



**Federal Reserve System  
Docket No. R-1314**

August 4, 2008

**VIA INTERNET AND U.S. MAIL**

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

Re: Proposed Rule Regarding Unfair or Deceptive Acts or Practices

Ladies and Gentlemen:

The American Securitization Forum (“ASF”)<sup>1</sup> appreciates the opportunity to comment on the amendments to Regulation AA<sup>2</sup> that the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration (collectively, the “Agencies”) jointly published on May 19, 2008 (the “Proposed Rule”).

Among its requirements, the Proposed Rule would prohibit institutions from engaging in certain acts or practices in connection with consumer credit card accounts. The concerns that underlie the Proposed Rule are important, and we share the Agencies’ view that they should be addressed to prevent problematic credit practices from affecting consumers. Although we believe that these concerns can be largely addressed via simplified disclosures, such as the concurrently proposed amendments to the Truth In Lending Act’s implementing Regulation Z, we recognize the Agencies’ concern that some additional measures may be required to address them. We are concerned, however, that the Proposed Rule too greatly restricts issuers’ ability to re-price interest rates, apply payments, and charge appropriate and disclosed fees. As drafted, the impact of the Proposed Rule’s restrictions on pricing will likely limit the scope and increase the cost of credit products available to consumers because, in part, it will heighten risks and increase costs

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<sup>1</sup> ASF is a broad-based professional forum of over 360 organizations that are active participants in the U.S. securitization market. Among other roles, ASF members act as issuers, investors, financial intermediaries, and professional advisers in connection with securitization and structured credit transactions. This letter was developed principally in consultation with ASF’s Credit Card Issuers Subforum, with input from all other ASF member constituencies and committees. More information about ASF’s members and activities is available at [www.americansecuritization.com](http://www.americansecuritization.com).

<sup>2</sup> 73 Fed. Reg. 28904 (May 19, 2008) (to be codified at 12 C.F.R. pt. 227).

associated with credit card asset backed securities (“ABS”) for secondary market participants that will necessarily be passed on to consumers. In contrast, a proposal that preserves credit card issuers’ ability to re-price for borrower default risk, maintains their flexibility in applying payments, and protects issuers and investors from litigation risk in connection with existing accounts, will ensure that consumers enjoy continued access to low cost and convenient credit products and services.

Specifically, a narrowing of the Proposed Rule’s scope will prevent unintended and negative consequences for the availability and cost of credit to consumers. For example, severely restricting issuers’ ability to re-price credit card assets, which are revolving credit products that require continual risk re-evaluation, to match funding costs associated with credit card loans, will depress investor yield. Ultimately, this will increase the cost of credit and decrease its availability. In addition, the lack of any safe harbor for litigation in connection with existing loans exposes both issuers and secondary market investors to significant risks, including market risk from ABS ratings downgrades and from the placement of securities in contractual default because the underlying assets were found in a judicial proceeding to be originated in an unsafe or unsound manner. The combination of diminished revenue streams and heightened risks that would result from the Proposed Rule will prompt secondary market purchasers of credit card ABS to adjust by either paying less for credit card ABS or not purchasing them at all. This will likely reduce the amount of secondary market capital, creating liquidity issues that could increase the cost of credit for consumers and potentially further restrict credit to consumers.

This letter discusses the beneficial role the securitization industry plays in the process of extending credit to consumers (Section I), provides an overview of the Proposed Rule (Section II), discusses why we believe the Agencies should, among other things, refine the proposal to restrict re-pricing on existing loans and provide a safe harbor against litigation in connection with existing receivables (Section III) and sets forth our conclusions (Section IV).

## **I. THE ROLE OF SECURITIZATION AND THE SECONDARY MARKET**

During the past 25 years, consumer use of credit cards has increased dramatically. Credit cards, which began as a product mainly for high-income individuals, have become a financial instrument used by most American households. Credit cards have expanded consumers’ choice, convenience, and access to credit at lower costs, thereby fueling economic growth. Additionally, many typical transactions—such as, renting a car, making internet purchases, and reserving hotel rooms—require or are simplified by the use of a payment card. The funding of credit card loans through securitization transactions has been central to these developments.

