AFSA

American Financial Services Association

April 14, 2010

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1384

Dear Ms. Johnson:

This comment letter is submitted by the American Financial Services Association ("AFSA")[1] in response to the Proposed Rule ("Proposal") published on March 15, 2010 by the Board of Governors of the Federal Reserve System ("FRB") in the *Federal Register*. The Proposal would regulate certain penalty fees and mandate certain account repricings on a periodic basis. AFSA appreciates the opportunity to provide its comments on the Proposal.

Summary

Although the FRB is constrained in many ways by statute, AFSA believes that the Proposal will result in continued—and unnecessary—increases in the price of credit and reductions in credit availability. We are particularly concerned that the provisions relating to penalty fees will result in arbitrary price caps on penalty fees, which will force all cardholders to pay more in the form of increased fees or reduced benefits. Although this appears to be a stated goal of the FRB, AFSA does not believe that such an outcome is appropriate or beneficial to consumers or the economy. Regardless, AFSA urges the Board to issue a final rule as soon as reasonably practicable in light of the upcoming effective date of August 22, 2010.

Scope of Proposal

The Proposal applies only to credit card accounts that are not home-secured. It would therefore not apply to home equity loans, lines of credit, or open-end personal loans. This is consistent with the FRB's implementation of other portions of the CARD Act, and AFSA strongly urges the Board to retain this limited scope in the final rule.

Penalty Fees

Under the Proposal, a card issuer may not impose a penalty fee unless the issuer has determined that the fee either represents a reasonable proportion of the total costs incurred by the issuer as a result of that type of violation, or that the fee is reasonably necessary to deter that type of

[1] The American Financial Services Association is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. The association encourages and maintains ethical business practices and supports financial education for consumers of all ages.

violation. The FRB will also provide a safe harbor amount (although the FRB declined to specify such an amount for comment in the Proposal). If the issuer intends to establish the fee based on deterrence, the issuer must use an empirically derived, demonstrably and statistically sound model that reasonably estimates the effect of the amount of the fee on the frequency of the violations. Regardless of whether the issuer uses a cost-based approach or a deterrence-based approach, the issuer must conduct its own analysis and make its own determinations—the fact that an issuer's penalty fees are comparable to fees assessed by other card issuers does not satisfy the requirements.

Cost-Based Analysis

With respect to the cost-based analysis, the FRB specifically states that losses and associated costs, such as the cost of holding reserves against potential losses, are *not* costs incurred by an issuer that may be factored into an issuer's calculations. AFSA strongly disagrees with this approach. The FRB states in the preamble to the Proposal that violations of account terms (*e.g.*, late payments) generally do not result in losses, and therefore costs associated with such losses should not be considered. While it may be true that most consumers who pay late will not ultimately charge off, it is indisputably true that a consumer who pays late is more likely to result in a loss. For this reason, such a consumer imposes additional risk—and therefore costs—on a card issuer. AFSA will not belabor this point because it is not a concept that requires significant additional explication to a safety and soundness regulator. We believe it is inappropriate to require card issuers to ignore these costs when determining appropriate penalty fees.

Not only is it unwise to prohibit the consideration of risk when setting penalty fees, we believe the FRB should *encourage* issuers to explore ways to continually improve risk management. The CARD Act and its implementation have significantly reduced the risk management tools available to card issuers. Although the societal benefits of these changes are subject to debate, it is indisputable that card issuers must "price in" risk up front to account for the risks posed by specific cardholders. Penalty pricing, such as penalty APRs, are one of the few options still available to card issuers when attempting to manage risk on existing accounts, although even this tool has significantly diminished value as a result of the CARD Act. In addition to using penalty APRs to control risk, we believe it would be appropriate for card issuers to use penalty fees to control risk.[2] So, while the FRB states in the preamble that card issuers do not currently price for the risk of loss through penalty fees, AFSA believes not only that issuers do price for risk through penalty fees, but also that it would be imprudent to preclude the ability to do so in the future.

When considering costs, the Proposal includes several examples of costs for various penalty fees. For example, the costs incurred by an issuer as a result of late payments include costs associated with the collection of late payments, such as notifying consumers and resolving delinquencies. We suspect there are additional costs resulting from late payments, such as the need to establish and maintain account management procedures for delinquent accounts. AFSA also notes that, if the late payment fees are truly intended to recover the costs of late payments, an issuer should be permitted to include as a factor the likelihood of actually receiving the late payment. For

[2] This may be one of the concepts supporting the use of penalty fees as a deterrent although, as we discuss below, the Proposal essentially precludes an issuer from using penalty fees as a deterrent to risky behavior.

example, if an issuer's likelihood of collecting a late payment is 75%, the issuer should be permitted to divide the cost-based penalty fee determined assuming a 100% collection by 0.75 to allow the issuer to recover its costs associated with late payments. For example, a cost-based fee of $18 assuming 100% collections divided by 0.75 would permit a $24 fee. When considering this point, we urge the FRB to keep in mind that either those consumers who make late payments can cover the costs of late payments, or those consumers who pay on time can cover the costs. AFSA strongly believes that late payers should assume the costs of late payments.

