TRANSCRIPT OF THE
FEDERAL RESERVE SYSTEM
CONSUMER ADVISORY COUNCIL

THURSDAY, JUNE 19, 2008

The Consumer Advisory Council met at the office of the Board of Governors of the Federal Reserve System, in Dining Room E Terrace Level in the Martin Building at 20th and C Streets, N.W., Washington, D.C., at 9:00 a. m., Tony Brown, Chair, presiding.

Members present:
Tony Brown, Chair
Edna Sawady, Vice Chair
Michael Calhoun
Alan Cameron
Jason Engel
Kathleen Engel
Joseph Falk
Louise Gissendaner
Greta Harris
Patricia Hasson
Thomas James
Lorenzo Littles
Sarah Ludwig
Mark Metz
Lance Morgan
Saurabh Narain
Joshua Peirez
Ronald Phillips
Anna McDonald Rentschler
Kevin Rhein
Faith Arnold Schwartz
Edward Sivak
Shanna Smith
Cooke Sunoo
Jennifer Tescher
Linda Tinney
Luz Urrutia
Alan White

Others present:
Sandra Braunstein, Director, Division of Consumer and Community Affairs
Benjamin Bernanke, Chairman, Board of Governors
Randall Kroszner, member, Board of Governors
Frederic Mishkin, member, Board of Governors

TABLE OF CONTENTS

Meeting Convenes, Announcements...3

Proposed Rules Regarding Credit Cards and
Overdraft Services..3

Proposed Rules on Risk-Based
Pricing Notices...62

Members Forum..73

Committee Reports 78

Adjourn

P-R-O-C-E-E-D-I-N-G-S

9:05 a. m.

CHAIR BROWN: Good morning. My name is Tony Brown. I'm Chairman of the CAC, and I'd like to open our meeting by welcoming everyone. And before we begin, as customary, I'd like to take a moment to acknowledge the Governors who are here in attendance: Chairman Bernanke, good morning; Governor Randall Kroszner; and Governor Frederic Mishkin.

On behalf of the Council, we'd like to thank you for your time in joining us here today, and also I would like to acknowledge that this is Governor Mishkin's last CAC meeting. How sad.

GOVERNOR MISHKIN: I'm becoming a civilian again.

CHAIR BROWN: Before his departure from the Board at the end of August, we have greatly appreciated your support of the CAC and its activities, and we wish you well in your future endeavors.

GOVERNOR MISHKIN: Thank you very much.

CHAIR BROWN: Also, I'd like to take a moment and thank Governor Kroszner who, as many of you know, has been out in the local communities visiting low-income communities and trying to get a local sense of the impact of foreclosures in low-income communities and what they're doing in the way of community development.

So Governor Kroszner, I'd like to thank you for your personal interest and visibility for undertaking and understanding the impact of foreclosures in the local community as you address this national issue. Thank you.

We will begin the meeting by discussing the Board's proposal to exercise its authority under the Federal Trade Commission Act to prohibit unfair or deceptive acts or practices by banks. The proposal would amend the Board's Regulation AA to prohibit banks from engaging in certain acts or practices in connection with credit cards and overdraft services for deposit accounts.

The FTC Act rules would be complemented by separate Board proposals under the Truth in Lending Act regarding credit cards and the Truth in Savings Act regarding overdraft services.

Yesterday, members of the Consumer Credit and Depository and Delivery

Systems Committees discussed various issues related to the proposed rules. At this point, I'd like to turn it over to Faith Schwartz to lead the discussion on the portion of the proposal related to credit cards.

Faith?

MS. SCHWARTZ: Thank you. Thank you, Tony, and good morning, everyone, Chairman Bernanke, Governors here, and our colleagues.

This morning's section is going to be focused on the timing of payments, allocation of payments, applying rate increases to existing balances, and financing of security deposits and fees.

So for the first section, I'm going to ask us to speak about the timing of payments. In the proposal, it would prohibit institutions from treating a payment as late unless the consumer has been provided a reasonable amount of time to make the payment. Institutions would have a safe harbor when they send periodic statements at least 21 days before the payment due date.

And before we get started in some other discussions about the timing of payments, I'd like to ask Mark Metz to speak a little bit about Unfair or Deceptive Acts or Practices (UDAP).

MR. METZ: Thank you, Faith. I guess as a starting point, labeling banking practices as unfair or deceptive creates a number of risks and problems for the banks. Essentially what we're doing is -- or what is being proposed is -- to take practices that were widely accepted, lawful, widely used, and now call them or just label them as unfair and deceptive. And maybe that applies to certain provisions that were on the margins by certain institutions, but I think to sort of sweep in all of the credit card provisions and the overdraft provisions creates a number of risks.

The first risk is obviously lawsuit risk, class-action risk, because you could now be sued on things that were previously lawful and now they're considered unfair and deceptive. I think that also raises concerns under state law and state UDAP claims, which tend to -- state UDAP laws tend to be vague, and I think you would allow a boot-strapping of claims under state UDAP laws.

I think another concern is -- this may be affecting the landscape with respect to preemption, and things that were previously preempted may not be now.

And I think sort of the final risk -- and I think this may be the biggest concern -- is reputational risk. Because if a bank is -- say ABC Bank, some kind of claim is brought against them

by a plaintiffs class-action lawyer or a state agency under Reg E or Reg Z, that's probably not really newsworthy. But if somebody stands up and says, I'm suing ABC Bank because they're doing unfair and deceptive things, they're deceiving customers, that potentially becomes page one. And it's how you label it is really the concern.

And so we would ask the Fed staff to take a real hard look at whether they really have to pass these laws under Reg AA, unfair and deceptive, or whether they could possibly look at other regulations that already exist such as Reg E or Reg DD. Thank you.

MS. SCHWARTZ: Thank you. Alan?

MR. WHITE: I have to disagree with Mark's premise. I think his reasoning is fair, but the premise is that we are talking about widely accepted practices that have now somehow had a pall cast over them through actions of the Fed. The fact is that the practices that the Fed is addressing I regard as, in some ways, the low-hanging fruit. I mean, I commend the Fed for this rule. I think it's an excellent first step. But these are practices that have been identified as unfair and deceptive practices for quite some time, and none of them are particularly long-standing, I don't think. Things like double-cycle billing and, you know -- the credit card industry has evolved these practices over time, and a number of them are fairly recent phenomena. The fee-harvester kind of cards, which I think we all agree is sort of the most egregious practice that the Fed is going after, those have already been identified by state attorneys general as unfair and deceptive practices.

A number of actions have been brought under existing state unfair and deceptive practice laws saying that these are currently illegal practices. So I think there's certainly litigation risk on the part of the banks that are card issuers for engaging in unfair and deceptive practices, whether or not they're defined as such by the Fed. I think the particular six or seven practices we're talking about all have been identified by state regulators, by private attorneys -- and I can tell you as a class-action lawyer, as a former class-action lawyer, that I don't know that the Fed's identifying these practices as unfair and deceptive or Congress proposing to outlaw them or any number of other kinds of steps are going to be that influential on a state court judge's decision about whether or not to allow class-action litigation to proceed under comparable state law.

If banks are engaged in unfair and deceptive practices, they're going to get sued. And I don't know that -- and there's no private right of action under Reg AA or under the FTC Act. So nothing the Fed does under Reg AA is going to directly create litigation. In fact, if you shift this to Reg Z, you create more possibility for that happening.

And so I do think these are -- it's not news that these practices that have been identified are potentially violations of existing state unfair and deceptive practice law. Those of us who have been following this industry have been thinking that for a while.

MS. SCHWARTZ: Okay, Mark and then Josh.

MR. METZ: I guess rather than go point by point, I will focus on the deposits. The deposit issues are also included as part of unfair and deceptive. Debit holds -- the whole actions around debit cards, that is widely used. To call that unfair and deceptive is a real problem. And parts of the credit card issues, they may be on the fringes, some of that may be, but a lot -- to sweep it all in, I think, is a real problem.

MS. SCHWARTZ: Josh?

MR. PEIREZ: I agree with much of what Alan actually had to say in terms of the fact that things have been identified. I think the critical point is that for the most part, none of these things have been proven to be violations of state law with very, very few exceptions and very limited cases that are still under way.

I think the critical point is that the Fed in acting under UDAP as to a number of these practices, and again, I'm not talking about necessarily the fee-harvester things that Alan was referring to. I'm talking about these more broad, general practices that almost every single institution is using. By determining them to be unfair and deceptive and acting under the Act, the Fed is making a determination that it either caused or is likely to cause substantial injury, that it was unavoidable, that there were no countervailing benefits that outweighed the possible harms, that there was deception through a misrepresentation or omission, and that it was material.

I think the problem that the industry is identifying here is that while we do support, in some cases quite strongly, the Fed's desire to lay out a standard of action for banks going forward that allows everyone to know what the expectation is, by doing it through UDAP and making those determinations, it creates quite a strong statement from the Fed on those actions not so much in terms of what you're looking for going forward, but what your point of view is of those acts as they've existed to date. And that, I think, is the problem that the lenders have.

MS. SCHWARTZ: Okay. Yes.

MS. ENGEL: I guess I am more thinking along the same lines as Alan here. I don't think that this issue of litigation risk is a serious issue.

The Fed is not creating a new cause of action here. All it's doing is defining the

parameters of an existing cause of action, so states still have their UDAP laws. There are two ways to look at the new standards. One way to look at them is that they can now be the basis for liability. But the other way to look at them is that they say, look, if you comply with this standard, it is less likely that you'll be liable. So you just have to turn it on your head and the same argument -- there's a good argument for saying that these standards are appropriate. So lenders who were sued under state UDAP laws could go in and say, look, we complied with the Fed standard. That is some indication of what's a non-deceptive practice. The argument then goes that that lender should adopt the -- or agree with these regulations.

In addition, to the extent that regulations like this make it easier for lenders to predict their potential liability, it actually will reduce the cost of credit to consumers.

MS. SCHWARTZ: Okay, one more. Hi, Mike.

MR. CALHOUN: I think there are a couple other factors here that substantially concern risk. First of all, state UDAP laws do not apply to regulated financial institutions in about half the states. Furthermore, they have a number of additional requirements that make it difficult to bring claims. Typically, they have causation, actual damage requirements. Then you have also virtually all credit card agreements have mandatory arbitration clauses which prohibit class actions. So those provide additional protections.

Part of this is just an inherent component of doing regulation here. There's not authority. I think there's agreement. No one has pointed to another statute or regulation which could be used as a basis for taking this badly needed action. And as Kathleen mentioned, it's an inherent cost in any unfair trade practice or any rulemaking. For example, as we talk more about the fee harvester, there are concerns that when you say the fee-harvester card is unfair if it has fees of more than 50 percent of the credit limit, there are fears that that creates a safe harbor of sorts. I think in both not making it unnecessarily a safe harbor in the case of the fee-harvester case, and in the case of the credit card rules not making it an ex post facto violation, that there is room for the Fed through its comments and its findings to greatly mitigate the risk of both of those unfortunate outcomes.

MS. SCHWARTZ: Thank you, Mike. I think we can answer a few questions under the timing of payments. We'll keep the theme of UDAP going here.

Would the 21-day safe harbor give consumers sufficient time to review their statements and make payments? Should the rule apply to only mailed payments as opposed to payments made electronically or by telephone? And what are the operational impacts? Those were

the areas we discussed.

You should know this got almost an hour's worth of discussion yesterday, so we'll have lots of participants. I know Kevin had some thoughts on this.

MR. RHEIN: Thank you, Faith. I guess yesterday our conversation started to talk about the logic behind the regulation was seven days to mail, seven days for the consumer to take a look at their statement, and then seven days potentially for them to make the payment coming back. And you know, generally, I don't think you need that long a time frame. I think it's easy enough to go to card issuers and find out what is your average statement delivery time frame? We all do studies. It would be pretty easy to be able to say it really isn't seven days. It might be three days. It might be four days.

We talked about the percentage of payments that actually go through the lockbox. In our particular case, the vast majority do not. They tend to be electronic payments --either through bill pay, internal transfers, things like that. So in part, I think you may be trying to solve a problem that is really the way business used to be done. As there have been more and more electronic statements and more and more capabilities to make payments electronically and the growth of bill pay, it just isn't as relevant as the way it used to be ten years ago or so in terms of the time frames needed.

There was also some dialogue about the 21 days. The only way to have this safe harbor was 21 days plus the number of days from when your statement is cycled to when the statement got in the mail. So 21 would become 24 or 25. So it starts to become a little more onerous for a financial institution to be able to feel comfortable that they've got that safe harbor overall.

So I would just say maybe some additional data collection from the staff to get at that seven and seven might help you start to say that -- does it really need to be 21 plus the statement cut-off time or perhaps it's 21 from the statement cut-off as opposed to plus three. I think I'd be a little more comfortable if that was the standard.

MS. SCHWARTZ: Josh?

MR. PEIREZ: Actually, first, I want to commend the Fed for trying to lay out a clear standard of safe harbor for certain periods of time. To be honest, I can't weigh in as to exactly what is reasonable given the consumer concern and the industry. We'll have to weigh those comments.

But I do want to note that I think this goes to the core of what we were discussing

in terms of concerns about terming this a UDAP issue, in that if you look at the existing 14-day rule that was congressionally passed for grace periods -- which I know you carve out of the proposal -- nonetheless, that's the standard everyone has been going by. So it's not as though people have generally been making up their own standard and going with two or three days. They've been going with a congressionally dictated standard that is ultimately now being stated to be okay for grace periods, but not within what you're determining to at least be safe for timing of general payments and for late payments. And I think that is very problematic, and it goes to the core of what we were pointing out in the prior discussion.

I would also note that in reality, while you do exempt the grace period payments, you ultimately are changing everything to a 21-day time frame, because I don't see how a lender is going to come up with a disclosure of two different due dates that you would not deem under the same reasoning in this proposal to be unfair and deceptive as well, because frankly, you know, that seems to be much more confusing to a consumer than saying it's 14 days for everything or it's 21 for everything.

So in reality, while you are exempting that grace-period payment, the reality is you're moving everything to a 21-day period notwithstanding the clear congressional intent on 14.

MS. SCHWARTZ: Jennifer?

MS. TESCHER: Leaving aside the UDAP issue, I do think that, for the sake of customer clarity, it's not such a bad thing to apply the standard evenly across. I think it would be very confusing for the average consumer to know that if I mail, it's this many days I have and if it's electronic, it's a different standard. I think, frankly, it would be difficult for lenders to apply the differing standards as well. So this notion of should the ruling be applied to mailed payments versus other kinds of payments, even though to Kevin's point the world is changing and a declining number of payments are coming via mail. That's certainly the case. Whatever the rule is and whatever the amount of the window should be, I think it should be standardly applied.

MS. SCHWARTZ: Yes, Edna?

MS. SAWADY: Just to elaborate on what Jennifer was saying, the clarity that is needed is not only on the consumer side, but maybe also on the receiving end because there are many transactions these days that are initiated as an electronic transaction, but somewhere through the process they are turned into a paper document or a check that is sent to the provider. So is that mail coming in or is it electronic? The consumer thinks it's electronic because it was initiated

electronically. On the receiving end, it's a paper check so that creates just some more confusion. Just to add another point of view of why I think it should be a universal or the same date.

MS. SCHWARTZ: Patty?

MS. HASSON: When you're gathering the data, one of the things I want to caution you is, while a vast majority may be moving to electronic, defining what that vast majority is and specifically who is mailing their payments -- because we tend to see the clients we have in the lower-income range are mailing their payments, and they're the ones who are going to be, in all likelihood, more hit with the late fees and those types of things also. So I think we have to take that into consideration. Senior citizens is another group that I would say are not using electronic means as much as other groups. So it's something to think about in trying to get that data as to who is mailing in payments.

MS. SCHWARTZ: Any other comments on the timing of payments? Yes, Jennifer?

MS. TESCHER: One other comment that actually Patty raised yesterday in our group discussion, which I thought was important to note, is that as bill payments of all kinds move to electronic payment or that's now an option, an increasing number of companies are charging fees to pay your bills electronically. That's also something to keep in mind as we're thinking about standards here -- that if there's a shorter window for electronic than for others, it's going to encourage consumers who can't afford that extra fee to continue paying by mail, and I don't think that's necessarily the way we want to go.

MR. RHEIN: One last comment? What I don't want to have lost either is this is really all about, I think, late fees, whether somebody incurs a late fee. I think almost all issuers offer auto pay, where a customer can set up and they have tremendous flexibility to be able to say, pay minimum, pay a set dollar amount, pay balance in full. Customers are given those tools to try to help them avoid those sorts of fees. So, simply setting up your account on auto pay can dramatically solve this issue. Many, many issuers, certainly the large bank issuers, also are offering the electronic statement. So again, the whole notion of how many days does it take to get, I think changes quite a bit.

MS. HASSON: Again, just when you're looking at it, and that's a great suggestion and I think for many of us in this room we use those features. But the clients that we work with, they're worried about having the cash and having it drawn out even electronically at that

moment. So I think the concern is looking at who is using those means and what methods are being used and who are the people mailing in the payments.

MS. SCHWARTZ: Okay, thank you. The next subject that we will discuss and had another robust discussion on yesterday was on the allocation of payments. When different APRs apply to different balances on an account, institutions would have to allocate payments exceeding the minimum payment using one of three methods: highest rate balance, split equally among balances, or applying pro rata among balances, or a method equally beneficial to consumers.

Some of the questions that were posed -- are there other allocation methods that should be expressly permitted, what are the operational issues associated with this? Again, we had quite a discussion on this yesterday. Josh, if you could lead us off on that, that would be great.

MR. PEIREZ: I planned not to address this subject.

(Laughter.)

But since you're calling on me, let me start by saying once again I think that providing clarity to lenders as to how to allocate payments and ways to disclose it that will provide them with protections going forward is an excellent step. I'm not going to reiterate my concerns around doing it under UDAP, but I think they apply equally, if not more strongly here since it really does pretty much affect every single lender and every single credit card issuer in the country in terms of these practices and what they've done historically.

But I would also note that I particularly was troubled by the promotional rate approach, in that introductory or promotional rates are somehow treated differently than all other rates where there may be differentials. I would simply suggest that, first of all, that is a more confusing disclosure because now you've got to disclose two different allocation methods where one is excluded versus others. Secondly, it seems to be inconsistent with the inherent logic of the proposal -- that you should just have an allocation method that sort of cuts across all of the different rate categories in some equal amount, whether it be pro rata or just a split equally across the types.

