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October 3, 2008

By Electronic Delivery

Mr. Leonard Chanin
Assistant Director, Division of Consumer & Community Affairs
Board of Governors of the Federal Reserve System
Washington, D.C 20551
Attention: Docket NO. R-1314

Dear Mr. Chanin:

We are writing to share selected findings from our recent work on credit cards, as requested. Though we remain hopeful that credit card issuers will act voluntarily to address the needs of their customers, our experience has led us to conclude that certain necessary changes will not occur without regulatory intervention. The proposed rules currently under consideration, and in particular the rule that limits an issuer's ability to re-price existing balances, are necessary to protect consumers and ensure that industry participants consistently abide by the same rules.

As described below and illustrated in the attached documents, our findings are summarized as follows:

- Though positioned as necessary to encourage responsible payment behavior, penalty re-pricing practices today can have severe and sometimes devastating effects upon household finances.
- Current practices make it challenging to predict the cost of credit cards. Even cards with similar advertised interest rates can vary in cost by hundreds or thousands of dollars per year based on re-pricing practices.
- Though issuer revenues may decline upon enactment of the proposed rules, simple up-front pricing adjustments could recover lost revenue. These adjustments would make the cost of credit more predictable while significantly reducing the risks credit cards currently pose to American families.

The Pew Charitable Trusts views financial well-being as a vital component of the overall health and safety of American families. Early in 2007, Pew began a program, the Credit Card Standards Project, with the goal of helping to bring better credit cards to the market. Our approach was to establish objective standards which would define a safe credit card for consumers while preserving options for reasonable rates of return to issuers. To formulate our standards, we initiated dialogue with industry leaders and consumer groups alike.

As part of our project, we have developed analytic models that evaluate both the penalty-related costs of credit cards to consumers and the impact of proposed reforms on issuers' revenues. For consumers, we established a method of assessing the cost of credit cards and then applied it to a group of actual products advertised by the top issuers in America. To assess the impact of reforms on issuers, we engaged a leading industry consulting firm to develop a financial model which estimates the revenue impact on a typical credit card portfolio as certain practices are altered.

Selected findings from our work are attached in three exhibits as summarized below.

Exhibit One – Working Paper: Credit Card Penalty Re-Pricing Impact on Households

This paper explores the three key variables of credit card penalty re-pricing (trigger, cure and penalty premium) and the significant additional costs to consumers when existing balances are re-priced.

- Different cards may have identical advertised purchase rates but could differ in actual cost by hundreds or thousands of dollars per year due to penalty re-pricing terms.
- When a balance of \$3,500 is re-priced, the additional interest can consume one-quarter of an average household's discretionary income during a year. For the most aggressively structured credit cards, this result may occur after just one or two late payments without possibility of returning to the originally advertised rate.
- Penalty interest rate provisions and other methods of re-pricing existing balances expose consumers to significant risks which are difficult to evaluate up-front.

Exhibit 2 – Analysis of Cards in the Market

This paper highlights penalty cost exposure associated with mainstream, general purpose credit card products from the top 10 Visa and MasterCard issuers (as ranked by outstandings in *The Nilson Report*), American Express, Discover and one of the largest credit union issuers. Out of this sample:

- All issuers, except one, use penalty re-pricing, typically adding 13 percentage points to the average advertised purchase rate when the penalty is triggered.
- Penalty interest exposure ranges from zero to nearly \$600 per year.
- When accounting for penalty charges, the actual rate of interest paid may exceed 33 percent, more than double the advertised purchase rate.

Exhibit 3 – Impact of Penalty Re-Pricing Rule on Issuers and Possible Offsets

This paper presents results from our model credit card portfolio, developed through an engagement with a leading industry consulting firm. We focused specifically on the section of the proposed rule that would have the most revenue impact on issuers – the restriction on applying penalty interest rates to existing balances. Key findings include:

- While the proposal could prevent issuers from collecting 4.66 percent of present revenue streams, it would also protect millions of households from practices which presently can consume up to 70 percent of their discretionary income (assuming the average level of household credit card debt in America of approximately \$10,000).
- Issuers could offset estimated revenue impacts with a 0.85 percentage point increase in advertised interest rates or a \$15 annual fee paid by most accounts.
- Estimated up-front pricing adjustments would consume a small fraction of household income compared to present re-pricing terms, and would add transparency to a system which currently makes it nearly impossible for consumers to evaluate the true costs and risks of using different credit cards.