Securitization transactions themselves also represent an integral and growing segment of our economy. The securitization industry is a large and significant market that provides an efficient funding mechanism for originators of consumer and business receivables. The industry provides liquidity to nearly every sector of the economy—including the consumer credit industry, the residential and commercial mortgage industry, the automobile industry, the leasing industry, and the insurance industry—as well as to the commercial loan and corporate bond market. Securitization, moreover, provides effective mechanisms for financial institutions and other entities to manage credit and other risks associated with their business activities.

The credit card securitization process starts with credit card issuers or loan originators that, after approving and making loans with unsecured lines of credit for specified amounts to certain applicants, decide not to retain the loans on their balance sheets, instead securitizing them for sale in what is called the secondary market. Before securitization of credit card receivables became prevalent, banks funded extensions of revolving credit through their customers' deposits, and credit availability was dictated, in part, by the volume of bank deposits. Today, banks and other card issuers have the option of retaining credit card receivables or revenue streams or selling them into the secondary market where those receivables or streams often underlie asset-backed securities.

After loans are originated, the assets—here, receivables or revenue streams—are sold into a trust often referred to as a special purpose entity (“SPE”). The SPE’s purpose typically is to transform individual receivables into new securities with specific risk and return characteristics. Securities backed by credit card loans can be created for any desired maturity, since new receivables can replace old ones that borrowers have paid in full. When transforming loans into ABS, SPEs often divide them into tranches with specific risk and return characteristics. The ultimate lenders become the investors—often pension funds, investment funds, banks, insurance companies, and other financial institutions—that purchase the securities from the different tranches. In addition to serving the risk, return, and investment grade needs of the secondary market, the tranching structure also can function as a credit enhancement or a method of reducing credit risk of senior securities—with both features serving to attract more investors.

Investors in credit card ABS supply the capital needed to make credit card loans that, otherwise, might not be available. The ability of credit card issuers to sell loans in the secondary market, thus, both increases the credit available to lend and, in turn, lowers borrowing costs. Conversely, a reduction in issuers’ ability to access the secondary market for credit card receivables would decrease available credit and increase borrower costs.

The yield on credit card loans is used to pay interest on the securities sold to secondary market investors and to pay servicing fees. The remaining yield, net of the amount of receivables charged off in a month, is known as the excess spread. Credit-rating agencies and investors monitor excess spread to evaluate the strength of a credit card portfolio.

Any appreciable reduction in excess spread resulting from the implementation of the Proposed Rule could result in a reduction in the secondary market value of the related securities, loss of access to the securitization market based upon the issuer's deteriorating performance, an increase in required rating enhancement levels, the funding from collection of receivables of spread or reserve accounts to provide additional credit enhancement when excess spread is reduced below specified trigger levels, and both pay-out events requiring early repayment of outstanding securities and the termination of the existing securitization program—resulting in a loss of financing through securitization. Any such impact would increase a bank's on-balance sheet assets, would require additional capital at a particularly challenging time to raise capital, and has the potential to create a liquidity crisis for banks. Increases in secondary market costs will be passed through to borrowers.

While there has recently been a major disruption in the broader ABS market, and while secondary trading of outstanding credit card ABS has been significantly reduced, the credit card securitization sector has been relatively stable. As of June 30, 2008, approximately \$49 billion in credit card ABS have been issued this year—a record issuance run rate and roughly 45 percent of all ABS issued this year. In 2007, credit card ABS issuances totaled nearly \$96 billion and accounted for 23 percent of all ABS issued. Nonetheless, the credit card securitization sector, like the broader securitization market, is fragile. Secondary market investors in card receivables have taken comfort from the underwriting discipline of card issuers, including the ability to adjust on a real-time basis for changes in borrower default risk. The ability to re-price for borrower default risk or generate fee revenue to offset such risk helps to minimize the uncertainty that borrower default risk can create and to restrain future funding costs. Thus, the Proposed Rule's restrictions on card issuers' ability to re-price for borrower default risk, to assess certain fees, and to require certain payment allocations all will operate to reduce the availability of funds or increase their cost—with that cost likely being passed on to borrowers.

