THE PEW CHARITABLE TRUSTS

2005 Market Street, Suite 1700
Philadelphia, PA 19103-7077
215.575.9050 Phone
215.575.4939 Fax

901 E Street NW, 10th Floor
Washington, DC 20004
www.pewtrusts.org
202.552.2000 Phone
202.552.2299 Fax

June 25, 2009

By Electronic Delivery

Ms. Sandra Braunstein
Division of Consumer & Community Affairs
Board of Governors of the Federal Reserve System
Washington, D.C 20551

RE: "Reasonable and Proportional" Rules Under Credit CARD Act of 2009 (Pub. L. 111-24)

Dear Ms. Braunstein:

I am writing to share comments in support of the Board's rulemaking efforts under the Credit CARD Act of 2009. As you may know, Pew's Safe Credit Cards Project began in 2007 as an effort to protect customers from unfair credit card practices and promote responsible management of debt. Since then, we have published a set of Safe Credit Card Standards as well as various results from our research and analysis. On several occasions we have discussed our work with your team.

We applaud the significant accomplishments you and your team have made recently, particularly in establishing balanced safeguards against unfair and deceptive acts and practices. The new law is in many ways a testament to your efforts. I hope that the comments we enclose below are helpful as your team develops the rules called for in this new law.

Our comments focus specifically on the new law's requirement that penalty fees and charges must be reasonable and proportional to the violations or omissions that trigger those penalties. The law has defined a very narrow basis for justifying these penalties. The Board's rules should reflect that narrowing approach, particularly in regard to the cost considerations that may justify a penalty. Similarly, because the law is designed in favor of maximizing price transparency and market efficiency, the Board's rules generally should err on the side of those goals by constraining the proliferation of confusing or potentially "rent seeking" penalty structures. For penalties that are not readily justifiable based on the factors provided in the law, we urge the Board to tolerate no more than *de minimis* fees.

We look forward to continuing our dialogue with your team, and we are available to discuss these comments or any other aspect of our work on credit cards at any time.

Sincerely,

Nick Bourke
Manager, Pew Safe Credit Cards Project
nbourke@pewtrusts.com | 202-552-2123 direct
www.pewtrusts.com/creditcards

CC: Leonard Chanin, Ben Olson

Reasonable and Proportional Penalty Fees and Charges

In 2007, The Pew Charitable Trusts launched an effort, in partnership with the Sandler Foundation, to address growing concerns about abuses in the credit card industry. The project team, led by a former credit card company chief executive officer, researched consumer use of credit cards, conducted economic analyses of credit card practices and revenues, and closely reviewed hundreds of credit card products. Based on these efforts, we published a set of Safe Credit Card Standards to promote responsible lending and borrowing, and to help make credit card products more transparent, simple and predictable. In the following comments, we have drawn on these experiences as well as additional research and analysis specifically intended to address requirements found in the new law.

These comments are divided into the following sections:

A. <u>Definitional Issues</u>. We discuss ways the Board may simplify the analysis regarding which penalties and charges will be subject to the reasonable and proportional rules.
   - The Board should define a set of fees and charges that will *not* be subject to the reasonable and proportional rules, and presume that any other type of fee or charge will be subject to the rule.
   - Taking the further step of requiring all fees for the issuance or availability of credit to be disclosed in the form of a single, annualized figure would greatly enhance pricing transparency.

B. <u>Analytical Factors</u>. This section discusses the analytical factors established in the law.
   - Costs are to be determined based on the actual consequences of the cardholder's violation or omission; therefore, while marginal costs of special mailings or other actions may be considered, compensation for risk or lost revenue may not.
   - The deterrence value of penalty fees is not clear, and must be balanced carefully against established problems of rent extraction.
   - Cardholder behavior is the only purely punitive factor in the analysis; and penalties can only be justified on this basis to the extent they are closely tied to "bad actions" that are in the cardholder's power to control.
   - Other appropriate considerations are timing issues (how quickly, how long and how substantially the fee or charge may be applied) and relationship to the law's fundamental goals of transparency and efficient market behavior.

C. <u>Discussion of Specific Penalty Fees and Charges; Safe Harbor Issues.</u> Key points for late fees, penalty interest rate increases and over-the-limit fees are discussed. Where possible, we suggest safe harbor guidelines.

Appendix A: Data on Penalty Fees and Charges in the Market

Appendix B: Discussion of Proposed Seven-Point Penalty Premium Threshold

Appendix C: Sample State Law Limiting Penalty Fees

A. Definitional Issues

Section 102(b) of the Credit CARD Act of 2009 (Pub. L. 111-24) adds the following language to the Truth in Lending Act:

> **Sec. 149. REASONABLE PENALTY FEES ON OPEN END CONSUMER CREDIT PLANS**
>
> (a) IN GENERAL.—The amount of any penalty fee or charge that a card issuer may impose with respect to a credit card account under an open end consumer credit plan in connection with any omission with respect to, or violation of, the cardholder agreement, including any late payment fee, over-the-limit fee, or any other penalty fee or charge, shall be reasonable and proportional to such omission or violation.

The law requires the Board, in consultation with the federal financial supervisory agencies, to issue rules "to establish standards for assessing whether the amount of any penalty fee or charge… is reasonable and proportional to the omission or violation to which the fee or charge relates." The law specifically authorizes the Board to set "safe harbor" guidelines for penalties that will be presumed to be reasonable and proportional.

The reasonable and proportional requirement applies to "any penalty fee or charge… in connection with any omission with respect to, or violation of, the cardholder agreement…." These fees may include any "late payment fee," "over-the-limit fee," or "any other penalty fee or charge;" but the law does not provide a complete definition. We encourage the Board to define "penalty fees or charges" in a manner that minimizes the incentive for card issuers to introduce new or duplicative fees.[1] By doing so, the Board will help promote the specific legislative intent to restrain penalties to reasonable levels, as well as the general intent to maximize price transparency.