And I think what you will end up having is promotional rates or introductory rates either morph into something else, increased by some amount if they continue to exist, or shrink for certain borrowers. You seem to recognize that, actually, as a possible outcome and say that it's okay through some socialization of the costs so that other people may bear them rather than the ones who most need these promotional rates. But I think that it's important to keep in mind that by singling out promotional or introductory rates, you simply will move those to things like deferred interest rates,

so you'll have a balance transfer rate that has deferred interest rather than a pure zero percent for a certain period of time. That will get you out of the carve-out, allow you to treat it pro rata throughout the period.

I really think that I would encourage you, if you do go forward with the proposal like this on UDAP, to take a good hard look at whether really treating promotional introductory rates makes sense, especially because you're drawing the conclusion on the theory that today, the way that they're disclosed is misleading to consumers, a conclusion I disagree with. But even if you draw that conclusion, once you go to one of these clear payment allocation methods, I find it really difficult to accept that a disclosure to the consumer that says, no matter what you pay we will proportionately apply that payment to each rate category, pro rata, or in equal amounts. There's nothing confusing or deceptive about that, even for promotional rates, and I think we can find a way to have a disclosure on promotional rates that you and consumer groups can be comfortable with, with one of the payment allocation methods that you're proposing here. So that would be my strongest comment.

In terms of additional ones to consider, I would certainly encourage the Fed to look at the current practice of applying payments to the lowest rate first.

MS. SCHWARTZ: Kevin?

MR. RHEIN: I wasn't at all emotional about this one. I guess a couple of comments. One is I want to play off of something Josh said and really trying to model out -- does the Fed have an understanding of what are the revenue implications to banks in doing this, and actually trying to model out different types of payment scenarios, just to understand, because obviously the bigger the magnitude, potentially the bigger reaction is going to come out of all of that.

To my knowledge, there has not been any request for information or modeling that's going on to try to actually simulate what happens here and maybe avoid some of the unintended consequences.

Josh mentioned the impact on BTs (balance transfers). I think you will likely see some higher fees, and obviously in any of these changes it's important to know that if you affect the revenue on an account, it may affect the future pricing and even more so may affect the availability of credit. Staff seems to know that, but again I don't know that they understand maybe the full magnitude of what some of those changes might be.

Customer confusion, you know, I find this sort of amazing. So far the staff has

tried to put out some sample disclosures around this, and what I've heard so far through the research is the consumer is still confused. So if you start to introduce things like pro rata, you know, equal shares, stuff like that, I think it's going to be very, very difficult, as opposed to something fairly simple like lowest balances are paid off first. I don't know what's confusing or deceptive about that.

And then finally, I do want to say, if you ignore everything we have to say and it goes forward, there's significant systems implications in this. So clearly understanding -- my guess would be between the statementing and the calculations on the pro rata, you're probably looking at a couple of years for institutions to be able to go and modify many of those legacy systems to be able to do potentially what the regulation might require and just to be very cognizant of that.

MS. SCHWARTZ: Thank you. We have Alan, then Tony, and Mike. So Alan?

MR. WHITE: I would certainly support the concept of using a single balance payment computational method rather than providing a menu, because if the point of the Fed's research -- and I think it's very good research -- is that this is just not a salient aspect of pricing structure that consumers can or will focus on, then it seems to me you want to push pricing to the other more readily understood features like the APR and the annual fee.

You do that much more effectively if all the issuers were using the same balance computation method, whatever that may be. I understand operationally it's probably easier to just reverse what's going on now, apply payments to the lowest-interest rate balance first and then it may actually be more difficult to do the equal distribution or the pro rata distribution. And obviously, that's the most advantageous from the consumer's standpoint.

Clearly, it will change the revenue picture, but what I think that means is that pricing is going to become more transparent. Right now, people think that they're getting these low introductory rates, but they're never actually getting them because of balance computation methods they can't possibly understand. So they will see rates that nominally look higher, but if you were to calculate the true effective APR, it's going to be essentially the same. There will be some redistribution. I think the redistribution, the results in changing the balance computation method, is going to be from more sophisticated, affluent consumers to less sophisticated, less affluent consumers, and I don't think that's a bad distributive consequence.

MS. SCHWARTZ: Okay, Tony?

CHAIR BROWN: I'd like to take a consumer approach to this and I think Alan may have -- Alan said the lower-rate balance. I would opt for a very simple allocation, and that

simple allocation would mean that any excess over the minimum should first be applied to the higher-rate balance. And I would think that the economists in this room would clearly understand the importance of trying to pay off higher-priced debt first --

MR. WHITE: I am sorry. That's what I meant.

(Laughter.)

MR. ?????? (speaker unclear): We thought you were on our side.

(Laughter.)

MS. SCHWARTZ: Alan, you're on the right side.

CHAIR BROWN: I was going to ask you how many beers did Josh buy you -- no.

(Laughter.)

I think you can keep it simple, and the simplicity would be to allow the excess payment to be allocated first to a higher rate.

MS. SCHWARTZ: I think I had Mike next. All three of you can have a --

MR. CALHOUN: I think it's useful to look at sort of what brought us in a lot of respects to this issue, the impact of the current practices on both consumers and the industry.

As anybody who has a mailbox knows, the U.S. credit card market is pretty saturated, with young, new cardholders being the growth opportunity, but everyone else has pretty much seen all the credit card offers that they can handle. So the current practice in industry is to, in effect, cannibalize each other's accounts with these offers of six-months, zero interest, for example, on balances. But the offers are structured in an inherently deceptive and unfair way because of the allocation of payments, which the testing shows that virtually no consumers understand. The structures make it virtually impossible for any consumer to realize the reasonable expected benefits of such a transfer.

For example, if you do one of those transfers and you made new purchases and pay those purchases off in full each month, your payments will be allocated in full to your zero-interest balance, and your purchases will go to the full interest-bearing cost of their higher rates.

It was suggested by one industry representative that the way you should properly use this is to transfer the balance and then not use that credit card for any other purchases during the six-month period, which is counter to how it's marketed and even counter to practices that are not prohibited -- that many of these transfer offers require use of the card as a condition of getting this

attractive low-rate period on the balance transfer.

But this just adds confusion and deception and injury to consumers and additional costs to the overall industry, which are passed on to all consumers. So this practice helps the industry. I will say there's some, and I hope they will come forward, there are some in the industry who regard this practice as an inefficient and unfortunate component of today's market that serves neither industry nor the consumers. I too would advocate, as Tony and Alan have, for a simplified system of allocation of payments to the highest rate first. Then it provides a level playing field where both consumers are not deceived and companies can compete fairly.

And I think in the credit card world, it's not unlike what we saw in the subprime mortgage world, where in the absence of any rules, the worst practices drag the whole industry down because you cannot compete against other companies who are engaging in those practices without consequence unless you do so also. Fair rules benefit both the consumers and the overall industry.

MS. SCHWARTZ: Okay, Josh and then Saurabh.

MR. PEIREZ: Yes, let me -- I said it half in jest before, but let me make the case for why I think that saying that a bank does have the option to apply the payment to lowest-rate balances first is perfectly acceptable, and I think it goes to something we are confusing here. This is unfair or deceptive acts, okay? And this one, as I read the proposal, seems to be saying this is unfair, not that this is deceptive. And I just want to make sure because people keep talking about deception and confusion. This seems to be about fairness.

If it's about deception, then I think very clearly if it's acceptable to have a disclosure that is clear to consumers that says, your payments will go to your highest-rate balance first, there is nothing at all less understandable to a consumer that says, this will go to your lowest-rate balance first. Those are exactly the same disclosures.

So if one is understandable to consumers, so is the other. I think that's why you have probably gone through an unfairness analysis on this rather than a deception analysis, because I actually think this is perfectly capable of being understood by consumers. I just think that they may not like it in some cases, particularly for those consumers who wanted to believe that they could just have a free loan for six months with the ability to use the card whenever they wanted and not have any negative consequences of that. And whether they really believe that or wanted to believe that is a separate question, and I think that's why you look under the unfairness standard.

In the unfairness standard, when you look at it as I understand, the standard is

you're looking at the injury -- and I'm going to ignore that one for a second -- but it's supposed to be unavoidable and not have countervailing benefits. There seem to be just blanket statements in the proposal that it can't be avoided, and you give some examples of maybe how it could, but that it's unreasonable to expect consumers to do that. Then you also say that there are probably some countervailing benefits, but on the whole you think that it will probably be more beneficial to consumers through transparency than through the obvious pricing benefits that exist in today's market structure.

I think that's exactly the problem with looking at this under a UDAP standard, rather than just saying it's your expectation for banks to do these things differently going forward. Because I don't think that it's inherently unfair the way that things are being done today, in so much as a requirement of that standard is to be able to establish and prove that there are not benefits of the current system that possibly outweigh what's being proposed here. And I think it is at the very least difficult to say that, if not certainly impossible to be sure.

MS. SCHWARTZ: Saurabh?

MR. NARAIN: Just as background, I've been a banker for many years, and I'm also slightly mathematically inclined, and I'm also one of those people who pays off the balances every month, excepting that every so often the issuer company gets me. And I've tried to oftentimes understand what the calculation is of the finance charge as well as the late payment charge and many other charges that get slapped on, and I've never done it. I've always been confused about it.

So I commend the Fed for bringing out such an important issue, which people like us cannot figure out and most of the low-income folks who are sort of the target of this barrage of credit card offers are suffering on account of.

Whether it's unfair or deceptive is a matter for the attorneys to figure out. But to me, it seems that when we are offering these large six-month loans at no cost, that's in big, bold print. When we have this allocation of payments, two-cycle billing, et cetera, et cetera, that's in very fine print. I don't think it's understood by consumers, and I think the balances should actually go to what Tony was suggesting, the highest-rate balances.

MS. SCHWARTZ: Yes, thank you. Alan?

MR. WHITE: I did just want to take issue with Josh's distinction between unfairness and deception. I think it's very clear that this is both an unfair and a deceptive practice. It's deceptive for all the reasons Mike has explained about making it impossible for consumers to

understand pricing. And it's a kind of deception that can't be cured by disclosure. I mean, the problem with Josh's argument is, well, if this is deception, let's fix it with disclosure. But the point of the Board's research is it's the kind of deception that disclosure doesn't fix, and we have to just deal with regulating the price structure so that price competition occurs where prices are transparent and understood by consumers.

MS. SCHWARTZ: Kevin?

MR. RHEIN: A couple of quick comments. One is the notion of highest rate first. One of the obvious implications is it's going to have a greater revenue impact. So what will -- the consequences of that is going to be greater as opposed to a pro rata or anything like that, so just to be cognizant of.

Second thing, I'd be curious if the Fed has done research on people specifically who have taken a balance transfer and what their expectations are. And the reason I ask the question is, if you go to highest rate first, then what will end up happening is more of the balances that were at the BT offer, the balance transfer discounted offer, will re-price to standard rate. So I'm not sure how much you've really accomplished in that sense. And in many cases, it could be that the consumer wanted to pay off that introductory rate so that it did roll into standard pricing. So I think for us to presume that we know what all consumers want is just wrong. And I would just be curious if the Fed did any research specifically around what customers' intentions were around those balance transfers and how they would feel about this.

MS. SCHWARTZ: Patty and then Tony.

MS. HASSON: I am just going to be quick because I want to reiterate again that sophisticated borrowers use this as a method to finance other things -- and it's been brought up before -- so I think the unsophisticated borrowers who are the ones that are being targeted for these need to be taken into consideration.

And the second point that I'd just like to mention is around -- I've learned a lot at this committee about different-sized banks and different-sized systems and credit unions. So I would really -- two years, though, to make these system changes? I really would press you to find out why that would take two years and get the details, because I would like to see why it would take two years. It's not that I don't believe there are systems implications. I just feel that's a very long time period for a programming change that could take place.

MS. SCHWARTZ: Tony?

CHAIR BROWN: This comment may sound harsh, and I guess I probably intentionally mean to do so in order to state a point. I don't think that the proportionality ought to be about padding banks' revenue. I think that the issue of applying a simple calculation to allow the excess payment to go to the higher-priced balance is more about improving household spending power and getting the credit balances reduced quicker as opposed to enhancing the revenue of the credit card issuer. So again, I state that point to say that it should go first to the higher-priced balances, recognizing this probably is a revenue impact. We don't know the magnitude of it, but I think this should be more about consumer protection and trying to get unsecured credit reduced in various households.

MS. SCHWARTZ: Maybe Kevin can speak to this or others, but it seems to me there would be a rate change on cards that would make up for a revenue loss, but I don't know if you have some thoughts on that.

MR. RHEIN: There could be a number of ways that revenue gets recovered. It could be higher BT fees. It could be just general pricing goes up. But the other alternative is, if you don't try to recover that, accounts that may have provided some level of profit might not anymore, in which case you're just going to deny the credit. So if the goal is to make credit less available as a result of this, you may get what you wish for. And the magnitude of the reduction could in part be based on the magnitude of the impact to the institutions and today, I don't think we know because I don't think there's been modeling done of what these payment hierarchy proposals might result in.

MS. SCHWARTZ: Kathleen?

MS. ENGEL: I just want to make a couple of quick points. One thing is that practices like the balance transfers, they have really functioned to have unsophisticated borrowers subsidize sophisticated borrowers. The borrowers who understand it are getting the full benefit, and the borrowers who don't are really bearing the cost. And I think in the credit card market we see a lot of cross-subsidization of more savvy borrowers. And that just perpetuates all sorts of problems and goes to both unfairness and deception.

And the second thing is, I was worried about these operational challenges because I think it is a big deal to say to an industry, you have to change your practices. But I was really encouraged by some of the discussion yesterday that if there was just one standard such as the pay off the highest-rate balance first, that would be the -- the industry would be able to implement that more quickly than they could the options and the rules. So I think that's another argument for having

the payments go to the highest-rate balance, because it will add to the ease with which it can be operationally implemented and hopefully shorten the industry's timeline for putting it in place.

MS. SCHWARTZ: Ed?

MR. SIVAK: I'm also in favor of paying off the highest rate first, and the logic that I would use is that the Federal Reserve System has invested a lot of money in financial literacy and financial education, and one of the tenets of that is that, in fact, you would pay off higher-rate balances first. It's just a simple thing to be taught in those classes. And I think that implementing that policy would be consistent with other aspects of what the System has engaged in over time.

MS. SCHWARTZ: Do we have any other comments on the allocation of payments? Yes, Ronald?

MR. PHILLIPS: I think just on behalf of consumers, agreeing with the comments along those lines, I think probably in addition to death and taxes the only certainty is credit cards in our life. I think they're among the highest in our household of documents and letters that get thrown away immediately and not even -- let alone understood, not even presumed to be understood, and already I sense that there is a promotion going on and some deception probably likely to take place.

And so I'm very intrigued with Kevin's model about the warnings to the federal regulators to be aware of the revenue impact of some of the ways in which you're trying to, I would presume, maintain some way of reaching into these markets with the types of products that are not really, at the end of the day may be, in fact, hurting the revenue model of the household.

One offer or suggestion I'd make is that if we go through with these regulations that we actually study the revenue impact of the actions on not only the issuers, but the households and see what the cost benefits are. In fact, hopefully, there's a much better opportunity that lies ahead for family asset-building versus what happens in the credit card market to so many families that need and take advantage or try to take advantage of opportunities they think are before them with these various issuers.

MS. SCHWARTZ: Thank you. Anna?

MS. RENTSCHLER: Just real quickly, I want to address both Kevin's concerns and Patty's comment with regard to how quickly we can turn these aircraft carriers around and change our systems. This is just one of the issues we as banks are facing, and I come from the smaller bank world. We're changing systems for bank secrecy models, different feeds that go in there. We're changing systems that address the red-flags issues, and so this is just one of the many

issues that our priorities committee with regard to system changes does address. And so it's not just this. It's this with everything else that we're trying to change that may have an impact on the time that's needed to make these appropriate changes.

MS. SCHWARTZ: Thank you. Tom?

MR. JAMES: Yes. One other thought, just on the unfairness aspect, which I know the FTC rule is being applied here in the rule-making process. But in that process, I think it's important to keep an eye on not only the reasonable expectations of the parties when they enter a credit card agreement -- which is not necessarily what's disclosed as, you know, in the big print as opposed to the small print -- but also the ultimate use of the product and whether or not the use in the end is really what was rationally intended.

And I think things have evolved to the point where the application of payments at this point to be employed with the most rational outcome by the consumer is completely counter-intuitive. They've got to treat the product like it's a closed-end product, when they think they're dealing with an open-ended, revolving product.

And so again, you're in a place where the normal consumer is simply not going to be able to price the product in rational fashion, and that's going to cause all kinds of problems down the line.

MS. SCHWARTZ: Thank you, Tom. Okay, Josh?

MR. PEIREZ: Yes, just one comment. A couple of people were talking about the way that promotional balances or introductory balances are communicated. People talk about big print versus small print. Alan mentioned that in terms of why he thought this was deceptive and not just unfair.

And I think that that is exactly the point that I was making at the beginning. And so I'll end on the same point I started with, which is looking at promotional or introductory rates differently from all other rates, I think, is a huge mistake, especially because I think that to the extent the concern on those is how they are communicated and understood by consumers, that if you're changing the allocation method anyway so that there will be some method of allocation that you've said is fair -- whether it's pro rata or just splitting the numbers equally or highest first, whatever you determine -- there really does seem to be no reason to treat promotional or introductory rates differently so long as you could then under TILA talk about how you want the communication of a promotional or introductory rate done. And you could deal with the concerns people have about

whether that is deceptive or not as communicated and how those get communicated and treat the allocation of those exactly the same as everything else.

MS. SCHWARTZ: Thank you, Josh. The next area we discussed is applying rate increases to existing balances.

The proposal would prohibit institutions from increasing the interest rate on the outstanding balance, which is the balance 14 days after the institution has provided the 45-day advance notice of a rate increase. An institution may, however, apply an increased rate to the outstanding balance in specified circumstances -- change in the index for variable rate cards, expiration or loss of a promotional rate, or minimum payment not received within 30 days of the due date.

So we had a pretty robust discussion on this as well yesterday. Some of the questions were -- Are there means of protecting consumers from application of increased rates? Are the proposed exceptions necessary and appropriate? Is 30 days appropriate? And if I don't have any takers for the first one, I know who to call on.

So Tom, you had a few thoughts on that, didn't you? If not, I know others do. Mike? Mike did as well.

MR. JAMES: Go with Mike first.

MS. SCHWARTZ: Mike? Thank you.