Deterrence-Based Analysis

With respect to establishing fees based on deterrence, AFSA agrees that card issuers should be permitted to set fees at a sufficient level to deter account violations. Indeed, this option is specifically included in the statute. We fear, however, that the Proposal does not provide issuers with any practical ability to actually set penalty fees based on the concept of deterrence. AFSA believes it would be relatively simple to determine the fee levels that would deter various consumers from making late payments (*e.g.*, a "one-fee-fits-all" approach, segmented by card type, segmented by credit score, segmented by account history, etc.). This could be done by a third party for the industry as a whole or on an issuer-by-issuer basis. The Proposal, however, would require each issuer—no matter how big or small—to amass significant amounts of data and build a model to determine with relative precision the exactly optimal fee for deterring account violations with that card issuer. The FRB provides no real guidance as to how an issuer could conceivably meet the standard in the Proposal, and we suspect such guidance is unlikely to be forthcoming. AFSA urges the FRB to reconsider its approach to how an issuer could establish penalty fees based on deterrence so that issuers may have a legitimate opportunity to take an approach that is specifically described in the statute.

At the very least, we believe the FRB should clarify that an issuer need only show that some correlation existing between the amount of the fee and behavior deterrence. The Proposal currently suggests that correlation between these two factors would not be enough to support a fee determination. Statistical models, however, cannot necessarily prove causation.

Reevaluation

Regardless of whether an issuer uses a cost-based analysis or deterrence-based analysis, the Proposal requires the issuer to reevaluate its determinations no less than every twelve months. If the reevaluation indicates that a lower fee is consistent with the cost- or deterrence-based approach, the issuer would need to reset to a lower fee within 30 days after completing the reevaluation. If a fee could be increased as a result of the reevaluation, the issuer must comply with the applicable requirements of § 226.9.

AFSA does not believe it is unreasonable to ask issuers to continually evaluate their penalty fees, but we do have some concerns with respect to actual effects of the Proposal. As a practical matter, absent more flexibility than is currently in the Proposal, it is not clear how an issuer could engage in a full reevaluation of deterrence-based fees since the issuer must have data relating to higher fees than currently necessary to deter conduct. Not only would imposing a higher fee than previously justified by the issuer violate the Proposal, but even testing higher fees would require significant effort to comply with CIT notice requirements when raising the fees for testing purposes.[3] Issuers would therefore need relief from those regulatory requirements to engage in any such evaluation. It also appears to us that the reevaluation is a one-way path to lower fees when evidence supports a decrease, with significant limitations on the ability to increase fees when evidence supports an increase. Specifically, since the Proposal would require an issuer to provide the consumer with the ability to opt out of an increased penalty fee, AFSA believes many cardholders may opt out of fee increases. This artificially limits an issuer's ability to recover costs or deter penalty behaviors—despite the clear statutory intent to permit such capabilities. Although cardholders should receive a notice if a penalty fee increases, we do not believe it is necessary or appropriate to allow them to opt out of such an increase if the increase is appropriate based on the required reevaluation. We ask the FRB to grant such an exception to the requirements of § 226.9(h).

We also ask the FRB to grant issuers additional time to reduce the relevant penalty fee resulting from the reevaluation. Not only will such a reduction require systems and business changes, but issuers would also be required to update their disclosure tables. This can be a time consuming process, especially for disclosures provided at the point of sale. We believe issuers should have at least 60 days to implement such changes.

Prohibited Fees

The Proposal prohibits an issuer from charging certain penalty fees. Specifically, an issuer may not charge a penalty fee that exceeds the dollar amount associated with the violation. A card issuer also may not charge a fee in connection with declined authorizations, account inactivity, or the closure or termination of an account. The Proposal also prohibits an issuer from imposing more than one penalty fee based on a single event or transaction. AFSA strongly urges the FRB to delete these prohibitions in the final rule, and we discuss each of these separate issues below.

AFSA does not believe it is appropriate to limit a penalty fee to the dollar amount associated with the violation. If an issuer has determined that a particular violation costs $20, or that deterring such a violation requires a fee of $25, it is not clear why the issuer should be restricted by an arbitrary standard that will result in a fee that neither covers costs nor deters consumer behavior. Indeed, such a requirement would appear to conflict with the provisions drafted by Congress that direct the FRB to consider costs and deterrence.[4] We also note that an issuer may not be able to reliably determine the dollar amount associated with a violation. Although the FRB provides relatively basic examples (*e.g.*, a late payment fee cannot exceed the minimum payment amount), compliance may oftentimes be much more complicated. For example, if a consumer misses several payments, and then makes only a partial payment on the required minimum payment, it is not clear how the Proposal would apply.