The best way to maximize the efficacy of the rule, and to minimize issuers' incentive to circumvent the reasonable and proportional requirement, is to define fees that will *not* be subject to those requirements and apply the rules to all other fees or charges. In the course of developing our Safe Credit Card Standards[2], we learned that creating a structure to constrain the proliferation of fees was vital to achieving the fundamental goals of transparent and predictable pricing. Similarly, in the present rulemaking, constraining fees in such a way that there is little room for argument about which fees will be subject to the reasonable and proportional rule will be vital to achieving the rule's purpose.

Therefore, we propose that the Board define three types of fees that will *not* be considered penalties for purposes of the reasonable and proportional rules, and declare that all other fees *will* be subject to the rules. The three suggested types of exempt fees are as follows:

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[1] There is evidence of a "rent extraction" problem related to penalty fees, which may encourage issuers to allow or even encourage their customers to engage in behavior that maximizes penalty fee income. See further below in these comments for a discussion.

[2] See www.pewtrusts.org/creditcards. The Safe Credit Card Standards were designed to protect cardholders and promote a functional marketplace, largely by ensuring transparent and predictable pricing. Pew developed the Standards after extensive consultation with industry, consumer group and government representatives.

1. *Fees for the issuance or availability of credit.* The Board has already defined this type of fee, and we would encourage the Board to use that definition in its present rulemaking. In § 227.26 of Regulation AA (as effective July 1, 2010), the Board defines "fees for the issuance or availability of credit" to include any annual or other periodic fee for issuance or availability of credit, including any fee based on account activity or inactivity, and any non-periodic fee related to opening an account. Elsewhere, Regulation Z requires disclosures of "any annual or other periodic fee that may be imposed for the issuance or availability of a credit or charge card, including any fee based on account activity or inactivity" and a statement of how frequently it will be imposed and the annualized amount of the fee (§ 226.5a(b)(2) as effective July 1, 2010).

   Further, we strongly encourage the Board to take the additional step of requiring issuers to disclose all fees for the issuance or availability of credit *in the form of a single, annualized cost figure*. In our Safe Credit Card Standards, we proposed requiring all such account-level fees to be expressed as an annual account maintenance fee. Consolidating fees for the issuance or availability of credit in this way would greatly enhance pricing transparency and reduce incentives issuers may have to embed multiple service fees that make the overall price of credit difficult to identify or compare. It would also help to limit the number of fees that must be disclosed by issuers, evaluated by consumers and analyzed by government authorities.

   This requirement to express fees for the issuance or availability of credit as a single annualized cost figure would fit easily within the Board's existing rule structure. The fee would be disclosed as a single, annualized fee, but could be charged periodically throughout the year as appropriate. Thus, this requirement would not interfere with the requirement, in § 226.26 of Regulation AA, to charge the fee in installments over a period of months in cases where the fee would exceed 25 percent of the initial credit limit for the account.

   This new requirement should take precedence over related disclosure rules. For example, to accommodate the requirement in Regulation Z, § 226.5(a)(b)(2), which will require issuers to label any non-periodic account opening fee as a "one-time" fee, issuers may be directed to provide the single annualized cost figure prominently with a notation underneath indicating the portion of the annualized fee represented by the one-time application fee.

2. *Transaction surcharges*. These fees would be surcharges imposed on any approved transaction meeting specified characteristics based on the place or nature of the transaction. Examples include transactions occurring at a foreign point of sale or requiring foreign currency exchange, cash advances or balance transfers.[3]

   To strengthen the definition of this type of fee, we encourage the Board to create a definitive list of fees which it would consider transaction surcharges, with the

[3] It should be noted that an excess of transaction surcharges on an account would tend to undermine pricing transparency by shrouding the true cost of credit. Though these types of fees may require safeguards to ensure transparency and protect consumers from unfair and deceptive practices, we have not addressed those issues in this comment.

presumption that any other type of charge will not be considered a transaction charge without further analysis.

3. *Customer-initiated service fees*. These fees would result from non-transactional, customer-initiated service requests, such as copy charges or rush delivery of a new card. A fee will not qualify as a customer-initiated service fee unless the cardholder expressly requests the service and explicitly agrees to pay the stated fee.

   As with transaction surcharges, the Board may wish to create a list of fees considered to be customer-initiated service fees, with a presumption that other types of fess will not be categorized as such without further analysis. This list may include: Expedited payment fee, card replacement fee, expedited delivery fee, copy fee, research fee and/or stop payment fee.

All other fees or charges, with the exception of standard (non-punitive) interest charges established at the account opening or via a change in terms notice, should be presumed to be penalty fees or charges for purposes of the reasonable and proportional requirements. (We also note that our Safe Credit Card Standards would prohibit any penalty fee or charge, other than a late fee, a returned payment fee and a limited temporary penalty interest rate increase, and that the Board could consider a similar rule as a way to clarify the analysis and restrict the confusing proliferation of fees and charges).

B. Analytical Factors

Section 102(b) of the law instructs The Board to consider the following in forming the reasonable and proportional standards:

> “(1) The cost incurred by the creditor for such omission or violation;
> “(2) The deterrence of such omission or violation by the cardholder;
> “(3) The conduct of the cardholder; and
> “(4) Such other factors as the Board may deem necessary or appropriate.”

Cost

The first factor, cost, is specifically constrained to include only those costs the creditor incurs for the “omission or violation” for which the penalty is being imposed. By delimiting costs to those incurred for the omission or violation specifically, the legislation makes it clear that any costs related to the normal costs of doing business, such as general overhead, risk exposure, customer service, billing and account maintenance costs, must not be included. The only costs that remain to be considered are whatever actual marginal costs may be attributable to any extraordinary efforts an issuer makes in response to the omission or violation, such as sending a special letter or email, making a phone call or suspending a delinquent account.