MR. CALHOUN: I think we've talked about one of the biggest concerns in the credit card area has been the re-pricing mechanism and how to balance industry needs and reasonable consumer expectations. And I think to start with, to commend the Federal Reserve to take on these efforts on credit cards and overdrafts, which have a profound impact on households. I think as all of us know the Fed has had a few other things to be working on recently as well.

But the pricing, again, is a matter of setting reasonable practices that are consistent with consumer expectations and fit the real world of what consumers do to avoid the harm, going through the UDAP test.

The proposal by the staff on this to allow a notice before new purchases are caught in the re-pricing -- I think it's a particularly refined proposal in that there's the notice that's given that you will be re-priced. And then there's the time limit for the re-pricing, 45 days. And then there's the 14-day shorter trigger that prevents consumers from gaming the system and trying to load up cards before the re-pricing happens. So it both provides protection for consumers and

provides safeguards for industry that they're not going to be adversely selected in purchases.

MS. SCHWARTZ: Thank you.

MR. RHEIN: I think the whole practice of providing customers a notice that says, your risk situation has changed, your profile from a riskiness perspective has changed, and giving them the ability to say they're not going to accept the change and opt out, close down the line, amortize it out. I mean, frankly, I think they get options in this process today. Limiting the ability for a card issuer to apply a different rate to an existing balance really is taking away a fundamental risk-management tool that we have.

And understanding a credit card is an evergreen product, and the profile of the customer at the time of purchase is potentially very dramatically different than the profile when it comes time to start to repay that.

We are in the risk business, and if we lose the ability to target risk pricing on the customers that are riskiest, it's going to result in more of a socialization of the pricing. If you lose that tool, then you'll have to be trying to compensate for that in aggregate pricing. And if the intent is more socialization of the pricing, again, I think you will get that, but you will also be impacting revenues, potentially. Again, it goes back to the same arguments on who is going to have credit available.

And if the customer wasn't given an opt-out, I think it would be a different story. And normally speaking, the pricing that a customer is offered in a risk-based re-price is typically the pricing that a brand-new customer walking in the door would get. And what it really reflects is that their risk profile has changed dramatically from where they were before. So I again would just caution on what are potentially the unintended consequences of this happening.

MS. SCHWARTZ: Thank you, Kevin. Patty?

MS. HASSON: I think when you look at it individually and you're talking about one issuer or one customer, that's fine. But most customers have seven credit cards, or at least those that come to see us. So they're looking at the same profile, and while they may not do it at the same time, the ball starts rolling and it's seven different issuers saying, you're riskier, we're going to raise your rate.

So we're almost setting these customers up for failure in the sense that they're either coming to us because of it, or they're going to bankruptcy because they just finally throw up their hands and say, I can't do this anymore.

So I think that that has to be factored in. It's not the one creditor doing it to one consumer. It's seven creditors doing it to one consumer. That really has a major impact.

And the second thing I'd like to just, you know -- the media, this is one that they love and they build a frenzy on and I probably get the most phone calls to talk about.

So I think from a creditor's standpoint, if it was a consistent way -- if you were saying, okay, you made your purchases at this rate and we're going to let you pay it down at that rate, I think you would also do yourselves a favor because you would be cutting off that media frenzy in terms of them looking at it as an unfair practice.

MS. SCHWARTZ: Josh?

MR. PEIREZ: Thanks, Faith. I guess I have mixed opinions on different parts of this. Let me start with the payoff calculation and time period provided. I think that it's very commendable for the Fed to lay out a standard that everyone can be in compliance with. I think that the standard seems appropriate and fair. There may well be other things you want to look at there, but I think that that makes a lot of sense. I certainly encourage the Fed to try to keep some sort of standard that's very clear for how to allow a consumer to pay off in a reasonable period of time an existing balance should they not continue with the card.

I am very concerned, however, that frankly one of the three options in that type of a circumstance has been eliminated from the consumer and the lender, which is the ability of the lender to have consent and frankly, whether in the form of an opt-in or an opt-out, to re-price an existing balance and have the consumer keep the card. The only two options that are provided are to only re-price new purchases and events or to close the account for future purchases and events.

And I have a really hard time with the argument that closing the account is always or the majority of the time is presumed to be a better option for the consumer than the ability perhaps to keep that account at an increase on the existing balance should the consumer choose to do that, even in an opt-in scenario, which seems to be the way the proposal has gone.

And I think that that is true for a number of reasons, but at the very least the consumer having closed an account with an existing balance that they now have to be paying off over a defined period of time definitely decreases the likelihood of that consumer getting another card at rates that are probably close to even as beneficial as the one that they were just on.

So I think it actually creates a situation where the consumer may well be harmed, notwithstanding the intent to benefit them. So I would encourage the Fed to take a really hard look

at that particular piece, even in the context of an opt-in, although I would propose that an opt-out in that situation, effectively communicated through a form that everyone would have to use, would be sufficient.

I also want to note on this one, again, on the justification that's stated in the proposal for the harm -- I think that saying that it is not avoidable, to me, goes back to the exceptions to some extent. There may well be certain risk-based pricing increases that aren't unavoidable in the sense that credit scores change for a variety of factors, but usually it's something that the consumer has done.

And certainly for on-us activity on that product, the only exception that seems to be given is a 30-day delinquency, not two missed payments out of three, not any variety of other things that perhaps the consumer has done that would cause their risk on that exact product to be problematic, let alone on-us activity with the lender where the consumer may have a broader relationship of mortgage, depository account, credit card, a line of credit, or other things, where there's a very broad picture that the lender has. I would really urge the Fed in that situation to take a good, hard look at on-us activity and re-pricing based on that on-us activity very differently perhaps, because in that circumstance to say it's unavoidable -- which is the first trigger that we look at in the standard or second, I guess, after injury -- I don't see the unavoidability there at all. You know, if they didn't miss the payment, if they didn't fail to pay twice in three months, if they did not do these other things, that was avoidable.

Now you can argue that in the world they couldn't make the payments so it wasn't avoidable to them because they didn't have money, but that's not really what the standard is about. It was totally within their control.

MS. SCHWARTZ: Alan?

MR. WHITE: I think this is a really important and valuable rule, and I think it deals with this fundamental inequity in what's evolved in the pricing of credit cards, where more and more of the revenue of the credit card industry comes from people who are in distress. And Professor Ron[ald] Mann, who’s at Columbia [University], has referred to this system as the “sweat box” of credit card revenue. It's that -- it relates to bankruptcy reform as well. The people we can get the most revenue from are the people who are late, have no other options, or are unlikely to be able to be shopping around actively for other cards. Therefore, rather than shut off their credit -- which in some ways would be the best thing for the lender and the consumer -- we're going to

increase the amount they pay and squeeze them for every nickel we can until they're finally forced into bankruptcy, which we've now made more expensive and difficult for them to use.

So I see this retroactive application of higher interest rates as a part of that "sweat box" picture. You can look at the technical issues and the deception and the unfairness, but I think, fundamentally, there really is an equity issue in the evolution of credit card pricing, and I do think that some of these rules, which are improvements at the margin, are going to be redistributive.

I think the term "socialization" is kind of a funny term to use. We're not going to socialize costs that are now being borne by the most vulnerable credit card consumers. We're going to redistribute them to other credit card consumers.

I think that redistribution is a very good thing, and I think it improves the transparency and the efficiency of pricing, but also the fairness of the pricing in the credit card market. To have the most vulnerable people getting hit with retroactive rate increases, it's just fundamentally unfair.

MS. SCHWARTZ: Okay, Jennifer?

MS. TESCHLER: I want to react to a couple of the things that Josh said. I disagree with some and agree with others. His point about avoidability, I don't think is a reasonable one because until we're ready to open up the black box and make it very clear to customers exactly how their behavior influences their score, I don't think we can make that argument, particularly in the relationship context where I'm in a relationship with a financial institution and they have multiple of my accounts and so they're using internal information coupled with external credit data to analyze me every moment and determine whether or not my risk has -- the risk to the institution has increased.

I think it's very difficult for consumers to understand exactly what lever they've moved that's causing something else to change. So I certainly agree that consumers need to take responsibility for their actions, but I think that we've made financial products so complex that it's just impossible for consumers to know exactly what it is they've done in some cases that is causing a change.

However, I do think that the notion of preserving consumer choice is important, particularly at the margins. And so the notion of offering consumers the choice on an opt-in basis to continue with the card is something worth thinking about. If we went in that direction, I really would want to see it as an opt-in, and I also would want to see some model language or disclosure

around how companies should be describing that opportunity to the consumer.

And I think the other reason why it's compelling to think about allowing the consumer to continue with that card is exactly the point that Josh made around relationships. Again, if you're in a relationship with a financial institution, you have multiple products with them. Oftentimes the pricing in terms of those other products has a lot to do with how they've been bundled and priced, and changing one may change the terms of others. And so there may be an advantage in some cases for the consumer to want to keep that card. But again, I think giving the consumer an opt-in, so that there's a real affirmative choice, would be important.

MS. SCHWARTZ: Thank you, Jennifer. Are there any other comments on this?

Okay, well, thank you. We're going to move on to the last discussion item prior to our break, and that's the financing of security deposits and fees.

The proposal would address concerns regarding subprime credit cards by prohibiting institutions from financing security deposits and fees for credit availability, such as account-opening fees or membership fees, if such charges total more than 50 percent of the initial credit limit during the 12 months after the account opening.

The proposal would also require security deposits and fees exceeding 25 percent of the initial credit limit to be spread over the first year, rather than charging a lump sum at the account opening. So a few of the thoughts that were discussed were, can consumers with limited or damaged credit histories obtain credit cards without high fees, and if implemented, would the proposal inappropriately curtail consumers' access to credit? We'll get that started with those thoughts.

So we had a pretty good discussion on this yesterday. I can always count on Josh to kick us off, I think.

(Laughter.)

MR. PEIREZ: Let me say I'm a big fan of this proposal, start with that, actually. Actually, I don't know whether the 50 percent and 25 percent are the right numbers. They strike me as maybe being a little -- you might be able to actually go a little lower on those percentages actually, because a $400 line with $200 eaten up at the moment you get the card still strikes me as pretty problematic. I think the reason I like this -- and I'll contrast it with some of the others -- is that it's exactly the kind of practice at the margins only targeted at the exact segment of people you're trying to protect as opposed to the others, which are applied to everybody and maybe impact some

people negatively, but certainly impact others positively.

In terms of the availability of credit, I think striking some balance in terms of allowing these things, but at some limitation, does try to do that. I also want to make sure -- and staff has assured me this is true -- but I want to make sure that in the final proposal it is crystal clear to draw a distinction between a secured card where the consumer effectively deposits money to get the benefit of a card that they can then use to build credit, but it's not financed. It's not fees, and it's something that allows the very consumers we're worried about here, consumers who are out of bankruptcy, consumers who are looking for ways to build a credit history that is positive. Those products, I think, are of a very, very different nature, and I understand them to be excluded in this proposal, but I would just encourage the Fed to make sure that's crystal clear in the final rule-making.

MS. SCHWARTZ: Thank you, Josh. Mark?

MR. METZ: Josh made many of the points that I was going to make, and he made them very well. This is the sort of thing that’s at the margin and that I completely support the Fed taking action against and trying to eliminate. This feels like unfair and deceptive. To sweep all the other things in is where, again, we had the problems. We'll talk about this some more, particularly with respect to deposits. I think that raises a lot of concerns as well.

MS. SCHWARTZ: Mike?

MR. CALHOUN: I think one of the questions posed was whether this would adversely affect access to credit. Our organization is primarily devoted to expanding access to credit, so that's a major concern for us. We have experience through some of the affiliates we have with customers who come in with these cards. And these are essentially Catch-22 cards.

Ideally, this card would be a transition product that would allow someone to help establish credit, move to a more mainstream credit card, but they're structured so it's virtually impossible. I think it was noted by one of the other folks, one of the primary targets of these cards are recent bankruptcy filers who are coming out of bankruptcy. They can't file again for the statutory period, but it's virtually impossible to establish any credit.

The typical scenario in these cards is often the borrower gets these cards, is hit with these enormous fees the first month, and then even if they make no purchases or maybe one minor purchase, they suddenly are over-limit on the card, which further damages their credit and has got them in this financial hole that they can't dig out of. And so the typical result of the consumer

taking out one of these cards is they not only don't get the benefit of the card, they further lock themselves out of mainstream credit products.

MS. SCHWARTZ: Kathleen?

MS. ENGEL: I want to echo Josh's point about the percentages. I'm a little bit worried that this is going to set a standard under the UDAP laws for what's acceptable just so that a 51 percent financing would be or 51 percent of fees would be acceptable. I really encourage the Fed to consider lowering the percentage here because this is, I would consider, still an unfair product at 50 percent. And it would, in some ways, confirm the race to the bottom that's happened with these products or legitimize it.

MS. SCHWARTZ: Thank you, Kathleen. Alan?

MR. WHITE: I think on the question of access to credit there is some good empirical data. If you look at the research that Professor [Elizabeth] Warren and Katie Porter have done on debtors coming out of bankruptcy -- and they actually have a database and I suspect Katie would be happy to share it with the staff to investigate this particular question -- looking at the actual credit offers being made to people coming out of bankruptcy who really ought to be, presumably, the people with the most difficulty having access to credit. And it turns out that they have no problem getting credit cards. Most of them are very wary of getting anymore, and they voluntarily refrain, her research also shows. And I don't think her research suggested that they were all secured credit card offers, and I don't think they were necessarily fee-harvester cards either.

Our problem right now in the credit card market is not access to credit. It's really the reverse. It's a huge overabundance, an oversupply of promiscuously granted credit card credit. Credit cards are all essentially granted as no-doc loans, right? We don't verify anybody's income or determine that they have repayment ability. So I think that there's a whole range of other issues.

The rule certainly deals with some very important things, and I commend the Fed for the rule. But I think it's unfinished business. There is unfinished business in looking at the credit card market, which strikes me as the next likely consumer credit crisis. Unless you focus on the repayment ability issue in the way you have in the mortgage market, there's a huge problem that's left untouched.

MS. SCHWARTZ: One of the questions posed was, is 12 months the appropriate time period to consider in determining how much of the credit limit is consumed by the security deposit and those fees charged? Are there any thoughts on that? Yes, Saurabh.

MR. NARAIN: Well, it strikes me that, in the context of payday lending, the FDIC has pushed for the small-dollar loan program in trying to term out these small loans. And this is not yet a fully considered thought, but, you know, is it possible that this revenue stream arising out of the financing of security deposits or fees can actually be termed out beyond 12 months, you know, and provide an ability, if indeed it's a question of reducing credit, which, based on what Alan's saying, doesn't seem to be the case.

Well, even if you give the benefit of doubt there that it is going to reduce credit if you don't allow these security deposits and fees to be financed, well, can we term it out to help the low-income consumers to get into the mainstream financial system?

MS. SCHWARTZ: Any other comments on the financing of security deposits and fees? Alan?

MR. CAMERON: Faith, really a comment on the use of UDAP, the unfair and deceptive practices. As staff has noted, this rule doesn't affect all financial services firms and does not affect state-chartered credit unions. And as a result, it takes away what is really a fundamental precept of the dual-chartering system, which is a level playing field. And it creates, I think, a lack of effectiveness in the rule by having a substantial group of creditors out there able to avoid the rule because they're not subject to the strictures of the rule.

I understand that the FTC has indicated they're not going to act because they have to go through an evidentiary rule-making process, which they find too cumbersome in this area. So I would urge that, like many of my colleagues here, that you look at other bases for doing what is, I think, needful of doing, and I applaud the staff and the Board for looking at these areas and regulating practices which can be harmful to consumers.

MS. SCHWARTZ: Thank you, Alan. I think Sarah had something.

MS. LUDWIG: Yes, it's sort of a question, I think, more than a comment, although I'll start with the comment, which is that, like a lot of the proposed rules here, and certainly the one around fee-harvesting cards is really front and center, and sounds like people agree that it needs to be addressed. And certainly for the low-income borrowers that come to our consumer law project, fee-harvesting cards have been really, really problematic.

So my question is whether or not the 50 percent, which strikes me intuitively as very high, is not problematic also in another respect, which is that, and this is my question -- am I missing something here?

What's to stop an issuer from just taking a $400 credit limit, for example, with a $200 fee, and then just saying, okay, your credit limit is $401. It just seems like it would lend itself really quickly to a circumvention of the intent of the proposed change.

MS. SCHWARTZ: Any other comments? Lance.

MR. MORGAN: Yes, I'm not the industry expert, but I'm pretty well versed on Native American issues, and this has happened, something similar. I'm thinking of something similar that happened in our universe when the federal government did us the favor of passing the gaming law. They put a cap on management fees for non-Indian companies to work with us of 30 percent and 40 percent. Now the normal industry was five, six, seven, and all of a sudden everything became 30 percent to 40 percent for us. And it took us about 10, maybe 15 years to recover from that one thing to get things back to a normalized rate. And I think that, if you put this high cap on it, it almost -- in our situation, it was almost like a federal endorsement for that cap. And that became the standard, and I think you would risk that.

MS. SCHWARTZ: Thank you. Any other comments on just the proposed rules regarding credit cards? Yes, Patty?

MS. HASSON: We didn't talk about the two-cycle billing and the ban on that, and I just want to commend the Board on that one. I think that it's long overdue that it's outlawed. You will never get consumers to understand that, and you will never get, I think, most people to understand how that impacts them.

And the second one is the firm offer of credit and the disclosures around the APR. But I think you need to take that a step further, because many consumers who are in financial trouble are getting those offers in the mailbox. It's really got to be bold. It's really got to be in some way obvious to them that, because I have a 16.9 percent rate or a 20 percent rate, and I get this great offer, they can't believe they're just going to be able to switch it over.

MS. SCHWARTZ: Yes, Josh.

MR. PEIREZ: I would just also note, however the Fed chooses to go forward with these various proposals that, not so much on the systems side, which I think Kevin has already spoken to, but in terms of the overall configuration of the way the marketplace is working, these are very, very significant changes, taken as a package. And my concern with that, from a timing perspective, is two things.

The two things I'm concerned about are, one, giving sufficient time, and not trying

to do these each piecemeal with different time frames, for the full package to be understood and explored.

And I would look at it in two different things. One, for new products issued, and two, on existing products, especially those with existing balances, because those existing balances were taken on by banks in an environment where all these practices of pricing and re-pricing and how they were going to allocate payments were very much understood to be okay.

