in its earlier rulemakings to implement the Act,[2] and as discussed below, similar action is needed now to further strengthen the proposed rule to provide meaningful relief to American families as quickly as possible.

<u>Reasonable and Proportional Penalty Fees</u>

The section of the Credit CARD Act that imposes the reasonable and proportional fee requirement, as codified in 15 U.S.C. § 1665d, addresses concerns that credit card companies are charging unwarranted penalty fees. Consumers are not likely to budget for or comparison-shop based on after-the-fact penalty fees, in part because they may tend to underestimate the likelihood of incurring such fees. As a result, penalty fees are not likely set by market forces in a fully competitive environment. Indeed, penalty fees have become such a major revenue driver that they may provide credit card companies with a strong financial incentive to encourage the very behavior they claim to seek to deter. While the Credit CARD Act outlawed several specific unfair practices (such as shifting payment due dates and times to maximize late fee revenues), the risk of skewed incentives will remain absent implementation of the reasonable and proportional requirement.

At the outset, <u>*the Board's proposal to ban fees based upon transactions that are declined by the card issuer, account inactivity, and account closure is helpful and appropriate.*</u> As the Board noted, these situations do not appear to impose any significant costs or risks on card issuers. Moreover, the latter two types of fees do not involve consumer debt activity in the first place, but rather effectively penalize families that reduce their credit card usage or take other actions to better manage their finances. To the extent that credit card companies have legitimate general administration costs, they retain other ways of covering those expenses. In addition, <u>*the Board should consider whether to ban or restrict fees for provision of paper statements.*</u> Consumers have a right under the Truth in Lending Act, as well as various other federal consumer laws, to receive mandatory disclosures in paper form. It does not appear reasonable or proportional to penalize the exercise of such statutory rights by elderly or disadvantaged consumers who may not have easy computer access.

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[1] *See, e.g.,* Letter from Senator Carl Levin to Jennifer J. Johnson (Nov. 23, 2009), available at http://levin.senate.gov/newsroom/release.cfm?id=320217; Letter from the National Consumer Law Center et al. to Jennifer J. Johnson (Nov. 20, 2009), available at http://www.nclc.org/issues/credit_cards/content/CARD-RegulationsTo-Fed1109.pdf?bcsi_scan_9AA99EB32CAE9A8A=0&bcsi_scan_filename=CARD-RegulationsTo-Fed1109.pdf; Pew Charitable Trusts Health Group, Still Waiting: "Unfair or Deceptive" Credit Card Practices Continue as Americans Wait for New Reforms to Take Effect (Oct. 28, 2009), available at http://www.pewtrusts.org/our_work_detail.aspx?id=630; Center for Responsible Lending, Dodging Reform: As Some Credit Card Abuses Are Outlawed, New Ones Proliferate (Dec. 10, 2009), available at http://www.responsiblelending.org/credit-cards/research-analysis/Dodging-Reform-As-Some-Credit-Card-Abuses-Are-Outlawed-New-Ones-Proliferate.html.

[2] *See, e.g.*. 12 C.F.R. pt. 226, supp. 1, para. 55(b)(2)-2(ii), (iii) (construing the CARD Act to prohibit interest rate increases on existing balances or during the first year after opening a card account where the card's variable rate formula is structured so that the variable rate does not decrease consistent with reductions in the base index or where the issuer may calculate the variable rate based on any index value during the time period specified in the card agreement).

Second, in evaluating penalty fee amounts under the reasonable and proportional requirement, *we agree with the Board's proposal to prohibit credit card companies from using penalty fees—rather than interest rates—to cover their risk of losses from charge-offs (and the cost of reserving against losses) that are associated with particular types of violations*, such as late payments. Adding a variable pricing element based on the risk of loss to one-time fees would make the rule even more complicated to apply, given that the proposed rule already relies heavily on detailed financial analyses of costs associated with particular violations and statistical testing of the deterrence value of particular fee levels. Further, as the Board notes, accounting for losses through interest rates encourages greater transparency and competition in the marketplace, since consumers are more likely to comparison shop based on rates than penalty fees.