An estimation of these costs should *not* include an accounting for the marginal risk an account may pose because of the omission or violation.

Compared to commercial and investment banking, the risk involved with retail lending portfolios is both more diverse and more predictable. Though risk concentrations can vary in retail portfolios, risks tend to be spread widely, with credit delivered in small pieces, over an extended period of time, to thousands or millions of borrowers. Consequently, retail lenders can confidently estimate future losses based on their initial underwriting policies. "The high predictability of retail credit losses mean that the expected loss rate dominates retail credit risk and can be built into the price charged to the customer," notes the authors of *The Essentials of Risk Management*.[4]

Though it may be possible for an issuer to demonstrate that accounts with certain violations (such as a late payment) have a higher incidence of chargeoffs, it is not reasonable to translate that risk into a punitive fee or charge that will apply when an account demonstrates the supposedly risky behavior. At a portfolio-wide level, card issuers create complex pricing models that are intended to account for a number of factors, including risk as well as corporate goals such as profitability and market share. In fact, the book *The Essentials of Risk Management* advises that a "well-designed RBP [Risk-Based Pricing] strategy allows the bank to map alternative pricing strategies at the credit score level to key corporate metrics (e.g., revenue, profit, loss, risk-adjusted return, market share, and portfolio value…."[5] Depending on the overall mix of these corporate metrics, creditors will accept more or less risk, set more or less aggressive pricing, and market their products more or less broadly.

It is at the portfolio level, not the specific account level, where issuers make these determinations. Thus, the risk associated with omissions and violations of account agreements may be factored into the price of a credit card account at the front end, so that by the time an omission or violation occurs, risk is not part of the new costs the issuer will incur. Every day, as issuers earn interest on outstanding balances, they are compensated for risk and the costs of doing business in the context of their overall marketing, pricing and risk management strategy.

Deterrence

The second factor relates to deterring the specific omission or violation in question. There is little available research to help identify the deterrence value of fees, let alone how to distinguish between a fee that is used to discourage behavior versus one that is primarily a revenue tool. In a recent paper, Sumit Agarwal, et. al., identified a learning affect associated with fees. It found that cardholders pay "very large" fees immediately after opening an account, but learn to reduce those fees over time, such that monthly fee payments fell by 75 percent during the first four years of an account's life. The more recently a fee was applied, the less likely the cardholder was to incur the fee again in subsequent months.[6]

In theory, credit card issuers will want to take advantage of this learning effect to discourage their customers from missing payment due dates, exceeding credit limits or any other activity which warrants a penalty fee. However, companies also have a powerful incentive to allow, or even encourage, their customers to trigger fees as a way of boosting revenue. As a recent

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[4] Crouhy, Michel, Dan Galai and Robert Mark, *The Essentials of Risk Management* (McGraw-Hill, 2006), at p. 209.
[5] Ibid., at p. 228.
[6] Agarwal, Sumit, John C. Driscoll, Xavier Gabaix and David I. Laibson, "Learning in the Credit Card Market" (Februray 8, 2008). Available at SSRN: http://ssrn.com/abstract=1091623.

Harvard Business Review feature noted, "a company is less likely to help customers make good choices if it knows that it can generate more profits when they make poor ones."[7] The problem extends particularly to penalty fees:

> Such charges may have been conceived as a way to deter undesirable customer behavior and offset the costs that businesses incur as a result of that behavior. Penalties for bouncing a check, for example, were originally designed to discourage banking customers from spending more than they had and to recoup administrative costs. The practice was thus fair to company and customer alike. But many firms have discovered just how profitable penalties can be; as a result, they have an incentive to encourage their customers to incur them – or at least, not to discourage them from doing so.[8]

Given the strong incentive companies have to allow or encourage customers to trigger penalty fees, it is unclear how strongly Agarwal's learning effect may be attributed to deterrence. In learning to avoid penalty fees that are common in the early stages of an account's life, customers may be adopting more responsible behavior based on a deterrent effect; or, they may simply be gaining a fuller understanding of the actual costs they can incur and a sophistication about how to reduce those costs.[9]

Another study, by Nadia Massoud et. al., would suggest the latter. While this study identified a correlation between penalty fees and default risk, no deterrence effect was found. However, the authors did identify a strong correlation between an issuer's market power and the magnitude of penalty fees. Banks with higher market share were able to "extract rents" in the form of penalty fees, even after holding consumer risk constant.[10]

While the deterrence value of penalty fees would seem to be limited, the incentive for companies to allow or encourage customer behavior that maximizes revenues, including fee revenues, is significant. In 2008, penalty fees (exclusive of penalty interest rate increases) accounted for 6.6 percent of credit card revenue, or more than $8.5 billion dollars.[11] The Center for Responsible Lending, in separate comments currently being submitted to the Board, has estimated that these fees have steadily increased as a percentage of revenue since the Supreme Court's *Smiley* decision effectively deregulated credit card fees.

To be reasonable and proportional, a penalty fee or charge should be designed to allow for a modest deterrence effect while minimizing the negative "rent extraction" factors. To accomplish this balance, penalties generally should be kept to a *de minimis* level, particularly absent compelling evidence from issuers that larger fees are both necessary for deterrence *and* can be designed with sufficient safeguards to minimize risks of rent extraction.