And notwithstanding that, Alan, you didn't think they were okay, but there were no laws against it, and nobody has found at any court for them to have been illegal. In changing that here, with the Fed saying, you should not do that anymore, on existing products that were created, developed, money that was lent on those existing products, giving some real thought to an appropriate time for banks to be able to migrate what they have and are risking right now to something in compliance with this.

So I would look at, separately, timelines for new stuff and timelines to bring existing stuff into compliance, both from a systems perspective but, more importantly, from a marketplace impact.

MS. SCHWARTZ: Any other comments? Well, Tony, it appears that we are five minutes early.

CHAIR BROWN: How about that? I think we're going to shortly get started for a break. I just can't help but notice that Mr. Falk has been quite relaxed.

(Laughter.)

MR. FALK: It's nice not having to talk about mortgages in the first half of this morning.

(Laughter.)

CHAIR BROWN: We're going to take a 15-minute break, and we should be back, get started at 10:40.

(Whereupon, the above-entitled matter went off the record at 10:25 a.m. and resumed at 10:40 a.m.)

CHAIR BROWN: First, let me thank everybody for the robust discussion we had on credit cards. And we're going to continue our discussion, and I'd like to ask Mark Metz to lead the discussion on the proposed rules related to overdraft services for deposit accounts.

Mark?

MR. METZ: Thank you, Tony. Actually, before we start to talk about overdrafts on deposit accounts, there are two quick issues we're going to cover on credit cards. The first is the due date for mailed payments. The proposal would prohibit creditors from requiring mailed payments received earlier than 5 o'clock -- those would be considered timely. There could be different rules for other forms of payment in terms of the cutoff, but anything received by mail before 5 is timely.

I think there was agreement yesterday about that, and are there any comments on that? I think the sense of the discussion was people supported that -- both sides, industry and consumer groups -- and that people were comfortable with that.

Similarly, if a creditor does not -- if the due date is on a weekend or payment is received on a weekend, it's given credit for the following business day. This was also a topic I believe there was agreement on on both sides. Any comments on that?

Okay, let's now shift to deposit accounts and how the UDAP rules affect deposit accounts. Specifically, the rules would relate to the payment of overdrafts on deposit accounts regardless of whether the overdraft is created by check, a debit card purchase, an ATM withdrawal, or other transactions such as an ACH debit.

Some background on this -- banks typically offer overdraft services to their customers where they will pay an overdraft and charge the customer a fee for paying that overdraft. The first topic for discussion is the customer's right to opt out of that service. And specifically, the proposal would prohibit banks from imposing the fee for paying the overdraft unless the bank has provided the consumer with an opportunity to opt out of the payment of overdrafts and the customer has not opted out. So that's what's proposed.

Our first discussion topic is, instead of allowing an opt-out for the service of paying overdrafts, should banks be required to obtain affirmative consent for customers to opt in to the payment of overdrafts?

Any comments on that? Mike, you want to start us?

MR. CALHOUN: Sure. I'll start there, and actually I'm going to pass something around. The Center for Responsible Lending does a lot of research, and I'll pass around the report that we had been working on for more than a year -- I've got a couple of copies and there are more here and it's also on our website -- where we have actually looked at both aggregate data and then we subscribe to databases that allow us to look at individual anonymous bank accounts and look at

every transaction through that account and so lets us look at when are overdraft fees are incurred, what effect it has on the balance, et cetera.

And that data, along with surveys that we have performed, overwhelmingly support an opt-in requirement for a couple of reasons. First of all, overdraft protection has become one of the largest fee generators in the banking industry. We're now talking about in excess of $17 billion a year in revenue from these overdraft fees, which has a substantial impact on American households.

The primary fee generator now is debit cards, rather than checks that are returned NSF (non-sufficient funds). And what’s striking is when you look at the size of the overdraft, the amount of the overdraft protection, and the duration of it compared to the fee. Presently, for debit cards, the overdraft fee -- which the typical fee now is $34 -- matches up against the amount of overdraft protection provided each transaction, which is typically less than $20. You have almost a two-to-one ratio of the fee being almost double the amount of the loan.

The funds are recaptured as soon as the account has a positive balance so the typical duration of these loans is around three days. So it makes it a very expensive form of credit. We have done surveying, which is detailed in this report, both for older consumers, families, and also more generally. Nearly 80 percent of families wanted overdraft protections declined on debit card purchases. They also want the choice of whether to have overdraft protection. And given those facts, it seems that an opt-in, which would be normally the way that a service, particularly a potentially expensive one, is marketed and is agreed to by consumers.

I think it's important also to realize that the current state of overdraft fees and programs is a relatively recent phenomenon. If you go back less than four years, 80 percent of banks as their regular practice did not cover debit card purchases with overdraft protection. There are a number of consulting firms that widely advertise that providing overdraft services provides some benefits to the banks' customers, but also provides a tremendous source of revenue and in fact is widely recognized as often the most profitable activity that the bank engages in.

There also is a major issue here that I would urge the Board and the staff to look at. There are a lot of indications that overdraft has already drifted into a bank-operated payday lending model in many circumstances. Similar to payday, it is the frequent users who generate the overwhelming bulk of overdraft fees. About 17 percent of customers who get overdraft coverage loans, actually have the fee triggered, produce about 80 percent of the total overdraft fees.

And we have examples where we use an anonymous name, but one of these accounts is of a borrower on limited Social Security, and in the course of two months, much like the typical transactions, she incurred $448 of overdraft fees for $210 of coverage. And it just digs her deeper and deeper into a hole rather than helping her there.

So for all those reasons -- the potential harm, it's a relatively new product -- there should be an opt-in requirement. And then I'd like later to talk about ultimately there need to be -- I'll toss it in right now since I may not get back.

In the payday lending context, we had a very similar situation where the FDIC initially authorized state-chartered, federally insured banks to engage in payday lending in partnership with nonbank entities. And it was authorized on the premise that this was a convenience, occasional product. The FDIC looked at the data that it started to collect and found that, again as with overdraft, in the payday world over two-thirds of the revenue comes from the repeat customers who have more than a dozen payday loans a year. And the numbers are even higher for the repeat customers in the overdraft world.

And so the FDIC's response was to say, let's allow this product to be offered as it's advertised, as an occasional convenience product. But the FDIC adopted a rule that if a borrower had more than six payday loans per 12 months, then the bank had to offer an installment-loan product because there was strong evidence that it was essentially a high-cost revolving line of credit at that point and it was putting the borrower into a spiral downward into a debt trap. And I would urge the Board and the staff -- I think overdraft can provide a valuable service for bank customers. But for the repeat borrowers, there is temptation for some banks to encourage repeat borrowing due to the extreme profitability, but it has extreme adverse consequences. But let me stop there.

MR. METZ: I have got some comments, and I'm guessing some other folks will as well. I think the issue of an opt-in or an opt-out, I'll talk about that first. I think opting in has a number of problems. Number one, I think if you tell a customer, you're going to opt in to our overdraft services, the implication is that you will pay every overdraft that they create. And that is not what would happen. That's not the way these programs work now. They're at the discretion of the bank whether to pay them or not based on -- it's a credit analysis that's done very quickly.

So point one, you would have very upset customers who would say, wait, I thought you were going to pay all my overdrafts. And that's exactly not the behavior we would want to encourage. The second point, I think there are a number of operational problems that this would

present, specifically on customer service.

I think people would either not remember that they had opted in and -- or opted out. If they were required to opt in, and folks didn't, they would get to the -- you can imagine the scene at the department store where people are lined up wanting to use their debit cards and then they're turned down by their bank because they don't have sufficient funds in there.

And the implication is going to be, well, I deposited a check yesterday. Well, that may be -- that may not show up on the authorized balance yet. We are going to get as banks tons and tons of complaints, questions. We would literally have to probably tenfold increase our staffs for customer service and telephone reception because of complaints related to this.

I'm pleased that Mike has shown research. I would really encourage the Fed to look at research and to talk to the banks. I think the industry research -- this deals with the point of whether people want this overdraft service or not -- I think industry research would show that right now at the ATMs, when people go to an ATM and they're warned that they may overdraw their account, I would say the majority of people still proceed with that transaction because they really need the money. And they understand that they might incur a fee. So I would encourage the Fed to look at that research as well. I'll stop there. Luz?

MS. URRUTIA: I think the opt-out option would not allow the customer to have the service when it's most needed. And the returned-item fee or the fees that would be assessed by the merchants for that item being returned could potentially be higher.

Also, we should consider that in this economic climate when credit scores are deteriorating rapidly and people have less access to credit, that overdrafts, having access to those funds and paying the overdraft fees, might be the only options for some consumers to get access to money.

MR. RHEIN: A couple of quick points. One is I want to reiterate what was said around the credit card UDAP standards, that UDAP was being used for this regulation. I really do believe there is significant litigation risk that goes up for the banks with something that we were doing yesterday and can't do anymore because it was deemed unfair and deceptive practice, especially by somebody like the Federal Reserve Board. I think that just opens things up dramatically. So I really would encourage the Board to look for Reg E, Reg DD -- are there other things within the regulations where you might be able to accomplish potentially many of these things without it being a UDAP standard.

Secondly, I just want to -- I'm very perplexed by how you would do an opt-in. So, if you were to say to a customer if they said, yes, I want you to cover my overdrafts, there's not a limit. There's not an understanding. There's no concurrence between the parties as to well, when will you do that and up to what amount? And banks as a standard practice, I think, are offering overdraft protection vehicles to those that qualify, and in that case the consumer clearly knows this is my credit line and it will cover overdrafts.

If you go to an opt-in, there's an expectation established with the consumer that the bank is likely not going to be willing to live with, because they might think they'll go up to $500. We might be thinking we'll pay things up to $50. So I don't know how you do that in an opt-in. I think it sets the wrong expectation for the consumer.

The other thing, I mean I haven't read this, Mike. I guess I find it as you start to think about debit card transactions, our experience with seniors is they don't use debit cards. The youth is typically what uses debit cards. So I'd be curious, you started to bring in debit card transactions and overdrafts, and I don't know whether this study gets at that or not, but I would like to understand that a little bit better. And I'll turn it over.

MR. METZ: Josh.

MR. PEIREZ: Thanks, Mark. Let me state that when you're looking at opt-in versus opt-out, what you've proposed here -- which I generally support in terms of the opt-out component -- is not what is traditionally thought of when we say opt-out. It's actually quite unique in terms of an opt-out in that it occurs early on before anything has happened. It's obviously an ongoing right, which is then reminded to the consumer every time they actually incur this fee. So yes, they may have to incur the one, right, and then they get notice of that again and an opportunity to opt out that existed anyway, but that they're reminded of at that time every time they do it.

I would actually suggest there's probably some number per year that are sufficient where you don't have to keep doing it throughout that year and noticing, providing that notice every single time if it's sort of a monthly occurrence. But either way, I think that this is not what is traditionally thought of as an opt-out, and I certainly support the general approach.

I do want to respond to one thing that Mike said, though, in terms of consumer expectations. I think that our research shows that consumers get more angry about their cards being declined than virtually anything else because in fact, whether it's a credit card or a debit card, the primary functionality they're usually thinking of is, I can use it to pay for something. When they pull

it out thinking it's going to work and they get declined there, they are very angry.

And, you know, I think that anything that serves to lessen the ability of a bank to service that customer by approving that transaction, which in this case due to the fact that the bank is taking on a risk because it is not money that is in the account, they are taking on that risk, they should be able to price for that service to the consumer. We had a lot of discussion yesterday as to whether the appropriate way to price for that was through interest and charging interest on the account versus a fee. I think that's to some extent semantics. I think that, ultimately, the reality is that if the bank provides this service and chooses to do so, it should be able to charge a reasonable amount for it. And I see no implication that the amounts being charged are unreasonable, even in the Fed proposal, because you're continuing to allow those amounts just with an opt-out or even here the discussion being an opt-in. It is still the indication that there is a valuable service here.

So I would just encourage, to Kevin's point, I'm looking at it in terms of UDAP. I actually think the service being afforded today and the risk that it goes away is a quite powerful countervailing impact that should be considered and does not seem to have been considered in anything other than an off-handed way in analyzing whether the current system is unfair or deceptive. And so I would simply say, look at Reg E or look at your notice requirements. Require someone to provide notice of opt-outs and try to avoid doing it in UDAP because this one really doesn't fit.

MR. METZ: Mike, I think you're next, and then Alan.

MR. CALHOUN: I promise I'll be much briefer this time. First, I would agree that there is a risk of and evidence of consumer confusion and unmet expectations. But I think that argues strongly for opt-in rather than opt-out. I mean, under which scenario is a consumer more likely to receive information from the bank about the services and the limitations of the services -- if it's default and they're automatically signed up? Or if they have to sign up?

And again, remember, given the profitability of this service, there is a very strong incentive for account tellers, service representatives at the bank to market and sign folks up, so it's not like they're not going to want to sign people up, it's not worth their effort to sign them up.

It's also, I would note, inconsistent with one of the other widespread practices -- the arguments that I've heard from industry here, about we don't want to lead people to think that we're going to cover this necessarily -- because one of the other practices that this rule addresses is that as a way of encouraging these overdraft fees being incurred, a number of institutions now

automatically include the amount of the overdraft protection in the balance amount that a consumer pulls up, for example, at an ATM. They don't have in bold print that we may not really cover this. They, in fact, encourage people to use all that money and incur the fee, and that seems inconsistent with a big concern that people will be overly assured that they'll have the coverage here.

The other thing is the opt-out form itself must include all the options for overdraft protection. Before we had the very high overdraft fees, most overdraft protection was provided by a very low-cost connection to a line of credit or to a checking or savings account. We give the example of the borrower in our case. If she had had that tie to her account or revolving line of credit, she would have incurred a couple dollars of fees, rather than $440.

And finally, our research shows that, not surprisingly, there's a strong household wealth correlation as to which households incur large amounts of overdraft fees, and there's also a racial correlation between which households incur the largest number of overdraft fees. I think there are real equal-credit issues that are raised by the fact that overdraft products are marketed when far less expensive products that perform the same service at a small fraction of the cost are not presented as equally as options to households.

MR. METZ: Alan?

MR. WHITE: I am really intrigued from a consumer behavior standpoint from both Mark and Kevin's comments that if we had an opt-in system, it would be very difficult to explain, let alone convince consumers, that they should opt into this product because it's so discretionary and we'd have to qualify what it is what we're offering them and it's hardly even contractual because it's so discretionary. I mean, I think that really tells you a lot about the nature of this product.

I think what Mike is saying about the alternatives -- it's very important to keep in mind that the product being regulated here is not overdraft protection, because classic overdraft protection is a line of credit or a link to a savings account. This is this discretionary bounce-loan product, which is what I prefer to call it. And it seems to me there's a good case to be made that the product itself is an unfair practice and could just be banned.

What the Fed is proposing to do is far less than that -- is just require that consumers affirmatively opt in. I agree with Mike that the industry is going to have to make the case to the consumer that this is a product that anybody would want to opt into.

I think as to the point whether you regulate under the UDAP authority or other

regulatory authority, part of the reason this problem was created was because of prior action by the Fed in carving out overdraft protection from the scope of Reg Z and saying that this is not an extension of credit, when we all know perfectly well that it is an extension of credit. I think, from a bank safety and soundness standpoint, the regulators actually treat overdrafts as credit for which capital has to be adjusted and so forth.

But for consumer protection purposes, the Fed chose several years ago not to treat this as credit for which credit disclosures should be given. And if we went to that model, our Reg Z model, and said, this is credit and you have to disclose an APR, then maybe we wouldn't be having this whole discussion about regulating it as an unfair trade practice.

But I will say, apart from just banning this product, another option is to do what the United Kingdom's financial services regulator is looking at, which is to look at regulating the price directly and saying, well, does $35 bear any relationship to the losses that are being incurred? If you're going to treat this as a fee rather than as a credit product, is it a reasonable fee? That's what the Financial Services Authority (FSA) is looking at now, and they're looking at setting caps on the overdraft fees. And that would be another approach. But I think the opt-in approach is a very minimal step for consumer protection on the spectrum of things that you could quite reasonably choose to do.

MR. METZ: Jennifer?

MS. TESCHER: I want to build on what Josh said a little bit ago on the disclosure piece of this -- this notion that in every cycle in which a consumer overdrafts or is charged, assessed an overdraft fee that there would be a disclosure. I actually think it may be more effective to follow the best practice guidelines that Mike referred to, which suggest that after a consumer hits a certain threshold of overdraft activity that the bank reaches out to that consumer and says, hey, you might have a little bit of a problem here. I don't remember whether the threshold was six at any given time. I don't remember what the best practice guidelines say, but it might be worth trying to mirror those best practice guidelines. Some banks have already adopted them and use that as the trigger for when you need to provide subsequent disclosure.

I'll actually go a step further. I think this is the harm that we're most concerned about -- consumers who use it repeatedly and get stuck. And if that's really what we're worried about, I think we should be talking about enabling and potentially requiring banks to offer consumers who get themselves deep in the muck of significant overdraft activity to term out what

they owe. Because what happens now is consumers are cycled in and out of the banking system, right, because they accumulate a huge number of overdrafts and you're out of here, we're closing your account. And as you all know, it's quite difficult to get back in the system once you've been kicked out for overdraft activity.

And so I think that beyond this notion of disclosing to consumers, we should help consumers who get too far in the muck to enable them to stay in the institution by terming out what they owe and potentially not allowing future overdrafts for some period of time. I think that really addresses the harm that most of us are concerned about.

I also think that this notion of adding the total, the aggregate fees that you're assessed to the monthly bank account statement is a really good idea from the notion of providing more feedback to the consumer to help them visualize and understand the expense they're accumulating. I actually think that's more effective than a sentence that says, gee, you had an overdraft this month, remember you can opt out.

And unlike sort of balance computation or other issues on credit cards, which are quite difficult to understand, I think it's pretty simple for a consumer to understand, gee, I spent $300 this month in overdrafts.

MS. RENTSCHLER: I want to address a comment that was made earlier with regard to ATMs and taking withdrawals out of those. In the industry, individuals that were in our committee, it was quite common and is our practice when you go to an ATM and you want to overdraw the account, it comes out and says, you will overdraw this account if you continue with the transaction. I think that's pretty standard in our industry.

So we have an available balance, and the actual balance is disclosed on that. However, on foreign ATMs -- not on-us ATMs -- that isn't always available, although they can do a balance check on that.