We have found that that millions of American households face substantial but virtually hidden risks based on practices which the proposed rules would significantly curtail. Though the proposed rules would not eliminate all risks of re-pricing, they would add important new protections by creating a 30-day window in which cardholders and card providers alike could identify and respond to account issues before existing balances are re-priced. Exceptions to the rule as proposed, such as allowing penalty re-pricing upon the second late payment in 12 months or periodic re-pricing every year or two, serve neither the best interests of the consumer nor the long-term interests of the industry. The rules as proposed would improve consumers' ability to predict the cost of credit over time and create an environment in which the industry may compete based on clear up-front pricing.

Please do not hesitate to contact us if we can be of further assistance.

Sincerely,



R. Dwane Krumme
General Manager, Credit Card Standards Project
The Pew Charitable Trusts

Working Paper: Credit Card Penalty Re-Pricing Impact on Households

Revised 10/3/2008

In addition to reserving the right to change terms at any time, credit card issuers generally reserve the right to increase interest rates for specific reasons, such as if the cardholder misses a payment due date. Known variously as “default rates,” “penalty rates” or “delinquency rates,” this re-pricing mechanism is a pervasive component of modern credit card portfolio management. It is also a poorly-understood feature which has the potential to increase a family’s debt burden dramatically.

Three key variables impact the cost of penalty rates to consumers:

- Trigger: What actions activate the penalty rate, and which balances are affected?
- Cure: How long may the penalty rate apply?
- Penalty Premium: What is the difference between the penalty rate and the purchase rate?

Depending on these metrics, two consumers with identical credit profiles, who make identical purchases and who have identical payment histories, may have credit card bills that differ by hundreds or thousands of dollars. The following examples illustrate how the key metrics may combine to impact the overall cost of using a credit card. Examples below examine only the *additional* cost imposed by the re-pricing event (base purchase interest cost is not included).

Note: Calculations in this document are based on applying a periodic rate to an average daily balance for the period shown. The sample balances chosen in the examples below reflect the average balance of re-priced accounts at major issuers and the average U.S. household credit card debt respectively.¹

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¹ See: Ireland, Oliver: Morrison & Foerster LLP, Response to the Federal Reserve System UDAP Proposal (August 7, 2008) (Average account balances in February, 2008, were \$3,650 for accounts penalty re-priced due to 30+ days past due – Exhibit Two; and \$4,230 for all accounts penalty re-priced – Exhibit Three. See also: The Nilson Report, Issue 909 (August, 2008) at 7 (Average household credit card debt in 2007 was \$10,385).

Exhibit One

Example One: Short Trigger Creates Significant Penalty for a Late Payment

Penalty rates may be triggered when issuers do not receive timely payment from cardholders. On some cards, the penalty rate may be triggered the first or second time a payment fails to arrive by the due date within a 12-month period, or whenever an account becomes 15 days past due. For these cards, the act of missing one due date can trigger penalties leading to hundreds or thousands of dollars in additional interest charges per year.

The following example compares the cost of a late payment on two cards. The two cards are identical except that, for Card A, the late payment has not triggered a penalty rate but on Card B it has triggered a penalty rate.

Penalty Fees and Interest Due to a Late Payment (Over 12 Months)

	Penalty Cost	
	<u>Card A</u> Penalty Rate Not Triggered by Late Payment	<u>Card B</u> Penalty Rate Triggered By Late Payment
\$3,500 Balance	\$39	\$494
\$10,000 Balance	\$39	\$1,339

Assumptions: Identical transaction and payment histories, with one late payment. Penalty cost is a \$39 late fee and, for Card B, penalty interest based on a 13 percentage point penalty rate premium applied over 12 months.²

Continued on the following page...

² We recently conducted a study showing that, among cards offered by the largest issuers, most charge a maximum \$39 late fee and the average penalty interest premium is 13 percentage points. See Exhibit Two for details.