## II. OVERVIEW OF THE PROPOSED RULE

The Proposed Rule<sup>3</sup> addresses certain credit card and overdraft protection practices. Among its provisions, the Proposed Rule would prohibit the following credit card practices:

- Treating a payment as late for any purpose,<sup>4</sup> unless consumers are provided with a reasonable time to make payment.<sup>5</sup>
- Allocating any amounts paid in excess of the minimum monthly payment other than in one of three defined methods, or a method that is no less beneficial to consumers.<sup>6</sup>
- Increasing the annual percentage rate on outstanding balances, unless one of the following circumstances exists: (1) a variable rate has increased based on an index; (2) a promotional rate has expired; or (3) the minimum payment has not been received within 30 days of the due date.

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<sup>3</sup> 73 Fed. Reg. 28,904 (to be codified at 12 C.F.R. pt. 227).

<sup>4</sup> Any purpose includes: (1) increasing the annual percentage rate as a penalty, (2) reporting the consumer as delinquent to a credit reporting agency, and (3) assessing a late or other fee based on failure to make a payment.

<sup>5</sup> The proposed rule, however, would create a safe harbor for institutions that adopt reasonable procedures designed to ensure that periodic statements are mailed or delivered at least 21 days before the payment due date.

<sup>6</sup> The methods are: (1) applying the entire amount first to the balance with the highest annual percentage rate; (2) applying the entire amount equally among the balances; and (3) splitting the amount *pro rata* among the balances. In addition, when an account has a discounted promotional rate balance or a balance on which interest is deferred, institutions: (1) would be required to allocate payment amounts greater than the minimum payment first to balances on which the rate is not discounted or interest is not deferred; and (2) would be prohibited from denying consumers a grace period on purchases solely because they have not paid off a balance at a promotional rate or a balance on which interest is deferred.

- Assessing a fee if a consumer exceeds the limit on an account due solely to a hold placed on the available credit, unless the transaction amount would have exceeded the credit limit as well.
- Computing finance charges on outstanding balances based on balances in billing cycles preceding the most recent billing cycle—i.e., “double cycle billing.”
- Charging fees or security deposits for the issuance or availability of credit during the first 12 months of an account—such as account-opening or membership fees—if those fees or deposits utilize the majority of the credit available on the account.<sup>7</sup>
- Advertising multiple annual percentage rates (“APRs”) or credit limits without disclosing in the solicitation the factors that determine whether a consumer will qualify for the lowest annual percentage rate and highest credit limit advertised.

### III. DISCUSSION

This letter reflects our strongly held belief that the Proposed Rule risks a number of unintended consequences that could harm consumers, credit card issuers, and secondary market investors. In particular, the Proposed Rule will function as price controls, resulting in fewer beneficial product offerings and choices for consumers, and a simultaneous decrease in the availability and increase in the cost of credit. Our comments on the Proposed Rule, which we provide from the perspective of participants in securitization transactions and in the secondary market, are set forth below.

#### A. The Proposed Rule Will Increase the Cost and Reduce the Availability of Credit to Consumers.

Overall, the Proposed Rule’s prohibitions on credit card practices will operate as price controls, unintentionally resulting in more costly and limited credit for most borrowers. The Proposed Rule affects securities that have already been issued based on the expectation that rates could be re-priced and certain fees could be charged. Such unanticipated changes have the effect of reducing investor confidence in future offerings. In addition, the Proposed Rule’s restrictions on the ability to re-price for changes in borrower default risk or impose certain fees will directly reduce investor yield and render risk assessment of certain credit card products extremely difficult, if not impossible. Such provisions could reduce the secondary market value of credit card ABS, and, ultimately, could require issuers to fund spread accounts or repay outstanding securities—events that would require them to raise further capital, a difficult task in the current environment, and could create a liquidity crisis for issuers. Simply put, the Proposed Rule will diminish the appeal of investing in credit card securitizations, and, ultimately, will increase the future costs of funding credit card loans. In response, card issuers will be forced to utilize more

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<sup>7</sup> The Proposed Rule also would require security deposits and fees that exceed 25 percent of the available credit limit to be paid over the first year of the account, as opposed to an up-front lump sum charged during the first billing cycle.

rigid pricing structures (e.g., eliminating products with zero or low initial interest rates on purchases or balance transfers), which will diminish consumers' ability to use credit cards for "convenience" transactions, unnecessarily overcharge many prime borrowers, and curtail the availability of credit, particularly to non-prime borrowers.