First of all, I have to point out that the consumer is always in the best position to know whether they're going to be overdrawn. It's very difficult, even in a family relationship, when you have multiple people on an account to know what's going on. I'm in Washington, I'm using my debit card. My daughter has access to it. Is she going to a gas station and pumping gas in there, putting a hold on it? My husband is paying the mortgage payment. What's going on? It's difficult for us. How is the bank to be expected to know what's going on or what checks are coming in? So that's something to be looked at.

But when you talk about the different fees and the accumulation of fees for overdrafts, you have to remember that if we bounce that check or send it back, they're also going to be charged for that service. They're also going to be charged by the gas station or wherever they wrote that check, too. In addition, they may end up publicly embarrassed because they're on the wall of shame. If you've ever gone to the grocery store and seen the list of people that you know in small-town America, it's oh my goodness, look who's on there. I think that needs --

GOVERNOR MISHKIN: This is the advantage of living in New York.

(Laughter.)

MS. RENTSCHLER: I guess so, unless you have the same name as many other people.

(Laughter.)

And Mishkin is probably not a common one, but Tony Brown might be.

So I think it's important to realize that even though we are charging the fees and we're getting that income, that we're getting it if we bounce the check and there are cumulative fees after the fact as well. And if we don't offer this service or some people choose not to use it, you may be driving those people underground.

We had a presentation yesterday that talked about the refund anticipation loans, the payday loans, the pawnshops, et cetera, so they may be going to other sources for that. It is a source of income for that. I also echo the comments with regard to not paying an item, the unintended consequences. Again, I'm in Washington. What has my husband done with regard to my account. If he doesn't pay that -- he pays the house payment and they bounce it back, I'm in a lot more peril than if I just paid that $34 fee. So I think that that's something to keep in mind when you're talking about the opt-in versus the opt-out. What are the unintended consequences?

And I don't intend to overdraw my account, but sometimes it happens and so you're going to really tick off your best customers a lot of times, too. And I do have a low- to moderate-income person in my household. She's a college student. And quite frankly, I would rather that they pay those rather than having her type of things bounce around. So there are lots of things to consider in that regard.

MR. METZ: Cooke.

MR. SUNOO: I sit here and basically when I hear the bankers and Josh talking about all the advantages of having an overdraft protection, I don't disagree with that particularly.

Overdraft protection is not a bad thing. I have it on my account.

I think the principal point of difference that I have with that side of the conversation is the lack or the way that a person avails themselves to that particular service. And it is an expensive service. The $30 fee is an expensive price to pay. And if you choose to pay that because you don't want your daughter's check to bounce, that's a choice that should be made. But if it's made on an opt-out basis at the time of the opening of the account or whenever it might be, it kind of gets lost in all of the other things that you're signing up for at that particular time.

If you are required to opt in, then it does require the banker to do a good sales job with you, to tell you the advantages and to tell you the costs and to tell you the limitations of what you're getting. And I think that that becomes a very, very valuable decision-making matrix for the customer.

Without the overdraft protection, if you go -- and I think it's very clear in the industry that paper checks are going to be an anachronism not too far in the future, being replaced with electronic banking, being replaced with the debit card.

If I go to McDonald's with my debit card, and I'm buying a hamburger and a milkshake for me and my family and I get declined, yes, it's embarrassing if I don't have overdraft protection and I get declined on it. It's embarrassing, but you know, is that embarrassment worth, or the saving or the avoidance of that embarrassment worth $30? I'm not so sure. And with regard to declines, that's what happens in the credit card market anyway. Any credit card you have, if you hit that limit and you get declined, you get declined. You either reach into your wallet and you pull out another card, or you do without, or you somehow have to get around it. The idea of opting in, I think, is extremely important from a consumer point of view.

MR. METZ: Sarah?

MS. LUDWIG: Yes, the whole issue of these bounce loans as a courtesy, overdraft protection -- which we don't think of as a courtesy, perhaps it's protection, and I would challenge that as well -- has presented a really big sort of challenge to our community education around financial issues in New York. We do, very frequently, financial education workshops and seminars with community groups that are working with low- and moderate-income people from a very diverse set of neighborhoods and demographic groups.

And you know, over the years we found that in our curriculum and in the sort of teaching about the merits and advantages of having a bank or credit union account, bounce

protection has presented a really serious new wrinkle. It's very hard for us now unequivocally to recommend to people that a bank account is a categorical advantage across the board, and that given bounce protection, which is really a land mine for a lot of people that we work with, we have to sound the warning for them that if you're going to open an account, you need to find out is there bounce protection attached, et cetera.

So now in our curriculum material, which we keep having to expand in our basic banking section, our material is a lot about the mechanics of personal finance, but it's also about people's rights. And so we have a section in there about overdraft and we have to explain a whole lot of things. We have to say, first of all, it's not the same as an overdraft, it's not the same as a line of credit. That's what you apply for -- it has a set interest rate. People sometimes blur the two in conversations about the merits of bounce protection.

The second thing is that it's attached to accounts without people's knowledge or consent. Most people that we know, and our clients or individual clients that come to us with problems with bounce protection, found out when they got their statement. So it's often way after the fact and when they're really jammed up and it's kind of snowballing.

We have to explain to people that the overdrafts are paid, as you've heard, at the discretion of the financial institution. We have to explain to people that the fees that they're charged are not related to the amount of the overdraft and that, actually, and I don't think this has come up yet although I've been listening for it. We haven't even talked about the fact that, in addition to the initial zap, there are oftentimes daily fees incurred around the overdraft.

We have to explain to people that they have to be careful with the disclosure of balances, which I know the proposed rule addresses, in terms of not allowing for the disclosure of a balance that includes the overdraft amount as if that's the amount that somebody has on hand because that's absolutely confusing and deceptive.

We have to explain to people that some of the lenders or financial institutions can at their discretion and do charge, sorry, pay out the higher amounts on the checks first, so that they stack the checks to pay off the higher amounts and trigger the overdraft, rather than doing it in a temporal sequence.

And you know, we hear a lot about -- and people say, well, I have no choice in this? I don't get that. This is attached without my consent? So clearly the Fed's proposal of having an opt-out is very important, but I don't see why we wouldn't have an opt-in. And if it is so hard to

explain to people what the implications of the product are and therefore we shouldn't have the opt-in, I think it speaks volumes about how problematic the product is.

And the last thing I'll say is that if people are so clamoring for this because they want to avoid stigma, which is the argument that we frequently hear, then let them make that choice. Let them clamor for it, right? Opt in.

Actually, I have one more point, I'm sorry, and that is that our work in New York at the organization I work with is almost exclusively low- and moderate-income people. This is by definition the people with the smallest cushion in their accounts to the extent that they have accounts. So by definition, these are people who tend to overdraw, but beyond that, these are people who are targeted for this product. Young people, it's a huge marketing blitz in New York and, I imagine, everywhere because it's by a national financial institution -- unnamed and not present, so far as I know, at the table -- that targets young people for so-called free banking, free checking, get your free checking account.

And this is the institution that gets the highest amount of bounce protection fees in the country because it's putting people into accounts, luring them, young people with these zippy, hip ads to get these accounts because it's free, knowing full well that the students, the young people are going to be the ones with the least cushion. And a lot of seniors come to us as well.

MR. MORGAN: If you look at the payday loan industry, which we spend a lot of time kind of picking on in a lot of ways in our meetings, basically what they're doing is they're getting a loan. They're charging high fees and high rates, and you'll pay it back when you get paid again. There really isn't much difference, fundamentally, with what's happening on the overdraft-protection side of the equation, except in the payday industry, at least it's somehow tied to the amount you're getting. And you don't have that in this situation. So what's strange about this is you can easily imagine a situation where it makes more economic sense to go to the predatory kind of payday lender than write a bad check at the bank. And I think that's a strange result.

MR. METZ: Josh.

MR. PEIREZ: I assume we're going to transition away from the opt-out/opt-in discussion at some point, so this may serve as part of that transition. I think that there's also this concept of the partial opt-out, which I think if you looked at an opt-out versus opt-in regime becomes much more complicated in either case.

And I would encourage the Fed to dispense with the partial opt-out and make it,

whether you do opt-out or opt-in, a single disclosure that the service exists on all types of transactions or it does not exist on all types of transactions and let the consumer make the decision whichever way you go.

I think that the concept of having the partial opt-out solely for overdrafts at ATMs or POS versus for all transactions, especially as these things are more and more becoming interchangeable in their ultimate purposes, particularly as cards are being used for bill payment, for recurring payments that are set up and the like, that you know this goes a long way, I think, to allowing consumers to have the knowledge of what's going on and, frankly, whether you opt out or opt in, to make a decision. I would encourage you to make it a single decision for all ways of accessing a particular account at issue.

And I just want to note, whoever -- Cooke, I think it was you who said this happens on credit cards all the time. There is similar overdraft type of protection, over-the-limit protection on credit cards, so you have the same fundamental issue, I agree, but it's not that it just gets declined, you provide the same service.

MR. METZ: Saurabh, then Tony. Excuse me, Saurabh, then Alan.

MR. NARAIN: Yes, as background, I work with small community banks around the country which are developmentally oriented, and I have to say overdraft fees are probably one of their largest net-income items, which is kind of interesting.

That said, I think I'm actually standing in favor of an opt-out provision because of the uniqueness of the opt-out provision that the Fed is proposing, i.e., each time there is an overdraft, you go and tell the people that, you know, you have an opportunity to opt out because you have this kind of fee and that disclosure of how much fee and how much you incur in terms of cost is an important disclosure. That actually helps much more than the opt-in provision where you have to start anticipating what kind of transactions you can have and what kind of fees you can incur. Thanks.

MR. METZ: I want to jump in with a comment, and then Alan and then Tony, and then we'll shift to debit holds.

I think, Alan, before you had said, I think, the product in itself is an unfair product. I think that's just too broad and sweeping a statement and doesn't reflect a lot of reality. As I mentioned before, at ATMs when responsible banks warn people, the majority of people choose to go forward even though they might incur an overdraft.

The second thing, and let me just give an example of how, when someone opts out, how it affects their account. And I would argue in this case it hurts a customer. Say somebody has got a $50 balance in their account and they do a $60 point-of-sale transaction, and they've also deposited a check somewhere along the line. Well, in their mind they think they've got $150 in their account when in fact they don't if that check has not cleared. In that case, we would bounce them and decline their transaction and not charge a fee.

We would get a lot of customers upset as a result of that, and in that case the customer is not really benefited. So I think just saying per se it's unfair, per se it's bad, is just too broad. I agree with Saurabh's point. I think the opt-out is the way to go, and I think the Fed has done a good job about disclosing it. I think when you disclose it every time it happens, either on the statement or when it occurs, I think people are warned and they can make the appropriate decision and I'll stop.

Alan?

MR. WHITE: You made the point earlier about unhappy customers getting debit transactions bounced. I think if you look at the empirical data from the center (Center for Responsible Lending), consumers when they're surveyed who use debit cards want their debit card to be stopped when they're out of money. And I think this relates to some of the behavioral literature about mental accounting and self-control mechanisms, and also relates somewhat to what Josh was talking about with credit cards. When you have a credit card, you want to have credit. You want to be approved, and you want to have access to more money.

Many consumers, in my experience, use debit cards precisely because they don't want to have a credit card because they have this anxiety about running up debt that they can't control and because they believe that the debit card is almost like cash, in the sense that when you're out of money, you're out of money and they will stop -- somebody else will stop you from spending money you don't have.

And so I think that there's a behavioral explanation for the survey results that Mike's folks get -- that people want to regard their debit card as not giving them access to overdraft credit.

Apart from that point, I wanted to suggest that if the Fed is going to adopt an opt-in or an opt-out model, I think an opt-in would make a lot more sense. In either case though, whatever the notification to the consumer is, the form on which they opt in has to, must disclose the

other ways in which a consumer can protect themselves from overdraft which are cheaper and better. So any institution that has an overdraft protection scheme linked to a linked savings, which is obviously something we want to encourage people to do, right, to save money as opposed to just borrowing it at $35 a hit. The availability of a savings-linked overdraft protection feature should be on that same opt-in or opt-out form as should the availability of a line of credit, because I think many of the institutions that do this overdraft protection also do offer lines of credit where you're paying an APR, I don't know -- it's like a credit card interest rate, much, much lower-cost overdraft protection.

So if the institution has those two other products as alternatives to the discretionary bounce loan, I think they should be required to disclose that at the same time you're making your opt-in or opt-out choice, whatever you decide on, so that the consumer knows it isn't just a choice, do I have protection from overdrafts or don't I? There's overdraft protection and there's overdraft protection, and that should be disclosed.

MR. METZ: We'll do Tony and then Kevin and we'll -- maybe Mike will have the last word and then we'll switch to debit -- oh, Joe.

CHAIR BROWN: Actually, I have no comments. My confusion was clarified by Sandy.

MR. METZ: Kevin?

MR. RHEIN: I guess I want to clarify a couple of things. First off, if customers are offered extra products -- so I think it's a complete fallacy and an allegation that just is not true that if you can -- if the customer has savings or if they are eligible for credit, banks are going to try to offer overdraft protection products. So I completely reject that characterization.

Second is, I think the issue and the answer you get through a survey can be very much based on how you ask the question. I think a lot of the vehemence around this particular product is the $2 overdraft at Starbucks.

What's important to understand is a debit card transaction is not just point of sale. There are millions of customers that have recurring debits that are set up on their debit card. They are doing card-not-present transactions, and the banks are not going to be able to delineate a McDonald's or a Starbucks' type of fee from any other type of recurring payment that might be occurring on the debit card.

And you're right, people do select a debit card because they're attempting to try to pay with today's dollars to an extent. So this notion of a split balance and the ability to be able to

delineate, it's not how the system works. There's one potential shadow line that exists for a customer, and somebody made the comment that you're either all in or you're all out. Under current capabilities, you're not going to be able to delineate a point-of-sale transaction or an ATM transaction from in-clearings, basically the processing of the checks.

We had a lot of dialogue yesterday that many people felt there was value in some overdraft coverage for in-clearings because the automobile check might be there, the rent check might be there, but not necessarily for the Starbucks. I just want folks to understand the debit card is used for far more purposes than the $2 latte at Starbucks.

MR. METZ: Joe.

MR. FALK: Let me give you a slightly different overview perspective from the mortgage industry and transcend some of the detail that we've talked about today.

My industry, the mortgage industry, is now greeted with fear and suspicion, confusing terms, a presumption of gotcha, that the mortgage originator, mortgage broker is trying to trick you. In interviews and comments I've heard all over the country, people have said to me, why are consumers always asking what have I missed? You haven't disclosed something. There is a clear fear and suspicion that has entered the mortgage arena, broad sweeping condemnations of an entire industry, rather than trying to pick and choose between good operators and outliers.

And so for my friends in the credit card and banking industries, I think we're walking down a very dangerous slope here by trying to maximize profits everywhere you turn, by creating all of these different subsets, subdivisions, ways to increase revenue, which I understand why. The larger danger here is that consumers on a very real basis will now treat the banking system with fear and suspicion. And that cannot be a good outcome for all of us.

And so from my perspective, when mortgage brokers are constantly being accused of being predatory per se, just a word of caution, you don't want to go there. You really don't want to go there.

(Laughter.)

MR. METZ: Joe, thank you. And Lance just reminded me that it's sort of refreshing to see you to the left of Sarah here.

(Laughter.)

MR. FALK: Those are preassigned seats, you know that.

GOVERNOR MISHKIN: I just want to make a quick comment after this, which

is this is one of the reasons why this committee is a very valuable committee. My experience here at the Federal Reserve being here two years, the fact that we're actually getting representatives of both industry and consumer groups to actually talk to each other has huge benefits. And so this is an example, and we also do have some sense of humor about it as well. So thank you, Joe.

MS. LUDWIG: I have to say something which is left, right, I just say it as I see it.

(Laughter.)

MR. PHILLIPS: Could I just say that that was just an excellent presentation on this whole issue. I just want to applaud Joe for saying that. Just from the consumers' perspective and outside this whole thing in America, people think the overdraft is part of the business model of the banking system and it has -- it reeks of the payday kind of characteristic, so something has to be done somewhere to make -- to get rid of it or do something with it, that's all.

MR. METZ: Mike?

MR. CALHOUN: Two quick things that address related issues here. One was there have been comments about consumer activity at ATMs when they're informed that they might overdraft. We have suggested and strongly recommend that requirements of notice that you may overdraft include the fee that you will incur, because I think the consumer response is much different if they go to that ATM and it says, if you proceed with this you may incur a fee versus if it says, this is going to cost you $34 extra if you go forward, particularly when a lot of those withdrawals at ATMs tend to be at or less than $35 each.

Second, I wanted to mainly address the issue that staff asked about and that the proposal offers and we strongly support, and that is that consumers be given the option to differentiate between overdraft protection for their checks versus for their debit cards. Some folks talked about the major differences in how folks use this. And again, while it doesn't apply necessarily to every debit card user, for lots of debit card users it would be valuable to have that distinction.

And again, as I've mentioned earlier, that is what was the overwhelming norm less than four years ago when debit cards were not included in overdraft. It's a more recent phenomenon to sweep debit cards into the overdraft, and overdraft protection has been around for a long time. And clearly, one of the reasons that debit cards are being swept in is they produce the biggest proportion of overdraft fees for the smallest loan coverage amounts.

MS. HASSON: I just wanted to echo what Sarah said earlier from a financial

education standpoint. It's really difficult working with low-wealth individuals who look at checking accounts already negatively and then many of them here in their community, the fees associated with it or have tried a checking account and got hit with those fees and so to -- and make conscious decisions that using check cashers is cheaper than paying those overdraft fees. So I think that we need to also consider that.

And the second piece, and although I have no data on this, I will say that the customers that you talk about that are angry are the ones who typically have money in their account and something went wrong. From experience, our customers, they take the fees. They say, that's what the system does to me. They accept it, and they either walk away or they're told to leave eventually. So I don't think that the angry customers that we're all talking about are necessarily low-wealth customers who this system is going to hurt.

MR. METZ: Edna?

MS. SAWADY: I just wanted to comment on -- it seems to me that there are benefits to this service, and I've listened throughout today and I also have my own experience that there are definitely some benefits of the service. We keep talking about it and saying it's problematic in the way that it is currently structured.

So the challenge that I'd like to throw out is, well, in the short term, let's figure out the fees and whether the fees are reasonable or not reasonable and whether they should be tied to the size of the overdraft or not. So that's something that can be done in a relatively shorter time period. And then the longer-term issue of that calls for innovation, that calls for a different type of service that would address the need in the market and be structured in a different way. And that may be a longer-term proposition, but still something that I believe could be achieved, especially with mobile technology today and it might be a call to the cell phone.