Exhibit One

Example Two: Impact of Cure Periods

Whenever triggered, the cost of penalty price increases will differ based on how long the penalty interest rate applies. This example assumes that the two cards in Example 1 are now in penalty status. A third card with an identical balance is added to the comparison. Each card differs only in the length of time it will take the consumer to cure the penalty and return to the original purchase rate. The cost shown is the additional interest paid due to the penalty rate premium, exclusive of any fees or base purchase interest.

Cost of Penalty Interest Premium Based on Cure Period

	Penalty Interest Premium		
	<u>Card A</u> Cure = 3 months	<u>Card B</u> Cure = 6 months	<u>Card C</u> Cure = 12 months
\$3,500 Balance	\$114	\$228	\$455
\$10,000 Balance	\$325	\$650	\$1300

Assumptions: Thirteen percentage point penalty rate premium applies. Cardholder will make timely payments for the stated number of months, after which the card will return to the original purchase APR.

Note: Many cards do not specify a cure period. Such accounts are subject to the 12-month cost shown above each year for an indefinite number of years. Other cards may propose to restore a rate that is “lower” than the penalty rate, but higher than the original purchase rate, with the effect that the cardholder will continue to pay a penalty interest premium beyond the cure period.

Example Three: Impact of Penalty Premium (Amount of Rate Increase)

While the penalty rate premium is typically 13 percentage points above the purchase APR, some issuers impose penalty premiums as high as 22 percentage points³. This example shows the impact of the size of the penalty premium, assuming that each card is in penalty status and that the penalty rate premium will apply for a 12-month period.

Cost of Penalty Rate Premium (Over 12 Months)

	Penalty Interest Premium		
	<u>Card A</u> +5 percentage points	<u>Card B</u> +10 percentage points	<u>Card C</u> +15 percentage points
\$3,500 Balance	\$175	\$350	\$525
\$10,000 Balance	\$500	\$1,000	\$1,500

³ Based on findings of our recent study, supra note 2.

Exhibit One

Example Four: Impact of Re-Pricing Existing Balances on Household Discretionary Income

When account balances are re-priced, the additional penalty interest premium may represent a significant portion of a household's discretionary income. The following table shows the impact of penalty re-pricing on family discretionary income for households earning up to \$100,000.

Impact of Re-Pricing Existing Balances on Households (Over 12 Months)

	Annual Discretionary Income ⁴	Penalty Interest Premium (% of discretionary income)	
		\$3,500 balance (\$455 premium)	\$10,000 balance (\$1,300 premium)
Households Earning Less Than \$50,000	\$1,900	24%	68%
Households Earning \$50,000 - \$99,999	\$11,078	4%	12%

Assumptions: Thirteen percentage point penalty rate premium over the original purchase rate, over a 12-month period.

Notes:

- In addition to the penalty rate premiums shown above, late fees of up to \$39 for each occurrence typically would apply.
- Out of all households in America, nearly 60% earn less than \$50,000 per year and approximately 29% earn between \$50,000 and \$99,999.⁵
- More than one-third of all Americans have no discretionary income⁶. For them, credit card penalty charges cut directly into the household's budget for necessities such as food and other basic living expenses.

⁴ Li, Allen and Lynn Franco, "A Marketer's Guide to Discretionary Income," The Conference Board Consumer Research Center (2007), at 4. Annual Discretionary Income is the average for all households with discretionary income in each indicated income range.

⁵ Ibid.

⁶ The Conference Board, "More Americans Have Discretionary Income" (Nov. 8, 2007), available at http://www.conference-board.org/utilities/pressDetail.cfm?press_ID=3254 (accessed 9/30/08).

Exhibit One

Example Five: Advertised APR Versus Actual Cost

Advertisements for credit cards often focus on the purchase APR (Annual Percentage Rate). However, the purchase APR does not include fees (which are disclosed separately) and is listed separately from the penalty APR, which in turn is listed separately from the penalty trigger and cure (if any). As a result, it is difficult for consumers to understand, avoid and cure these penalties.

The following chart illustrates the incremental costs of penalty fees and interest by comparing a typical card's "Advertised" APR to an "Actual After Penalties" APR.