We offer the following further general comments on the Proposed Rule's prohibitions.

- **Limitations on Treatment of Payments as Late.** We support in concept the Proposed Rule's restrictions on treating certain payments as late unless the consumer is given reasonable time to pay. However, we have a concern that the proposed safe harbor provision will likely become a *de facto* requirement, and present card issuers with the burden of extending payment due dates when a reasonable time to pay has already been given. Extending the time to pay does not uniformly help consumers. Consumers who carry balances from month to month will incur more finance charges, as they take the extra time to pay. Consumers who pay their balance in full every month will benefit from having the "grace period" extended for a few days. The rationale for the 21 day safe harbor presumes that all consumers receive statements and pay bills by ordinary mail. Increasingly, consumers pay bills electronically, not by mail. Also, billing statements are increasingly available online for immediate viewing. The proposal's assertion that consumers need seven days to receive their statements and seven days for their payment to arrive presumes that consumers are reliant on regular mail. However, technology is providing consumers with ever-increasing ways to receive billing statements and pay bills more quickly and cheaply than by relying on mail, and consumers' use of those methods continues to increase.

The Proposed Rule's restrictions on treating certain payments as late also will likely present card issuers with certain operational difficulties insofar as it will require them to process payments within a shorter time period and will result in issuers having less time to cure system errors. In addition, an overall restriction on the ability to assess late fees will likely compress excess spread and reduce investor yield. In turn, this will increase the cost of future credit. To compensate, card issuers will likely increase or impose other standard fees—such as annual fees—on card accounts. Imposition of such fees could diminish the prime borrower market, a result that could reduce interchange revenue and increase card delinquencies and charge-offs due mainly to the lower credit quality of remaining borrowers. Such results would only further increase the cost of credit, while also making it less available.

- **Required Payment Allocation Methods.** The payment allocation requirements set forth in the Proposed Rule will result in a significant reduction in interest and fee revenue for credit card assets. This will lower the yield and excess spread on credit card portfolios. To offset this lower yield, it is reasonable to anticipate that credit card issuers will significantly curtail or eliminate promotional products, such as zero or low initial interest rates on purchases or balance transfers, which provide significant benefits and convenience to consumers. Elimination of such offers could diminish the prime borrower market, which, as detailed above, risks a number of adverse effects.

- **Prohibition on Ability to Increase Interest Rates on Existing Balances.** The Proposed Rule will prevent card issuers from adjusting interest rates on existing balances to reflect increased consumer default risk. Because initial underwriting focuses on default risk at the time of account opening, it does not capture default risk over the life of a revolving line of credit, and issuers need to periodically reevaluate such risk over time. Increasing interest rates for consumers who, for example, have seen deterioration in their credit scores, provides issuers with revenue to offset the default risk within their loan portfolio. By eliminating card issuers' ability to re-price assets to match the costs of funding credit card loans, this proposal will depress investor yield and compress excess spreads across securitization trusts. This will further increase the cost of credit to fund future loans and will reduce the amount of available credit. As a result, issuers will charge higher initial interest rates to all borrowers. Likewise, issuers will likely replace fixed rate products with variable rate products. Regardless, under any circumstance, issuers will remain exposed to market risk because, without re-pricing ability, they cannot accurately hedge their excess spread, which could raise potentially significant safety and soundness issues. At a minimum, therefore, the Agencies, rather than prohibiting rate increases on existing balances, should permit such increases if consumers are provided full and fair disclosure about what factors will trigger an increase, and those factors can be managed by the consumer to avoid the "costly surprise" of an unexpected rate increase.
- **Prohibitions on Two-Cycle Billing, Certain Advance Fees, and Hold-related Fees.** Elimination of two-cycle billing as well as prohibitions and restrictions on advance and hold-related fees also will likely compress excess spread, reduce investor yield, reduce available credit, increase the cost of credit, and potentially lead to increased loan charge-offs.

#### **B. Suggestions To Minimize Adverse Impacts.**

In addition to our overarching concerns about the Proposed Rule and in an effort to minimize the potential adverse impacts of the Proposed Rule, we offer the following suggestions.