It may be a service that is priced and that people pay for that will call you and ask you whether you want it covered. I'm just throwing an idea out, but there may be other ideas of how to restructure that service that may be valuable in its essence, but is very problematic in the way it is currently structured.

MR. METZ: We're going to have two more comments on this, and then we're going to switch to debit holds. Kevin, and then Saurabh.

MR. RHEIN: I just want to basically -- the notion of restructuring or whatever, great idea. The technical issues that are involved is most banks, particularly in their deposit systems,

they're operating on legacy deposit systems that are 20 plus years old.

Today, there really is one settlement, and that includes electronic, point of sale, in-clearings. So if we go down this road trying to delineate the debit card, POS transactions from in-clearings, it's major, major system work. It will take a lot of money and a lot of time to get that done. It doesn't mean we shouldn't do it, but just relative to the timing of when this would occur, this is huge.

MS. SAWADY: I did stress that it's a long-term proposition.

MR. RHEIN: I understand. I want to make sure the Fed understands that as they start to think about these regulations and when would that potentially start to kick in.

MS. SAWADY: And then the other thing is there may be other ways of restructuring that may not have such huge systems implications. Believe me, I've been in a large commercial bank for 20 years, so I know what the limitations are. But I'm intrigued with the advance of a mobile technology -- there are many banks today that offer services that will call your cell phone and will tell you if somebody is charging on your account. That has been done from a fraud-prevention perspective. But it maybe can expand the scope and use the same technology here.

So my suggestion was to try and think expansively over a period of time -- it could be years -- but we could start now about what potentially valuable services could be delivered in a way that is much less problematic.

MR. METZ: Thank you. Saurabh.

MR. NARAIN: I guess a small point and just to reiterate something that's been partly said before but not emphasized enough. It seems to me the opt-in, opt-out provision may become irrelevant if we actually examine the structure in terms of whether it's a line of credit versus a one-off bounce loan.

But more importantly, the amount of fees. Is $30 the appropriate amount of fees for a $2 overdraft? And if it's $5, would banks continue to offer that or not is an open question. I suspect not.

So I think the question may be and the Board might actually want to look at the question differently and say, are the fees excessive as opposed to whether the opt-in or opt-out provision should be taken out.

MR. METZ: Thank you. We are now going to shift to a discussion around debit holds. And let me give just a minute of background on that.

A debit hold occurs when a customer uses a debit card for a transaction in which the actual purchase amount is not known at the time the transaction is authorized. So what occurs is that the merchant will place a hold on a customer's account that may exceed the actual purchase price in order to protect the merchant against risk of loss. These things often occur at gas stations, hotels, and restaurants.

The issue is consumers are not aware of the debit hold policies and that they may incur overdrafts on the assumption that the funds in their account will only be reduced by the actual amount of the purchase.

I think it's useful to give an example to illustrate this. An example I think in the materials is a customer goes in, buys $20 worth of gas at a pay-at-the-pump situation with a debit card. There is a $75 hold put on their account, and as a result $55 that they may think is available is now unavailable.

Now the proposal from the Fed provides that a bank cannot assess an overdraft fee when the account was overdrawn solely because of the hold. Any commenters on that? Josh?

MR. PEIREZ: I think that this is a very tricky issue, quite honestly. And I applaud the Fed for trying to tackle it. And I think that it's becoming a bigger issue, frankly, as gas prices go up because actually gas stations are asking us to raise what is now $75 worth of protection when they authorize for $1, because they don't know what the transaction amount is going to be. They would like to see that up to about $125, which we've thus far refused to do because, frankly, filling a tank these days, $125, not out of the question. And they've got consumers at the pump who are angry because they can't fill up.

And also when you try to use the same card twice, that's actually a fraud trigger, so you may get rejected for that. So that's not necessarily an obvious solution.

The reality is that the whole reason that this structure exists was to allow the convenience both to consumers and merchants of being able to pay at the pump in a self-service fashion. Otherwise, they could go inside and say exactly the amount they wanted to pay for, get only that amount, have the pump shut off, but many consumers did not like that. They have kids in the car. They have other reasons they didn't want to leave their car there. It takes more time. Service stations didn't like it because they had to have higher levels of employees servicing it, and they could go to this quicker, faster way of processing transactions with the pay at the pump. The $75 protection is one of the tools that were given there.

What I think is interesting, though, is that this actually comes up in two different fashions in the proposal and is treated differently. It is to some extent semantics and I find it interesting, and I think it's something I would ask the Fed to really take a close look at. So first, in the exceptions to the opt-out altogether, you deal with it in terms of the authorization-exceeded concept. And in this context, the authorization from the hotel or the gas station or whatever is very often, if not always, going to be exceeded when the transaction actually settles. And in that instance, it's okay to have an overdraft fee or an over-the-limit fee, frankly.

Whereas, if it happens to be the case that that transaction took place so the bank is now recognizing they're at risk for $75 because they approved the $1 authorization, they're keeping that $75 targeted, and then the next transaction that comes in is the one that puts you over, that's not okay.

But it's really the exact same transaction, and the exact same system issue that has led to the over-the-limit authorization situation. The reality is that the most likely scenario, I think, as a result of the proposal is that we have to look at eliminating some of those services for those merchants, which I would encourage you would talk to them about, in particular the gas station operators, maybe the hotels. People keep bringing up restaurants. I think it's actually much less of an issue for them.

So I would encourage you -- car rental companies, as well -- to really understand what that type of a restriction would have on them because the banks are on the hook for any fraud losses that result from that transaction, even though they've only authorized $1. And very standard practice, based on our rules and some of our competitors' rules, is three days is the maximum duration of a hold. Also finding ways to have gas stations or others clear those transactions more quickly and to do so in a way where the transaction records match up cleanly, which they do not today, would allow those holds to come off faster.

So I would encourage the Fed to go down those paths on this, rather than try to distinguish this. And just while I mention the exception issue, I would just state that when you're looking at debit cards, there are a number of transaction types that are very similar to what you're trying to protect on the check side, whether it be recurring bill payments, mortgage payments, maintenance payments, things that are coming up more and more where you would probably want to exempt those.

And similarly, you seem to draw this unauthorized transaction but paper-based

exception, and I would simply say eliminate the paper-based concept. If the bank did not authorize it and it then comes in through clearing and they honor it, that should be an exception. It should not matter whether it was paper-based or electronic.

MR. METZ: Other comments?

MR. CALHOUN: We would just note, I think the Board makes a useful distinction on how it treats holds, and the distinction is in the one case the consumer has actually had money pulled out of the account where the actual expenditure was more than the authorization. I mean, what it's saying is, if you in fact overdrew the account with withdrawals, you're allowed to assess the overdraft. If you weren't, you don't get to assess the overdraft. That seems to me like the rational and fair approach.

MR. RHEIN: Mark, I guess again I want to come back to this settlement experience and the authorization and then the ultimate settlement potentially occurring three days later. I don't know how banks can make decisions on the intervening items if they're not sure if in paying those they would have the ability to charge an overdraft fee or not. So this whole de-linking of the authorization from the settlement and the ability to know whether there's a fee or not a fee, you know, the net result of that would likely be far more rejected transactions if you just can't be certain.

And there clearly is, I think, there's an experience for the consumer. There's an experience for the merchant. Again, it's these unintended consequences. I think in general we have been trying to move away from paper and move to electronic items. Some of these proposed changes, as a result of rules that are set up by the associations around protecting the merchant over a certain dollar value, you know, may start to drive people back to paper because of the uncertainty that starts to get introduced into this process. So I don't know how you model that or whatever, but it would be very problematic to know which items, whether to pay it or return it.

MR. METZ: Edna?

MS. SAWADY: I just wanted to mention that I believe I am a fairly sophisticated consumer. Until I met Josh, I never knew that there was a $75 hold on my account every time I pump gas, and I suspect that I wouldn't know if you raised it to $125 either. I'm well aware of the limitations of what the Fed can regulate, but I'm wondering if there is any way to get this information out to the public in a more visible way because I do understand that there are people who are in a rush and they want to go in and out and they have kids in the car, and that's all fine. But

there are also other people who would prefer to just go in and pay exactly and not have the hold.

I recently rented a car, and there was a big sign, a huge sign, that nobody could miss saying, if you pay by debit card, there will be a $600 hold on your account for three days. And I think it needs to be in as big letters and as clear every place that there is a hold so people can make their own decisions -- and we're going back to the consumer choice issues.

MR. PEIREZ: We would agree.

MR. RHEIN: We would agree.

MS. TESCHER: I think that's right. I also want to go back to Josh. I have to give Josh a little bit of a hard time because he's encouraging the Fed to encourage gasoline stations to clear their payments in less than three days. But that has a lot to do with the rules that the associations and others set, so I would encourage some sort of industry action to close that gap.

It wasn't that long ago that we did batch processing, and so the balance that you got at the ATM was meaningless because it wasn't real-time. And I think Josh has demonstrated that over the course of time, the debit holds have come down significantly and debit is still a relatively new product. But I just think that there has got to be a fix here in dramatically shortening that time. There's always going to be that occasional mismatch on the hold, but I just can't believe that we can't do a better job of getting folks to put them through faster.

MR. PEIREZ: I agree. I'd like to get there. Our relationship with the gas stations these days is not the tightest in the world, and we have a number of other issues with them as well. I think the thought of us trying to mandate something on them, frankly, would be unworkable and ignored. But I do think that them disclosing something is something they'd probably be willing to do. It becomes -- as long as it's done in a relatively inexpensive way, which it can be, I think there's a willingness. And in terms of the timing, the timing is coming down and will continue to come down as technology evolves.

The problem is many gas stations -- and I'd be really curious if the Fed gets more information on this -- but they use one system for authorization and a different system to clear and settle. So we don't even receive comparable messages to match up. So actually what banks do is they just drop the pre-auth after three days assuming the clearing has come in, rather than actually being able to match it necessarily. So until we solve for the matching, which involves them having to switch one of the two systems -- which I'd love for them to do, but it's not my decision, quite honestly, to make them do it.

MR. METZ: Actually, Josh, that's a great segue into one of the questions: What are the operational issues associated with implementing this proposal? You just mentioned one of them. Are there other comments?

MS. HASSON: I guess this is an operational issue. I'm trying to get my arms around this. If a person goes and gets gas and the $75 hold goes on, and they spend $25 over here, right, you hit them automatically with that overdraft if they go over, I guess at that point. But when it settles, you're settling on the date that it happened. Now I know it's an operational issue, but can a system look back? Can't you build into your system -- look back three days and reverse that overdraft because the person never, in fact, went over?

MR. METZ: I can try to address part of that. I think that points up part of the problem. When you go to the gas pump and you've got, say, $50 in your account and you only buy $25, the bank doesn't know that you've only bought $25. They think you've bought $75 because that's what the authorization is.

If you have opted out of overdraft protection, your transaction is going to be denied. You're not going to get your gas. I mean that is sort of point one. I think point two is, could the banks go back and reconcile these accounts? Probably, if we hired a lot more people and bought a lot more computers, there is probably a way to do that, but I would say that's really not feasible at all.

I think what the banks would do instead, operationally, is either they would reject them all or drop all deposit holds, debit holds, and then take the risk that you really only are buying $50 worth of gas, if you only have $50 in your account. I don't think -- there's no way, I don't think, a bank would be able to go --

MS. HASSON: I challenge that. I'm not a programmer, but I believe that programming is -- there are people who are bright enough to do that. I think the second piece of it is, if a bank chose to do that, they would get a competitive advantage in the marketplace.

MR. METZ: I really disagree. I don't think there would be any competitive advantage.

MS. HASSON: At the point you're giving them a fee, right, you're doing it at that moment. You're allowing them to do it, and you're giving them a fee. If you look back and they didn't actually incur that fee, and it settles, am I missing something?

MR. METZ: We are not actually giving a fee at that moment because if they are

overdrawn at that point, we may reject the transaction if they've opted out. If they've opted in, or if they chose not to opt out, we may pay that transaction because they may have deposited a check for $100, so at the end of the day when we batch off, when we look at things on a batch basis, we will actually pay that transaction and not charge them a fee. So that's the point I was making before. There is an advantage to the overdraft system. People may not agree with that, but that's how it works right now.

And a lot of times -- checks -- people don't understand when their checks are coming in. The bank is not in a position to know if somebody is going to charge more than they think they have in their account. I mean, the bank looks at the balances at the end of the day. If we have the overdraft protection as a courtesy, we will pay those. And we won't bounce.

MR. RHEIN: Effectively, you’re going to have to run month-end twice because somebody cycles, you've got their current transactions, but the settlement might occur three days later. So you're going to have to go back because there was that settlement and go back and reverse the transactions. It's operationally impractical, causing massive confusion, and I don't think people are going to understand it.

MS. HASSON: Could you delay the posting of that fee for three days until it settles?

MR. PEIREZ: I don't think it's a question of the posting of the fee or whether you can reconcile it 30 days later. I'm sure there are programmers who could figure out how to reconcile it 30 days later. Okay? I don't think that's the issue.

I think the issue is that when the bank is making the decision as to whether to authorize that transaction that's coming in for $1, okay, where they know that they are bearing a risk that it could be as high as $75 that they will have to pay, they look at it as a $75 transaction request, period.

And they are looking at it and saying, if it comes through at $75, am I prepared to authorize it? And the only way to change that dynamic is for me to change my rules so that they don't bear that risk of the $75 and that they only bear the risk of the $1 that the gas station actually authorized for. And that is why it becomes a big merchant issue.

As long as they are bearing that risk of the $75, they're going to make a decision that says, okay, if the customer only has $50, I'm prepared to approve it on the theory that if they end up at $75 -- frankly, even if they end up at $100 -- I may still honor that. Most of the time, banks

will honor it, and some gas stations will go up to $100 and take on an incremental $25 risk. They may be saying, okay, I'll take that risk because if, in fact, it shows that at the end of the day when I batch-clear where everything was, that this was into an overdraft situation, then I will charge a fee for it.

If the fee is gone, that calculation will be different and they may decline. They may not. There could be a competitive differentiation there, although it's not clear to me how you would communicate it. But I think it just has to be understood that it's at the point of the decision that if the bank knows it has a fee, its likelihood of approval is much greater than if they don't know they have that fee. So the fact that you could look back 30 days later doesn't change that dynamic. You may not like it anyway, but it does not change that dynamic.

MS. TESCHER: In the spirit of Governor Mishkin's comment earlier, I actually would urge the Fed to convene a group from the associations, from banks, from retailers, from consumer groups to really talk about this at a technical level and an operational level to see if there's anything we can't do to try to shrink the hold time and make the hold issue go away.

I think if we could solve that issue, then we'd still have the overdraft issue, which we've just debated, but this piece of it goes away. I think at the very least we need to discuss what the alternatives are or what the possibilities are before we make a big policy decision.

MS. BRAUNSTEIN: Just so you know, we have held a number of discussions on this issue, and we will continue to do so.

MS. ENGEL: If I'm understanding this correctly, the real challenge here is at least -- is that there's just a few types of transactions where this comes up, the primary ones being the gas station and the rental cars. Putting the rental cars aside for a second, the issue with the gas station is, should we force people to have to walk into the gas station versus should we subject them to huge overdraft fees because they're getting holds on their accounts that they don't realize they're getting. That's what we're talking about. It goes back to something Cooke said earlier.

And if you think of it that way, it seems pretty obvious that forcing people into the gas station probably is in the best interest of the society, even if it means taking your kid out of the car seat, number one.

Number two, in the old days, it used to be that you would have to go in and you'd pay cash to the store clerk and the store clerk would set the pump for whatever cash you gave. It doesn't seem to me that it would be impossible to go backwards, right? I mean, I understand the

problems with going forward, but going backwards and having -- and the pumps, you put in your credit card and you say, I'm going to buy $20 worth of gas and then the pump shuts off when you hit $20. Just like when you pay cash at the counter, the pump shuts off when you hit $20.

I'm a little bit confused about why this is so complicated, at least in terms of gas stations. You get what you pay for, and that amount gets taken out of your account.

MR. PEIREZ: Let me say first, I don't agree with the characterization of those two extremes as being the choice. But setting that aside, I do agree that ultimately it becomes about how the gas station interacts with its customer more so than anything else. And if the solution is, we're so concerned about what impact the debit hold has on overdrafts, which to be honest I've not seen any empirical evidence on.

I've heard the complaints. I see the articles get written, but I've not seen the kind of research, Michael, you've shown here for other things particular to debit card gas station holds. And I'd really like to see that before we weigh that against the societal benefit of the way gas stations operate today versus the 1970s. The reality is it becomes about how gas stations interact with their customers. That has a lot more to it than whether it's walking in or not. It has to do with how much the gas station has to staff. It has to do with fees the gas station pays. It has to do with the way that they -- whether they're a 24-hour service or less, based on the number of people they would have to have there. There's a lot more to that that's specific to them, and I don't want to weigh in on what is or is not problematic for them.

And in terms of the choose-what-you-want-to-pay-for option, I have no problem with that philosophically, except that there's a large proportion of people who want to choose to fill up. Once you offer the filling-up option, you don't know how much it's going to be for. Quite frankly, even if you chose $20 or $30, or today $80, as your option of what you want to buy, you may or may not fill up with that, and frankly you may spend less than that, in which case you have to have a way to then get change. And so then you'll have the reverse problem, which is the authorization was for $80, but it only actually ended up being a $60 transaction, and we'll be in the exact same discussion.

So unless the consumer always buys very conservatively less than they know it would take to fill up -- and someone else can tell me how to communicate that -- you end up in the same place. But I'm fine with gas stations giving consumers the right to choose, I want $30. Frankly, they have that option today. They just pump $30.

MR. METZ: We just have time for a couple more questions, and then we've got to switch to another topic, but go ahead, Mike.

MR. CALHOUN: It seems that all the proposed rule asks for banks to do is to base the assessment of overdraft fees on the actual charges, not the holds. You don't have to impose the overdraft fee and then unwind it three days later or unwind at the month. You simply have to do what Mastercharge is saying they do now -- they take this nominal authorization and then drop it after three days and then operate the account just based on the actual charge. I mean, I think we're making this – there are complexities here, but I think we've managed to take it to some additional orders of magnitude.

If you just do what the rule says, don't count the holds when you're imposing the overdrafts. If people actually go over, hit them with the overdrafts if they're in the program. You have that same kind of uncertainty, and you've talked about it today. You don't know what deposits are coming into the account a lot of times when they're making a purchase, and you're going to have to put on an overdraft fee and you let it shake out when the settlement happens.