Advertised APR Versus "Actual After Penalties" APR (Over 12 Months)

	Base Charges		Penalty Charges		Total Annual Costs	Purchase APR	
	Annual Fee	Purchase Interest	Penalty Fee	Penalty Interest		Advertised	Actual After Penalties
\$3,500 Balance 15% Purchase APR	\$0	\$525	\$39	\$455	\$1,019	15.0%	29.1%
\$10,000 Balance 15% Purchase APR	\$0	\$1,500	\$39	\$1,300	\$2,839	15.0%	28.4%

Assumptions: 13-point penalty premium applies over a 12-month period, with one \$39 late fee.

Analysis of Cards in the Market

The analysis that follows focuses on general purpose, non-reward credit cards from each of the ten largest (as measured by largest outstanding balances) Visa/MasterCard issuers, plus American Express and Discover and one of the largest credit union issuers.¹ The sources of the data were online account disclosures on October 2, 2008, cardholder agreements (when available) and calls to an issuer's call center.

Of the 13 representative card products analyzed:

- All, except for one, had penalty conditions which could increase the rate on existing balances.
- The penalty rate premium averaged 13 percentage points above the average advertised purchase APR. The largest penalty rate premium was 22 percentage points above the lowest advertised purchase APR.
- Five could impose the penalty rate after a single late payment, exposing approximately 35 percent of all active accounts to the risk of a re-pricing event². The remaining cards with penalty pricing had triggers such as two late payments in 12 months or two billing cycles past due.
- Eight could trigger a penalty rate for exceeding the credit limit one or more times, even though the issuer approved the over-the-limit transaction.
- Most (10 of 13) charged a maximum late fee of \$39.

The chart that follows groups card based on the potential penalty costs (interest and fees) a consumer could incur after making a late payment. To reflect the impact of various penalty rate triggers, the additional penalty charges are averaged over three scenarios: 1) consumer makes one late payment in 12 months; 2) consumer makes 2 late payments in 12 months (or is 15 - 30 days past due on one payment); and 3) consumer makes 3 late payments in 12 months (or is 31+ days past due on one payment).

Penalty costs range from \$40 to as high as \$675 and are also expressed as a percent of Household Discretionary Income. The "Actual After Penalties" APR expresses the additional penalty costs as an APR. A summary of the penalty terms for each card is also included, to illustrate how the terms combine to affect the cost to consumers.

¹ The sample is composed of general purpose, non-reward credit cards currently advertised by each issuer. Where possible, we identified and used the most popular card product available. Our research suggested that each issuer maintains substantially similar penalty re-pricing policies across all its reward and non-reward card offerings.

² In 2005, 35 percent of active credit card accounts from the six largest issuers incurred one or more late fees. "Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," Government Accountability Office (September, 2006), page 5.

Sample -- Ranking by Total Penalty Cost

Ratings reflect the average additional penalty cost on an account with a \$3,500 average daily balance that results when consumer makes 1, 2 or 3 late payments

Card	Additional Penalty Costs ¹			Penalty Costs as % of Household Discretionary Income ³		Purchase APR		Delinquency			
	Penalty Fees	Penalty Interest ²	Total	Households earning less than \$50,000	Households earning \$50,000 - \$99,999	Advertised	Actual After Penalties	Penalty Interest Trigger		Penalty Interest Premium over Purchase APR	Cure Months
								Times Late in 12 months	Times Overlimit in 12 months		
Less than \$150											
Card 1 (credit union)	\$40	\$0	\$40	2%	0%	12.95%	14.61%	No Penalty Rate			
Card 2	\$70	\$35	\$105	6%	1%	12.33%	15.33%	2 payments past due	0	6.0%	6
\$150 - \$299											
Card 3	\$78	\$100	\$178	9%	2%	14.65%	19.74%	2 payments past due	2 consecutive	10.3%	6*
Card 4	\$78	\$119	\$197	10%	2%	19.80%	25.43%	2	0	5.1%	12
Card 5	\$78	\$157	\$235	12%	2%	15.49%	22.20%	2	2	13.5%	6
\$300 - \$449											
Card 6	\$0	\$327	\$327	17%	3%	12.99%	22.33%	2	0	14.0%	12
Card 7	\$78	\$269	\$347	18%	3%	17.49%	27.40%	2	0	11.5%	12
Card 8	\$78	\$350	\$428	23%	4%	12.99%	25.22%	2	2	16.0%	6
\$450 - \$599											
Card 9	\$78	\$473	\$551	29%	5%	15.49%	31.22%	1	1	13.5%	12 [†]
\$600+											
Card 10	\$78	\$525	\$603	32%	5%	15.99%	33.22%	1	2	15.0%	12 [†]
Card 11	\$78	\$578	\$656	35%	6%	12.49%	31.22%	1	1	16.5%	12 [†]
Card 12	\$78	\$595	\$673	35%	6%	13.99%	33.22%	1	1	17.0%	12 [†]
Card 13	\$78	\$597	\$675	36%	6%	12.45%	31.72%	1	1	17.0%	12 [†]