- **Preserve Issuers' Ability to Re-Price for Borrower Default Risk.** For the reasons outlined in Section III.A above, including more expensive and less available credit and the potential for an unsafe and unsound lending environment, the Agencies should not prohibit rate increases on existing balances. Such increases should be permitted for factors that are explained to the consumer and that can be managed effectively by the consumer to avoid a costly surprise.
- **Preserve Flexible Payment Allocation.** In addition to the significant reduction in revenue for credit card assets that likely will result from the Proposed Rule's required payment allocation methods, these methods will be extremely difficult for issuers to implement. As set forth in Section III.A above, we believe the Proposed Rule will prove costly for consumers because it will likely reduce significantly the number of convenient and beneficial products now available to consumers. Accordingly, we ask the Agencies to preserve maximum flexibility in allocating consumer payments. At a minimum, we

urge the Agencies not to include provisions in the Proposed Rule that would enable consumers to direct how payments are allocated.

- **Adopt an effective date at least 18 months after issuing of a final rule.** The Proposed Rule asks for guidance on an appropriate effective date. We are concerned about the practical ability of card issuers and servicers to implement various provisions of the Proposed Rule. In particular, we are concerned it will be enormously expensive and time consuming for issuers to redesign their billing and payment processing systems and methodologies. We, thus, believe that 18 months represents the minimum period needed to implement the changes required under the Proposed Rule, but that additional time for card issuers to bring systems into compliance would be beneficial and would reduce the risk of system errors.
- **Apply the Proposed Rule prospectively.** The prohibitions on lending and servicing practices set forth in the Proposed Rule, if ultimately incorporated into a final rule, can only be safely and soundly implemented prospectively by the Agencies. Although the Proposed Rule contemplates this, we believe further clarification that the Proposed Rule cannot be applied retroactively to applicable card issuer practices is appropriate.
- **Provide card issuers and secondary market investors with a safe harbor from litigation in connection with existing accounts.** Secondary market investors, trustees, and credit card issuers should be given safe harbor from litigation, in particular class action litigation, in connection with existing accounts. Instead, giving issuers an opportunity to cure errors or issues will fully safeguard consumers. An absence of a litigation safe harbor for existing credit, aside from direct litigation and reputation risks, exposes ABS to ratings downgrades and could put such securities in contractual default if underlying assets were found, as the result of litigation, to be originated under unsafe or unsound practices and, thus, needed to be removed from securitizations trusts. This removal could cause banks to hold more capital at a time when many banks have existing needs for increased capital because of problems related to subprime mortgages.

#### IV. CONCLUSION

Although we believe that simplified disclosures—such as those being proposed in connection with Regulation Z—could adequately address most, if not all, of the concerns that have motivated the Proposed Rule, we respectfully submit that, to the extent a final Rule going beyond disclosure is promulgated, it should be narrower in scope than the Proposed Rule. Accordingly, we ask the Agencies, at a minimum, to preserve issuers' ability to re-price for borrower default risk, provide additional flexibility in how payments are allocated, confirm that the Proposed Rule is to be applied prospectively in time, and provide a safe-harbor from litigation in connection with existing accounts. A final Rule modified in this manner can achieve the intended purpose of safeguarding consumers without sacrificing the wide-array of products, services, and conveniences now available to them by ensuring liquidity in the credit card lending market.


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The ASF appreciates this opportunity to present our comments concerning the Proposed Rule, and would be happy to discuss any questions you may have about the foregoing or to provide further information that you may find helpful in finalizing the Rule. Should you have any questions, please do not hesitate to contact the undersigned at 212.313.1135 or [tdeutsch@americansecuritization.com](mailto:tdeutsch@americansecuritization.com) and Andrew M. Faulkner of Skadden, Arps, Slate, Meagher & Flom LLP at 212.735.2853 or [andrew.faulkner@skadden.com](mailto:andrew.faulkner@skadden.com), who has served as ASF's outside counsel on this matter.

Yours sincerely,

A handwritten signature in cursive script that reads "Tom Deutsch".

Tom Deutsch  
Deputy Executive Director,  
American Securitization Forum