MR. METZ: That last question and Jennifer and others, and Kathleen, Josh have offered suggestions. Are there alternatives that would allow consumers to avoid overdraft fees caused by debit holds?

I guess I wanted to point out something first. I think this whole recent discussion really drives home the point why using UDAP regulations with respect to banks, with respect to debit holds, is just not right. Banks cannot control the relationship between a gas station and a merchant. We can't control the relationship with Josh and his ability to make us hold $75 or $1.

MS. TESCHER: It's all Josh.

(Laughter.)

MR. METZ: I love Josh, but this is a situation where to call the bank's role in this unfair and deceptive is just wrong.

In terms of alternatives, I like Jennifer's suggestion. I like Kathleen's suggestion. I really encourage the Fed and Sandy, it sounds like you've already done this, to get the groups together that can help solve this.

With respect to the gas issue and I think a bigger issue, too, is with respect to ATMs. It's already been talked about, and we can debate whether you have to disclose the fee and how much you need to tell somebody. But most responsible banks, when you go to an ATM, at

their ATM and you're going to overdraw your account or the potential to overdraw your account, they will warn you and say that you have a fee.

As Anna mentioned, you can't do that at a foreign ATM. So if we could solve the foreign ATM issue, and I'm hoping the Fed could pull a group together to do that, I think we're going a long way to what the intent is here -- where a customer doesn’t know how much money they've got in their account, you want to warn them. You want to tell them about the implications of what could happen.

MR. RHEIN: The only thing I want to add is I'd love to see the Fed do some research to Josh's point on what percentage of the overdrafts are caused as a result of debit holds. I think we've heard a lot of anecdotal evidence, but I just don't know and I couldn't tell you from my bank. So it would be very interesting to know how much is truly due to what's been held and, you know, maybe we're trying to solve for something that just doesn't occur all that often. When you think about $75 at a gas station, it's a pretty small car before you're up to $50 or $60, so I don't know that you're going to see that much difference in today's daily -- so to me, it would be very curious to know that.

MR. METZ: Tony, I'll turn it back to you.

CHAIR BROWN: I think I'd have to agree with Governor Mishkin.

MS. ENGEL: Do I have time for a quick comment?

CHAIR BROWN: Quick comment.

MS. ENGEL: I'll be really quick. Okay, first of all, if the Fed is going to go back and do more research, I think there should be research also done on what consumers would choose if they had full information about how these work. It shouldn't be just what happens, but what they want when they don't understand.

The second thing is, I don't think this is about the Fed trying to control market actors. I have incredible confidence that the Fed can impose rules, and market actors can work together and come up with solutions. So I think control is an overstatement.

And the other thing I think is important is that I'm a huge fan of research, and I think that the Fed has done a lot of important research in this area and lots of organizations have and that we have learned from the subprime crisis that delaying implementation of rules can have devastating consequences.

Now I don't think that debit holds are going to risk the international financial

system the way subprime lending did, but there are risks to delays. I think acting with expedience here will be both protective of consumers and also instill confidence in the society in the Fed, in the Fed's ability to respond quickly and effectively to problems that consumers have identified.

CHAIR BROWN: Great. A lot of good discussion. As I was about to say, I agree with Governor Mishkin. This is a great committee. You learn so much, and I think I'll join with Mark in the lovefest with Josh. You show great poise.

(Laughter.)

Now if my payment can go to higher-priced balances by the next meeting, I'll give you a hug.

(Laughter.)

We're going to shift our attention now to issues related to rules on risk-based pricing or risk-based pricing notices that were recently proposed by the Board and the Federal Trade Commission.

Risk-based pricing refers to the practice of using a consumer's credit report, which reflects his or her risks of nonpayment, in setting or adjusting the price and other terms of credit offered to a particular consumer. The proposed regulations generally would require a creditor to provide a consumer with a risk-based pricing notice when, based in whole or in part on the consumer's credit report, when the creditor offers or provides the credit to the consumer on terms less favorable than the terms it offers or provides to other consumers.

Yesterday, members of the Consumer Credit Committee discussed this proposal, and so now I'll call on Tom James to lead our discussion.

Thanks, Tom.

MR. JAMES: Great. I just want to preface this discussion since we're sort of running out of time and this is pretty important.

Our committee is going to look at this further and spend a considerable amount of time next time around because I think between now and our meeting in October, we're going to get comments and we'll have a lot more material to work with.

This is a very complicated rule, by the way, and my admiration for staff surfaces when I look at this kind of thing. This is the classic dilemma for the law student where they're given a question that's got a rule, where they've got to find the rule and then they've got to find the exception to the rule and they've got to find the exception to the exception.

That's what this rule really is all about. It's so complex that what I want to do in a way is hand it off to Jason, who is really an expert in this field and let him kind of frame things for us and then open up the discussion.

MR. ENGEL: I am happy to attempt to do that, Tom, preface with “attempt.” I think I'm the only person who voted to make three hours in discussion on risk-based pricing and a half hour on this credit card stuff.

(Laughter.)

I'm also the only guy that has a pocket copy of the Fair Credit Reporting Act (FCRA). So it sets the table for you on that.

I agree with Tom, in his preliminary remarks, that this is an incredibly complex topic and a complex rule. It became evident in our discussions yesterday that there's a lot to digest here, and that we're part way through that. I look forward to returning to this discussion and obviously commenting on the rule separately and through our trade associations.

This is a very important consumer right, and it's important that we get an appropriate notice in the hands of the consumer at the right time for the consumer to use it and exercise their rights to review their credit report, et cetera, and to understand what's going on with risk-based pricing.

Now having said that, that's a very difficult task and not made any easier by Congress. The standard, Tony, that was a paraphrase. The standard is when the credit grantor extends credit to the consumer on material terms that are materially less favorable than the most-favorable terms available to a substantial proportion of consumers from or through that person. That's not easy to write to, obviously, and it hasn't been that the staff has just taken their time to do this. I know they've been very active in talking to us and members of industry in terms of what practices are and trying to tailor something that really fits disparate lending practices, disparate kinds of businesses, and with a goal of operational feasibility. And I think what we've got here is a draft that goes a long way towards meeting those goals, frankly.

Obviously, there will be comment at the margins and some of the provisions, I'm sure, by us and others. But I'd like to commend the staff on the effort in the years leading up to this, the review they've done, and the rule that they've proposed in dealing with this complex standard -- and not made any easier by the fact that what Congress put into the FACT Act really does have conflicting provisions in it. The conference committee took the House and Senate bills and kind of

put them together without really reconciling in a lot of ways.

There are a number of provisions in the proposal that go towards that goal of operational feasibility. I've probably got these turned backwards from my perspective and how these affect the consumer reporting industry, but I look to the provisions that make clear that this applies to consumer credit as being fairly important -- consumer credit versus business credit. I think that follows from, as being part of the Fair Credit Reporting Act and consumer protection statute, that it is that these deal with credit primarily for personal, family, or household use and that's an appropriate way to draft this rule.

Likewise, and I think very important, that the risk-based pricing notice not be triggered by pre-screened solicitations, and that's distinct from the back-end application for credit that comes from pre-screens. But that pre-screened solicitations, as has already been noted -- all the mailing folks get with respect to that, imagine that coming along in many cases with the risk-based pricing notice, and I think you'd acknowledge that soon this rule would be diluted, that this would be stuff that consumers throw away and that it's appropriate to except out the solicitation stage of pre-screened from the rule.

Likewise, another aspect that goes to operational feasibility is the one notice per transaction, a concept that's carried into the rule.

In terms of the substance of the notice itself, again I commend the staff in coming up with bright-line tests. I think there'll be comment around a lot of these, but the effort to -- with regard to the applicability of the general standard, look to generally APR tests. It seems to me to be important and certainly Kevin and others, Mark, will comment in terms of their use of that kind of a test and operations. But all of the factors that go into risk-based pricing make this so complex that you need to narrow it down in order to determine the applicability of the rule and the obligation to give that notice, so that's important.

And then the proxy methods, I think, are again a step towards that operational feasibility and help in applying the rule -- the credit score proxy method, being able to pick a score cutoff to decide whether to give the notice or use the tiered-pricing method, proxy method will aid that goal.

I think you'll receive again comment on both of these and how they might function or if there are better or different proxies, but all with a view towards achieving that right balance of not having this notice over-used, which is a danger, and having it lose effectiveness or

having it under-used and not get to consumers where appropriate.

There's an aspect of the rule obviously I can't help but comment on, and that is the creation of a free report by application of the risk-based pricing notice. I've got a couple pages of notes here, but I know no one wants to go through a blow-by-blow of the section 615 notice provisions and the section 612, FCRA creating the rights to free reports.

Suffice it to say, I think there is a way to read the statute, and a fair reading, that would have the risk-based pricing notice itself point back to the annual credit report, annual free report, as opposed to creating a new right to a free report. And I think wherever we come out with regard to operational feasibility, it has to be acknowledged that the actual risk-based pricing notice is going to go to a lot of people. It's going to create a lot of coupons, if you will, out there for a free report.

There was comment in the supplementary information that one reason for avoiding and not drafting an application-based notice was that it would come with a free report, and I appreciate that concern and that protection. I think that's one particular area, no matter whether you read the actual risk-based pricing notice to come with a free report and that right to be created under the FCRA, if you allowed an application notice, I think you'd have to acknowledge that notice is not adverse. And therefore, by the language of 612 creating that right to a free notice with regard to adverse action notices -- the traditional adverse action, yes or no adverse action notice -- that wouldn't apply and that application notice, therefore, wouldn't carry a right to a free report. And obviously, we'll paint that out.

I think industry comment will probably pick that up as well. But I think there's a way to get there to an application notice that doesn't carry with it a right to a free report that gives the consumer the information that they need, absent the additional coupon, but does point them back to the annual credit report and where they can get their free report if they haven't exercised it already. Frankly, if they have exercised that right already within the year, they probably know what's on their credit report and have had a chance to deal with it.

So I'll suffice that as comments in terms of free reports.

The rule also has a number of exceptions in situations where no risk-based pricing notice needs to be given, and it's done largely through the credit score exception. And the application certainly of that exception to the situation already created under the FACT Act and the Fair Credit Reporting Act in terms of the mortgage score disclosure seems a fair enough exception

-- that if that score disclosure is already going as required by the statute, that there's not a need for further risk-based pricing notice, and a creation of an exception for that seems natural.

I guess I'll reserve comment as to whether the creation of a new notice and extension of that notice is then fair to say -- having created that I've now, I will call that an exception. We'll digest that further and certainly comment on it. I think there are other possibilities for exceptions in the true sense of an exception coverage, perhaps for de minimis charges, small credit lines.

We had some discussion of point-of-sale transactions and the difficulty of giving these kinds of notices over the counter in those situations. I think again you'll see much comment on that and whether there can be further exceptions.

One thing I think the Board should consider with regard to the credit-score disclosure exceptions are the privacy and security aspects of having these notices go out to consumers who may or may not be aware that they're coming. Taking us back to the Fair Credit Reporting Act amendments in 2003, the FACT Act amendments, there were, early on, proposals that the right to an annual free credit report should simply be something that we send out to the consumer every year. Imagine 200 million, 210 million credit reports going out to consumers through the mail. For obvious reasons, that was rejected.

The reg was set up as an ability to approach us at a centralized source. But likewise, there's a high possibility that these notices that go out with a modest amount of credit information, but a score which is nonetheless a credit report, are going out to consumers who have done a remote application or are at a point where it needs to be mailed or otherwise transmitted to the consumer, and I just ask for consideration of the security aspects of that as the final rule is developed.

And finally maybe just a comment on the notices themselves. I think it's noted in a number of places in the supplementary information that risk-based pricing is complex. It is dependent upon a number of facts, one of which is typically information in the consumer report, and indeed the rule is when the creditor has based its decision in whole or in part on a consumer report.

But many other factors go into that underwriting decision, and I think that the notices could and should fairly succinctly spell that out. The notices right now, and appropriately so, point the consumer to check their consumer report and correct any errors or ask any questions that they might have with us. But I think the notices could state simply to the effect, other factors may

have affected the terms offered to you such as, and there could be examples there, given or not: income, down payment, loan to value, et cetera.

And just finally to point out that the adverse action notice that's currently required under the law, as well as the 609(g) notice, the mortgage-score disclosure, contained a statement that I think each of these notices should contain as well and that is – it is near and dear to us for obvious reasons -- but that the consumer reporting agency didn't make the decision to offer less-favorable terms and is unable to provide you with the specific reasons that less-favorable terms were granted. That's paraphrasing what's in with regard to denial of credit now in the adverse action notice and in the mortgage-score disclosure.

So Tom, those are my thoughts and kind of the overview of the whole rule. I know there's a lot of detail there aside from that, and we look forward to further commenting and discussing with staff.

MR. JAMES: Thank you so much. What I'd like to do is kind of start at the top. Of course, I think the first question is simply what the committee feels about the choices that are in the rule or in the proposed rule on the process that tests for generating the notice -- and particularly with regard to materially less favorable and the consumer pool, the designation of that consumer pool. Does anybody have a comment?

MS. SAWADY: Beyond operational feasibility, I really like much more the concept of trying to find some trigger that is more standardized across different providers. As it currently is worded, it seems that a provider who provides equally better credit terms to everyone is really not bound by any of these provisions, whereas if a more standardized trigger is set, it would level the playing field across the industry in a much better way.

MR. NARAIN: We already have a precedent here under the HMDA rules -- if a loan is provided to a borrower at more than 300 basis points above the index, then that's reported. I suspect using a trigger, something substantially larger, making it much more discrete and quantifiable is better than "materially better than," worse than and so on. So putting a number like 300 basis points over some benchmark would probably achieve that much faster and much more effectively.

MR. JAMES: Kevin?

MR. RHEIN: I do worry about some of the vagueness and what is the definition of materiality and who should get the notices. As a result, I think it -- one of the alternatives, if I

understand this correctly, is you can send out a notice that gives somebody what their score is and where they fit in the distribution of the general population and that would satisfy where this starts to get triggered.

What isn't clear is there's clearly an incremental cost, or I think there will be an incremental cost, because I don't believe today credit card companies can provide customers with their score. We can direct them to the bureau. The bureau does not give them their score. So I think there is an operational element to what's being asked to be done here, as well as a cost potentially that lenders will bear -- large, small, in between -- relative to the incremental fee for the credit score unless we can beat up Jason enough so we don't have to pay that fee.

But I mean it's certainly relevant. It seems to be what is really being intended here is to get people to go look at their credit report, and I would be very curious as to, with the law as it is today, what percentage of the population is taking advantage of that. Annually, you can check your credit report, and the reality is you can check it three times a year because there are three separate bureaus and each one of them have to give you a report. And I don't think the scores are going to be all that materially off.

So just in general, it seems to me has there been enough consumer education on what their core right is. Now we're starting to do all of this extra work, and the reality is, my guess would be most people are not taking advantage of this.

Maybe you know, Jason, how many -- what percentage of the population has asked for a free report?

MR. ENGEL: Not to that level. There are difficulties in having three competitors that have to do this together through the central source anyway and then comparing notes in terms of levels and volumes because it starts to turn into market information and how broadly -- or what market share, that sort of thing, that you have. But we have published that after -- in the year of ramp-up and the first year of operations, that total time frame, there was, if memory serves -- it's failing more and more these days -- but something like 54 million consumer reports through annual credit report. That may be one consumer getting three reports would count for three or one consumer looking at one would be one. But I think that suggests a fairly high rate of usage, and that's one channel for getting free credit reports.

Be mindful that there’s also the right to get a free report with regard to the traditional Reg B adverse action notice, and that accounts for, among the three of us, tens of millions

of additional reports, plus paid products, credit monitoring products, consumers that decide to go ahead and pay the statutorily set fee to get their credit report or otherwise. So there are tens of millions of reports that go out into the consumers' hands.

So I think there is a fairly broad knowledge among consumers. Now you never get everybody to come in and look at their report annually. I think that's just not going to happen, but it's been a fairly active channel. Obviously, that information is dated a little bit and we haven't compiled the National Information Center (NIC) flash (???) reports that suggest that that volume is continuing in about those levels, so you can extrapolate from that. People know where to get their report even absent this rule prompting them to go look at it again.

MR. JAMES: I wanted to touch a little bit on -- well, you point something out, which is adverse action as opposed to the creditor actually going through some kind of calculus and making the determination that they're going to extend credit somehow on less than the most favorable terms. And I'm just wondering if people can comment on, given the content, there's the credit report itself, the score, as an alternative, or then some of the other alternatives.

If people can comment, first of all, I think, on the concept of what constitutes this middle ground the rule seems to be trying to cover between the adverse action and extending credit on the best terms, and whether or not any of these alternatives are going to really accomplish that.

MR. ENGEL: I'll say the purpose of the rule is to cover what's seen as, when the law was passed, that now broader and perhaps bigger situation where people aren't simply given a yes or no decision triggering the traditional adverse action, but have fallen into this risk-based pricing where you get credit on some terms, but perhaps different and materially different than you would with better credit.

Obviously, the impetus towards the score disclosure exception -- that is to say, if you give this kind of score report, you're taken completely out of the risk-based pricing notice -- is an attempt at education. I think that will have some value. Clearly the staff in drafting the supplementary information feels that it is, and valuable enough that it will supplant for those who decide to take advantage of that exception giving the risk-based pricing notice and provide that information about a credit score which is, one would have to acknowledge, very important in the decision-making process for risk-based pricing in terms of the credit factors that go into risk-based pricing, as opposed to wealth and income and factors with regard to the security of the asset and that sort of thing.

Is that responsive, Tom, to what you were thinking?

MR. JAMES: Alan? Patricia?

MS. HASSON: I guess because I keep hearing the word financial education will solve this -- I think one of the things that when you're thinking about this, number one, I guess, Jason, a point you made, if somebody does get their three reports today and six months from now they do get risk-based priced to a higher rate, they're not eligible for that annual credit report. Correct? They have to wait six months. Something can happen in six months.

MR. ENGEL: Yes, absent creating the right to a free report.

MS. HASSON: Right. You're a junior on your dad's info, and your dad was a deadbeat, you know, that can happen. So I don't think by offering it, I don't think you're going to be flooded. I think offering that person the opportunity to get another report is a fair and just thing to do so that they can understand what might have happened in the interim.

I think the second point that I want to make around financial education is -- and through a generous grant from Wachovia, we did some financial education when annual credit report came out. And we went out into the community, and we talked about your credit report and how important it is, and we had forms there for annualcreditreport.com and fill out this form.