Sources: 10/2/08 Online Application Disclosures, Cardholder Agreements, and calls to service centers.

¹ Additional Penalty Costs represent the average of 3 customer scenarios: 1) customer makes one late payment in 12 months; 2) customer makes 2 late payments in 12 months (or is 15 - 30 days past due on one payment); and 3) customer makes 3 late payments in 12 months (or is 31+ days past due on one payment).

² Penalty interest premium over the Purchase APR multiplied by the number of periods in penalty (Cure Period) multiplied by the average daily balance. Purchase APR is the average of the high and low advertised APR.

³ Average discretionary income of \$1,900 for households earning less than \$50,000 and \$11,078 for households earning \$50,000 to \$99,999. *Li, Allen and Lynn Franco, "A Marketer's Guide to Discretionary Income," The Conference Board Consumer Research Center (2007), at 4.*

[†] Cure period is unspecified or not guaranteed, therefore 12 month cure is assumed.

* Rate after cure is unspecified ("lower"), therefore premium of cash advance rate over original APR is assumed to apply for 6 months.

Exhibit Three

Impact of Penalty Re-Pricing Rule on Issuers and Possible Offsets

The Credit Card Standards Project of the Pew Charitable Trusts has approached the issue of credit card policy by considering both the challenges facing consumers as well as the business implications of reform. Through an engagement with a leading financial services consultancy, we developed a model to evaluate how proposed regulatory rules and other changes would impact issuer revenues. This model estimates revenue streams based on a number of input categories described at the end of this exhibit.

Our analysis shows that the proposed rules would not fundamentally jeopardize card issuers' ability to maintain revenue but would provide significant relief to American households. With modest increases in up-front pricing, issuers could preserve status quo revenue flows. In return, all households would gain a 30-day window in which to resolve payment difficulties or other account issues before being exposed to re-pricing events which can consume so much income as to jeopardize a family's ability to build savings or pay basic living expenses. As shown below, up-front price increases designed to offset the impact of the proposed rules would have only a nominal impact on household budgets, particularly in comparison to the impact caused when issuers re-price outstanding balances.

We illustrate our findings below with an analysis of the proposed restriction against imposing a penalty interest rate until an account is 30 days past due (Section __.24 of the proposed rule).

Gross Revenue Impact on Issuers and Potential Offsets

The proposed rules could impact credit card portfolio revenues by creating new requirements for advertised grace periods and the allocation of payments to balances. The revenue implications of these requirements are minor, however, compared to the potential impact of restricting when and how quickly issuers may re-price existing balances. The table below illustrates our estimation of the revenue impact of the proposed rule to prohibit imposition of penalty interest rates on existing balances before an account becomes 30 days past due. It also shows two possible changes to the up-front pricing structure of the card portfolio which could fully offset this revenue impact.

Up-Front Pricing Adjustments to Offset Potential Revenue Impact of Penalty Re-Pricing Rule

Estimated Revenue Impact	Potential Offsets	Net Revenue Impact
(4.66%)	Either: <ul style="list-style-type: none">▪ \$15.00 annual fee Paid by 86.25% of accountholders;or▪ 0.85 percentage point increase Applied to all advertised APRs	0.00%

Key Assumptions: The percentage of interest-earning balances accruing at the penalty interest rate is estimated to fall from a current level of approximately 11.6 percent to approximately 5.5 percent (only accounts 30 days or more past due could attract the penalty APR). The differential (6.1 percent) is distributed proportionally among interest-earning balances accruing at other rates of interest (purchase, cash advance and so on).