Third, in light of the complexity of the calculations under the proposed regulation, it appears likely that many issuers will rely on the safe harbors created by the final rule. We strongly agree with the Board that the Act was not intended to authorize the imposition of penalty fees or other charges that are significantly higher than those currently imposed by credit card issuers. Rather, *we strongly encourage the Board to set the maximum safe harbors significantly below such levels.* The safe harbor is defined under the statute as an amount that is "presumed to be reasonable and proportional." 15 U.S.C. § 1665d(e). The fact that Congress and the President enacted a prohibition against imposing fees or charges that are not "reasonable and proportional" demonstrates that they did not presume that current levels of penalty fees and charges satisfied this statutory standard.

Finally, *additional measures are needed to increase transparency and consistency concerning penalty fee calculations.* The effectiveness of this rule will depend entirely on banking regulators, since the Act does not provide for a private cause of action in connection with the reasonable and proportional requirement. Ensuring consistency across examination teams and agencies is a major concern, particularly because the rule as proposed would rely on complex data analyses by each individual credit card issuer as the basis for exceeding the safe harbors specified by the rule. The resources and expertise needed to conduct independent analyses on a regular basis may be significant. It is therefore critical for the Board to allocate its own research resources to analyze penalty fees and other charges imposed on consumers and to coordinate closely with the other regulators to develop vigorous and consistent examination procedures.

Risk-Based Repricing Analyses

The section of the Act codified at 15 U.S.C. § 1665c is designed to ensure that card companies do not use so-called "risk-based pricing" based on market conditions, changes in borrowers' credit scores, and other factors solely as a one-way ratchet to increase consumers' annual percentage rates, but never to reduce them when risk is reduced or market conditions improve. The Act therefore requires card issuers that have imposed a risk-based price increase since January 1, 2009, to begin conducting periodic reviews at least once every six months to determine whether changes in the factors considered warrant a rate reduction. The card companies are further required to maintain reasonable methodologies for assessing the factors used in such models and to explain to consumers the factors considered in making risk-based increases.

At the outset, *the deadline for the initial reassessment of accounts on which a rate increase was imposed between January 1, 2009, and February 22, 2010, should be shortened.* This period is the one in which abusive rate increases were most likely to have occurred, since the bulk of the CARD Act protections—including the general prohibition on increasing rates on existing balances—had not yet taken effect. Yet under the proposed rule, the initial reassessment would not be due until February 22, 2011, as much as two years after the original rate increases were imposed. Such a long lag-time appears inconsistent with congressional intent.[3] We therefore urge the Board to complete its rulemaking process as quickly as possible and to provide an implementation period of no more than three months from issuance of the Board's final rule so that the first reassessment process will occur before the end of calendar year 2010. As economic conditions improve and the credit card industry stabilizes, cardholders as well as card issuers should benefit from those improvements.

More specificity should be required in disclosures about risk-based pricing increases, so as to reasonably assist responsible consumers in determining whether there are steps they can take through better financial behavior to improve the pricing on their cards. If a rate increase is based on a change in credit score, for instance, a consumer may wish to request his or her credit report to examine it for inaccuracies. If a rate increase is based on overall debt levels, the consumer may wish to pay off relevant balances. But the proposed rule would permit issuers to use extremely vague language simply attributing rate increases to "a decline in your creditworthiness." A disclosure standard comparable to what is required under the Equal Credit Opportunity Act to explain adverse actions appears appropriate here, particularly to the extent that disclosures may be required under both statutes in connection with the same rate increase. Indeed, credit reporting agencies and companies that compile credit scores already provide lenders with "reason codes" for use in satisfying Regulation B notice requirements.