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[7] McGovern, Gail and Youngmee Moon, "Companies and the Customers who Hate Them" Harvard Business Review, June, 2007.
[8] Ibid.
[9] For an overview of scholarly studies exploring how sophisticated firms may attempt to exploit consumer ignorance or biases, see: Gabaix, Xavier and David I. Laibson, "Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets" (April 11, 2005), MIT Department of Economics Working Paper No. 05-18 (at footnote 1). Available at SSRN: http://ssrn.com/abstract=728545.
[10] Massoud, Nadia, Anthony Saunders and Barry Scholnick, "The Cost of Being Late: The Case of Credit Card Penalty Fees" (March 2006), AFA 2007 Chicago Meetings Paper (see p.29-32 for a discussion of the correlations among penalty fees, risk and market share). Available at SSRN: http://ssrn.com/abstract=890826.
[11] Cards & Payments, May, 2009.

Cardholder Conduct

The third factor relates to the conduct of the cardholder. Presumably, this factor may be intended to allow for a consideration of the cardholder's prior omissions or violations in setting the rate of a current penalty. It follows that cardholders who repeatedly pay late, for example, may be subjected to a higher degree of penalty fee or charge as a punishment for the repeated bad conduct.

Given that the law sets aside cost and deterrence in separate factors, the conduct factor is the only purely punitive factor in the analysis. As such, any consideration of cardholder conduct should focus on "bad" behavior, such as willful failures to pay on time, and not any additional costs or need for deterrence that may stem from the behavior. The key question regards what may an issuer reasonably do to punish a cardholder's behavior, and whether the punishment is proportional to the behavior.

Similarly, penalties for bad conduct should only respond to violations or omissions that are fully in the cardholder's power to control. The less an issuer can directly tie the punitive fee to the cardholder's willful bad conduct, the less reasonable and proportional the fee will be.

Other Factors

Among the other factors the board may generally consider, we suggest the following:

- *Timing issues*. The timing of when a penalty fee or charge is imposed, and in some cases how long the penalty charge will be applied, will affect the reasonability and proportionality analysis. For simplicity, an issuer may wish to impose a fee or charge according to uniform rules, which may in some cases mean that a penalty is imposed even before the issuer has incurred a cost. While this type of simplification is understandable, even desirable, it may require that the amount of the fee, or the duration of the charge, must be sufficiently low to ensure that the fee is reasonable and proportional portfolio-wide.

- *Impact on transparency.* Among the primary objectives of the Credit CARD Act of 2009 were improving the transparency of credit card pricing arrangements and protecting consumers from unfair, misleading or deceptive practices.[12] In evaluating whether a penalty fee or charge is reasonable and proportional, the Board should consider whether the penalty in question would tend to undermine these goals. Penalty schemes that would tend to create non-transparent pricing arrangements, complexity, unpredictability regarding the expected cost of an account, or risk of rent extraction should be closely scrutinized.

[12] See, e.g., the report, "Amending the Consumer Protection Act, to Ban Abusive Credit Card Practices, Enhance Consumer Disclosures, Protect Underage Consumers, and for Other Purposes," submitted by Chairman Chris Dodd, May 4, 2009. Available at: http://www.thomas.gov/cgi-bin/cpquery/T?&report=sr016&dbname=111&.

C. Discussion of Specific Penalty Fees and Charges; Safe Harbor Issues

In this section, we review common types of penalty fees and charges. For each, we discuss the analytical factors outlined above and suggest potential safe harbor guidelines.

1. Late Fees

Key Points

- Hair-trigger penalties for the late fee, such as allowing the fee to apply immediately on the payment due date, should be closely scrutinized.
    - Issuers will tend not to incur additional costs due to the late payment immediately after the due date; rather, any additional costs that may arise would not occur before several days have passed.
    - For the fee to be based on deterrence and cardholder behavior factors, it is appropriate to create a leniency period of several days after the due date to ensure that the late payment is not due to factors beyond the cardholder's control, such as delays in the mail or the payment posting process.
- Generally, the size of the fee should be in proportion to the amount of the payment that is *past due*.
    - The median late fee on a credit card account is $39 for accounts with outstanding balances of $250 or more (see Appendix A for data on current market conditions). Most credit card accounts, which have balances significantly higher than the $250 threshold, are subject to this $39 late fee.
    - For an account with a balance of $3,000 (the median household credit card debt[13]), a $39 fee represents only 1.3 percent of the overall account balance. But compared to the *minimum payment due* for the month, which is likely to be approximately $65, a $39 late fee represents a penalty of approximately 60 percent of the past due amount.[14] A 60 fee that increases a cardholder's minimum required payment by 60 percent may be difficult to justify as being proportional.

[13] Our estimate based on Survey of Consumer Finance Data. See: Bucks, Brian K., Arthur B. Kennickell, Traci L. Mach and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, vol. 95, February 12, 2009, at p. A45

[14] The minimum payment due is demonstrated based on an annual percentage rate of 14 percent (roughly the current average advertised purchase rate – see e.g. www.indexcreditcards.com) multiplied by the $3,000 average daily balance, plus a one percent principal reduction.
[i.e.: $3,000 * (.14/12) + $3,000 * 0.01, or $35 + $30 = $65]

Safe Harbor Considerations

We have not established complete safe harbor guidelines for late fees. However, we refer the Board to a State of California law that may serve as a useful guideline. This law establishes a maximum late fee based on the number of days past due an account becomes (starting at five days past due), and limits issuers to charging only one late fee per billing cycle. This structure helps prevent hair trigger penalties. The relevant section of the law, Cal Fin Code § 4001, is provided in Appendix C.

Note that in separate comments currently being presented to the Board, Center for Responsible Lending and other consumer groups have suggested the Board review common standards for late fees from the time period before the Supreme Court's *Smiley* decision effectively deregulated late fees (e.g., the less of a fixed amount, such as $5-$10 or a specified percentage of the minimum payment due, such as five percent). We agree that these structures provide appropriate models, particularly to the extent they looked to the *past due* amount and not the *total account balance* as the relevant factor in establishing proportionality.