Exhibit Three

Impact on American Households: Up-Front Adjustments vs. Penalty Re-Pricing

Exhibit One of this letter demonstrated the impacts on households when issuers re-price existing credit card balances. It showed that a 13 percentage point rate increase will cost a cardholder hundreds or thousands of dollars in additional charges per year.¹ The table below compares the cost of a 13-point penalty interest premium on existing balances versus the potential up-front pricing adjustments noted above (\$15 Annual Fee or 85 basis point increase in APR).

Comparison of Consumer Cost as a Percent of Household Discretionary Income (Penalty Interest vs. \$15 Annual Fee vs. 0.85% Increase in Purchase APR)

	Discretionary Income ²	Costs as % of Household Discretionary Income (\$3,500 balance)		
		Penalty Interest (\$455)	Annual Fee (\$15)	0.85% APR Increase (\$30)
Households Earning Less Than \$50,000	\$1,900	24.0%	0.8%	1.6%
Households Earning \$50,000 - \$99,999	\$11,078	4.1%	0.1%	0.3%

Note: Comparisons will vary depending on size of credit card balance. At the average U.S. household balance³ of approximately \$10,000, a 13-point penalty interest premium can cost \$1,300 over a year. For a household earning less than \$50,000, this additional interest would consume 68% of discretionary income, versus 0.8% of discretionary income for a \$15 annual fee or 4.5% for a 0.85% APR increase.

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¹ As explained in Exhibit Two of this letter, 13 percentage points is the average penalty interest premium (average advertised purchase APR versus penalty APR) from our sample of representative cards from the largest issuers.

² Li, Allen and Lynn Franco, "A Marketer's Guide to Discretionary Income," The Conference Board, Consumer Research Center (2007), at 4. Annual Discretionary Income is the average for all households with discretionary income in each indicated income range.

³ The Nilson Report, Issue 909 (August, 2008) at 7 (Average household credit card debt in 2007 was \$10,385).

Exhibit Three

Demonstration of Model Output and Supplemental Model Information

The following graphics demonstrate model outputs for the estimated revenue impact and \$15 annual fee up-front pricing adjustment discussed in the previous section. The model is designed to approximate the characteristics of a typical mainstream credit card portfolio for a one year period. Revenue is evaluated per every one million cards assuming 1.2 cards per account.

Estimated Revenue Impact

Ratios	User's Credit Card Portfolio	User's Credit Card Portfolio (w/o Penalty APR applied to accts <30days overdue)	% Change
Key Impacts Per Active Account			
Total direct revenue per active account			
Interest income	\$334	\$310	-7.21%
Fee revenue	\$77	\$77	0.00%
Interchange income	\$106	\$106	0.00%
Total	\$517	\$493	-4.66%
Total Portfolio Impact			
Total direct revenue - portfolio			
Interest income	\$145,783,743	\$135,266,956	-7.21%
Fee revenue	\$33,598,984	\$33,598,984	0.00%
Interchange income	\$46,339,431	\$46,339,431	0.00%
Total	\$225,722,158	\$215,205,370	-4.66%

Estimated Impact with \$15 Annual Fee

Ratios	User's Credit Card Portfolio	User's Credit Card Portfolio (w/o Penalty APR applied to accts <30days overdue)	% Change
Key Impacts Per Active Account			
Total direct revenue per active account			
Interest income	\$334	\$310	-7.21%
Fee revenue	\$77	\$101	31.31%
Interchange income	\$106	\$106	0.00%
Total	\$517	\$517	0.00%
Total Portfolio Impact			
Total direct revenue - portfolio			
Interest income	\$145,783,743	\$135,266,956	-7.21%
Fee revenue	\$33,598,984	\$44,117,276	31.31%
Interchange income	\$46,339,431	\$46,339,431	0.00%
Total	\$225,722,158	\$225,723,663	0.00%

The assumptions are supported by multiple industry sources including The Nilson Report and Card Industry Directory. Inputs have been further validated based on the experience and analyses of a leading financial services consultancy engaged by the project. As the assumptions regarding fees, interest rates and other factors change, the model shows the expected impact on revenues. Assumptions were held constant in the two examples above except for the addition of the \$15 annual fee.