[3] We also believe that issuers who engage in such testing will likely face significant reputational, political, and customer service harm as the testing of fee levels could garner unwanted criticism.
[4] The statute also allows the FRB to consider "other factors," but it strains credulity to suggest that such other factors could override those provided for by Congress. Such an interpretation would render the specifically enumerated factors as essentially meaningless, violating a canon of statutory construction.

We are also concerned that the FRB is attempting to outlaw a variety of fees, none of which are considered penalty fees or fees imposed for omissions/violations of an agreement. The FRB simply cannot rely on the statute to support these prohibitions. Not only are these price controls not supported by the statute, but the price controls are also patently inappropriate. For example, it is perfectly appropriate for an issuer to inform a consumer that the consumer will pay a fee for the account unless the consumer uses the card (*i.e.*, otherwise generates revenue for the card issuer, such as through interchange). This is neither a penalty nor an omission with respect to the agreement—certainly no more than charging a fee for other behaviors, such as a cash advance fee, a per transaction fee, or an international transaction fee is a fee for a violation or omission of the agreement. We fear this portion of the Proposal will not only require issuers to incur costs associated with maintaining unused accounts, but it may also result in issuers canceling inactive accounts that cardholders would prefer to have the option of retaining for a small fee (*e.g.*, emergency cards).

AFSA also believes the limitation of one penalty fee per transaction, regardless of the number of violations associated with the transaction, should be eliminated. If a cardholder engages in an activity that results in multiple violations with multiple costs, the issuer should be permitted to recover costs associated with each of those violations. It is unfair to other cardholders to expect the issuer—and therefore those other cardholders—to absorb the costs associated with those multiple violations. Furthermore, issuers will have a very difficult time determining when multiple violations are associated with one transaction or multiple transactions. We realize the FRB has provided a safe harbor of one fee per month, but this is inadequate for purposes of cost recovery or deterrence.

Safe Harbor Fee Amount

Although the FRB proposes to provide a safe harbor penalty fee amount, the Proposal did not include a specific amount. AFSA believes the safe harbor will likely become the *de facto* fee amount for many card issuers. We recognize that the FRB intends to provide issuers the flexibility to use a cost-based or deterrence-based analysis, but we also believe that issuers will have a high burden of proof to demonstrate why a fee amount that exceeds the safe harbor amount is permissible. This will be especially true for smaller issuers that may not have the expertise or resources to engage in a cost-based or deterrence-based analysis.

It is therefore critically important that the FRB provide a safe harbor that is a rough proxy as a deterrence-based or cost-based amount. AFSA understands that several issuers intend to provide the FRB with data that supports certain safe harbor levels. We encourage the FRB to carefully consider this data when establishing a safe harbor.

AFSA also urges the FRB to recognize that because the safe harbor amount will become the default for many issuers, it is in setting the safe harbor that the FRB may have the most impact on cost shifts to consumers who do not incur penalty fees. If the FRB sets a safe harbor amount that is significantly lower than the *status quo* or even below a reasonable cost-based/deterrence-based amount, it is obvious that card issuers will receive significantly reduced compensation for the risk they incur. We recognize that the FRB appears to believe that, at least in some circumstances, it is appropriate to socialize these costs among all consumers as opposed to those who actually impose the increased risk. AFSA clearly disagrees with this approach, and we ask the FRB to evaluate the impact its final rule will have on all cardholders—including those who abide by their account terms.

<u>Account Repricing</u>

If an issuer increases the APR based on any "factors" (*i.e.*, for any reason), and such an increase requires the issuer to send a notice under §§ 226.9(c)(2) or 226.9(g), the issuer must evaluate whether such factors have changed and reduce the APR as appropriate.[5] This repricing evaluation must occur at least every six months after the APR increase. Under the Proposal, the issuer is not required to review the same factors which led to the APR increase. The issuer may, at its option, review the factors it currently considered when determining the APR applicable to its credit card accounts. If an APR reduction is required, the issuer must reduce the APR no later than 30 days after the repricing evaluation.

Evaluation of Factors

AFSA believes the Proposal implements the statute in a reasonable manner given the requirements of the statute. We especially urge the FRB to retain the flexibility provided to issuers with respect to the factors they must consider when repricing an account. It is unreasonable to expect a card issuer to track a variety of factors for several years and to evaluate them meaningfully for purposes of compliance with the Proposal. For example, an APR may have been increased for business purposes that are not easily quantifiable, especially over time, and an issuer cannot necessarily evaluate such a "factor" every six months for the years (decades?) the account is open. This flexibility is especially critical with respect to the reviews of accounts with an increased APR dating back to January 1, 2009, when issuers did not necessarily record "factors" leading to the increase in a manner that is easily reviewable. For each of these reasons, it is certainly appropriate to allow an issuer to review the account using its current criteria for accounts to determine whether the account is mispriced.