2. Penalty Interest Rate Increases

Key Points

- A penalty interest rate increase is subject to the reasonable and proportional rules because it is imposed in response to a cardholder's violation of the account agreement and would not qualify as any other type of fee or charge.

- In prior comments to the Board we emphasized the importance of three key variables regarding penalty interest rate increases.[15] These variables are the trigger (what actions activate the penalty rate and which balances are affected); the cure (how long may the penalty rate apply and whether the original rate is guaranteed to be restored); and the penalty premium (the difference between the penalty rate and the original rate). These three variables together constitute the penalty interest rate, and any consideration of whether such penalty is reasonable and proportional must consider the three variables together.

- Penalty interest rate increases on *existing balances* are justifiable only to the extent they compensate the issuer for actual marginal costs caused by the cardholder's violation.

    - In general, where separate penalty fees are imposed for the violation that may trigger the penalty interest rate increase, those fees should be looked to first for cost recovery.

    - Penalty interest rates on existing balances may be justified as compensation for costs if the issuer follows policies, such as credit counseling or establishment of workout arrangements, for seriously delinquent accounts (i.e., accounts that are 60 or more days past due, the threshold established in the law).

[15] Comments from the Pew Charitable Trusts, dated October 3, 2008, available at: www.pewtrusts.org/creditcards.

- The deterrence value of penalty rate increases on existing balances is not shown. Nor is it reasonable to allow creditors to have the power to use retroactive price increases (in effect, a rewriting of the past agreement after the cardholder has incurred the debt) as a tool for deterrence. Similarly, though penalty fees may justifiably punish a cardholder for errant behavior, there is no basis for deeming retroactive price increases an appropriate punitive response to a cardholder's behavior. In contrast, the threat of rate increases on *future* balances as a deterrent to violating the account agreement would be appropriate, but only because it would apply to transactions that have not yet been completed and are therefore still subject to negotiation between the cardholder and the issuer.

- Retroactive rate increases that can last indefinitely should be presumed to be unreasonable. Definite cure periods, which guarantee automatic restoration of the originally agreed rate after a period of on-time payments, are essential features of reasonable and proportional penalty interest rate increases. Cardholders should always have the opportunity to escape ongoing penalty charges whenever they resume making on-time payments for a reasonable period of time.

- The appropriateness of the penalty rate increase should be balanced against the potential for price shocks that could trap cardholders in high levels of debt, or for payments that they could not have predicted and may be unable to pay. For example, it may be unreasonable and disproportionate to allow the penalty to have the effect of instantly doubling the minimum payment due for the month.

- Interest rate increases on *future balances* may be justified based on a variety of factors, including cost, cardholder behavior factors and risk factors. However, it is questionable whether such a rate increase can be justified as a *penalty* for specific cardholder violations or omissions, or as compensation for costs specifically related to those violations or omissions, since it is in effect the result of a new underwriting analysis.

Safe Harbor Considerations

We recommend the following safe harbor guidelines for interest rate increases on *existing balances*. These guidelines are based on our Safe Credit Card Standards.

- Triggered only if an account is 60 or more days past due (per § 102(b) of the law).

- Cure period of six months, requiring the original rate of interest applicable to each penalized balance to resume automatically after six consecutive months of on-time payment behavior. This cure would exceed the explicit requirements of § 102 (b) of the law by requiring the cure no matter when the cardholder begins the six-month repayment process.

- Penalty premium of` no more than seven percentage points above the original rate. (For discussion of how we established this threshold, see Appendix B).

Additionally, the Board may wish to require issuers to provide representations or substantiation regarding the actual marginal costs associated with penalized accounts that are not otherwise covered by normal interest rates or specific penalty fees such as late fees.

Regarding penalty interest rate increases on *future balances,* it is our recommendation that (1) the Board impose the same safe harbor guidelines expressed for increases on existing balances; and (2) the Board establish a presumption that any form of automatic penalty rate increase on future balances that does not meet the safe harbor guidelines is unreasonable. Instead, issuers that wish to raise interest rates on future balances under circumstances not covered by the safe harbor should be instructed to use a process of account underwriting and amending the account agreement.

- As noted above, the case for allowing penalty interest rate increase on *future balances* as an automatic response to specific cardholder violations or omissions is questionable; but the negative effects associated with problems of rent seeking are clear. Automatic interest rate increases would create a significant incentive for issuers to allow or encourage specific cardholder behavior, such as exceeding a credit limit, that would trigger a rate increase.

- Though we see possible justifications for increasing *go-forward* interest rates based on a variety of changing factors, including risk factors, we see no reason why automatic penalty interest rate increases would be the proper mechanism for doing so, except perhaps in cases of serious delinquency (60 days past due) as a means to recuperate costs of administering credit counseling or workout plans (as the safe harbor would allow).

Under this formulation, issuers would be free to exercise discretion regarding to whom they will continue to lend and on what terms, and cardholders will experience less risk of experiencing significant penalties for insignificant transgressions (of course, individual fees for late payments and the like may still apply). These rules would benefit issuers by not automatically requiring them to reduce rates on future balances, leaving the issuers free to consider a variety of factors, such as marketing priorities or overall economic conditions, when setting go-forward pricing. However, the law has already provided a mechanism, under § 101(c), to protect cardholders by requiring issuers to review repriced accounts periodically for possible rate reductions. Further, § 101(d) of the law will reduce the risks of "bait and switch" repricing by prohibiting most interest rate increases during the account's first year. The proposed safe harbor would conform to these requirements.

Finally, we note that this formulation should not exempt issuers from the Board's authority, including its authority to ensure reasonable and proportional penalty charges, in cases where issuers are found to be engaging in systematic repricing practices that are injuring cardholders, exceeding the bounds of reasonability and proportionality, undermining transparency or otherwise frustrating the law's purpose.