And if you want to get a score, by the way, you can't get it through the mail. So if you're doing something around credit scoring and trying to explain credit scoring -- and I think you do a fabulous job, the credit bureaus, I have to give you credit, in explaining the consumer reports that people get today. We've gotten great feedback that the information provided when somebody gets their report with their score, it's very comprehensive.

However, even if I wanted to pay it, doing it through the mail, I can't do that and you're aware of that. So I think that that's a loophole that needs to be somehow or another at least considered in this. Perhaps there's not a huge, about 18 million who did it through the mail, so maybe I'm overreacting. But if you're talking about financial education, I think all of these factors need to be put into it because you're going to lose a population.

MR. ENGEL: Patty, I know it's not on the form for annualcreditreport.com, but I want to go back and check is whether we make it available in the mail and whether we can publish that information better if people can write in separately from annualcreditreport.com

MS. HASSON: From what I understand, again, and I do understand this operational issue. We have three credit bureaus -- who would take the cash to accept it to give

somebody their scores or the money order? I mean I understand that. I'm just saying that's a reality.

MR. ENGEL: But just to point out that each of us, certainly at our own websites, offer the score report. It may just be a matter of making clear that there's also a write-in availability, but to the individual bureau to get that score report, so that in your educational efforts you can say, annual credit report form here, if you want to mail, by the way if you want a score report here's a form for each of the three bureaus.

MS. HASSON: Accepting payment?

MR. ENGEL: Again, not directed to annualcreditreport.com, but there would be an ability to direct it to us. I'll look at that.

MS. HASSON: Okay.

MS. TESCHER: While we're talking about education, I got excited yesterday in our meeting when I saw the model form H-5, which was for folks where credit score is not available, only to have my hopes dashed by staff who told me I was interpreting it incorrectly, and I think it's a little bit of a problem.

Right now, if I'm understanding the way it's written, these forms are only -- lenders are compelled to send the form only when credit data is being used. I'm interested in the millions of consumers who don't have a credit -- not only don't have a credit score, but they don't have a credit file. And I would suggest that the fact that there's an absence of a credit file is being used to make an underwriting decision. And I don't think this is just semantics.

I'll give an example in a minute. So this form would only apply to consumers who have a credit file, but not enough trade lines to actually be scored. But there are millions of others who don't even have a file at all. Forget that it's thin. It doesn't exist. And I think in the past, those consumers, most of them would have been denied outright, and so they would get an adverse action letter. But I think today there is a growing recognition of the value of alternative credit data that is not in your credit file, and it's being used increasingly to underwrite consumers -- part of the sort of bigger picture that Jason talked about, both your credit file, nontraditional credit data, and then whatever other internal information an institution might have about you if you have other relationships with them.

And so today, I think some of those consumers are actually being approved for credit, but they are certainly not getting it at the best terms in most cases. It's a perfect example of where they would really benefit from this information, because wouldn't we want them to know?

Here, you don't have a credit file. Here are some ways to start building one. And so I think we're missing an important educational opportunity by interpreting the rule in this narrow way.

I would just close by saying that we just released some research recently where, among other things, we asked un- and underbanked consumers about how they perceived their credit score or their credit profile. In general, consumers were pretty close to accurate. We were able to pair their perception with the reality of their score, and in most cases consumers were pretty close to accurate. I think I have a good score and indeed I do. Or I think I have a bad score and indeed my score is not so great.

But for consumers who it turned out didn't have a score or didn't have a file, they had no clue. They were all over the map. Some thought, I have a great score. Some thought, I have a bad score. Only 11 percent actually got it right that they had no score. So I think it's really important that we start to educate these consumers both about how to build a traditional file, but also so that they understand how new forms of data are being used and how their behavior can impact the way they're being underwritten.

MR. JAMES: I kind of wanted to move to what might be seen as the more controversial aspect of this proposed rule, which I think has to do with one example, I guess -- the extension of credit, say, in the credit card arena where if the product doesn't cover a range of differently risked individuals that are offered products at different prices that correspond to those risks, there's no need for the notice. So you can essentially slice and dice up the population ahead of time for risk components and price out different products in isolation and make discrete offers for those products without giving the notice, and I'd like to solicit comment on that.

CHAIR BROWN: Tom, how much time do you want to take on that matter?

MR. JAMES: A second or two.

(Laughter.)

MR. FALK: The problem with that goal is that the statute is clear. What was written into the act, whether we like what Congress did or did not do, it's pretty specific in its complexity that the notice is only to those who give materially less-favorable terms to certain consumers. And so I think that expanding it outside of its congressional mandate would be inappropriate.

CHAIR BROWN: I'll let Joe have the last word.

MR. JAMES: I'm going to.

CHAIR BROWN: It is time now for us to transition to the Members Forum. First, let me thank everyone for the thoughtful debate on the issues presented today. As many of you know, during our meetings we have the privilege of hearing from Council members about programs and initiatives at their organizations and institutions. For this meeting, Luz Urrutia will provide us with a brief presentation.

Luz is president of El Banco de Nuestra Comunidad. It's in Georgia, state of Georgia, and it's a division of The Peoples Bank. Her responsibilities include oversight of the branches, operations, credit and risk management, compliance, sales and marketing, customer service, product development, training, and community outreach.

Previously, Luz was a senior vice president with Wachovia for 18 years, most recently in the Global Services Department. She developed and implemented several domestic and international strategic alliances in the United States and overseas and led efforts in Wachovia's expansion into Canada and Mexico.

In 2006, Luz was recognized as the community banker of the year by *American Banker* for her commitment to meeting the financial needs of the unbanked and underbanked, primarily in the Hispanic community. She serves on the boards of the Center for Financial Services Innovation, an affiliate of ShoreBank in Chicago, and Worthwhile Ventures, which provides microfinancing worldwide.

I'll now turn things over to you.

MS. URRUTIA: Thank you. Well, good afternoon, everybody. A lot of the issues that we have discussed here clearly impact our customers 100 percent, since what we do is serve the Hispanic immigrant community, both unbanked and underserved.

Briefly, our company, El Banco de Nuestra Comunidad, which stands for "the bank of our community," is a chartered financial institution in the state of Georgia. We've been in business for about five years, and we were created with the primary focus of serving the nonbanking and banking needs of the Latino immigrant community currently not being served by other financial mainstream institutions, but who are going to nonbank financial institutions to fulfill their financial needs.

We have 12 branches in the Georgia market and about 50,000 customers, many of whom is their first time ever having a bank account. And with the knowledge that we have gained we have assisted other banks that want to get into the Hispanic market using our customer insights

and our technology platform. And today, regulatory authorities as well as other industry participants recognize our company as a leader in serving the needs of this community.

On the right-hand side (of the PowerPoint slide), you've got all the financial institutions, which many are promoting and actively marketing to the Hispanic community. A little bit of a problem is that they're translating their existing mainstream product brochures, hiring bilingual people, and trying to provide the same products and services that they provide to their mainstream consumer. With the Latino customer, unfortunately, this model doesn't work. The bank looks at a bankable customer, somebody who has had banking experience, credit history, previous relationship, and standard documentation. The Latino consumer generally does not fall in that category.

On the left-hand side, you have the nonbank financial institutions. And while they do offer some of the basic nonbanking transactions that the customers need, unfortunately they don't help this consumer migrate. They don't educate them and help them to access fairly priced financial services.

What we have created is a category that brings the two together. While we offer all the nonbanking basic transaction services that this consumer needs, our number one focus is to help the consumer understand the benefit of migrating to a financial mainstream relationship, saving their money in a bank, and, very importantly, building fairly priced credit histories.

A little bit of information about the Hispanic market, and many of you may know this. These consumers generally have never had a banking relationship in their home country, nor in the United States. In the United States, about 65 percent of the Hispanic population is from Mexico, and in Mexico, 80 percent of the population is outside the banking system. And that ratio is pretty much across the board in other countries in Central and South America.

Also, about one-third of these consumers do not read or write Spanish, and about 75 percent don't read, write, or speak English. They don't trust banks and that is a fact. In their home countries, banks have been nationalized, currencies have devalued, and they've lost their lifetime savings. But there are some very common and important characteristics about this segment. They're all hard working. They're net savers. They're very loyal, and they're very upwardly mobile. So there is an opportunity here to target a segment that other financial institutions are not focusing directly on that is very attractive that we can help educate, migrate, establish long-term relationships with a bank. But a very different approach is needed than the traditional approach that we, as

bankers, have used in the past.

There is also a misconception about the Hispanic market because there are 18 countries and we all speak Spanish, we're all the same. And we all have the same needs. Well, we've identified, based on our experience and market research, there are about six different distinct consumer groups: those that have been here two years or less and those Latin Americans that have been here for 20 years and behave more like mainstream customers. And that is important because that actually drives the risk management, pricing, products, et cetera.

What we've also learned is that in 80 percent of the cases, this Latino consumer does business in three different worlds. On the right-hand side, they cash checks, send money orders, send money home, and that's where they spend the majority of their money, okay? Now the traditional bank relationship is deposits and loans. Unfortunately, some of these consumers, the majority of them, are not ready yet for just a deposit and loan account that would be profitable to a bank. And unfortunately, they are borrowing, but they're borrowing from the buy-here, pay-here, payday lenders and other predators.

We've created an analogy to train our people, and how many of you like fast food?

(Laughter.)

When we go to a fast food place, we like to get the hamburger and the fries and the drink and the dessert, and that's why we go there. It's a one-stop shop. Think about for this customer -- there is a financial services combo meal where the check cashing is representing the hamburger. Wherever this customer cashes their check, that's where they're going to send money home, buy phone cards, reload their cell, pay insurance for their car, buy money orders, pay bills. And then if there's any money left, which generally there is, they're going to deposit it in a bank account, and they need access to credit. So what we've chosen to do is provide the financial combo meal all under one roof where we also provide all standard banking products.

This is our model. We start providing to the customer all the basic services that you see at the bottom, which are basically nonbanking transactional services, which is what they need. And then immediately we start the education process. You don't need to be paying fees. You don't need to be in this cash economy. You don't need to be in this underground market. You can open a bank account.

And I hear about overdrafts. We have a bank account for starters that does not

allow overdraft, okay? And we have that in the system where you are not allowed overdrafts because allowing overdrafts would generate us a lot of fees. But it does not help that consumer. And what we want to have is long-term bankable relationships, which ultimately tend to be a lot more profitable.

We offer all types of savings, CDs, investment accounts. And then we offer them lending, and a lot of you might be going, how can you offer lending to somebody that has no credit history and no standard documentation? Well, these are what we call pre-prime lending customers. They don't have bad credit; they simply have no credit. They have excellent transaction and payment history, and I'll talk about that briefly.

We're open seven days a week until 10 o'clock at night. We're staffed by 62 individuals, all of whom are native Spanish speakers and understand our customer needs and their background.

And the infrastructure, the foundation of our success is a very strong financial literacy program. We are involved in every school, every church, every consulate, every community center, apartment complexes because we believe that as a financial institution, we have a responsibility to educate this consumer on responsible handling of their finances, both on the account side as well as on the credit side.

We start by making the customer a member, and membership is very important. In the Latino community, having a photo ID from a financial institution is of a lot of value to them. Second, it's the way that we can go through the U.S.A. PATRIOT Act, compliance, and Office of Foreign Assets Control (OFAC).

Once that customer becomes a member, then he can do all the nonbanking and banking transactions with us. We don't look at direct deposit of payroll because in this community there's not much of that. But they have check cashing that they do every week or every other week. So we use the check cashing to prove where they work and how much money they earn. And while we're helping them build a credit history, we're making some fees from that consumer, but we're also helping them save because we can open bank accounts for them.

Our system will generate an internal credit score for all of these consumers that are not part of FICO, that are not part of the general system. It's based on the frequency and the type of transactions they do with us -- check cashing, bill payment, all the cards, whether they have stored-value card or a bank account with a debit card, in addition to employment verification and

other assets that they may have -- we use to create an internally generated credit score that we then use to grant these individual credits.

I will say that we have extended over $60 million worth of credit, both homes and consumer loans, and our default rates are less than 50 basis points.

The “NewPrime” lending relationship -- can we lend to customers without Social Security numbers? Absolutely. We can lend to them with ITINs, and we've been doing that now for five years.

The keys to success in this community are twofold: first of all, very strong financial literacy and education, and very high-touch services, especially the first 90 days of that consumer accessing credit. And the reason is for all of us, if we do something for 90 days, we create a habit. This consumer does that.

And also, to make them understand that in this country, credit is what will keep you moving forward. In our countries, if you don't pay your bills, it really doesn't have an impact on you long term and that they seem to understand, especially when you show them a credit report that went from having no history to having 700. It's amazing how many of our customers in 18 to 24 months can create a credit score greater than 680.

So basically, we bring the consumer into the system. We make them a member. We allow them to do all kinds of transactions. We reward frequency and type. We give them an internal credit score. We then grant them credit. Some of these are credit-building loans. Some of them are half-secured, half-not, and some of them get the ability to do totally nonsecured. And what that does is then it gives them the ability to migrate into a prime financial relationship with prime pricing, which all we have seen is they come to us and if they want to come to another institution, then they're free to do so.

Thank you. Any questions?

MR. PHILLIPS: I just have one question. What is the portfolio mix of loans? What do they look like? What kind of businesses or projects?

MS. URRUTIA: Our biggest portfolio of loans was ITIN mortgages, believe it or not. We have been absolutely amazed at the performance of that portfolio.

We then have $3 million that are secured. We give people money to put in a bank account, and then they pay us every month and at the end of 12 months they have that savings and they have a credit history.

And then we have a hybrid of combination of secured and unsecured, and we are now issuing credit cards as well.

Thank you.

CHAIR BROWN: Thank you. Thanks, Luz.

(Applause.)

CHAIR BROWN: We'll turn our attention to the committee chairs, just for a brief report on the work accomplished yesterday as well as plans for the future meetings.

So Mark, I look to you.

MR. METZ: Sure. As you can probably gather, we had a great discussion yesterday on the deposit issues with respect to UDAP. In terms of next steps or our next meeting, we are going to talk about the comments that are received by the Fed on those rules. We are also going to talk about Bank Secrecy Act (BSA) and some unintended consequences in terms of access to deposit products.

Ron Phillips may do some on-the-ground research for us. If he can get some questions from the Fed, he was going to talk to some folks in the community where he works. Then the last thing we may discuss is the interplay between foreign ATMs and on-us ATMS that we mentioned already.

CHAIR BROWN: Ed?

MR. SIVAK: We spent some time talking about GSE rules and their relationship to credit-risk policies. We had two senior folks from both Freddie Mac and Fannie Mae come and make a presentation. We talked about both the delivery fees and just other ways of doing business in the current environment.

We also spent some time talking about what types of data are available and what types of data are not available to inform policymaking here at the Federal Reserve Board and hope that we'll continue that discussion to look at ways where we can make that more complete, both from the policymaking perspective and from the research perspective.

And finally, we spent some time talking about foreclosures and loss mitigation issues.

Moving forward, we're going to be looking at Home Mortgage Disclosure Act (HMDA) in the next meeting. It's been five years since the last revision. I think in general those types of policies are reviewed every five years, and we're going to use the release of the data as the

launching point for that discussion. We know HOEPA will be done by then. I know in the last meeting we spent a lot of time talking about HOEPA. There were concerns about relaxation of triggers and things like that, and we look forward to a good outcome and a briefing on that discussion.

We also talked about possibly looking at the rental housing market as well. We'll look at affordable housing and how that's an option that's obviously available to folks, and it's one that needs to be explored more deeply as different sources of credit dry up for the production of that type of product.

And finally, we want to look at what's going on in the Gulf Coast region. It's still an important part of this -- the recovery is going on, rebuilding is still going on. We want to see if there're lessons to be learned from that to work on the current foreclosure crisis as well.

CHAIR BROWN: Thanks, Ed. We've also got the flooding in the Midwest. That might also bring some interest.

Tom?

MR. JAMES: Yes, well, our discussions were really reflected in today's conversation here. There was pretty much total coverage so I'll just move on to next October. We'll talk a little bit more about the risk-based pricing notice. We'll have, of course, comments in by then, and we can flesh that out a little bit more.

We'll also talk about the address discrepancy rule, a red-flag requirement under the FACT Act. We'll talk about short-term lending again, this time more focused on payday and small-value as opposed to bank overdrafts, and auto loans and student lending. So that sounds like a pretty full and interesting agenda.

CHAIR BROWN: Thanks, Tom. Louise, Compliance and Community Reinvestment.

MS. GISSENDANER: Yes, the CAC Compliance and Community Reinvestment Committee focused their attention around reverse mortgages, bank secrecy and immigrant banking, and payday lending. It led to a lot of robust discussion around these subjects.

It also sparked the need for additional review in all of these areas, and therefore our committee at the next meeting would like to take a look again at reverse mortgages. But what we'd like to do there is to review some questions around things that may be raised by the Fed staff as well as looking at the average loan size and also looking at the HUD counseling issue that's a huge

component of this particular product that really needs a more in-depth study. Also looking at the new people who are entering the market and something around these new 14 products that's been created around the reverse mortgage. So we see that as a pretty significant opportunity for us to make sure that we're not experiencing a lot of difficulties with that market.

In addition to that, on the bank secrecy side and the immigrant population, the committee also was going to take a look at some community groups' questions and answers on the advocacy side for additional research in terms of how this bank secrecy is affecting the immigrant population to be able to transition into the banking world.

Payday lenders is another one that is getting a lot of additional conversation to determine the scale of the issue and also to take a look at the trends and review some of the legislative proposals that have come out of several states like Ohio, Mississippi, and Virginia.

Thanks.

CHAIR BROWN: Let me thank everyone for their participation today. It looks like we'll have a full agenda at our next meeting. Governor Mishkin, thank you for your support of the CAC and good luck in your future endeavors.

GOVERNOR MISHKIN: I won't be able to attend in the future, but I will tell you this is one of the most interesting aspects of my job. It's not something I thought initially was going to be very interesting.

(Laughter.)

But in fact, because my expertise has never been in this area, so -- but it actually has been fascinating. I've learned a lot from this committee. So thank you very much.

CHAIR BROWN: Thank you. And Governor Kroszner, we'll see you on the road, and we appreciate your sharing your expertise and visibility in the CDC and the CDFI world. Thank you.

We will adjourn for lunch in Dining Room L. Thank you.

(Whereupon, at 12:54 p.m., the meeting was concluded.)