Finally, *we urge the Board to tighten the proposed rule to discourage cherry-picking, maximize competition, and promote consistent enforcement.* The current proposal would allow each card issuer discretion to base its pricing reassessment on either the factors that it used at the time the initial rate increase was imposed *or* the factors that it uses today to underwrite the same card product for new customers. A reduction to the original rate would not be required; rather, the proposed staff commentary instructs that the amount of any reduction "must be determined based upon the card issuer's reasonable policies and procedures" for risk-based pricing. However, the current proposal does not provide rules or even general guidance for determining whether an issuer's risk-based policies and procedures are in fact "reasonable" under the Act. 15 U.S.C. § 1665c.

We are concerned that the proposal may provide leeway for issuers to manipulate factors, policies, and procedures to ensure that risk-based pricing effectively remains a one-way ratchet. While the Board has raised concerns that overly prescriptive standards would be unduly

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[3] Congress directed that rules implementing the reassessment requirement be finalized on or before February 22, 2010, six months before the statute takes effect on August 22, 2010. *See* 15 U.S.C. § 1665c(d). The lag time appears to have been designed to allow issuers to prepare for the initial reassessment due upon the effective date. Although the initial rulemaking deadline has passed, we urge the Board to move quickly to finalize its rules so that implementation can occur as close as possible to the original timeline.

burdensome and potentially disadvantageous to both creditors and consumers, it is noteworthy that the Board has already taken steps to prohibit credit card issuers from creating variable rate formulas that similarly operate only to increase rates.[4] A similar common sense approach here might be to require issuers to (1) use the risk-based pricing model that they use to underwrite the same card product for *new* customers to conduct the periodic pricing assessments with regard to *older* accounts, and (2) implement any reduction called for under such model in order to provide a comparable rate on the older account.[5] This approach could significantly reduce risks that issuers would manipulate their policies and procedures to disadvantage existing customers, given that doing so would make the issuers less competitive in attracting new customers who are the most likely to comparison shop based on interest rates.

We also urge the Board to exercise its authority to issue rules "to implement the requirements of and evaluate compliance with" the statutory requirement that card issuers maintain reasonable methodologies for assessing risk-based pricing factors by providing guidance on permissible analytical methods. 15 U.S.C. § 1665c(b)(1), (d). For instance, the Board could require the use of an empirically derived, demonstrably and statistically sound model, as it has done in other contexts,[6] or identify other reasonable methodologies.

In addition, we again urge the Board to coordinate closely with other banking regulators to develop vigorous and consistent examination procedures. As with the reasonable and proportional penalty fee rule, the effectiveness of the risk-based repricing rule will depend entirely on administrative enforcement. Ensuring consistency across examination teams and agencies is a major concern, particularly if the Board does not provide guidance regarding policies and procedures that would satisfy the statutory standard.

Conclusion

In closing, I want to thank the Board and its staff again for their efforts to bring implementation of the Act to completion, consistent with the intent of Congress to require greater transparency, fairness, and accountability across the industry.

Sincerely,

Michael S. Barr /RJE

Michael S. Barr
Assistant Secretary for Financial Institutions

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[4] 12 C.F.R. pt. 226, supp. I, para. 55(b)(2)-2.

[5] As the Board itself suggests, a credit card issuer would not be required to change the underlying index that serves as the basis for a variable rate. *See* proposed 12 C.F.R. pt. 226, supp. I, para. 59(d)-2, 75 Fed. Reg. 12,335, 12,375 (Mar. 15, 2010).

[6] *See, e.g.,* 12 C.F.R. pt. 226, supp. I, para. 51(a)(1)-4 (authorizing use of empirically derived, demonstrably and statistically sound models to estimate consumers' income or assets to satisfy the CARD Act's requirements concerning consideration of ability to pay); proposed 12 C.F.R. § 226.52(b)(1)(ii) (requiring use of an empirically derived, demonstrably and statistically sound model to justify penalty fees based on deterrence effects), 75 Fed. Reg. at 12,360.