Should the Board disagree, and allow automatic penalty rate increases on future balances other than according to the safe harbor proposed above, we make the following additional observations:

- Hair triggers, such allowing automatic interest rate increases based on a single late payment or overlimit event, should be prohibited. Instead, triggers should be based on the severity of the transgression and should only apply once the individual triggering event has exceeded a threshold, such as when an account becomes several days past due.

- For any automatic penalty rate increase, a guaranteed cure should apply, restoring the originally agreed rate after any six month period of on-time payment.

3. Over-the-Limit Fees

Key Points

- Whether an account exceeds the credit limit is entirely within the issuer's control. The issuer sets the credit limit, authorizes the transactions and decides how far beyond the limit the account may extend. Conversely, cardholders often have no knowledge or control of their account's proximity to the credit limit, due to factors such as unavailability of information at the point of sale and, potentially, unknowable holds placed against the account due to hotel reservations or for other reasons.[16] Therefore, any penalty fee associated with exceeding the limit should be scrutinized carefully to identify how the fee relates to an omission or violation on the cardholder's part.

- We question whether over-the-limit fees can be justified by any of the factors identified in the law. Because over-limit transactions are processed automatically, it is unclear what additional costs the issuer may be said to incur due to the violation or omission of the cardholder. Further, because the cardholder is often unaware of the account's proximity to the credit limit, and because the issuer *always* can control whether the account exceeds the limit, it is difficult to see how an over-the-limit fee furthers goals such as deterrence or punitive action (indeed, better forms of deterrence and punitive action are available, in the form of denied transactions). Penalties that are triggered at the instant an account exceeds its limit, or which charge more than a *de minimis* amount, are especially difficult to justify.

- In our Credit Card Standards, we proposed to prohibit all over-the-limit fees, both for the reasons noted above and because of the complexity of expressing sufficient safeguards to avoid abuse of the fee (some of these safeguards, such as requiring the cardholder to opt-in and restricting application of over-the-limit fees to once per month, are explicitly provided in the law, while others are left to the Board to determine). We encourage the Board to prohibit over-limit fees, or else restrict all but the most minimal forms of this fee.

Safe Harbor Considerations

Absent a ban on the over-the-limit fee, we encourage the board to consider safe harbor guidelines that would allow only a *de minimis* fee that could apply only once an account has exceeded the credit limit by a certain threshold. Establishing a buffer threshold would help avoid problems associated with a cardholder's lack of information about the account's proximity to the credit limit, holds placed against the account and potential rent extraction motivations.

Though we have not established complete safe harbor guidelines for over-the-limit fees, we refer the Board to a State of California law that may serve as a useful guideline (e.g., "[n]o overlimit

[16] The Board discussed similar concerns in its December, 2008, notice of final rulemaking for Regulation AA. The Board declined address credit holds at the time, but the new law adds weight to arguments in favor of creating safeguards on when over-the-limit fees may apply.

fee may be charged unless the charge causes the outstanding balance to exceed the credit limit by five hundred dollars ($500) or 120 percent, whichever is less”). The relevant section of the law, Cal Fin Code § 4001, is provided in Appendix C.

APPENDIX A: Data on Penalty Fees and Charges in the Market

Included below are selected findings from Pew's research on commonly deployed penalty fees in the market.[17] These findings are based on our review of credit card terms of the country's 12 largest issuers, which together hold more than 88 percent of outstanding credit card debt.[18] In December, 2008, researchers gathered available online disclosures for all of the more than 400 Visa®, MasterCard®, American Express® and Discover® branded consumer credit card products offered by these top issuers.

Late Fees

We found that 99 percent of cards included a late fee. The late fee was tiered based on account balance in 98 percent of these instances. For these accounts, the amount of the late fee was expressed in two or three tiers, as follows:

Table A-1: Allowable Late Fees (Tiered Accounts)

	Median Balance Thresholds	Median Late Fee	Range of Late Fee
Late Fee Tier 1	$0 to $100	$15	$15 - $20
Late Fee Tier 2	$100 to $250	$29	$15 - $29
Late Fee Tier 3	$250 or Above	$39	$35 - $39

For most of these accounts, the maximum late fee became applicable once an account's balance exceeded $250. This maximum fee, ranging from $35 to $39, represents as much as 15.6 percent of the entire account balance (and a much higher percentage of the minimum monthly payment due). For the two percent of cards with fixed late fees, the median late fee was $35, with a range from $30 to $39.

Over-the-Limit Fees

Fees for exceeding the credit limit applied to 92 percent of the cards. As with late fees, most overlimit fees were tiered based on account balances (though the figure was lower, at 56 percent). The amount of the overlimit fee for these accounts was expressed in two or three tiers, as follows:

Table A-2: Allowable Overlimit Fees (Tiered Accounts)

	Median Balance Thresholds	Median Late Fee	Range of Late Fee
Overlimit Fee Tier 1	$0 to $500	$15	$15 - $19
Overlimit Fee Tier 2	$500 to $1,000	$29	$15 - $29
Overlimit Fee Tier 3	$1,000 or Above	$39	$35 - $39

[17] Some data in this section was published in March, 2009, in a report by the Pew Health Group, *Safe Credit Card Standards*, available at www.pewtrusts.org/creditcards. Other data is published here for the first time.
[18] The largest twelve issuers included the top-10 Visa / MasterCard issuers, American Express and Discover (issuer size is measured by outstanding balances based on data available as of December, 2008). See: The Nilson Report, Issue 895 (January 2008) and Issue 902 (May 2008).

For the 44 percent of cards with fixed overlimit fees, the median overlimit fee was $39, with a range from $29 to $39.