AFSA is concerned, however, with the requirement that an issuer must review the same factors for accounts with similar features that are offered for similar purposes, and may not consider different factors for each of its individual accounts. AFSA does not believe an issuer should have different factors for each of its individual accounts, but we do believe it is necessary to permit an issuer to have different scorecards for different portfolios, even if the accounts have otherwise similar features. For example, a basic, no frills account offered in connection with one agent bank relationship may have very different underwriting criteria than a basic, no frills account offered in connection with a different agent bank relationship. The same could be said for different private label programs, or a variety of other card offerings that are similar in features, but vastly different in pricing. The Proposal should not require the card issuer in these or similar circumstances to artificially harmonize the factors it uses when setting the terms of accounts.

Circumstances When a Fee Is Actually Imposed

[5] We urge the FRB to retain the notion that the evaluation requirement does *not* apply unless a notice under §§ 226.9(c)(2) or 226.9(g) is required. For example, as the FRB implicitly indicates, it does not make sense to evaluate an account for repricing if the APR increase is as a result of an expired promotion.

Comment 226.59(a)-2 in the Proposed Rules states that the re-evaluation requirements in Section 226.59(a) do not apply if the increased rate is not actually imposed on the consumer's account. While AFSA supports this Comment, we ask for further clarification regarding the its application. It is unclear when reading the Comment whether the creditor may exclude from the re-evaluation any account for which there is no balance subject to an increased rate, or whether the creditor must determine whether the account has ever had a balance subject to the increased rate and include any accounts that have had a balance in the re-evaluation. It would clearly be much more burdensome on the creditor from a tracking perspective to have to determine whether the increased rate has ever applied to the account and that seems unnecessary if there is currently no balance on the account to which the increased rate applies. Therefore, AFSA requests that the Board clarify that creditors may check at the time of each re-evaluation whether an account has a balance subject to the increased rate, and if not, exclude them from the current six month review with respect to that particular rate increase.

Implementation Time Frame

The Proposal requires the issuer to implement a reduced APR within 30 days of the account review. We believe that such a timeframe may be too short for some issuers, and ask the FRB to allow issuers at least 60 days to implement the reduced APR. We also ask the FRB to clarify that an issuer may wait until the first day in a billing cycle after the specified time period to reduce the APR. Without such flexibility, the Proposal may require issuers to implement the changes within a day or two depending on the timing of a billing cycle.

Termination of Obligation

The Proposal allows an issuer to terminate the six-month account review process if the issuer reduces the APR to the APR applicable immediately prior to the APR increase, or to a lower APR. The FRB specifically solicited comment on whether the obligation should terminate after a specific period of time. AFSA believes the obligation should terminate two years after an APR increase. We believe the FRB must balance the costs associated with this regulatory burden with the benefits to cardholders. If an account has not been repriced downward within two years—and the consumer has not found a better deal within two years—that strongly suggests the account is priced appropriately from the standpoint of both parties. Furthermore, it is not as if the cardholder is trapped in a mispriced account. If another issuer believes the cardholder presents less risk than the existing issuer is pricing into the account, the cardholder can obviously switch to a different card.

Disclosure Revisions

CIT and Penalty Notices

The Proposal implements the statutory requirement that CIT and penalty notices include the reasons for an APR increase. The Proposal requires an issuer to include no more than four such reasons, listed in their order of importance. The Proposal also provides guidance as to the level of detail necessary in connection with listing such reasons. AFSA believes these provisions are appropriate and should be retained. Although it appears the FRB is drawing heavily from its interpretations under Regulation B with respect to a similar requirement in connection with adverse action notices, we believe it would be helpful for the FRB to explicitly reference such interpretations in a final rule to provide issuers with certainty with respect to the FRB's expectations. We do not believe the FRB intends for there to be any difference between the practical implications of the requirements, and an explicit reference to Regulation B and its Official Staff Commentary would eliminate any ambiguity.

Effective Date

The statute requires that these provisions become effective August 22, 2010. It is likely that card issuers will not know what the regulatory requirements are until mid-June at the earliest. If compliance with the Proposal were required by August 22, 2010, card issuers would have approximately two months to develop compliance programs, revise disclosures, and otherwise meet their regulatory obligations. This is simply unreasonable, especially in light of issuers' existing compliance obligations under the CARD Act and revised Regulation Z.

Conclusion

AFSA appreciates the opportunity to provide its comments on the Proposal. Please do not hesitate to contact me at 202-296-5544 if you have any questions about our comments or if we can provide further assistance with respect to the Proposal.

Sincerely,

Chris Stinebert
President and CEO