<u>Penalty Interest Rate Increases</u>

Current Conditions. We found that 87 percent of cards allowed the issuer to impose automatic interest rate increases on all balances as a penalty for paying late, exceeding the credit limit or for other reasons. Under present rules, this penalty charge may apply equally to existing balances as well as balances resulting from future transactions. The median advertised (non-penalty) annual interest rates for purchases made with the cards were between 9.99 percent to 17.99 percent (issuers advertise a range of interest rates which may apply depending on a consumer's credit profile). By comparison, the median allowable penalty interest rate applicable to these accounts was 27.99 percent per year. The additional allowable charges represented by this 27.99 percent penalty rate are summarized in the following table.

Table A-3: Allowable Penalty Costs due to Penalty Interest Rate Increases, Market-Wide

Avg. Daily Balance	18-Point Penalty Premium *(27.99% penalty rate applied to card with 9.99% base rate)*		10-Point Penalty Premium *(27.99% penalty rate applied to card with 17.99% base rate)*	
	Annual Cost	Monthly Cost	Annual Cost	Monthly Cost
$1,000	$180	$15	$100	$8
$2,000	$360	$30	$200	$17
$3,000	$540	$45	$300	$25
$4,000	$720	$60	$400	$33
$5,000	$900	$75	$500	$42
$6,000	$1,080	$90	$600	$50
$7,000	$1,260	$105	$700	$58
$8,000	$1,440	$120	$800	$67
$9,000	$1,620	$135	$900	$75
$10,000	$1,800	$150	$1,000	$83

Note: Amounts shown in the table above are only the costs of the penalty interest rate premium, not inclusive of the base interest charges

Significantly, most cards allowed issuers to impose penalty rate increases indefinitely once they were triggered. Only eight percent of cards with penalty rate conditions offered to restore the original rate terms when payments are made on-time, usually after 12 months.

Cumulative Penalties

For all cards surveyed, penalty fees and charges could be cumulative. A penalty interest rate increase, a late fee and an overlimit fee could all apply concurrently to an account during any given time period (in addition to any other applicable fee or charge).

APPENDIX B: Discussion of Proposed Seven-Point Penalty Premium Threshold

In Section C(2) of our comments, we recommend several safe harbor guidelines on penalty interest rate increases, including a maximum penalty premium of seven percentage points above the base, non-penalty rate. In our judgment, this seven-point threshold establishes a simple rule that will in most cases allow for a reasonable and proportional fee, when imposed in connection with an appropriate cure period and penalty rate trigger. We selected this threshold, which is part of our Safe Credit Card Standards, after considering a wide variety of factors and discussing the issue with industry and consumer groups. Some of the considerations are outlined below.

Impact on cardholder

- A seven percentage-point premium would significantly reduce the overall amount of penalties a cardholder may be required to pay compared to today's conditions.

    - A seven-point premium would add nearly $6.00 in interest charges, per month, for every $1,000 borrowed.[19] At an account balance of $3,000 (the median household credit card balance[20]), a seven-point interest penalty would add $17.50 per month[21].

    - The total cost for a cardholder who cures the penalty after six months would be $105 ($17.50 * 6 months). Additional monthly charges of $17.50 could apply, up to a maximum of $210 per year, if the penalty is not cured and removed.

    - By comparison, allowable penalty interest rate increases in the market today typically would add between $25 and $45 per month to this $3,000 balance.[22] Because cures are seldom guaranteed on accounts currently, this premium could last for an unlimited number of months, even in cases where the cardholder resumes on-time payments. A $45 monthly penalty would add $540 in additional charges each year.

    - Whereas a cardholder with a $3,000 balance in a proposed safe harbor account would pay $105 in penalties after six months of on-time payment, a cardholder in today's market would be charged up to $540 in additional penalties *in the first year alone*, with additional charges possible indefinitely thereafter, regardless of his or her subsequent repayment behavior.

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[19] $1,000 * (.07/12) = $5.83

[20] Our estimate based on Survey of Consumer Finance Data. See: Bucks, Brian K., Arthur B. Kennickell, Traci L. Mach and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, vol. 95, February 12, 2009, at p. A45

[21] $3,000 * (.07/12) = $17.50.

[22] See Table A-3 in Appendix A, showing current market conditions and demonstrating that current allowable monthly penalties on a $3,000 balance equal $25 to $45 dollars.

- A penalty interest rate increase can create substantial increases in the amount of the monthly minimum payment due. While current penalty premiums can increase the monthly minimum payment due by 50 to 100 percent, a seven-point premium would create a much smaller payment shock.

    - Table B-1, below, estimates the minimum payment due for accounts based on the average daily balance and the applicable annual percentage rate.

    - For example, an account with a balance of $3,000 that is subject to a 14 percent annual interest rate would be have a monthly minimum payment due of approximately $65.[23] Raising the interest rate to 28 percent (the current median allowable penalty rate[24]) would bring the monthly minimum payment to $100, an increase of 65 percent.

    - By comparison, the maximum safe harbor penalty premium of seven points would bring the interest rate to 21 percent. The monthly minimum payment due would reach $83, an increase of only 28 percent.

    - Note: The lower the base annual interest rate, the greater the proportional impact of the penalty. For example, if the base interest rate is ten percent, the minimum monthly payment due on an account with a $3,000 balance would be $55. Raising this account's interest rate to 28 percent would bring the minimum monthly payment to $100, an increase of 82 percent. Limiting the penalty premium to seven points would bring the monthly minimum payment to $73, an increase of 33 percent.

    - The seven-point premium would significantly reduce the risk of payment shock by noticeably reducing monthly penalty charges compared to their current levels. Restricting payment shocks in this way can help cardholders to return to responsible payment behavior and effectively work toward eliminating their debt burden. We believe that this benefit makes the seven-point premium more reasonable than current market conditions allow, and represents a penalty that is more proportional to the cardholder's offense.

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[23] The current average advertised interest rate is approximately 14 percent (see, e.g., www.indexcreditcards).
[24] See Appendix B for a summary of current market conditions.

Table B-1: Minimum Payment Due Based on Applicable Annual Percentage Rate

Avg Daily Balance	Minimum Payment Due Based on Applicable APR									
	9%	**10%**	**11%**	**12%**	**13%**	**14%**	**15%**	**16%**	**17%**	**18%**
$1,000	$18	$18	$19	$20	$21	$22	$23	$23	$24	$25
$2,000	$35	$37	$38	$40	$42	$43	$45	$47	$48	$50
$3,000	$53	$55	$58	$60	$63	$65	$68	$70	$73	$75
$4,000	$70	$73	$77	$80	$83	$87	$90	$93	$97	$100
$5,000	$88	$92	$96	$100	$104	$108	$113	$117	$121	$125
$6,000	$105	$110	$115	$120	$125	$130	$135	$140	$145	$150
$7,000	$123	$128	$134	$140	$146	$152	$158	$163	$169	$175
$8,000	$140	$147	$153	$160	$167	$173	$180	$187	$193	$200
$9,000	$158	$165	$173	$180	$188	$195	$203	$210	$218	$225
$10,000	$175	$183	$192	$200	$208	$217	$225	$233	$242	$250

Avg Daily Balance	Minimum Payment Due Based on Applicable APR									
	19%	**20%**	**21%**	**22%**	**23%**	**24%**	**25%**	**26%**	**27%**	**28%**
$1,000	$26	$27	$28	$28	$29	$30	$31	$32	$33	$33
$2,000	$52	$53	$55	$57	$58	$60	$62	$63	$65	$67
$3,000	$78	$80	$83	$85	$88	$90	$93	$95	$98	$100
$4,000	$103	$107	$110	$113	$117	$120	$123	$127	$130	$133
$5,000	$129	$133	$138	$142	$146	$150	$154	$158	$163	$167
$6,000	$155	$160	$165	$170	$175	$180	$185	$190	$195	$200
$7,000	$181	$187	$193	$198	$204	$210	$216	$222	$228	$233
$8,000	$207	$213	$220	$227	$233	$240	$247	$253	$260	$267
$9,000	$233	$240	$248	$255	$263	$270	$278	$285	$293	$300
$10,000	$258	$267	$275	$283	$292	$300	$308	$317	$325	$333

Minimum payment due is estimated by multiplying the monthly periodic rate by the account balance and adding an amount equal to a one percent principal reduction:
*Balance * (APR/12) + Balance * .01 = Minimum Payment Due*

Impact on issuer

- In developing our Safe Credit Card Standards we created an issuer revenue model and tested the Standards to determine their impact on issuer revenue streams. Though this revenue analysis is not necessarily relevant to the present reasonable and proportional analysis, we note that our estimates show that issuers would receive a significant amount of penalty interest income even under our proposed safe harbor guidelines, including the seven-point penalty premium.

- An example calculation illustrates that issuers can earn significant income even from constrained penalty interest charges. For every one million credit card accounts held by an issuer, several thousand will be delinquent at any given time. In 2008, the average overall delinquency rate (accounts 30 days past due) was approximately five percent.[25] Though we do not have data showing the number of accounts that are 60 days past due(the minimum trigger for applying penalty interest rate increases on existing balances under the new law), we will assume the figure to be between two and three percent for the present illustration. If 2.5 percent of accounts are 60 days past due, 25,000 accounts per million would be subject to a penalty interest charge. If the average minimum charge were $105 for a six month penalty, as noted above, the issuer's *minimum* revenue on the penalty interest rate increase would be $2.6 million per one million accounts. The actual charges are likely to be higher because some accounts will take longer than six months to establish the cure.

- Even if a percentage of these charges would not be collected due to chargeoffs, the example illustrates that issuers may expect to receive an amount of revenue from the new safeguarded penalty charges that is significant enough to cover the marginal costs associated with workouts or counseling of seriously delinquent accounts. We are unaware of any data showing otherwise.

In the final analysis, we agreed with the seven-point threshold suggested in several proposed pieces of legislation in the 110th Congress, including those from Senator Levin (S.1395) and Senator Menendez (S.2753). A set threshold based on the number of allowable percentage points sets a clear and easily understandable rule. We believe that a seven-point threshold is both reasonable and proportional because it offers cardholders substantial relief from the risks of price shocks found in the market today, while retaining a significant revenue stream that issuers can rely on to cover the costs of responding to seriously delinquent accounts.

[25] Federal Reserve Statistical Release

Appendix C: Sample State Law Limiting Penalty Fees

Cal Fin Code § 4001

§ 4001. Permissible amounts to be charged by supervised financial organization or charge card issuer

(a) A supervised financial organization or charge card issuer may not charge more than any of the following amounts:

(1) If set forth in the consumer credit or charge card agreement, one of the following fees:

(A) Seven dollars ($7) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within five days after the date the payment is due.

(B) Ten dollars ($10) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within 10 days after the date the payment is due.

(C) Fifteen dollars ($15) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within 15 days after the date the payment is due.

(2) In lieu of the fee permitted by paragraph (1), if the consumer has already incurred two late payment fees during the preceding 12-month period, the fee charged may be no more than ten dollars ($10) with respect to any monthly billing cycle as a late payment charge on the minimum payment due that is not paid within five days after the date the payment is due.

(3) Ten dollars ($10) with respect to any charge that causes the outstanding balance to exceed the credit limit by five hundred dollars ($500) or 120 percent, whichever is less. No overlimit fee may be charged unless the charge causes the outstanding balance to exceed the credit limit by five hundred dollars ($500) or 120 percent, whichever is less. Not more than one overlimit charge may be assessed with respect to any monthly billing cycle.

* * *